TIMBERLAND BANCORP INC
Form 10-Q
August 08, 2007

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

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2007

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 number 0-23333

TIMBERLAND BANCORP, INC.
(Exact name of registrant as specified in its charter)

Washington	91-1863696
(State of Incorporation)	(IRS Employer Identification No.)

624 Simpson Avenue, Hoquiam, Washington	98550
(Address of principal executive office)	(Zip Code)

(360) 533-4747
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is 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 X ____ Non-accelerated filer ____

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

CLASS	SHARES OUTSTANDING AT July 31, 2007
Common stock, $.01 par value	6,965,360

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

TIMBERLAND BANCORP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
June 30, 2007 and September 30, 2006
Dollars in thousands, except share amounts

	June 30, 2007	September 30, 2006
Assets	(Unaudited)	
Cash equivalents:		
Non-interest bearing	$ 11,798	$ 14,870
Interest bearing deposits in banks	1,188	2,519
Federal funds sold	205	5,400
	13,191	22,789
Certificates of deposit ("CDs") held for investment	- -	100
Investments and mortgage-backed securities: held to maturity	72	75
Investments and mortgage-backed securities: available for sale	64,911	81,408
Federal Home Loan Bank ("FHLB") stock	5,705	5,705
Loans receivable	500,694	426,318
Loans held for sale	1,165	2,449
Less: Allowance for loan losses	(4,529)	(4,122)
Net loans receivable	497,330	424,645
Accrued interest receivable	3,177	2,806
Premises and equipment	16,557	16,730
Other real estate owned ("OREO") and other repossessed items	68	15
Bank owned life insurance ("BOLI")	12,294	11,951
Goodwill	5,650	5,650
Core deposit intangible	1,292	1,506
Mortgage servicing rights	1,018	932
Other assets	2,881	2,775
Total assets	$624,146	$577,087
Liabilities and shareholders' equity		
Deposits	$433,514	$431,061
FHLB advances	112,463	62,761
Other borrowings: repurchase agreements	775	947
Other liabilities and accrued expenses	3,402	2,953
Total liabilities	550,154	497,722
Commitments and contingencies	--	--
Shareholders' equity		
Preferred stock, $.01 par value; 1,000,000 shares authorized; none issued		
Common stock, $.01 par value; 50,000,000 shares authorized;		
June 30, 2007 - 7,025,360 shares issued and		

outstanding September 30, 2006 - 3,757,676 shares issued and outstanding on a pre-split basis	70	38
Additional paid in capital	11,425	20,888
Unearned shares - Employee Stock Ownership Plan ("ESOP")	(3,106)	(3,305)
Unearned shares - Management Recognition and Development Plan ("MRDP")	(415)	(188)
Retained earnings	66,915	62,933
Accumulated other comprehensive loss	(897)	(1,001)
Total shareholders' equity	73,992	79,365
Total liabilities and shareholders' equity	$624,146	$577,087

See notes to unaudited condensed consolidated financial statements

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TIMBERLAND BANCORP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
For the three and nine months ended June 30, 2007 and 2006
Dollars in thousands, except per share amounts
(unaudited)

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2007	2006	2007	2006
Interest and dividend income				
Loans receivable	$ 9,981	$ 8,036	$28,050	$23,144
Investments and mortgage-backed securities	350	529	1,185	1,642
Dividends from investments	426	370	1,259	1,036
Federal funds sold	49	121	192	292
Interest bearing deposits in banks	8	18	61	54
Total interest and dividend income	10,814	9,074	30,747	26,168
Interest expense				
Deposits	2,866	2,058	8,113	5,554
FHLB advances - short term	651	- -	1,298	13
FHLB advances - long term	627	718	1,875	2,188
Other borrowings	12	10	39	36
Total interest expense	4,156	2,786	11,325	7,791
Net interest income	6,658	6,288	19,422	18,377
Provision for loan losses	260	- -	416	--
Net interest income after provision for loan losses	6,398	6,288	19,006	18,377
Non-interest income				
Service charges on deposits	692	769	2,061	2,226
Gain on sale of loans, net	79	60	250	264
BOLI net earnings	116	112	343	333
Escrow fees	22	32	77	87

Servicing income on loans sold	127	80	373	266
ATM transaction fees	295	266	830	742
Other	170	209	471	674
Total non-interest income	1,501	1,528	4,405	4,592
Non-interest expense				
Salaries and employee benefits	2,752	2,727	8,303	8,095
Premises and equipment	557	583	1,827	1,814
Advertising	190	185	569	501
Loss (gain) from other real estate operations	1	5	(14)	(79)
ATM expenses	128	105	354	299
Postage and courier	113	123	347	370
Amortization of core deposit intangible	71	82	214	246
State and local taxes	148	138	420	427
Professional fees	175	222	524	611
Other	626	621	2,052	1,863
Total non-interest expense	4,761	4,791	14,596	14,147
Income before federal income taxes	3,138	3,025	8,815	8,822
Federal income taxes	1,000	964	2,806	2,809
Net income	$ 2,138	$ 2,061	$ 6,009	$ 6,013
Earnings per common share:				
Basic	$ 0.32	$ 0.29	$ 0.88	$ 0.85
Diluted	$ 0.31	$ 0.28	$ 0.85	$ 0.82
Weighted average shares outstanding:				
Basic	6,713,777	7,141,700	6,863,253	7,058,116
Diluted	6,910,165	7,382,876	7,080,530	7,305,004
Dividends paid per share:	$ 0.09	$ 0.08	$ 0.27	$ 0.24

See notes to unaudited condensed consolidated financial statements

TIMBERLAND BANCORP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY
For the year ended September 30, 2006 and the nine months ended June 30, 2007
Dollars in thousands, except per share amounts and common stock shares

	Common Stock Shares Outstanding	Common Stock Amount	Additional Paid-In Capital	Unearned Shares Issued to ESOP	Unearned Shares Issued to MRP	Retained Earnings	Accumulated Other Comprehensive Loss
Balance, Sept. 30, 2005	7,519,874	$ 38	$22,040	($3,833)	$ - -	$57,268	($871)

Net income	- -	- -	- -	- -	- -	8,157	- -
Issuance of MRDP shares	12,000	- -	195	- -	(195)	- -	- -
Repurchase of common stock	(217,200)	(1)	(3,700)	- -	- -	- -	- -
Exercise of stock options	200,678	1	1,827	- -	- -	- -	- -
Cash dividends ($.33 per share)	- -	- -	- -	- -	- -	(2,492)	- -
Earned ESOP shares	- -	- -	480	528	- -	- -	- -
Earned MRDP shares	- -	- -	(4)	- -	7	- -	- -
Stock option compensation exp.	- -	- -	50	- -	- -	- -	- -
Change in fair value of securities available for sale, net of tax	- -	- -	- -	- -	- -	- -	(130)
Balance, Sept. 30, 2006	7,515,352	$ 38	$20,888	($3,305)	($188)	$62,933	($1,001)
(Unaudited)							
Net income	- -	- -	- -	- -	- -	6,009	- -
Stock split	- -	36	- -	- -	- -	(36)	- -
Issuance of MRDP shares	15,080	- -	263	- -	(263)	- -	- -
Repurchase of common stock	(615,542)	(4)	(11,232)	- -	- -	- -	- -
Exercise of stock options	110,470	- -	1,207	- -	- -	- -	- -
Cash dividends ($.27 per share)	- -	- -	- -	- -	- -	(1,991)	- -
Earned ESOP shares	- -	- -	280	199	- -	- -	- -
Earned MRDP shares	- -	- -	- -	- -	36	- -	- -
Stock option compensation exp.	- -	- -	19	- -	- -	- -	- -
Change in fair value of securities available for sale, net of tax	- -	- -	- -	- -	- -	- -	104
Balance, June 30, 2007	7,025,360	$ 70	$11,425	($3,106)	($415)	$66,915	($897)

See notes to unaudited condensed consolidated financial statements

TIMBERLAND BANCORP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
For the nine months ended June 30, 2007 and 2006
In thousands
(unaudited)

	Nine Months Ended June 30,	
Cash flow from operating activities	2007	2006
Net income	$ 6,009	$ 6,013
Non-cash revenues, expenses, gains and losses included in income:		
Provision for loan losses	416	- -
Depreciation	760	755
Deferred federal income taxes	(178)	- -
Amortization of core deposit intangible	214	246
Earned ESOP shares	199	396

Earned MRDP shares	36	- -
Stock option compensation expense	19	38
Stock option tax effect less excess tax benefit	110	92
Gain on sale of OREO, net	(19)	(49)
Gain on sale of premises and equipment	(64)	(38)
BOLI cash surrender value increase	(343)	(333)
Gain on sale of loans	(250)	(264)
Increase (decrease) in deferred loan origination fees	123	(322)
Loans originated for sale	(20,102)	(16,000)
Proceeds from sale of loans	21,636	17,595
Increase in other assets, net	(412)	(203)
Increase in other liabilities and accrued expenses, net	449	85
Net cash provided by operating activities	8,603	8,011
Cash flow from investing activities		
Decrease in certificates of deposit held for investment	100	- -
Proceeds from maturities of securities available for sale	16,630	4,011
Proceeds from maturities of securities held to maturity	2	17
Increase in loans receivable, net	(74,580)	(10,868)
Additions to premises and equipment	(847)	(1,271)
Proceeds from the disposition of premises and equipment	324	- -
Proceeds from sale of OREO	37	473
Net cash used in investing activities	(58,334)	(7,638)
Cash flow from financing activities		
Increase in deposits, net	2,453	7,719
Increase (decrease) in FHLB advances - long term	5,952	(577)
Increase (decrease) in FHLB advances - short term	43,750	(8,000)
Increase (decrease) in repurchase agreements	(172)	371
Proceeds from exercise of stock options	744	1,011
ESOP tax effect	280	299
Stock option excess tax benefit	353	376
Purchase and retirement of common stock	(11,236)	(1,745)
Payment of dividends	(1,991)	(1,810)
Net cash provided (used in) by financing activities	40,133	(2,356)
Net decrease in cash equivalents	(9,598)	(1,983)
Cash equivalents		
Beginning of period	22,789	28,718
End of period	$ 13,191	$ 26,735

See notes to unaudited condensed consolidated financial statements
(continued)

TIMBERLAND BANCORP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (concluded)
For the nine months ended June 30, 2007 and 2006
In thousands
(unaudited)

	Nine Months Ended June 30, 2007	Nine Months Ended June 30, 2006
Supplemental disclosure of cash flow information		
Income taxes paid	$ 2,674	$ 2,625
Interest paid	11,222	7,544
Supplemental disclosure of non-cash investing activities		
Market value adjustment of securities held for sale, net of tax	104	(489)
Loans transferred to OREO and other repossessed assets	71	27
Supplemental disclosure of non-cash financing activities		
Shares issued to MRDP	263	- -

See notes to unaudited condensed consolidated financial statements

TIMBERLAND BANCORP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
For the three and nine months ended June 30, 2007 and 2006
In thousands
(unaudited)

	Three Months Ended June 30, 2007	Three Months Ended June 30, 2006	Nine Months Ended June 30, 2007	Nine Months Ended June 30, 2006
Comprehensive income:				
Net income	$2,138	$2,061	$6,009	$6,013
Increase (decrease) in fair value of securities available for sale, net of tax	(162)	(197)	104	(489)
Total comprehensive income	$1,976	$1,864	$6,113	$5,524

See notes to unaudited condensed consolidated financial statements

Timberland Bancorp, Inc. and Subsidiaries
Notes to Condensed Consolidated Financial Statements (unaudited)

(1) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of Presentation: The accompanying unaudited condensed consolidated financial statements for Timberland Bancorp, Inc. ("Company") were prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and with instructions for Form 10-Q and therefore, do not include all disclosures necessary for a complete presentation of financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America. However, all adjustments which are in the opinion of management, necessary for a fair presentation of the interim condensed consolidated financial statements have been included. All such adjustments are of a normal recurring nature. The unaudited condensed consolidated financial statements should be read in conjunction with the audited financial statements included in the Company's Annual Report on Form 10-K for the year ended September 30, 2006 ("2006 Form 10-K"). The results of operations for the nine months ended June 30, 2007 are not necessarily indicative of the results that may be expected for the entire fiscal year.

(b) Stock Split: On June 5, 2007 the Company's common stock was split two-for-one in the form of a 100% stock dividend. Each shareholder of record as of May 22, 2007 received one additional share for every share owned. All share and per share amounts (including stock options) in the condensed consolidated financial statements and accompanying notes were restated to reflect the split, except as otherwise noted.

(c) Principles of Consolidation: The interim condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Timberland Bank ("Bank"), and the Bank's wholly-owned subsidiary, Timberland Service Corp. All significant inter-company balances have been eliminated in consolidation.

(d) Operating Segment: The Company provides a broad range of financial services to individuals and companies located primarily in Western Washington. These services include demand, time and savings deposits; real estate, business and consumer lending; escrow services; and investment advisory services. While the Company's chief decision maker monitors the revenue streams from the various products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Accordingly, all of our operations are considered by management to be aggregated in one reportable operating segment.

(e) 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 reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

(f) Certain prior period amounts have been reclassified to conform to the June 30, 2007 presentation with no change to net income or shareholders' equity previously reported.

(2) EARNINGS PER SHARE

Basic earnings per share ("EPS") is computed by dividing net income by the weighted average number of common shares outstanding during the period, without considering any dilutive items. Diluted EPS is computed by dividing net income by the weighted average number of common shares and common stock equivalents for items that are dilutive, net of shares assumed to be repurchased using the treasury stock method at the average share price for the Company's common stock during the period. Common stock equivalents arise from assumed conversion of outstanding stock options and awarded but not released MRDP shares. In accordance with Statement of Position ("SOP") 93-6, Employers' Accounting for Employee Stock Ownership Plans, issued by

the American Institute of Certified Public Accountants, shares owned by the Bank's ESOP that have not been allocated are not considered to be outstanding for the purpose of computing earnings per share. At June 30, 2007 and 2006, there were 440,830 and 511,364 ESOP shares, respectively, that had not been allocated.

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2007	2006	2007	2006
Basic EPS computation				
Numerator - net income	$2,138,000	$2,061,000	$6,009,000	$6,013,000
Denominator - weighted average common shares outstanding	6,713,777	7,141,700	6,863,253	7,058,116
Basic EPS	$ 0.32	$ 0.29	$ 0.88	$ 0.85
Diluted EPS computation				
Numerator - net income	$2,138,000	$2,061,000	$6,009,000	$6,013,000
Denominator - weighted average common shares outstanding	6,713,777	7,141,700	6,863,253	7,058,116
Effect of dilutive stock options	193,827	241,176	215,232	246,888
Effect of dilutive MRDP shares	2,561	- -	2,045	- -
Weighted average common shares and common stock equivalents	6,910,165	7,382,876	7,080,530	7,305,004

Diluted EPS	$ 0.31	$ 0.28	$ 0.85	$ 0.82

(3) STOCK BASED COMPENSATION

On October 1, 2005, the Company adopted Statement of Financial Accounting Standards ("SFAS" or "Statement") SFAS No. 123(R), Share Based Payment, which requires measurement of the compensation cost for all stock-based awards based on the grant-date fair value and recognition of compensation cost over the service period of stock-based awards. The fair value of stock options is determined using the Black-Scholes valuation model, which is consistent with the Company's valuation methodology previously utilized for options in footnote disclosures required under SFAS No. 123. The Company has adopted SFAS No. 123(R) using the modified prospective method, which provides for no restatement of prior periods and no cumulative adjustment to equity accounts. It also provides for expense recognition, for both new and existing stock-based awards.

(4) STOCK COMPENSATION PLANS

Stock Option Plans

Under the Company's stock option plans (i.e., the 1999 Stock Option Plan and the 2003 Stock Option Plan), the Company may grant options for up to a combined total of 1,622,500 shares of common stock to employees, officers and directors. Shares issued may be purchased in the open market or may be issued from authorized and unissued shares. The exercise price of each option equals the fair market value of the Company's common stock on the date of grant. The options generally vest over a ten-year period, which may be accelerated if the Company meets certain performance criteria. Generally, options vest in annual installments 10% on each of the ten anniversaries from the date of the grant and if the Company meets three of four established performance criteria the vesting is accelerated to 20% for that year. These four performance criteria are: (i) generating a return on assets which exceeds that of the median of all thrifts in the 12th FHLB District having assets within

$250 million of the Company; (ii) generating an efficiency ratio which is less than that of the median of all thrifts in the 12th FHLB District having assets within $250 million of the Company; (iii) generating a net interest margin which exceeds the median of all thrifts in the 12th FHLB District having assets within $250 million of the Company; and (iv) increasing the Company's earnings per share over the prior fiscal year. The Company performs the accelerated vesting analysis in February of each year based on the results of the most recently completed fiscal year. At June 30, 2007, options for 279,416 shares are available for future grant under these plans.

Following is activity under the plans:

	Nine Months Ended June 30, 2007 Total Options Outstanding		
		Weighted Average Exercise	Weighted Average Grant Date Fair

	Shares	Price	Value
Options outstanding, beginning of period	524,144	$7.26	$1.85
Exercised	(110,470)	6.73	1.76
Forfeited	(1,000)	7.61	1.99
Granted	--	--	--
Options outstanding, end of period	412,674	$7.39	$1.87
Options exercisable, end of period	391,670	$7.30	$1.85

	Nine Months Ended June 30, 2006 Total Options Outstanding		
	Shares	Weighted Average Exercise Price	Weighted Average Grant Date Fair Value
Options outstanding, beginning of period	724,822	$6.93	$1.79
Exercised	(167,678)	6.04	1.64
Granted	--	--	--
Options outstanding, end of period	557,144	$7.20	$1.84
Options exercisable, end of period	510,136	$7.06	$1.81

The aggregate intrinsic value of all options outstanding at June 30, 2007 was $3.43 million. The aggregate intrinsic value of all options that were exercisable at June 30, 2007 was $3.29 million. The aggregate intrinsic value of all options outstanding at June 30, 2006 was $4.69 million. The aggregate intrinsic value of all options that were exercisable at June 30, 2006 was $4.36 million.

	Nine Months Ended June 30, Total Unvested Options			
	2007		2006	
	Shares	Weighted Average Grant Date Fair Value	Shares	Weighted Average Grant Date Fair Value
Unvested options, beginning of period	45,008	$2.15	77,680	$2.09
Vested	(23,004)	2.07	(30,672)	2.00
Forfeited	(1,000)	1.99	--	--
Granted	--	--	--	--
Unvested options, end of period	21,004	$2.23	47,008	$2.14

The total fair value of options vested during the nine months ended June 30, 2007 was $48,000. The total fair value of options vested during the nine months ended June 30, 2006 was $61,000.

