

ATHEROS COMMUNICATIONS INC  
Form 10-K  
March 10, 2006  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM 10-K**

(Mark One)

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

For the fiscal year ended December 31, 2005

OR

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

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

Commission File No. 0-50534

**ATHEROS COMMUNICATIONS, INC.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of

incorporation or organization)

**5480 Great America Parkway, Santa Clara, CA 95054-3644**

(Address of principal executive offices, Zip Code)

**(408) 773-5200**

(Registrant's telephone number, including area code)

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

**None**

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

**Common stock, \$0.0005 par value per share**

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

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

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 Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

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

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant was approximately \$281,063,202 based upon the closing price of \$8.06 of such common stock on the Nasdaq National Market on June 30, 2005 (the last business day of the registrant's most recently completed second quarter). Shares of common stock held as of June 30, 2005 by each director and executive officer of the registrant, as well as shares held by each holder of 5% of the common stock known to the registrant, have been excluded for purposes of the foregoing calculation. This determination of affiliate status is not a conclusive determination for other purposes.

As of February 28, 2006, there were 50,814,323 shares of common stock of the registrant outstanding.

### **DOCUMENTS INCORPORATED BY REFERENCE:**

Items 10 (as to directors, executive officers and Section 16(a) Beneficial Ownership Reporting Compliance), 11, 12 (as to beneficial ownership), 13 and 14 of Part III incorporate by reference information from the registrant's Definitive Proxy Statement to be filed with the Securities and Exchange Commission in connection with the registrant's 2006 Annual Meeting of Stockholders to be held on May 24, 2006.

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**ATHEROS COMMUNICATIONS, INC.**

**PART I**

**Item 1. Business**

*When used in this Report, the words will, shall, may, expects, anticipates, intends, estimates, plans, believes, and similar expressions are intended to identify forward-looking statements. These are statements that relate to future periods and include statements about our future results, sources of revenue, market trends, technological developments, the features, benefits and performance of our current and future products, future price reductions, our dependence on any one third party license, benefits of open source license agreements, our competitive status, our original design manufacturer customer base, our sales in Asia, our dependence on our senior management and our ability to attract and retain key personnel, potential litigation, the effects of government regulations, our compliance with laws and regulations related to our encryption technologies, our participation in wireless standards bodies and the effects of the adoption of standards, the expected benefits of our intellectual property, our future office space needs, our expected future expenditure levels for research and development, sales and marketing, and general and administrative expenses, our future capital expenditures, our future liquidity and cash needs, future acquisitions of and investments in complimentary businesses, and the expected impact of various accounting policies and rules adopted by the Financial Accounting Standards Board. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those projected. These risks and uncertainties include, but are not limited to, factors affecting our quarterly results, our ability to manage our growth, our ability to sustain or increase profitability, demand for our chipsets, the effect of declines in average selling prices for our products, our ability to compete, our ability to rapidly develop new technology and introduce new products, our ability to safeguard our intellectual property, trends in the semiconductor industry and fluctuations in general economic conditions, and the risks set forth throughout this Report, including under Item 1, Business and under Item 1A, Risk Factors. These forward-looking statements speak only as of the date hereof. We expressly disclaim any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in our expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.*

In this Report, references to Atheros, we, us, our or the Company mean Atheros Communications, Inc. and its subsidiaries, except where it is made clear that the term means only the parent company.

Atheros, Super G, Super AG, XR, eXtended Range, VLocity MIMO, VLocity Video and XSPAN are our trademarks. We also refer to trademarks of other corporations and organizations in this document.

**Overview**

We are a leading developer of semiconductor system solutions for wireless communications products. We combine our wireless systems and software expertise with high-performance radio frequency, mixed signal and digital semiconductor design skills to provide highly integrated chipsets that are manufacturable on low-cost, standard complementary metal-oxide semiconductor, or CMOS, processes.

We provide a comprehensive portfolio of multi-chip and single chip products ranging from entry-level wireless networking products for the home and small office markets to sophisticated wireless infrastructure systems-on-chip with advanced network management capabilities for the

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enterprise market. Our wireless systems solutions target applications in the personal computer, enterprise access, small office and home networking, mobile communications and consumer electronics markets supporting the Institute of Electrical and Electronics Engineers, or IEEE, family of wireless local area networking, or WLAN, standards, including the 802.11b, 802.11g, 802.11a and anticipated 802.11n standards.

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In addition, since June 2005 we have been shipping our single chip cellular solution for Personal Access Systems, or PAS, also referred to as Personal Handyphone Systems. Our PAS solution targets handset and base station products for use primarily in the China market.

We were incorporated as T-Span Systems Corporation in Delaware in May 1998. In May 2000, we changed our corporate name to Atheros Communications, Inc.

Our website address is <http://www.atheros.com>. The information contained in our website does not form any part of this Annual Report on Form 10-K. However, we make available free of charge through our website our annual reports 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) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file this material with, or furnish it to, the SEC.

## **Our Products and Technology**

We are shipping production volumes of our seventh generation of semiconductors, hardware designs and software for wireless LAN applications, as well as of our first generation cellular solution for the PAS market. We offer customers guidelines known as reference designs that can be used to design a wide variety of systems, including networking cards and access points, mobile devices and handsets. Our wireless LAN solutions provide basic standards-compliant connectivity and other features such as substantial throughput enhancement and range enhancement, supporting video, voice and outdoor broadband access. Our products support several encryption and authentication security standards, network management protocols, operating systems, and interfaces to non-computing environments, such as consumer electronics. Our highly integrated PAS solution is used in both handset and base station products sold primarily in the China market. Our PAS product allows service providers in China to transition their network capabilities from wireline to wireless, allowing them to offer both mobile wireless voice and data services within a city or community.

We currently provide wireless system solutions based on four types of semiconductors:

*Radio-on-a-chip, or RoC*, is a radio transmitter and receiver for either or both of the frequency bands in which our products operate and is primarily an analog radio frequency, or RF, circuit.

*MAC + Baseband* is an implementation of mixed signal circuitry containing low frequency analog circuits and data converters integrated with a digital interface, media access controller, or MAC, and baseband processor. The MAC contains a silicon implementation to support the protocol for network communications.

*Wireless system-on-a-chip, or WiSoC*, incorporates a MAC + baseband integrated with a network processor and network interfaces, which are otherwise typically separate components. The processor is a digital device and is integrated to reduce the cost of the solution in an infrastructure product (access point, gateway, or router).

*Single chip solutions* are highly integrated, complete wireless solutions, including one or more radios-on-a-chip, media access controllers, baseband processors, and optionally, a network processor and network interfaces. These devices encapsulate substantially all of the digital and analog circuitry within a single chip.

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Our WLAN customers can use a variety of combinations of our chips to create differentiated client and access products to meet the needs of the specific market segment that they address, and our PAS customer benefits from our single chip solution.

Client devices typically include a single RoC or multiple RoCs combined with a single MAC + baseband, or are a single chip solution.

Infrastructure devices usually include single or multiple RoCs and a WiSoC, which implements the MAC + baseband section with an integrated microprocessor, or are a single chip solution.

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Handset and base station devices for the PAS network implement our single chip solution with an integrated cellular transceiver, baseband, application processor, audio paths, power management, keyboard, speaker and display interfaces.

Our WLAN products not only meet the appropriate IEEE 802.11 WLAN standards for which they are designed, but also offer enhanced capabilities that benefit the users with enhanced performance and functionality. Some of the key features are:

*Super G<sup>®</sup> and Super AG<sup>®</sup>* are performance enhancing extensions that allow our products with 802.11g and 802.11a WLAN capabilities to operate at link rates of up to 108 Mbps, twice the industry standard maximum link rate of 54 Mbps, while maintaining the ability to work at industry standard data rates. We achieve this by adapting the operating protocols to maximize throughput based on several advanced signaling technologies.

*Atheros eXtended Range<sup>®</sup>, or Atheros XR<sup>®</sup>,* is a range enhancing extension that can more than double the distance at which an Atheros client device can maintain a connection with an Atheros access point minimizing dead spots and providing better coverage in large homes from a single access point. We achieve this by adapting the OFDM algorithms in the baseband to increase the sensitivity of the receiver when the signal level is too low for standard operation.

*XSPAN , VLocity MIMO , and VLocity Video* take advantage of multiple radio, smart antenna technologies including multiple-input multiple-output, or MIMO, designs to increase the performance of wireless networks. Our XSPAN family of products is designed to meet the draft 802.11n specification recently approved by the IEEE. Our first XSPAN solution uses a triple radio RF design and delivers up to 300 Mbps physical data rate, with real end user throughput of 150-180 Mbps.

*Power Management Technology* enables our products to use significantly less power in the transmit, receive and sleep operating modes, which offers the benefit of longer battery life for the access device. This is achieved by monitoring functions and using custom timing circuits to keep non-active circuitry in sleep mode when possible.

We are actively developing new extensions to further benefit users as the standards continue to evolve.

We believe that wireless LANs and other wireless products will continue to improve by transitioning from multi-chip systems to more highly integrated systems providing radio, baseband and MAC functionality on a single silicon chip such as those offered by us. We have released in volume a family of single chip wireless LAN solutions, and expect to continue to both integrate additional functionality in these solutions as well as develop single chip solutions for other markets.

In addition, in 2005 we introduced our cellular solution for the PAS cellular market. Our solution consists of a single chip that implements a complete cellular transceiver, baseband, application processor, audio paths, power management, keyboard, speaker and display interfaces. PAS, which is widely deployed in China, Japan and Taiwan, is an advanced Time Division Multiple Access-Time Division Duplex, or TDMA-TDD, technology operating at 1.9 gigahertz, or GHz, providing high quality voice, advanced data services and long battery life. Our unique, highly integrated single chip solution for PAS products provides full support for the PAS networking standard and a robust set of product features at a competitive price.

To enable our customers to easily incorporate our wireless systems solutions into their products, we support a network of authorized design centers and contract engineering firms based in the United States, Europe and Japan that we have trained in the use of our tools and technologies. These design centers have enabled our customers to introduce a number of products based upon our wireless system solutions, extending our market reach. In addition, we provide technical and design support to our customers developing products based on our chips through our main office in Santa Clara, California and our local offices throughout Asia.





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### Customers

We sell our products directly to original equipment manufacturers, or OEMs, who include our chipsets in their products, and to original design manufacturers, or ODMs, who in turn include our chipsets in products they supply to OEMs. For direct sales to OEMs, we incorporate our wireless system solutions directly into the OEMs' products, and the OEM is the licensee and the end-user of the technology. However, we primarily sell directly to ODMs, as many OEMs choose to specify an ODM to integrate our technology in a module, such as a peripheral component interconnect, or PCI, card, which is then delivered to the OEM customer. For OEMs who use an ODM as an intermediary, our shipments and revenue are directly with the ODM. However, we attempt to maintain close relationships with the target OEM and the initial technology design win is generally awarded by the OEM. We also have ongoing contact with the OEM for forecasting and technology update purposes. Currently, our target markets include the retail wireless networking, personal computer OEM, enterprise and carrier infrastructure equipment, mobile communications, and consumer electronics markets.

In 2005, Alpha Networks, Inc., Hon-Hai Precision Industry, Cameo Communications, Inc., and Askey Computer Corporation accounted for 15%, 15%, 13% and 10% of our net revenue, respectively. In 2004, Hon-Hai Precision Industry, Askey Computer Corporation, Cameo Communications, Inc. and Alpha Networks, Inc. accounted for 23%, 17%, 12% and 10% of our net revenue, respectively. In 2003, Cameo Communications, Inc. and Hon Hai Precision Industry accounted for 28% and 20% of our net revenue, respectively.

Substantially all of our sales are to customers outside the United States and Canada. Sales to customers in Asia accounted for 96% of net revenue in 2005 and 98% of net revenue in each of 2004 and 2003. Sales to customers in Taiwan accounted for 70%, 86% and 88% of our net revenue in 2005, 2004 and 2003, respectively.

While we primarily sell directly to ODMs, on the purchase order submitted by the ODM they generally identify for whom they are purchasing our product. We do not have the ability to directly confirm with the sell-through party that they received the final product from the ODM. Based on the sell-through information provided to us by the ODMs, the following companies or their subsidiaries are among those that have incorporated Atheros products through ODMs during the year ended December 31, 2005:

2Wire, Inc.

3Com Corporation

Acer Co. Ltd

Belkin Corporation

Buffalo, Inc.

Cisco Systems, Inc. (including The Linksys Group, Inc.)

Corega

D-Link Corporation

Fujitsu Limited

Hewlett-Packard Company

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Lenovo (Singapore) PTE Ltd (formerly IBM Singapore PTE Ltd)

NEC Electronics Corporation

NETGEAR, Inc.

Oki Electric Industry Co., Ltd.

Proxim, Inc.

Siemens AG

Sony Corporation

Toshiba Corporation

TP-LINK Technologies Co. Ltd.

UTStarcom, Inc.

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### **Sales and Marketing**

We have a direct sales staff in the United States and Asia who support our major OEM and ODM customers. We have strategically located this organization near our major customers with offices in California, China, Japan, Hong Kong, Korea and Taiwan. Each salesperson has specific end-user market expertise.

We also have field application engineers, or FAEs, who provide technical support and assistance to existing and potential customers in designing, testing and qualifying systems that incorporate our products. Our FAE organization is segmented by end-user market as well as the core competencies in hardware, software and radio frequency necessary to support our customers.

To supplement our direct sales, we have independent sales representatives with locations throughout the world. We selected these independent representatives based on their ability to provide effective field sales, marketing communications and technical support for our products. Our customers place orders directly with us rather than with the representatives, and our representatives do not generally maintain product inventory.

Our third-party design centers provide expertise in RF design, board layout, operating system and driver development, industrial design and prototyping to customize our software or hardware for smaller customers' requirements. These third-party design centers typically provide their services on a contract engineering basis and enable rapid time-to-market in areas of expertise.

In addition to providing chipsets, we also license software in source code form to some of our customers. Since the licensing of software in source code requires that we enter into a technology license directly with end customers, we usually maintain a direct relationship with the end customer whether they have purchased chipsets directly from us or through one of our ODMs or independent representatives. Contractual obligations of our licensees not to disclose or misuse our source code may not sufficiently protect us from misuse or disclosure of our intellectual property. The costs of enforcing contractual rights could substantially increase our operating costs and may not ultimately succeed in protecting our proprietary rights. If our competitors access our source code, they may gain further insight into our technology and duplicate or design around our products, which would harm our competitive position.

Our marketing group focuses on our product strategy, product development road maps, new product introduction process, demand assessment, competitive analysis, customer application support, customer program management and corporate communications. The group also ensures that product development activities, product launches, channel marketing program activities, and ongoing demand and supply planning occur in a well-managed, timely basis in coordination with our development, operations, and sales groups, as well as our ODMs, OEMs and representatives.

Our sales are made primarily pursuant to standard purchase orders. Because industry practice allows customers to reschedule or cancel orders on relatively short notice, we believe that backlog is not a good indicator of our future sales.

Our net revenue consisted of sales to customers in the following countries for the periods indicated in the following table:

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	Year Ended December 31,		
	2005	2004	2003
Taiwan	70%	86%	88%
China	16	3	
United States	3	1	1
Other	11	10	11

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### **Regulatory Environment and Industry Standards**

Our products and our customers' products transmit and receive radio signals across both licensed and unlicensed, regulated spectrum. To certify our products for use in a broad geographic market, we maintain communication with a variety of government and certification agencies in the United States and international markets, including, but not limited to, Japan, China, Taiwan, Korea, France, Germany and the United Kingdom. As the wireless communications market is particularly influenced by regulations and policy on spectrum allocations and licensing provisions, this direct contact gives us insight into market requirements and appropriate product plans. We have developed and obtained necessary certifications for certain proprietary technologies and algorithms that enable our products to roam between and adapt to various standards and to international regulatory and operational requirements. These technologies are not necessarily exclusive to us, but have been refined by us and are a requirement for many multinational equipment manufacturers.

We intend to participate in, support our employees' participation in, or monitor, as appropriate, the activities of various standards bodies, including the IEEE standards group, the European Telecommunications Standards, or ETSI, the International Telecommunications Union, or ITU, the WiFi Alliance, WiMax, a nonprofit group formed to create and promote the development of IEEE wireless broadband standard 802.16, Mobile Internet Technical Architecture, or MITA, and the Digital Living Networking Alliance, or DLNA.

The rights to use spectrum are subject to changes made by the government entities that allocate and regulate radio spectrum. Changes in United States and international spectrum policy may limit or prevent our ability to sell products, require substantial engineering effort and expense to address and work around any such changes, and substantially and adversely affect future revenue. In addition, our products and our customers' products could be denied the regulatory certifications required to sell these products.

Our products include encryption technologies that are regulated by the U.S. and foreign governments. We believe we are in compliance with all export and import laws and regulations related to our encryption technologies. However, these laws and regulations may change and limit our ability to continue to export and import our products internationally until we can adapt to these changes.

### **Intellectual Property**

Our success will depend in part on our ability to protect our intellectual property. We rely on a portfolio of intellectual property rights, both foreign and domestic, including patents, trademark registrations, copyright rights, trade secrets, contractual provisions and licenses to protect our intellectual property. Many of our issued patents and pending patent applications relate to algorithms, integrated circuit, or IC, designs, software and systems related to wireless communications and networking, with a focus on innovations we believe we have achieved in our implementations of industry standards-compliant wireless networking.

#### ***Patents***

As of December 31, 2005, we held 50 U.S. issued patents and 95 pending U.S. patent applications. We continue to pursue actively the filing of additional patent applications in both the United States and foreign jurisdictions. Our domestic patents and applications have expiration dates from September 2019 through December 2025.

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We may not receive competitive advantages from the rights granted under our patents and other intellectual property rights. Our continued success and future growth is based on execution capability, technical expertise, speed of implementation and process management abilities of our employees and our ability to defend our intellectual property. Our existing and future patents may be circumvented, blocked, licensed to others or challenged as to inventorship, ownership, scope, validity or enforceability. It is possible that literature we may be advised of by third parties in the future could negatively affect the scope or enforceability of either our present or future patents. Furthermore, our pending and future patent applications may not issue with the scope of claims sought by us, if at all, or the scope of claims we are seeking may not be sufficiently broad to protect our proprietary technologies.

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Others may develop technologies that are similar or superior to our proprietary technologies, duplicate our proprietary technologies or design around the patents owned or licensed by us. If our products, patents or patent applications are found to conflict with any patents held by third parties, we could be prevented from selling our products, our patents may be declared invalid or our patent applications may not result in issued patents. In addition, in foreign countries, we may not receive effective patent and trademark protection. We cannot be sure that steps we take to protect our proprietary technologies will prevent misappropriation of our technologies.

### ***Intellectual Property Litigation***

The wireless communications industry is characterized by frequent litigation and other vigorous protection and pursuit of intellectual property rights or positions. There are also numerous patents in the wireless communications industry and new patents are being issued at a rapid rate. This often results in significant and often protracted and expensive litigation. Questions of infringement in the wireless market involve highly technical and subjective analyses. Litigation may be necessary in the future to enforce any patents we may be granted and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity, and we may not prevail in any future litigation. In the last few years, we and our customers have received several written notices and license offers from research institutions, intellectual property holding firms, our competitors and others claiming to have patent and other intellectual property rights that apply to the IEEE family of wireless local area networking standards, including the 802.11a, 802.11b, 802.11e, 802.11g and 802.11n wireless standards, as well as other intellectual property relevant to our chips, software and system solutions. These notices or offers have been made directly to us and through our U.S. and foreign customers. We have responded directly, or indirectly through our customers, to these notices, and continue to correspond regarding the offers with some of the parties that have sent the notices. In addition, at least two of our customers have been sued in the U.S. for allegedly infringing patents related to 802.11a, 802.11b and 802.11g technology. Neither that litigation nor any of these notices has to date resulted in litigation directly against us. We have received legal advice and opinions from our patent counsel regarding these matters. We believe that the rights offered are either already licensed to us or our products do not infringe any valid claim to the issued patents identified to date. We cannot assure you that any of these or other third-parties will not pursue litigation or assert their patent and other intellectual property rights against us in the future. We have certain indemnification obligations to customers with respect to infringement of third-party patents and intellectual property rights by our products. We cannot assure you that our potential obligations to indemnify such customers will not harm us, our business or our financial condition and results of operations. The results of any litigation are inherently uncertain. Any successful infringement claim or litigation against us or our customers could have a significant adverse impact on our business.

If it is necessary or desirable, we may seek licenses under third-party patents or other intellectual property rights. However, we cannot be sure that third parties will offer licenses to us or that we will find and secure acceptable terms for any offered licenses. If we fail to obtain a license from a third party for proprietary technologies that we use, we could incur substantial liabilities, or suspend sales or use of our products or our use of processes requiring the technologies. Whether or not any litigation is determined in our favor or settled, it could cause us to incur significant expenses, harm our sales of the challenged technologies or products and divert the attention and efforts of our technical and management personnel, whether or not a court decides the litigation in our favor. Adverse determinations in litigation could result in the loss or impairment of our proprietary rights, subject us to significant liabilities and money damages, require us to seek licenses from third parties, cause us to spend significant resources and revenues to design around or develop non-infringing technology, or prevent us from licensing our technology or selling our products, any of which could harm our business.

### ***Copyrights and Trademarks***

We claim copyright and trademark protection for proprietary documentation and a variety of branding marks. We also pursue foreign copyrights and trademarks where applicable and necessary. The branding marks are sublicensed to our customers and used by them to identify and promote their products capabilities in markets, including, but not limited to, computing and consumer electronics. As of December 31, 2005, we held ten registered U.S. trademarks.





