

AGERE SYSTEMS INC  
Form 10-K  
December 12, 2005

As filed with the Securities and Exchange Commission on December 12, 2005

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

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**Form 10-K**

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

For the fiscal year ended September 30, 2005

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File Number 001-16397

**Agere Systems Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of incorporation or organization)

**22-3746606**  
(I.R.S. Employer  
Identification No.)

**1110 American Parkway N.E.  
Allentown, Pennsylvania**  
(Address of principal executive offices)

**18109**  
(Zip Code)

Registrant's telephone number, including area code: **610-712-1000**

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

| <b>Title of Each Class</b>    | <b>Name of Each Exchange on Which Registered</b> |
|-------------------------------|--|
| Common Stock, \$.01 par value | New York Stock Exchange                          |

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## 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 Exchange Act). Yes  No

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 an accelerated filer (as defined in Exchange Act Rule 12b-2).  
Yes  No

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 voting common equity held by non-affiliates of the registrant as of March 31, 2005 was approximately \$2.5 billion, based on the reported last sale prices on the New York Stock Exchange of such equity on such date.

As of December 1, 2005, 179,962,331 shares of common stock were outstanding.

## DOCUMENTS INCORPORATED BY REFERENCE

Certain information required by Part III of this report is incorporated by reference from the registrant's proxy statement to be filed pursuant to Regulation 14A with respect to the registrant's 2006 annual meeting of stockholders.

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**Agere Systems Inc.**  
**Form 10-K**  
**For the Year Ended September 30, 2005**

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## FORWARD-LOOKING STATEMENTS

Certain statements in this Form 10-K are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. The words estimate, plan, intend, expect, anticipate, believe and similar expressions are intended to identify forward-looking statements. These forward-looking statements are found at various places throughout this report and in the documents incorporated herein by reference. Agere disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Although we believe that our expectations are based on reasonable assumptions, we can give no assurance that our goals will be achieved. Important factors that could cause our actual results to differ from estimates or projections contained in the forward-looking statements are described in Item 1A.

## PART I

### Item 1. Business.

#### General

We are a leading provider of integrated circuit solutions for a variety of applications, including high-density storage, mobile wireless communications and enterprise and telecommunications networks. These solutions form the building blocks for a broad range of computing and communications applications. Some of our solutions include related software and reference designs. Our customers include manufacturers of hard disk drives, mobile phones, high-speed communications systems and personal computers.

Integrated circuits, or chips, are made using semiconductor wafers imprinted with a network of electronic components. They are designed to perform various functions such as processing electronic signals, controlling electronic system functions and processing and storing data. Reference designs are complete specifications for products that a customer can use to build an end product, including components, board layouts and software. By using one of our reference designs, a customer can reduce the amount of product design it must perform and the amount of time required to introduce a new product into the market.

We have operating segments that focus on four target markets: Storage, Mobility, Enterprise and Networking and Telecommunications. We have two reportable segments for financial reporting purposes, Consumer Enterprise and Telecommunications. The Consumer Enterprise segment includes the Storage, Mobility and Enterprise and Networking operating segments. Information about each of these groups is provided below. We also have an operations group that manages our manufacturing and supply chain activities.

In fiscal 2005 and fiscal 2004, 17% of our revenue was generated in the United States and 83% was generated outside the United States. See We conduct a significant amount of our sales activity and manufacturing efforts outside the United States, which subjects us to additional business risks and may adversely affect our results of operations due to increased costs in Item 1A. See Item 8 for financial information about our

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reportable segments and geographic financial information.

In the fourth quarter of fiscal 2005, we ceased operations at our Orlando, Florida, manufacturing facility and sold substantially all of the semiconductor manufacturing equipment at the facility.

We have research and development and manufacturing sites in the United States, Australia, Canada, China, Germany, India, Ireland, Israel, Japan, Korea, Singapore, Spain, Taiwan, Thailand and the United Kingdom. As of September 30, 2005, we had approximately 6,200 employees worldwide, including approximately 500 employees who were expected to go off-roll as a result of the closure of our Orlando, Florida manufacturing facility. We were incorporated in Delaware in 2000 as part of the plan of Lucent Technologies Inc. to spin off its microelectronics business to its stockholders. Lucent completed our spin-off in June 2002.

On May 27, 2005, we reclassified our Class A common stock and Class B common stock into a new, single class of common stock and effected a 1-for-10 reverse stock split.

We maintain an Internet website at <http://www.agere.com>. We make available free of charge on our website our annual report on Form 10-K, our quarterly reports on Form 10-Q, our current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) of the Securities Exchange Act of 1934

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as soon as practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. Information on our website is not incorporated by reference into this report.

In March 2005, our Chief Executive Officer submitted to the New York Stock Exchange an annual certification stating that he was not aware of any violations of the New York Stock Exchange's corporate governance listing standards.

### **Consumer Enterprise Segment**

#### **Storage**

We sell integrated circuits for hard disk drives, which are used to store data in personal computers, corporate network servers and consumer electronics products such as digital video recorders, digital media players, mobile phones and game consoles.

Our TrueStore® family of storage electronics includes read channels, preamplifiers, motor controllers, disk controllers and firmware, as well as systems-on-a-chip. These are the critical chips required to read, write and protect data.

Read channels convert analog signals that are generated by reading the stored data on the hard disk into digital signals. Analog refers to a transmission technique employing a continuous signal that varies in amplitude, frequency or phase of the transmission. Digital refers to a method of transmitting, storing and processing data that uses distinct electronic or optical pulses to represent the binary digits 0 and 1. We also sell pre-amplifiers, or preamps, which are used to amplify the initial signal from the hard disk so the signal can be processed by the read channel. Together, these components are critical to determining the overall performance of a hard disk drive.

Our disk controllers are used to control signal processing and communications functions within the disk drive. We also sell motor controllers, which are used to control functions related to the spinning of the physical storage media.

A storage system-on-a-chip is an integrated circuit that combines the functionality of a read channel and a disk controller in a small, high-performance, low-power and cost-effective package. With these devices, manufacturers of hard disk drives get the performance and design flexibility needed to develop drives with outstanding storage capacity, speed, reliability and power savings.

Consumers are increasingly in need of more storage to manage their digital content whether it is MP3 files, home videos, digital photographs or downloaded video. As disk drives reach a capacity ceiling using current longitudinal recording techniques, design innovations are required in a disk drive's heads, media and electronics to deliver more storage. Perpendicular recording increases the amount of storage possible on a disk drive's platter. In fiscal 2005, we introduced our TrueStore CE family of integrated circuits targeting hard disk drives for portable consumer electronics. These integrated circuits support both horizontal and perpendicular recording, at a performance level that enables hard disk drives to store more data than competing solutions.

#### **Mobility**

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We sell integrated circuits for use in mobile phones and other wireless data and voice communications products. We offer integrated wireless solutions that include:

Digital baseband processors for speech compression and encoding and transmission of voice and data;

Conversion signal processors to convert signals between frequencies used in digital signal processors and frequencies used for radio transmission; and

Software that controls the communication process.

Several different standards exist for mobile phones. The most prevalent standards are commonly referred to as second generation, or 2G, standards. Carriers are deploying advancements to their 2G networks that provide customers with higher data rates, thereby enabling services like Internet surfing and e-mail. Some carriers are also beginning to deploy networks based on third generation, or 3G, standards. These networks offer even higher data throughput, enabling revenue-generating applications, like streaming video, that require higher data rates than 2G networks can provide.

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Our mobile phone products support a number of protocols, including General Packet Radio Service, or GPRS, which operates on the second generation Global System for Mobile Communications, or GSM, standard. GPRS provides enhanced data transmission capabilities for GSM mobile phones. We also provide integrated circuits for an extension of GPRS called EDGE. GPRS and EDGE are often referred to as 2.5G solutions because of the enhanced data rates they provide. We are sampling products that support the wideband Code Division Multiple Access, or W-CDMA, standard. W-CDMA is a third generation, or 3G, standard. In March 2005, we acquired Modem-Art Ltd., a privately-held developer of advanced processor technology for 3G mobile phone devices as part of our effort to develop 3G solutions. Because it is costly for a carrier to replace its network infrastructure to support 3G service, we expect that many carriers will choose to replace their infrastructure only in high usage areas, and to retain 2.5G infrastructure in lower use areas. To address this, we are developing a 3G solution which is designed to support both W-CDMA and EDGE and to enable consumers to experience 3G data rates in a 3G service area, while providing 2.5G data rates outside of 3G coverage.

In fiscal 2005, we introduced a new generation solution for mainstream EDGE feature phones and Smartphones. This is a dual-core, multi-processor solution that separates communications and applications processing to deliver improved handling of advanced multimedia tasks while ensuring that voice calling is continuously maintained. It delivers high-quality video and audio without requiring costly applications processors or multimedia companion chips. We have been sampling this solution and expect it will be available for volume production in late 2005.

### **Enterprise and Networking**

The majority of our revenue from products used in enterprise and networking applications is derived from the sale of integrated circuits that are custom developed for our customers. These integrated circuits incorporate our intellectual property or combine our intellectual property with the intellectual property of our customers or other third parties to create a customized solution for these customers. For some customers, we design and manufacture the integrated circuit while the key intellectual property belongs solely to our customers.

Our systems-level knowledge and integrated circuit design methodologies allow us to turn our customers' design concepts into a systems solution quickly and effectively. Our intellectual property gives our customers the flexibility to customize their products to meet their individual cost and performance objectives.

#### ***Networking Products***

We sell custom-designed integrated circuits for use in storage area networks, Ethernet networks and wireless and wireline telecommunications applications. We are developing a family of standard products for high speed data networking applications. These products are intended to address enterprise and client applications for gigabit Ethernet, a high-speed data networking standard that operates at data rates of one billion bits, or one gigabit, per second. We are currently in production with five different products: our single and octal physical layer devices, our fully and lightly managed 48-port switches and our physical layer device controller.

#### ***Client Access Products***

We sell integrated circuits and associated software for modem products, primarily to leading manufacturers of personal computers, modems and other electronic equipment. We also offer integrated circuits and software for use in packet telephony products that provide access to converged voice and data communications networks.

We sell high speed input/output products primarily to manufacturers of computers, peripheral equipment and communications equipment. Input/output refers to the transfer of data within and between computers; peripheral equipment, such as printers, scanners and digital cameras; and data networks. Our products support established connectivity and transmission standards known as Universal Serial Bus, or USB, and IEEE-1394.

We also sell integrated circuits for use in computer printing and imaging applications.

#### ***Other Products***

We sell custom-designed integrated circuits for use in satellite digital radio receivers. Our integrated circuits process signals received from satellites and ground-based repeaters. In fiscal 2005, we introduced new media server chips that can be used in digital media servers and network-attached storage devices in homes and small businesses

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to provide central data storage capabilities at a lower cost than a computer server. We also sell integrated circuits for use in other computing applications.

#### **Telecommunications Segment**

We offer solutions targeting wireless and wireline access and multiservice communications networks. Our products encompass integrated circuits, software and reference designs that facilitate the transmission and traffic management of voice, video and data signals within communications networks and are used primarily in the following types of equipment:

Wireline telecommunications equipment, including:

Network communications equipment, which facilitates the transmission and management of data and voice traffic within communications networks; and

Network access equipment, such as data communications equipment, which allows devices to connect with communications networks.

Wireless telecommunications equipment, such as a cellular base station, which transmits and receives data and voice communications through radio waves.

We sell integrated circuit solutions that include integrated circuits supporting SONET/SDH communication standards, broadband aggregation devices, network processing and traffic management devices and digital signal processing (DSP) devices, each of which is described below.

#### ***Wireline Telecommunications Equipment Solutions***

We sell products designed for wired communications infrastructure. These products are used in high-speed transport networks and in the equipment used to access and interconnect these networks.

***Multiservice Network Processing and Traffic Management Devices.*** Multiservice network processing and traffic management devices ensure that quality of service and service level agreement specifications are adhered to within wide area networks. Quality of service and service level agreements provide for reliable delivery of voice, video and data services to business and residential customers. These devices process data being sent over the network, providing for classification, traffic policing, queuing, scheduling and shaping of multiservice data.

***Broadband Aggregation Devices.*** Broadband is a general term that refers to high-speed data transmission. Our broadband access integrated circuits, or mappers, support data transport between central offices and enterprise sites by aggregation and termination. Aggregation refers to the

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combining of many low-speed, or tributary, data signals from enterprises into higher speed, or trunk, data signals for transmission to a central office. Termination refers to the separation of trunk data signals into lower-speed, tributary data signals.

Our products support data transport for T-carrier data transport in North America. T-carrier is a digital transmission service from a common carrier. We support similar services worldwide. These services are referred to as J-carrier in Japan and E-carrier in Europe. T-carrier services such as T1 and T3 lines are widely used to create point-to-point networks for use by enterprises. T1 and T3 lines refer to different levels of T-carrier service that transmit data at 1.544 megabits per second and 44.736 megabits per second, respectively. A megabit is a unit of measurement for data and is equal to approximately one million bits.

*SONET/SDH Network Devices.* Synchronous optical networks, which are typically referred to as SONET, and synchronous digital hierarchy standard networks, or SDH, carry data, voice and video traffic through a network by combining lines carrying traffic at slower speeds with lines carrying traffic at higher speeds. This process is known as multiplexing, and involves directing traffic from the individual lines into designated time slots in the higher speed lines, and those lines into still higher speed lines. The SONET/SDH equipment that handles the directing of traffic into slower speed and faster speed lines is the add-drop multiplexer. Add-drop multiplexers handle the addition and removal of traffic from a SONET/SDH communication transmission. We offer single-chip integrated circuit solutions, or framers, for add-drop multiplexing of data and voice traffic. In addition, our framers are used in high-speed routers within optical networks. A router is an interface, or link, between two networks.

### ***Wireless Telecommunications Equipment***

*Wireless Infrastructure Devices.* We sell integrated circuit solutions used in wireless infrastructure products, which are primarily cellular base stations and cellular base transceiver stations. Our solutions include digital signal processors for speech compression and encoding and transmission of voice and data and networking products that

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connect cellular equipment to the wired communications network. Some of these products are standard offerings that are sold to multiple customers and some are customized for a particular customer. The customized offerings may combine our intellectual property with intellectual property from our customer. Many of the multiservice networking devices used in wireline communications infrastructure, including network processors and asynchronous transfer mode, or ATM, traffic management devices, are also used in wireless infrastructure.

In fiscal 2005, we introduced a new telecommunications product platform, TrueAdvantage , to serve as a building block for intelligent converged access networks and services. The TrueAdvantage family includes hardware and software development tools, application software and reference designs that are intended to help telecommunications equipment makers reduce product development costs, increase their products revenue-generating capabilities and accelerate time-to-market. We also announced new TrueAdvantage wireless access solutions that can simultaneously support current and future wireless systems over a single network.