Proceeds, related tax benefits realized from options exercised and intrinsic value of options exercised were as follows:

	Nine Months Ended June 30, (In Thousands) 2007	2006
Proceeds from options exercised	$744	$1,012
Related tax benefit recognized	463	468
Intrinsic value of options exercised	1,231	1,377

Options outstanding at June 30, 2007 were as follows:

	Outstanding			Exercisable		
Range Exercise Prices	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
$ 6.00-6.19	233,810	$ 6.00	1.7	233,810	$ 6.00	1.7
6.80-7.45	66,638	7.35	3.9	66,638	7.35	3.9
7.60-7.98	6,000	7.91	4.9	2,000	7.85	4.8
9.53	56,680	9.52	5.7	39,676	9.52	5.7
11.46-11.63	49,546	11.51	6.5	49,546	11.51	6.5
	412,674	$ 7.39	3.2	391,670	$ 7.30	3.1

Options outstanding at June 30, 2006 were as follows:

	Outstanding			Exercisable		
Range Exercise Prices	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)
$ 6.00-6.19	351,110	$ 6.01	2.6	350,110	$ 6.01	2.6
6.80-7.45	66,678	7.35	5.1	60,010	7.35	5.1
7.60-7.98	21,000	7.76	5.7	10,000	7.68	5.6
9.53	56,680	9.53	6.7	28,340	9.53	6.7
11.46-11.63	61,676	11.53	7.6	61,676	11.53	7.6
	557,144	$ 7.20	4.0	510,136	$ 7.06	3.8

There were no options granted during the nine months ended June 30, 2007 and June 30, 2006.

Stock Grant Plans

The Company adopted the MRDP in 1998, which was subsequently approved by shareholders in 1999 for the benefit of employees, officers and directors of

the Company. The objective of the MRDP is to retain and attract personnel of experience and ability in key positions by providing them with a proprietary interest in the Company.

The MRDP allows for the issuance to participants of up to 529,000 shares of the Company's common stock. Shares may be purchased in the open market or may be issued from authorized and unissued shares. Awards under the MRDP are made in the form of restricted shares of common stock that are subject to restrictions on the transfer of ownership. Compensation expense in the amount of the fair value of the common stock at the date of the grant to the plan participants is recognized over a five-year vesting period, with 20% vesting on each of the five anniversaries from the date of the grant. During the nine months ended June 30, 2007 the Company awarded 15,080 MRDP shares to officers and directors. These shares had a weighted average grant date fair value of $17.44 per share. There were no MRDP shares granted during the nine months ended June 30, 2006.

At June 30, 2007 there were a total of 27,080 unvested MRDP shares with a weighted average grant date fair value of $16.90. There were no MRDP shares that vested during the nine months ended June 30, 2007 and 2006. At June 30, 2007, there were 92,066 shares available for future award under the MRDP.

Expenses for Stock Compensation Plans

Compensation expenses for all stock-based plans were as follows:

	Nine Months Ended June 30,			
	2007		2006	
	(In thousands)			
	Stock Options	Stock Grants	Stock Options	Stock Grants
Compensation expense recognized in income	$ 19	$ 40	$ 38	$ - -
Related tax benefit recognized	7	14	13	- -

The compensation expense yet to be recognized for stock based awards that have been awarded but not vested for the years ending September 30 is as follows (in thousands):

	Stock Options	Stock Grants	Total Awards
Remainder of 2007	$ 6	$ 23	$ 29
2008	5	92	97
2009	2	92	94
2010	1	91	92
2011	--	85	85
2012	--	32	32
Total	$14	$415	$429

(5) DIVIDEND / SUBSEQUENT EVENT

On July 12, 2007, the Company announced a quarterly cash dividend of $0.10 per common share, payable August 23, 2007, to shareholders of record as of the

close of business on August 9, 2007.

(6) RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, Fair Value Measurements, which defines fair value, establishes a framework for measuring fair value under Generally Accepted Accounting Principles ("GAAP"), and expands disclosures about fair value measurements. This Statement expands other accounting pronouncements that require or permit fair value measurements. This Statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Management is assessing the impact of adoption of SFAS 157 on the Company's consolidated financial statements.

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes - an Interpretation of FASB Statement No. 109 ("FIN 48"). The interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The new interpretation is effective for fiscal years beginning after December 15, 2006. The Company will adopt the provisions of FIN 48 on October 1, 2007 and is currently evaluating FIN 48 to determine the effect the guidance will have on the Company's consolidated financial statements.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets. SFAS No. 156 amends Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, to require all separately recognized servicing assets and servicing liabilities to be initially measured at fair value, if practicable. SFAS No. 156 also permits servicers to subsequently measure each separate class of servicing assets and liabilities at fair value rather than at the lower of cost or market. For those companies that elect to measure their servicing assets and liabilities at fair value, SFAS No. 156 requires the difference between the recorded value and fair value at the date of adoption to be recognized as a cumulative effect adjustment to retained earnings as of the beginning of the fiscal year in which the election is made. The Company adopted SFAS No. 156 on October 1, 2006 and will continue to measure servicing assets at the lower of cost or market.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities   Including an amendment of FASB Statement No. 115. This Statement permits entities to choose to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This Statement is expected to expand the use of fair value measurement, which is consistent with

the FASB's long-term measurement objectives for accounting for financial instruments. This Statement is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. The adoption of this Statement is not expected to have a material impact on the Company's consolidated financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following analysis discusses the material changes in the financial condition and results of operations of the Company at and for the three and nine months ended June 30, 2007. This analysis as well as other sections of this report contains certain "forward-looking statements." The Company desires to take advantage of the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995 and is including this statement for the express purpose of availing itself of the protection of such safe harbor with forward looking statements. These forward looking statements may describe future plans or strategies and include the Company's expectations of future financial results. The words "believe," "expect," "anticipate," "estimate," "project," and similar expressions identify forward-looking statements. The Company's ability to predict results or the effect of future plans or strategies is inherently uncertain. The Company's actual results, performance, or achievements may differ materially from those suggested, expressed, or implied by forward looking statements as a result of a wide variety or range of factors including, but not limited to: interest rate fluctuations; economic conditions in the Company's primary market areas; deposit flows; demand for residential, commercial real estate, consumer, and other types of loans; real estate values; success of new products and services; technological factors affecting operations; and other risks detailed in the Company's reports filed with the SEC, including its 2006 Form 10-K. Accordingly, these factors should be considered in evaluating forward-looking statements, and undue reliance should not be placed on such statements. The Company undertakes no responsibility to update or revise any forward-looking statements.

Overview

Timberland Bancorp, Inc., a Washington corporation, was organized on September 8, 1997 for the purpose of becoming the holding company for Timberland Savings Bank, SSB upon the Bank's conversion from a Washington-chartered mutual savings bank to a Washington-chartered stock savings bank ("Conversion"). The Conversion was completed on January 12, 1998 through the sale and issuance of 13,225,000 shares of common stock by the Company. At June 30, 2007, the Company had total assets of $624.15 million and total shareholders' equity of $73.99 million. The Company's business activities generally are limited to passive investment activities and oversight of its investment in the Bank. Accordingly, the information set forth in this report relates primarily to the Bank.

The Bank was established in 1915 as "Southwest Washington Savings and Loan Association." In 1935, the Bank converted from a state-chartered mutual savings and loan association to a federally-chartered mutual savings and loan association, and in 1972 changed its name to "Timberland Federal Savings and Loan Association." In 1990, the Bank converted to a federally chartered mutual savings bank under the name "Timberland Savings Bank, FSB." In 1991, the Bank converted to a Washington-chartered mutual savings bank and changed its name to "Timberland Savings Bank, SSB." In 2000, the Bank changed its name to "Timberland Bank." The Bank's deposits are insured by the Federal Deposit Insurance Corporation ("FDIC") up to applicable legal limits. The Bank has been a member of the Federal Home Loan Bank System since 1937. The Bank is regulated by the Washington State Department of Financial Institutions, Division of Banks and the FDIC.

The Bank is a community-oriented bank which offers a variety of deposit and loan products to its customers. The Bank operates 21 branches (including its main office in Hoquiam) and a loan production office in the following market areas:

* Grays Harbor County
* Thurston County
* Pierce County
* King County
* Kitsap County
* Lewis County

Critical Accounting Policies and Estimates

The Company has identified two accounting policies that as a result of judgments, estimates and assumptions inherent in those policies, are critical to an understanding of the Company's Consolidated Financial Statements.

Allowance for Loan Losses. The allowance for loan losses is maintained at a level sufficient to provide for probable loan losses based on evaluating known and inherent risks in the portfolio. The allowance is based upon management's comprehensive analysis of the pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, actual loss experience, current economic conditions, and detailed analysis of individual loans for which the full collectibility may not be assured. The appropriate allowance for loan loss level is estimated based upon factors and trends identified by management at the time consolidated financial statements are prepared.

Mortgage Servicing Rights. Mortgage servicing rights ("MSRs") are capitalized when acquired through the origination of loans that are subsequently sold with servicing rights retained and are amortized to servicing income on loans sold in proportion to and over the period of estimated net servicing income. The value of MSRs at the date of the sale of loans is determined based on the discounted present value of expected future cash flows using key assumptions for servicing income and costs and prepayment rates on the underlying loans. The estimated fair value is periodically evaluated for impairment by comparing actual cash flows and estimated cash flows from the servicing assets to those estimated at the time servicing assets were originated. The effect of changes in market interest rates on estimated rates of loan prepayments represents the predominant risk characteristic underlying the MSR portfolio. The Company's methodology for estimating the fair value of MSRs is highly sensitive to changes in assumptions. For example, the determination of fair value uses anticipated prepayment speeds. Actual prepayment experience may differ and any difference may have a material effect on the fair value. Thus, any measurement of MSRs' fair value is limited by the conditions existing and assumptions as of the date made. Those assumptions may not be appropriate if they are applied at different times.

Comparison of Financial Condition at June 30, 2007 and September 30, 2006

The Company's total assets increased by $47.06 million, or 8.2%, to $624.15 million at June 30, 2007 from $577.09 million at September 30, 2006, primarily attributable to a $72.68 million, or 17.1%, increase in net loans receivable. This increase was partially offset by a $16.50 million decrease in investment and mortgage-backed securities and a $9.60 million decrease in cash equivalents.

Total deposits increased by $2.45 million to $433.51 million at June 30, 2007 from $431.06 million at September 30, 2006 primarily attributable to an increase in certificate of deposit accounts and money market accounts. These increases were partially offset by decreases in non-interest bearing accounts and N.O.W. checking accounts.

Shareholders' equity decreased by $5.38 million to $73.99 million at June 30,

2007 from $79.37 million at September 30, 2006. The decrease in shareholders equity was primarily a result of share repurchases and dividends paid to shareholders.

A more detailed explanation of the changes in significant balance sheet categories follows:

Cash Equivalents: Cash equivalents decreased by $9.60 million or 42.1% to $13.19 million at June 30, 2007 from $22.79 million at September 30, 2006. The decrease was primarily a result of federal funds sold decreasing by $5.20 million, non-interest bearing accounts decreasing by $3.07 million, and interest bearing deposits in banks decreasing by $1.33 million. These liquid funds decreased primarily to fund loan portfolio growth.

Investment Securities and Mortgage-backed Securities: Investment and mortgage-backed securities decreased by $16.50 million or 20.3% to $64.98 million at June 30, 2007 from $81.48 million at September 30, 2006, as a result of regular amortization and prepayments on mortgage-backed securities and the maturity or call of U.S. agency securities. At June 30, 2007, the Company's securities' portfolio was comprised of mutual funds of $31.86 million, U.S. agency securities of $18.90 million, and mortgage-backed securities of $14.22 million. The mutual funds invest primarily in mortgage-backed products and U.S. agency securities. For additional information, see the "Investment Securities" table included herein.

Loans: Net loans receivable increased by $72.68 million or 17.1% to $497.33 million at June 30, 2007 from $424.65 million at September 30, 2006. The increase in the portfolio was primarily a result of a $26.96 million increase in construction loans (net of undisbursed portion of construction loans in process), a $24.20 million increase in land loans, a $14.03 million increase in multi-family loans, a $7.52 million increase in consumer loans, a $5.17 million increase in one- to four-family loans and a $4.82 million increase in commercial business loans. These increases were partially offset by a $9.49 million decrease in commercial real estate loans. The majority of the increase in multi-family loan category was a result of several loans being switched to the multi-family category from the commercial real estate category.

Loan demand remained strong as loan originations totaled $233.37 million for the nine months ended June 30, 2007 compared to $169.82 million for nine months ended June 30, 2006. The Bank also continued to sell longer-term fixed rate loans for asset liability management purposes. The Bank sold fixed rate one- to four-family mortgage loans totaling $21.64 million for nine months ended June 30, 2007 compared to $17.60 million for the nine months ended June 30, 2006.

For additional information, see the sections entitled "Loan Portfolio Composition" and "Construction and Land Development Loan Portfolio Composition" included herein.

Other Real Estate Owned and Other Repossessed Items: OREO and other repossessed items increased to $68,000 at June 30, 2007 from $15,000 at September 30, 2006 as one manufactured home was repossessed. At June 30, 2007, OREO and other repossessed items consisted of one manufactured home. For additional information, see the section entitled "Non-performing Assets" included herein.

Premises and Equipment: Premises and equipment decreased to $16.56 million at June 30, 2007 from $16.73 million at September 30, 2006. The decrease was

primarily a result of selling a land parcel in Grays Harbor County.

Goodwill and Core Deposit Intangible: The value of goodwill remained unchanged. The amortized value of core deposit intangible decreased to $1.29 million at June 30, 2007 from $1.51 million at September 30, 2006. The decrease is attributable to scheduled amortization of the core deposit intangible.

Deposits: Deposits increased by $2.45 million, or 0.6%, to $433.51 million at June 30, 2007 from $431.06 million at September 30, 2006. The deposit increase was primarily a result of a $15.61 million increase in certificate of deposit accounts and a $4.07 million increase in money market accounts. These increases were

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partially offset by a decrease of $9.22 million in N.O.W. checking accounts, a $7.33 million decrease in non-interest bearing accounts, and a $677,000 decrease in savings accounts. For additional information, see the section entitled "Deposit Breakdown" included herein.

FHLB Advances and Other Borrowings: FHLB advances and other borrowings increased by $49.53 million to $113.24 million at June 30, 2007 from $63.71 million at September 30, 2006 as the Bank used additional advances to fund loan portfolio growth. For additional information, see "FHLB Advance Maturity Schedule" included herein.

Shareholders' Equity: Total shareholders' equity decreased by $5.38 million to $73.99 million at June 30, 2007 from $79.37 million at September 30, 2006, primarily as a result of share repurchases of $11.24 million and dividends to shareholders of $1.99 million. These decreases to shareholders' equity were partially offset by net income of $6.01 million, an increase of $1.72 million from the exercise of stock options and vesting associated with the Company's benefit plans, and a $104,000 net increase in the fair value of securities available for sale.

During the nine months ended June 30, 2007 the Company repurchased 615,542 shares of its common stock for $11.24 million at an average price of $18.25 per share. Cumulatively, the Company has repurchased 7,566,984 shares (57.2%) of the 13,225,000 shares that were issued in its 1998 initial public offering, at an average price of $8.82 per share. For additional information, see Item 2 of Part II of this Form 10-Q.

Non-performing Assets: Non-performing assets to total assets were 0.17% at June 30, 2007 compared to 0.02% at September 30, 2006, as total non-performing assets increased to $1.05 million at June 30, 2007 from $95,000 at September 30, 2006.

Total non-performing assets of $1.05 million at June 30, 2007 consisted of a $347,000 commercial real estate loan, four single-family mortgage loans totaling $351,000, a $250,000 single-family construction loan, a $34,000 land loan and other repossessed items totaling $68,000. The Company had a net charge-off of $9,000 during the nine months ended June 30, 2007. For additional information, see the section entitled "Non-performing Assets" and "Activity in the Allowance for Loan Losses" included herein.

Investment Securities

The following table sets forth the composition of the Company's investment securities portfolio.

	At June 30, 2007	At September 30, 2006

	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Held-to-maturity:				
Mortgage-backed securities	$ 72	0.1%	$ 75	0.1%
Available-for-sale (at fair value)				
U.S. agency securities	18,904	29.1	31,718	38.9
Mortgage-backed securities	14,145	21.8	17,603	21.6
Mutual funds	31,862	49.0	32,087	39.4
Total portfolio	$64,983	100.0%	$81,483	100.0%

Loan Portfolio Composition

The following table sets forth the composition of the Company's loan portfolio.

	At June 30, 2007		At September 30, 2006	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Mortgage loans:				
One- to four-family (1)	$103,883	18.2%	$98,709	20.1%
Multi-family	31,719	5.6	17,689	3.6
Commercial	128,118	22.4	137,609	28.1
Construction and land development	181,157	31.7	146,855	29.9
Land	53,794	9.4	29,598	6.0
Total mortgage loans	498,671	87.3	430,460	87.7
Consumer loans:				
Home equity and second mortgage	44,347	7.8	37,435	7.6
Other	11,735	2.0	11,127	2.3
	56,082	9.8	48,562	9.9
Commercial business loans	16,625	2.9	11,803	2.4
Total loans	571,378	100.0%	490,825	100.0%
Less:				
Undisbursed portion of construction loans in process	(66,598)		(59,260)	
Deferred loan origination fees	(2,921)		(2,798)	
Allowance for loan losses	(4,529)		(4,122)	
Total loans receivable, net	$497,330		$424,645	

(1) Includes loans held-for-sale.

Construction and Land Development Loan Portfolio Composition

The following table sets forth the composition of the Company's construction and land development loan portfolio.

	At June 30, 2007		At September 30, 2006	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Custom and owner/builder const.	$ 48,894	27.0%	$ 46,346	31.6%
Speculative construction	43,655	24.1	34,363	23.4
Commercial real estate	50,729	28.0	42,398	28.9
Multi-family	19,801	10.9	7,662	5.2
Land development	18,078	10.0	16,086	10.9
Total construction loans	$181,157	100.0%	$146,855	100.0%

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Activity in the Allowance for Loan Losses

The following table sets forth information regarding activity in the allowance for loan losses.

	Three Months Ended June 30, 2007	2006
	(In thousands)	
Balance at beginning of period	$4,272	$4,119
Provision for loan losses	260	- -
Loans charged off	(3)	(2)
Recoveries on loans previously charged off	--	3
Net recovery (charge-off)	(3)	1
Balance at end of period	$4,529	$4,120

	Nine Months Ended June 30, 2007	2006
	(In thousands)	
Balance at beginning of period	$4,122	$4,099
Provision for loan losses	416	- -
Loans charged off	(10)	(2)
Recoveries on loans previously charged off	1	23
Net recovery (charge-off)	(9)	21
Balance at end of period	$4,529	$4,120

Non-performing Assets

The following table sets forth information with respect to the Company's non-performing assets.

	At June 30, 2007	At September 30, 2006
	(Dollars in thousands)	
Loans accounted for on a non-accrual basis:		
Mortgage loans:		
One- to four-family	$ 351	$ 80
Commercial real estate	347	- -
Construction and land development	250	- -
Land	34	- -
Total	982	80
Accruing loans which are contractually past due 90 days or more:	- -	- -
Total	- -	- -
Total of non-accrual and 90 days past due loans	982	80
Other real estate owned and other repossessed items	68	15
Total non-performing assets	$1,050	$ 95

Restructured loans	- -	- -
Non-accrual and 90 days or more past due loans as a percentage of loans receivable (1)	0.20%	0.02%
Non-accrual and 90 days or more past due loans as a percentage of total assets	0.16%	0.01%
Non-performing assets as a percentage of total assets	0.17%	0.02%
Loans receivable (1)	$501,859	$428,767
Total assets	$624,146	$577,087

(1) Includes loans held-for-sale and is before the allowance for loan losses.