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### ***Licenses***

We also rely on third-party licensors for certain technologies embedded in our semiconductor, hardware and software designs. These are typically non-exclusive contracts for general capabilities provided under royalty-accruing or paid-up licenses. These licenses are generally perpetual or automatically renewed for so long as we continue to pay any royalty that may be due. We have entered into a number of licensing arrangements pursuant to which we license third-party technologies. We do not believe our business is dependent to any significant degree on any individual third-party license.

We generally enter into confidentiality agreements with our employees, vendors, industry partners and customers, as well as generally control access to and distribution of our documentation and other proprietary information. Despite this protection, unauthorized parties may copy aspects of our current or future products or obtain and use information that we regard as proprietary.

Certain software compatible with our chipsets has been made available to others through open source licensing agreements. We believe that this has been a source of benefit and differentiation as it expands the market for our products and enables these products to benefit from the design efforts of the open source community. This practice does provide to others some level of insight into the design and the features of our products, although we maintain and retain proprietary rights to the substantial portion of our wireless capabilities.

### **Research and Development**

We engage in substantial research and development to develop new products and integrate additional capabilities in our core wireless designs. We conduct research into digital and analog IC design, hardware reference board design, software reference code development, systems integration and manufacturing process flow development at our corporate headquarters. We also perform test emulation, digital design verification and application software development at our offices in India. We use a number of proprietary design tools and processes that enable us to deliver high-performance wireless capabilities using low-cost manufacturing facilities. We employ a team of engineers with extensive experience in mixed signal design, systems and communications architecture, CMOS technology and software development. Our research and development expense was \$46.7 million in 2005, \$41.5 million in 2004 and \$29.1 million in 2003.

### **Manufacturing**

We design and develop our proprietary designs and provide them to third-party foundries, contract manufacturers, ODMs, assembly and test companies and other licensees and contractors to produce silicon wafers and semiconductors. We produce a variety of digital, analog and mixed-signal chip designs using standard CMOS production facilities. The use of this process enables us to produce cost-effective products, and we have proprietary rights to the particular design methodologies that we use to maintain high-performance levels on generic processes.

We currently have in production products using 0.13-micron, 0.18-micron, and 0.25-micron process geometries for wafer production at Taiwan Semiconductor Manufacturing Corporation, or TSMC, in Taiwan, and we are also using a 0.18-micron process at Semiconductor Manufacturing International Corporation, or SMIC, in Shanghai, China and at Tower Semiconductor Ltd. in Israel. We also qualify and package wafers and test packaged units at multiple locations, including, but not limited to, Amkor Technology Inc. (China and Korea), ASAT Holdings Limited (China and Hong Kong), Siliconware Precision Industries Co., Ltd. (Taiwan) and STATS ChipPAC Limited (Singapore). We store and distribute our inventory from a contracted warehouse in Singapore.

We also maintain software test facilities at both our corporate headquarters and at our research and development facility in India. This enables us to operate certain test processes on demand, so as to reduce the time-to-market of our designs and improve their reliability.

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### **Competition**

The retail wireless networking, personal computer OEM, enterprise and carrier infrastructure equipment, mobile communications, and consumer electronics markets are intensely competitive with a variety of large and small companies providing semiconductors, hardware and software designs. We believe that our focus on wireless technology has enabled us to compete favorably with respect to the following factors:

product performance;

feature set and quality, including network throughput, product range, power efficiency, security features, reliability and consistency;

level of integration;

time-to-market;

price;

customer support and application support; and

ability to comply with, and influence, industry standards and international regulatory requirements.

We compete with large semiconductor manufacturers and designers and start-up semiconductor design companies as well as large, established suppliers. Our primary competitors include Broadcom Corporation, Conexant Systems, Inc., Intel Corporation, Marvell Technology Group Ltd. and Texas Instruments Incorporated. All of our primary competitors and many of our other current and potential competitors have longer operating histories, significantly greater resources and name recognition, and a larger base of customers than we do. Many of our competitors also have significant influence in the semiconductor industry. We may not be able to compete effectively against current and potential competitors, especially those with significantly greater resources and market leverage. As a result, these competitors may respond more quickly than we do to new or emerging technologies or changes in customer requirements. Moreover, our competitors may foresee the course of market developments more accurately than we can. In addition, some of our larger competitors may be able to provide greater incentives to customers through rebates and marketing development funds and similar programs. Furthermore, some of our competitors with multiple product lines may integrate wireless functionality into products that we do not sell or bundle their products to offer a broader product portfolio, which may make it difficult for us to gain or maintain market share. For example, Intel markets its Centrino mobile technology brand and we believe Intel provides a substantial marketing development fund incentive for buyers of a combination of its microprocessor, a related chipset and an 802.11 wireless network module that uses the brand. We believe a separate WLAN chipset solution offers advantages compared to a solution integrated with other communications protocols because of the rapid changes in WLAN technologies that occur on a different cycle than those of other communications technologies and due to the significant differences in the performance available from standalone solutions. Our competitors may be able to adopt more aggressive pricing policies and devote greater resources to the development, promotion and sale of their products than we can. In addition, new competitors, including lower cost Asian semiconductor companies or alliances among existing competitors, could emerge.

Many of our customers are also large, established integrated circuit suppliers. Our sales to and support of such customers may enable them to become a source of competition to us, despite our efforts to protect our intellectual property rights. Competition could increase pressure on us to lower our prices and lower our margins. If we do not compete successfully, we will be unable to gain or retain market share.

**Employees**

As of December 31, 2005, we employed 327 full-time employees, including 224 in research and development and operations, 69 in sales and marketing, and 34 in general and administration. We have never had a work stoppage and none of our employees is represented by a labor organization nor under any collective bargaining arrangements. We consider our employee relations to be good.

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

*Fluctuations in our operating results on a quarterly and annual basis could cause the market price of our common stock to decline.*

Our revenue and operating results have fluctuated significantly from period to period in the past and are likely to do so in the future. These fluctuations could cause the market price of our common stock to decline. As a result, you should not rely on period to period comparisons of our operating results as an indication of our future performance. In future periods, our revenue and results of operations may be below the expectations of analysts and investors, which could cause the market price of our common stock to decline. Factors that are likely to cause our revenue and operating results to fluctuate include those discussed in the risk factors below.

*If demand for our chipsets declines or does not grow, we will be unable to increase or sustain our revenue and our business will be severely harmed.*

We derive substantially all of our revenue from the sale of chipsets for wireless applications. We currently expect our chipsets for wireless applications to account for substantially all of our revenue for the foreseeable future. If we are unable to develop new products in a timely manner or demand for our chipsets declines as a result of competition or technological changes, it would have a material negative impact on our business, operating results and financial position and our competitive position. The markets for our wireless networking products are characterized by frequent introduction of next generation and new products, short product life cycles and significant price competition. If our customers or we are unable to manage product transitions in a timely and cost-effective manner, our business and results of operations will suffer. In addition, frequent technology changes and introduction of next generation products may result in inventory obsolescence, which could reduce our gross margins and adversely affect our operating performance. Also, we are currently dependent on one customer for our single chip solution for PAS products. If we fail to maintain or grow our share of business with this customer and to win new customers for our PAS product, our revenue growth would be adversely affected.

*Since we have limited visibility as to the volume of sales of our products by our customers and inventory levels of our products held by our customers, our ability to forecast accurately future demand for and sales of our products is limited.*

We sell our chipsets to OEMs who integrate our chipsets into their products or to ODMs who include our chipsets in the products they supply to OEMs. We have limited visibility as to the volume of our products that our OEM and ODM customers are selling to their customers or carrying in their inventory. If our customers have excess inventory or experience a slowing of products sold through to their end customers, it would likely result in a slowdown in orders from our customers and adversely impact our future sales and inventory.

*Any future downturns in the semiconductor industry may reduce our revenue and result in excess inventory.*

The semiconductor industry is highly cyclical and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving standards, short product life cycles and wide fluctuations in product supply and demand. The industry has, from time to time, experienced significant downturns, often connected with, or in anticipation of, maturing product cycles of both semiconductor companies and their customers' products and declines in general economic conditions. These downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. Any future downturns may reduce our revenue or our percentage of revenue growth on a quarter-to-quarter basis and result in us having excess inventory. Furthermore, any upturn in

the wireless communications market in which we sell our chipsets could result in increased competition for access to limited third-party foundry, assembly and test capacity.

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*Although we achieved profitability in past quarters and in fiscal 2005 and 2004, we incurred a net loss in the second quarter of 2005, and we may incur losses in the future. Accordingly, we may not be able to generate sufficient revenue, or sufficiently control costs, in the future to sustain profitability.*

At December 31, 2005, we had an accumulated deficit of approximately \$57.1 million. During 2005, we incurred \$75.5 million in operating expenses and generated net income of \$16.7 million. During 2004, we incurred operating expenses of \$68.6 million and generated net income of \$10.8 million. We did, however, incur a net loss in the second quarter of 2005 and may incur losses in the future. To sustain profitability, we will need to maintain or increase our revenue while maintaining reasonable cost and expense levels. In addition, since we expect average selling prices of our products to continue to decrease in the future, we will need to continue to reduce the average unit costs of our products and increase sales volumes in our existing markets as well as successfully introduce additional products for new markets in order to maintain profitability. We expect to increase expense levels in absolute dollars in each of the next several quarters to support increased research and development efforts related to new and existing product development and sales and marketing efforts. Because many of our expenses are fixed in the short term, or are incurred in advance of anticipated sales, we may not be able to decrease our expenses in a timely manner to offset any shortfall of sales. We may not be able to sustain or increase profitability on a quarterly or an annual basis.

*The average selling prices of products in our markets have historically decreased rapidly and will likely do so in the future, which could harm our revenue and gross profits.*

The products we develop and sell, especially those for wireless networking solutions, are used for high volume applications and are subject to rapid declines in average selling prices. The average selling prices have historically decreased significantly in order to meet market demand, and we expect that we will continue to reduce prices in the future. Reductions in our average selling prices to one customer could impact our average selling prices to all customers. Historically, we have generally been able to substantially offset reductions in our average selling prices with decreases in our product costs and increases in our unit volumes. Our financial results will suffer if we are unable to offset any future reductions in our average selling prices by increasing our unit volumes, reducing our costs or developing new or enhanced products on a timely basis with higher selling prices or gross profit. While gross profit may decline as a result of reductions in average selling prices, we may continue to incur research and development costs at higher or existing levels to develop future products. This continued spending would have an adverse impact on our immediate operating results if our revenue does not continue to grow or our gross margins decline.

*We may not be able to compete effectively and increase or maintain revenue and market share.*

We may not be able to compete successfully against current or potential competitors. If we do not compete successfully, our market share and revenue may decline. We compete with large semiconductor manufacturers and designers and start-up integrated circuit companies. Most of our current and potential competitors have longer operating histories, significantly greater resources and name recognition and a larger base of customers than we do. This may allow them to respond more quickly than us to new or emerging technologies or changes in customer requirements. In addition, these competitors may have greater credibility with our existing and potential customers. Moreover, many of our competitors have been doing business with customers for a longer period of time and have established relationships, which may provide them with information regarding future trends and requirements that may not be available to us. In addition, some of our larger competitors may be able to provide greater incentives to customers through rebates and marketing development funds and similar programs. Some of our competitors with multiple product lines may bundle their products to offer a broader product portfolio or integrate wireless functionality into other products that we do not sell, which may make it difficult for us to gain or maintain market share. For example, Intel markets its Centrino mobile technology brand and we believe they provide a substantial marketing development fund incentive for buyers of a combination of its microprocessor, related chipsets and wireless networking module that use the brand. Intel or other large competitors may also be able to discourage OEMs from placing our brand on their products, which could substantially harm our marketing efforts.





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***We depend on key personnel and consultants to operate our business, and if we are unable to retain our current personnel and hire additional personnel, our ability to develop and successfully market our products could be harmed.***

We believe our future success will depend in large part upon our ability to attract and retain highly skilled managerial, engineering and sales and marketing personnel. The loss of any key employees or the inability to attract or retain qualified personnel, including engineers and sales and marketing personnel, could delay the development and introduction of, and harm our ability to sell, our products and harm the market's perception of us. We believe that our future success is highly dependent on the contributions of our senior management, including our President and Chief Executive Officer and our senior engineering personnel. We do not have long-term employment contracts with these or any other key personnel, and their knowledge of our business and industry would be extremely difficult to replace.

There is currently a shortage of qualified technical personnel with significant experience in the design, development, manufacture, marketing and sales of integrated circuits for use in wireless products. Our key technical personnel and consultants represent a significant asset and serve as the source of our technological and product innovations. We may not be successful in attracting and retaining sufficient numbers of technical personnel to support our business plan.

***We may not be able to sustain our recent growth rate, and we may not be able to manage our future growth effectively.***

We have experienced significant growth in a short period of time. Our revenue increased from \$169.6 million in 2004 to \$183.5 million in 2005 and our quarterly revenue increased from \$41.2 million in the first quarter of 2005 to \$53.1 million in the fourth quarter. We may not be able to achieve similar revenue growth rates for 2006 or in future periods. In the event that we do achieve continued growth, the expansion of our business and operations will likely place a significant strain on our resources and increased demands on our management information and reporting systems, financial and management controls and personnel. We may not be able to develop the internal capabilities or collaborative relationships required to manage future growth and expansion or to support future operations. If we are unable to manage growth effectively, our financial results could be adversely affected.

***If we fail to develop and introduce new products and enhancements for wireless applications or if our proprietary features do not achieve market acceptance on a timely basis, our ability to attract and retain customers could be impaired, and our competitive position may be harmed.***

The wireless communications market is characterized by rapidly changing technology, evolving industry standards, rapid changes in customer requirements and frequent product introductions. We must continually design, develop and introduce new products with improved features to be competitive. Our current and future products may not achieve market acceptance or adequately address the changing needs of the wireless market, and we may not be successful in developing and marketing new products or enhancements to our existing products on a timely basis. The introduction of products embodying new technologies, the emergence of new industry standards or changes in customer requirements could render our existing products obsolete and unmarketable. In addition, we introduce from time to time products with proprietary enhancements. Although we believe our products are fully compliant with applicable industry standards, proprietary enhancements may not in the future result in full conformance with existing industry standards under all circumstances. Our introduction of proprietary features involves risks associated with market acceptance of these new products and certification by industry standards groups. We have reviewed the rules and regulations of the various standards bodies and related industry organizations to which we belong or with which we are affiliated, and we believe there is not a significant risk that action would be taken that would undermine our ability to continue to leverage our affiliation with these organizations.

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The development of our products is highly complex. We occasionally have experienced delays in completing the development and introduction of new products and product enhancements, and we could

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experience delays in the future. Unanticipated problems in developing wireless products could also divert substantial engineering resources, which may impair our ability to develop new products and enhancements and could substantially increase our costs. Even if the new and enhanced products are introduced to the market, we may not be able to achieve market acceptance of these products and our proprietary features in a timely manner.

***We will continue to expend substantial resources developing products for new applications or markets and may never achieve the sales volume for these products that we anticipate, which may limit our future growth and harm our results of operations.***

With the exception of our new product for the PAS cellular handset market, all of our products introduced to date have been for use in wireless networking applications. Our strategy includes developing and introducing new products for use in applications other than wireless networking. Our future success will depend in part upon the success of any such products, and we face a number of risks in connection with these products, including those described in other risk factors in this report. We have in the past, and will likely in the future, expend substantial resources in developing new and additional products for new applications and markets. We may experience unforeseen difficulties and delays in developing these products and defects upon volume production and broad deployment. In addition, we have no experience in markets other than wireless networking and PAS, and may be unsuccessful in marketing and selling any products we develop. The markets we choose to enter will likely be highly competitive and many of our competitors will have substantially more experience in these markets. Our success will depend on the growth of the markets we enter, the competitiveness of our products and our ability to increase our market share in these markets. If we choose to enter markets that do not achieve or sustain the growth we anticipate, or if our products are not competitive, we may not achieve volume sales, which may limit our future growth and harm our results of operations.

***If our product for the PAS cellular market is not successful, or if the PAS cellular market does not grow, our future results will be harmed.***

We introduced a new product for the PAS cellular handset market and commenced shipments in the second quarter of 2005. Our future success will depend in part upon the success of this product, and we face a number of risks in connection with the product, including those described in the risk factors in this report. Since the product was recently developed, we may experience unforeseen defects in this product upon volume production and broad deployment. In addition, we have no experience in the cellular market, and may be unsuccessful in marketing and selling this product. The China PAS cellular market is dominated by a very small number of handset providers and to date we have relied solely on UTStarcom for sales of our new product. If these providers, and in particular UTStarcom, are not successful in this market, or if they do not choose to incorporate our products into a significant number of their handsets, we will not be successful in selling our product. In addition we have no control over UTStarcom's schedule for launching its products, and UTStarcom's initial launch of products using our PAS product was delayed from our prior expectations. Any further delay by UTStarcom would delay revenues for our PAS products and could adversely affect our quarterly operating results. In addition, the China PAS cellular market may stop growing or may contract as competing technologies, such as wideband cellular third generation technologies become available. The market for cellular handset semiconductors is highly competitive and many of our competitors have substantially more experience in this market. There are a number of cellular technologies, some of which have technological advantages over PAS, and the market for PAS cellular may not continue to grow or remain a successful technology. If this product is not successful, our future growth would be adversely affected and our future results harmed.

***Our PAS customer has trial licenses for PAS handsets in China.***

Our PAS customer has trial licenses for PAS systems and handsets. Our customer has applied for, but has not yet received, a final official network access license for its PAS systems and handsets, including handsets that include our chipsets. We understand that these PAS systems and handsets are considered to still be in the trial period and that sales of PAS systems and handsets may continue to be made by our customer during this trial



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period, but that licenses will ultimately be required. If our customer fails to obtain the required licenses, or if the trial period ends, it could be prohibited from making further sales of the unlicensed products in China, including PAS handsets that include our chipsets, which would substantially harm our business, financial condition and results of operations. The regulations implementing these requirements have not been applied by a court and may be interpreted and enforced by regulatory authorities in a number of different ways. China's governmental authorities may interpret or apply the regulations with respect to which licenses are required, and with respect to our customers' ability to sell a product while a product is in the trial period, in a manner that could have a material adverse effect on our business, financial condition and results of operations.

*We rely on a limited number of independent foundries and subcontractors for the manufacture, assembly and testing of our chipsets and on a third party logistics provider to ship products to our customers. The failure of any of these third-party vendors to deliver products or otherwise perform as requested could damage our relationships with our customers, decrease our sales and limit our growth.*

We do not have our own manufacturing or assembly facilities and have limited in-house testing facilities. Therefore, we must rely on third-party vendors to manufacture, assemble and test the products we design. We primarily rely on Taiwan Semiconductor Manufacturing Corporation in Taiwan, Semiconductor Manufacturing International Corporation in Shanghai, China and Tower Semiconductor Ltd. in Israel to produce our chips. We also rely on Amkor Technology, Inc. in China and Korea, ASAT Holdings Limited in China and Hong Kong, Siliconware Precision Industries Co., Ltd. in Taiwan, STATS ChipPAC Limited in Singapore and other third-party assembly and test subcontractors to assemble, package and test our products. In addition, we use JSI Shipping in Singapore to warehouse and ship our products to our customers. If these vendors do not provide us with high-quality products, services and/or production and test capacity in a timely manner, or if the relationship with one or more of these vendors is terminated, we may be unable to obtain satisfactory replacements and/or we may be unable to fulfill customer orders on a timely basis, our relationships with our customers could suffer, our sales could decrease and our growth could be limited.

*We face risks associated with relying on third-party vendors for the manufacture, assembly and testing of our chipsets.*

We face significant risks associated with relying on third-party vendors, including:

capacity shortages;

reduced control over product cost, delivery schedules and product quality;

potential price increases;

inability to achieve sufficient production, increase production or test capacity and achieve acceptable yields on a timely basis;

increased exposure to potential misappropriation of our intellectual property;

shortages of materials that foundries use to manufacture products; and

labor shortages or labor strikes.

***We do not have long-term supply contracts with our third-party manufacturing vendors and they may allocate capacity to other customers and may not allocate sufficient capacity to us to meet future demands for our products.***

We currently do not have long-term supply contracts with any of our third-party vendors. Therefore, they are not obligated to perform services or supply products to us for any specific period, in any specific quantities, or at any specific price, except as may be provided in a particular accepted purchase order. None of our third-party foundry or assembly and test vendors has provided contractual assurances to us that adequate capacity will be available to us to meet future demand for our products. Recently, our manufacturing vendors have indicated that, due to the current upturn in the semiconductor market, they will likely experience production capacity

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constraints for the foreseeable future. Under these circumstances, these foundries and assembly and test vendors may allocate capacity to the production of other companies' products while reducing deliveries to us on short notice. In particular, other customers that are larger and better financed than us or that have long-term agreements with these foundries or assembly and test vendors may cause these foundries or assembly and test vendors to reallocate capacity to those customers, decreasing the capacity available to us. If we enter into costly arrangements with suppliers that include nonrefundable deposits or loans in exchange for capacity commitments, commitments to purchase specified quantities over extended periods or investment in a foundry, our operating results could be harmed. To date, we have not entered into such arrangements with our suppliers. If we need another integrated circuit foundry or assembly and test subcontractor because of increased demand, or the inability to obtain timely and adequate deliveries from our providers, we might not be able to cost-effectively and quickly retain other vendors to satisfy our requirements.