### **Customers, Sales And Distribution**

#### ***Customers***

We have a globally diverse base of customers, consisting primarily of manufacturers of computer and communications equipment. In fiscal 2005, we sold our products directly to approximately 260 end customers and indirectly, through distributors, to approximately 339 end customers. For some end customers, we deliver the product to, and are paid by, a third party associated with the customer, such as their contract manufacturer. Our top 20 end customers in fiscal 2005, based on revenue, accounted for approximately 80% of our revenue and our top 10 end customers in fiscal 2005, based on revenue, accounted for approximately 67% of our revenue. These amounts include both product revenue and revenue from the licensing of intellectual property. Our top ten end customers in fiscal 2005 were:

|                                     |                               |
|-------------------------------------|-------------------------------|
| Apple Computer, Inc.                | NEC Corporation               |
| Cisco Systems, Inc.                 | Nokia Corporation             |
| Hitachi Global Storage Technologies | Samsung Electronics Co., Ltd. |
| Lucent Technologies Inc.            | Seagate Technology, Inc.      |
| Maxtor Corp.                        | Toshiba Corporation           |

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In fiscal 2005, our sales to Maxtor represented 15% of our total revenue, our sales to Seagate represented 15% of our total revenue and our sales to Samsung represented 14% of our total revenue. No other customer accounted for 10% or more of our total revenue in fiscal 2005.

### ***Sales and Distribution***

We have a worldwide sales organization with approximately 300 employees as of September 30, 2005, located in seven U.S. sales offices and 16 sales offices outside the U.S. We sell our products globally primarily through our direct sales force. To complement our direct sales force, we also sell our products through distributors, which sales in fiscal 2005 represented approximately six percent of our revenue.

We aim to have our customers incorporate our products into the end products they design and develop. Typically, manufacturers of computer and communications equipment conduct a competitive process to select suppliers for the parts that they will include in their end products. Our sales, marketing and technical personnel work with customers to demonstrate our products' ability to satisfy any specific requirements. We call winning the competitive process a design win. A design win is important because it allows us to establish a long-term relationship with the customer, at least through the life cycle of the product. We generally do not, however, enter into written agreements with our customers after achieving a design win. A customer could terminate its relationship with us or discontinue developing the product. Most of our revenue originates from sales that are the result of design wins.

After we achieve a design win and negotiate the terms of the sale, we deliver our products to our end customers in a number of ways. Our end customers typically have us ship our products to their facilities directly. In some instances, however, our customer may use a contract manufacturer to manufacture and assemble its end product. When our product is being incorporated into an end product being manufactured by a contract manufacturer, we often ship our product directly to the contract manufacturer and receive payment from that contract manufacturer. To determine our sales to particular customers, however, we recognize this type of transaction as a sale to, and revenue from, the end customer. Sometimes a customer for whom we have achieved a design win will have us sell

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that product to a distributor or trading company from whom the customer then buys our product. We recognize these transactions as indirect sales.

### **Manufacturing**

We had three facilities located in two countries devoted to manufacturing integrated circuits as of September 30, 2005. These sites utilized approximately 687,000 square feet of space dedicated to manufacturing. As of September 30, 2005, we had joint venture wafer fabrication operations in Singapore, while our assembly and test operations were in Singapore and Thailand. Prior to September 30, 2005, we also conducted wafer fabrication operations in Orlando, Florida. As of September 30, 2005, we had approximately 3,100 employees in manufacturing and other functions involved in delivering products to customers. Included in this amount are approximately 500 people who were expected to go off-roll as a result of the closure of the Orlando facility.

Because of the high cost of implementing new manufacturing processes, we have decided to use foundry partners, rather than internal manufacturing capabilities, to produce integrated circuits using newer processes. Our primary foundry partners are Chartered Semiconductor Manufacturing, Ltd. and Taiwan Semiconductor Manufacturing Corporation. We believe that our internal assembly and test operations provide us with a competitive advantage and intend to continue operating those facilities.

We have a joint venture, called Silicon Manufacturing Partners, with Chartered Semiconductor Manufacturing Ltd., that operates a 54,000 square foot integrated circuit manufacturing facility in Singapore. We are entitled to 51% of the managed wafer capacity of the facility. The joint venture agreement may be terminated by either party upon two years' written notice, but may not be terminated prior to February 2008. The agreement may also be terminated for material breach, bankruptcy or insolvency of either party.

### **Competition**

We sell products designed for communications, consumer electronics and computer equipment manufacturers. Our customers' products are sold in market segments that are intensely competitive and characterized by:

Rapid technological change;



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Evolving standards;

Short product life cycles; and

Price erosion.

There are many competitors for our products. We expect the intensity of competition in the market segments we serve to continue to increase in the future as existing competitors enhance and expand their product offerings and as our customers attempt to limit the number of suppliers from which they buy. Increased competition may result in price reductions, reduced revenues and loss of market share. We cannot assure you that we will be able to compete successfully against existing or future competitors. Some of our customers and companies with which we have strategic relationships also are, or may be in the future, competitors of ours.

Our primary competitors are listed in the table below.

| <u>Storage</u>                 | <u>Mobility</u>   | <u>Enterprise and Networking</u>                             | <u>Telecommunications</u>  |
|--------------------------------|---|--|--|
| Infineon Technologies AG       | Broadcom Corp.  | Broadcom Corp.   | Applied Micro Circuits Corp.   |
| Marvell Technology Group Ltd.  | Koninklijke Philips Electronics N.V.  | Conexant Systems International Business Machines             | Infineon Technologies AG Intel Corp.                                     |
| STMicroelectronics N.V.        | Freescale Semiconductor, Inc.   | LSI Logic Corp.  | Freescale Semiconductor, Inc. PMC-Sierra, Inc.                           |
| Texas Instruments Incorporated | QUALCOMM Inc. Skyworks Solutions, Inc. STMicroelectronics N.V. Telefonaktiebolaget LM Ericsson Texas Instruments Incorporated | Marvell Technology Group Ltd. Texas Instruments Incorporated | STMicroelectronics N.V. Vitesse Semiconductor Corporation Wintegra, Inc. |

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Our competitive position varies depending on the market and product areas within these markets. For example, we are number one or two, based on revenue, in many of our product areas, including read channels and systems-on-a-chip for hard disks used in consumer electronics products, integrated circuits for notebook computer modems, digital signal processors for wireless infrastructure, SONET/SDH integrated circuits and wired communications integrated circuits. However, our competitive position is not as strong in the gigabit Ethernet product area, which is a new area for us. While improving our position in many of the product areas where our position is less well-established is an objective of ours, we cannot assure you that we will be able to accomplish this goal. Further, because we expect to face increasing competitive pressures from both current and future competitors in the product areas we serve, we may not be able to maintain our position in the product areas in which we are currently a leader.

We believe competition in our industry is based on the following factors:

Performance and reliability;

Price;

Compatibility of products with other products and communications standards used in communications networks;

Product size;

Ability to offer integrated solutions;

Time to market;

Breadth of product line;

Customer support;

Logistics and planning systems; and

Quality of manufacturing processes.

While we believe we are competitive on the basis of all the factors listed above, we believe some of our competitors compete more favorably on the basis of price and on delivering products to market more quickly. However, we feel we are particularly strong in offering integrated solutions, our broad product lines, our customer support and our logistics and planning systems.

### **Research and development**

As of September 30, 2005, our product development team consisted of approximately 2,000 employees. Our research and development expenditures were \$462 million, \$496 million and \$467 million for fiscal 2005, 2004 and 2003, respectively. We anticipate that we will continue to make significant research and development expenditures to maintain our competitive position with a continuing flow of innovative products and technology.

### **Patents, Trademarks And Other Intellectual Property**

We own or have rights to a number of patents, trademarks, copyrights, trade secrets and other intellectual property directly related to and important to our business. We have approximately 5,875 U.S. patents and patent applications and their corresponding foreign patents and patent applications. These patents include patents related to the following technologies:

Integrated circuit and optoelectronic manufacturing processes;

Modems, digital signal processors, wireless communications, network processors and communication protocols; and

Optoelectronic products including lasers, optical modulators, optical receivers and optical amplifiers.

The patents described above include patents of all ages ranging from pending applications, which will have a duration of 20 years from their filing dates, through patents soon to expire.

We indemnify our customers for some of the costs and damages of patent infringement in circumstances where our product is the primary factor creating the customer's infringement exposure. We generally exclude coverage where infringement arises out of the combination of our products with products of others.

We protect our products and processes by asserting our intellectual property rights where appropriate and prudent. We also obtain licenses to patents, copyrights and other intellectual property rights used in connection with our business when practicable and appropriate.

### **Government Regulation**

Many of our customers' end products that include our products are subject to extensive telecommunications-based regulation by the United States and foreign laws and international treaties. We must design and manufacture our products to ensure that our customers are able to satisfy a variety of regulatory requirements and protocols established to, among other things, avoid interference among users of radio frequencies and to permit interconnection of equipment.

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Each country has different regulations and a different regulatory process. In order for our customers' products to be used in some jurisdictions, regulatory approval and, in some cases, specific country compliance testing may be required. The delays inherent in this regulatory approval process may force our customers to reschedule, postpone or cancel the incorporation of our products into their products, which may result in significant reductions in our sales. The failure to comply with current or future regulations or changes in the interpretation of existing regulations in a particular country could result in the suspension or cessation of sales in that country by us or our customers. It also may require us to incur substantial costs to modify our products to aid our customers in complying with the regulations of that country. Changes in our regulatory environment that generally result from our expansion into new areas or changes in current regulations could increase the cost of manufacturing our products because we must continually modify our products to respond to these changes.

In addition, domestic and international authorities continue to regulate the allocation and auction of the radio frequency spectrum. These regulations have a direct impact on us because many of our customers' licensed products can be marketed only if permitted by suitable frequency allocations, auctions and regulations. The implementation of these regulations may delay our end-users in deploying their systems, which could, in turn, lead to delays in orders of our products by our customers and end users.

### **Employees**

As of September 30, 2005, we had approximately 6,200 full-time employees, including approximately 500 employees who were expected to go off-roll as a result of the closure of our Orlando manufacturing facility in September 2005. As of September 30, 2005, we had approximately 450 U.S. union-represented employees covered by collective bargaining agreements. Three hundred and seventy of these employees had been assigned to our Orlando manufacturing facility and were expected to go off-roll as a result of the closure of that facility.

On May 27, 2003, we entered into a collective bargaining agreement with local unions 1522, 1560, 1898 and 2000 of the International Brotherhood of Electrical Workers. This agreement, which covers our U.S. union-represented employees, will be effective until May 31, 2006, unless the parties reach a mutual agreement to amend the terms.

We believe that we generally have good relationships with our employees and the unions that represent them.

### **Backlog**

Our backlog, which represents the aggregate of the sales price of orders received from customers for delivery within six months, but not yet recognized as revenue, was approximately \$311 million and \$447 million on September 30, 2005 and September 30, 2004, respectively. The majority of these orders are fulfilled within three months. All orders, however, are subject to possible rescheduling by customers. Our customers often change their orders two or three times between initial order and delivery. Our customers' frequent changes usually relate to quantities or delivery dates, but sometimes relate to the specifications of the products we are shipping. Although we believe that the orders included in the backlog are firm, generally orders may be cancelled by the customer without penalty. We also may elect to permit cancellation of orders without penalty where we believe it is in our interest to do so. For these reasons, we believe that our backlog at any given date may not be a reliable indicator of future revenues.

### **Environmental, Health And Safety Matters**

We are subject to a wide range of laws and regulations relating to protection of the environment and employee health and safety. Our manufacturing facilities have undergone regular internal audits relating to environmental, health and safety requirements. Most of those facilities also are regularly audited and certified by an independent and accredited third party registrar, such as Lloyd's Register Quality Assurance, as conforming to the internationally recognized ISO 14001 standard relating to environmental management. In addition, our non-U.S. manufacturing facilities conform to BS 8800, the British standard for occupational health and safety management systems. Based upon these reviews, we believe that our manufacturing facilities are in substantial compliance with all applicable environmental, health and safety requirements.

### **Item 1A. Risk Factors**

Set forth below are some of the risks and uncertainties that, if they were to occur, could materially adversely affect our business or that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report and other public statements we make.

**Because our sales are concentrated on a limited number of key customers, our revenue may materially decline if one or more of our key customers do not continue to purchase our existing and new products in significant quantities.**

Our customer base is highly concentrated. Our top 10 end customers accounted for approximately 67% of our revenue in fiscal 2005. If any one of our key customers were to decide to purchase significantly less from us or to terminate its relationship with us, our revenue may materially decline. Because we have a long product design and development cycle for most of our products, we may be unable to replace these customers quickly or at all. We could lose our key customers or significant sales to our key customers because of factors beyond our control, such as a significant disruption in our customers' businesses generally or in a specific product line.

**If we fail to keep pace with technological advances in our industry or if we pursue technologies that do not become commercially accepted, customers may not buy our products and our results of operations may be adversely affected.**

The demand for our products can change quickly and in ways we may not anticipate because our industry is generally characterized by:

rapid, and sometimes disruptive, technological developments;

evolving industry standards;

changes in customer requirements;

limited ability to accurately forecast future customer orders;

frequent new product introductions and enhancements; and

short product life cycles with declining prices over the life cycle of the product.

If we fail to make sufficient investments in research and development programs in order to develop new and enhanced products and solutions, or if we focus on technologies that do not become widely adopted, new technologies could render our current and planned products obsolete, resulting in the need to change the focus of our research and development and product strategies and disrupting our business significantly.

**The integrated circuit industry is intensely competitive, and our failure to compete effectively could result in reduced revenue.**

The market for integrated circuits is intensely competitive and subject to rapid and disruptive technological change. We expect the intensity of competition to continue to increase as existing competitors enhance and expand their product offerings and as new participants enter the market. Increased competition may result in price reductions, reduced gross margins and loss of market share. We may not be able to compete successfully against existing or future competitors, which may result in reduced revenue.

The size and number of our competitors vary across our product areas, as do the resources we have allocated to the segments we target. Therefore, many of our competitors have greater financial, personnel, production capacity and other resources than we have in a particular market segment or overall. Competitors with greater financial resources may be able to offer lower prices, additional products or services or other incentives that we cannot match or offer. These competitors may be in a stronger position to respond quickly to new technologies and may be able to undertake more extensive marketing campaigns. They also may adopt more aggressive pricing policies and make more attractive offers to potential customers, employees and strategic partners. These competitors may also make strategic acquisitions or establish cooperative relationships among themselves or with third parties to increase their ability to gain market share.