Deposit Breakdown

The following table sets forth the composition of the Company's deposit balances.

	At June 30, 2007	At September 30, 2006
	(In thousands)	
Non-interest bearing	$ 50,580	$ 57,905
N.O.W. checking	80,290	89,509
Savings	59,558	60,235
Money market accounts	46,446	42,378
Certificates of deposit under $100,000	131,803	128,183
Certificates of deposit $100,000 and over	64,837	52,851
Total Deposits	$433,514	$431,061

FHLB Advance Maturity Schedule

The Bank has short- and long-term borrowing lines with the FHLB of Seattle with total credit on the lines equal to 30% of the Bank's total assets, limited by available collateral. Borrowings are considered short-term when the original maturity is less than one year. FHLB advances consisted of the following:

	At June 30, 2007		At September 30, 2006	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Short-term	$ 72,750	64.7%	$29,000	46.2%
Long-term	39,713	35.3	33,761	53.8
Total FHLB advances	$112,463	100.0%	$62,761	100.0%

The Bank's FHLB borrowings mature at various dates through December 2016 and bear interest at rates ranging from 4.10% to 6.18%. Principal reduction amounts due for future years ending September 30 are as follows (in thousands):

2007	$ 72,767
2008	15,069
2009	4,627
2010	- -
2011	- -
Thereafter	20,000
Total	$112,463

A portion of these advances have a putable feature and may be called by the FHLB earlier than the above schedule indicates.

Comparison of Operating Results for the Three and Nine Months Ended June 30,

2007 and 2006

The Company's net income increased by $77,000 or 3.7% to $2.14 million for the quarter ended June 30, 2007 from $2.06 million for the quarter ended June 30, 2006. Diluted earnings per share increased 10.7% to $0.31 for the quarter ended June 30, 2007 from $0.28 for the quarter ended June 30, 2006.

Net income decreased slightly by $4,000 but remained at $6.01 million for the nine months ended June 30, 2007 and for the comparable period in 2006. Diluted earnings per share increased to $0.85 for the nine months ended June 30, 2007 from $0.82 for the nine months ended June 30, 2006.

The increase in diluted earnings per share was primarily a result of increased net interest income and a decrease in the weighted average number of shares outstanding due to share repurchases. Net interest income increased during the current periods as a result of a larger interest earning asset base, however, margin compression resulting from higher funding costs mitigated the impact of this growth. Following the industry trend and a flat yield curve environment, the net interest margin compressed to 4.67% and 4.72% for the three and nine months ended June 30, 2007 from 5.00% and 4.90% for the three and nine months ended June 30, 2006.

A more detailed explanation of the income statement categories is presented below.

Net Income: Net income for the quarter ended June 30, 2007 increased by $77,000 to $2.14 million from $2.06 million for the quarter ended June 30, 2006. Earnings per diluted share for the quarter ended June 30, 2007 increased to $0.31 from $0.28 for the quarter ended June 30, 2006. The $0.03 increase in diluted earnings per share for the quarter ended June 30, 2007 was primarily a result of a $370,000 ($244,000 net of income tax - $0.04 per diluted share) increase in net interest income and a decrease in the number of weighted average shares outstanding ($0.02 per diluted share) primarily due to share repurchases. These increases to earnings per share were partially offset by a $260,000 ($172,000 net of income tax - $0.03 per diluted share) increase in the provision for loan losses.

Net income for the nine months ended June 30, 2007 decreased by $4,000 to $6.01 million, or $0.85 per diluted share from $6.01 million, or $0.82 per diluted share for the nine months ended June 30, 2006. The $0.03 increase in diluted earnings per share for the nine months ended June 30, 2007 was primarily the result of a $1.04 million ($690,000 net of income tax - $0.10 per diluted share) increase in net interest income, and a decrease in the number of weighted average shares outstanding ($0.03 per diluted share) primarily due to share

repurchases. These increases were partially offset by a $449,000 ($296,000 net of income tax - $0.04 per diluted share) increase in non-interest expense, a $416,000 ($275,000 net of income tax - $0.04 per diluted share) increase in the provision for loan losses and a $187,000 ($123,000 net of income tax - $0.02 per diluted share) decrease in non-interest income.

Net Interest Income: Net interest income increased by $370,000, or 5.9%, to $6.66 million for the quarter ended June 30, 2007 from $6.29 million for the quarter ended June 30, 2006, primarily as a result of a larger interest earning asset base. Total interest income increased by $1.74 million to $10.81 million for the quarter ended June 30, 2007 from $9.07 million for the quarter ended June 30, 2006 as average total interest earning assets increased

by $67.79 million. The yield on interest earning assets increased to 7.58% for the quarter ended June 30, 2007 from 7.22% for the quarter ended June 30, 2006. Total interest expense increased by $1.37 million to $4.16 million for the quarter ended June 30, 2007 from $2.79 million for the quarter ended June 30, 2006 as the average rate paid on interest bearing liabilities increased to 3.42% for the quarter ended June 30, 2007 from 2.65% for the quarter ended June 30, 2006. The net interest margin decreased to 4.67% for the quarter ended June 30, 2007 from 5.00% for the quarter ended June 30, 2006.

Net interest income increased by $1.04 million to $19.42 million for the nine months ended June 30, 2007 from $18.38 million for the nine months ended June 30, 2006, primarily as a result of a larger interest earning asset base. Total interest income increased by $4.58 million to $30.75 million for the nine months ended June 30, 2007 from $26.17 million for the nine months ended June 30, 2006 as average total interest earning assets increased by $49.32 million. The yield on interest earning assets increased to 7.47% for the nine months ended June 30, 2007 from 6.98% for the nine months ended June 30, 2006. Total interest expense increased by $3.54 million to $11.33 million for the nine months ended June 30, 2007 from $7.79 million for the nine months ended June 30, 2006 as the average rate paid on interest bearing liabilities increased to 3.26% for the nine months ended June 30, 2007 from 2.47% for the nine months ended June 30, 2006. The net interest margin decreased to 4.72% for the nine months ended June 30, 2007 from 4.90% for the nine months ended June 30, 2006.

The margin compression was primarily attributable to increased funding costs which were greater than the increased yield on interest earning assets. Increased funding costs resulted from an increase in interest rates on deposits and an increased reliance on FHLB advances to fund loan growth. For additional information, see the section entitled "Rate Volume Analysis" included herein.

Rate Volume Analysis

The following table sets forth the effects of changing rates and volumes on the net interest income on the Company. Information is provided with respect to the (i) effects on interest income attributable to change in volume (changes in volume multiplied by prior rate), and (ii) effects on interest income attributable to changes in rate (changes in rate multiplied by prior volume), and (iii) the net change (sum of the prior columns). Changes in rate/volume have been allocated to rate and volume variances based on the absolute values of each.

	Three months ended June 30, 2007 compared to three months ended June 30, 2006 increase (decrease) due to			Nine months ended June 30, 2007 compared to nine months ended June 30, 2006 increase (decrease) due to		
	Rate	Volume	Net Change	Rate	Volume	Net Change
	(In thousands)					
Interest-earning assets:						
Loans receivable (1)	$ 39	$1,904	$1,943	$ 728	$4,179	$4,907
Investments and mortgage-backed securities	27	(206)	(179)	(14)	(443)	(457)
FHLB stock and equity securities	49	7	56	211	12	223

Federal funds sold	7	(77)	(70)	(4)	(97)	(101)
Interest-bearing deposits	2	(12)	(10)	7	- -	7
Total net increase in income on interest-earning assets	124	1,616	1,740	928	3,651	4,579
Interest-bearing liabilities:						
Savings accounts	1	(4)	(3)	- -	(11)	(11)
NOW accounts	(5)	(24)	(29)	7	(24)	(17)
Money market Accounts	135	30	165	331	15	346
Certificate accounts	415	260	675	1,461	779	2,240
Short-term borrowings	4	649	653	41	1,247	1,288
Long-term borrowings	(23)	(68)	(91)	(59)	(253)	(312)
Total net increase in expense on interest bearing liabilities	527	843	1,370	1,781	1,753	3,534
Net increase (decrease) in net interest income	($403)	$ 773	$ 370	($853)	$1,898	$1,045

(1) Includes loans originated for sale.

Provision for Loan Losses: A provision for loan losses of $260,000 was made during the quarter ended June 30, 2007 compared to no provision made during quarter ended June 30, 2006. For the nine months ended June 30, 2007 a provision for loan losses of $416,000 was made compared to no provision for the nine months ended June 30, 2006. The provisions were made primarily in connection with strong loan portfolio growth and changes in the composition of the loan portfolio. At June 30, 2007, the Company's non-performing assets to total assets were 0.17%.

The Bank has established a comprehensive methodology for determining the provision for loan losses. On a quarterly basis the Bank performs an analysis that considers pertinent factors underlying the quality of the loan portfolio. The factors include changes in the amount and composition of the loan portfolio, historic loss experience for various loan segments, changes in economic conditions, delinquency rates, a detailed analysis of loans on non-accrual status, and other factors to determine an appropriate level of allowance for loan losses. Based on its comprehensive analysis, management deemed the allowance for loan losses of $4.53 million at June 30, 2007 (0.90% of loans receivable and 461% of non-performing loans) adequate to provide for probable losses based on an evaluation of known and inherent risks in the loan portfolio at that date. The allowance for loan losses was $4.12 million (1.03% of loans receivable and 213% of non-performing loans) at June 30, 2006. The Company had a net charge-off of $3,000 for the quarter June 30, 2007 and net recovery of $1,000 for the quarter ended June 30, 2006. The Company had a net charge-off of $9,000 for nine months ended June 30,

2007 and a net recovery of $21,000 for the nine months ended June 30, 2006.

For additional information, see the section entitled "Activity in the Allowance for Loan Losses" included herein.

Non-interest Income: Total non-interest income decreased by $27,000 to $1.50 million for the quarter ended June 30, 2007 from $1.53 million for the quarter ended June 30, 2006, primarily as a result of a decrease in service charges on deposits and a decrease in fee income from the sale of non-deposit investment products. These decreases were partially offset by increased servicing income on loans sold, increased gains on sale of loans, and increased ATM transaction fees.

Total non-interest income decreased by $187,000 to $4.41 million for the nine months ended June 30, 2007 from $4.59 million for the nine months ended June 30, 2006, primarily as a result of a decrease in services charges on deposits and a decrease in fee income from the sale of non-deposit investment products. The decrease in service charges on deposits was primarily a result of fewer overdrafts on checking accounts. The reduction in non-deposit investment sale fee income was a result of decreased sales volume. These decreases were partially offset by increased servicing income on loans sold and increased ATM transaction fees.

Non-interest Expense: Total non-interest expense decreased by $30,000 to $4.76 million for the quarter ended June 30, 2007 from $4.79 million for the quarter ended June 30, 2006. The decrease was primarily attributable to a $59,000 gain on the sale of a land parcel that was recorded in the premises and equipment expense category. The Company's efficiency ratio improved to 58.35% for the quarter ended June 30, 2007 from 61.30% for the quarter ended June 30, 2006.

Total non-interest expense increased by $449,000 or 3.2% to $14.60 million for the nine months ended June 30, 2007 from $14.15 million for the nine months ended June 30, 2006. The increase was primarily a result of a $208,000 increase in salary expense, a $68,000 increase in advertising expense, a $55,000 increase in ATM expense and smaller increases in several other categories. The Company's efficiency ratio improved to 61.26% for the nine months ended June 30, 2007 from 61.59% for the nine months ended June 30, 2006.

Provision for Income Taxes: The provision for income taxes increased to $1.00 million for the quarter ended June 30, 2007 from $964,000 for the quarter ended June 30, 2006 primarily as a result of higher income before taxes. The Company's effective tax rate was 31.87% for the quarters ended June 30, 2007 and June 30, 2006.

The provision for income taxes was $2.81 million for the nine months ended June 30, 2007 and the nine months ended June 30, 2006. The Company's effective tax rate was 31.83% for the nine months ended June 30, 2007 and 31.84% for the nine months ended June 30, 2006.

Liquidity and Capital Resources

The Company's primary sources of funds are customer deposits, proceeds from principal and interest payments on loans and mortgage-backed securities, proceeds from the sale of loans, proceeds from maturing securities, FHLB advances, and other borrowings. While maturities and the scheduled amortization of loans are a predictable source of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition.

An analysis of liquidity should include a review of the Condensed Consolidated Statement of Cash Flows for the nine months ended June 30, 2007. The statement of cash flows includes operating, investing and financing

categories. Operating activities include net income, which is adjusted for non-cash items, and increases or decreases in cash due to changes in assets and liabilities. Investing activities consist primarily of proceeds from maturities and sales of securities, purchases of securities, and the net change in loans. Financing activities present the cash flows associated with the Company's deposit accounts, other borrowings and stock related transactions.

The Company's total cash equivalents decreased by $9.60 million to $13.19 million at June 30, 2007 from $22.79 million at September 30, 2006. The Company's decreased liquid assets were primarily a result of funding loan growth.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds for loan originations and deposit withdrawals, to satisfy other financial commitments and to take advantage of investment opportunities. The Bank generally maintains sufficient cash and short-term investments to meet short-term liquidity needs. At June 30, 2007, the Bank's regulatory liquidity ratio (net cash, and short-term and marketable assets, as a percentage of net deposits and short-term liabilities) was 8.95%. The Bank maintained an uncommitted credit facility with the FHLB of Seattle that provided for immediately available advances up to an aggregate amount of $181.20 million, under which $112.46 million was outstanding at June 30, 2007. The Bank also has a $10.00 million overnight credit line with Pacific Coast Banker's Bank. At June 30, 2007, the Bank did not have any outstanding advances on this credit line.

Liquidity management is both a short and long-term responsibility of the Bank's management. The Bank adjusts its investments in liquid assets based upon management's assessment of (i) expected loan demand, (ii) projected loan sales, (iii) expected deposit flows, and (iv) yields available on interest-bearing deposits. Excess liquidity is invested generally in interest-bearing overnight deposits, federal funds sold, and other short-term investments. If the Bank requires funds that exceed its ability to generate them internally, it has additional borrowing capacity with the FHLB and Pacific Coast Banker's Bank.

The Bank's primary investing activity is the origination of one- to four-family mortgage loans, commercial mortgage loans, construction and land development loans, land loans, consumer loans, and commercial business loans. At June 30, 2007, the Bank had loan commitments totaling $43.30 million and undisbursed loans in process totaling $66.60 million. The Bank anticipates that it will have sufficient funds available to meet current loan commitments. Certificates of deposit that are scheduled to mature in less than one year from June 30, 2007 totaled $170.45 million. Historically, the Bank has been able to retain a significant amount of its certificates of deposit as they mature.

Federally-insured state-chartered banks are required to maintain minimum levels of regulatory capital. Under current FDIC regulations, insured state-chartered banks generally must maintain (i) a ratio of Tier 1 leverage capital to total assets of at least 3.0% (4.0% to 5.0% for all but the most highly rated banks), (ii) a ratio of Tier 1 capital to risk weighted assets of at least 4.0% and (iii) a ratio of total capital to risk weighted assets of at least 8.0%. At June 30, 2007, the Bank was in compliance with all applicable capital requirements. For additional details see the section below entitled "Regulatory Capital."

Regulatory Capital

The following table compares the Bank's regulatory capital at June 30, 2007 to its minimum regulatory capital requirements at that date (Dollars in thousands):

	Amount	Percent of Adjusted Total Assets (1)
Tier 1 (leverage) capital	$59,101	9.69%
Tier 1 (leverage) capital requirement	24,409	4.00
Excess	$34,692	5.69%
Tier 1 risk adjusted capital	$59,101	11.60%
Tier 1 risk adjusted capital requirement	20,380	4.00
Excess	$38,721	7.60%

Total risk based capital	$63,630	12.49%
Total risk based capital requirement	40,761	8.00
Excess	$22,869	4.49%

(1) For the Tier 1 (leverage) capital, percent of total average assets calculation, total average of assets were $610.22 million. For the Tier 1 risk-based capital and total risk-based capital calculations, total risk-weighted assets were $509.51 million.

TIMBERLAND BANCORP, INC. AND SUBSIDIARIES
KEY FINANCIAL RATIOS AND DATA
(Dollars in thousands, except per share data)

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2007	2006	2007	2006

PERFORMANCE RATIOS:				
Return on average assets (1)	1.38%	1.49%	1.34%	1.45%
Return on average equity (1)	11.24%	10.57%	10.36%	10.48%
Net interest margin (1)	4.67%	5.00%	4.72%	4.90%
Efficiency ratio	58.35%	61.30%	61.26%	61.59%

	At June 30, 2007	At September 30, 2006
ASSET QUALITY RATIOS:		
Non-performing loans	$ 982	$ 80
OREO and other repossessed assets	68	15
Total non-performing assets	$1,050	$ 95
Non-performing assets to total assets	0.17%	0.02%
Allowance for loan losses to non-performing loans	461%	5,153%
Book value per share (2)	$10.53	$10.56
Book value per share (3)	$11.19	$11.22
Tangible book value per share (2) (4)	$ 9.54	$ 9.61
Tangible book value per share (3) (4)	$10.14	$10.21

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(1) Annualized
(2) Calculation includes ESOP shares not committed to be released
(3) Calculation excludes ESOP shares not committed to be released
(4) Calculation subtracts goodwill and core deposit intangible from the equity component

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2007	2006	2007	2006
AVERAGE BALANCE SHEET:				
Average total loans	$494,137	$399,849	$466,200	$396,141
Average total interest earning assets	570,597	502,804	548,942	499,624
Average total assets	619,120	554,716	598,688	552,100
Average total interest bearing deposits	388,610	366,228	381,946	363,246
Average FHLB advances and other borrowings	98,467	55,597	82,139	58,218
Average shareholders' equity	76,087	77,969	77,364	76,478

Item 3. Quantitative and Qualitative Disclosures About Market Risk

There were no material changes in information concerning market risk from the information provided in the Company's Form 10-K for the fiscal year ended September 30, 2006.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures: An evaluation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) of the Securities Exchange Act of 1934 (the "Exchange Act")) was carried out under the supervision and with the participation of the Company's Chief Executive Officer, Chief Financial Officer and several other members of the Company's senior management as of the end of the period covered by this report. The Company's Chief Executive Officer and Chief Financial Officer concluded that as of June 30, 2007 the Company's disclosure controls and procedures were effective in ensuring that the information required to be disclosed by the Company in the reports it files or submits under the Exchange Act is (i) accumulated and communicated to the Company's management (including the Chief Executive Officer and Chief Financial Officer) in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

(b) Changes in Internal Controls: There have been no changes in our internal control over financial reporting (as defined in 13a-15(f) of the Exchange Act) that occurred during the quarter ended June 30, 2007, that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. The Company continued, however, to implement suggestions from its internal auditor and independent auditors to strengthen existing controls. The Company does not expect that its disclosure controls and procedures and internal controls over financial reporting will prevent all error and fraud. A control procedure, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control procedure are met. Because of the inherent limitations in all control procedures, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns in controls or procedures can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any control procedure is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; as over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control procedure, misstatements due to error or fraud may occur and not be detected.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Neither the Company nor the Bank is a party to any material legal proceedings at this time. Further, neither the Company nor the Bank is aware of the threat of any such proceedings. From time to time, the Bank is involved in various claims and legal actions arising in the ordinary course of business.