***If our third-party foundries or suppliers do not achieve satisfactory yields or quality, our relationships with our customers and our reputation will be harmed.***

The fabrication of chipsets is a complex and technically demanding process. Minor deviations in the manufacturing process can cause substantial decreases in yields, and in some cases, cause production to be suspended. Our third-party foundries and suppliers have from time to time experienced manufacturing defects and reduced manufacturing yields. Changes in manufacturing processes or the inadvertent use of defective or contaminated materials by our foundries could result in lower than anticipated manufacturing yields or unacceptable performance. Many of these problems are difficult to detect at an early stage of the manufacturing process and may be time consuming and expensive to correct. In addition, designing RF circuits using standard, complementary metal-oxide semiconductor processes is difficult and can result in unsatisfactory yields. Because we primarily purchase wafers, our exposure to low wafer yields from our foundries is increased. Poor yields from our foundries or defects, integration issues or other performance problems in our products could cause us significant customer relations and business reputation problems, or force us to sell our products at lower gross margins and therefore harm our financial results. In addition, manufacturing defects may not be detected by our testing, or may be caused by defective packaging of our products by our third-party suppliers. If these defects arise or are discovered after we have shipped our products, our reputation and business would suffer.

***We depend on a small number of customers for a significant portion of our revenue. If we fail to retain or expand customer relationships, our revenue could decline.***

We derive a significant portion of our revenue from a small number of customers, and we anticipate that we will continue to do so in the foreseeable future. These customers may decide not to purchase our products at all, to purchase fewer products than they did in the past, for example due to an increase in inventory, or to alter their purchasing patterns in some other way, particularly because substantially all of our sales are made on a purchase order basis, which permits our customers to cancel, change or delay product purchase commitments with little or no notice to us and without penalty.

In the year ended December 31, 2005, Alpha Networks, Inc., Hon-Hai Precision Industry, Cameo Communications, Inc., and Askey Computer Corporation accounted for 15%, 15%, 13% and 10% of our net revenue, respectively. In the year ended December 31, 2004, Hon-Hai Precision Industry, Askey Computer Corporation, Cameo Communications, Inc., and Alpha Networks, Inc. accounted for 23%, 17%, 12% and 10% of our net revenue, respectively. Some of our OEM customers are also original design manufacturer customers, which may increase the impact of the loss of any customer. We must obtain orders from new customers on an ongoing basis to increase our revenue and grow our business. Our largest customers are typically ODMs. Sales to our largest customers have fluctuated significantly from period to period primarily due to OEMs that incorporate our products changing their designated ODM and the continued diversification of our OEM customer base in our current markets. We believe that sales will likely continue to fluctuate significantly in the future as we enter into new markets. The loss of any significant customer, a significant reduction in sales we make to them, or any problems collecting receivables from them would likely harm our financial condition and results of operations.





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***We will have difficulty selling our products if customers do not design our products into their product offerings or if our customers' product offerings are not commercially successful.***

We sell our products directly to OEMs, who include our chipsets in their products, and to ODMs, who include our chipsets in the products they supply to OEMs. Our products are generally incorporated into our customers' products at the design stage. As a result, we rely on OEMs to design our products into the products they sell. Without these design wins, our business would be materially and adversely affected. We often incur significant expenditures on the development of a new product without any assurance that an OEM will select our product for design into its own product. Once an OEM designs a competitor's product into its product offering, it becomes significantly more difficult for us to sell our products to that customer because changing suppliers involves significant cost, time, effort and risk for the customer. Furthermore, even if an OEM designs one of our products into its product offering, we cannot be assured that its product will be commercially successful, that we will receive any revenue from that manufacturer or that a successor design will include one of our products.

***The complexity of our products could result in unforeseen delays or expenses from undetected defects, errors or bugs in hardware or software, which could reduce the market acceptance for our new products, damage our reputation with current or prospective customers and adversely affect our operating costs.***

Highly complex products such as our chipsets and the related reference designs we provide to our customers frequently contain defects, errors and bugs when they are first introduced or as new versions are released. We have in the past and may in the future experience these defects, errors and bugs. If any of our products have reliability, quality, or compatibility problems, we may not be able to successfully correct these problems. In addition, if any of our proprietary features contain defects, errors or bugs when first introduced or as new versions are released, we may be unable to correct these problems. Consequently, our reputation may be damaged and customers may be reluctant to buy our products, which could harm our ability to retain existing customers and attract new customers and our financial results. In addition, these defects, errors or bugs could interrupt or delay sales to our customers. If any of these problems are not found until after we have commenced commercial production of a new product, we may be required to incur additional development costs and product recalls, repairs or replacement costs. These problems may also result in claims against us by our customers or others.

***Because we do not have long-term commitments from our customers, we must estimate customer demand, and errors in our estimates can have negative effects on our inventory levels, sales and operating results.***

Our sales are largely made on the basis of individual purchase orders rather than long-term purchase commitments. Our customers have the right to cancel or defer some purchase orders. We have experienced in the past cancellations or deferrals of purchase orders, and additional cancellations and deferrals may occur from time to time. We have historically placed firm orders for products with our foundries up to approximately 16 weeks prior to the anticipated delivery date and typically prior to receiving an order for the product. Therefore, our order volumes are based on our forecasts of demand from our customers. This process requires us to make multiple demand forecast assumptions, each of which may introduce error into our estimates. If we overestimate customer demand or incorrectly estimate product mix, we may allocate resources to manufacturing products that we may not be able to sell when we expect or at all. As a result, we would have excess inventory, which would harm our financial results. Conversely, if we underestimate customer demand or if insufficient manufacturing capacity is available, we would forego revenue opportunities, lose market share and damage our customer relationships. On occasion, we have been unable to adequately respond to increases in customer purchase orders, and therefore, were unable to complete, or needed to delay, sales. We have in the past, and may in the future, allocate our supply among our customers. Product allocation may result in the loss of current customers, and if we are unable to commit to provide specified quantities of products over a given period of time, we will not attract new customers. The failure to maintain customer relationships would decrease our revenue and harm our business.

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*We may experience difficulties in transitioning to smaller geometry process technologies or in achieving higher levels of design integration, which may result in reduced manufacturing yields, delays in product deliveries and increased expenses.*

To remain competitive, we continually work to improve our chipsets and, in particular, our high-performance RF products, to be manufactured using increasingly smaller geometries and to achieve higher levels of design integration. These ongoing efforts require us from time to time to modify the manufacturing processes for our products and to redesign some products. To remain competitive, our chipset must be redesigned from time to time, which may result in delays in product deliveries. We periodically evaluate the benefits, on a product-by-product basis, of migrating to smaller geometry process technologies to reduce our costs. In the past, we have experienced some difficulties in shifting to smaller geometry process technologies or new manufacturing processes, which resulted in reduced manufacturing yields, delays in product deliveries and increased expenses. In addition, while we purchase wafers from foundries, we also assume the yield risk related to manufacturing these wafers into die. We may face similar difficulties, delays and expenses in the future. We depend on our relationships with our foundries to transition to smaller geometry processes successfully and cannot assure that our foundries will be able to effectively manage the transition. If our foundries, or we, experience significant delays in this transition or fail to efficiently implement these transitions, our business, financial condition and results of operations could be adversely affected.

*Changes to financial accounting standards may affect our results of operations and could cause us to change our business practices.*

We prepare our financial statements to conform with generally accepted accounting principles, or GAAP, in the United States. These accounting principles are subject to interpretation by the American Institute of Certified Public Accountants, the Securities and Exchange Commission and various bodies formed to interpret and create appropriate accounting rules and regulations. A change in those accounting rules can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. Changes to those rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business. For example, in December 2004, the Financial Accounting Standards Board issued SFAS No. 123R, *Share-Based Payment* which will require us, starting in our first quarter of 2006, to record a charge to earnings for employee stock option grants and other equity incentives. Since we historically have used equity-related compensation as a component of our total employee compensation program, the accounting change could make the use of equity-related compensation less attractive to us and therefore make it more difficult to attract and retain employees. However, because we believe that providing equity-related compensation for our employees is a competitive necessity, we will likely incur significant and ongoing accounting charges resulting from option grants and other equity incentive expensing that could adversely affect our overall results of operations. Moreover, we intend to implement the requirements of SFAS 123R using the modified prospective method and accordingly we will not be restating prior period financial statements to reflect the historical impact of option grants. This may potentially cause readers of our financial statements to draw incorrect conclusions regarding our future operating performance since our financial statements going forward, which will reflect stock-based compensation expense, will not be comparable to our prior period financial statements that exclude stock-based compensation expense.

*Unanticipated changes in our tax rates could affect our future results.*

Our future effective tax rate could be unfavorably affected by unanticipated changes in the valuation of our deferred tax assets and liabilities. In addition, since we operate in different countries and are subject to taxation in different jurisdictions, our future effective tax rates could be impacted by changes in such countries tax laws or their interpretations. Both domestic and international tax laws are subject to change as a result of changes in fiscal policy, changes in legislation, evolution of regulation and court rulings. The application of these tax laws and related regulations is subject to legal and factual interpretation, judgment and uncertainty. Changes in our effective tax rate could have a material adverse impact on our results of operations.

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*We may not be able to consummate or successfully integrate any businesses that we may choose to acquire and any future acquisitions could harm our operating results and share price.*

We expect at some point in the future that we may make acquisitions of, and investments in, businesses that may offer complementary products and technologies, augment our market segment coverage, or enhance our technological capabilities, if appropriate opportunities arise. Risks that could have a material adverse effect on our business, results of operations or financial condition include among other things:

the difficulty or inability of completing the development and application of the acquired technology or products or of integrating that technology with our own,

the difficulty of assimilating the operations and personnel of acquired businesses,

the potential disruption of our ongoing business,

the distraction of management and employees from our business,

the risk of entering a geographic or business market in which we have little or no prior experience,

the difficulty of establishing and maintaining uniform standards, controls, policies and procedures,

the risk that there could be deficiencies in the internal control of any acquired company that could result in a material weakness in our overall internal control,

the potential for unanticipated costs, expenditures and liabilities,

the potential for incurring amortization expenses or impairment charges if an acquisition results in significant goodwill or other intangible assets,

the potential for changing relationships with customers, suppliers or contractual, intellectual property or employment issues, including the potential loss of key employees, and

the potential for dilution if we pay for the transaction with equity securities.

Any future acquisitions could result in dilutive issuances of equity securities, one-time charges, the incurrence of debt or contingent liabilities, adverse tax consequences, deferred compensation charges, dilution to future earnings and amortization of amounts related to deferred compensation and certain purchased intangible assets and large and immediate write-offs, any of which could negatively impact our results of operations and could cause our stock price to decline. We cannot assure that we will be able to identify suitable acquisition opportunities or that we will be able to consummate any such transactions or relationships on terms and conditions that are acceptable to us, that such transactions or relationships will be successful or that we will achieve the anticipated benefits of the acquisition.

*If we fail to secure or protect our intellectual property rights, competitors may be able to use our technologies, which could weaken our competitive position, reduce our revenue or increase our costs.*

We rely on a combination of patent, copyright, trademark and trade secret laws, confidentiality procedures and licensing arrangements to establish and protect our proprietary rights. Our pending patent applications may not result in issued patents, and our existing and future patents may not be sufficiently broad to protect our proprietary technologies or may be held invalid or unenforceable in court. Policing unauthorized use of our products is difficult and we cannot be certain that the steps we have taken will prevent the misappropriation or unauthorized use of our technologies, particularly in foreign countries where the laws may not protect our proprietary rights as fully as United States law. Any patents we have obtained, or may obtain in the future, may not be adequate to protect our proprietary rights. Our competitors may independently develop or may have already developed similar technology, duplicate our products or design around any patents issued to us or other intellectual property rights. In addition, we may be required to license our patents as a result of our participation in various standards organizations.

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***Because we license some of our software source code directly to customers, we face increased risks that our trade secrets will be exposed through inadvertent or intentional disclosure, which could harm our competitive position or increase our costs.***

We license some of our software source code to our customers, which increases the number of people who have access to some of our trade secrets and other proprietary rights. Contractual obligations of our licensees not to disclose or misuse our source code may not be sufficient to protect us from disclosure or misuse. The costs of enforcing contractual rights could substantially increase our operating costs and may not ultimately succeed in protecting our proprietary rights. If our competitors access our source code, they may gain further insight into the technology and design of our products, which would harm our competitive position.

***Intellectual property litigation, which is common in our industry, could be costly, harm our reputation, limit our ability to license or sell our proprietary technologies or products and divert the attention of management and technical personnel.***

The wireless communications market is characterized by frequent litigation regarding patent and other intellectual property rights. In the last few years, we have received several written notices or offers from our competitors and others claiming to have patent and other intellectual property rights in certain technology and inviting us to license this technology and related patents that apply to the IEEE family of wireless local area networking standards, including the 802.11a, 802.11b, 802.11e, 802.11g and 802.11n wireless standards, as well as other technology and patents relevant to our chips, software and system solutions. These notices or offers have been made directly to us and through our U.S. and foreign customers. We have certain indemnification obligations to customers with respect to any infringement of third-party patents and intellectual property rights by our products. We have responded, or are in the process of responding, directly, or indirectly through our customers, to all of these notices, and continue to correspond regarding the offers with some of the parties that have sent the notices. While at least two of our customers have been sued in the U.S. by the holders of patents related to 802.11a, 802.11b and 802.11g technology, neither that litigation nor any of these notices or offers to license has to date resulted in litigation directly against us. Questions of infringement and misappropriation in the wireless communications market involve highly technical and subjective analyses. Litigation may be necessary in the future to enforce any patents we may receive and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or misappropriation, and we may not prevail in any future litigation. If litigation were to be filed against us in connection with an offer to license technology or claims of infringement, our business could be harmed. Litigation, whether or not determined in our favor or settled, could be costly, could harm our reputation and could divert the efforts and attention of our management and technical personnel from normal business operations. In addition, adverse determinations in litigation could result in the loss of our proprietary rights, subject us to significant liabilities, and require us to seek licenses from third parties or prevent us from licensing our technology or selling our products, any of which could seriously harm our business. Any of these consequences could result from litigation whether initiated by our competitors or others, including those that have already sent notices or offers to us and our customers claiming patent rights and offering licenses.

***Any potential dispute involving our patents or other intellectual property could also include our industry partners and customers, which could trigger our indemnification obligations to them and result in substantial expense to us.***

In any potential dispute involving our patents or other intellectual property, our customers or licensees could also become the target of litigation, and certain customers have received notices of written offers from our competitors and others claiming to have patent rights in certain technology and inviting our customers to license this technology. At least two of our customers have been sued in the U.S. for allegedly infringing patents related to 802.11a, 802.11b and 802.11g technology. Because we indemnify our customers for intellectual property claims made against them for products incorporating our technology, any litigation could trigger technical support and indemnification obligations in some of our license or sales agreements, which could result in substantial expenses.

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In addition to the time and expense required for us to supply support or indemnification to our customers, any such litigation could severely disrupt or shut down the business of our customers, which in turn could hurt our relations with our customers and cause the sale of our proprietary technologies and products to decrease.

*We face business, political, regulatory, operational, financial and economic risks because most of our operations and sales activities take place outside of the United States.*

A significant portion of our products is sold to customers outside the United States and Canada. Sales to customers in Asia have accounted for substantially all of our net revenue since 2003. Because most of our ODMs and our PAS customer are located in Asia, we anticipate that substantially all of our revenue will continue to be represented by sales to customers in that region. In addition, we conduct research and development activities in India and China and have sales, marketing and support personnel in Japan, Taiwan, Korea, Hong Kong, Macao and China. Our success depends upon continued expansion of our international operations. Our international business involves a number of risks, including:

multiple, conflicting and changing laws and regulations, tax laws, export and import restrictions, employment laws, regulatory requirements and other governmental approvals, permits and licenses;

difficulties in staffing and managing foreign operations as well as cultural differences;

trade restrictions or higher tariffs that favor local competition in some countries;

difficulties of managing sales representatives, especially because we expect to increase our sales through our sales representatives;

inadequate local infrastructure and transportation delays;

financial risks, such as longer payment cycles, greater difficulty collecting accounts receivable and exposure to foreign currency exchange rate fluctuations;

failure by us or our customers to gain regulatory approval for use of our products; and

political and economic instability, including wars, terrorism, and political unrest, recurrence of the SARS, avian flu, or any other outbreak, boycotts, curtailment of trade and other business restrictions.

Any of these factors could significantly harm our future international sales and operations, consequently, our revenue and results of operations and business and financial condition.

*Our headquarters are located in California, and we have sales offices in Japan and elsewhere in Asia, and research and development facilities in India and China. Our third-party foundries and subcontractors are concentrated in Asia and elsewhere in the Pacific Rim. These areas are subject to significant weather and earthquake-related risks. Any disruption to the operations of these offices, foundries and*

*subcontractors resulting from typhoons, earthquakes or other natural disasters could cause significant delays in the production, shipment and sales of our products.*

TSMC and SMIC, which manufacture our chipsets and subcontractors which perform substantially all of our assembly and testing are located in Asia. In addition, our headquarters are located in Northern California, and we have sales offices in Japan, Taiwan, Hong Kong, China and elsewhere in Asia, and research and development facilities in India and China. These areas are subject to typhoons, and the risk of an earthquake or an earthquake-related disaster such as a tsunami in the Pacific Rim region or the Indian Ocean region, including Asia and Northern California, is significant due to the proximity of major earthquake fault lines. In the past, major earthquakes in Taiwan have disrupted the facilities of several of these third-party contractors, as well as other providers of these services, and impaired their production capacity. In addition, a tsunami in December 2004 caused widespread destruction and disruption of business in India and throughout the Indian Ocean coastal region. The occurrence of additional earthquakes or other natural disasters could result in the disruption of our foundry, assembly and test capacity or research and development efforts, or our ability to market and sell our products. We may not be able to obtain alternate capacity on favorable terms, if at all and our research and development efforts could be slowed.



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***We rely upon third parties for technology that is integrated into some of our products, and if we are unable to continue to use this technology and future technology or the technology fails to operate, our ability to sell technologically advanced products would be limited.***

We rely on third parties for technology that is integrated into some of our products. If we are unable to continue to use or license on reasonable terms third-party technologies used in some of our products or the technology fails to operate, we may not be able to secure alternatives in a timely manner and our business would be harmed.

***If our internal control over financial reporting does not comply with the requirements of the Sarbanes-Oxley Act, investor perceptions of our company may be adversely affected and could cause a decline in the market price of our stock.***

Section 404 of the Sarbanes-Oxley Act of 2002 requires our management to report on, and our independent auditors to attest to, the effectiveness of our internal control structure and procedures for financial reporting. We have an ongoing program to perform the system and process evaluation and testing necessary to comply with these requirements. This legislation is relatively new and neither companies nor accounting firms have significant experience in complying with its requirements. As a result, we have incurred and expect to continue to incur increased expense and to devote additional management resources to Section 404 compliance. In the event that our chief executive officer, chief financial officer, chief accounting officer, or independent registered public accounting firm determine that our internal control over financial reporting is not effective as defined under Section 404, investor perceptions of our company may be adversely affected and could cause a decline in the market price of our stock.

***Changes in current laws or regulations or the imposition of new laws or regulations could impede the sale of our products or otherwise harm our business.***

Wireless networks can only operate in the frequency bands, or spectrum, allowed by regulators and in accordance with rules governing how the spectrum can be used. The Federal Communications Commission, or the FCC, in the United States, as well as regulators in foreign countries, have broad jurisdiction over the allocation of frequency bands for wireless networks. We therefore rely on the FCC and international regulators to provide sufficient spectrum and usage rules. For example, countries such as China, Japan or Korea heavily regulate all aspects of their wireless communications industries, and may restrict spectrum allocation or usage, or may impose requirements that render our products or our customers' products unmarketable in these jurisdictions. If this were to occur, it would make it difficult for us to sell our products in that region. In addition, some of our chipsets operate in the 5 GHz band, which is also used by government and commercial services such as military and commercial aviation. The FCC and European regulators have traditionally protected government uses of the 5 GHz bands by setting power limits and indoor and outdoor designation and requiring that wireless local area networking devices not interfere with other users of the band such as government and civilian satellite services. Changes in current laws or regulations, reversal of usage rights, or the imposition of new laws and regulations in the United States or elsewhere regarding the allocation and usage of the 5 GHz band on us, our customers or the industries in which we operate may materially and adversely impact the sale of our products and our business, financial condition and results of operations.

***Rapidly changing standards could make our products obsolete, which would cause our operating results to suffer.***

We design some of our products to conform to standards set by industry standards bodies such as the Institute of Electrical and Electronics Engineers, Inc. We also depend on industry groups such as the WiFi Alliance to certify and maintain certification of our products. If our customers adopt new or competing industry standards with which our products are not compatible, or such industry groups 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 chipsets is affected by a variety of factors beyond our control. In



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particular, our products are designed to conform to current specific industry standards. 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. For example, the IEEE recently adopted a draft 802.11n specification after considering many different proposals for the 802.11n standard and we are working to develop products based on this draft specification. If the IEEE does not adopt the current draft 802.11n standard or if we are unable to complete development of products based on the draft specification on a timely basis, we will lose customers and revenue and our business will be harmed.

*If our customers or the industries using wireless technology prefer to integrate wireless capability into other products, we may not be able to compete effectively, we will lose customers, our revenue will decline and our business will be harmed.*

We have adopted the strategy of maintaining wireless technology on a chipset that is separate from functionality contained on other chips within a product. Our customers or the industries using wireless technology may prefer to integrate wireless capability into other products such as DSL modems, or determine that an integrated chip with multiple functionality results in products that perform better or are less expensive or more efficient to manufacture. If wireless functionality becomes commonly integrated with other functionality, the market for our products may decline. Consequently, we may miss product cycles in order to redesign our products, and we may not be able to forge strategic relationships necessary in order to design and arrange for the production of chips that include multiple functionality. If we miss product cycles, we will lose customers, our revenue will decline and our business will be harmed.