Further, some of our competitors are currently selling commercial quantities of products that we are sampling to our customers, that are still in the initial stages of development or that we may develop in the future. By being able to offer these products in commercial quantities before we do, our competitors can establish significant market share, acquire design wins in customer equipment programs and create a market position that we may be unable to overcome once we have completed development and testing of our product.

**Our revenue and operating results may fluctuate because we derive most of our revenue from semiconductor devices and the integrated circuits industry is highly cyclical, and because of other characteristics of our business, and these fluctuations may cause our stock price to fall.**

We expect to derive most of our revenue from the sale of integrated circuits. Because the integrated circuits industry is highly cyclical, we may experience declines in our revenue that are primarily related to industry conditions and not our products. This industry has experienced significant downturns, often in connection with, or in anticipation of, excess manufacturing capacity worldwide, maturing product cycles and declines in general economic conditions.

We focus primarily on winning competitive selection processes to develop products for use in our customers' equipment. These selection processes can be lengthy. After winning a product design for a customer, that customer may not begin volume production of their equipment for a period of up to two years, if at all. Due to this lengthy design and development cycle, we may experience delays from the time we begin incurring expenses until the time we generate revenue from our products. We have no assurances that our customers will ultimately market and sell their equipment or that such efforts by our customers will be successful. Thus, we may never generate any revenue from our products after incurring significant design and development expenditures.

If we are not selected by a customer to provide a product, we may experience significantly lower revenue later, as compared to prior periods with more revenue from earlier design wins. In addition, sales of our products for specific customer projects often begin and end abruptly, so revenue may increase rapidly and later decrease just as quickly. The relative timing of the beginning and end of our sales and design processes can make our revenues less predictable.

Fluctuations in our revenue or operating results could cause our stock price to decline, even if our results meet expectations. Further, stock prices in our industry have recently been highly volatile for reasons that sometimes are unrelated to the performance of the companies in the industry. These broad fluctuations could adversely affect our stock price.

**If we do not achieve adequate manufacturing utilization, yields or volumes or sufficient product reliability, our gross margins will be reduced.**

Because the manufacturing costs at our owned and joint venture manufacturing facilities are relatively fixed, efficient utilization of manufacturing facilities and manufacturing yields are critical to our results of operations. If we do not experience adequate utilization of our manufacturing facilities, our results of operations may be adversely affected. In addition, from time to time, we may have to pay to reserve capacity at third-party manufacturers. If this is the case and we overestimate demand for our products, we may have to pay for capacity that we do not use, and our results of operations may be adversely affected.

The manufacture of our products involves highly complex and precise processes, requiring production in highly controlled and clean environments. Changes in our manufacturing processes or those of our suppliers or contractors, or the inadvertent use of defective or contaminated materials, could significantly reduce our manufacturing yields and product reliability. Lower than expected manufacturing yields could adversely affect our results of operations and delay product shipments.

**Because we are subject to order and shipment uncertainties, any significant cancellations or deferrals could cause our revenue to decline or fluctuate.**

We generally sell products pursuant to purchase orders that customers may cancel or defer on short notice without incurring a significant penalty. Cancellations or deferrals could cause us to hold excess inventory, which could adversely affect our results of operations. If a customer cancels or defers product shipments, we may incur unanticipated reductions or delays in our revenue. If a customer refuses to accept shipped products or does not pay for these products in a timely manner, we could incur significant charges against our income, which could materially and adversely affect our results of operations.

**A joint venture and third parties manufacture all of our wafers for us. If these suppliers are unable to fill our orders on a timely and reliable basis, our revenue may be adversely affected.**

The integrated circuit manufacturing industry has a history of developing new manufacturing processes. We believe that the costs associated with implementing new processes, including acquiring the necessary equipment and building appropriate facilities, are increasing with each generation of manufacturing processes. We have not wanted to make the significant financial investments necessary for new processes and in the last few years we have relied on contract manufacturers to fabricate products using processes that we did not have internally or at our joint

venture manufacturer. We recently discontinued operations at our last wholly-owned wafer fabrication facility and now rely on our joint venture and third-party manufacturers to fabricate all of our wafers. To the extent we rely on joint ventures and third-party manufacturing relationships, we face the following risks:

that they may not be able to develop manufacturing methods appropriate for our products;

that manufacturing costs will be higher than planned;

that reliability of our products will decline;

that they may be unwilling to devote adequate capacity to produce our products;

that they may not be able to maintain continuing relationships with our suppliers; and

that we may have reduced control over delivery schedules and costs of our products.

If any of these risks were to be realized, we could experience an interruption in supply or an increase in costs, which could adversely affect our results of operations.

In the event of an increase in demand, failure to increase our manufacturing volumes or obtain capabilities from third parties may result in our not being able to meet customer demand for our products, which could hurt our relationships with our customers and result in our recording lower revenues than would be the case if we had greater manufacturing capacity.

**Because many of our current and planned products are highly complex, they may contain defects or errors that are detected only after deployment in commercial applications, and if this occurs, it could harm our reputation and result in reduced revenues or increased expenses.**

Our products are highly complex and may contain undetected defects, errors or failures. These products can only be fully tested when deployed in commercial applications and other equipment. Consequently, our customers may discover errors after the products have been deployed. The occurrence of any defects, errors or failures could result in:

cancellation of orders;

product returns, repairs or replacements;

diversion of our resources;

legal actions by our customers or our customers' end-users;

increased insurance costs; and

other losses to us or to our customers or end-users.

Any of these occurrences could also result in the loss of or delay in market acceptance of our products and loss of sales, which would harm our business and adversely affect our results of operations. We have from time

to time experienced defects in our products and expect to experience defects in the future. Because the trend in our industry is moving toward

even more complex products in the future, this risk will intensify over time and may result in increased expenses.

**We are expanding, and may seek in the future to expand, into new areas, and if we are not successful, our results of operations may be adversely affected.**

We are currently developing products in new areas, including wireless communications infrastructure, high-speed networking and consumer electronics. We may seek to expand into additional areas in the future. We may expand through internal development efforts, through acquisitions of companies or technologies, or a combination of these methods.

Our efforts may not result in sales that are sufficient for us to recoup our investment, and we may experience higher costs than we anticipated. For example, we may not be able to manufacture our products at a competitive cost, may need to rely on new suppliers or may find that the development efforts are more costly or time consuming than we had anticipated. Our products may support protocols that are not widely adopted. Where we choose to develop capabilities by acquiring another company, we may not be able to integrate the other company successfully into our operations, which may mean that we have difficulty retaining employees from the acquired company or integrating its technology into our products. We may have difficulties entering markets where competitors have strong market positions.

**We have recently upgraded our enterprise financial management system, and it is possible that we may have a defect in the design of the system that may result in the generation of incorrect financial information, an adverse impact on the processing of customer orders or some other adverse impact on our business.**

We recently upgraded the enterprise-wide computer system that we use to control activities such as the processing of customer orders and accounts, the generation of financial data used in the preparation of financial statements and the handling of employee expense and payroll information. The system is extremely complex because of the wide range of processes that it integrates. Because of the complex nature of the system, it is possible that we will have a flaw in our design of the upgrade that has an adverse impact on our business. While we tested the system before implementing the upgrade, we cannot assure you that our testing would uncover every defect in the design or implementation of the upgrade that might be made. If such a defect did exist in the system after the upgrade, it could have a significant impact on how we conduct our business and we may not be able to mitigate that impact through other actions.

**A widespread outbreak of an illness or other health issue could negatively affect our manufacturing, assembly and test, design or other operations, making it more difficult and expensive to meet our obligations to our customers, and could result in reduced demand from our customers.**

A widespread outbreak of an illness such as severe acute respiratory syndrome, or SARS, or avian influenza, or bird flu, could adversely affect our operations as well as demand from our customers. A number of countries in the Asia/Pacific region have experienced outbreaks of SARS and/or bird flu. As a result of such an outbreak, businesses can be shut down temporarily and individuals can become ill or quarantined. We have assembly and test and back-office operations as well as our joint venture wafer fabrication facility in Singapore, assembly and test and back-office operations in Thailand and design operations in China, countries where outbreaks of SARS and/or bird flu have occurred. If our operations are curtailed because of health issues, we may need to seek alternate sources of supply for manufacturing or other services and alternate sources can be more expensive. Alternate sources may not be available or may result in delays in shipments to our customers, each of which would affect our results of operations. In addition, a curtailment of our design operations could result in delays in the development of new products. If our customers' businesses are affected by health issues, they might delay or reduce purchases from us, which could adversely affect our results of operations.

**We may be subject to intellectual property litigation and infringement claims, which could cause us to incur significant expenses or prevent us from selling our products. If we are unable to protect our intellectual property rights, our business and prospects may be harmed.**

Like other companies in the semiconductor industry, we are frequently involved in disputes regarding patent and other intellectual property rights. From time to time, we receive notices from third-parties of potential infringement and receive claims of potential infringement when we attempt to license our intellectual property to

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others. Defending these claims could be costly and time consuming and would divert the attention of management and key personnel from other business issues. The complexity of the technology involved and the uncertainty of intellectual property litigation increase these risks. Claims of intellectual property infringement also might require us to enter into costly royalty or license agreements. However, we may be unable to obtain

royalty or license agreements on terms acceptable to us or at all. In addition, third-parties may attempt to appropriate the confidential information and proprietary technologies and processes used in our business, which we may be unable to prevent and which would harm our business and prospects.

**We have relatively high gross margin on the revenue we derive from the licensing of our intellectual property, and a decline in this revenue would have a greater impact on our net income than a decline in revenue from the sale of our integrated circuits products.**

The revenue we generate from the licensing of our intellectual property has a higher gross margin compared to the revenue we generate from the sale of our integrated circuits products. Although we derive less than 10% of our total revenue from the licensing of intellectual property, a decline in this licensing revenue would have a greater impact on our profitability than a similar decline in revenues from the sale of our integrated circuit products.

**If our customers do not qualify our products or manufacturing lines or the manufacturing lines of our third-party suppliers for volume shipments, our results of operations may be adversely affected.**

Some customers will not purchase any of our products, other than limited numbers of evaluation units, until they qualify the manufacturing line for the product. We may not always be able to satisfy the qualifications. Delays in qualification may cause a customer to discontinue use of our products and result in a significant loss of revenue.

**We conduct a significant amount of our sales activity and manufacturing efforts outside the United States, which subjects us to additional business risks and may adversely affect our results of operations due to increased costs.**

In fiscal 2005, we derived approximately 83% of our revenue from sales of our products shipped to locations outside the United States. We also manufacture a significant portion of our products outside the United States and are dependent on non-U.S. suppliers for many of our parts. We intend to continue to pursue growth opportunities in both sales and manufacturing outside the United States. Operations outside the United States are subject to a number of risks and potential costs, which could adversely affect our revenue and results of operations, including:

our brand may not be recognized locally, which may cause us to spend significant amounts of time and money to build a brand identity;

unexpected changes in regulatory requirements;

inadequate protection of intellectual property in some countries outside of the United States;

currency exchange rate fluctuations;

international trade disputes;

political and economic instability; and

disruptions in international air transport systems.

**If we fail to attract, hire and retain qualified personnel, we may not be able to develop, market or sell our products or successfully manage our business.**

In some of our fields of operation, there are only a limited number of people in the job market who possess the requisite skills. In the past we have experienced difficulty in identifying and hiring sufficient numbers of qualified engineers in parts of our business as well as in retaining employees. The loss of the services of any key personnel or our inability to hire new personnel with the requisite skills could restrict our ability to develop new products or enhance existing products in a timely manner, sell products to our customers or manage our business effectively.

**The development and evolution of markets for our integrated circuits are dependent on factors over which we have no control. For example, if our customers adopt new or competing industry standards with which our products are not compatible or fail to adopt standards with which our products are compatible, our existing products would become less desirable to our customers and our sales would suffer.**



The emergence of markets for our integrated circuits is affected by a variety of factors beyond our control. In particular, our products are designed to conform to current specific industry standards. Our customers may not adopt or continue to follow these standards, which would make our products less desirable to our customers and

reduce our sales. Also, competing standards may emerge that are preferred by our customers, which could also reduce our sales and require us to make significant expenditures to develop new products. To the extent that we are not able to effectively and expeditiously adapt to new standards, our business will suffer.

**Class action litigation due to stock price volatility or other factors could cause us to incur substantial costs and divert our management's attention and resources.**

In the past, securities class action litigation often has been brought against a company following periods of volatility in the market price of its securities. Companies in the integrated circuit industry and other technology industries are particularly vulnerable to this kind of litigation due to the high volatility of their stock prices. Accordingly, we may in the future be the target of securities litigation. Any securities litigation could result in substantial costs and could divert the attention and resources of our management.

**Item 1B. Unresolved Staff Comments**

Not applicable.

**Item 2. Properties**

As of September 30, 2005, we operated three manufacturing facilities in Singapore and Thailand. We also operated an additional 50 facilities, including research and development facilities and design centers. We had facilities in a total of 20 countries. Our manufacturing facilities were located in Singapore and Thailand. We also have a 51% interest in our Silicon Manufacturing Partners joint venture located in Singapore, which is predominantly used as a manufacturing site.

Our facilities have an aggregate floor space of approximately 5.5 million square feet, of which approximately 3.9 million square feet, including all of our manufacturing facilities other than our assembly and test facility in Singapore, is owned and approximately 1.6 million square feet is leased. Our lease terms range from monthly leases to ten years. We believe that all of our facilities and equipment are in good condition and are well maintained and able to operate at present levels. We are currently not utilizing approximately 3.1 million of our 5.5 million square feet of this space due to our previous facility consolidation efforts.

**Item 3. Legal Proceedings**

Not applicable.

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

During the fourth quarter of fiscal 2005, no matter was submitted to a vote of our security holders.