Item 1A. Risk Factors

There have been no material changes in the Risk Factors previously disclosed

in Item 1A of the Company's 2006 Form 10-K.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

Not applicable

Stock Repurchases

The following table sets forth the shares repurchased by the Company during the quarter ended June 30, 2007:

Period	Total No. of Shares Purchased	Average Price Paid per Share	Total No. of Shares Purchased as Part of Publicly Announced Plan (1)(2)	Maximum No. of Shares that May Yet Be Purchased Under the Plan(1)(2)
04/01/2007 - 04/30/2007	50,000	$17.74	50,000	120,532
05/01/2007 - 05/31/2007	170,532	17.90	170,532	306,950
06/01/2007 - 06/30/2007	90,000	18.41	90,000	216,950
Total	310,532	$18.02	310,532	

(1) On May 7, 2007, the Company completed its previously announced share repurchase program. The Company repurchased 5% of its outstanding common shares or 372,532 shares, at an average price of $18.23 per share. All shares were repurchased through open market broker transactions and no shares were directly repurchased from directors or officers of the Company.

(2) On May 25, 2007, the Company announced a share repurchase plan authorizing the repurchase of up to 5% of its outstanding shares, or 356,950 shares. As of June 30, 2007, a total of 140,000 shares had been repurchased at an average price of $18.09 per share. All shares were repurchased through open market broker transactions and no shares were directly repurchased from directors or officers of the Company.

Item 3. Defaults Upon Senior Securities

None to be reported.

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

None to be reported

Item 5. Other Information

None to be reported.

Item 6. Exhibits

(a) Exhibits

3.1	Articles of Incorporation of the Registrant (1)
3.2	Bylaws of the Registrant (1)
3.3	Amendment to Bylaws (2)
10.1	Employee Severance Compensation Plan, as revised (3)
10.2	Employee Stock Ownership Plan (3)
10.3	1999 Stock Option Plan (4)
10.4	Management Recognition and Development Plan (4)
10.5	2003 Stock Option Plan (5)
10.6	Form of Incentive Stock Option Agreement (6)
10.7	Form of Non-qualified Stock Option Agreement (6)
10.8	Form of Management Recognition and Development Award Agreement (6)
10.9	Employment Agreement between the Company and the Bank and Michael R. Sand (7)
10.10	Employment Agreement between the Company and the Bank and Dean J. Brydon (7)
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes Oxley Act
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes Oxley Act
32	Certifications of Chief Executive Officer and Chief Financial Officer Pursuant to Section 906 of the Sarbanes Oxley Act

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(1) Incorporated by reference to the Registrant's Registration Statement of Form S-1 (333- 35817).
(2) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2002.
(3) Incorporated by reference to the Registrant's Quarterly Report on Form 10-Q for the quarter ended December 31, 1997; and to the Registrant's Current Report on Form 8-K dated April 13, 2007.
(4) Incorporated by reference to the Registrant's 1999 Annual Meeting Proxy Statement dated December 15, 1998.
(5) Incorporated by reference to the Registrant's 2004 Annual Meeting Proxy Statement dated December 24, 2003.
(6) Incorporated by reference to the Registrant's Annual Report on Form 10-K for the year ended September 30, 2005.
(7) Incorporated by reference to the Registrant's Current Report on Form 8-K dated April 13, 2007.

SIGNATURES

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

Timberland Bancorp, Inc.

Date: August 7, 2007

By:/s/Michael R. Sand

Michael R. Sand
Chief Executive Officer
(Principal Executive Officer)

Date: August 7, 2007

By:/s/Dean J. Brydon

Dean J. Brydon
Chief Financial Officer
(Principal Financial Officer)

EXHIBIT INDEX

Exhibit No.	Description of Exhibit
31.1	Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
31.2	Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act
32	Certification Pursuant to Section 906 of the Sarbanes-Oxley Act

Exhibit 31.1
Certification of Chief Executive Officer Pursuant to Section 302
of the Sarbanes Oxley Act

I, Michael R. Sand, certify that:

1. I have reviewed this Form 10-Q of Timberland Bancorp, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

   (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

   (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

   (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

   (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 7, 2007

/s/Michael R. Sand

Michael R. Sand
Chief Executive Officer

Exhibit 31.2
Certification of Chief Financial Officer Pursuant to Section 302
of the Sarbanes Oxley Act

I, Dean J. Brydon, certify that:

1. I have reviewed this Form 10-Q of Timberland Bancorp, Inc.;

2. Based on my knowledge, this report does not contain any untrue statement of material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:

   (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others

within those entities, particularly during the period in which this report is being prepared;

(b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;

(c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 7, 2007

/s/Dean J. Brydon

Dean J. Brydon
Chief Financial Officer

EXHIBIT 32
Certification Pursuant to Section 906 of the Sarbanes Oxley Act

CERTIFICATION OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
OF TIMBERLAND BANCORP, INC.
PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. Section 1350), each of the undersigned hereby certifies in his capacity as an

officer of Timberland Bancorp, Inc. (the "Company") and in connection with the Company's Quarterly Report on Form 10-Q for the quarterly period ended June 30, 2007 ("Report"), that:

* the Report fully complies with the requirements of Sections 13(a) and 15(d) of the Securities Exchange Act of 1934, as amended, and
* the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company as of the dates and for the periods presented in the financial statements included in the Report.

/s/Michael R. Sand	/s/Dean J. Brydon
Michael R. Sand	Dean J. Brydon
Chief Executive Officer	Chief Financial Officer

Date: August 7, 2007

ing yields may adversely affect our cost of goods sold and our results of operations.

We are subject to the risks of doing business internationally.

For fiscal 2004, approximately 91% of our net revenues were from customers located outside of the United States, primarily in the Asia-Pacific region and Europe. Approximately 90% of Conexant s net revenues for fiscal 2003 and approximately 92% of GlobespanVirata s net revenues for fiscal 2003 were from customers located outside the United States, primarily in the Asia-Pacific region and Europe. In addition, we have design centers and suppliers located outside the United States, including an assembly and test provider in Mexico and assembly and test service providers and foundries located in the Asia-Pacific region. Our international sales and operations are subject to a number of risks inherent in selling and operating abroad. These include, but are not limited to, risks regarding:

currency exchange rate fluctuations;

local economic and political conditions;

disruptions of capital and trading markets;

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

changes in legal or regulatory requirements;

difficulty in obtaining distribution and support;

- the laws and policies of the United States and other countries affecting trade, foreign investment and loans, and import or export licensing requirements;
- tax laws; and
- limitations on our ability under local laws to protect our intellectual property.

Because most of our international sales are currently denominated in U.S. dollars, our products could become less competitive in international markets if the value of the U.S. dollar increases relative to foreign currencies. We cannot assure you that the factors described above will not have a material adverse effect on our ability to increase or maintain our foreign sales.

From time to time, we may enter into foreign currency forward exchange contracts to minimize risk of loss from currency exchange rate fluctuations for foreign currency commitments entered into in the ordinary course of business. We have not entered into foreign currency forward exchange contracts for other purposes. Our financial condition and results of operations could be affected (adversely or favorably) by currency fluctuations.

We may be subject to claims of infringement of third-party intellectual property rights or demands that we license third-party technology, which could result in significant expense and loss of our ability to use, make, sell, export or import our products or one or more components comprising our products.

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights. From time to time, third parties have asserted and may in the future assert patent, copyright, trademark and other intellectual property rights to technologies that are important to our business and have demanded and may in the future demand that we license their patents and technology. Any litigation to determine the validity of claims that our products infringe or may infringe these rights, including claims arising through our contractual indemnification of our customers, regardless of their merit or resolution, could be costly and divert the efforts and attention of our management and technical personnel. We cannot assure you that we would prevail in litigation given the complex technical issues and inherent uncertainties in intellectual property litigation. If litigation results in an adverse ruling we could be required to:

- pay substantial damages;
- cease the manufacture, use or sale of infringing products;
- discontinue the use of infringing technology;
- expend significant resources to develop non-infringing technology; or
- license technology from the third party claiming infringement, which license may not be available on commercially reasonable terms, or at all.

If we are not successful in protecting our intellectual property rights, it may harm our ability to compete.

We rely primarily on patent, copyright, trademark and trade secret laws, as well as nondisclosure and confidentiality agreements and other methods, to protect our proprietary technologies and processes. At times we incorporate the intellectual property of our customers into our designs, and we have obligations with respect to the non-use and non-disclosure of their intellectual property. In the past, Conexant and GlobespanVirata have engaged in litigation to enforce their intellectual property rights, to protect their trade secrets or to determine the validity and scope of proprietary rights of others, including their customers. We may engage in future litigation on similar grounds, which may require us to expend significant resources and to divert the efforts and attention of our management from our

business operations. We cannot assure you that:

- the steps we take to prevent misappropriation or infringement of our intellectual property or the intellectual property of our customers will be successful;
- any existing or future patents will not be challenged, invalidated or circumvented; or
- any of the measures described above would provide meaningful protection.

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Despite these precautions, it may be possible for a third party to copy or otherwise obtain and use our technology without authorization, develop similar technology independently or design around our patents. If any of our patents fails to protect our technology it would make it easier for our competitors to offer similar products. In addition, effective patent, copyright, trademark and trade secret protection may be unavailable or limited in certain countries.

We may be liable for penalties under environmental laws, rules and regulations, which could adversely impact our business.

Conexant s former manufacturing operations used a variety of chemicals and were subject to a wide range of environmental protection regulations in the United States and Mexico. We have been designated as a potentially responsible party and are engaged in groundwater remediation at one Superfund site located at a former silicon wafer manufacturing facility and steel fabrication plant in Parker Ford, Pennsylvania formerly occupied by Conexant. In addition, we are engaged in remediations of groundwater contamination at Conexant s former Newport Beach, California wafer fabrication facility. We currently estimate the remaining costs for these remediations to be approximately $3.2 million and have accrued for these costs as of September 30, 2004.

In the United States, environmental regulations often require parties to fund remedial action regardless of fault. Consequently, it is often difficult to estimate the future impact of environmental matters, including potential liabilities. While we have not experienced any material adverse effects on our operations as a result of such regulations, we cannot assure you that the costs that might be required to complete remedial actions, if any, will not have a material adverse effect on our business, financial condition and results of operations.

We may be limited in the future in the amount of net operating losses that we can use to offset taxable income.

As of September 30, 2004, Conexant had approximately $1.6 billion of U.S. federal income tax net operating loss (NOL) carryforwards that can be used to offset taxable income in subsequent years. The NOL carryforwards are scheduled to expire at various dates through 2023. Section 382 of the Internal Revenue Code could limit the future use of some or all of the NOL carryforwards if the ownership of our common stock changes by more than 50 percentage points in certain circumstances over a three-year testing period. Based on information known to us, we have not undergone such a change of ownership and the merger of Conexant and GlobespanVirata did not constitute a change of ownership, although the shares of our common stock issued in the Merger will be taken into account in any change of ownership computations. Direct or indirect transfers of our common stock, when taken together with the shift in ownership resulting from the Merger, could result in a change of ownership that would trigger the section 382 limitation. If such an ownership change occurs, section 382 would limit our use of NOL carryforwards in each subsequent taxable year to an amount equal to a federal long-term tax-exempt rate published by the Internal Revenue Service at the time of the ownership change, multiplied by our fair market value at such time; any unused annual limitation amounts may also be carried forward. The Merger resulted in a change of ownership of GlobespanVirata and the future use of GlobespanVirata s NOL carryforwards are subject to the section 382 limitation (or further limitation in the case of NOL carryforwards already subject to limitation as a result of previous transactions) based on the fair market value of GlobespanVirata at the time of the Merger.

Provisions in our organizational documents and rights agreement and Delaware law may make it difficult for someone to acquire control of us.

We have established certain anti-takeover measures that may affect our common stock and convertible notes. Our restated certificate of incorporation, our by-laws, our rights agreement with Mellon Investor Services LLC, as rights agent, dated as of November 30, 1998, as amended, and the Delaware General Corporation Law contain several provisions that would make more difficult an acquisition of control of us in a transaction not approved by our board of directors. Our restated certificate of incorporation and by-laws include provisions such as:

the division of our board of directors into three classes to be elected on a staggered basis, one class each year;

- the ability of our board of directors to issue shares of our preferred stock in one or more series without further authorization of our shareholders;
- a prohibition on shareholder action by written consent;
- a requirement that shareholders provide advance notice of any shareholder nominations of directors or any proposal of new business to be considered at any meeting of shareholders;
- a requirement that a supermajority vote be obtained to remove a director for cause or to amend or repeal certain provisions of our restated certificate of incorporation or by-laws;
- elimination of the right of shareholders to call a special meeting of shareholders; and
- a fair price provision.

Our rights agreement gives our shareholders certain rights that would substantially increase the cost of acquiring us in a transaction not approved by our board of directors.

In addition to the rights agreement and the provisions in our restated certificate of incorporation and by-laws, Section 203 of the Delaware General Corporation Law generally provides that a corporation shall not engage in any business combination with any interested shareholder during the three-year period following the time that such shareholder becomes an interested shareholder, unless a majority of the directors then in office approves either the business combination or the transaction that results in the shareholder becoming an interested shareholder or specified shareholder approval requirements are met.

Our internal control over financial reporting may not be considered effective, which could result in a loss of investor confidence in our financial reports and in turn have an adverse effect on our stock price.

Pursuant to Section 404 of the Sarbanes-Oxley Act of 2002, beginning with our Annual Report on Form 10-K for the fiscal year ending September 30, 2005, we will be required to furnish a report by our management on our internal control over financial reporting. Such report will contain, among other matters, an assessment of the effectiveness of our internal control over financial reporting as of the end of our fiscal year, including a statement as to whether or not our internal control over financial reporting is effective. This assessment must include disclosure of any material weaknesses in our internal control over financial reporting identified by management. The report will also contain a statement that our independent registered public accounting firm has issued an attestation report on management s assessment of internal controls.

We are currently performing the system and process documentation needed to comply with Section 404 and the new standard issued by the Public Company Accounting Oversight Board. This process is both costly and challenging. During this process, if our management identifies one or more material weaknesses in our internal control over financial reporting, we will be unable to assert that such internal control is effective. If we are unable to assert that our internal control is effective as of September 30, 2005 (or if our independent registered public accounting firm is unable to attest that our management s report is fairly stated or they are unable to express an opinion on our management s evaluation or on the effectiveness of our internal controls), investors could lose confidence in the accuracy and completeness of our financial reports, which in turn could have an adverse effect on our stock price.

Executive Officers

Our executive officers are:

Name	Age	Position
Dwight W. Decker	54	Chairman of the Board and Chief Executive Officer
F. Matthew Rhodes	47	President
Lewis C. Brewster	40	Executive Vice President and Chief Operating Officer
J. Scott Blouin	54	Senior Vice President and Chief Financial Officer
Dennis E. O Reilly	60	Senior Vice President, Chief Legal Officer and Secretary

There are no family relationships among our directors or executive officers. Set forth below are the name, office and position held with the Company and principal occupations and employment during the past 5 years of each of our

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executive officers.

Dwight W. Decker Chairman of the Board and Chief Executive Officer since November 2004; non-executive Chairman of the Board from February 2004 to November 2004; and Chairman of the Board and Chief Executive Officer prior thereto. Mr. Decker received a Ph.D. in applied mathematics from the California Institute of Technology and a B.Sc. in mathematics and physics from McGill University.

F. Matthew Rhodes President since June 2003; Senior Vice President and President of our former Broadband Communications segment from May 2002 to June 2003; and Senior Vice President and General Manager, Personal Computing prior thereto. Mr. Rhodes received an M.B.A. from the Anderson Graduate School of Management of the University of California, Los Angeles, an M.S. in electrical engineering from Lehigh University and a B.S. in physics from The Pennsylvania State University.

Lewis C. Brewster Executive Vice President and Chief Operating Officer since November 2004; Executive Vice President, Sales, Operations and Quality from February 2004 to November 2004; Executive Vice President and Chief Operating Officer from June 2003 to February 2004; and Senior Vice President, Worldwide Sales prior thereto. Mr. Brewster received an M.B.A. from Stanford University and a B.S. in electrical engineering and biomedical engineering from Duke University.

J. Scott Blouin Senior Vice President and Chief Financial Officer since August 2004; Senior Vice President and Chief Accounting Officer from February 2004 to August 2004; Senior Vice President and Chief Financial Officer from June 2003 to February 2004; Senior Vice President, Chief Accounting Officer and Controller from March 2002 to June 2003; Senior Vice President and Chief Accounting Officer from January 2001 to March 2002; and Chief Financial Officer of Burr-Brown Corporation (semiconductors) from February 1996 to August 2000. Mr. Blouin received an M.B.A. from Wake Forest University and a B.S. in administration from the University of New Hampshire at Durham.

Dennis E. O Reilly Senior Vice President, Chief Legal Officer and Secretary since February 2004; and Senior Vice President, General Counsel and Secretary prior thereto. Mr. O Reilly received a J.D. from Boston University School of Law and a B.A. from the State University of New York at Binghamton.

Available Information

We maintain an Internet website at http://www.conexant.com. Our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, along with our annual report to shareowners and other information related to our company, are available free of charge on this site as soon as reasonably practicable after we electronically file or furnish these reports with the Securities and Exchange Commission. Our Internet website and the information contained therein or connected thereto are not intended to be incorporated into this Annual Report on Form 10-K.

Item 2. Properties

Our headquarters in Newport Beach, California consists of approximately 90,000 square feet of owned and approximately 235,000 square feet of leased floor space. An additional 363,000 square feet of owned floor space at our Newport Beach facility is leased to Jazz, 3,000 square feet of owned floor space at our Newport Beach facility is leased to Skyworks, and 190,000 square feet of leased floor space is sub-leased to Mindspeed. We also have facilities in Red Bank, New Jersey which consists of approximately 100,000 square feet of leased space, Palm Bay, Florida

which consists of approximately 52,000 square feet of leased space, and in San Diego, California which consists of approximately 180,000 square feet of leased space. We also own a facility in Noida, India with approximately 23,000 square feet of floor space.

Activities at all above locations include administration, sales and marketing, research and development (including design centers) and operations functions.

At September 30, 2004, we also operated in 18 domestic and 21 international offices. These facilities had an aggregate of approximately 290,000 square feet of leased floor space.

As a result of our reorganization and various restructuring related activities, at September 30, 2004 we have an additional 466,000 square feet of unused and vacant leased space, approximately 58% of which is being sub-leased. We believe our properties have been well maintained, are in sound operating condition and contain all the equipment and facilities necessary to operate at present levels.

Our California facilities, including one of our design centers, are located near major earthquake fault lines. We maintain no earthquake insurance with respect to these facilities. Certain of our facilities are located in countries that may experience civil unrest, including Israel.