*The proliferation of wireless devices may expand beyond the capacity of the channels available in the 2.4GHz or 5 GHz bands, which may overload the networks and result in decreased market demand for our products.*

Wireless networks currently operate in the 2.4 GHz or 5 GHz bands, within which there are a limited number of channels available for use. The increasing number of wireless devices and networks may overburden the frequency bands and overload the networks. Recent studies have predicted that congestion in the 2.4 GHz band could result from the increasing number of wireless devices using that band with limited channel availability. If this occurs, our customers or the industries in which we operate may be adversely affected because the networks become inoperable or because only a limited number of devices will be able to access the networks. In turn, we may experience a decrease in market demand for our products that would adversely impact our business and results of operations.

*We may experience a decrease in market demand due to uncertain economic conditions in the United States and in international market, including as a result of the concerns of terrorism, war and social and political instability.*

Terrorist attacks in the United States and elsewhere, the continued presence of United States military forces in Iraq, and turmoil in the Middle East have contributed to the uncertainty in the United States and global economy and may lead to a decline in economic conditions, both domestically and internationally. Further terrorist acts, or other conflicts or wars, or a recession, or general economic slowdown in the U.S. or globally, could cause a slowdown of the market demand for goods and services, including demand for our products, and could harm our operating results.

*Because the NASDAQ National Market is likely to continue to experience extreme price and volume fluctuations, the price of our stock may decline.*

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Since we completed our initial public offering in February 2004, the market price of our shares has been and likely will continue to be highly volatile and could be subject to wide fluctuations in response to numerous factors, including the following:

actual or anticipated variations in our quarterly operating results or those of our competitors;

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announcements by us or our competitors of new products or technological innovations;

introduction and adoption of new industry standards;

changes in financial estimates or recommendations by securities analysts;

changes in the market valuations of our competitors;

announcements by us or our competitors of significant acquisitions or partnerships; and

sales of our common stock.

Many of these factors are beyond our control and may negatively impact the market price of our common stock, regardless of our performance. In addition, the stock market in general, and the market for technology and semiconductor companies in particular, have been highly volatile. Our common stock may not trade at the same levels of shares as that of other semiconductor and technology companies, and shares of semiconductor and technology companies, in general, may not sustain their current market prices. In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. We may be the target of similar litigation in the future. Securities litigation could result in substantial costs and divert management's attention and resources, which could seriously harm our business and operating results.

*Our ability to raise capital in the future may be limited and our failure to raise capital when needed could prevent us from executing our growth strategy.*

We believe that our existing cash and cash equivalents and existing amounts available under our revolving credit facility will be sufficient to meet our anticipated cash needs for at least the next 12 months. The timing and amount of our working capital and capital expenditure requirements may vary significantly depending on numerous factors, including:

market acceptance of our products;

the need to adapt to changing technologies and technical requirements;

the existence of opportunities for expansion; and

access to and availability of sufficient management, technical, marketing and financial personnel.

If our capital resources are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity securities or debt securities or obtain debt financing. The sale of additional equity securities or convertible debt securities would result in additional dilution to our stockholders. Additional debt would result in increased expenses and could result in covenants that would restrict our operations. We have not

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made arrangements to obtain additional financing and there is no assurance that financing, if required, will be available in amounts or on terms acceptable to us, if at all.

*Delaware law and our corporate charter and bylaws contain anti-takeover provisions that could delay or discourage takeover attempts that stockholders may consider favorable.*

Provisions in our certificate of incorporation may have the effect of delaying or preventing a change of control or changes in our management. These provisions include the following:

the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors;

the establishment of a classified board of directors requiring that not all members of the board be elected at one time;

the prohibition of cumulative voting in the election of directors which would otherwise allow less than a majority of stockholders to elect director candidates;

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the requirement for advance notice for nominations for election to the board of directors or for proposing matters that can be acted upon at a stockholders meeting;

the ability of the board of directors to alter our bylaws without obtaining stockholder approval;

the ability of the board of directors to issue, without stockholder approval, up to 10,000,000 shares of preferred stock with terms set by the board of directors, which rights could be senior to those of common stock;

the required approval of holders of at least two-thirds of the shares entitled to vote at an election of directors to adopt, amend or repeal our bylaws or amend or repeal the provisions of our certificate of incorporation regarding the election and removal of directors and the ability of stockholders to take action;

the required approval of holders of at least two-thirds of the shares entitled to vote at an election of directors to remove directors for cause; and

the elimination of the right of stockholders to call a special meeting of stockholders and to take action by written consent.

In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law. These provisions may prohibit large stockholders, in particular those owning 15% or more of our outstanding voting stock, from merging or combining with us. These provisions in our certificate of incorporation, bylaws and under Delaware law could discourage potential takeover attempts and could reduce the price that investors might be willing to pay for shares of our common stock in the future and result in the market price being lower than they would without these provisions.

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

None.

**Item 2. *Properties***

Our corporate headquarters and primary research and development and operations facilities occupy approximately 87,329 square feet in Santa Clara, California under a lease that expires in July 2010. We have the option to extend the lease beyond the initial term for two periods of three years each. We also lease properties around the world and within the facilities of certain customers and suppliers for use as sales and support offices, warehouses and logistics centers and test facilities. The size and location of these properties change from time to time based on business requirements. We do not own any manufacturing facilities, and we contract and license to third parties the production and distribution of our chipsets, hardware and software. Our international sales and support offices are in locations within the countries and administrative regions of China, Hong Kong, Japan and Taiwan, and we have research and development facilities in Chennai, India and Shanghai, China and an administrative center in Macau. While we believe our facilities are adequate to meet our immediate needs, it may become necessary to lease or acquire additional or alternative space to accommodate any future growth.

**Item 3. *Legal Proceedings***

We are not involved in any material pending legal proceedings. Many companies in the semiconductor, networking, software and related industries have a significant number of patents and have demonstrated a willingness to instigate litigation based on allegations of patent, trademark and other claims of infringement. From time to time, we have received, and expect to continue to receive, notices of claims of infringement, misappropriation or misuse of other parties' proprietary rights. Some of these claims may lead to litigation.

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

No matters were submitted to a vote of security holders during the quarter ended December 31, 2005.



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

Our shares of common stock are traded on the Nasdaq National Market under the symbol ATHR. Our common stock began trading on February 12, 2004, upon our initial public offering. The following table shows, for the periods indicated, the high and low intra-day sale prices for our common stock on the Nasdaq National Market.

	<b>Year ended December 31, 2004</b>	
	<b>High</b>	<b>Low</b>
First Quarter (from February 12, 2004)	\$ 19.48	\$ 16.11
Second Quarter	\$ 17.48	\$ 9.49
Third Quarter	\$ 11.03	\$ 6.24
Fourth Quarter	\$ 12.40	\$ 9.03

  

	<b>Year ended December 31, 2005</b>	
	<b>High</b>	<b>Low</b>
First Quarter	\$ 14.00	\$ 8.85
Second Quarter	\$ 10.42	\$ 6.65
Third Quarter	\$ 11.15	\$ 7.83
Fourth Quarter	\$ 13.40	\$ 8.18

As of February 28, 2006, the number of record holders of our common stock was 137. Because most of our shares are held by brokers and other institutions on behalf of stockholders, we are unable to estimate the total number of beneficial stockholders represented by these record holders.

**Dividends**

We have never declared or paid a cash dividend on our common stock and do not anticipate paying any cash dividends in the foreseeable future. Any future determination with respect to the declaration and payment of dividends will be at the discretion of our Board of Directors. In addition, we currently maintain a revolving credit facility that prohibits the payment of dividends without prior written consent of the bank.

**Securities Authorized for Issuance under Equity Compensation Plans**

Information regarding the securities authorized for issuance under our equity compensation plans can be found under Item 12 of this annual report on Form 10-K.

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The following selected consolidated financial data should be read in conjunction with the consolidated financial statements and the notes to the consolidated financial statements and Management's Discussion and Analysis of Financial Condition and Results of Operations, which are included elsewhere in this report.

In thousands, except per share data	Year Ended December 31,				
	2005	2004	2003	2002	2001
<b>Consolidated Statements of Operations Data:</b>					
Net revenue	\$ 183,485	\$ 169,607	\$ 87,357	\$ 22,200	\$ 1,831
Cost of goods sold	102,389	91,321	50,505	10,170	897
Gross profit	81,096	78,286	36,852	12,030	934
Operating expenses:					
Research and development	46,696	41,462	29,112	23,115	23,104
Sales and marketing	17,225	14,907	11,515	7,381	6,064
General and administrative	9,769	8,523	5,825	3,953	3,429
Stock-based compensation	1,856	3,718	3,358	488	597
Total operating expenses	75,546	68,610	49,810	34,937	33,194
Income (loss) from operations	5,550	9,676	(12,958)	(22,907)	(32,260)
Interest income (expense), net	4,854	2,089	(83)	614	1,646
Income (loss) before income taxes	10,404	11,765	(13,041)	(22,293)	(30,614)
Income tax (benefit) provision(1)	(6,284)	941	125	66	28
Net income (loss)	\$ 16,688	\$ 10,824	\$ (13,166)	\$ (22,359)	\$ (30,642)
Basic net income (loss) per share	\$ 0.34	\$ 0.25	\$ (1.07)	\$ (2.13)	\$ (4.08)
Diluted net income (loss) per share	\$ 0.31	\$ 0.21	\$ (1.07)	\$ (2.13)	\$ (4.08)
Shares used in computing basic net income (loss) per share	48,777	42,886	12,335	10,513	7,511
Shares used in computing diluted net income (loss) per share	53,572	51,981	12,335	10,513	7,511
<b>December 31,</b>					
In thousands	2005	2004	2003	2002	2001
<b>Consolidated Balance Sheet Data:</b>					
Cash, cash equivalents and marketable securities	\$ 173,645	\$ 154,485	\$ 29,039	\$ 27,602	\$ 49,668
Working capital	190,399	170,039	19,164	28,140	48,751
Total assets	239,179	206,363	55,886	39,325	58,741

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Short and long-term debt and capital lease obligations		51	6,737	2,269	2,769
Total stockholders' equity	196,966	173,040	22,286	30,462	52,336

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- (1) During 2005, the Company recorded an income tax benefit of \$7,535,000 or \$0.14 per share related to the release of a portion of the valuation allowance previously recorded against the Company's deferred tax assets.

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

#### **Overview**

We are a leading developer of semiconductor system solutions for wireless communications products. We combine our wireless systems and software expertise with high-performance radio frequency, or RF, mixed signal and digital semiconductor design skills to provide highly integrated chipsets that are manufacturable on low-cost, standard complementary metal-oxide semiconductor, or CMOS, processes. We were incorporated in May 1998 and commenced operations in December 1998. Through December 31, 2000, we were engaged principally in research and development. We first generated meaningful revenue from sales of our products in the fourth quarter of 2001 and have experienced increased revenue and chipset volumes while lowering our average selling price for our chipsets during each of the years ended December 31, 2002 through December 31, 2005. During 2004, we began volume shipments of our first single chip wireless solution and introduced additional single chip solutions in 2005, including our first PAS cellular solution. These single chip solutions are generally priced lower than the combined average selling prices of our multi-chip solutions and have contributed to the decline in our average selling prices in 2004 and 2005. Therefore, the average selling price per chipset may continue to decline as our single chip volume increases. We generated net income for the first time during the year ended December 31, 2004 and again in 2005. Through December 31, 2005, we had an accumulated deficit of \$57.1 million.

Our product portfolio includes various generations of our radio-on-a-chip, media access controller+baseband and wireless system-on-a-chip products supporting the Institute of Electrical and Electronics Engineers, or IEEE, family of wireless local area networking, or WLAN, standards, including the 802.11b, 802.11g and 802.11a standards. These products are sold together as chipsets as part of a wireless system solution that also incorporates software and system-level reference designs or are sold as a single chip wireless solution that integrates the radio, media access controller and baseband onto one chip. Our wireless systems solutions are used in a variety of applications in the retail wireless networking, personal computer OEM, enterprise and carrier infrastructure equipment, mobile communications and consumer electronics markets. In addition, since June 2005 we have been shipping our cellular solution for Personal Access Systems, or PAS, also referred to as Personal Handyphone Systems, or PHS, consisting of a single chip that implements a complete cellular transceiver, baseband, application processor, audio paths, power management, keyboard, speaker and display interfaces. PAS/PHS, which is widely deployed in China, Japan and Taiwan, is an advanced Time Division Multiple Access-Time Division Duplex technology operating at 1.9 GHz providing high quality voice, advanced data services and long battery life. Our unique, highly integrated single chip solution for PAS products provides full support for the PAS networking standard and a robust set of product features at a competitive price.

*Revenue.* Our revenue is derived primarily from the sale of WLAN chipset products, PAS chip solutions and, to a lesser extent, from licensed software and services. Our sales have historically been made on the basis of purchase orders rather than long-term agreements. Original equipment manufacturers, or OEMs, utilize our chipsets in developing their wireless system solutions such as access point, cardbus handsets and integrated circuit card products. Some OEMs purchase chipsets directly from us and manufacture their products. Other OEMs utilize original design manufacturers, or ODMs, to design and build subsystem products that the OEM then purchases from the ODM and incorporates into the OEM's wireless system solution. Accordingly, we ship our products either directly to the OEM or to the ODM based on the requirements of each OEM. Purchase orders are received from an OEM or an ODM and we generally recognize revenue based on the shipment of chipsets to this customer. A single ODM usually provides our chipsets to numerous OEMs. However, we attempt to maintain a close relationship with the target OEM to monitor end-market demand. Due to the use of ODMs, our direct customer base is relatively concentrated, although we believe that the number of total OEMs who purchase our chipsets through ODMs is broader. We anticipate that we may continue to experience changes in our ODM customer base as our end customers change ODMs for a variety of reasons while still using our chipsets.

We provide customer incentives to some of our direct and indirect customers. These obligations are estimated and recorded as a reduction of revenue at the time at which we ship product to the customers. Estimating incentive amounts requires that we make estimates regarding the percentage of committed incentives



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that will be submitted by our customers and the value of the incentives at the time of redemption. These estimates may require revisions at later dates if the actual sales data submitted by the customers differs significantly from the original estimates, which may have the effect of increasing or decreasing net revenue in particular periods.

We expect to continue to have major concentrations of sales to a relatively small list of ODM customers. The following table shows the customers that represented greater than 10% of revenue for the years ended December 31, 2005, 2004 and 2003:

	December 31,		
	2005	2004	2003
Alpha Networks, Inc.	15%	10%	*%
Hon-Hai Precision Industry	15	23	20
Cameo Communications, Inc.	13	12	28
Askey Computer Corporation	10	17	*

\* less than 10% in the applicable period.

Substantially all of our sales are to customers outside the United States and Canada. Sales to customers in Asia accounted for 96% of net revenue in 2005 and 98% of net revenue in each of 2004 and 2003. Because many of our ODM customers are located in Asia, we anticipate that a majority of our revenue will continue to be represented by sales to customers in that region. Although a large percentage of our sales are made to customers in Asia, we believe that a significant number of the systems designed by these customers are then sold through to OEMs outside of Asia. All of our sales are denominated in United States dollars.

*Cost of Goods Sold.* Cost of goods sold relates primarily to the purchase of silicon wafers, costs associated with assembly, test and inbound and outbound shipping of our chipsets, costs of personnel, materials and occupancy associated with manufacturing support and quality assurance, royalty costs and writedowns to state inventory at the lower of cost or market caused by product obsolescence and transitions from older to newer products. Additionally, our cost of goods sold includes accruals for warranty obligations, which we record when revenue is recognized. Because we do not have long-term, fixed supply agreements, our wafer, assembly and test costs are subject to changes based on the cyclical demand for semiconductors. In addition, after we purchase wafers from foundries, we also bear the yield risk related to manufacturing these wafers into finished goods.

*Research and Development.* Research and development expense relates primarily to compensation and associated costs related to development employees and contractors, mask and reticle costs, prototype wafers, software and computer-aided design software licenses, intellectual property license costs, reference design development costs, development testing and evaluation costs, regulatory testing costs, depreciation expense and allocated occupancy costs. All research and development costs are expensed as incurred. We expect our research and development costs to increase in absolute dollars in the future as we invest to develop new products to be competitive and address new markets in the future.

*Sales and Marketing.* Sales and marketing expense relates primarily to compensation and associated costs for marketing and selling personnel, sales commissions to independent sales representatives, public relations, promotional and other marketing expenses, travel, trade show expenses, depreciation expenses and allocated occupancy costs. We expect sales and marketing expenses will increase in absolute dollars as we hire additional personnel and expand our sales and marketing efforts.

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*General and Administrative.* General and administrative expense relates primarily to compensation and associated costs for general and administrative personnel, professional fees and banking fees, charges related to allowance for doubtful accounts and allocated occupancy costs. We expect that general and administrative expense will increase in absolute dollars as we hire additional personnel and incur costs related to the anticipated growth of our business.



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*Stock-Based Compensation.* In connection with the grant of stock options and the issuance of restricted stock, we have recorded an aggregate of \$10.0 million in stock-based compensation. These awards were considered compensatory because the fair market value of our stock on the date of grant was greater than the exercise price. As of December 31, 2005, we had an aggregate of \$935,000 in stock-based compensation remaining to be amortized. We are amortizing deferred stock-based compensation over the vesting period of the related options, which is generally four to five years using the graded vesting method. This deferred stock-based compensation balance will be amortized as follows, assuming no forfeiture of awards: \$762,000 during 2006; \$162,000 during 2007; and \$11,000 during 2008. However, we will adopt SFAS 123R in the first quarter of 2006 so the amounts of stock-based compensation that will be expensed in 2006, 2007 and 2008 will be considerably greater than these amounts.

*Interest Income and Expense.* Interest income consists of interest earned on cash and cash equivalents and marketable securities balances. Interest expense consists of interest on our revolving line of credit, equipment loans and equipment lease.

*Provision for Income Taxes.* From inception through December 31, 2003, we incurred net losses for federal and state tax purposes. We recorded an income tax benefit of \$7,535,000 in 2005 related to the release of a portion of the valuation allowance previously recorded against our deferred tax assets. The tax expense of \$914,000 in 2004 consists primarily of U.S. alternative minimum tax and foreign income taxes, while the tax expense of \$125,000 in 2003, consists entirely of foreign income tax expense incurred as a result of local country profits.

## **Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and the results of operations are based on our financial statements which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our critical accounting policies are set forth below.

*Revenue Recognition.* We derive revenue primarily from three sources:

the sale of our wireless chipsets and reference designs;

our licensed software and technical documentation; and

service and support revenue relating to the licensed software.

We recognize revenue in accordance with SEC Staff Accounting Bulletin, or SAB, No. 104, *Revenue Recognition*. SAB 104 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services have been rendered; (3) the fee is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (3) and (4) are based on management's judgment regarding the fixed nature of the fee charged for the products delivered and the collectibility of those fees. Should changes in conditions cause management to determine these criteria are not met for certain future transactions, revenue recognized for any reporting period could be adversely impacted.

We provide customer incentives to some of our direct and indirect customers. These obligations are estimated and recorded as a reduction of revenue at the time at which we ship product to the customers in accordance with Emerging Issues Task Force Issue No. 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*. Estimated incentive amounts are recorded as a reduction of revenue

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and are based on agreements between us and our customers. Estimating incentive amounts requires that we make estimates regarding the percentage of committed incentives that will be submitted by our customers and the value of the incentives at the time of redemption. These estimates may require revisions at later dates if the actual claims submitted by the customers differ significantly from the original estimates, which may have the effect of increasing or decreasing net revenue and gross profit as a percentage of revenue in a particular period.

*Inventory valuation.* We continually assess the recoverability of our inventory based on assumptions about demand and market conditions. Forecasted demand is determined based on historical sales and expected future sales. We value our inventory at the lower of actual cost (using the first-in, first-out method) or its current estimated market value. We adjust our inventory to the estimated lower of cost or market value to account for its obsolescence or lack of marketability. Adjustments are calculated as the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required that may adversely affect our operating results. If actual market conditions are more favorable, we may have higher gross margins when products are sold.

*Stock-based compensation.* We have elected to follow the intrinsic value-based method prescribed by Accounting Principles Board Opinion 25, *Accounting for Stock Issued to Employees*, or APB 25, and related interpretations in accounting for employee stock options rather than adopting the alternative fair value accounting provided under Statement of Financial Accounting Standards, or SFAS, No. 123, *Accounting for Stock Based Compensation*. Therefore, we do not record any compensation expense for stock options we grant to our employees where the exercise price equals the fair market value of the stock on the date of grant and the exercise price, number of shares eligible for issuance under the options and vesting period are fixed. We comply with the disclosure requirements of SFAS No. 123 and SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosures*, which require that we disclose our pro forma net income or loss and net income or loss per common share as if we had expensed the fair value of the options. In calculating such fair value, there are certain assumptions that we use, as disclosed in Note 1 of our audited financial statements. On December 16, 2004, the FASB issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123R. SFAS 123R requires all share-based payments to employees, including grants of employee stock options and purchases under employee stock purchase plans, to be recognized in the statement of operations based on their fair values. We are required to adopt this new standard in the first quarter of 2006 and expect that the additional expenses recorded under SFAS 123R will have a significant adverse impact on our results of operations. The pro forma disclosures of the impact of SFAS No. 123 provided in Note 1 to the consolidated financial statements may not be representative of the impact of adopting SFAS 123R.