**Executive Officers of the Registrant**

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Our executive officers as of December 1, 2005 were as follows:

| <u>Name</u>        | <u>Age</u> | <u>Position</u>   |
|--------------------|------------|---|
| Richard L. Clemmer | 53         | President and Chief Executive Officer                           |
| Peter Kelly        | 48         | Executive Vice President and Chief Financial Officer            |
| Denis P. Regimbal  | 44         | Executive Vice President, Mobility                              |
| Samir F. Samhouri  | 33         | Executive Vice President, Telecom and Enterprise and Networking |
| Ruediger Stroh     | 43         | Executive Vice President, Storage                               |

*Richard L. Clemmer* has been our President and Chief Executive Officer since October 2005. Mr. Clemmer has also been a member of our Board of Directors since October 2002. Mr. Clemmer has over 30 years of experience in the technology industry, where he has held a variety of executive, financial and management positions. Between June 2004 and October 2005, he was an active partner at Shelter Capital Partners, a private investment fund. Between 2003 and October 2005, he was Chairman and President of Venture Capital Technology LLC, which was focused on investing in and consulting for technology companies, primarily involved as Chairman of uNav Microelectronics, an emerging global positioning systems chipset company. Between May 2001 and January 2003, he was on the Board and served as an executive at PurchasePro.com, Inc., a provider of electronic procurement and strategic sourcing solutions. Between 1996 and May 2001, Mr. Clemmer was Executive Vice President, Finance and Chief Financial Officer of Quantum Corp., which was a provider of hard disk drives and other storage solutions. Prior to Quantum, Mr. Clemmer served at Texas Instruments Incorporated for over 20 years, including between 1988 and 1996 as Senior Vice President and Chief Financial Officer of Texas Instruments Semiconductor Group. Mr. Clemmer is a director of i2 Technologies, Inc.

In September 2002, while Mr. Clemmer was Chairman, Chief Executive Officer and Chief Financial Officer of PurchasePro, having been asked to take over from prior management, PurchasePro filed a voluntary petition under Chapter 11 of the United States Bankruptcy Code in connection with an agreement to sell substantially all of its assets.

*Peter Kelly* has been our Chief Financial Officer since August 2005. Prior to that, he had been Executive Vice President, Operations Group, since October 2001 and Vice President of Operations for Integrated Circuits from September 2000 to October 2001. Mr. Kelly joined the business in 2000 from Fujitsu-ICL Systems Inc., a joint venture of ICL and Fujitsu that provided computer systems and services to retailers and banks, where he was Executive Vice President and Chief Operating Officer. Mr. Kelly had been with Fujitsu-ICL for six years. Mr. Kelly is a director of Plexus Corp.

*Denis P. Regimbal* has been the head of our Mobility group since December 2005. Prior to that, he was the head of our Telecommunications group from August 2004 to December 2005, Vice President and General Manager of the Media Connectivity Division from July 2003 to July 2004, Vice President of Strategy for the Client Systems Group from March 2003 to July 2003, Vice President of sales and applications for Europe, Middle East and Africa from September 2001 to March 2003 and General Manager of the Wireless Infrastructure Division from 1999 to September 2001. Prior to joining the business in 1988, Mr. Regimbal held several management positions with Analog Devices, Inc. and Intel Corporation.

*Samir F. Samhouri* has been the head of our Telecommunications group since December 2005 and the head of our Enterprise and Networking group since September 2005. Previously, Mr. Samhouri was the head of our Ethernet Division from December 2004 to September 2005, Vice President of marketing, applications and product line management for the Telecommunications Division from January 2002 to December 2004 and General Manager for network communications intellectual property from 2000 to January 2002.

*Ruediger Stroh* has been the head of our Storage group since November 2005. Since August 2004, he has been a director, and from August 2004 until November 2005, he was Chief Executive Officer, of Intematix Inc., a nano and thin film materials design and manufacturing company. From November 2003 to November 2005, he was an active principal of RST Partners, a technology consulting firm. From February 2003 through November 2003, he was President and Chief Executive Officer and a director of Trebia Networks Inc., a storage area networking chipset company. From April 2001 to January 2003, Mr. Stroh was President and Chief Executive Officer and a director of Systemonic Inc., a wireless local area networking chipset company. Prior to that, he held a number of management positions at Infineon Technologies Corporation.

Officers are not elected for a fixed term of office but hold office until their successors have been elected.

## PART II

**Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.*****Price Range of Common Stock***

On May 27, 2005, we reclassified our Class A common stock and Class B common stock into a new, single class of common stock and effected a 1-for-10 reverse stock split. The new class of common stock trades under the symbol AGR on the New York Stock Exchange. The high and low sale prices for our common stock for each quarter during our last two full fiscal years are set forth below, as reported in the consolidated transaction reporting system and as adjusted to give retroactive effect to our 1-for-10 reverse stock split:

| <u>Fiscal 2004</u>  | <u>High</u> | <u>Low</u> |
|---|-------------|------------|
| Quarter ended December 31, 2003                           |             |            |
| Class A common stock                                      | \$44.50     | \$27.00    |
| Class B common stock                                      | \$37.50     | \$25.60    |
| Quarter ended March 31, 2004                              |             |            |
| Class A common stock                                      | \$41.40     | \$28.90    |
| Class B common stock                                      | \$38.80     | \$28.30    |
| Quarter ended June 30, 2004                               |             |            |
| Class A common stock                                      | \$34.60     | \$19.80    |
| Class B common stock                                      | \$33.30     | \$18.90    |
| Quarter ended September 30, 2004                          |             |            |
| Class A common stock                                      | \$23.00     | \$10.00    |
| Class B common stock                                      | \$21.70     | \$ 8.90    |
| <br><u>Fiscal 2005</u>                                    |             |            |
| Quarter Ended December 31, 2004                           |             |            |
| Class A common stock                                      | \$15.40     | \$10.70    |
| Class B common stock                                      | \$14.90     | \$10.40    |
| Quarter ended March 31, 2005                              |             |            |
| Class A common stock                                      | \$16.90     | \$12.60    |
| Class B common stock                                      | \$16.90     | \$12.50    |
| Quarter ended June 30, 2005                               |             |            |
| Class A common stock (April 1, 2005 through May 27, 2005) | \$14.60     | \$11.00    |
| Class B common stock (April 1, 2005 through May 27, 2005) | \$14.30     | \$11.00    |
| Common stock (May 31, 2005 through June 30, 2005)         | \$13.65     | \$10.85    |
| Quarter ended September 30, 2005                          |             |            |
| Common stock  | \$12.98     | \$ 9.63    |

As of November 28, 2005, there were approximately 1.85 million record and beneficial holders of our common stock.

***Dividend Policy***

We have never declared or paid and we do not anticipate paying any dividends on our common stock in the foreseeable future. We currently intend to retain our future earnings for use in the operation and expansion of our business.

See Item 12 for information about our equity compensation plans.

**Item 6. Selected Financial Data**

The following table sets forth selected financial information for our company. The financial information for the years ended September 30, 2005, 2004, and 2003, and as of September 30, 2005 and 2004, has been derived from our audited financial statements included elsewhere in this report. The financial information for the year ended September 30, 2002 and 2001 and as of September 30, 2003, 2002 and 2001 has been derived from our audited financial statements not included in this report. The historical selected financial information may not be indicative of our future performance and should be read in conjunction with the information contained in Management's Discussion and Analysis of Financial Condition and Results of Operations in Item 7 and the consolidated financial statements and the related notes in Item 8.

| <i>(Dollars in millions except per share amounts)</i>               | <b>Year Ended September 30,</b> |                 |             |                 |             |
|---|---------------------------------|-----------------|-------------|-----------------|-------------|
|   | <b>2005 (1)</b>                 | <b>2004 (1)</b> | <b>2003</b> | <b>2002 (2)</b> | <b>2001</b> |
| <b>Statement of operations information:</b>                         |                                 |                 |             |                 |             |
| Revenue   | \$ 1,676                        | \$ 1,912        | \$ 1,839    | \$ 1,923        | \$ 2,886    |
| Gross profit  | 664                             | 866             | 579         | 494             | 915         |
| Loss from continuing operations                                     | (8)                             | (90)            | (371)       | (803)           | (1,454)     |
| <b>Basic and diluted earnings (loss) per share: (3) (4)</b>         |                                 |                 |             |                 |             |
| Loss from continuing operations                                     | \$ (0.04)                       | \$ (0.52)       | \$ (2.23)   | \$ (4.90)       | \$ (10.90)  |
| Weighted average shares outstanding - basic and diluted (thousands) | 177,775                         | 171,248         | 166,699     | 163,720         | 133,428     |

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- (1) During fiscal 2005 and fiscal 2004 we recorded reversals of tax and interest contingencies of \$120 million and \$86 million, respectively, resulting from settlements of certain prior year tax audits. This relates to the company's tax sharing agreement with Lucent and covers periods the company operated as either a division of AT&T Corp. or Lucent. In fiscal 2005 we also recorded a reversal of \$22 million for tax and interest contingencies related to non-U.S. income tax.
  - (2) During fiscal 2002, our short-term debt decreased significantly as we repaid \$2.5 billion of borrowings under a credit facility. Also, our total assets decreased significantly as we used \$1.6 billion of cash on hand to partially repay the credit facility and recorded significant impairments of property, plant and equipment, as well as goodwill and acquired intangible assets.
  - (3) On May 27, 2005, we reclassified our Class A common stock and Class B common stock into a new single class of common stock, and effected a 1-for-10 reverse stock split. All per share and share amounts have been restated to reflect the reverse stock split. Basic and diluted earnings (loss) per common share are calculated by dividing income (loss) from continuing operations by the weighted average number of common shares outstanding during the period.
  - (4) The weighted average number of common shares outstanding on a historical basis includes retroactive recognition to October 1, 2000 of the 103,510,000 shares owned by Lucent prior to our initial public offering in fiscal 2001.

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

*The following discussion of our financial condition and results of operations should be read in conjunction with our financial statements and the related notes in Item 8. This discussion contains forward-looking statements. Please see Forward-Looking Statements and Item 1A Risk Factors for a discussion of the uncertainties, risks and assumptions associated with these statements.*

**Overview**

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We are a leading provider of integrated circuit solutions for a variety of applications, including high-density storage, mobile wireless communications and enterprise and telecommunications networks. These solutions form the building blocks for a broad range of computing and communications applications. Some of our solutions include related software and reference designs. Our customers include manufacturers of hard disk drives, mobile phones, high speed communications systems and personal computers. We also generate revenue from the licensing of intellectual property.

Our business is organized into operating segments that focus on four key markets: Storage, Mobility, Enterprise and Networking, and Telecommunications. We have two reportable segments, Consumer Enterprise and Telecommunications. Each segment includes product revenue and revenue from the licensing of intellectual property. The Consumer Enterprise segment includes the Storage, Mobility and Enterprise and Networking operating segments. Storage targets computing and consumer electronic devices that need high capacity storage and provides integrated circuit solutions for hard disk drives. Mobility targets the consumer communications market and provides integrated circuit solutions for a variety of end-user applications such as data-enabled mobile phones. Enterprise and Networking targets the data networking equipment market and also provides solutions for consumer communications applications. The Telecommunications segment targets the telecommunications network equipment market and provides integrated circuit solutions for wireless and wireline infrastructure.

On March 8, 2005, we acquired Modem-Art Ltd., a privately held developer of advanced processor technology for third generation, or 3G, mobile communications for \$144 million in common stock and cash. We issued common stock valued at \$113 million and paid \$31 million in cash in exchange for all the outstanding shares of Modem-Art. This acquisition complements our existing mobile phone products, and enhances our ability to address the rapidly evolving cellular technologies with integrated chips and software for today's 3G market and widely anticipated future demand for High Speed Downlink Packet Access, or HSDPA technology.

On May 27, 2005 we reclassified our Class A common stock and Class B common stock into a new, single class of common stock and effected a 1-for-10 reverse stock split.

On October 26, 2005, we announced that our Board of Directors had authorized the repurchase of up to \$200 million of our common stock.

### **Operating Environment**

Our business depends in large part on demand for personal computers and associated equipment, wireless communications equipment such as mobile phones, enterprise networking equipment and telecommunications infrastructure equipment. Our revenues can be affected by changes in demand for any of these types of products. The markets for these products are competitive and rapidly changing. Accordingly, significant technological changes, new customer requirements, changes in customer buying behavior or the emergence of competitive products with new capabilities or technologies could adversely affect our revenues and operating results. Also, several customers have each recently accounted for more than 10% of our revenues. In fiscal 2005, each of Maxtor and Seagate represented 15% of our revenue and Samsung represented 14% of our revenue. In fiscal 2004 and 2003, sales to Maxtor represented 16% and sales to Seagate represented 12% of our revenue.

As our revenue declined over the last few years, we determined on several occasions that we needed to reduce our cost structure. As a result, we implemented programs to reduce our headcount, consolidate our operations into fewer facilities and reduce our owned manufacturing capacity, including exiting our optoelectronic components business, selling several non-core businesses and reducing our capital spending.

The integrated circuit manufacturing industry has a history of developing new manufacturing processes. We believe that the costs associated with implementing new processes, including acquiring the necessary equipment

and building appropriate facilities, are increasing with each generation of manufacturing processes. Because we do not want to make the financial investments necessary for future processes, we have increased our reliance on third-party contract manufacturers to make integrated circuits for us, as we transition to new technologies. We refer to this strategy as our "fab-lite" strategy. We believe this strategy will lead to lower capital expenditures, fixed costs and process development expenses than if we continued to invest in new manufacturing facilities. As part of this strategy, we have closed our manufacturing facilities in Madrid, Spain; Orlando, Florida; and Allentown and Reading, Pennsylvania.

When we ceased operations at our Orlando facility in September 2005 we had pre-built inventory of \$28 million to meet our estimates of our customers' future demand for products we will no longer have the capability to produce. We expect to sell the majority of this inventory during fiscal 2006, with the remainder being sold by the end of fiscal 2007.

### **Restructuring and Decommissioning Activities**

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We implemented restructuring and consolidation actions to improve gross profit, reduce expenses and streamline operations and, on September 30, 2005, we had restructuring reserves related to three separate restructuring programs. The first is a resizing and consolidation of the business which began in fiscal 2001. This restructuring is substantially complete. We undertook this restructuring in response to significant declines in our revenue, particularly from our telecommunications network equipment customers. We believe that our customers were themselves experiencing significant declines in demand from their customers. As part of this restructuring, we:

Sold our optoelectronic components business, including the manufacturing facilities associated with that business;

Reduced our total headcount by approximately 9,700 employees;

Consolidated our operations into fewer facilities, resulting in the closure of over 25 smaller manufacturing, administrative, support and warehouse facilities; and

Closed integrated circuit wafer manufacturing facilities in Allentown and Reading, Pennsylvania and Madrid, Spain.

Our second restructuring program was announced on September 23, 2004, and consists of a further resizing of our business to align the cost structure with revenue projections. As part of this program, we reduced our workforce by approximately 550 employees across the business, including administrative functions, sales, marketing, product development and manufacturing support, and exited our standalone wireless local area networking chipset, or WiFi, business, our radio-frequency power transistor, or RF power, business, and all operations in the Netherlands. This restructuring is substantially complete.