Item 3. Legal Proceedings

Texas Instruments, Inc. The Company s Conexant, Inc. (formerly GlobespanVirata, Inc.) subsidiary has been involved in a dispute with Texas Instruments, Inc. (Texas Instruments) over a group of patents (and related foreign patents) that Texas Instruments alleges are essential to certain industry standards for implementing ADSL technology. On June 12, 2003, Conexant, Inc. filed a complaint against Texas Instruments, Stanford University, and its Board of Trustees, and Stanford University OTL, LLC (collectively, the Defendants) in the U.S. District Court of New Jersey. The complaint asserts, among other things, that the Defendants have violated the antitrust laws by creating an illegal patent pool, by manipulating the patent process and by abusing the process for setting industry standards related to ADSL technology. The complaint also asserts that the Defendants patents relating to ADSL are unenforceable, invalid and/or not infringed by Conexant, Inc. products. Conexant, Inc. is seeking, among other things, (i) a finding that the Defendants have violated the federal antitrust laws and treble damages based upon such a finding, (ii) an injunction prohibiting the Defendants from engaging in anticompetitive practices, (iii) a declaratory judgment that the claims of the Defendants ADSL patents are invalid, unenforceable, void, and/or not infringed by Conexant, Inc and (iv) an injunction prohibiting the Defendants from pursuing patent litigation against Conexant, Inc. and its customers. On August 11, 2003 and September 9, 2003, the Defendants answered the complaint, denied Conexant, Inc. s claims and filed counterclaims alleging that Conexant, Inc. has infringed certain of their ADSL patents. In addition to other relief, the Defendants are seeking to collect damages for alleged past infringement and to enjoin Conexant, Inc. from continuing to use the Defendants ADSL patents. Although the Company believes that Conexant, Inc. has strong arguments in favor of its position in this dispute, it can give no assurance that Conexant, Inc. will prevail on any of these grounds in litigation. If any such litigation is adversely resolved, Conexant, Inc. could be held responsible for the payment of damages and/or future royalties and/or have the sale of certain of Conexant, Inc. products stopped by an injunction, any of which could have a material adverse effect on the Company s business, financial condition and results of operations. The Company is a counterclaim defendant.

Agere Systems, Inc. On October 17, 2002, Agere Systems, Inc. (Agere) filed suit against Intersil Corporation (Intersil) in the U.S. District Court for the District of Delaware. Conexant, Inc. (formerly GlobespanVirata, Inc.) acquired the WLAN Group of Intersil in August 2003. Agere alleged that Intersil infringed certain of its U.S. patents. Intersil counterclaimed against Agere for infringement of certain patents, some of which are now owned by the Company s Conexant, Inc. subsidiary and licensed to Intersil for purposes of the suit. The parties filed a stipulated order adding Conexant, Inc. as a party to the suit. On July 22, 2003, Agere filed a separate suit against Intersil in the U.S. District Court for the District of Delaware alleging that Intersil infringed certain additional U.S. patents. Conexant, Inc. was also added as a party to this action.

On October 30, 2002, Intersil and certain of its affiliated companies filed a suit against Agere in the U.S. District Court for the Eastern District of Pennsylvania alleging that Agere misappropriated certain Media Access Control

Wireless Local Area Network technology. This action sought an injunction to prevent Agere, either alone or in cooperation with others, from developing, making, and/or selling products that use that technology. Agere made similar counterclaims against Conexant, Inc. and its affiliated companies and Intersil and its affiliated companies. As a result of the acquisition of Intersil s WLAN Products Group and its Choice-Intersil Microsystems, Inc.

subsidiary, which was a party to this suit and the only remaining plaintiff, Conexant, Inc. (formerly GlobespanVirata, Inc.) became involved in this suit.

On November 4, 2004, the Company reached a settlement with Agere with respect to the three lawsuits described above. Under the settlement, all pending litigation between the companies has been dismissed with prejudice. As part of this overall settlement, the Company made a cash payment to Agere in the amount of $8.0 million in November 2004. The two companies have also entered into various license agreements covering the patents involved in the suits and other semiconductor devices.

***IPO Litigation*.** In November 2001, Collegeware Asset Management, LP, on behalf of itself and a putative class of persons who purchased Conexant, Inc. (formerly GlobespanVirata, Inc.) common stock between June 23, 1999 and December 6, 2000, filed a complaint in the U. S. District Court for the Southern District of New York alleging violations of federal securities laws by the underwriters of Conexant, Inc. s initial and secondary public offerings as well as certain Conexant, Inc. officers and directors. The complaint alleges that the defendants violated federal securities laws by issuing and selling Conexant, Inc. s common stock in the initial and secondary offerings without disclosing to investors that the underwriters had (1) solicited and received undisclosed and excessive commissions or other compensation and (2) entered into agreements requiring certain of their customers to purchase the stock in the aftermarket at escalating prices. The complaint seeks unspecified damages. The complaint was consolidated with approximately 300 other actions making similar allegations regarding the public offerings of hundreds of other companies during 1998 through 2000. In June 2003, the issuers, the individual defendants and plaintiffs reached a tentative settlement agreement that would, among other things, result in the dismissal with prejudice of all claims against Conexant, Inc. s officers and directors. The settlement remains subject to a number of conditions, including class certification and approval of the settlement by the court. It is possible that the parties will not reach agreement on the final settlement or that the settlement will not be approved. Even if the settlement is approved, individual class members will have an opportunity to opt out of the class and to file their own lawsuits, and some may do so. In either event, the Company believes that the Conexant, Inc. officers and directors have meritorious defenses to the plaintiffs claims and expects that those defendants will defend themselves vigorously. The Company also believes that it has sufficient insurance coverage to cover any indemnification obligations to the directors and officers related to this litigation.

Various other lawsuits, claims and proceedings have been or may be instituted or asserted against us or our subsidiaries, including those pertaining to product liability, intellectual property, environmental, safety and health, and employment matters.

The outcome of litigation cannot be predicted with certainty and some lawsuits, claims or proceedings may be disposed of unfavorably to the Company. Many intellectual property disputes have a risk of injunctive relief and there can be no assurance that a license will be granted. Injunctive relief could have a material adverse effect on the financial condition or results of operations of the Company. Based on its evaluation of matters which are pending or asserted and taking into account the Company s reserves for such matters, management believes the disposition of such matters will not have a material adverse effect on the financial condition or results of operations of the Company.

Item 4. Submission of Matters to Vote of Security Holders

No matters were submitted to a vote of our shareholders during the quarter ended September 30, 2004.

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PART II

Item 5. Market for Registrant s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

Our common stock is traded on the Nasdaq National Market under the symbol CNXT . The following table lists the high and low per share sale prices for our common stock as reported by the Nasdaq National Market for the periods indicated:

	High	Low
Fiscal year ended September 30, 2004:		
First quarter	$6.42	$4.64
Second quarter	7.85	5.16
Third quarter	6.70	3.72
Fourth quarter	2.65	1.37
Fiscal year ended September 30, 2003:		
First quarter	$2.35	$0.53
Second quarter	2.09	1.20
Third quarter (1)	4.75	1.49
Fourth quarter	6.77	4.02

(1) Sales prices for our common stock beginning in the third quarter of fiscal 2003 reflect the completion of the Mindspeed Spin on June 27, 2003. As a result of the Mindspeed Spin, Conexant shareholders received one share of common stock of Mindspeed Technologies, Inc. for every three Conexant shares held and the Conexant shareholders continued to hold their Conexant shares.

At November 26, 2004, there were approximately 44,200 holders of record of our common stock.

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

The following provides information about purchases by or on our behalf or any affiliated purchaser of shares of our common stock during the quarter ended September 30, 2004:

Issuer Purchases of Equity Securities

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plan or Programs

7/1/04	7/31/04				
8/1/04	8/31/04	533,649*	$1.51		
9/1/04	9/30/04				
Total		533,649	$1.51		

* In August 2004, we reacquired 533,649 shares of our common stock held by two of our former executive officers as part of the settlement of certain promissory notes and accrued interest owed to us by these executives. The average price paid per share represents the average closing price of our common stock for a specified number of days prior to the date these shares were reacquired.

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Item 6. Selected Financial Data

The following selected financial data for the five years ended September 30, 2004 was derived from the audited consolidated financial statements of Conexant and its subsidiaries. In June 2002, Conexant completed the spin-off of its wireless communications business and the sale of its Mexicali Operations, and in June 2003, Conexant completed the spin-off of its Mindspeed Technologies Internet infrastructure business. The selected financial data for all periods have been restated to reflect these businesses as discontinued operations. In February 2004, Conexant completed the merger with GlobespanVirata, Inc. The results of GlobespanVirata, Inc. have been included in the consolidated results since February 28, 2004.

The selected financial data should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements and notes thereto appearing elsewhere in this report.

	2004	2003	2002	2001	2000
	(in thousands, except per share amounts)				
Net revenues	$ 901,854	$ 599,977	$ 521,726	$ 541,688	$1,211,410
Cost of goods sold	523,129	338,161	317,921	522,560	692,551
Gross margin	378,725	261,816	203,805	19,128	518,859
Operating expenses:					
Research and development	239,971	159,354	156,350	175,026	186,618
Selling, general and administrative	125,474	93,426	95,750	141,276	154,992
Amortization of intangible assets	20,769	3,437	19,489	19,814	11,508
In-process research and development (3)	160,818				
Special charges (1)	32,801	18,379	30,499	369,258	35,000
Total operating expenses	579,833	274,596	302,088	705,374	388,118
Operating income (loss)	(201,108)	(12,780)	(98,283)	(686,246)	130,741
Debt conversion costs			10,435	42,584	
Gain on extinguishment of debt		(42,021)		(11,710)	
Other (income) expense, net (4)	99,808	5,808	36,870	(837)	(4,896)
Income (loss) before income taxes	(300,916)	23,433	(145,588)	(716,283)	135,637
Provision (benefit) for income taxes (3)	243,733	(129)	(1,838)	(55,373)	35,985

Income (loss) from continuing operations	(544,649)	23,562	(143,750)	(660,910)	99,652
Loss from discontinued operations (2)		(728,877)	(737,017)	(784,424)	(290,579)
Net loss	$ (544,649)	$ (705,315)	$ (880,767)	$ (1,445,334)	$ (190,927)
Income (loss) from continuing operations per share :					
Basic	$ (1.40)	$ 0.09	$ (0.56)	$ (2.70)	$ 0.47
Diluted	(1.40)	0.09	(0.56)	(2.70)	0.47
Balance Sheet Data					
Working capital	$ 434,802	$ 233,017	$ 443,948	$ 444,974	$ 1,319,638
Total assets	1,880,522	931,707	1,911,035	2,815,480	4,416,197
Long-term obligations	780,708	643,260	743,523	761,927	1,054,934
Shareholders equity	828,387	166,766	947,827	1,773,176	2,906,759

(1) In fiscal 2004, 2003 and 2002, we recorded special charges of $32.8 million, $18.4 million and $30.5 million, respectively, principally related to the impairment of certain assets and restructuring activities. Also included in the $32.8 million of special charges for fiscal 2004 is $3.0 million related to our litigation settlement with Agere Systems, Inc. In fiscal 2001, we recorded special charges of $369.3 million, principally related to the impairment of certain manufacturing assets and restructuring activities. In fiscal 2000, we recorded special charges of $35.0 million related to the settlement of certain litigation.

(2) Loss from discontinued operations (net of income taxes) for all periods represents the operating results of our former wireless communications business and our Mexicali Operations which we disposed of in June 2002 and the Mindspeed Technologies Internet infrastructure business which we disposed of in June 2003.

(3) In fiscal 2004, we recorded $160.8 million of in-process research and development expenses related to the Merger and a $255.7 million charge for the impairment of deferred tax assets.

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(4) See Note 7 of Notes to Consolidated Financial Statements for components of other (income) expense, net.

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

Except where otherwise noted, this discussion of our financial condition and results of operations represents our continuing operations, excluding our discontinued wireless communications business and Mexicali Operations which we disposed of in June 2002, and our discontinued Mindspeed Technologies business which we disposed of in June 2003, and including the GlobespanVirata, Inc. business from February 28, 2004, following completion of our merger with GlobespanVirata, Inc. (the Merger).

Merger with GlobespanVirata

On February 27, 2004, we completed the Merger with GlobespanVirata, Inc., or GlobespanVirata, a provider of broadband communications solutions for consumer, enterprise and service provider markets. In May 2004, GlobespanVirata was renamed Conexant, Inc. See Note 2 of Notes to Consolidated Financial Statements for further information.

Overview of Current Performance

Our net revenues for fiscal 2004 and 2003 were $901.9 million and $600.0 million, respectively. This represents an increase of $301.9 million or 50.3%. However, our quarterly revenues have declined sequentially each quarter from March 2004 (as if the Merger had been completed on January 1, 2004) to September 2004, and we anticipate that revenue will continue to erode for the quarter ending December 31, 2004. If the Merger had been completed on January 1, 2004, the net revenues for the combined companies for the full quarter ended March 31, 2004 would have been $293.3 million, or $49.5 million higher than the reported net revenues of $243.8 million. Our actual net revenues for the quarter ended September 30, 2004 were $213.1 million, or a decrease of approximately 27% from the March 2004 quarter pro forma amount. This sequential decrease in net revenues was predominately attributable to: lower than expected customer demand which resulted in excess channel inventory build-up at our direct customers, distributors and resellers; price erosion in the Wireless and Broadband/DSL product lines; and market share loss in our Wireless product line. These factors will continue to negatively impact our net revenues and gross margin levels. Additionally, these conditions are expected to further impact the valuation of our inventories.

The use of net revenues for the combined companies as if the Merger had closed at the beginning of the quarter ended March 31, 2004 is a non-GAAP financial measure, which is used by management to provide useful information in establishing a meaningful comparison of sequential revenue levels. It is not intended to be an alternative to GAAP measures.

At the time of the Merger, we announced certain workforce reductions and facilities consolidation actions in order to achieve operational efficiencies. In the fourth quarter of fiscal 2004, we announced additional workforce reductions to implement further Merger synergies and to align our operating expenses to lower revenue forecasts. Certain of these actions have been completed, and others are in the process of being completed. In November 2004, we announced a plan to reduce quarterly operating expenses by $15.0 million by the end of the fourth fiscal quarter ending September 30, 2005. The primary drivers of the expense reductions will be an increasing shift of production development resources to lower-cost regions and continued Merger-related selling, general and administrative expense consolidation. We estimate that the charges associated with such actions, which will be recorded in fiscal 2005, will be in the range of $10.0 million to $15.0 million. See Notes 2, 15 and 18 of Notes to Consolidated Financial Statements for further information. The cost savings of these actions has not yet been fully reflected in our operating results for the periods discussed below. We continuously evaluate our business in light of current market and competitive conditions to ensure that our operating expenses are in line with our expected revenue forecasts. As a result, future periods may require further actions to reduce operating expenses. We do not believe that the actions

announced to date, or possible future actions, have or will inhibit our ability to invest in appropriate levels of research and development in growth areas and be competitive in the marketplace.

Spin-off of Mindspeed Technologies Business

On June 27, 2003, we completed the distribution to Conexant shareholders of all outstanding shares of Mindspeed, our wholly owned subsidiary, to which we contributed our Internet infrastructure business, including the stock of certain subsidiaries, and certain other assets and liabilities, including $100.0 million in cash. In the Mindspeed Spin, Conexant shareholders received one share of Mindspeed common stock for every three Conexant shares held and the Conexant shareholders continued to hold their Conexant shares. Mindspeed issued us a warrant to purchase 30 million shares of Mindspeed common stock, representing approximately 20 percent of Mindspeed s outstanding common stock on a fully diluted basis. The warrant is exercisable until June 27, 2013 at an exercise price of $3.408 per share. The fair value of the warrant is presented as an asset on our consolidated balance sheet. Additionally, we entered into a senior secured revolving credit facility pursuant to which Mindspeed may borrow up to $50.0 million for working capital and general corporate purposes. On December 8, 2004, the Mindspeed credit facility was terminated (see Notes 11 and 18 of Notes to Consolidated Financial Statements).

Spin-off of Wireless Communications Business

On June 25, 2002, we completed the distribution to Conexant shareholders of outstanding shares of our wholly owned subsidiary Washington Sub, Inc. (Washington), to which we contributed our wireless communications business, other than certain assets and liabilities which we retained. Immediately thereafter, Washington merged with and into Alpha Industries, Inc. (Alpha), with Alpha the surviving corporation. As a result of these transactions, Conexant shareholders received 0.351 of a share of Alpha common stock for each Conexant share held and the Conexant shareholders continued to hold their Conexant shares.

Upon completion of the above transactions, Alpha and its subsidiaries purchased our semiconductor assembly and test facility located in Mexicali, Mexico and our package design team that supports the Mexicali facility. In connection with the purchase, we, Alpha and certain subsidiaries of Alpha entered into a financing agreement pursuant to which Alpha and a subsidiary of Alpha delivered to us promissory notes for $150.0 million (the Term Notes) guaranteed by Alpha and certain Alpha subsidiaries and secured by substantially all assets of Alpha in payment of the purchase price for the Mexicali facility and the package design team. The financing agreement also provided for a revolving credit facility under which Alpha could borrow up to $100.0 million, less specified reserves, for one year at the same interest rate and with the same security applicable to the Term Notes. Alpha subsequently changed its name to Skyworks Solutions, Inc. (Skyworks). All the above transactions associated with the spin-off of our wireless communications business and the sale of our Mexicali operations, are herein referred to as the Skyworks Spin.

In November 2002, we entered into a refinancing agreement with Skyworks pursuant to which Skyworks repaid $105.0 million of the principal amount and all accrued interest owed to us under the Term Notes, and the remaining principal balance of the Term Notes was exchanged for $45.0 million principal amount of a new 15% convertible note with a maturity date of June 30, 2005. Skyworks also paid us all amounts outstanding under the credit facility, the credit facility was cancelled and we released all security interests in Skyworks assets and properties. In May 2004, the convertible note was converted into 5.7 million shares of common stock of Skyworks (see Note 6 of Notes to Consolidated Financial Statements).

Newport Foundry Joint Venture

In March 2002, we and The Carlyle Group formed a new specialty foundry company named Jazz Semiconductor, Inc. (Jazz). We contributed our Newport Beach, California wafer fabrication operations and related assets and liabilities and certain intellectual property to Jazz. We also issued to Jazz a warrant to purchase 2.9 million shares of Conexant common stock (with a current exercise price of $3.76 per share, subject to adjustment). In connection with this transaction, we received $19.3 million in cash and a 45% equity interest in Jazz, having an estimated fair value of

$42.5 million. We recognized a $2.6 million gain on the transaction. In fiscal 2003, an unrelated party made an additional investment in Jazz thereby reducing our equity interest to 38%. In accordance with Staff Accounting Bulletin No. 51, we recognized a $0.3 million gain upon this additional investment. Through September 30, 2004,

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Jazz has purchased approximately 0.5 million shares under the warrant. The outstanding balance of approximately 2.3 million shares subject to the warrant are currently purchasable and the warrant expires in January 2007.

We purchase a portion of our requirements for silicon-based semiconductor products from Jazz. In March 2002, we entered into a five-year supply arrangement with Jazz under which it provides capacity to meet a portion of our requirements for CMOS and specialty-process wafer fabrication services and we agreed to purchase certain minimum annual volumes of wafers during the first three years of the supply agreement. We expect our minimum purchase obligations under the supply agreement with Jazz, net of a portion of the wafer purchase obligations assumed by a third party, will be approximately $14.0 million in fiscal 2005.