*Allowance for doubtful accounts.* We perform ongoing credit evaluations of our customers and adjust credit limits and their credit worthiness, as determined by our review of current credit information. We continuously monitor collections and payments from our customers and maintain an allowance for doubtful accounts based upon our historical experience, our anticipation of uncollectible accounts receivable and any specific customer collection issues that we have identified. While our credit losses have historically been within our expectations and the allowance established, we might not continue to experience the same credit loss rates that we have in the past. Our receivables are concentrated in a relatively few number of customers. Therefore, a significant change in the liquidity or financial position of any one customer could make collection of our accounts receivable more difficult, require us to increase our allowance for doubtful accounts and negatively affect our working capital.

*Product Warranty Reserve.* We provide for the estimated cost of product warranties at the time revenue is recognized. While we engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our chipset suppliers, our warranty obligation is affected by product failure rates, the cost of replacement chipsets and inbound and outbound freight costs incurred in replacing a chipset after failure. We continuously monitor chipset returns for warranty and maintain an accrual for the related warranty expenses based on historical experience of similar products as well as various other assumptions that we believe to be reasonable under the circumstances. Should actual failure rates, cost of chipset replacement and inbound and outbound freight costs differ from our estimates, revisions to the estimated warranty accrual would be required.

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*Income Taxes.* We account for income taxes under the asset and liability approach. We record a valuation allowance to reduce our net deferred tax assets to the amount that we believe is more likely than not to be realized. In assessing the need for a valuation allowance, we consider historical levels of income, expectations and risks associated with estimates of future taxable income and ongoing prudent and practical tax planning strategies. On a periodic basis we evaluate our deferred tax asset balance for realizability. To the extent that we believe it is more likely than not that some portion of our deferred tax assets will not be realized, we will increase the valuation allowance against the deferred tax assets. Realization of our deferred tax assets is dependent primarily upon future U.S. taxable income.

**Results of Operations**

The following table shows the percentage relationships of the listed items from our consolidated statements of operations, as a percentage of net revenue for the periods indicated.

	Years Ended December 31,		
	2005	2004	2003
<b>Consolidated Statements of Operations Data:</b>			
Net revenue	100%	100%	100%
Cost of goods sold	56	54	58
Gross profit	44	46	42
Operating expense:			
Research and development	26	24	33
Sales and marketing	9	9	13
General and administrative	5	5	7
Stock-based compensation	1	2	4
Total operating expenses	41	40	57
Income (loss) from operations	3	6	(15)
Interest income, net	3	1	
Income tax benefit (provision)	3	(1)	
Net income (loss)	9%	6%	(15)%

**Years Ended December 31, 2005 and 2004**

(tables presented in thousands, except percentage amounts)

*Net Revenue*

Years Ended December 31,

	2005	2004	% Change in 2005
Net revenue	\$ 183,485	\$ 169,607	8%

The increase in net revenue was due to the increased volume of chipsets shipped as a result of increased acceptance of our wireless chipset products, the continued migration from our multi-chip solution products to our single chip solution products, integrating the radio, media access controller and baseband in a single chip, increased market demand for wireless networking products and the introduction of our cellular solution for PAS products. The total number of chipsets shipped increased from approximately 15.4 million in 2004 to approximately 24.3 million in 2005. The increase in chipsets shipped was partially offset by a decrease in the average selling price as we competitively priced our chipsets to aggressively pursue market share. Additionally, our single chipset solutions are generally priced lower than the combined average selling prices of our multi-chip solutions. Single chip solutions represented 62% of total chipset units shipped in 2005 compared with 16% in 2004.

**Table of Contents***Gross Profit*

	Years Ended December 31,		% Change in 2005
	2005	2004	
Gross profit	\$ 81,096	\$ 78,286	4%
% of net revenue	44%	46%	

Gross profit as a percentage of revenue decreased primarily due to a decline in the overall blended average selling prices of our products from \$11.01 for the year ended December 31, 2004 to \$7.54 for the year ended December 31, 2005, partially offset by a decrease in our product costs over the respective periods as a result of our customers' migration to our single chip solutions. In addition, in 2005 the decrease in higher margin 802.11a/g products as a percentage of our total product mix adversely affected the gross profit percentage.

*Research and Development*

	Years Ended December 31,		% Change in 2005
	2005	2004	
Research and development	\$ 46,696	\$ 41,462	13%
% of net revenue	26%	24%	

The increase in research and development expenses was primarily due to an increase in compensation-related costs of \$4.4 million, primarily attributable to a 20% increase in the number of employees engaged in research and development activities in 2005. In addition, there were increases in equipment-related expenses and costs of additional software development licenses of \$644,000 related to development of new products.

*Sales and Marketing*

	Years Ended December 31,		% Change in 2005
	2005	2004	
Sales and marketing	\$ 17,225	\$ 14,907	16%
% of net revenue	9%	9%	

The increase in sales and marketing expenses was primarily due to an increase in compensation-related costs of \$2.4 million, primarily attributable to a 41% increase in the number of employees engaged in sales and marketing activities in 2005. In addition, costs relating to recruiting, consulting and tradeshows increased \$521,000. The increases were partially offset by a one time decrease in commissions to

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independent sales representatives of \$728,000 as a result of a large account, previously assigned to an independent sales representative, becoming an in-house account.

### *General and Administrative*

	<u>Years Ended December 31,</u>		<u>% Change in 2005</u>
	<u>2005</u>	<u>2004</u>	
General and administrative	\$ 9,769	\$ 8,523	15%
% of net revenue	5%	5%	

The increase in general and administrative expenses was primarily due to an increase in compensation-related costs of \$1.2 million, primarily attributable to a 36% increase in the number of employees engaged in general and administrative activities in 2005. In addition, there was an increase in consulting expenses of \$500,000, including consulting related to compliance with the requirements of the Sarbanes-Oxley Act of 2002. The increases were partially offset by a decrease in bad debt expense of \$449,000.

**Table of Contents***Stock-Based Compensation*

	Years Ended December 31,		% Change in 2005
	2005	2004	
Stock-based compensation	\$ 1,856	\$ 3,718	(50%)
% of net revenue	1%	2%	

We have recorded deferred stock-based compensation in connection with the grant of stock options and restricted stock to our employees and directors. The decrease in stock-based compensation expense is primarily due to us amortizing deferred stock-based compensation using the graded vesting method which results in accelerated vesting as compared to the straight-line method. We will adopt SFAS 123R in the first quarter of 2006. The pro forma disclosures of the impact of SFAS No. 123R provided in Note 1 to the consolidated financial statements may not be representative of the impact of adopting SFAS 123R.

*Interest Income (Expense), Net*

	Years Ended December 31,		% Change in 2005
	2005	2004	
Interest income, net	\$ 4,854	\$ 2,089	132%
% of net revenue	3%	1%	

During 2005, we experienced an increase of approximately \$2.8 million in interest income resulting from increased balances of cash, cash equivalents and marketable securities. In addition, yields achieved on our investment portfolio have increased in 2005 compared with 2004.

*Income Tax Provision (Benefit)*

	Years Ended December 31,		% Change in 2005
	2005	2004	
Income tax provision (benefit)	\$ (6,284)	\$ 941	N/A

At December 31, 2005, we reassessed the valuation allowance previously recorded against our net deferred tax assets, which consisted primarily of net operating loss carryforwards and research and development tax credits. Based on our earnings history and projected future taxable income, we determined that it is more likely than not that a full valuation allowance for deferred tax assets would not be required. Accordingly, we released a portion of the valuation allowance in the amount of \$7,535,000 that was previously recorded against our deferred tax assets, partially offset by income tax expense for U.S. alternative minimum tax and foreign taxes, resulting in a net income tax benefit of \$6,284,000 for 2005.



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The income tax provision for 2004 consisted primarily of U.S. alternative minimum tax and foreign income taxes.

### Years Ended December 31, 2004 and 2003

*(tables presented in thousands, except percentage amounts)*

#### Net Revenue

	Years Ended December 31,		% Change in 2004
	2004	2003	
Net Revenue	\$ 169,607	\$ 87,357	94%

The increase in net revenue was due to the increased acceptance of our wireless chipset products, an increase in the number of Personal Computer Original Equipment Manufacturer, or PC OEM, and networking manufacturer design wins, the broadening of our product line to provide integrated 802.11b, 802.11g and 802.11a products and the introduction of our single chip solution, integrating the radio, media access controller and baseband in a single

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chip. As a result, the total number of chipsets shipped increased from approximately 5.4 million in 2003 to approximately 15.4 million in 2004. The increase in chipsets shipped was partially offset by a decrease in the average selling price as we competitively priced our chipsets to aggressively pursue market share.

*Gross Profit*

	Years Ended December 31,		% Change in 2004
	2004	2003	
Gross profit	\$ 78,286	\$ 36,852	112%
% of net revenue	46%	42%	

The increase in gross profit was due to a 94% increase in net revenue and a decrease in per unit costs of our chipsets related to design efficiencies and volume purchasing discounts, partially offset by a 32% decrease in the average selling price of our chipsets.

*Research and Development*

	Years Ended December 31,		% Change in 2004
	2004	2003	
Research and development	\$ 41,462	\$ 29,112	42%
% of net revenue	24%	33%	

The increase in research and development expenses was primarily due to increased compensation-related costs of \$6.6 million and additional software development licenses of \$782,000 resulting from a 45% increase in research and development headcount in 2004. Additionally, consulting and outside services costs related to the development of new products increased \$1.8 million and equipment and prototype expenses increased \$1.5 million.

*Sales and Marketing*

	Years Ended December 31,		% Change in 2004
	2004	2003	
Sales and marketing	\$ 14,907	\$ 11,515	29%
% of net revenue	9%	13%	

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The increase in sales and marketing expenses was primarily due to an increase in compensation costs and travel expenses of \$2.3 million related to a 26% increase in sales and marketing headcount and higher commissions to independent sales representatives of \$263,000 associated with a 94% increase in revenue during 2004 over 2003. Additionally, trade show and other marketing related costs increased \$585,000.

### *General and Administrative*

	Years Ended December 31,		% Change in 2004
	2004	2003	
General and administrative	\$ 8,523	\$ 5,825	46%
% of net revenue	5%	7%	

This increase in general and administrative expenses was primarily due to incremental compensation-related costs of \$896,000 resulting from a 47% increase in the number of general and administrative personnel. Additionally, professional and consulting fees, insurance costs and license fees increased \$1.1 million as a result of becoming a public company in February 2004.

**Table of Contents***Stock-Based Compensation*

	Years Ended December 31,		% Change in 2004
	2004	2003	
Stock-based compensation	\$ 3,718	\$ 3,358	11%
% of net revenue	2%	4%	

We have recorded deferred stock-based compensation in connection with the grant of stock options to our employees and directors. The increase of approximately \$360,000 resulted from the amortization of these related stock-based compensation charges.

We amortize deferred stock-based compensation using the graded vesting method which results in accelerated vesting as compared to the straight-line method.

*Interest Income (Expense), Net*

	Years Ended December 31,		% Change in 2004
	2004	2003	
Interest income (expense), net	\$ 2,089	\$ (83)	N/A
% of net revenue	1%	%	

During 2004, we experienced increased interest income resulting from increased balances of cash, cash equivalents and marketable securities, primarily as a result of \$133.2 million in net proceeds received from our initial public offering in February 2004.

*Income Tax Provision*

	Years Ended December 31,		% Change in 2004
	2004	2003	
Income tax provision	\$ 941	\$ 125	653%

The income tax provision for 2004 consisted primarily of U.S. alternative minimum tax and foreign income taxes. During 2003 the income tax provision consisted solely of foreign income tax incurred as a result of local country profits.

## Liquidity and Capital Resources

Our principal sources of liquidity as of December 31, 2005, consisted of cash, cash equivalents and marketable securities of \$173.6 million and our revolving credit facility, which had \$10.0 million available to borrow. In February 2004, we raised \$133.2 million in our initial public offering of common stock. Prior to our initial public offering, we financed our operations primarily through private placements of convertible preferred stock, capital equipment loans and lease lines and borrowings under our revolving line of credit.

*Operating Activities.* Our operating activities provided cash in the amount of \$17.1 million in 2005 and used cash in the amount of \$2.7 million and \$2.3 million in 2004 and 2003, respectively. The increase in cash provided in operating activities in 2005 compared to 2004 was primarily due to the net income generated in 2005. The increase in cash used in operating activities in 2004 compared to 2003 was due to an increase in working capital requirements, partially offset by generating net income in 2004 compared to a net loss in 2003. Our accounts receivable decreased by \$1.4 million in 2005 as a result of improved collection efforts and increased by \$19.9 million and \$8.1 million in 2004 and 2003, respectively, related to increased revenue and the timing of customer payments. Our inventory increased by \$5.3 million, \$4.3 million and \$6.5 million in 2005, 2004 and 2003, respectively, to meet the increased customer demand for our products. Our accounts payable increased by \$3.4 million in 2005, decreased by \$4.4 million in 2004 and increased by \$13.0 million in 2003. The increases in accounts payable in 2005 and 2003 were primarily due to the increase in inventory to meet increased demand for our products. The decrease in accounts payable in 2004 related primarily to the timing of inventory purchases and

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payments to our vendors. Our accrued and other liabilities increased by \$2.9 million, \$10.3 million and \$7.2 million in 2005, 2004 and 2003, respectively. The increase in 2005 was primarily due to an increase in accrued compensation and benefits of \$2.1 million associated with an increase in our headcount. The increase in 2004 was primarily due to a \$7.4 million increase in accrued customer incentives associated with increases in revenues during the year. The increase in 2003 was primarily due to growth in accrued compensation and benefits associated with an increase in our headcount, and a \$2.9 million growth in accrued customer incentives associated with an increase in revenue during the year.

*Investing Activities.* Our investing activities provided \$20.1 million in 2005 primarily from maturities of marketable securities, partially offset by purchases of marketable securities and purchases of property and equipment. Our investing activities used \$107.7 million in 2004 primarily related to the purchase of marketable securities and property and equipment, partially offset by maturities of marketable securities. Our investing activities provided cash of \$6.7 million in 2003, which resulted primarily from maturities of marketable securities, partially offset by purchases of marketable securities and purchases of property and equipment.

Capital expenditures were \$4.1 million, \$2.3 million, \$1.5 million in 2005, 2004 and 2003, respectively. Capital expenditures in 2005 primarily consisted of leasehold improvements for our corporate headquarters and computer and test equipment purchases. In 2004 and 2003 capital expenditures primarily consisted of computer and test equipment and software purchases. We anticipate that further capital expenditures will be required to support future growth.

*Financing Activities.* Our financing activities provided cash of \$5.3 million in 2005, \$129.7 million in 2004, and \$6.1 million in 2003. Financing activities in 2005 primarily represented exercises of options to purchase our common stock and purchases of our common stock pursuant to our employee stock purchase plan, partially offset by repayment of an equipment loan. Financing activities in 2004 primarily represented proceeds from the sale of our common stock pursuant to our initial public offering of \$133.2 million, exercises of options to purchase our common stock and purchases of our common stock pursuant to our employee stock purchase plan, partially offset by repayments of short-term borrowings, equipment loans and capital lease obligations. Financing activities in 2003 primarily represented proceeds from exercises of options to purchase our common stock and proceeds from borrowings against the revolving line of credit, and borrowings against an equipment loan, partially offset by repayments, against the equipment loans and capital leases.

Our revolving credit facility with Silicon Valley Bank provides financing up to \$10.0 million for working capital requirements. The credit facility will expire on March 29, 2006 but we anticipate that we will renew the facility for an additional year. As of December 31, 2005, no balances were outstanding against the revolving credit facility. Interest on borrowings under the revolving credit facility is calculated at the bank's prime rate. The loan is collateralized by all of our tangible assets. The loan agreement contains financial and nonfinancial covenants with which we must comply. Through December 31, 2005, we were in compliance with all required covenants.

We believe that research and development resources are required to expand our core technologies and product offerings. Our research and development expenses were \$46.7 million, \$41.5 million and \$29.1 million in 2005, 2004 and 2003, respectively. These expenditures resulted in enhancement of our product offerings, technological know-how and inventions that have yielded numerous issued and pending U.S. patents. We expect to continue to incur significant research and development expenses and intend to fund these expenses with operating cash flow, cash and cash equivalents and marketable securities.

We expect to experience a significant increase in our operating expenses in absolute dollars, particularly in research, and development but also in sales and marketing and general and administrative expenses, for the foreseeable future in order to execute our business strategy. As a result, we anticipate that operating expenses, as well as planned capital expenditures, will constitute a material use of our cash resources.



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We believe that our existing cash and cash equivalents, marketable securities and amounts available under our revolving credit facility will be sufficient to meet our anticipated cash needs for at least the next 12 months. Our future capital requirements will depend on many factors including our rate of revenue growth, the timing and extent of spending to support development efforts, the expansion of sales and marketing activities, the timing of introductions of new products and enhancements to existing products, the costs to ensure access to adequate manufacturing capacity and the continuing market acceptance of our products. Although we are currently not a party to any agreement or letter of intent with respect to potential investments in, or acquisitions of, complementary businesses, products or technologies, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. The sale of additional equity securities or convertible debt securities would result in additional dilution to our stockholders. Additional debt would result in increased interest expense and could result in covenants that would restrict our operations. We have not made arrangements to obtain additional financing and there is no assurance that such financing, if required, will be available in amounts or on terms acceptable to us, if at all.

As of December 31, 2005 we had no off-balance sheet arrangements as defined in Item 303(a)(4) of the Securities and Exchange Commission's Regulation S-K. The following summarizes our contractual obligations at December 31, 2005 and the effect those obligations are expected to have on our liquidity and cash flow in future periods (in millions):

	Payments due by period			
	Less Than	1-3	After	Total
	1 Year	Years	3 Years	
<b>Contractual obligations</b>				
Operating leases	\$ 2.1	\$ 3.1	\$ 2.2	\$ 7.4
Commitments under licensing agreements	4.2	5.3		9.5
<b>Total</b>	<b>\$ 6.3</b>	<b>\$ 8.4</b>	<b>\$ 2.2</b>	<b>\$ 16.9</b>

**Recent Accounting Pronouncements**

In November 2004, the Financial Accounting Standards Board, or FASB, issued Statement of Financial Accounting Standards No. 151, *Inventory Costs - an amendment to ARB No. 43, Chapter 4*, or SFAS 151. SFAS 151 amends the guidance in Accounting Research Bulletin No. 43, Chapter 4, *Inventory Pricing* to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) by requiring these items to be recognized as current-period charges. The provisions of this Statement are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not believe adoption of SFAS 151 would have a material effect on our consolidated financial position or results of operations.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29*, or SFAS 153. Accounting Principles Board (APB) Opinion No. 29, *Accounting For Nonmonetary Transaction*, or APB 29, is based on the opinion that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. SFAS 153 amends APB 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets whose results are not expected to significantly change the future cash flows of the entity. The provisions of this Statement are effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS 153 did not have a material impact on our consolidated financial position or results of operations.



We account for stock-based compensation awards issued to employees using the intrinsic value measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, or APB 25. Accordingly, no compensation expense has been recorded for stock options granted with exercise prices greater than or equal to the fair value of the underlying common stock at the option grant date. On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment*, or SFAS 123R. SFAS 123R eliminates

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the alternative of applying the intrinsic value measurement provisions of APB 25 to stock compensation awards issued to employees. Rather, the new standard requires enterprises to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award, known as the requisite service period.

We will recognize stock-based compensation expense on all share-based payment awards made to employees on a graded vesting basis over the requisite service period using the modified prospective method beginning in the first quarter of fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107, or SAB 107, which provides supplemental implementation guidance for SFAS 123R. In addition, the FASB has issued several FASB Staff Positions or FSPs, that provide interpretive guidance for the implementation of SFAS 123R. We will apply the principles of SAB 107 and the FSPs in conjunction with our adoption of SFAS 123R. We expect that the adoption of SFAS 123R will have a significant adverse impact on our consolidated results of operations. The pro forma disclosures of the impact of SFAS No. 123 provided in Note 1 to the consolidated financial statements may not be representative of the impact of adopting SFAS 123R.

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, a replacement of APB Opinion No. 20, *Accounting Changes*, and Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements*, or SFAS 154. SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition of a cumulative effect adjustment within net income of the period of the change. SFAS 154 requires retrospective application to prior periods financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the new standard does not change the transition provisions of any existing accounting pronouncements. Our consolidated financial position and results of operations would only be impacted following the adoption of SFAS 154 if we implement changes in accounting principles that are addressed by the standard or correct accounting errors in future periods.

In November 2005, the FASB issued FSP Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of other-than-temporary impairments. The guidance in this FSP is effective for reporting periods beginning after December 15, 2005. We do not believe adoption of this FSP will have a material impact on our consolidated financial position or results of operations.

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

The primary objectives of our investment activity are, in order of importance, to preserve principal, provide liquidity and maximize the income without significantly increasing the risk. Some of the securities we invest in are subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. To minimize this risk, we maintain our portfolio of cash equivalents and short-term investments in a variety of securities, including commercial paper, money market funds, government and non-government debt securities and certificates of deposit. The risk associated with fluctuating interest rates is limited to our investment portfolio and we do not believe that a 10% change in interest rates will have a significant impact on the fair value of our portfolio or on our interest income. As of December 31, 2005, our investments were in money market funds, commercial paper, corporate notes, corporate bonds, market auction preferred stock and U.S. government securities.