Our third restructuring program was announced on September 29, 2004, and relates to the closure of our Orlando wafer manufacturing facility. In September 2005, we ceased operations in the Orlando facility. Approximately 530 people were employed at the facility on September 30, 2005, the majority of which are expected to be off roll by December 31, 2005. We currently estimate that our costs in fiscal 2006 will be \$80 million lower than if the facility was still in operation.

As a result of our restructuring activities, we recorded a charge of \$18 million for the year ended September 30, 2005, classified within restructuring and other charges net. The net charge for the year ended September 30, 2005 is comprised of \$1 million of net charges related to workforce reductions, \$2 million related to facility lease terminations, \$14 million of other charges, \$11 million of which related primarily to decommissioning activity and relocation of employees and equipment at locations other than Orlando, and \$3 million of which related to Orlando decommissioning activities, \$5 million of non-cash charges related to the impairment of assets, primarily related to our Singapore operations, and \$4 million related to the reversal of a non-cash charge for a pension liability in the Netherlands. In addition, within gross margin we recorded \$139 million of restructuring related charges for the year ended September 30, 2005, of which \$120 million resulted from increased depreciation, \$16 million is related to inventory and purchase commitment charges, and \$3 million relates to other charges. The increased depreciation is due to the shortening of the estimated useful lives of assets resulting from our Orlando restructuring actions. Of the inventory and purchase commitment charges, \$11 million is the result of lower demand for WiFi and RF power transistor products in connection with our decision to exit the WiFi and RF power businesses, and \$5 million

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relates to commitments related to our Orlando facility. For additional details regarding our restructuring activities, see Note 4 to our financial statements in Item 8.

In addition, in the fourth quarter of fiscal 2005, we developed plans to resize and discontinue some of our shared business support groups. As a result, we have recorded a charge of \$5 million related to workforce reductions within Restructuring and Other Charges net.

During fiscal 2004, we recorded a charge of \$37 million for an asset retirement obligation related to the decommissioning of our former manufacturing facilities in Allentown and Reading, classified within restructuring and other charges net. We also recorded \$160 million for net restructuring and related charges, classified within restructuring and other charges net. The net charges for fiscal 2004 include \$132 million related to workforce reductions and \$28 million related to other restructuring and related charges including facility lease terminations, asset impairments, and other charges, including relocation of employees and equipment. In addition, within gross margin we recorded \$7 million of restructuring related charges during fiscal 2004, of which \$5 million resulted from increased depreciation. This increased depreciation is due to the shortening of estimated useful lives of certain assets in connection with our restructuring actions.

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We recorded net restructuring and related charges of \$131 million within continuing operations for the year ended September 30, 2003, classified within restructuring and other charges net. We also recorded restructuring related costs within continuing operations in gross profit of \$103 million for fiscal 2003, of which \$71 million resulted from increased depreciation.

To complete our first restructuring program which began in fiscal 2001, we estimate that we will incur approximately \$2 million in additional cash charges during fiscal 2006, related primarily to the relocation of employees. We also estimate that we will spend an additional \$1 million for capital expenditures primarily related to the decommissioning of our former manufacturing facility in Allentown during the first quarter of fiscal 2006. To complete our exit from manufacturing operations at our Orlando facility, we estimate that we will have a total future cash outlay of approximately \$38 million. Included in this amount are cash charges of \$31 million related to the shutdown of the facility, of which we expect to pay \$25 million in fiscal 2006 and \$6 million in fiscal 2007. We also estimate that we will pay \$3 million in the first quarter of fiscal 2006 related to equipment disposition costs. This amount was previously recognized in restructuring and other charges net in the fourth quarter of fiscal 2005. We will also pay approximately \$4 million in the first quarter of fiscal 2006 related to purchase commitments which were previously recorded in gross margin in the fourth quarter of fiscal 2005. We also anticipate that we will pay a total of approximately \$3 million related to our 2005 business resizing, of which \$2 million and \$1 million are expected to be paid in fiscal 2006 and 2007, respectively. These restructuring related charges were previously recognized in restructuring and other charges net in the fourth quarter of fiscal 2005.

On September 13, 2005, we entered into an agreement to sell the majority of the equipment at our Orlando facility for \$89 million, which is \$19 million more than previously estimated. In the fourth quarter of fiscal 2005, we incurred a non-cash charge of \$19 million related to increased depreciation. This charge was \$19 million lower than previously expected as we adjusted our estimated salvage value related to the equipment as a result of the proceeds from the sale of Orlando equipment. We are also looking for a buyer for the land and buildings at the Orlando facility and we anticipate that we will receive cash proceeds of approximately \$10 million for these assets.

We expect that our future cash requirements to complete these restructuring and restructuring related programs will be approximately \$72 million. This amount includes amounts in the restructuring reserve at September 30, 2005 and the estimated future cash charges and payments associated with our 2001 restructuring actions, 2004 business resizing, closure of Orlando and 2005 business resizing.

On October 26, 2005, we announced that we are considering additional actions that would further improve profitability and consolidate our operations. Although we have not finalized our plans, we currently anticipate that we will incur additional charges of approximately \$20 million to \$25 million related to these actions, of which approximately \$15 million to \$20 million will be cash charges.

### **Application of Critical Accounting Policies and Estimates**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial

statements and revenues and expenses during the period reported. The following accounting policies involve one or more critical accounting estimates because they are particularly dependent on estimates and assumptions made by management about matters that are highly uncertain at the time the accounting estimates are made. In addition, while we have used our best estimates based on facts and circumstances available to us at the time, different estimates reasonably could have been used in the current period, and changes in the accounting estimates we used are reasonably likely to occur from period to period, which may have a material impact on the presentation of our financial condition and results of operations. We review these estimates and assumptions periodically and reflect the effects of revisions in the period that they are determined to be necessary. We have reviewed our critical accounting policies with our audit committee.

### ***Property, Plant and Equipment***

Property, plant and equipment that is held and used is generally reflected in our financial statements at historical cost less an allocation for depreciation. The resulting book value may not be reflective of its fair market value. However, we have impaired property, plant and equipment in connection with our restructuring initiatives. Property, plant and equipment is reviewed for impairment whenever events such as a significant industry downturn, product discontinuance, plant closures, product dispositions, technological obsolescence, or other changes in circumstances indicate that their carrying amount may not be recoverable. We perform impairment tests on groups of assets that are related and have separately identifiable cash flows. In some cases, it may not be practical to measure the cash flows associated with a particular asset or group of assets due to the integrated nature of our production process. When an asset's economic life is shorter than previously expected or when we plan to abandon an asset as a result of a restructuring plan or otherwise and are unable to measure the associated cash flows, we shorten the recovery period for

that asset to its remaining useful life, which would cause us to recognize increased depreciation. If separate cash flows can be identified, we compare the carrying amount of the assets to their undiscounted expected future cash flows. If an impairment exists, assets classified as held and used are written-down to fair value and are depreciated over their remaining useful life, while assets classified as held for sale are written down to fair value less costs to sell. It is reasonably likely that the actual fair value may differ from our current estimate, in which case we may under- or over-value our property, plant and equipment and under- or over-value the related impairment charge.

#### ***Tax Valuation Allowance***

A tax valuation allowance is established, as needed, to reduce net deferred tax assets to the amount for which recovery is more likely than not to be realized. Since 2001, we established a full valuation allowance against our U.S. net deferred tax assets excluding deferred tax liabilities related to indefinite-lived goodwill. We recorded a valuation allowance because of our continuing losses and our long term financial forecast has enough uncertainty that we do not meet the standard of more likely than not that is required for measuring the likelihood of realization of net deferred tax assets. In the event it becomes more likely than not that some or all of the deferred tax assets will be realized, we will adjust our valuation allowance. Depending on the amount and timing of taxable income we ultimately generate in the future, as well as other factors, we could recognize no benefit from our deferred tax assets, in accordance with our current estimate, or we could recognize some or all of their full value.

#### ***Tax Contingencies***

Tax contingencies are recorded to address potential exposures involving tax positions we have taken that could be challenged by taxing authorities. These potential exposures result from the varying application of statutes, rules, regulations and interpretations. Our estimate of the value of our tax contingencies contains assumptions based on past experiences and judgments about potential actions by taxing jurisdictions. The majority of our tax contingencies were transferred to us from Lucent as part of our separation from Lucent and reflect our potential exposures under our tax sharing agreement with Lucent. We believe our tax contingencies are reasonable although the accruals may change in the future due to new developments with each issue. It is possible that the ultimate resolution of these matters may be greater or less than the amount that we have accrued.

#### ***Retirement Benefits***

Postretirement liabilities are for benefits that we expect to pay to eligible retirees. We consider various factors in determining our postretirement liability, including the number of employees who we expect to receive benefits, the type and length of benefits they will receive, trends in health care costs and other actuarial assumptions. If the actual postretirement benefits paid differ from our current estimate we may be over- or under-accrued.

We also have pension plans covering substantially all U.S. employees, excluding management employees hired after June 30, 2003. We consider various factors in determining our pension liability, including the number of employees who we expect to be paid, their salary levels and years of service, the expected return on plan assets, the discount rate used to determine the benefit obligation, the timing of the payment of benefits, and other actuarial assumptions. If the actual results and events of our pension plan differ from our current assumptions, our benefit obligations may be over- or under-valued.

We reassess our retirement benefit plan assumptions on an annual basis or more frequently if changes in circumstance indicate a re-evaluation of assumptions is required. The key benefit plan assumptions are the discount rate and the expected rate of return on plan assets. These assumptions are discussed below.

To select a discount rate for our retirement benefit plans, we use a modeling process that involves selecting a portfolio of bonds that will match the expected cash outflows of our benefit plans. We use the average yield of this hypothetical portfolio as a discount rate benchmark. In our model, we use a portfolio of fixed-income debt instruments rated AA- or better and with maturities matching the expected timing of the benefit obligation. We extrapolate values for any year in which an actual bond matching the needed criteria is not available in the financial market place. In fiscal 2005, we used discount rates of 6.0% and 5.5% to determine our net periodic benefit cost and our benefit obligation, respectively. This is a decrease from the rates used in prior years. In fiscal 2004, we used discount rates of 6.25% and 6.0% to determine our net periodic benefit cost and our benefit obligation, respectively. In fiscal 2003 we used a discount rate of 6.25% for the determination of both our net periodic benefit cost and our benefit obligation for U.S. retirement benefit plans.

We base our salary increase assumptions on historical experience and future expectations. The expected rate of return for our retirement benefit plans represents the average rate of return expected to be earned on plan assets over the period that benefits included in the benefit obligation are



expected to be paid. In developing the expected rate of return, we consider long-term compound annualized returns based on historical market data, historical and expected returns on the various categories of plan assets, and the target investment portfolio allocation between debt and equity securities. For fiscal 2005, we increased the weighted-average long-term rate of return on assets to 8.0% and 8.25% for the represented and management pension plans, respectively. For fiscal 2004, we reduced the weighted-average long-term rate of return on assets to 7.75% from 8.0% in fiscal 2003 for our U.S. retirement benefit plans. The target investment policy was changed in August 2004 to a mix of 57% equity and 43% debt instruments for the management pension plan and 48% equity and 52% debt instruments for the occupational pension plan. The weighted average target investment portfolio allocation for our U.S. management and occupational pension plans is 53% in equity and 47% in debt investments. The portfolio's equity weighting is consistent with the long-term nature of the plans' benefit obligation. For fiscal 2006, we are using an expected rate of return on plan assets of 8.0% and 8.25% for the represented and management pension plans, respectively, consistent with the target investment portfolio allocation.

Actuarial assumptions are based on our best estimates and judgment. Material changes may occur in retirement benefit costs in the future if these assumptions differ from actual events or experience. We performed a sensitivity analysis on the discount rate, which is the key assumption in calculating the pension benefit obligation. Each change of 25 basis points in the discount rate assumption would have an estimated \$2 million impact on annual net retirement benefit costs and a \$47 million impact on benefit obligations. Each change of 25 basis points in the expected rate of return assumption would have an estimated \$3 million annual impact on net retirement benefit costs.

### ***In-process research and development***

We review our acquisitions to determine if there are any intangible assets relating to purchased in-process research and development. Projects that have not achieved technological feasibility and have no alternative future use are valued at fair market value using a discounted cash flow analysis and are expensed in the statement of operations on the date of acquisition. We use a discount rate that reflects the development stage of the technology and the risks associated with attaining full technological and commercial feasibility. When we value in-process research and development, we must make a number of estimates, including the timing and amounts of future cash flows to be generated as a result of the projects, how close the projects are to technological feasibility and how much risk and cost is involved in finalizing the projects. It is reasonably likely that our estimates for these amounts will differ from actual results, in which case our in-process research and development charge may be over- or under-valued, which would also result in an under- or over-valuation of our goodwill.

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### ***Goodwill***

Goodwill is the excess of the purchase price over the fair value of identifiable net assets acquired in business combinations accounted for as purchases. Goodwill is tested for impairment at the reporting unit level annually, or more frequently if events and circumstances indicate that there may be an impairment. The test involves a two-step process. The first step requires us to compare the fair value of the reporting unit to its carrying value including goodwill. The fair value of the reporting unit is calculated using discounted expected future cash flows. If the fair value is less than the carrying value, a potential impairment exists and the second step of the process is performed. The second step requires us to calculate the excess of the fair value of the reporting unit over the fair value of the reporting unit's net assets other than goodwill. If this excess, referred to as the implied fair value of the goodwill, is less than the carrying value of the goodwill, an impairment exists and is recorded. Our estimates of future cash flows are dependent upon many factors, including general economic trends, industry trends, technological developments and customer demand. It is reasonably likely that future cash flows associated with these assets may exceed or fall short of our current estimates, in which case a different amount for an impairment would result. If our actual cash flows exceed our estimates of future cash flows, any impairment charge would be greater than needed. If our actual cash flows are less than our estimates of future cash flows, we may need to recognize additional impairment charges in future periods, which would be limited to the carrying value of the goodwill.

### ***Purchased In-process Research and Development***

In connection with the acquisitions of Modem-Art Ltd. and TeraBlaze, Inc., a portion of each purchase price was allocated to purchased in-process research and development. In analyzing these acquisitions, we made decisions to buy technology that had not yet reached commercialization rather than develop the technology internally. We relied on factors such as the amount of time it would take to bring the technology to market and our own resource allocation in making these decisions. At the date of acquisition, the in-process research and development projects had not yet reached technological feasibility and had no alternative future uses. Accordingly, the value allocated to these projects was immediately expensed at acquisition.