Business Enterprise Segments

We operate in one reportable operating segment, broadband communications. Statement of Financial Accounting Standards No. 131 (SFAS No. 131), Disclosures about Segments of an Enterprise and Related Information , establishes standards for the way that public business enterprises report information about operating segments in annual consolidated financial statements. Although we had four operating segments at September 30, 2004, under the aggregation criteria set forth in SFAS No. 131, we only operate in one reportable operating segment, broadband communications.

Under SFAS No. 131, two or more operating segments may be aggregated into a single operating segment for financial reporting purposes if aggregation is consistent with the objective and basic principles of SFAS No. 131, if the segments have similar economic characteristics, and if the segments are similar in each of the following areas:

- the nature of products and services;
- the nature of the production processes;
- the type or class of customer for their products and services; and
- the methods used to distribute their products or provide their services.

We meet each of the aggregation criteria for the following reasons:

- the sale of products is the only material source of revenue for each of our four operating segments;
- the products sold by each of our operating segments use the same standard manufacturing process;
- the products marketed by each of our operating segments are sold to similar customers; and
- all of our products are sold through our internal sales force and common distributors.

Because we meet each of the criteria set forth above and each of our operating segments has similar economic characteristics, we aggregate our results of operations in one reportable operating segment.

Net revenues by our product lines are as follows (in millions):

	2004	2003	2002
Broadband/DSL Access Products	$254.6	$ 64.3	$ 26.5
Universal and Voice Access Products	323.1	325.2	256.6

Wireless and Networking Components Products and other	110.0	45.0	61.8
Broadband Media Processing Products	214.2	165.5	176.8
	$901.9	$600.0	$521.7

The increase in net revenues from fiscal 2003 to fiscal 2004 for Broadband/DSL Access and Wireless and Networking Components is predominantly related to the Merger.

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Results of Operations

Net Revenues

(in millions)	2004	Change	2003	Change	2002
Net revenues	$901.9	50%	$600.0	15%	$521.7

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

Our net revenues for fiscal 2004 increased 50% over fiscal 2003. The increase is primarily associated with increased unit shipments of our DSL and Wireless products associated with the Merger, and to a lesser extent the increase in sales of satellite set-top box solutions, and convergence video products using MPEG codec technology. Partially offsetting the increase in revenues from increased unit shipments is the erosion of average selling prices beginning in the fourth quarter of fiscal 2004 due to (i) unfavorable product mix as newer, higher margin products experienced slower than expected growth in the latter portion of fiscal 2004 and (ii) intense competition in certain of our product lines.

Our net revenues for fiscal 2003 increased 15% over fiscal 2002. The increase primarily reflects higher demand for our ADSL customer premises modems, increased revenue from set-top box designs comprised of a richer mix of our back-end and complete system level content as well as substantially increased sales volume from dial-up modems embedded in consumer products such as gaming consoles. Our revenues also were higher as a result of incremental sales of new stand-alone MPEG audio and video processing devices from our acquisition of GlobespanVirata s video compression business as well as soft modem revenues from products acquired from PCTEL in the third quarter of fiscal 2003. In total, these increased revenue levels more than offset the loss of revenues in fiscal 2003 resulting from the divestiture of Pictos CMOS sensors and image processing products in late fiscal 2002 and substantially lower video encoder sales resulting from an industry-wide transition toward integrated encoding functionality within more powerful video system graphics processors.

Gross Margin

(in millions)	2004	Change	2003	Change	2002
Gross margin	$378.7	45%	$261.8	28%	$203.8
Percent of net revenues	42%		44%		39%

Gross margin represents revenues less cost of goods sold. As a fabless semiconductor company, we use third parties for wafer production, assembly and test services. Our costs of goods sold consist predominately of purchased finished wafers, assembly and test services, royalty and other intellectual property costs, and labor and overhead associated with product procurement. Prior to the divestiture of our manufacturing operations in March 2002, our cost of goods

sold consisted primarily of purchased materials, labor and overhead (including depreciation) associated with product manufacturing and procurement, and sustaining engineering expenses.

Gross margin percentage decreased from 44% in 2003 to 42% in 2004. This decrease resulted from the effects of revenues in fiscal 2003 for products that we had written down to zero cost basis during fiscal 2001. Gross margin percentage increased from 39% in 2002 to 44% in 2003. This increase resulted from the elimination of the burden of our underutilized former manufacturing operations (which we contributed to Jazz in the second quarter of fiscal 2002) and the favorable impact of our cost reduction actions. Gross margin for 2003 also benefited from a slightly

improved product mix and the redeployment of our product and test engineering teams previously assigned to our former manufacturing operations and included in cost of goods sold and now redeployed to product development efforts and part of research and development costs.

Our gross margin for fiscal 2003 and 2002 also benefited from the sale of inventories with an original cost of $10.9 million and $45.6 million, respectively, that we had written down to a zero cost basis during fiscal year 2001. These sales resulted from renewed demand for certain products that was not anticipated at the time of the write-downs. The previously written-down inventories were generally sold at prices which exceeded their original cost. Had we not previously written down the cost basis of these goods, our cost of goods sold would include the original cost of these items, and our gross margin for 2003 would have been $250.9 million (42% of our net revenues) compared to $158.2 million (30% of our net revenues) for fiscal 2002.

We assess the recoverability of our inventories at least quarterly through a review of inventory levels in relation to foreseeable demand, generally over nine to twelve months. Foreseeable demand is based upon all available information, including sales backlog and forecasts, product marketing plans and product life cycle information. When the inventory on hand exceeds the foreseeable demand, we write down the value of those inventories which, at the time of our review, we expect to be unable to sell. The amount of the inventory write-down is the excess of historical cost over estimated realizable value. Once established, these write-downs are considered permanent adjustments to the cost basis of the excess inventory. Demand for our products may fluctuate significantly over time, and actual demand and market conditions may be more or less favorable than those projected by management. In the event that actual demand is lower than originally projected, additional inventory write-downs may be required.

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

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

Research and Development

(in millions)	2004	Change	2003	Change	2002
Research and development	$240.0	51%	$159.4	2%	$156.4
Percent of net revenues	27%		27%		30%

Our research and development (R&D) expenses consist principally of direct personnel costs to develop new communications and semiconductor products, photomask and other costs for pre-production evaluation and testing of

new devices and design and test tool costs. Our R&D expenses also include the costs for design automation and advanced package development, and non-cash stock compensation charges related to the amortization of the unvested stock options exchanged in the Merger.

The $80.6 million increase in R&D expenses for fiscal 2004 compared to fiscal 2003 primarily reflects additional development costs associated with DSL and Wireless products as a result of the Merger, an increase of $4.9 million in stock compensation charges primarily as a result of the Merger, and to a much lesser extent, increased R&D project costs associated with purchased R&D and electronic design automation tools. As a result of cost reduction

initiatives we have implemented in fiscal 2004 and in the first quarter of fiscal 2005, we expect that R&D expenses will be lower in future periods.

The increase in R&D expenses for fiscal 2003 compared to fiscal 2002 primarily reflects the higher costs of acquired technology, the 2003 addition of product and test engineering teams and the additional week of activity to accommodate our 52/53 week fiscal year. These increases were partially offset by workforce reductions in our 2002 and 2003 restructuring actions and the contribution of a majority of our advanced process development efforts to Jazz in March 2002.

Selling, General and Administrative

(in millions)	2004	Change	2003	Change	2002
Selling, general and administrative	$125.5	34%	$93.4	(2)%	$95.8
Percent of net revenues	14%		16%		18%

Our selling, general and administrative (SG&A) expenses include personnel costs, sales representative commissions, advertising and other marketing costs. Our SG&A expenses also include costs of corporate functions including legal, accounting, treasury, human resources, real estate, information systems, customer service, sales, marketing, field application engineering and other services, and non-cash stock compensation charges related to the amortization of the unvested stock options exchanged in the Merger.

The $32.1 million increase in SG&A expense for fiscal 2004 as compared to fiscal 2003 are attributable to additional SG&A costs as a result of the Merger, an increase of $1.8 million in stock compensation charges as a result of the Merger, and $4.5 million in additional bad debt reserves, partially offset by ($1.3) million in stock compensation charges associated with an employee bonus plan in prior years which had variable accounting. As a result of cost reduction initiatives we have implemented in fiscal 2004 and in the first quarter of fiscal 2005, we expect that SG&A expenses will be lower in future periods.

The decrease in SG&A expenses for fiscal 2003 compared to fiscal 2002 primarily reflects lower headcount and personnel-related costs resulting from the expense reduction and restructuring actions initiated during fiscal 2003 and 2002, partially offset by the additional week of activity in fiscal 2003 to accommodate our 52/53 week fiscal year.

Amortization of Intangible Assets

(in millions)	2004	Change	2003	Change	2002
Amortization of intangible assets	$20.8	nm	$3.4	nm	$19.5

nm = not meaningful

Amortization expense of $20.8 million in fiscal 2004 increased by $17.4 million over the $3.4 million recorded in fiscal 2003. This increase is attributable to the significant intangible assets we acquired in the Merger.

The lower amortization expenses in fiscal 2003, as compared to fiscal 2002, primarily resulted from the adoption of SFAS 141 and SFAS 142 as of the beginning of fiscal 2003. SFAS 141 requires that all business combinations be

accounted for using the purchase method and provides new criteria for recording intangible assets separately from goodwill. SFAS 142 addresses financial accounting and reporting for acquired goodwill and other intangible assets, and requires that we no longer amortize goodwill into our results of operations. Instead, goodwill must be tested at least annually for impairment and written down when impaired. We expect that amortization of intangible assets will be approximately $31.6 million for fiscal 2005.

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Special Charges

Special charges consist of the following:

(in millions)	2004	Change	2003	Change	2002
Asset impairments	$ 5.4	nm	$ 9.6	nm	$13.5
Restructuring charges	9.3	nm	5.2	nm	16.1
Integration costs	7.3	nm		nm	
Separation costs		nm		nm	0.9
Other	10.8	nm	3.6	nm	
	$32.8		$18.4		$30.5

nm = not meaningful

Asset Impairments

For a discussion of our asset impairment charges, see Note 15 of Notes to Consolidated Financial Statements.

Restructuring Charges

We implemented a number of cost reduction initiatives to improve our operating cost structure. For a discussion of our cost reduction initiatives and activity under our restructuring plans, including remaining liabilities at September 30, 2004, see Note 15 of Notes to Consolidated Financial Statements.

Integration Costs

In fiscal 2004, we incurred $7.3 million of costs related to the integration efforts of the employees, customers, operations and other business aspects related to the Merger.

Separation Costs

In fiscal 2002, we incurred separation costs of approximately $0.9 million in connection with the divestiture of our Newport Beach wafer fabrication operations and our digital imaging business.

Other Special Charges

Other special charges for fiscal 2004 consist of stock option modification charges of $0.8 million, one-time executive bonuses which were contractually committed in the closing of the Merger of $1.2 million, $3.0 million related to the settlement of our litigation with Agere Systems, Inc., and $5.8 million of other special charges.

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

Debt Conversion Costs

In fiscal 2002, we exchanged 2.2 million shares of our common stock for approximately $28.0 million principal amount of our 4.25% Convertible Subordinated Notes due 2006. In connection with this transaction, we recognized debt conversion costs of $10.4 million for the fair value of the shares we issued in excess of the number of shares issuable in a conversion of the notes pursuant to their original terms.

Gain on Extinguishment of Debt

During fiscal 2003, we purchased $100.0 million principal amount of our 4% Convertible Subordinated Notes due 2007 at prevailing market prices, resulting in a net gain of $42.0 million.

Other Expense, Net

(in millions)	2004	Change	2003	Change	2002
Other expense, net	$99.8	nm	$5.8	nm	$36.9

Other expense, net for fiscal 2004 was comprised of $30.7 million of interest expense primarily from our convertible subordinated notes, a $13.4 million write-down of certain non-marketable investments, a $6.3 million decrease in the fair value of the conversion right under the Skyworks 15% convertible senior subordinated note prior to its conversion into Skyworks common stock in May 2004, a $92.7 million decrease in the fair value of the Mindspeed warrant, offset by $7.7 million of investment and interest income on invested cash balances, $14.4 million of income in our equity method investees, and $24.1 million of gains on sales of investments. Due to variations in the fair value of the common stock underlying the Mindspeed warrant, we expect that other (income) expense may fluctuate significantly in future periods until this derivative instrument is liquidated.

Other expense, net for fiscal 2003 was comprised of a $30.2 million increase in the fair value of the Mindspeed warrant, a $9.4 million increase in the fair value of the conversion right under the Skyworks 15% convertible senior subordinated notes, $8.6 million of gains on sales of investments and $15.6 million of investment income and interest income on invested cash balances, offset by $28.1 million of interest expense primarily from our convertible subordinated notes, a $39.4 million write-down of certain non-marketable investments, and $3.1 million of losses in our equity method investments.

Other expense, net for fiscal 2002 was comprised of $31.1 million of interest expense on our convertible subordinated notes, a $21.2 million write-down of certain non-marketable investments and $2.7 million of losses in our equity method investments, partially offset by $13.1 million of investment income and interest income on invested cash balances.

The carrying values of certain non-marketable investments were written down to their estimated fair values (in most cases, zero). These investments consist of equity interests in early stage technology companies which we had accounted for under the cost method. We estimated the fair value of these investments based upon available financial and other information, including the then-current and projected business prospects for the subject companies, and determined that the decline in the fair value of these investments was other than temporary.

Provision (Benefit) for Income Taxes

In fiscal 2004, we recorded an income tax provision of $243.7 million. This provision is comprised of an increase in the valuation allowance on deferred tax assets of $255.7 million, a current provision of $2.0 million for foreign taxes incurred by certain of our international subsidiaries, partially offset by a $14.0 million credit related to a federal income tax refund received in September 2004 related to the carryback of a portion of our fiscal year 2001 net operating loss. The loss was carried back under the five-year carryback provision enacted in 2002 and income taxes paid while Conexant was a subsidiary of Rockwell Automation, Inc. were recovered.

In fiscal 2003, we recorded income tax benefits of $0.1 million. These benefits relate to tax refunds received offset by foreign income taxes incurred by certain of our international subsidiaries.

As a result of our cumulative operating losses, we determined that it is more likely than not that the additional income tax benefits (principally net operating losses we can carry forward to future years) will not be realized. Accordingly, we increased our valuation allowance by approximately $255.7 million during fiscal 2004 for the deferred tax assets

which we do not expect to realize through the reduction of future income tax payments. See Note 8 of Notes to Consolidated Financial Statements for further information. We do not expect to recognize any income tax benefits relating to future operating losses until we believe that such tax benefits are more likely than not to be realized. While we will continue to be subject to foreign income taxes and federal alternative minimum tax, we expect those taxes will be insignificant.

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Quarterly Results of Operations

The following table presents our operating results for each of the eight fiscal quarters in the period ended September 30, 2004. The information for each of these quarters is derived from our unaudited interim financial statements which have been prepared on the same basis as the audited consolidated financial statements included in this report. In our opinion, all necessary adjustments, which consist only of normal and recurring accruals as well as the special charges, in-process research and development, debt conversion costs, the gain on extinguishment of debt, and the deferred tax asset valuation allowance have been included to fairly present our unaudited quarterly results. The quarterly financial data for all periods have been restated to reflect the wireless communications business and Mexicali Operations and the Mindspeed Technologies business as discontinued operations. In February 2004, Conexant completed the merger with GlobespanVirata, Inc. The results of GlobespanVirata, Inc. have been included in the consolidated results since February 28, 2004. This data should be read together with our consolidated financial statements and the notes thereto included in this report.

	Three months ended							
	Dec. 31, 2002	**Mar. 31, 2003**	**June 30, 2003**	**Sept. 30, 2003**	**Dec. 31, 2003**	**Mar. 31, 2004**	**June 30, 2004**	**Sept. 30, 2004**
	(in thousands, except per share amounts)							
Statement of Operations Data								
Net revenues	$ 144,201	$140,123	$150,950	$164,703	$177,333	$ 243,781	$267,617	$ 213,123
Cost of goods sold	81,462	78,107	86,000	92,592	98,196	142,116	155,136	127,681
Gross margin	62,739	62,016	64,950	72,111	79,137	101,665	112,481	85,442
Research and development	40,237	38,741	38,849	41,527	39,154	53,734	74,317	72,766
Selling, general and administrative	22,779	23,777	22,915	23,955	22,809	30,602	36,371	35,692
Amortization of intangible assets	799	799	925	914	955	3,653	7,956	8,205
In-process research and development						160,818		
Special charges	6,774	285	6,526	4,794	605	5,514	8,294	18,388
Total operating expenses	70,589	63,602	69,215	71,190	63,523	254,321	126,938	135,051
Operating income (loss)	(7,850)	(1,586)	(4,265)	921	15,614	(152,656)	(14,457)	(49,609)
Gain on debt extinguishment		(34,645)	(7,376)					
Other (income) expense,	(3,403)	44,732	(544)	(34,977)	(25,281)	(9,736)	56,308	78,517

net								
Income (loss) before income taxes	(4,447)	(11,673)	3,655	35,898	40,895	(142,920)	(70,765)	(128,126)
Provision (benefit) for income taxes	316	381	488	(1,314)	248	459	661	242,365
Income (loss) from continuing operations	(4,763)	(12,054)	3,167	37,212	40,647	(143,379)	(71,426)	(370,491)
Loss from discontinued operations, net of income tax	(620,610)	(55,970)	(52,297)					
Net income (loss)	$ (625,373)	$ (68,024)	$ (49,130)	$ 37,212	$ 40,647	$ (143,379)	$ (71,426)	$ (370,491)
Income (loss) per share, basic:								
Continuing operations	$ (0.02)	$ (0.05)	$ 0.01	$ 0.14	$ 0.15	$ (0.41)	$ (0.15)	$ (0.79)
Discontinued operations	(2.33)	(0.21)	(0.19)					
Net income (loss)	$ (2.35)	$ (0.26)	$ (0.18)	$ 0.14	$ 0.15	$ (0.41)	$ (0.15)	$ (0.79)
Income (loss) per share, diluted:								
Continuing operations	$ (0.02)	$ (0.05)	$ 0.01	$ 0.12	$ 0.13	$ (0.41)	$ (0.15)	$ (0.79)
Discontinued operations	(2.33)	(0.21)	(0.19)					
Net income (loss)	$ (2.35)	$ (0.26)	$ (0.18)	$ 0.12	$ 0.13	$ (0.41)	$ (0.15)	$ (0.79)
Shares used in computing diluted loss per share-basic	265,714	266,543	268,489	273,241	277,190	349,968	463,804	467,556
Shares used in computing diluted	265,714	266,543	271,051	303,488	307,545	349,968	463,804	467,556

loss per
share-diluted

Throughout fiscal 2003 and 2004 we recorded special charges primarily related to our restructuring initiatives. We also recorded special charges for asset impairments and litigation settlements.

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In the second quarter of fiscal 2004, we recorded a $160.8 million non-cash charge related to in-process research and development (IPR&D) in the Merger, and in the fourth quarter of 2004, we recorded a $255.7 million non-cash charge for the impairment of our deferred tax assets.