The following table presents the amounts of cash equivalents and marketable securities (in thousands, except percentages) that are subject to market risk by range of expected maturity and weighted-average interest



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rates as of December 31, 2005. This table does not include money market funds because those funds are not subject to market risk.

	<b>Maturing in Three Months or Less</b>	<b>Maturing Between Three Months and One Year</b>	<b>Maturing Greater Than One Year</b>	<b>Total</b>
Fixed Rate	\$ 78,568	\$ 35,275	\$ 13,072	\$ 126,915
Weighted Average Interest Rate	4.19%	3.41%	4.64%	4.02%
Variable Rate	\$ 22,685	\$	\$	\$ 22,685
Weighted Average Interest Rate	4.37%	%	%	4.37%

Our exposure to market risk also relates to the increase or decrease in the amount of interest we must pay on our outstanding debt instruments, primarily certain borrowings under the revolving credit facility. Our revolving credit facility provides financing up to \$10.0 million for working capital requirements. As of December 31, 2005, no balances were outstanding under the revolving credit facility. The loan bears interest at the bank's prime rate. We do not believe that a 10% change in the prime rate would have a significant impact on our interest expense.

We do not currently engage in foreign currency hedging transactions and as a result we have relatively little exposure to foreign currency exchange rate risk.

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

The response to this Item is submitted as a separate section of this Form 10-K. See Item 15.

**Item 9. Changes and Disagreements with Accountants on Accounting and Financial Disclosure**

Not applicable.

**Item 9A. Controls and Procedures***Conclusion Regarding the Effectiveness of Disclosure Controls and Procedures*

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of our disclosure controls and procedures, as such term is defined under Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, or the Exchange Act. Based on this evaluation, our principal executive officer and our principal

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financial officer concluded that as of December 31, 2005, our disclosure controls and procedures were effective at the reasonable assurance level.

### *Management's Report on Internal Control over Financial Reporting*

Our management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of our internal control over financial reporting based on the framework set forth in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on our evaluation under the framework set forth in *Internal Control - Integrated Framework*, our management concluded that our internal control over financial reporting was effective as of December 31, 2005. Our management's assessment of the effectiveness of our internal control over financial reporting as of December 31, 2005 has been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report which is included herein.

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*Changes in Internal Control Over Financial Reporting*

There were no significant changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with the evaluation described in Item 9A(a) above that occurred during our fourth quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of Atheros Communications, Inc.:

We have audited management's assessment, included in the accompanying Management's Report on Internal Control Over Financial Reporting, that Atheros Communications, Inc. and its subsidiaries (collectively, the Company) maintained effective internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. 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 an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit 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. Our audit included 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 considered 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 by, or under the supervision of, the company's principal executive and principal financial officers, or persons performing similar functions, and effected by the company's board of directors, management, and other personnel 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 (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) 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 (3) 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.

Because of the inherent limitations of internal control over financial reporting, including the possibility of collusion or improper management override of controls, material misstatements due to error or fraud may not be prevented or detected on a timely basis. Also, projections of any evaluation of the effectiveness of the internal control over financial reporting to future periods are subject to the risk that the controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that the Company maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission. Also, in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated financial statements of the Company as of and for the year ended December 31, 2005, and our report dated March 10, 2006 expressed an unqualified opinion on those consolidated financial statements.

/s/ DELOITTE & TOUCHE LLP

San Jose, California

March 10, 2006



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**Item 9B. Other Information**

Not applicable.

**PART III**

**Item 10. Directors and Executive Officers of the Registrant**

The information required by Item 10 with respect to our directors and executive officers is incorporated by reference from the information set forth under the captions Election of Directors Executive Officers and Directors in our Definitive Proxy Statement in connection with our 2006 Annual Meeting of Stockholders to be held on May 24, 2006 (the 2006 Proxy Statement ) which will be filed with the Securities and Exchange Commission no later than 120 days after December 31, 2005.

Item 405 of Regulation S-K calls for disclosure of any known late filing or failure by an insider to file a report required by Section 16(a) of the Exchange Act. This information is contained in the section called Section 16(a) Beneficial Ownership Reporting Compliance in the 2006 Proxy Statement and is incorporated herein by reference.

We have adopted a code of ethics that applies to all of our directors, officers (including our chief executive officer (our principal executive officer), chief financial officer (our principal financial officer), chief accounting officer (our principal accounting officer), controller and any person performing similar functions) and employees. The Code of Ethics is available on our web site at [www.atheros.com](http://www.atheros.com). We will disclose on our web site amendments to, or waivers from, our Code of Ethics applicable to our directors and executive officers, including our chief executive officer (our principal executive officer), our chief financial officer (our principal financial officer) and our chief accounting officer (our principal accounting officer), in accordance with applicable laws and regulations.

We have a separately designated standing Audit Committee established in accordance with Section 3(a)(58)(A) of the Securities Exchange Act of 1934. The members of the Audit Committee are Marshall Mohr (Chairperson), Forest Baskett and Andrew Rappaport. All of such members meet the independence standards established by The Nasdaq Stock Market for serving on an audit committee. SEC regulations require us to disclose whether a director qualifying as an audit committee financial expert serves on our Audit Committee. Our Board of Directors has determined that Marshall Mohr qualifies as an audit committee financial expert within the meaning of such regulations.

**Item 11. Executive Compensation**

The information required by Item 11 is incorporated by reference from the information set forth under the captions Executive Compensation, Election of Directors Directors Compensation and Election of Directors Compensation Committee Interlocks and Insider Participation in our 2006 Proxy Statement.

**Item 12. *Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by Item 12 with respect to security ownership of certain beneficial owners and management is incorporated by reference from the information set forth under the caption *Security Ownership of Certain Beneficial Owners and Management* in our 2006 Proxy Statement.

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The following chart sets forth certain information as of December 31, 2005, with respect to our equity compensation plans, specifically our 1998 Stock Incentive Plan, or the 1998 Plan, 2004 Stock Incentive Plan, or the 2004 Plan, and 2004 Employee Stock Purchase Plan, or the ESPP. Each of the 1998 Plan, the 2004 Plan and the ESPP has been approved by our stockholders.

**Equity Compensation Plan Information**

Plan Category	Number of securities to be issued upon exercise of outstanding options, warrants and rights	Weighted average exercise price of outstanding options, warrants and rights	Number of securities remaining available for future issuance under equity compensation plans
Equity compensation plans approved by security holders	10,298,383	\$ 5.93	1,783,710(1)
Equity compensation plans not approved by security holders	None	None	None
<b>Total</b>	<b>10,298,383</b>	<b>\$ 5.93</b>	<b>1,783,710(1)</b>

- (1) Includes 1,001,004 shares reserved for issuance under the 2004 Plan. The number of shares reserved for issuance under the 2004 Plan automatically increases on January 1st of each year by the lesser of (i) 3,750,000 shares, (ii) five percent (5%) of the number of shares of our common stock outstanding on the last day of the immediately preceding fiscal year or (iii) the number of shares determined by the board of directors. In addition, the number of shares reserved for issuance under the 2004 Plan is increased from time to time in an amount equal to the number of shares subject to outstanding options under the 1998 Plan that are subsequently forfeited or terminate for any other reason before being exercised and vested shares that are forfeited pursuant to the 1998 Plan. Also includes 782,706 shares reserved for issuance under the ESPP. The number of shares reserved for issuance under the ESPP automatically increases on January 1st of each year by the lesser of (i) 750,000 shares, or (ii) one and one-quarter percent (1.25%) of the number of shares of our common stock outstanding on the last trading day of the immediately preceding fiscal year.

**Item 13. *Certain Relationships and Related Transactions***

The information required by Item 13 is incorporated by reference from the information set forth under the caption *Certain Relationships and Related Party Transactions* in our 2006 Proxy Statement.

**Item 14. *Principal Accounting Fees and Services***

The information required by Item 14 is incorporated by reference from the information set forth under the caption *Ratification of the Appointment of Independent Registered Public Accounting Firm Audit and Non-Audit Fees* and *Audit Committee Pre-Approval Policies* in our 2006 Proxy Statement.



**Table of Contents****PART IV****Item 15. Exhibits, Financial Statement Schedules****(a) 1. Financial Statements**

The financial statements filed as part of this report are identified in the Index to Consolidated Financial Statements on page F-1.

**2. Financial Statement Schedules**

See item 15(c) below.

**3. Exhibits**

See Item 15(b) below.

**(b) Exhibits**

The following exhibits are filed herewith or are incorporated by reference to exhibits previously filed with the Securities and Exchange Commission. Atheros Communications, Inc. (the Registrant) shall furnish copies of exhibits for a reasonable fee (covering the expense of furnishing copies) upon request.

<b>Exhibit Number</b>	<b>Description</b>
3.1	Restated Certificate of Incorporation of the Registrant (filed as Exhibit 3.2 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
3.2	Amended and Restated Bylaws of the Registrant (filed as Exhibit 3.4 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
10.1(1)	Form of Indemnification Agreement between the Registrant and its officers and directors (filed as Exhibit 10.1 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
10.2(1)	1998 Stock Incentive Plan and form of agreements thereunder (filed as Exhibit 10.2 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).

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- 10.3(1) 2004 Stock Incentive Plan and form of agreements thereunder (filed as Exhibit 10.3 to Amendment No. 4 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
- 10.4(1) 2004 Employee Stock Purchase Plan (filed as Exhibit 10.4 to Amendment No. 4 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
- 10.5 Lease Agreement dated as of April 8, 2005, between Registrant and Prentiss Properties Acquisition Partners, L.P., (filed as Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed on April 18, 2005, and incorporated herein by reference).
- 10.6 Warrant to Purchase Shares of Preferred Stock of Atheros Communications, Inc. dated September 6, 2001 by and between the Registrant and GATX Ventures, Inc. (filed as Exhibit 10.8 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
- 10.7(1) Employment Agreement, dated February 15, 2000, by and between the Registrant and Richard Bahr (filed as Exhibit 10.10 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
- 10.8(1) Offer Letter, dated April 9, 2003, by and between the Registrant and Craig Barratt (filed as Exhibit 10.13 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
- 10.9(1) Offer Letter, dated September 26, 2003, by and between the Registrant and Jack Lazar (filed as Exhibit 10.14 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).

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<b>Exhibit Number</b>	<b>Description</b>
10.10(1)	Offer Letter, dated November 19, 2003, by and between the Registrant and Paul G. Franklin (filed as Exhibit 10.21 to Amendment No. 1 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
10.11(1)	Offer Letter, dated July 4, 2005, by and between the Registrant and Todd Antes (filed as Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005, and incorporated herein by reference).
10.12(1)	Offer Letter, dated December 29, 2005, by and between the Registrant and Gary Szilagyi.
10.13(1)	Form of restricted stock agreement under 2004 Stock Incentive Plan (filed as Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005, and incorporated herein by reference).
10.14(1)	Summary of 2005 Executive Bonus Plan, adopted by the Compensation Committee of the Board of Directors on March 23, 2005 (filed as Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005, and incorporated herein by reference).
10.15(1)	Consulting Agreement, dated as January 1, 2002, between the Registrant and Teresa Meng (filed as Exhibit 10.19 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
10.16(1)	Amendment to Consulting Agreement dated as of January 1, 2006, between the Registrant and Teresa Meng.
10.17	Second Amended and Restated Investors' Rights Agreement dated April 18, 2001 and amendments thereto (filed as Exhibit 10.20 to Amendment No. 1 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
21.1	List of Subsidiaries of the Registrant.
23.1	Consent of Deloitte & Touche LLP, independent registered public accounting firm.
24.1	Power of Attorney (see page 48).
31.1	Certificate of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).
31.2	Certificate of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).
32.1(2)	Certificate of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).
32.2(2)	Certificate of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).

(1) Indicates management contract or compensatory plan or arrangement.  
(2) The material contained in Exhibit 32.1 and Exhibit 32.2 is not deemed filed with the SEC and is not to be incorporated by reference into any filing of the Company under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language contained in such filing, except to the extent that the registrant specifically incorporates it by reference.

**(c) Financial Statement Schedules.**

Schedules not listed above have been omitted because they are not applicable or required, or the information required to be set forth therein is included in the Consolidated Financial Statements or Notes thereto.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Date: March 10, 2006

ATHEROS COMMUNICATIONS, INC.

/s/ CRAIG H. BARRATT

---

**Craig H. Barratt**

**Chief Executive Officer and President**

**(Principal executive officer)**

/s/ JACK R. LAZAR

---

**Jack R. Lazar**

**Vice President, Chief Financial Officer and Secretary**

**(Duly authorized officer and principal financial officer)**

**POWER OF ATTORNEY**

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Craig H. Barratt and Jack R. Lazar and each of them, his true and lawful attorneys-in-fact and agents, each with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments to this Annual Report on Form 10-K, and to file the same, with exhibits thereto and other documents in connection therewith, with the Securities and Exchange Commission granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that each of said attorneys-in-fact and agents, or his substitute or substitutes may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

**Signature**

**Title**

**Date**

---

/s/ JOHN L. HENNESSY

Chairman of the Board of Directors

March 10, 2006



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**John L. Hennessy**

/s/ CRAIG H. BARRATT President and Chief Executive Officer (Principal Executive Officer) and Director March 10, 2006

**Craig H. Barratt**

/s/ JACK R. LAZAR Vice President, Chief Financial Officer and Secretary (Principal Financial Officer) March 10, 2006

**Jack R. Lazar**

/s/ DAVID D. TORRE Vice President and Chief Accounting Officer (Principal Accounting Officer) March 10, 2006

**David D. Torre**

/s/ DANIEL A. ARTUSI Director March 10, 2006

**Daniel A. Artusi**

/s/ FOREST BASKETT Director March 10, 2006

**Forest Baskett**

/s/ TERESA H. MENG Director March 10, 2006

**Teresa H. Meng**

/s/ MARSHALL L. MOHR Director March 10, 2006

**Marshall L. Mohr**

/s/ ANDREW S. RAPPAPORT Director March 10, 2006

**Andrew S. Rappaport**

**Table of Contents****Exhibit Index**

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10.11(1)	Offer Letter, dated July 4, 2005, by and between the Registrant and Todd Antes (filed as Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2005, and incorporated herein by reference).
10.12(1)	Offer Letter, dated December 29, 2005, by and between the Registrant and Gary Szilagyi.
10.13(1)	Form of restricted stock agreement under 2004 Stock Incentive Plan (filed as Exhibit 10.2 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005, and incorporated herein by reference).

**Table of Contents**

<b>Exhibit Number</b>	<b>Description</b>
10.14(1)	Summary of 2005 Executive Bonus Plan, adopted by the Compensation Committee of the Board of Directors on March 23, 2005 (filed as Exhibit 10.3 to the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005, and incorporated herein by reference).
10.15(1)	Consulting Agreement, dated January 2002, between the Registrant and Teresa Meng (filed as Exhibit 10.19 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
10.16(1)	Amendment to Consulting Agreement dated as of January 1, 2006, between the Registrant and Teresa Meng.
10.17	Second Amended and Restated Investors' Rights Agreement dated April 18, 2001 and amendments thereto (filed as Exhibit 10.20 to Amendment No. 1 to the Registrant's Registration Statement on Form S-1, file no. 333-110807, and incorporated herein by reference).
21.1	List of Subsidiaries of the Registrant.
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32.1(2)	Certificate of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350).
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- (1) Indicates management contract or compensatory plan or arrangement.
- (2) The material contained in Exhibit 32.1 and Exhibit 32.2 is not deemed filed with the SEC and is not to be incorporated by reference into any filing of the Company under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language contained in such filing, except to the extent that the registrant specifically incorporates it by reference.

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**ATHEROS COMMUNICATIONS, INC.**

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<u>Consolidated Statements of Operations</u>	F-4
<u>Consolidated Statements of Stockholders' Equity and Comprehensive Income (Loss)</u>	F-5
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of Atheros Communications, Inc.:

We have audited the accompanying consolidated balance sheets of Atheros Communications, Inc. and its subsidiaries (collectively, the Company ) as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity and comprehensive income (loss), and cash flows for each of the three years in the period ended December 31, 2005. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits 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 includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2005 and 2004, and the results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 10, 2006 expressed an unqualified opinion on management's assessment of the effectiveness of the Company's internal control over financial reporting and an unqualified opinion on the effectiveness of the Company's internal control over financial reporting.

/s/ DELOITTE & TOUCHE LLP

San Jose, California

March 10, 2006

**Table of Contents****ATHEROS COMMUNICATIONS, INC.****CONSOLIDATED BALANCE SHEETS****In thousands, except share and per share amounts**

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>ASSETS</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 75,425	\$ 32,971
Marketable securities	98,220	121,514
Accounts receivable, net	28,381	29,750
Inventory	20,475	15,215
Prepaid expenses, deferred income taxes and other current assets	9,111	3,611
	<u>231,612</u>	<u>203,061</u>
Total current assets	231,612	203,061
Property and equipment, net	5,557	2,757
Deferred income taxes and other assets	2,010	545
	<u>\$ 239,179</u>	<u>\$ 206,363</u>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 14,755	\$ 11,172
Deferred revenue	2,435	1,224
Accrued and other liabilities	24,023	20,626
	<u>41,213</u>	<u>33,022</u>
Total current liabilities	41,213	33,022
Other long-term liabilities	1,000	301
Commitments and contingencies		
<b>Stockholders equity:</b>		
Common stock, \$0.0005 par value, 200,000,000 shares authorized; 49,794,201 and 47,946,900 shares issued and outstanding at December 31, 2005 and 2004, respectively	255,469	249,638
Stockholder notes receivable		(7)
Deferred stock-based compensation	(935)	(2,484)
Accumulated other comprehensive loss	(489)	(340)
Accumulated deficit	(57,079)	(73,767)
	<u>196,966</u>	<u>173,040</u>
Total stockholders equity	196,966	173,040
	<u>\$ 239,179</u>	<u>\$ 206,363</u>

See notes to consolidated financial statements.



**Table of Contents****ATHEROS COMMUNICATIONS INC.****CONSOLIDATED STATEMENTS OF OPERATIONS****In thousands, except per share data**

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Net revenue	\$ 183,485	\$ 169,607	\$ 87,357
Cost of goods sold(1)	102,389	91,321	50,505
<b>Gross profit</b>	<b>81,096</b>	<b>78,286</b>	<b>36,852</b>
<b>Operating expenses:</b>			
Research and development(1)	46,696	41,462	29,112
Sales and marketing(1)	17,225	14,907	11,515
General and administrative(1)	9,769	8,523	5,825
Stock-based compensation	1,856	3,718	3,358
<b>Total operating expenses</b>	<b>75,546</b>	<b>68,610</b>	<b>49,810</b>
Income (loss) from operations	5,550	9,676	(12,958)
Interest income (expense), net	4,854	2,089	(83)
Income (loss) before income taxes	10,404	11,765	(13,041)
Income tax (benefit) provision	(6,284)	941	125
<b>Net income (loss)</b>	<b>\$ 16,688</b>	<b>\$ 10,824</b>	<b>\$ (13,166)</b>
<b>Basic net income (loss) per share</b>	<b>\$ 0.34</b>	<b>\$ 0.25</b>	<b>\$ (1.07)</b>
Shares used in computing basic net income (loss) per share	48,777	42,886	12,335
<b>Diluted net income (loss) per share</b>	<b>\$ 0.31</b>	<b>\$ 0.21</b>	<b>\$ (1.07)</b>
Shares used in computing diluted net income (loss) per share	53,572	51,981	12,335
<b>(1) Amounts exclude stock-based compensation, as follows:</b>			
Cost of goods sold	\$ 94	\$ 253	\$ 223
Research and development	1,092	1,242	1,561
Sales and marketing	133	918	244
General and administrative	537	1,305	1,330
	<b>\$ 1,856</b>	<b>\$ 3,718</b>	<b>\$ 3,358</b>



See notes to consolidated financial statements.

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**Table of Contents****ATHEROS COMMUNICATIONS, INC.****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME (LOSS)**

In thousands, except share amounts

	Convertible		Common Stock		Stockholder Notes	Deferred Stock- Based Compensation	Accumulated Other Comprehensive Income (Loss)	Accumulated Deficit	Total Accumulated Stockholders Equity
	Preferred Stock		Shares	Amount					
	Shares	Amount	Shares	Amount					
BALANCES, January 1, 2003	30,043,580	\$ 98,344	12,841,179	\$ 3,718	\$ (186)	\$	\$ 11	\$ (71,425)	\$ 30,462
Components of comprehensive loss:									
Net loss								(13,166)	(13,166)
Unrealized loss on marketable securities							(14)		(14)
Total comprehensive loss									(13,180)
Exercise of stock options			991,245	1,563					1,563
Issuance of stock options in exchange for services				968					968
Repurchase of common stock			(7,110)	(6)					(6)
Acceleration of vesting of stock options				929					929
Deferred stock-based compensation				7,828		(7,828)			
Amortization of deferred stock-based compensation						1,487			1,487
Collection of stockholder notes receivable					63				63
BALANCES, December 31, 2003	30,043,580	98,344	13,825,314	15,000	(123)	(6,341)	(3)	(84,591)	22,286
Components of comprehensive income:									
Net income								10,824	10,824
Unrealized loss on marketable securities							(337)		(337)
Total comprehensive income									10,487
Issuance of common stock pursuant to initial public offering, net of offering expenses			10,350,000	133,207					133,207
Conversion of preferred stock to common stock in conjunction with initial public offering	(30,043,580)	(98,344)	22,532,670	98,344					
Exercise of stock options and warrants			1,093,917	1,377					1,377
Issuance of common stock pursuant to employee stock purchase plan			165,117	1,744					1,744
Repurchase of common stock			(20,118)	(30)					(30)
Reversal of deferred stock-based compensation				(139)		139			
Amortization of deferred stock-based compensation						3,718			3,718
Tax benefit on employee stock transactions				135					135
					116				116

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Collection of stockholder notes  
receivable

BALANCES, December 31, 2004	47,946,900	249,638	(7)	(2,484)	(340)	(73,767)	173,040
Components of comprehensive income:							
Net income						16,688	16,688
Unrealized loss on marketable securities						(149)	(149)
Total comprehensive income							16,539
Exercise of stock options	1,367,234	2,857					2,857
Issuance of common stock pursuant to employee stock purchase plan	401,513	2,536					2,536
Repurchase of common stock	(15,446)	(28)					(28)
Issuance of restricted stock	94,000	785		(785)			
Reversal of deferred stock-based compensation		(478)		478			
Amortization of deferred stock-based compensation					1,856		1,856
Tax benefit on employee stock transactions		159					159
Forgiveness of stockholder notes receivable				7			7
BALANCES, December 31, 2005	\$ 49,794,201	\$ 255,469	\$	\$ (935)	\$ (489)	\$ (57,079)	\$ 196,966

See notes to consolidated financial statements.