We estimated the fair value of the in-process research and development for these acquisitions using the excess earnings method of the income approach. This method employs a discounted cash flow analysis using the present value of the estimated after-tax cash flows expected to be generated by the purchased in-process research and development using risk-adjusted discount rates and revenue forecasts as appropriate. The

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selection of the discount rates was based on consideration of our weighted average cost of capital, as well as other factors known at the time, including the projected useful life of each technology, profitability levels of each technology, the uncertainty of technology advances and the stage of completion of each technology. We believe that the estimated in-process research and development amounts so determined represented fair value and did not exceed the amount a third party would have paid for the projects.

Set forth below are descriptions for the major acquired in-process research and development projects and our assumptions in connection with these acquisitions.

### *Modem-Art Ltd.*

On March 8, 2005, we acquired Modem-Art, a developer of advanced processor technology for 3G mobile communications, for \$144 million. We issued common stock valued at \$113 million and paid \$31 million in cash in exchange for all the outstanding shares of Modem-Art. On the date of acquisition, we expensed \$55 million of the purchase price as in-process research and development.

At the date of acquisition, Modem-Art did not have any developed technology. Its projects underway were a 3G single-mode chipset, a variant of the single-mode chipset, which when combined with our software and advanced second generation, or 2.5G, chipset incorporating GPRS and Enhanced Global Rates for Global Evolution, or EDGE, can fulfill the requirements of dual-mode 2.5G and 3G, and the development of HSDPA technology, which will be integrated in a chipset that supports high speed data transmission from base stations to mobile phones. The in-process research and development allocated to these projects was \$12 million, \$10 million and \$33 million, respectively. These projects ranged from 10% to 90% complete at the time of acquisition and are expected to be completed through fiscal 2007. Projected net cash flows attributable to these projects, assuming successful development, were discounted to net present value using discount rates of 30% for the single-mode project, 35% for the dual-mode project and 40% for the HSDPA project.

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The 3G single-mode chipset is intended to permit mobile handsets to operate on a 3G network only and will not have the capability to switch to mobile phone networks based on other technologies such as 2.5G when outside of a 3G network range. We believe there will be few stand-alone markets for 3G networks because we expect telecommunications carriers to limit their 3G networks to high usage areas. As a result of this limited market opportunity, we anticipate that the 3G single-mode technology will derive most of its value as a building block for other projects involving 3G technology, including our dual-mode and HSDPA projects. We estimate that, as of the date of acquisition, the single-mode project was approximately 90% complete. As of September 30, 2005, we estimate that this project was approximately 95% complete and our current estimate of the costs to complete the project is less than \$1 million.

The dual-mode technology will enable mobile handsets to maintain high GPRS and EDGE data rates when outside 3G coverage. This technology will also integrate baseband processing and power management, resulting in lower power consumption. This solution is expected to be compatible with a large range of mobile handsets from entry-level to high-end solutions, and is expected to support multimedia features such as speakerphone, music playback, video playback and memory card capabilities. The dual-mode technology is also expected to be used in future technologies, such as HSDPA. We estimate that, as of the date of acquisition, this project was approximately 50% complete. As of September 30, 2005 we estimate that this project was approximately 90% complete and our current estimate of the costs to complete the research and development efforts is approximately \$4 million. The remaining development effort is primarily standards compliance and field testing the product. We expect to begin generating revenues from this product during the first half of fiscal 2006.

HSDPA technology will be an upgrade to existing wideband CDMA networks and is being designed to support significantly higher data throughput speeds on the downlink from base stations to mobile phones. This technology also represents a significant improvement to the dual-mode technology, with greater memory and expected data rates. We expect that we will be able to use the HSDPA technology in future generations that target data rates of 3.6 megabits per second and higher. We estimate that, as of the date of acquisition, this project was approximately 10% complete. As of September 30, 2005 we estimate that this project was approximately 50% complete and our current estimate of the costs to complete the research and development efforts is approximately \$5 million. The remaining research and development efforts include layout, mask set, firmware, integration and testing the product. We anticipate we will begin generating revenues from this product during the first half of fiscal 2007.

### *TeraBlaze, Inc*

On December 31, 2003, we acquired TeraBlaze, Inc., a developer of gigabit Ethernet switching solutions, for \$21 million in Agere common stock. On the date of acquisition, we expensed \$13 million of the purchase price as in-process research and development.

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At the date of acquisition, TeraBlaze did not have any developed technology. It had one project underway to develop gigabit Ethernet switching solutions. We expected to use this switch-on-a-chip technology to provide single-chip gigabit Ethernet solutions to equipment providers addressing small office, home office and enterprise applications. Based on the complexity and specific nature of this technology, there was no specific alternative future use for this technology. In determining the fair value of the project we used a discount rate of 40%, which reflected the development stage of the technology and risks associated with attaining full technological and commercial feasibility. As of the acquisition date, this project was estimated to be 70% complete, based on time, man-months completed and functionality. This project was completed during fiscal 2005 and we began generating revenues from this product in the fourth quarter of fiscal 2005.

### Sale of Optoelectronic Components Business

During the second quarter of fiscal 2003, we sold a substantial portion of our optoelectronic components business to TriQuint Semiconductor, Inc. for \$40 million in cash. The transaction included the products, product warranty liabilities, technology and certain facilities related to this business; and included lasers, detectors, modulators, passive components, arrayed waveguide-based components, amplifiers, transmitters, receivers, transceivers, transponders and micro electro-mechanical systems.

During the second quarter of fiscal 2003, we also sold the remainder of our optoelectronic components business, which provided cable television transmission systems, telecom access and satellite communications components, to EMCORE Corporation for \$25 million in cash. The transaction included the assets, products, product warranty liabilities, technology and intellectual property related to this business.

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Our exit from the optoelectronic components business was completed as a result of these two sales. See Note 16 to our financial statements in Item 8 for additional details.

### Results of Operations

#### *Fiscal year ended September 30, 2005 compared to fiscal year ended September 30, 2004*

The following table shows our revenue and the change in revenue both in dollars and in percentage terms, by segment:

|                         | Year Ended September 30, |          | Change   |       |
|-------------------------|--------------------------|----------|----------|-------|
|                         | 2005                     | 2004     | \$       | %     |
|                         | (dollars in millions)    |          |          |       |
| Revenue by Segment:     |                          |          |          |       |
| Consumer Enterprise:    |                          |          |          |       |
| Storage                 | \$ 620                   | \$ 635   | \$ (15)  | (2)%  |
| Mobility                | 364                      | 496      | (132)    | (27)  |
| Enterprise & Networking | 436                      | 513      | (77)     | (15)  |
| Consumer Enterprise     | 1,420                    | 1,644    | (224)    | (14)  |
| Telecommunications      | 256                      | 268      | (12)     | (4)   |
| Total Revenue           | \$ 1,676                 | \$ 1,912 | \$ (236) | (12)% |

*Revenue:* Revenue was \$1,676 million, a decrease of 12% or \$236 million from \$1,912 million in fiscal 2004. Product revenue of \$1,525 million in fiscal 2005 is a decrease of \$241 million versus fiscal 2004, and revenue from the licensing of intellectual property of \$151 million is an increase of \$5 million versus fiscal 2004. The revenue discussion below is qualitative in nature as it pertains to price, volume and mix analysis. Traditional price, volume and mix analysis is not practicable due to the diversity of our product lines and the rapid evolution of technology, including the frequent integration of additional functionality on a single integrated circuit.

In the Consumer Enterprise segment, revenue was \$1,420 million in fiscal 2005, a decrease of 14% or \$224 million, from \$1,644 million in fiscal 2004. Product revenue was \$1,300 million in fiscal 2005, a decrease of \$229 million from \$1,529 million in fiscal 2004. Revenue from the licensing of intellectual property was \$120 million in fiscal 2005, a \$5 million increase from \$115 million in fiscal 2004. The components of

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Consumer Enterprise segment revenue are discussed below.

In Storage, revenue was \$620 million in fiscal 2005, a decrease of \$15 million from \$635 million in fiscal 2004. Product revenue was \$576 million in fiscal 2005, an \$11 million decrease from \$587 million in fiscal 2004. Revenue from the licensing of intellectual property was \$44 million in fiscal 2005, a \$4 million decrease from \$48 million in fiscal 2004. The product revenue decline was driven by pricing pressures across all applications, and volume decreases in disk controllers, motor controllers and read channels, as they reached the mature stage of the product life cycle. These decreases were partially offset by volume increases in pre-amplifiers and system-on-a-chip and improved product mix as we sold more higher-priced integrated circuit solutions as a percentage of revenue compared to the prior fiscal year.

In Mobility, revenue was \$364 million in fiscal 2005, a decrease of \$132 million from \$496 million in fiscal 2004. Product revenue was \$326 million in fiscal 2005, a \$140 million decrease from \$466 million in fiscal 2004. Revenue from the licensing of intellectual property was \$38 million in fiscal 2005, an \$8 million increase from \$30 million in fiscal 2004. The product revenue decrease was mainly the result of an \$87 million decrease in 3G sales, primarily 3G custom chipsets, and a \$35 million decrease in WiFi sales following our decision to exit that business. We also experienced pricing declines throughout the remaining applications.

In Enterprise and Networking, revenue was \$436 million, a decrease of \$77 million from \$513 million in fiscal 2004. Product revenue was \$398 million in fiscal 2005, a \$78 million decrease from \$476 million in fiscal 2004. Revenue from the licensing of intellectual property was \$38 million in fiscal 2005, a \$1 million increase from \$37 million in fiscal 2004. The decrease in product revenue was attributable to weakening demand for custom networking products, including a shift in overall mix as we sold more lower-priced custom chips as a percentage of revenue compared to the prior fiscal year. In addition, we experienced pricing pressures across most product applications and volume decreases in analog modem solutions. These decreases were partially offset by increased demand for satellite radio chip-sets and custom computing and consumer solutions.

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In the Telecommunications segment, revenue was \$256 million, a decrease of \$12 million from \$268 million in fiscal 2004. Product revenue was \$225 million in fiscal 2005, a \$12 million decrease from \$237 million in fiscal 2004. Revenue from the licensing of intellectual property was \$31 million in both fiscal 2005 and fiscal 2004. The decrease in product revenue was primarily attributable to volume decreases in mature aggregation and physical layer devices, digital signal processors and multi-service switching fabrics. In addition, we experienced price declines throughout most applications. These decreases were partially offset by improved product mix, as we sold more higher-priced integrated circuit solutions as a percentage of revenue compared to fiscal 2004.

*Costs and gross margin:* Costs were \$1,012 million for fiscal 2005, a decrease of \$34 million from \$1,046 million in fiscal 2004. Gross margin as a percent of revenue decreased 5.7 percentage points to 39.6% in the current year from 45.3% in the prior year. The decrease in gross margin percentage is primarily driven by an increase in restructuring related costs, primarily related to the closing of our Orlando facility of \$139 million in 2005, compared to \$7 million in 2004. The increase in restructuring related costs resulted in an 8.0 percentage point decrease to gross margin in fiscal 2005 compared to fiscal 2004. In addition, we experienced price declines throughout most of the business. These decreases in gross margin were partially offset by lower cost of purchased material from our joint venture manufacturer, lower internal manufacturing costs, and increased revenue from the licensing of intellectual property, which has a higher gross margin than product revenue.

Although performance measurement and resource allocation for the reportable segments are based on many factors, the primary financial measure is segment gross margin, which excludes restructuring related charges included in costs. See Note 15 to our financial statements in Item 8 for additional segment information. The segment gross margin for Consumer Enterprise was 43.2% in fiscal 2005, an increase of 1.8 percentage points from 41.4% in fiscal 2004. The primary driver of the gross margin increase was lower cost of purchased material at our manufacturing joint venture, lower internal manufacturing costs primarily resulting from our restructuring actions announced in September 2004 and a higher percentage of revenue from the licensing of intellectual property which has a higher gross margin than product revenue. These improvements were somewhat offset by price declines throughout the segment. The segment gross margin for Telecommunications was 73.8% in the current year, an increase of 2.2 percentage points from 71.6% in the prior year. Improvements were realized due to lower internal manufacturing costs, a higher percentage of total revenue from the licensing of intellectual property and lower cost of purchased material at our manufacturing joint venture. Partially offsetting these increases to gross margin were price declines throughout most of the segment.

*Selling, general and administrative:* Selling, general and administrative expenses decreased 14% or \$38 million, to \$234 million in fiscal 2005 from \$272 million in fiscal 2004. The decrease is due to lower salary, benefit and other expenses throughout all corporate and business support areas due to the cost saving initiatives implemented through our restructuring programs and lower defensive litigation expenses. These decreases were partially offset by costs incurred in the current year of \$4 million for the reverse stock split, a \$3 million charge recognized in connection with a default on a lease we guaranteed, and increased bad debt expenses.

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**Research and development:** Research and development expenses decreased 7% or \$34 million, to \$462 million in fiscal 2005 from \$496 million in fiscal 2004. The reduction was driven by cost saving initiatives implemented through our restructuring programs, including \$13 million of lower design expenses resulting from the decision to exit the wireless local area networking business, \$16 million of lower design expenses for telecommunications applications, and lower information technology, test center, and design platform expenses. These decreases were partially offset by increases in design and mask expenses for storage, ethernet and enterprise and networking applications.

**Purchased in-process research and development:** In-process research and development was \$55 million in fiscal 2005 due to the acquisition of Modem-Art and \$13 million in fiscal 2004 due to the acquisition of TeraBlaze. See Purchased In-Process Research and Development for additional details.

**Restructuring and other charges net:** Net restructuring and other charges decreased 88% or \$173 million to \$24 million in fiscal 2005 from \$197 million in fiscal 2004. See Note 4 to our financial statements in Item 8 for additional details.

**Other income net:** Other income net decreased by 13% or \$1 million to \$7 million in fiscal 2005 compared to \$8 million in the prior year. The decrease is primarily due to a \$5 million increase in our loss from our equity investment in Silicon Manufacturing Partners Pte, Ltd., or SMP, and the absence in fiscal 2005 of a

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\$4 million gain on the sale of an investment recognized in fiscal 2004. These decreases were almost entirely offset by an \$8 million increase in interest income.

**Interest expense:** Interest expense decreased 33% or \$14 million, to \$29 million in fiscal 2005 from \$43 million in fiscal 2004. The reduction is primarily due to the repayment of our accounts receivable securitization facility in October 2004, and to a lesser extent, due to lower interest expense on capital lease obligations.

**Provision for income taxes:** For fiscal 2005, we recorded a benefit for income taxes of \$122 million on a pre-tax loss of \$130 million, yielding an effective tax rate of 94.1%. This rate differs from the U.S. statutory rate primarily due to: recording a reversal of \$120 million for tax and interest contingencies for U.S. audit settlements related to tax years that we operated as a division of AT&T Corp. or Lucent Technologies Inc.; recording a reversal of \$22 million for tax and interest contingencies related to non-U.S. income tax; recording a provision for taxes related to profitable non-U.S. jurisdictions and non-U.S. withholding taxes; recording of deferred taxes on indefinite-lived goodwill intangibles, and; the recording of a valuation allowance against U.S. net deferred tax assets and Singapore losses.