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

Liquidity and Capital Resources

Cash used in operating activities was $31.0 million in fiscal 2004 compared to $32.2 million in fiscal 2003. Fiscal 2004 operating cash flows reflect our loss from continuing operations of $544.6 million, offset by non-cash charges of $563.3 million and a net decrease in the cash components of working capital of $49.7 million. Non-cash charges consist primarily of IPR&D of $160.8 million, depreciation and amortization of $36.9 million, stock compensation of $9.6 million, a net decrease in the fair value of the Mindspeed warrant and the Skyworks convertible notes of $99.0 million, a write down of non-marketable investments of $13.4 million, a net decrease in deferred tax assets of $256.0 million, offset by gains on sales of investments of $24.1 million, and a net increase in equity in earnings of equity method investees of $14.4 million. The working capital primarily consists of a $17.8 million increase in accounts receivable, a $73.5 million increase in inventories, offset by a $46.3 million increase in accounts payable and accrued expenses.

The $73.5 million increase in inventories is attributable to the sequential decline in net revenues during fiscal 2004, and the $17.8 million increase in accounts receivable is attributable to growth in our days sales outstanding as a result of excess channel inventory levels at our direct customers, distributors and resellers.

Cash provided by investing activities of $67.0 million in fiscal 2004 includes net cash and cash equivalents acquired in acquisitions of $24.8 million, net proceeds from the sale of assets and investments of $57.2 million, and the net sales of marketable securities of $39.7 million, partially offset by capital expenditures of $17.6 million, payment of deferred purchase consideration of $4.0 million, payment of acquisition costs of $30.2 million, and investments of $3.0 million. Cash provided by investing activities of $183.7 million in fiscal 2003 includes the net repayment of the Term Notes and the credit facility by Skyworks in the amount of $135.0 million, proceeds from the sale of assets of $18.2 million, net sales of marketable securities of $62.5 million, partially offset by capital expenditures of $19.8 million and payments of $12.2 million for acquisitions and investments in early stage technology companies.

Cash provided by financing activities of $26.9 million in fiscal 2004 consisted of proceeds from the exercise of stock options and warrants of $24.6 million, and $2.3 million in proceeds upon repayment of notes receivable from shareholders. In fiscal 2003, cash used by financing activities of $34.1 million consisted of proceeds from the exercise of stock options of $22.3 million, offset by $56.4 million paid in connection with the repurchase of a portion of our convertible subordinated notes.

Cash used in the discontinued operations of Mindspeed in fiscal 2003 was $202.3 million, which includes the $100.0 million of cash contributed to Mindspeed prior to the Mindspeed Spin. Cash used in discontinued operations in fiscal 2002 of $222.6 million represents the funding of the discontinued wireless communications business, the Mexicali Operations and the Mindspeed Technologies business.

As of September 30, 2004, our principal sources of liquidity are our existing cash reserves, marketable securities, the current portion of the Mindpseed warrant and cash generated from product sales. Combined cash and cash equivalents and short-term investments at September 30, 2004 totaled $302.1 million compared to $175.5 million at September 30, 2003. Our working capital at September 30, 2004 was $434.8 million compared to $233.0 million at September 30, 2003. In addition, at September 30, 2004, we held $137.6 million in long-term marketable securities which we could liquidate to fund operations and/or future acquisitions.

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Total cash, cash equivalents and marketable securities are as follows:

(in millions)	September 30, 2004	September 30, 2003
Cash and cash equivalents	$ 139.0	$ 76.2
Skyworks 15% convertible senior subordinated notes		55.6
Equity securities- Skyworks Solutions, Inc. (6.2 million shares at September 30, 2004, 0.5 million shares at September 30, 2003)	61.8	4.6
Equity securities- SiRF Technologies, Inc. (5.9 million shares at September 30, 2004)	87.5	
Other short-term marketable securities (primarily mutual funds, domestic government agency securities and corporate debt securities)	13.8	39.1
Long-term marketable securities (primarily domestic government agency securities and corporate debt securities)	137.6	
	$ 439.7	$ 175.5

The current portion of the Mindspeed warrant at September 30, 2004 is $3.6 million, and the long-term portion is $23.0 million. The valuation of this derivative instrument is subjective, and at any point in time could ultimately result in the realization of amounts significantly different than the carrying value.

We believe that our existing sources of liquidity will be sufficient to fund our operations, research and development efforts, anticipated capital expenditures, and other liabilities and commitments, and other capital requirements, for at least the next twelve months. We will need to continue a focused program of capital expenditures to meet our research and development and corporate requirements. We may also consider acquisition opportunities to extend our technology portfolio and design expertise and to expand our product offerings. In order to fund capital expenditures, increase our working capital or complete any acquisitions, we may seek to obtain additional debt financing or issue additional shares of our common stock. However, we cannot assure you that such financing will be available to us on favorable terms, or at all.

We have $711.8 million aggregate principal amount of subordinated convertible notes outstanding of which approximately $200.0 million become due in fiscal 2006 and the remainder becomes due in fiscal 2007. The conversion prices of the notes are currently in excess of the market value of our common stock. As of September 30, 2004, we had $439.7 million of cash and investments. If we are unable to generate sufficient cash flows from our operations or realize additional value from our investments and other assets, we may have to seek additional sources of financing. We cannot assure you that such financing will be available to us on favorable terms, or at all.

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Commitments

The following summarizes our contractual obligations at September 30, 2004:

	Payments due by period				
(in millions)	Total	Less than 1 Year	1-3 years	3-5 years	More than 5 years
Convertible subordinated notes (1)	$711.8	$	$711.8	$	$
Operating leases	150.5	28.8	38.3	21.3	62.1
Assigned leases	17.5	7.7	4.9		4.9
Contingent consideration on acquisitions	4.0		4.0		
Capital commitments	5.4	5.4			
Purchase commitments	24.9	24.9			
Assigned purchase commitments	12.0	12.0			
Employee commitments	5.9	5.9			
	$932.0	$ 84.7	$759.0	$ 21.3	$ 67.0

(1) Excludes interest. See Note 9 of Notes to Consolidated Financial Statements for interest terms.

In addition to the contractual obligations listed above, we have exercised our purchase option for approximately $60.0 million to purchase two buildings in Newport Beach, California which we currently occupy under a lease agreement. Our plan is to complete a sale-leaseback transaction with respect to these facilities by early calendar 2005.

At September 30, 2004, the Company has many sublease arrangements on operating leases for terms ranging from near term to approximately 6 years. Aggregate scheduled sublease income based on current terms is approximately $8.5 million.

In November 2004, we announced a plan to reduce quarterly operating expenses by approximately $15.0 million by the end of the fourth fiscal quarter ending September 30, 2005. The primary drivers of the expense reductions will be an increasing shift of production development resources to lower-cost regions and continued merger-related SG&A consolidation. We estimate that the charges associated with such actions, which will be recorded in fiscal 2005, will be in the range of $10.0 million to $15.0 million.

Off-Balance Sheet Arrangements

Our off-balance sheet arrangements consist of conventional operating leases, capital commitments, employee commitments, and purchase commitments as described in Notes 10 and 11 of Notes to Consolidated Financial Statements. We also have contingent liabilities for other items assigned to Mindspeed and Skyworks at the time of

their separation from Conexant. See Note 10 of Notes to the Consolidated Financial Statements. We do not have any special purpose entities or variable interest entities as of September 30, 2004.

Critical Accounting Policies

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Among the significant estimates affecting our consolidated financial statements are those relating to allowances for doubtful accounts, inventories, long-lived assets, in-process research and development (IPR&D), valuation of and estimated lives of identifiable intangible assets, income taxes, valuation of derivative instruments, restructuring costs, long-term employee benefit plans and other contingencies. We regularly evaluate our estimates and assumptions based upon historical experience and various other factors that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. To the extent actual results differ from those estimates, our future results of operations may be affected.

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Business combinations

We account for acquired businesses using the purchase method of accounting which requires that the assets and liabilities assumed be recorded at the date of acquisition at their respective fair values. Because of the expertise required to value intangible assets and IPR&D, we typically engage a third party valuation firm to assist management in determining those values. Valuation of intangible assets and IPR&D entails significant estimates and assumptions including, but not limited to: determining the timing and expected costs to complete projects, estimating future cash flows from product sales, and developing appropriate discount rates and probability rates by project. We believe that the fair values assigned to the assets acquired and liabilities assumed are based on reasonable assumptions. To the extent actual results differ from those estimates, our future results of operations may be affected by incurring charges to our statements of operations. Additionally, estimates for purchase price allocations may change as subsequent information becomes available.

Impairment of long-lived assets

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

Goodwill is tested for impairment annually, or when a possible impairment is indicated, using the fair value based test prescribed by SFAS No. 142. The estimates and assumptions described above (along with other factors such as discount rates) will affect the outcome of our impairment tests and the amounts of any resulting impairment losses.

Deferred income taxes

We evaluate the realizability of our deferred tax assets and assess the need for a valuation allowance quarterly. We record a valuation allowance to reduce our deferred tax assets to the net amount that is more likely than not to be realized. Our assessment of the need for a valuation allowance is based upon our history of operating results, expectations of future taxable income and the ongoing prudent and feasible tax planning strategies available to us. In the event that we determine that we will not be able to realize all or part of our deferred tax assets in the future, an adjustment to the deferred tax assets would be charged against income in the period such determination is made. Likewise, in the event we were to determine that we will be able to realize our deferred tax assets in the future in excess of the net recorded amount, an adjustment to the deferred tax assets would increase income in the period such determination is made. To the extent that we realize a benefit from reducing the valuation allowance on acquired deferred tax assets, the benefit will be credited to goodwill.

Inventories

We assess the recoverability of our inventories at least quarterly through a review of inventory levels in relation to foreseeable demand, generally over nine to twelve months. Foreseeable demand is based upon all available information, including sales backlog and forecasts, product marketing plans and product life cycle information. When the inventory on hand exceeds the foreseeable demand, we write down the value of those inventories which, at the

time of our review, we expect to be unable to sell. The amount of the inventory write-down is the excess of historical cost over estimated realizable value. Once established, these write-downs are considered permanent adjustments to the cost basis of the excess inventory. Demand for our products may fluctuate significantly over time, and actual demand and market conditions may be more or less favorable than those projected by management.

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In the event that actual demand or product pricing is lower than originally projected, additional inventory write-downs may be required.

Allowance for doubtful accounts

We maintain allowances for doubtful accounts for estimated losses resulting from the inability of our customers to make required payments. We use a specific identification method for some items, and a percentage of aged receivables for others. The percentages are determined based on our past experience. If the financial condition of our customers were to deteriorate, our actual losses may exceed our estimates, and additional allowances would be required.

Non-marketable equity securities

We have a portfolio of strategic investments in non-marketable equity securities. Our ability to recover our investments in private, non-marketable equity securities and to earn a return on these investments is primarily dependent on how successfully these companies are able to execute to their business plans and how well their products are accepted, as well as their ability to obtain venture capital funding to continue operations and to grow. We review all of our investments periodically for impairment and an impairment analysis of non-marketable equity securities requires significant judgment. This analysis includes assessment of each investee s financial condition, the business outlook for its products and technology, its projected results and cash flows, the likelihood of obtaining subsequent rounds of financing and the impact of any relevant contractual equity preferences held by us or by others. Overall business valuations have declined significantly over the past two years, and as a result we have experienced substantial impairments in the value of non-marketable equity securities investments we hold. Future adverse changes in market conditions or poor operating results of underlying investments could result in an inability to recover the carrying value of our investments that may not be reflected in their current carrying values, which could require additional impairment charges to write down the carrying values of such investments.

Revenue recognition

Revenue from product sales is recognized upon shipment to the customer, when the risk of loss has been transferred to the customer, price and terms are fixed, no significant vendor obligation exists and collection of the resulting receivable is reasonably assured. Revenue recognition is deferred in all instances where the earnings process is incomplete. Certain product sales are made to electronic component distributors under agreements allowing for a right to return unsold products. Recognition of revenue on all sales to these distributors is deferred until the products are sold by the distributors to a third party. A reserve for sales returns and allowances for other customers is recorded based on historical experience or specific identification of an event necessitating a reserve. . Our revenue recognition policy is significant because our revenue is a key component of our operations and the timing of revenue recognition determines the timing of certain expenses, such as sales commissions. Revenue results are difficult to predict, and any shortfall in revenues could cause our operating results to vary significantly from period to period.

Valuation of derivative instruments

We had two primary types of derivatives our warrant to purchase shares of common stock of Mindspeed and the conversion right of the Skyworks 15% convertible senior subordinated notes. Until its conversion to common stock in May 2004, we determined the fair value of the conversion right of the Skyworks notes using the actual trading price of the underlying shares of Skyworks common stock. We determine the fair value of the current portion of the Mindspeed warrant using current pricing data. The fair value of the long-term portion of the Mindspeed warrant is determined using a standard Black-Scholes pricing model with assumptions consistent with current market conditions and our current intent to liquidate the warrant over a specified time period. The Black-Scholes pricing model requires

the input of highly subjective assumptions including expected stock price volatility. Changes in these assumptions, or in the underlying valuation model, could cause the fair value of the Mindspeed warrant to vary significantly from period to period.

Restructuring charges

We recorded $9.3 million, $5.2 million, and $16.1 million of restructuring charges in fiscal years 2004, 2003 and 2002, respectively. These charges relate primarily to reductions in our workforce and related impact on the use of facilities. The estimated charges contain estimates and assumptions made by management about matters which are uncertain at the time, for example the timing and amount of sublease income that will be achieved on vacated property and the operating costs to be paid until lease termination. While we have used our best estimates based on facts and circumstances available at the time, different estimates reasonably could have been used in the relevant periods, and the actual results may be different, and those differences could have a material impact on the presentation of our financial condition or results of operations. Our policies require us to review the estimates and assumptions periodically and reflect the effects of those revisions in the period that they are determined to be necessary. In addition, as a result of the Merger in February 2004, we acquired $11.5 million (as adjusted) of additional restructuring liabilities which were recorded through the purchase price allocation. Such amounts also contain estimates and assumptions made by management, and will be reviewed periodically and adjusted accordingly.

Employee benefit plans

We have long-term liabilities recorded for a retirement medical plan and a pension plan. These obligations and the related effects on operations are determined using actuarial valuations. There are critical assumptions used in these valuation models such as the discount rate, expected return on assets, compensation levels, turnover rates and mortality rates. The discount rate used is representative of a high-quality fixed income investment. The other assumptions do not tend to change materially over time. We evaluate all assumptions annually and they are updated to reflect our experience.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Our financial instruments include cash and cash equivalents, marketable debt securities, the Mindspeed warrant, equity securities and our long-term debt. Our main investment objectives are the preservation of investment capital and the maximization of after-tax returns on our investment portfolio. Consequently, we invest with only high-credit-quality issuers and we limit the amount of our credit exposure to any one issuer.

Our cash and cash equivalents, and short-term marketable securities are not subject to significant interest rate risk due to the short maturities of these instruments. As of September 30, 2004, the carrying value of our cash and cash equivalents and short-term marketable securities approximates fair value. Our long-term marketable securities (consisting of corporate bonds and government agency securities) principally have remaining terms of 1 to 3 years. Such securities are subject to interest rate risk**.** At September 30, 2004, a 10% adverse change in interest rates would result in a $13.7 million decrease in the value of our long-term marketable securities.

Marketable equity securities are subject to equity price risk. For most of our equity security holdings, there are risks associated with the overall state of the stock market, having available buyers for shares we sell, and ultimately being able to liquidate the securities at a favorable price. As of September 30, 2004, a 10% adverse change in equity prices would result in a $15.0 million decrease in the value of our marketable equity securities.

We classify all of our marketable debt and equity securities as available-for-sale securities. As of September 30, 2004, the carrying value of these securities included net unrealized gains of $92.5 million.

We hold a warrant to purchase 30 million shares of common stock of Mindspeed. For financial accounting purposes, this is a derivative instrument and the fair value of the warrant is subject to significant risk related to changes in the

market price of Mindspeed s common stock. As of September 30, 2004, a 10% decrease in the market price of Mindspeed s common stock would decrease the fair value of this warrant by approximately $3.7 million. At September 30, 2004, the market price of Mindspeed s common stock was $2.06 per share. For fiscal 2004, the market price of Mindspeed s common stock ranged from a low of $1.95 per share to a high of $11.36 per share.

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Our long-term debt consists of convertible subordinated notes with interest at fixed rates. Consequently, we do not have significant cash flow exposure on our long-term debt. However, the fair value of our convertible subordinated notes is subject to significant fluctuation due to their convertibility into shares of our common stock.

The following table shows the fair values of our financial instruments as of September 30, 2004:

(in millions)	Carrying Value	Fair Value
Cash and cash equivalents	$ 139.0	$ 139.0
Mutual funds	10.7	10.7
Marketable debt securities	34.7	34.7
Marketable government agency securities	105.2	105.2
Marketable equity securities	150.1	150.1
Mindspeed warrant	26.6	26.6
Long-term debt	711.8	641.9

We transact business in various foreign currencies, and we have established a foreign currency hedging program utilizing foreign currency forward exchange contracts to hedge certain foreign currency transaction exposures. Under this program, from time to time, we offset foreign currency transaction gains and losses with gains and losses on the forward contracts, so as to mitigate our overall risk of foreign transaction gains and losses. We do not enter into forward contracts for speculative or trading purposes. At September 30, 2004, we held no foreign currency forward exchange contracts. Based on our overall currency rate exposure at September 30, 2004, a 10% change in the currency rates would not have a material effect on our consolidated financial position, results of operations or cash flows.

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Item 8. Financial Statements and Supplementary Data

CONEXANT SYSTEMS, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except per share amounts)

	September 30,	
	2004	2003
ASSETS		
Current Assets		
Cash and cash equivalents	$ 139,031	$ 76,186
Short-term investments	163,040	99,283
Receivables, net of allowance of $5,974 (2004) and $1,547 (2003)	185,037	79,557
Inventories	194,754	59,548
Deferred income taxes		13,600
Mindspeed warrant-current portion	3,599	
Other current assets	20,768	26,524
Total current assets	706,229	354,698
Property, plant and equipment, net	55,741	36,310
Goodwill	708,544	56,865
Intangible assets, net	135,241	12,506
Deferred income taxes		241,260
Mindspeed warrant	23,000	119,230
Marketable securities	137,604	
Other assets	114,163	110,838
Total assets	$ 1,880,522	$ 931,707
LIABILITIES AND SHAREHOLDERS EQUITY		
Current Liabilities		
Accounts payable	$ 141,533	$ 55,909
Accrued compensation and benefits	40,423	28,865
Restructuring and reorganization liabilities	22,427	12,091
Other current liabilities	67,044	24,816
Total current liabilities	271,427	121,681
Convertible subordinated notes	711,825	581,825
Other liabilities	68,883	61,435

Total liabilities	1,052,135	764,941
Commitments and contingencies		
Shareholders Equity		
Preferred and junior preferred stock, no par value: 25,000 shares authorized; no shares issued or outstanding		
Common stock, $0.01 par value: 1,000,000 authorized shares; 469,441 (2004) and 276,134 (2003) shares issued and 468,257 (2004) and 276,134 (2003) shares outstanding	4,694	2,761
Treasury stock, 1,184 shares at cost	(5,584)	
Additional paid-in capital	4,648,325	3,506,070
Accumulated deficit	(3,877,176)	(3,332,527)
Accumulated other comprehensive income (loss)	82,551	(9,496)
Notes receivable from stock sales	(576)	
Unearned compensation	(23,847)	(42)
Total shareholders equity	828,387	166,766
Total liabilities and shareholders equity	$ 1,880,522	$ 931,707

See accompanying notes to consolidated financial statements.