**Table of Contents****ATHEROS COMMUNICATIONS, INC.****CONSOLIDATED STATEMENTS OF CASH FLOWS****In thousands**

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income (loss)	\$ 16,688	\$ 10,824	\$ (13,166)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization	1,846	1,743	1,839
Issuance of common stock in exchange for services			968
Acceleration of vesting of stock options			929
Amortization of deferred stock-based compensation	1,856	3,718	1,487
Amortization of warrants	4	25	61
Loss on disposal of property and equipment	57	168	25
Deferred income tax	(7,535)		
Tax benefit on employee stock transactions	159	135	
Change in assets and liabilities:			
Accounts receivable	1,369	(19,895)	(8,080)
Inventory	(5,260)	(4,286)	(6,483)
Prepaid expenses and other current assets	(452)	(1,523)	(118)
Accounts payable	3,420	(4,413)	13,012
Deferred revenue	1,059	786	(31)
Accrued and other liabilities	3,846	10,036	7,290
<b>Net cash provided by (used in) operating activities</b>	<b>17,057</b>	<b>(2,682)</b>	<b>(2,267)</b>
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Purchase of property and equipment, net	(4,087)	(2,322)	(1,466)
Purchase of marketable securities	(65,714)	(224,399)	(17,417)
Maturities of marketable securities	88,859	117,972	26,487
Other assets	1,025	1,059	(904)
<b>Net cash provided by (used in) investing activities</b>	<b>20,083</b>	<b>(107,690)</b>	<b>6,700</b>
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net proceeds from issuance of common stock	5,365	136,298	1,557
Collection of stockholder notes receivable		116	63
Short-term borrowings		(4,000)	4,000
Proceeds from issuance of debt			2,000
Repayments of debt and capital lease obligations	(51)	(2,686)	(1,532)
<b>Net cash provided by financing activities</b>	<b>5,314</b>	<b>129,728</b>	<b>6,088</b>
<b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>	<b>42,454</b>	<b>19,356</b>	<b>10,521</b>
CASH AND CASH EQUIVALENTS, Beginning of year	32,971	13,615	3,094

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CASH AND CASH EQUIVALENTS, End of year	\$ 75,425	\$ 32,971	\$ 13,615
<b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:</b>			
Cash paid for interest	\$ 3	\$ 120	\$ 378
Cash paid for income taxes	\$ 243	\$ 371	\$ 59

See notes to consolidated financial statements.

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**ATHEROS COMMUNICATIONS, INC.**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Summary of Significant Accounting Policies**

**Organization** Atheros Communications, Inc. (the Company), was incorporated in May 1998 in the state of Delaware and commenced operations in December 1998. The Company is a developer of semiconductor system solutions for wireless communications products.

**Basis of Presentation** The consolidated financial statements include the accounts of the Company and its subsidiaries, all of which are wholly-owned. All intercompany accounts and transactions have been eliminated in consolidation.

**Use of Estimates** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of expenses during the reporting period. Actual results may differ from these estimates.

**Certain Significant Risks and Uncertainties** The Company operates in a dynamic industry and, accordingly, can be affected by a variety of factors. For example, changes in any of the following areas could have a negative effect on the Company in terms of its future financial position, results of operations or cash flows: regulatory changes; fundamental changes in the technology underlying telecommunications products or incorporated in customers' products; market acceptance of the Company's products under development; development of sales channels; litigation or other claims against the Company; the hiring, training and retention of key employees; successful and timely completion of product development efforts; and new product introductions by competitors.

**Fair Value of Financial Instruments** The Company's financial instruments consist primarily of cash and cash equivalents, marketable securities, accounts receivable and accounts payable. The Company believes that the carrying amounts of the financial instruments approximates their respective fair market values due to their short maturities.

**Cash Equivalents** Cash equivalents consist of highly liquid debt instruments purchased with a maturity of three months or less from date of purchase.

**Marketable Securities** Marketable securities are classified as available for sale and are reported at fair value with unrealized gains and losses reported as other comprehensive income (loss) in stockholders' equity. The Company views its available-for-sale portfolio as available for use in its current operations. Accordingly, the Company has classified all investments in marketable securities as short-term, even though the stated maturity date may be one year or more beyond the current balance sheet date. The cost of securities sold is based on the specific-identification method. The amortized cost of securities is adjusted for the accretion of discounts to maturity.

**Inventory** Inventory cost is recorded at the lower of market value or standard cost basis (which approximates actual cost on a first-in, first-out basis).

**Property and Equipment** Property and equipment are stated at cost and depreciated using the straight-line method over estimated useful lives as follows: furniture and fixtures five years; computer software and hardware three to five years. Amortization of leasehold improvements and equipment under capital lease agreements is computed using the straight-line method over the shorter of the initial lease term or the estimated useful lives of the related assets.

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**ATHEROS COMMUNICATIONS, INC.**

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

**Long-Lived Assets** The Company evaluates its long-lived assets for impairment in accordance with Statement of Financial Accounting Standards ( SFAS ) No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future undiscounted net cash flows expected to be generated by the asset.

**Income Taxes** The Company accounts for income taxes under an asset and liability approach. Deferred income taxes reflect the impact of temporary differences between assets and liabilities recognized for financial reporting purposes and such amounts recognized for income tax reporting purposes, net operating loss carryforwards and other tax credits measured by applying currently enacted tax laws. Valuation allowances are provided when necessary to reduce deferred tax assets to an amount that is more likely than not to be realized.

**Revenue Recognition** The Company's revenue is derived primarily from the sale of wireless semiconductor chipsets. In addition, the Company generates revenues from arrangements to license its software and arrangements to provide services. Revenues from software licenses and services represented less than 10% of total revenues for all periods presented.

Revenue from the sale of semiconductors is recognized in accordance with Staff Accounting Bulletin ( SAB ) No. 104, *Revenue Recognition*. Accordingly, revenue is recognized when persuasive evidence of an arrangement exists, the product has been delivered, the price is fixed or determinable and collection is reasonably assured. Delivery is generally considered to have occurred upon shipment. For a limited number of customers, title does not pass until the product reaches the customer's premises, in which case revenue is recognized when the product is received by the customer.

The Company provides marketing incentives to certain of its direct and indirect customers. Such obligations are estimated and recorded as a reduction of revenue in accordance with Emerging Issues Task Force ( EITF ) Issue No. 01-09, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor's Products)*. Estimating incentive amounts requires that we make estimates regarding the percentage of committed incentives that will be submitted by our customers and the value of the incentives at the time of redemption. These estimates may require revisions at later dates if the actual sales data submitted by the customers differs significantly from the original estimates.

Software license revenue is recognized in accordance with AICPA Statement of Position No. 97-2, *Software Revenue Recognition*, ( SOP 97-2 ) as amended. Accordingly, license revenue is recognized when persuasive evidence of an arrangement exists, the software has been delivered, the fee is fixed or determinable, collectibility is probable and vendor-specific objective evidence of fair value exists to allocate a portion of the total fee to any undelivered elements of the arrangement. For electronic delivery, the software is considered to have been delivered when the Company has provided the customer with the access codes that allow for immediate possession of the software. If collectibility is not considered probable at the time of sale, revenue is recognized when the fee is collected.

For arrangements where vendor-specific objective evidence of fair value ( VSOE ) exists for the undelivered elements, the Company defers the full fair value of the undelivered elements and recognizes the difference between the total arrangement fee and the amount deferred for the undelivered items as revenue. If VSOE does not exist for the undelivered items, the Company recognizes the entire arrangement fee ratably over



the service period.

**Product Warranty** The Company provides a warranty on its products for a period of one year, and provides for warranty costs at the time of sale based on historical activity. The determination of such provisions

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## ATHEROS COMMUNICATIONS, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

requires the Company to make estimates of product return rates and expected costs to repair or replace the products under warranty. If actual return rates and/or repair and replacement costs differ significantly from these estimates, adjustments to recognize additional cost of sales may be required in future periods. Components of the reserve for warranty costs during the years ended December 31, 2005 and 2004 consisted of the following (in thousands):

	December 31,	
	2005	2004
Beginning balance	\$ 1,023	\$ 578
Additions related to current period sales	1,518	1,374
Warranty costs incurred in the current period	(418)	(365)
Adjustments to accruals related to prior period sales	(962)	(564)
Ending balance	\$ 1,161	\$ 1,023

**Stock-Based Compensation** The Company accounts for stock-based compensation to employees in accordance with the provisions of Accounting Principles Board Opinion ( APB ) No. 25, *Accounting for Stock Issued to Employees*, and complies with the disclosure provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation Transition and Disclosures*. The Company accounts for equity instruments issued to non-employees in accordance with the provisions of SFAS No. 123 and EITF No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Connection with Selling, Goods or Services*, which requires that the fair value of such instruments be recognized as an expense over the period in which the related services are provided. Such expenses are measured using the value of the equity instruments issued, as this is more readily determinable than the fair value of the services received.

The Company amortizes deferred stock-based compensation on the graded vesting method over the vesting periods of the stock options, generally four years. The graded vesting method provides for vesting of portions of the overall awards at interim dates and results in accelerated vesting as compared to the straight-line method. Had compensation expense been determined based on the fair value at the grant date for all employee awards, consistent with the provisions of SFAS No. 123, the Company's pro forma net income (loss) and net income (loss) per share would have been as follows (in thousands):

	Years Ended December 31,		
	2005	2004	2003
Net income (loss) as reported	\$ 16,688	\$ 10,824	\$ (13,166)
Add: total stock-based employee compensation included in reported net income (loss)	1,856	3,718	2,416
Less: total stock-based compensation determined under the fair value based method for all awards	(10,773)	(8,675)	(2,955)

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Pro forma net income (loss)	\$ 7,771	\$ 5,867	\$ (13,705)
Basic net income (loss) per share as reported	\$ 0.34	\$ 0.25	\$ (1.07)
Diluted net income (loss) per share as reported	\$ 0.31	\$ 0.21	\$ (1.07)
Pro forma basic net income (loss) per share	\$ 0.16	\$ 0.14	\$ (1.11)
Pro forma diluted net income (loss) per share	\$ 0.15	\$ 0.11	\$ (1.11)

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## ATHEROS COMMUNICATIONS, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Through November 26, 2003, the date of the Company's initial filing with the Securities and Exchange Commission (SEC) related to its proposed initial public offering, the Company used the minimum value method to estimate the fair value of options granted to employees. Options granted subsequent to November 26, 2003 through December 31, 2003 were valued using the Black-Scholes valuation model using estimated volatility of 95%. The following table summarizes the weighted-average assumptions used in estimating fair value:

	Stock Option Plans			Employee Stock Purchase Plan			
	Years Ended December 31,			Years Ended December 31,			
	2005	2004	2003	2005		2004	
	4.0	4.5	4.5	0.5	2.2%	1.3	1.9%
Estimated life (in years)	4.0	4.5	4.5	0.5	2.2%	1.3	1.9%
Risk-free interest rate	4.0%	3.4%	3.3%	1.8	60%	32	80%
Expected dividends							
Volatility (subsequent to November 26, 2003)	60%	80%	95%	32	60%	32	80%

Because the Company's common stock has recently become publicly traded, its historical data on the volatility of its common stock is limited. Therefore, the Company estimates volatility based on the average volatilities of similar entities. The estimated weighted average fair value of employee stock options granted during the years ended December 31, 2005, 2004 and 2003 were \$4.66, \$5.72 and \$1.52, respectively.

**Software Development Costs** Costs for the development of new software products and substantial enhancements to existing software products are expensed as incurred until technological feasibility has been established, at which time any additional costs would be capitalized in accordance with SFAS No. 86, *Computer Software To Be Sold, Leased or Otherwise Marketed*. The costs to develop such software have not been capitalized as the Company believes its current software development process is essentially completed concurrent with the establishment of technological feasibility.

**Research and Development** Costs incurred in research and development are charged to operations as incurred. The Company grants developers access to its technology through technology development arrangements. The Company recorded \$119,000 as a reduction of research and development costs for fees received under such arrangements in the year ended December 31, 2003. No such amounts were recorded as a reduction of research and development costs during the years ended December 31, 2005 and 2004. The Company expenses all costs for internally developed patents as incurred.

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**Foreign Currency** The functional currency of the Company's foreign subsidiaries is the U.S. dollar. For those subsidiaries whose books and records are not maintained in the functional currency, all monetary assets and liabilities are remeasured at the current exchange rate at the end of each period reported, nonmonetary assets and liabilities are remeasured at historical exchange rates and revenues and expenses are remeasured at average exchange rates in effect during the period. Transaction gains and losses, which are included in operating expense in the accompanying consolidated statements of operations were not significant for any period presented.

**Net Income (Loss) per Share** Basic net income (loss) per share is computed using the weighted-average number of common shares outstanding during the period, less shares subject to repurchase. Diluted net income (loss) per share is computed using the weighted-average number of common shares and dilutive potential common shares outstanding during the period. Dilutive potential common shares result from the assumed exercise of outstanding stock options and outstanding warrants, by application of the treasury stock method, that have a dilutive effect on earnings per share, and from the assumed conversion of outstanding shares of preferred stock.

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**Table of Contents****ATHEROS COMMUNICATIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Comprehensive Income (Loss)** Comprehensive income (loss) is comprised of two components: net income (loss) and other comprehensive income (loss). Other comprehensive income (loss) refers to revenues, expenses, gains and losses that under generally accepted accounting principles are recorded as an element of stockholders' equity, but are excluded from net income (loss). Statements of comprehensive income (loss) for the years ended December 31, 2005, 2004 and 2003 have been included within the consolidated statements of stockholders' equity. Accumulated other comprehensive income (loss) in the accompanying consolidated balance sheets consists of the unrealized loss on marketable securities.

**Concentration of Credit Risk** Financial instruments that potentially subject the Company to concentrations of credit risk consist primarily of cash and cash equivalents, marketable securities and trade receivables. Risks associated with cash and cash equivalents and marketable securities are mitigated by banking with and purchasing money market funds, commercial paper, market auction preferred stock, corporate notes and corporate bonds from creditworthy institutions. The Company sells its products primarily to companies in the technology industry and generally does not require its customers to provide collateral to support accounts receivable. To reduce credit risk, management performs ongoing credit evaluations of its customers' financial condition. The Company reduced the allowance for doubtful accounts by \$38,000 for the year ended December 31, 2005 and increased the allowance by \$410,000 and \$422,000 for the years ended December 31, 2004 and 2003, respectively. Receivables written off against the allowance aggregated \$51,000 and \$9,000 for the years ended December 31, 2005 and 2004, respectively, and no receivables were written off during the year ended December 31, 2003. The allowance for doubtful accounts at December 31, 2005, 2004 and 2003 was \$744,000, \$833,000 and \$432,000, respectively.

**Recently Issued Accounting Standards** In November 2004, the Financial Accounting Standards Board ( FASB ) issued SFAS No. 151, *Inventory Costs - an amendment to ARB No. 43, Chapter 4* ( SFAS 151 ). SFAS 151 amends the guidance in Accounting Research Bulletin No. 43, Chapter 4, *Inventory Pricing* to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) by requiring these items to be recognized as current-period charges. The provisions of this Statement are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The Company does not believe adoption of SFAS 151 would have a material effect on its consolidated financial position or results of operations.

In December 2004, the FASB issued SFAS No. 153, *Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29* ( SFAS 153 ). APB Opinion No. 29, *Accounting For Nonmonetary Transactions* ( APB 29 ), is based on the opinion that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. SFAS 153 amends APB 29 to eliminate the exception for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of nonmonetary assets whose results are not expected to significantly change the future cash flows of the entity. The provisions of this Statement are effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS 153 did not have a material impact on the Company's consolidated financial position or results of operations.

The Company accounts for stock-based compensation awards issued to employees using the intrinsic value measurement provisions of APB Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB 25 ). Accordingly, no compensation expense has been recorded for stock options granted with exercise prices greater than or equal to the fair value of the underlying common stock at the option grant date. On December 16, 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* ( SFAS 123R ). SFAS 123R eliminates the alternative of applying the intrinsic value measurement provisions of APB 25 to stock compensation awards issued to employees. Rather, the new standard requires enterprises to measure the cost of employee services



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**ATHEROS COMMUNICATIONS, INC.**

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

received in exchange for an award of equity instruments based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide services in exchange for the award, known as the requisite service period.

The Company will recognize stock-based compensation expense on all share-based payment awards made to employees on a graded vesting basis over the requisite service period using the modified prospective method beginning in the first quarter of fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ( SAB 107 ), which provides supplemental implementation guidance for SFAS 123R. In addition, the FASB has issued several FASB Staff Positions ( FSPs ) that provide interpretive guidance for the implementation of SFAS 123R. The Company will apply the principles of SAB 107 and the FSPs in conjunction with its adoption of SFAS 123R. The Company expects that the adoption of SFAS 123R will have a significant adverse impact on the Company's consolidated results of operations. The pro forma disclosures of the impact of SFAS No. 123 provided in Note 1 to the consolidated financial statements may not be representative of the impact of adopting SFAS 123R.

In June 2005, the FASB issued SFAS No. 154, *Accounting Changes and Error Corrections*, a replacement of APB Opinion No. 20, *Accounting Changes*, and Statement No. 3, *Reporting Accounting Changes in Interim Financial Statements* ( SFAS 154 ). SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle. Previously, most voluntary changes in accounting principles required recognition of a cumulative effect adjustment within net income of the period of the change. SFAS 154 requires retrospective application to prior periods' financial statements, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS 154 is effective for accounting changes made in fiscal years beginning after December 15, 2005; however, the new standard does not change the transition provisions of any existing accounting pronouncements. The Company's consolidated financial position and results of operations would only be impacted following the adoption of SFAS 154 if the Company implements changes in accounting principles that are addressed by the standard or corrects accounting errors in future periods.

In November 2005, the FASB issued FSP Nos. FAS 115-1 and FAS 124-1, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. This FSP addresses the determination as to when an investment is considered impaired, whether that impairment is other than temporary, and the measurement of an impairment loss. This FSP also includes accounting considerations subsequent to the recognition of other-than-temporary impairments. The guidance in this FSP is effective for reporting periods beginning after December 15, 2005. The Company does not believe adoption of this FSP will have a material impact on the Company's consolidated financial position or results of operations.



**Table of Contents****ATHEROS COMMUNICATIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****2. Marketable Securities**

Marketable securities consist of (in thousands):

	December 31, 2005			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Money market funds	\$ 15,604	\$	\$	\$ 15,604
Commercial paper	48,380	11		48,391
Corporate notes	5,408		(27)	5,381
Corporate bonds	4,523		(25)	4,498
U.S. government securities	69,093		(448)	68,645
Market auction preferred stock	22,685			22,685
<b>Total</b>	<b>165,693</b>	<b>11</b>	<b>(500)</b>	<b>165,204</b>
Less: Amounts included in cash and cash equivalents	(66,984)			(66,984)
	<b>\$ 98,709</b>	<b>\$ 11</b>	<b>\$ (500)</b>	<b>\$ 98,220</b>

	December 31, 2004			
	Amortized Cost	Gross Unrealized Holding Gains	Gross Unrealized Holding Losses	Fair Value
Money market funds	\$ 2,163	\$	\$	\$ 2,163
Commercial paper	20,560			20,560
Corporate notes	13,104		(82)	13,022
U.S. government securities	64,739		(258)	64,481
Market auction preferred stock	46,353			46,353
<b>Total</b>	<b>146,919</b>		<b>(340)</b>	<b>146,579</b>
Less: Amounts included in cash and cash equivalents	(25,065)			(25,065)
	<b>\$ 121,854</b>	<b>\$</b>	<b>\$ (340)</b>	<b>\$ 121,514</b>



The contractual maturities of available-for-sale debt securities at December 31, 2005 are presented in the following table (in thousands):

	<b>Amortized</b>	<b>Estimated</b>
	<b>Cost</b>	<b>Fair Value</b>
	<u>          </u>	<u>          </u>
Due in one year or less	\$ 85,575	\$ 85,148
Due between one and two years	13,134	13,072
	<u>          </u>	<u>          </u>
	<b>\$ 98,709</b>	<b>\$ 98,220</b>
	<u>          </u>	<u>          </u>

**Table of Contents****ATHEROS COMMUNICATIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****3. Inventory**

Inventory at December 31 consists of (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
Finished goods	\$ 8,574	\$ 4,442
Work in process	9,505	8,283
Raw materials	2,396	2,490
<b>Total</b>	<b>\$ 20,475</b>	<b>\$ 15,215</b>

**4. Property and Equipment**

Property and equipment at December 31 consist of (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
Machinery and equipment	\$ 8,090	\$ 7,316
Software	613	1,169
Furniture and fixtures	650	277
Leasehold improvements	2,132	311
	11,485	9,073
Accumulated depreciation and amortization	(5,928)	(6,316)
<b>Property and equipment, net</b>	<b>\$ 5,557</b>	<b>\$ 2,757</b>

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At December 31, 2005 and 2004, the Company had no assets under capital lease agreements.