For fiscal 2004, we recorded a benefit for income taxes of \$60 million on a pre-tax loss from continuing operations of \$150 million, yielding an effective tax rate of 40.2%. This rate differs from the U.S. statutory rate due to: the recording of an \$86 million reversal for tax and interest contingencies resulting from settlements of certain prior year tax audits; the recording of taxes related to non-U.S. jurisdictions; the impact of non-tax deductible in-process research and development expenditures related to the acquisition of TeraBlaze, and; the recording of a full valuation allowance against U.S. net deferred tax assets. The \$86 million reversal of tax and interest contingencies recorded in fiscal 2004 relates to our tax sharing agreement with Lucent and covers the settlement of periods we operated as a division of either AT&T or Lucent.

### ***Fiscal year ended September 30, 2004 compared to fiscal year ended September 30, 2003***

The following table shows our revenue and the change in revenue both in dollars and in percentage terms, by segment:

|                             | Year Ended September 30, |        | Change |     |
|-----------------------------|--------------------------|--------|--------|-----|
|                             | 2004                     | 2003   | \$     | %   |
|                             | (dollars in millions)    |        |        |     |
| <b>Revenue by Segment:</b>  |                          |        |        |     |
| <b>Consumer Enterprise:</b> |                          |        |        |     |
| Storage                     | \$ 635                   | \$ 623 | \$ 12  | 2%  |
| Mobility                    | 496                      | 417    | 79     | 19  |
| Enterprise & Networking     | 513                      | 560    | (47)   | (8) |

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|                     | Year Ended September 30, |          | Change |    |
|---------------------|--------------------------|----------|--------|----|
| Consumer Enterprise | 1,644                    | 1,600    | 44     | 3  |
| Telecommunications  | 268                      | 239      | 29     | 12 |
| Total Revenue       | \$ 1,912                 | \$ 1,839 | \$ 73  | 4% |

*Revenue:* Revenue was \$1,912 million, an increase of 4% or \$73 million from \$1,839 million in fiscal 2003. Product revenue of \$1,766 million in fiscal 2004 is a \$54 million increase from fiscal 2003, and revenue from the licensing of intellectual property of \$146 million was an increase of \$19 million from fiscal 2003. The revenue discussion below is qualitative in nature as it pertains to price and volume analysis. Traditional price and volume analysis is not practicable due to the diversity of our product lines and rapid evolution of technology, including the continuous integration of additional functionality on a single integrated circuit.

In the Consumer Enterprise segment, revenue was \$1,644 million in fiscal 2004, an increase of 3% or \$44 million from \$1,600 million in fiscal 2003. Product revenue was \$1,529 million in fiscal 2004, a \$29 million increase from \$1,500 million in fiscal 2003. Revenue from the licensing of intellectual property was \$115 million in fiscal 2004, a \$15 million increase from \$100 million in fiscal 2003. The components of Consumer Enterprise segment revenue are discussed below.

In Storage, revenue was \$635 million in fiscal 2004, an increase of 2% or \$12 million from \$623 million in fiscal 2003. Revenue from the licensing of intellectual property was \$48 million in fiscal 2004, an increase of \$16 million from \$32 million in fiscal 2003. Product revenue was \$587 million in fiscal 2004, a \$4 million decrease

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from \$591 million in fiscal 2003. The decrease in product revenue was driven by a decline in the demand for pre-amplifiers and pricing pressures in our system-on-a-chip solution for hard disk drives. The decrease was offset by a volume increase in our system-on-a-chip-solution as we completed the product ramp-up at a significant customer.

In Mobility, revenue was \$496 million in fiscal 2004, an increase of 19% or \$79 million from \$417 million revenue in fiscal 2003. Product revenue was \$466 million in fiscal 2004, an increase of \$75 million from \$391 million in fiscal 2003. The product revenue increase was driven by the continued initial deployment of custom chipsets based on the 3G standard and an increase in demand for our GPRS-based solution. Although we had an annual increase in revenue from the sales of 3G custom chipsets, demand for this solution fluctuated during the fiscal year and declined sequentially in the fourth quarter due to an initial ramp to have adequate supplies of 3G chipsets available for the launch of 3G phones by our customer and then subsequent inventory issues. This increase in demand for our mobile phone solutions was partially offset by \$101 million of lower revenues in wireless local area networking, primarily as a result of lower demand for our 802.11b solutions, and pricing pressures for our GPRS-based mobile phones solutions. Additionally, revenue from the licensing of intellectual property was \$30 million in fiscal 2004, an increase of \$4 million from \$26 million in fiscal 2003.

In Enterprise and Networking, revenue was \$513 million in fiscal 2004, a decrease of 8% or \$47 million from \$560 million in fiscal 2003. Product revenue was \$476 million in fiscal 2004, a \$42 million decrease from \$518 million in fiscal 2003. The decrease in product revenue was driven by decreased demand for mature telephony products. These decreases were slightly offset by volume increases in sales of satellite radio chipsets and solutions for public infrastructure, and personal computer and wired applications. Additionally, revenue from the licensing of intellectual property was \$37 million in fiscal 2004, a decrease of \$5 million from \$42 million in fiscal 2003.

In the Telecommunications segment, revenue was \$268 million in fiscal 2004, an increase of 12% or \$29 million from \$239 million in fiscal 2003. Product revenue was \$237 million in fiscal 2004, an increase of \$25 million from \$212 million in fiscal 2003. The increase in product revenue was driven by volume increases in mappers, framers and network processing devices as we saw increased demand for newer applications. We also saw volume increases in mature digital signal processors and multi-service switching fabric product applications. These increases were offset in part by pricing pressures and volume decreases in asynchronous transfer mode traffic management devices and pricing pressures in physical layer devices. Additionally, revenue from the licensing of intellectual property was \$31 million in fiscal 2004, an increase of \$4 million from \$27 million in fiscal 2003.

*Costs and gross margin:* Costs were \$1,046 million in fiscal 2004, a decrease of 17% or \$214 million, from \$1,260 million in fiscal 2003. Gross margin as a percent of revenue increased 13.8 percentage points to 45.3% in fiscal 2004 from 31.5% in fiscal 2003. The 13.8 percentage point improvement is the result of improved manufacturing yields, higher manufacturing utilization due to increased volumes and fewer

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manufacturing facilities, and a \$96 million decrease in restructuring related costs, as we completed the closure of our Allentown manufacturing facility. These improvements were offset slightly by pricing pressures in some applications in each of the four segments.

Although performance measurement and resource allocation for the reportable segments are based on many factors, the primary financial measure is gross margin, exclusive of restructuring related charges included in costs. Gross margin in the Consumer Enterprise segment was 41.4% in fiscal 2004, an increase of 9.5 percentage points from 31.9% in fiscal 2003. This increase was primarily driven by higher manufacturing utilization, improved manufacturing yields and by higher revenue from the licensing of intellectual property offset by increased product engineering cost. Gross margin in the Telecommunications segment was 71.6% in fiscal 2004 and 72.0% in fiscal 2003. The .4 percentage point decrease is driven by higher inventory provisions which was almost entirely offset by improvements resulting from higher manufacturing utilization.

*Selling, general and administrative:* Selling, general and administrative expenses decreased 7% or \$22 million to \$272 million in fiscal 2004 from \$294 million in fiscal 2003. The decrease is due to expense reductions as a result of restructuring actions primarily in information technology, with lesser reductions in worldwide sales and other corporate functions.

*Research and development:* Research and development expenses increased 6% or \$29 million to \$496 million in fiscal 2004 from \$467 million in fiscal 2003. The increase was due to \$43 million in higher design-related investments and increased headcount related to product development, partially offset by \$13 million in lower investment in silicon manufacturing process research due to our reduced focus on developing new internal manufacturing capabilities and \$6 million lower outside contractor expenses as we moved work to Agere employees.

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*Purchased in-process research and development:* Purchased in-process research and development expense for fiscal 2004 was \$13 million due to our acquisition of TeraBlaze in the first quarter of fiscal 2004. There was no purchased in-process research and development expense for fiscal 2003. See Note 5 to our financial statements in Item 8 for additional details.

*Restructuring and other charges net:* Net restructuring and other charges increased 50% or \$66 million to \$197 million in fiscal 2004 from \$131 million in fiscal 2003. See Note 4 to our financial statements in Item 8 for additional details.

*Gain on sale of operating assets net:* Gain on sale of operating assets net decreased \$17 million to \$4 million in fiscal 2004 from \$21 million in fiscal 2003. In fiscal 2003 we recognized a \$16 million gain on the sale of our analog line card business, which had previously been deferred.

*Other income net:* Other income net decreased 64% or \$14 million to \$8 million in fiscal 2004 compared to \$22 million in the prior year. The change was primarily due to an \$18 million decrease in income from our equity investment in SMP, offset in part by a \$4 million gain on the sale of an investment in fiscal 2004.

*Interest expense:* Interest expense decreased 9% or \$4 million to \$43 million in fiscal 2004 from \$47 million in fiscal 2003. This decrease is primarily due to lower interest expense related to capital lease obligations.

*Provision for income taxes:* For fiscal 2004, we recorded a benefit for income taxes of \$60 million on a pre-tax loss from continuing operations of \$150 million, yielding an effective tax rate of 40.2%. This rate differs from the U.S. statutory rate due to: the recording of an \$86 million reversal of tax and interest contingencies resulting from settlements of certain prior year tax audits; the recording of taxes related to non-U.S. jurisdictions; the impact of non-tax deductible in-process research and development expenditures related to the acquisition of TeraBlaze, and; the recording of a full valuation allowance against U.S. net deferred tax assets. The \$86 million reversal of tax and interest contingencies recorded in fiscal 2004 relate to our tax sharing agreement with Lucent and covers the settlement of periods we operated as a division of either AT&T or Lucent. For fiscal 2003, we recorded a provision for income taxes of \$46 million on a pre-tax loss from continuing operations of \$325 million, yielding an effective tax rate of (14.2)%. This rate differs from the U.S. statutory rate primarily due to the impact of recording a full valuation allowance against U.S. net deferred tax assets and the tax effect of non-U.S. operations.

*Income from discontinued operations:* For fiscal 2004, there was no income from discontinued operations. For fiscal 2003, income from discontinued operations was \$38 million, or \$0.23 per share, and consisted of income from operations of \$8 million and a gain on disposal of \$30 million. The gain from disposal reflects an \$11 million gain from the sale to TriQuint and a \$19 million gain from the sale to EMCORE.

### Liquidity and Capital Resources

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On September 30, 2005, our cash and cash equivalents were \$698 million, a decrease of \$80 million, from September 30, 2004. During the year our accounts receivable securitization expired and we repaid the \$122 million of borrowings. At the end of the year, our \$372 million of debt consisted entirely of our long-term convertible subordinated notes due in December 2009.

Net cash provided by operating activities was \$137 million in fiscal 2005 compared with \$166 million in fiscal 2004. The \$29 million decrease of cash provided by operating activities resulted primarily from lower cash collections from sales this year as sales declined by \$236 million, an increase of \$75 million in voluntary pension plan contributions and we received \$20 million less dividends from SMP. Offsetting these decreases were lower cash outflows resulting from initiatives taken to reduce our cost structure and \$26 million lower payments for our restructuring actions. In addition, in the prior year we paid taxes of \$55 million related to tax settlements for certain years in which we operated as a division of AT&T or Lucent.

Net cash provided by operating activities from continuing operations was \$166 million in fiscal 2004 compared with \$23 million cash used in fiscal 2003. The \$189 million improvement in cash provided (used) by operating activities was primarily driven by improved gross margin on higher sales volumes. In addition, in fiscal 2004 we received \$61 million in dividends from our joint venture, SMP, and had a \$37 million decrease in cash payments for restructuring activities. In fiscal 2003, we had a cash outflow of \$34 million related to a transitional supply agreement associated with the sale of our analog line card business. These improvements were offset in part by a fiscal 2004 tax payment of \$55 million related to tax settlements for certain years in which we operated as a division of AT&T or Lucent and higher bonus payments of \$23 million.

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Investing activities used net cash of \$45 million in fiscal 2005 compared to \$88 million in fiscal 2004 and \$11 million in fiscal 2003. The \$43 million improvement in cash used in investing activities from fiscal 2004 to fiscal 2005 reflects a \$93 million increase in proceeds from the sale of property, plant and equipment primarily related to the sale of equipment at our Orlando facility. Also, we had an increase of \$11 million in cash returned to us that was previously held in trust and \$3 million in proceeds from the sale of our radio frequency power business. These increases were partially offset by \$34 million of higher capital expenditures, a \$26 million net outflow in connection with the acquisition of Modem-Art and a decrease of \$4 million in proceeds from the sale of investments. The \$77 million increase in cash used in investing activities from fiscal 2003 to fiscal 2004 is related to the absence in fiscal 2004 of \$64 million in proceeds received in fiscal 2003 from the sale of our optoelectronic components business and \$35 million of lower proceeds from the sale or disposal of property, plant and equipment. These decreases were partially offset by \$19 million of lower capital expenditures in fiscal 2004 compared to fiscal 2003.

Financing activities used net cash of \$173 million, \$44 million, and \$28 million in fiscal 2005, 2004, and 2003, respectively. The fiscal 2005 use of cash primarily reflects the repayment of \$122 million upon the expiration of our accounts receivable securitization and \$67 million of repayments of long-term debt, including the repurchase of \$38 million of our convertible notes, partially offset by proceeds of \$16 million from the issuance of common stock under our employee benefit plans. The fiscal 2004 use of cash primarily reflects the repayment of \$53 million in long-term debt, the majority of which is related to capital leases, and the net repayment of \$32 million under our accounts receivable securitization facility, partially offset by proceeds of \$41 million from the issuance of common stock. The fiscal 2003 use of cash primarily reflects the repayment of \$65 million in long-term debt, the majority of which is related to capital leases, and the net repayment of \$9 million under our accounts receivable securitization facility, partially offset by borrowings of \$20 million under an installment note and proceeds of \$26 million from the issuance of common stock.

We have outstanding \$372 million of 6.5% Convertible Subordinated Notes due December 15, 2009. Interest on the notes accrues at the rate of 6.5% per annum and is payable semi-annually on June 15 and December 15 of each year. Investors can convert the notes into shares of common stock at a conversion price of \$33.075 per share, subject to adjustment for certain events, at any time prior to maturity, unless previously redeemed or repurchased by us. We may redeem the notes in whole or in part at any time on or after June 20, 2007. In addition, upon a fundamental change in our company, we may be required to repurchase the notes at a price equal to 100% of the principal amount of the notes plus any accrued and unpaid interest.