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CONEXANT SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share amounts)

	Years Ended September 30,		
	2004	**2003**	**2002**
Net revenues	$ 901,854	$ 599,977	$ 521,726
Cost of goods sold (including $812 in 2004 related to restructuring actions in the Merger- Notes 2 and 7)	523,129	338,161	317,921
Gross margin	378,725	261,816	203,805
Operating expenses:			
Research and development (including non-cash stock compensation of $5,364, $477 and $(595) in 2004, 2003 and 2002, respectively)	239,971	159,354	156,350
Selling, general and administrative (including non-cash stock compensation of $1,773, $1,272 and $(1,499) in 2004, 2003 and 2002, respectively)	125,474	93,426	95,750
Amortization of intangible assets	20,769	3,437	19,489
In-process research and development	160,818		
Special charges	32,801	18,379	30,499
Total operating expenses	579,833	274,596	302,088
Operating loss	(201,108)	(12,780)	(98,283)
Debt conversion costs			10,435
Gain on extinguishment of debt		(42,021)	
Other expense, net	99,808	5,808	36,870
Income (loss) before income taxes	(300,916)	23,433	(145,588)
Provision (benefit) for income taxes	243,733	(129)	(1,838)
Income (loss) from continuing operations	(544,649)	23,562	(143,750)
Loss from discontinued operations, net of income taxes		(728,877)	(737,017)
Net loss	$(544,649)	$(705,315)	$(880,767)
Income (loss) per share, basic:			

Continuing operations	$ (1.40)	$ 0.09	$ (0.56)
Discontinued operations		(2.72)	(2.84)
Net loss	$ (1.40)	$ (2.63)	$ (3.40)
Income (loss) per share, diluted:			
Continuing operations	$ (1.40)	$ 0.09	$ (0.56)
Discontinued operations		(2.65)	(2.84)
Net loss	$ (1.40)	$ (2.56)	$ (3.40)
Number of shares used in per share computation-basic	389,630	268,586	258,998
Number of shares used in per share computation-diluted	389,630	275,230	258,998

See accompanying notes to consolidated financial statements.

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CONEXANT SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)

	Years Ended September 30,		
	2004	**2003**	**2002**
Cash Flows From Operating Activities			
Income (loss) from continuing operations	$(544,649)	$ 23,562	$(143,750)
Adjustments required to reconcile income (loss) from continuing operations to net cash used in operating activities, net of effects of acquisition/dispositions of businesses:			
Depreciation	16,151	16,828	29,144
Amortization of intangible assets	20,769	3,437	19,489
In-process research and development	160,818		
Asset impairments	5,435	10,281	13,522
Write-down of non-marketable investments	13,423	39,402	21,207
Provision for losses on accounts receivable	4,475	(3,958)	(5,814)
Inventory provisions	11,586	14,451	14,364
Deferred income taxes	256,041	682	3,667
Stock compensation, option modification charges and other	9,616	2,520	9,196
Debt conversion costs			10,435
Gain on extinguishment of debt		(42,021)	
Decrease (increase) in fair value of derivative instruments	98,955	(39,632)	
Gain on sale of investments	(24,071)	(8,618)	
Other non-cash charges, net	(9,868)	6,103	(1,632)
Changes in assets and liabilities, net of acquisitions/dispositions:			
Receivables	(17,782)	(14,621)	21,428
Inventories	(73,524)	(21,910)	2,800
Accounts payable	43,453	(27,166)	5,293
Accrued expenses and other current liabilities	2,878	(10,810)	13,589
Other	(4,719)	19,313	(24,532)
Net cash used in operating activities	(31,013)	(32,157)	(11,594)
Cash Flows From Investing Activities			
Purchase of marketable securities	(74,586)	(79,632)	(334,461)
Sale of marketable securities	114,323	142,143	392,902
Refundable deposit			150,000
Proceeds from sale of assets and investments	57,236	18,228	72,927
Capital expenditures	(17,563)	(19,844)	(13,058)
Advances to Skyworks		(35,000)	(30,000)

Repayment of Term Notes and advances by Skyworks		170,000	
Cash received (paid for) acquisitions, net	24,752	(7,714)	(21,000)
Payment of acquisition related costs	(30,196)		
Payment of deferred purchase consideration	(4,000)		
Investments in businesses	(3,015)	(4,500)	(9,800)
Net cash provided by investing activities	66,951	183,681	207,510
Cash Flows From Financing Activities			
Proceeds from exercise of stock options and warrants	24,559	22,293	14,733
Repayment of notes receivable from stock sales and other employee notes	2,348		
Repurchase of convertible subordinated notes		(56,378)	
Net cash provided by (used in) financing activities	26,907	(34,085)	14,733
Net cash used in discontinued operations		(202,341)	(222,569)
Net increase (decrease) in cash and cash equivalents	62,845	(84,902)	(11,920)
Cash and cash equivalents at beginning of year	76,186	161,088	173,008
Cash and cash equivalents at end of year	$ 139,031	$ 76,186	$ 161,088

See accompanying notes to consolidated financial statements.

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CONEXANT SYSTEMS, INC.
CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY AND COMPREHENSIVE LOSS
(in thousands)

	Common Stock		Additional		Accumulated	Notes			Total
	Outstanding		Paid-In	Accumulated	Other Comprehensive Income	Receivable From Stock	Treasury	Unearned	Shareholders
	Shares	Amount	Capital	Deficit	(Loss)	Sales	Stock	Compensation	Equity
Balance at September 30, 2001	253,859	$ 253,900	$3,113,205	$(1,566,209)	$(17,204)	$	$(1,807)	$ (8,709)	$1,773,176
Net loss				(880,767)					(880,767)
Currency translation adjustment					(4,195)				(4,195)
Change in unrealized gains on investments					(1,072)				(1,072)
Minimum pension liability adjustment					(5,649)				(5,649)
Unrealized loss on forward exchange contracts					43				43
Comprehensive loss									(891,640)
Purchase acquisitions	1,420	1,420	16,658						18,078
Conversion of debt	2,233	2,233	35,720						37,953
Issuance of common stock and warrants	7,939	7,939	52,303					(459)	59,783
Tax benefits from stock plans			1,175						1,175
Cancellation of treasury stock		(41)	(1,766)				1,807		
Compensation expense related to employee stock plans	225	225	1,749					7,609	9,583

Distribution of business (discontinued operations)				(60,431)				150	(60,281)
Balance at September 30, 2002	265,676	265,676	3,219,044	(2,507,407)	(28,077)			(1,409)	947,827
Net loss				(705,315)					(705,315)
Currency translation adjustment					2,211				2,211
Change in unrealized gains on investments					1,388				1,388
Minimum pension liability adjustment					(2,731)				(2,731)
Comprehensive loss									(704,447)
Effect of change in par value		(263,779)	263,779						
Purchase acquisitions	150	2	812						814
Issuance of common stock	10,308	862	21,971					(154)	22,679
Tax benefits from stock plans			464						464
Compensation expense related to employee stock plans								1,521	1,521
Distribution of business (discontinued operations)				(119,805)	17,713				(102,092)
Balance at September 30, 2003	276,134	2,761	3,506,070	(3,332,527)	(9,496)			(42)	166,766
Net loss				(544,649)					(544,649)
Currency translation					(183)				(183)

adjustment									
Change in unrealized gains on investments					90,551				90,551
Minimum pension liability adjustment					1,679				1,679
Comprehensive loss									(452,602)
Purchase acquisitions	180,553	1,805	1,108,138			(2,469)	(4,778)	(30,948)	1,071,748
Issuance of common stock	12,754	128	32,859						32,987
Interest earned on notes receivable						(39)			(39)
Settlement of notes receivable						1,932	(806)		1,126
Tax benefits from stock plans			462						462
Stock option modifications			796						796
Compensation expense related to employee stock plans								7,143	7,143
Balance at September 30, 2004	469,441	$ 4,694	$ 4,648,325	$ (3,877,176)	$ 82,551	$ (576)	$ (5,584)	$ (23,847)	$ 828,387

See accompanying notes to consolidated financial statements.

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CONEXANT SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation and Significant Accounting Policies

Conexant Systems, Inc. (Conexant or the Company) designs, develops and sells semiconductor system solutions, comprised of semiconductor devices, software and reference designs, for use in broadband communications applications that enable high-speed transmission, processing and distribution of audio, video, voice and data to and throughout homes and business enterprises worldwide. The Company s access solutions connect people through personal communications access products such as personal computers (PCs), set-top boxes and game consoles to audio, video, voice and data services over wireless and wire line broadband connections as well as over dial-up Internet connections. The Company s central office solutions are used by service providers to deliver high-speed audio, video, voice and data services over copper telephone lines to homes and businesses around the globe. In addition, the Company s media processing products enable the capture, display, storage, playback and transfer of audio and video content in applications throughout home and small office environments. The Company operates in one reportable segment.

On February 27, 2004, the Company completed the merger with GlobespanVirata, Inc. (GlobespanVirata) with GlobespanVirata becoming a wholly-owned subsidiary of the Company. For accounting purposes, the transaction was accounted for under the purchase method of accounting with the Company as the acquiror. In exchange for 100% of the outstanding shares of common stock of GlobespanVirata (approximately 150.7 million shares), Conexant issued 1.198 shares of its common stock for each share of GlobespanVirata common stock outstanding (or approximately 180.6 million shares of Conexant common stock) and each outstanding option and warrant to purchase GlobespanVirata common stock was adjusted and converted into an option or warrant to purchase Conexant common stock based on the 1.198 merger ratio (or approximately 43.6 million options to purchase shares of Conexant common stock). In May 2004, the GlobespanVirata, Inc. subsidiary was renamed Conexant, Inc., and hereinafter will be referred to as Conexant, Inc., and the overall business combination is hereinafter referred to as the Merger.

On June 27, 2003, the Company completed the distribution to its shareholders of all outstanding shares of its wholly owned subsidiary Mindspeed Technologies, Inc. (Mindspeed), to which Conexant contributed its Internet infrastructure business, including the stock of certain subsidiaries, and certain other assets and liabilities, including $100.0 million in cash (hereinafter, the Mindspeed Spin). In the Mindspeed Spin, Conexant shareholders received one share of Mindspeed common stock for every three Conexant shares held and the Conexant shareholders continued to hold their Conexant shares. Mindspeed issued the Company a warrant to purchase 30 million shares of Mindspeed common stock, representing approximately 20 percent of Mindspeed s then outstanding common stock on a fully diluted basis. The warrant is exercisable until June 27, 2013 at an exercise price of $3.408 per share. The fair value of the warrant is recorded as an asset on the Company s consolidated balance sheet. Additionally, the Company entered into a senior secured revolving credit facility pursuant to which Mindspeed may borrow up to $50.0 million, subject to certain restrictions, for working capital and general corporate purposes. In December 2004, the Mindspeed credit facility was terminated. See Note 18.

On June 25, 2002, the Company completed the distribution to its shareholders of outstanding shares of its wholly owned subsidiary Washington Sub, Inc. (Washington), to which the Company contributed its wireless communications business, other than certain assets and liabilities which were retained. Immediately thereafter, Washington merged with and into Alpha Industries, Inc. (Alpha), with Alpha the surviving corporation. As a result of these transactions, Conexant shareholders received 0.351 of a share of Alpha common stock for each Conexant share held and the Conexant shareholders continued to hold their Conexant shares. Upon completion of the these transactions, Alpha and its subsidiaries purchased Conexant s semiconductor assembly and test facility located in

Mexicali, Mexico and Conexant s package design team that supports the Mexicali facility (together, the Mexicali Operations) for $150.0 million. Effective June 26, 2002, Alpha changed its name to Skyworks Solutions, Inc. (Skyworks). All these transactions, on a combined basis, are hereinafter referred to as the Skyworks Spin.

Basis of Presentation The consolidated financial statements, prepared in accordance with accounting principles generally accepted in the United States of America, include the accounts of the Company and each of its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation.

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

Fiscal Year The Company maintains a fifty-two/fifty-three week fiscal year ending on the Friday closest to September 30. Fiscal 2004 comprised 52 weeks and ended on October 1, 2004. Fiscal year 2003 comprised 53 weeks and ended on October 3. Fiscal year 2002 comprised 52 weeks and ended on September 27. For convenience, the accompanying consolidated financial statements have been shown as ending on the last day of the calendar month.

Use of Estimates The preparation of financial statements in conformity with generally accepted accounting principles accepted in the United States of America requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Among the significant estimates affecting the financial statements are those related to the allowance for doubtful accounts, inventories, long-lived assets, valuation of derivative financial instruments and investments, restructuring reserves, in-process research and development, valuation of and estimated useful lives of identifiable intangible assets, long-term employee benefit plans, income taxes and litigation. On an ongoing basis, management reviews its estimates based upon currently available information. Actual results could differ materially from those estimates.

Revenue Recognition Revenues from product sales are recognized upon shipment and transfer of title, in accordance with the shipping terms specified in the arrangement with the customer. Revenue recognition is deferred in all instances where the earnings process is incomplete. Certain product sales are made to electronic component distributors under agreements allowing for a right to return unsold products. Recognition of revenue on all sales to these distributors is deferred until the products are sold by the distributors to a third party. A reserve for sales returns and allowances for other customers is recorded based on historical experience or specific identification of an event necessitating a reserve. Development revenue is recognized when services are performed and was not significant for any of the periods presented.

Cash, Cash Equivalents and Investments marketable securities The Company considers all highly liquid investments with insignificant interest rate risk and original maturities of three months or less from the date of purchase to be cash equivalents. The carrying amounts of cash and cash equivalents approximate their fair values. Short-term marketable securities consist of mutual funds, debt securities with original maturity dates between ninety days and one year, and equity securities. Long-term marketable securities consist of debt securities with original maturity dates greater than one year. The Company s investments are classified as available-for-sale, and are reported at fair value at the balance sheet date. The unrealized gains and losses are reported as a component of accumulated other comprehensive income (loss). Management determines the appropriate classification of debt securities at the time of purchase and reassesses the classification at each reporting date. Gains and losses on the sale of available-for-sale investments are determined using the specific-identification method.

Equity securities included in short-term marketable securities represent the Company s common stock holdings in publicly traded companies and are classified as short-term based on the Company s ability and intent to liquidate the securities as necessary to meet liquidity requirements. The reported fair value of these equity securities is based on the quoted market prices of the securities at each reporting date. Based on the overall state of the stock market, the availability of buyers for the shares when the Company wants to sell, and other restrictions, at any point in time the amounts ultimately realized upon liquidation of these securities may be significantly different than the carrying value.

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

Total cash, cash equivalents and marketable securities are as follows (in thousands):

	September 30, 2004	September 30, 2003
Cash and cash equivalents	$139,031	$ 76,186
Skyworks 15% convertible senior subordinated notes		55,566
Equity securities- Skyworks Solutions, Inc. (6.2 million shares at September 30, 2004, 0.5 million shares at September 30, 2003)	61,767	4,576
Equity securities- SiRF Technologies, Inc. (5.9 million shares at September 30, 2004)	87,509	
Other short-term marketable securities (primarily mutual funds, domestic government agency securities and corporate debt securities)	13,764	39,141
Subtotal- short-term investments	163,040	99,283
Long-term marketable securities (primarily domestic government agency securities and corporate debt securities)	137,604	
	$439,675	$175,469

For all investment securities, unrealized losses that are other than temporary are recognized in net income. The Company does not hold these securities for speculative or trading purposes.

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

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

Investments The Company accounts for non-marketable investments using the equity method of accounting if the

investment gives the Company the ability to exercise significant influence, but not control, over an investee. Significant influence generally exists if the Company has an ownership interest representing between 20% and 50% of the voting stock of the investee. Under the equity method of accounting, investments are stated at initial cost and are adjusted for subsequent additional investments and the Company s proportionate share of income or losses and distributions. The Company records its share of the investees earnings or losses in other income (expense) in the consolidated statement of operations. Additional investments by other parties in the investee will result in a reduction in the Company s ownership interest, and the resulting gain or loss will be recorded in other income (expense) in the consolidated statement of operations. Where the Company is unable to exercise significant influence over the investee, investments are accounted for under the cost method. Under the cost method, investments are carried at cost and adjusted only for other-than-temporary declines in fair value, distributions of earnings or additional investments. See Note 7, Other Assets, for further information on investments.

Impairment of Long-Lived Assets Long-lived assets, including fixed assets and intangible assets (other than goodwill), are continually monitored and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of any such asset may not be recoverable. The determination of recoverability is based on an estimate of undiscounted cash flows expected to result from the use of an asset and its eventual disposition. The estimate of cash flows is based upon, among other things, certain assumptions about expected future operating performance, growth rates and other factors. Estimates of undiscounted cash flows may differ from actual cash flows due to, among other things, technological changes, economic conditions, changes to the business model or changes in operating performance. If the sum of the undiscounted cash flows (excluding interest) is less

CONEXANT SYSTEMS, INC.
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than the carrying value, an impairment loss will be recognized, measured as the amount by which the carrying value exceeds the fair value of the asset. See Note 15 for discussion of impairment charges for long-lived assets in fiscal years 2004, 2003 and 2002.

Goodwill is tested for impairment annually, or when a possible impairment is indicated, using the fair value based test prescribed by SFAS 142. The estimates and assumptions described above (along with other factors such as discount rates) will affect the outcome of the impairment tests and the amounts of any resulting impairment losses. The Company performed its annual assessment of goodwill and determined that no impairment exists as of September 30, 2004.

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

Derivative Financial Instruments Derivative financial instruments are recognized as either assets or liabilities in the balance sheet and are measured at fair value. The Company s derivative financial instruments principally consist of foreign currency forward exchange contracts which the Company uses to manage its exposure to foreign currency risks, the Mindspeed warrant, and prior to its conversion to Skyworks common stock, the conversion rights of the Skyworks convertible notes. The Company s objectives are to reduce the volatility of earnings and cash flows associated with changes in foreign currency exchange rates. The Company may use other derivatives from time to time to manage its exposure to changes in interest rates, equity prices or other risks. The Company does not enter into derivative financial instruments for speculative or trading purposes.

The Company designates certain forward contracts as hedges of forecasted intercompany transactions. Unrealized gains and losses on these contracts are recorded as a component of accumulated other comprehensive income. Other forward contracts are designated as hedges of intercompany accounts of the Company s foreign subsidiaries. Unrealized gains and losses on these forward contracts are recorded currently through earnings and offset the corresponding losses and gains on the assets and liabilities being hedged. At September 30, 2004, the Company had no foreign currency forward contracts outstanding. During fiscal 2004, 2003 and 2002, there were no significant gains or losses recognized in earnings for hedge ineffectiveness.

Prior to its conversion to Skyworks common stock in May 2004, the Company accounted for the right to convert the Skyworks 15% convertible senior subordinated notes into shares of Skyworks common stock as an embedded derivative instrument. Changes in the fair value of the Skyworks 15% convertible senior subordinated notes resulting from changes in the value of the conversion right were included in other (income) expense, net each period. The Company also accounts for the Mindspeed warrant as a derivative instrument (see Note 7), and changes in the fair value of the warrant are included in other (income) expense, net each period.

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

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

	2004