The Company entered into an agreement under which it will receive equipment in exchange for services. During 2005, the Company received equipment which the Company recorded at the equipment's fair value of \$285,000. Since the Company has not yet rendered any services for the equipment, the Company has recorded \$285,000 in accrued liabilities at December 31, 2005. There was no gain or loss recorded on the transaction.

### 5. Accrued Liabilities

Accrued liabilities at December 31 consist of (in thousands):

	December 31,	
	2005	2004
Accrued customer incentives	\$ 9,471	\$ 10,388
Accrued compensation and benefits	6,068	3,923
Other liabilities	8,484	6,315
Total	\$ 24,023	\$ 20,626

### 6. Bank Loan and Security Agreement

During 2003, the Company entered into a loan agreement (the Agreement) with a bank which allowed the Company to finance up to \$10,000,000 of working capital requirements (subject to certain limitations) and

**Table of Contents****ATHEROS COMMUNICATIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

\$2,000,000 of equipment purchases. In 2003 the Company borrowed \$4,000,000 and \$1,837,000 under the working capital and equipment purchase arrangements, respectively. The Company repaid all amounts in full, in February 2004, so that at December 31, 2004 there were no balances outstanding. The Agreement was originally due to terminate in March 2003 but has been subsequently amended and renewed on an annual basis. The amended Agreement, which currently expires in March 2006, provides the Company with a revolving line of credit facility of up to \$10,000,000 to fund working capital requirements. Borrowings under the amended Agreement are secured by all of the tangible assets of the Company. The amended Agreement contains certain financial and non-financial covenants. Interest on any borrowings is payable monthly and is calculated at the bank's prime rate (7.25% at December 31, 2005). Borrowings under this line are due March 29, 2006. The Company did not draw down on the line of credit during 2005, and at December 31, 2005 the Company had \$10,000,000 available for borrowing.

**7. Commitments and Contingencies*****Operating Leases***

The Company leases facilities and certain equipment under operating lease agreements. Under the former lease agreement for its previous principal facility, the Company was required to maintain a restricted cash balance of \$1,125,000, which was included in prepaid expenses and other current assets at December 31, 2004. Under the new lease agreement for its principal facility the Company is no longer required to maintain a restricted cash balance. This lease expires in 2010 and the Company has the option to extend the lease beyond the initial term for two periods of three years each.

At December 31, 2005, future minimum annual lease payments under operating leases are as follows (in thousands):

	<b>Operating Leases</b>
2006	\$ 2,080
2007	1,805
2008	1,331
2009	1,358
2010	805
Thereafter	
<b>Total minimum lease payments</b>	<b>\$ 7,379</b>

Rent expense was \$1,982,000, \$1,863,000 and \$1,610,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

***Licensing Agreements***

The Company entered into several licensing agreements which allow it to use certain software for specified periods of time. As of December 31, 2005, minimum payments under these agreements are \$4,192,000, \$3,149,000 and \$2,138,000 in 2006, 2007 and 2008, respectively. Research and development expense associated with these licensing agreements was \$5,115,000, \$4,678,000 and \$2,608,000 for the years ended December 31, 2005, 2004 and 2003, respectively.

***Contingencies***

From time to time, the Company may become involved in litigation. Management is not currently aware of any matters that will have a material adverse affect on the financial position, results of operations or cash flows of the Company.

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**ATHEROS COMMUNICATIONS, INC.**

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

Pursuant to its Restated Certificate of Incorporation, the Company has entered into indemnification agreements with its directors and executive officers. These agreements require the Company to indemnify these individuals to the fullest extent permitted under Delaware law against liabilities that may arise by reason of their service to the Company, and to advance expenses incurred as a result of any proceeding against them as to which they could be indemnified. The Company has not incurred any costs in connection with these indemnification agreements through December 31, 2005.

Under the indemnification provisions of the Company's standard software license agreements and standard terms and conditions of semiconductor sales, the Company agrees to defend the customer/licensee against third-party claims asserting infringement of certain intellectual property rights, which may include patents, copyrights, trademarks or trade secrets, and to pay any judgments entered on such claims against the customer/licensee. There have been no claims under such indemnification provisions through December 31, 2005.

**8. Stockholders' Equity**

*Common Stock Offering*

In February 2004, the Company completed an initial public offering of 10,350,000 shares of common stock for net proceeds of \$133,207,000. Immediately prior to the completion of the initial public offering, all outstanding shares of preferred stock were converted to a total of 22,532,670 shares of common stock.

*Preferred Stock*

The Company is authorized to issue 10,000,000 shares of undesignated preferred stock at a \$0.0005 par value per share. The board of directors may determine the rights, preferences, privileges, qualifications, limitations and restrictions granted or imposed upon any series of preferred stock. As of December 31, 2005, no preferred stock was outstanding.

*1998 and 2004 Stock Incentive Plans*

In October 1998 the Company's 1998 Stock Incentive Plan (the "1998 Plan") was adopted by the board of directors and was subsequently approved by stockholders. Upon completion of the Company's initial public offering, the 1998 Plan was terminated and no shares are available for future issuance under the 1998 Plan. Shares that are subject to options that expire, terminate or are cancelled, that are forfeited or as to which options have not been granted under the 1998 Plan will become available for issuance under the 2004 Stock Incentive Plan (the "2004 Plan"). The 1998

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Plan permitted the Company to grant stock options to employees, officers, directors, and consultants at prices not less than the fair market value at date of grant for incentive stock options and not less than 85% of fair market value for nonstatutory stock options as determined by the board of directors. These options generally expire ten years from the date of grant and are immediately exercisable. Options generally vest at a rate of 25% on the first anniversary of the grant date and 1/48 per month thereafter. At December 31, 2005, 79,139 unvested shares were subject to repurchase by the Company at the original issuance price.

In January 2004 the Company's 2004 Plan was adopted by the board of directors and was subsequently approved by stockholders. The 2004 Plan became effective upon the completion of the Company's initial public offering in February 2004. The 2004 Plan provides for the grant of options to purchase shares of common stock, restricted stock, stock appreciation rights and stock units. Incentive stock options may be granted only to employees. Nonstatutory stock options and other stock-based awards may be granted to employees, non-employee directors, advisors and consultants. A total of 2,250,000 shares of common stock were originally authorized for issuance under the 2004 Plan. In addition to shares that may from time to time be transferred from



**Table of Contents****ATHEROS COMMUNICATIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

the 1998 Plan to the 2004 Plan reserve, an annual increase in the 2004 Plan share reserve is added on the first day of each year. Initial hire-on stock options granted under the 2004 Plan are exercisable upon vesting and generally vest 25% on the first anniversary of the grant date and then monthly thereafter over the remaining 36 months. Subsequent discretionary stock option grants generally vest equally each month over 48 months.

Option activity under the Plans is as follows:

	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>
Outstanding, January 1, 2003 (1,076,629 vested at a weighted average exercise price of \$0.96 per share)	4,702,967	\$ 1.47
Granted	4,754,503	2.48
Exercised	(991,245)	1.58
Canceled	(560,339)	1.69
Outstanding, December 31, 2003 (1,944,034 vested at a weighted average exercise price of \$1.33 per share)	7,905,886	2.04
Granted	2,557,022	9.23
Exercised	(1,006,194)	1.41
Canceled	(337,611)	5.83
Outstanding, December 31, 2004 (3,219,989 vested at a weighted average exercise price of \$1.96 per share)	9,119,103	3.99
Granted	3,228,183	9.69
Exercised	(1,367,234)	2.17
Canceled	(681,669)	5.36
Outstanding, December 31, 2005	10,298,383	\$ 5.93

Additional information regarding options outstanding as of December 31, 2005 is as follows:

<b>Options Outstanding</b>				<b>Options Vested</b>	
<b>Range of Exercise Prices</b>	<b>Number of Options</b>	<b>Weighted Average Remaining Contractual Life (Years)</b>	<b>Weighted Average Exercise Price</b>	<b>Number of Options</b>	<b>Weighted Average Exercise Price</b>

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\$0.07-0.89	201,629	4.49	\$ 0.63	201,629	\$ 0.63
\$1.72	3,141,917	6.67	1.72	2,413,575	1.72
\$1.99-2.52	1,156,490	6.74	2.08	510,986	2.10
\$3.33-7.75	1,490,583	6.03	6.91	563,809	6.63
\$7.90-\$9.63	2,770,901	6.78	9.30	399,830	9.26
\$9.72-17.59	1,536,863	9.08	11.08	169,297	13.12
	<u>          </u>			<u>          </u>	
\$0.07-17.59	10,298,383	7.03	\$ 5.93	4,259,126	\$ 3.53
	<u>          </u>			<u>          </u>	

***Employee Stock Purchase Plan***

In January 2004, the 2004 Employee Stock Purchase Plan (the "2004 Purchase Plan") was adopted by the board of directors and was subsequently approved by stockholders. A total of 750,000 shares of common stock were originally reserved for issuance under the 2004 Purchase Plan. The number of shares reserved for issuance under the 2004 Purchase Plan is increased on the first day of each year. The 2004 Purchase Plan permits eligible

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**ATHEROS COMMUNICATIONS, INC.**

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

employees to acquire shares of the Company's common stock through periodic payroll deductions of up to 15% of total compensation. No more than 1,875 shares may be purchased by each eligible employee during a single purchase period. Each offering period will have a maximum duration of 24 months, with new offering periods beginning in May and November. Purchase periods for the 2004 Purchase Plan have a duration of six months. The purchase price under the 2004 Purchase Plan will be equal to 85% of the fair market value per share of common stock on either the first trading day of the offering period or on the last trading day of the purchase period, whichever is less. During the years ended December 31, 2005 and 2004, 401,513 and 165,117 shares, respectively, were purchased under the 2004 Purchase Plan.

***Restricted Stock***

In April 2005, the Company issued 94,000 shares of restricted stock to employees pursuant to the 2004 Plan. The Company determined the fair value of the restricted stock grant to be \$785,000 by reference to the quoted market price of the stock at the date of grant and is amortizing this amount on a graded vesting method over two years. Compensation expense related to the issuance of restricted stock was \$573,000 for the year ended December 31, 2005.

***Issuance of Equity Instruments in Exchange for Services***

During the year ended December 31, 2003, the Company issued options to outside advisors for the purchase of 105,000 shares of common stock at a weighted average exercise price of \$2.02 per share. The options originally vested over a period of 48 months. The Company accounted for the unvested options under variable accounting. The fair value of these awards during the year ended December 31, 2003 was calculated using the Black-Scholes pricing model with the following weighted average assumptions: option term, remaining statutory life; volatility, 75%, risk-free interest rate, 4.5% and no dividends during the option term. During November 2003 the Company accelerated the vesting of these options. This acceleration enabled the option-holders to vest immediately in 105,000 options, which otherwise would have vested over 48 months. In connection with this acceleration, the Company recorded \$721,000 as compensation expense based on the fair value of the options at the date of acceleration. At December 31, 2005 and 2004, all options granted to non-employees have vested.

The compensation expense for all non-employee awards for the year ended December 31, 2003, including charges related to the acceleration of vesting, aggregated \$968,000 and was recognized in the accompanying statement of operations in accordance with the related service being performed. During the years ended December 31, 2005 and 2004, the Company did not issue options to non-employees. Accordingly, there was no compensation expense for non-employee awards during the years ended December 31, 2005 and 2004.

***Acceleration of Vesting of Employee Stock Options***

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During the year ended December 31, 2003, in connection with severance agreements relating to the termination of certain employees, the Company accelerated the vesting of options to purchase common stock beyond their employment period. This acceleration enabled these employees to vest in an additional 331,156 options over the number to which they would normally be entitled. The Company recorded compensation expense equal to the intrinsic value of the options at the date that each employee accepted the severance agreement, which aggregated \$929,000 for the year ended December 31, 2003. The Company did not accelerate the vesting of employee stock options during the years ended December 31, 2005 and 2004.

### *Deferred Stock-Based Compensation*

During the year ended December 31, 2003, the Company issued 4,606,012 options to purchase common stock to employees at a weighted average exercise price of \$2.49 per share. The weighted average exercise price was below the weighted average deemed fair value of the Company's common stock of \$4.20 per share. The

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## ATHEROS COMMUNICATIONS, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

cumulative deferred stock-based compensation with respect to these grants totaled \$7,828,000 and is being amortized to expense on a graded vesting method over the vesting period of the options through 2008.

**9. Net Income (Loss) Per Share**

Net income (loss) per share is calculated as follows (in thousands, except per share data):

	Years ended December 31,		
	2005	2004	2003
<b>Numerator:</b>			
Net income (loss)	\$ 16,688	\$ 10,824	\$ (13,166)
<b>Denominator:</b>			
Weighted average shares outstanding	48,946	43,219	13,147
Weighted average shares subject to repurchase	(118)	(333)	(812)
Weighted average restricted stock	(51)		
Shares used to calculate basic net income (loss) per share	48,777	42,886	12,335
<b>Effect of dilutive securities:</b>			
Common stock options and warrants	4,626	6,100	
Common shares subject to repurchase	169	333	
Convertible preferred stock		2,662	
Shares used to calculate diluted net income (loss) per share	53,572	51,981	12,335
Basic net income (loss) per share	\$ 0.34	\$ 0.25	\$ (1.07)
Diluted net income (loss) per share	\$ 0.31	\$ 0.21	\$ (1.07)

The following common stock equivalents were excluded from the net income (loss) per share calculation as their effect would have been antidilutive (in thousands):

	Years ended December 31,		
	2005	2004	2003
Stock options and warrants	1,251	297	7,906
Common shares subject to repurchase			575
Convertible preferred stock			22,533
<b>Total potential shares of common stock excluded from diluted net income (loss) per share calculation</b>	<b>1,251</b>	<b>297</b>	<b>31,014</b>

## 10. Income Taxes

The U.S. and foreign components of income (loss) before income taxes are as follows (in thousands):

	Years Ended December 31,		
	2005	2004	2003
U.S.	\$ 21,874	\$ 11,767	\$ (13,105)
Foreign	(11,470)	(2)	64
	<b>\$ 10,404</b>	<b>\$ 11,765</b>	<b>\$ (13,041)</b>

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## ATHEROS COMMUNICATIONS, INC.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The income tax (benefit) provision consists of the following (in thousands):

	Years Ended December 31,		
	2005	2004	2003
Federal:			
Current	\$ 828	\$ 417	\$
Deferred	(7,066)		
State:			
Current	66	8	
Deferred	(469)		
Foreign			
Current	357	516	125
Income tax (benefit) provision	\$ (6,284)	\$ 941	\$ 125

The effective tax rate differs from the applicable U.S. statutory federal income tax rate as follows:

	Years Ended December 31,		
	2005	2004	2003
U.S. statutory federal tax rate	35.0%	35.0%	35.0%
State taxes, net of federal benefit	(6.1)	(6.1)	(11.6)
Research and development credits	(12.6)	(12.2)	9.1
Stock-based compensation	2.7	11.1	(8.2)
Change in valuation allowance	(126.1)	(22.4)	(27.1)
Foreign losses and tax rate differences	46.4		
Other	0.3	2.6	2.8
Effective tax rate	(60.4)%	8.0%	%

Significant components of the Company's net deferred tax assets consist of (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
Deferred tax assets:		
Credit carryforwards	\$ 13,139	\$ 14,158
Net operating loss carryforwards	10,499	17,431
Other accruals and reserves recognized in different periods	1,041	1,063
Capitalized research and development	708	859
Deferred revenue	285	400
Inventory valuation	219	871
Excess book over tax depreciation and other	151	265
	<hr/>	<hr/>
Total deferred tax assets	26,042	35,047
Valuation allowance	(18,507)	(35,047)
	<hr/>	<hr/>
Net deferred tax assets	\$ 7,535	\$
	<hr/>	<hr/>

At December 31, 2005, the Company reassessed the valuation allowance previously recorded against its net deferred tax assets which consisted primarily of net operating loss carryforwards and research and development tax credits. Based on the Company's earnings history and projected future taxable income, the Company



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**ATHEROS COMMUNICATIONS, INC.**

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

determined that it is more likely than not that a portion of the deferred tax assets would be realized. Accordingly, the Company released a portion of the valuation allowance previously recorded against its deferred tax assets. The valuation allowance decreased by \$16,540,000 and \$2,641,000 in 2005 and 2004, respectively. The change in the valuation allowance in 2005 included net operating losses realized as well as the benefit given to certain deferred tax assets in the amount of \$7,535,000. Approximately \$5,987,000 of the valuation allowance at December 31, 2005 relates to the tax benefits of stock option deductions, which will be credited to equity if and when realized.

At December 31, 2005, the Company has federal and state net operating loss carryforwards of approximately \$26,900,000 and \$18,900,000, respectively, available to offset future taxable income. The federal and state net operating loss carryforwards will begin to expire in 2021 and 2008, respectively, if not utilized before these dates.

At December 31, 2005, the Company also has research and development credit carryforwards of approximately \$7,600,000 and \$6,900,000 available to offset future federal and state income taxes, respectively. The federal tax credit carryforward expires beginning in 2018. The state tax credit carryforward has no expiration.

**11. Employee Benefit Plan**

The Company sponsors a 401(k) Savings Plan (the Plan) for all employees who meet certain eligibility requirements. Participants may contribute, on a pre-tax basis an amount not to exceed a maximum contribution amount pursuant to Section 401(k) of the Internal Revenue Code. The Company is not required to contribute, nor has it contributed, to the Plan for any of the periods presented.

**12. Segment Information, Operations By Geographic Area And Significant Customers**

The Company currently operates in one reportable segment, the design and marketing of semiconductors for the wireless industry. The Company's Chief Operating Decision Maker ( CODM ) is the CEO.

*Geographic Information*

Long-lived assets outside of the United States are insignificant. Net revenue consists of sales to customers in the following countries:

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	December 31,		
	2005	2004	2003
Taiwan	70%	86%	88%
China	16	3	
United States	3	1	1
Other	11	10	11

*Significant Customers*

Customers representing greater than 10% of net revenues are as follows:

	December 31,		
	2005	2004	2003
Alpha Networks, Inc.	15%	10%	*%
Hon Hai Precision Industry	15	23	20
Cameo Communications, Inc.	13	12	28
Askey Computer Corporation	10	17	*

**Table of Contents****ATHEROS COMMUNICATIONS, INC.****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Customers representing greater than 10% of accounts receivable are as follows:

	<u>December 31,</u>	
	<u>2005</u>	<u>2004</u>
Alpha Networks, Inc	16%	12%
Hon-Hai Precision Industry	16	13
Askey Computer Corp	11	25
UTStarcom, Inc.	11	
Cameo Communications, Inc.	*	11

\* less than 10% in the applicable period.

**12. Related Party Transactions**

During the years ended December 31, 2005, 2004 and 2003 the Company recorded charges of \$141,000, \$158,000 and \$211,000 related to a consulting agreement with one of its directors, under which this director provides engineering services to the Company.

**Supplementary Data (Unaudited)**

The following table presents our unaudited consolidated statements of operations data for each of the eight quarters in the period ended December 31, 2005. In our opinion, this information has been presented on the same basis as the audited consolidated financial statements included in a separate section of this report, and all necessary adjustments, consisting only of normal recurring adjustments, have been included in the amounts below to present fairly the unaudited quarterly results when read in conjunction with the audited consolidated financial statements and related notes. The operating results for any quarter should not be relied upon as necessarily indicative of results for any future period.

	<u>Fiscal 2005</u>			
	<u>First</u>	<u>Second</u>	<u>Third</u>	<u>Fourth</u>
	<u>Quarter</u>	<u>Quarter</u>	<u>Quarter</u>	<u>Quarter(1)</u>
Net revenue	\$ 41,233	\$ 43,374	\$ 45,800	\$ 53,078

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Gross profit	18,366	18,045	19,907	24,778
Net income (loss)	1,669	(216)	2,152	13,083
Net income per share:				
Basic	\$ 0.03	\$ 0.00	\$ 0.04	\$ 0.27
Diluted	\$ 0.03	\$ 0.00	\$ 0.04	\$ 0.24

**Fiscal 2004**

	<b>First</b>	<b>Second</b>	<b>Third</b>	<b>Fourth</b>
	<b>Quarter</b>	<b>Quarter</b>	<b>Quarter</b>	<b>Quarter</b>
Net revenue	\$ 43,099	\$ 46,593	\$ 38,262	\$ 41,653
Gross profit	19,031	23,246	17,462	18,547
Net income	2,379	5,522	767	2,156
Net income per share:				
Basic	\$ 0.08	\$ 0.12	\$ 0.02	\$ 0.05
Diluted	\$ 0.05	\$ 0.10	\$ 0.01	\$ 0.04

- (1) During the fourth quarter of 2005, the Company recorded an income tax benefit of \$7,535,000, or \$0.14 per share, related to the release of a portion of the valuation allowance previously recorded against the Company's deferred tax assets.