We have pension plans covering substantially all U.S. employees, excluding management employees hired after June 30, 2003. The funding requirements related to our pension plans are dependent on many factors, including actuarial assumptions and the actual performance of our plan assets. We do not expect that we will be required to make any contributions to our pension plans in fiscal 2006; however, we may make voluntary contributions to our pension plans of approximately \$55 million.

At September 30, 2005, we do not have any assets that have been segregated to pay for postretirement medical benefits. Previously, we had a Voluntary Employee Benefit Association ( VEBA ) trust, but the net assets in the trust were depleted during fiscal 2005. In fiscal 2005, benefit payments for postretirement medical plans, net of employee contributions, were approximately \$26 million, with approximately \$6 million of that amount being paid from the VEBA trust. Since the VEBA trust has been depleted, future payments required for postretirement medical benefits will be paid out of cash on hand. Due to actions we have taken in fiscal 2005 and 2004 to reduce benefits provided under these plans,



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we expect our benefit payments to decrease slightly over the next ten years. For postretirement life benefits, we have a VEBA trust with approximately \$55 million of net assets at September 30, 2005. Benefits related to this plan will be paid out of the trust and the benefit payment amount is expected to slightly increase over the next ten years. We are exploring the possibility of transferring net assets from the retiree life plan's VEBA trust to the retiree medical plan's VEBA trust, but such a transaction would require the prior approval of the Internal Revenue Service and therefore, we can not be certain when or if this transaction will take place. For additional details on our postretirement benefit plans, including the timing and expected amounts of future benefit payments, See Note 12 to our financial statements in Item 8 for additional details.

Our primary source of liquidity is our cash and cash equivalents. We believe our cash and cash equivalents, together with our cash provided from operations, will be sufficient to meet our projected cash requirements for at least the next 12 months.

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### *Contractual Obligations*

The following table summarizes the payments due for specific contractual obligations. These amounts are as of September 30, 2005.

|                                 | Fiscal Years          |               |                  |                  |                   |
|---------------------------------|-----------------------|---------------|------------------|------------------|-------------------|
|                                 | Total                 | 2006          | 2007 and<br>2008 | 2009 and<br>2010 | 2011 and<br>Later |
|                                 | (dollars in millions) |               |                  |                  |                   |
| <b>Contractual obligations:</b> |                       |               |                  |                  |                   |
| Convertible subordinated notes  | \$ 372                | \$            | \$               | \$ 372           | \$                |
| Operating leases                | 92                    | 21            | 33               | 25               | 13                |
| Purchase obligations (1)        | 156                   | 101           | 55               |                  |                   |
| Other long-term liabilities (2) | 12                    | 5             | 7                |                  |                   |
| <b>Total</b>                    | <b>\$ 632</b>         | <b>\$ 127</b> | <b>\$ 95</b>     | <b>\$ 397</b>    | <b>\$ 13</b>      |

(1) Purchase obligations are defined as agreements to purchase goods or services that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable pricing provisions; and the approximate timing of the transactions. These obligations primarily relate to \$105 million for software licenses and maintenance, \$22 million for manufacturing related agreements and \$11 million for capital purchase obligations. The amounts are based on our contractual commitments; however, it is possible we may be able to negotiate lower payments if we choose to exit these contracts earlier.

(2) Other long-term liabilities consist of miscellaneous taxes.

Our material contractual obligations also include a commitment with SMP, a joint venture with Chartered Semiconductor. SMP operates a 54,000 square foot integrated circuit manufacturing facility in Singapore. We own a 51% equity interest in this joint venture, and Chartered Semiconductor owns the remaining 49% equity interest. We have an agreement with SMP under which we have agreed to purchase 51% of the managed wafer capacity and Chartered Semiconductor has agreed to purchase the remaining 49% of the managed wafer capacity. SMP determines its managed wafer capacity each year based on forecasts provided by Agere and Chartered Semiconductor. If we fail to purchase our commitments, we will be required to pay SMP for the fixed costs associated with the unpurchased wafers. Chartered Semiconductor is similarly obligated with respect to the wafers allotted to it. The agreement also provides that Chartered Semiconductor will have a right of first refusal to purchase integrated circuits produced in excess of our requirements. During the first quarter of fiscal 2005 Agere and Chartered Semiconductor agreed to waive the take or pay agreement. The agreement may be terminated after February 2008 by either party upon two years' written notice. The agreement may also be terminated for material breach, bankruptcy or insolvency.

We have pension plans covering substantially all U.S. employees, excluding management employees hired after June 30, 2003. Although future contributions are likely to be required, the amount and timing of these contributions will be impacted by actuarial assumptions, the actual rate of return on plan assets, the level of market interest rates, and the amount of voluntary contributions to the plans.

**Recent Pronouncements**

On December 8, 2003, President Bush signed into law the Medicare Prescription Drug, Improvement and Modernization Act of 2003. The Act expanded Medicare to include, for the first time, coverage for prescription drugs. In May 2004, the Financial Accounting Standards Board, or FASB, issued Staff Position No. FAS 106-2, *Accounting and Disclosure Requirements Related to the Medicare Prescription Drug, Improvement and Modernization Act of 2003* or FSP 106-2. FSP 106-2 provides guidance on the effects of the Act. We have concluded that the Act will have no effect on our financial condition or results of operations.

In October 2004, President Bush signed into law the American Jobs Creation Act of 2004, or AJCA. In response to the AJCA, in December 2004 the FASB issued Staff Position No. FAS 109-1, *Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004*, or FSP 109-1 and Staff Position No. FAS 109-2, *Accounting and Disclosure*

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*Guidance for the Foreign Earnings Repatriation Provision within the American Jobs Creation Act of 2004*, or FSP 109-2. FSP 109-1 clarifies that the manufacturer's deduction provided for under the AJCA should be accounted for as a special deduction in accordance with SFAS 109 and not as a tax rate reduction. We currently do not expect to realize any benefit related to this provision. FSP 109-2 provides guidance under SFAS 109, *Accounting for Income Taxes* or SFAS 109 with respect to recording the potential impact of the repatriation provisions of the AJCA on companies' income tax expense and deferred tax liability. FSP 109-2 states that an enterprise is allowed time beyond the financial reporting period of enactment to evaluate the effect of the AJCA on its plan for reinvestment or repatriation of foreign earnings for purposes of applying SFAS 109. We do not plan to repatriate any foreign earnings pursuant to the repatriation provisions of the AJCA and, therefore, we have not adjusted our tax expense or deferred tax liability to reflect these provisions of the AJCA.

In November 2004, the FASB issued Statement No. 151, *Inventory Costs – an amendment of ARB No. 43, Chapter 4*, or SFAS 151, which clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material. Among other provisions, the new rule requires that items such as idle facility expense, excessive spoilage, double freight, and rehandling costs be recognized as current period charges regardless of whether they meet the criterion of "so abnormal" contained in Accounting Research Bulletin No. 43 *Restatement and Revision of Accounting Research Bulletins*. Additionally, SFAS 151 requires that the allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. SFAS 151 is effective for fiscal years beginning after June 15, 2005 and is required to be adopted by us in the first quarter of fiscal 2006. We have completed our evaluation of the impact that adoption of SFAS 151 could have and have concluded that such impact will not be significant to our financial position or results of operations.

In December 2004, the FASB issued Statement No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123R, which replaces SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board No. 25, *Accounting for Stock Issued to Employees*, or APB 25. Under the new standard, companies will no longer be allowed to account for stock-based compensation transactions using the intrinsic value method in accordance with APB 25. Instead, companies will be required to account for such transactions using a fair value method and to recognize the expense in the statements of operations. The adoption of SFAS 123R will require additional accounting related to the income tax effects of share-based payment arrangements and additional disclosure of their cash flow impacts. SFAS 123R also allows, but does not require, companies to restate prior periods. SFAS 123R is effective for periods beginning after June 15, 2005. Accordingly, we will adopt the provisions of SFAS 123R beginning October 1, 2005, using the modified prospective transition method, and will recognize share-based compensation cost on a straight-line basis over the requisite service periods of awards. Under the modified prospective method, non-cash compensation expense will be recognized for the portion of outstanding stock option awards granted prior to the adoption of SFAS 123R for which service has not been rendered, and for any future stock option grants. Although the adoption of SFAS 123R is not expected to have a significant effect on our financial condition or cash flows, we expect to record substantial non-cash compensation expense that will have a significant, adverse effect on our results of operations. We currently estimate that the effect on our results of operations could be as much as \$40 million for fiscal 2006. This is substantially less than the 2005 pro forma effect due to the full vesting in 2005 of stock options granted in fiscal 2001, and to the acceleration of certain unvested and out-of-the-money stock options in the fourth quarter of fiscal 2005. See Notes 2 and 10 to our financial statements in Item 8 for additional details.

In March 2005, the FASB issued Interpretation No. 47 *Accounting for Conditional Asset Retirement Obligations*, or FIN 47. FIN 47 clarifies that the term "conditional asset retirement obligation," as used in SFAS 143 *Accounting for Asset Retirement Obligations*, refers to a legal obligation to perform an asset retirement activity in which the timing or method of settlement are conditional on a future event that may or may not be within the control of the entity. FIN 47 also clarifies that we are required to recognize a liability for such an obligation when incurred if the liability's fair value can be reasonably estimated. FIN 47 will become effective no later than the end of the first fiscal year ending after December 15, 2005. Retrospective application for interim financial information is permitted, but is not required, and early application is encouraged. We do not expect that FIN 47 will have a significant effect on our financial condition or results of operations and are evaluating the timing of our adoption of FIN 47.

In June 2005, the FASB issued Statement No. 154, *Accounting Changes and Error Corrections* a replacement of APB Opinion No. 20 and FASB Statement No. 3 or SFAS 154. SFAS 154 replaces Accounting Principles Board Opinion No. 20, *Accounting Changes* or APB 20, and SFAS No. 3, *Reporting Accounting*

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*Changes in Interim Financial Statements.* SFAS 154 requires retrospective application to prior periods financial statements of a voluntary change in accounting principle unless it is impracticable to determine either the period-specific effects or the cumulative effects of the change. APB 20 previously required that most voluntary changes in accounting principle be recognized by including in net income of the period of the change the cumulative effect of changing to the new accounting principle. This standard will not apply generally with respect to the adoption of new accounting standards, as new accounting standards usually include specific transition provisions, and will not override transition provisions contained in new or existing accounting literature. SFAS 154 is effective for fiscal years beginning after December 15, 2005, and early adoption is permitted for accounting changes and error corrections made in fiscal years beginning after that SFAS 154 was issued. We are evaluating the timing of our adoption of SFAS 154 but do not expect that it will have a material effect on our financial condition or results of operations.

#### **Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

##### **Risk Management**

We are exposed to market risk from changes in foreign currency exchange rates and interest rates that could impact our results of operations and financial position. We manage our exposure to these market risks through our regular operating and financing activities and, when deemed appropriate, through the use of derivative financial instruments. We use derivative financial instruments as risk management tools and not for speculative purposes. In addition, derivative financial instruments are entered into with a diversified group of major financial institutions in order to manage our exposure to nonperformance on such instruments. Our risk management objective is to minimize the effects of volatility on our cash flows by identifying the recognized assets and liabilities or forecasted transactions exposed to these risks and appropriately hedging the risks.

We may use foreign currency forward contracts to manage the volatility of non-functional currency cash flows resulting from changes in exchange rates. Foreign currency exchange contracts are designated for recorded, firmly committed or anticipated purchases and services. The use of these derivative financial instruments allows us to reduce our overall exposure to exchange rate movements, since the gains and losses on these contracts substantially offset losses and gains on the assets, liabilities and transactions being hedged. As of September 30, 2005, we did not have any foreign exchange contracts outstanding.

While we hedge certain foreign currency transactions, any decline in value of non-U.S. dollar currencies may, if not reversed, adversely affect our ability to contract for product sales in U.S. dollars because our products may become more expensive to purchase in U.S. dollars for local customers doing business in the countries of the affected currencies.

As of September 30, 2005, we had \$372 million of fixed rate long-term convertible notes outstanding. Interest rate changes and changes in the value of our common stock would likely result in changes in the market value of these notes. The fair value of these notes was \$373 million at September 30, 2005. We performed a sensitivity analysis on our fixed rate long-term convertible debt to assess the risk of changes in fair value. The model to determine interest rate sensitivity assumes a hypothetical 150 basis point shift in interest rates, while keeping the price of our common stock constant. At September 30, 2005, assuming a 150 basis point increase in interest rates, the fair value of the notes would decrease by \$19 million. Conversely, a 150 basis point decrease in interest rates at September 30, 2005, would increase the fair value of the notes by \$21 million. The model to determine equity price sensitivity assumes a hypothetical 10% change in the price of our common stock, while keeping the interest rate constant. At September 30, 2005, assuming a 10% increase in the price of our common stock, the fair value of the notes would increase by \$2 million. Conversely, a 10% decrease in the price of our common stock would result in the fair value of the notes decreasing by \$1 million.

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#### **Item 8. Financial Statements and Supplementary Data**

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**Report of Independent Registered Public Accounting Firm**

To the Board of Directors and  
Stockholders of Agere Systems Inc.:

We have completed an integrated audit of Agere Systems Inc.'s 2005 consolidated financial statements and of its internal control over financial reporting as of September 30, 2005 and audits of its 2004 and 2003 consolidated financial statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Our opinions, based on our audits, are presented below.

**Consolidated financial statements**

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Agere Systems Inc. and its subsidiaries (the Company) at September 30, 2005 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2005 in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit of financial statements includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 17 to the consolidated financial statements, the Company changed its method of accounting for asset retirement obligations as of October 1, 2002.

**Internal control over financial reporting**

Also, in our opinion, management's assessment, included in Management's Report on Internal Control Over Financial Reporting appearing under Item 9A, that the Company maintained effective internal control over financial reporting as of September 30, 2005 based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), is fairly stated, in all material respects, based on those criteria. Furthermore, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of September 30, 2005, based on criteria established in Internal Control - Integrated Framework issued by COSO. The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express opinions on management's assessment and on the effectiveness of the Company's internal control over financial reporting based on our audit. We conducted our audit of internal control over financial reporting in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. An audit of internal control over financial reporting includes obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we consider necessary in the circumstances. We believe that our audit provides a reasonable basis for

our opinions.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

PricewaterhouseCoopers LLP  
New York, New York  
November 18, 2005