SIGMA DESIGNS INC
Form 10-Q
June 09, 2010

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

# FORM 10-Q

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

For the quarterly period ended May 1, 2010

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 001-32207

Sigma Designs, Inc.
(Exact name of registrant as specified in its charter)

| | |
|---|---|
| California<br>(State or other jurisdiction of incorporation or organization) | 94-2848099<br>(I.R.S. Employer Identification No.) |

1778 McCarthy Boulevard,
Milpitas, California 95035
(Address of principal executive offices including Zip Code)
(408) 262-9003
(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 R No £

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes £ No £

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

| | | | |
|---|---|---|---|
| Large accelerated filer £ | Accelerated filer R | Non-accelerated filer £<br>(Do not check if a smaller reporting company) | Smaller reporting company £ |

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

As of June 1, 2010, the Company had 31,107,489 shares of Common Stock outstanding.

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SIGMA DESIGNS, INC.

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PART I. FINANCIAL INFORMATION

ITEM 1. UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

SIGMA DESIGNS, INC.
UNAUDITED CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands, except share amounts)

| | May 1, 2010 | January 30, 2010 |
|---|---|---|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | $ 82,782 | $ 81,947 |
| Short-term marketable securities | 51,926 | 51,176 |
| Restricted cash | 1,583 | 1,500 |
| Accounts receivable, net | 34,407 | 36,127 |
| Inventories | 17,890 | 18,187 |
| Deferred tax assets | 2,247 | 2,235 |
| Prepaid expenses and other current assets | 9,599 | 8,925 |
| Total current assets | 200,434 | 200,097 |
| | | |
| Long-term marketable securities | 19,645 | 13,257 |
| Software, equipment and leasehold improvements, net | 28,866 | 23,810 |
| Goodwill | 44,910 | 44,910 |
| Intangible assets, net | 120,982 | 125,568 |
| Deferred tax assets, net of current portion | 11,599 | 11,575 |
| Long-term investments | 4,000 | 4,000 |
| Other non-current assets | 685 | 680 |
| Total assets | $ 431,121 | $ 423,897 |
| | | |
| Liabilities and Shareholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | $ 13,452 | $ 10,943 |
| Accrued liabilities | 22,488 | 23,164 |
| Total current liabilities | 35,940 | 34,107 |
| | | |
| Other long-term liabilities | 12,985 | 12,528 |
| Long-term deferred tax liabilities | 8,440 | 8,440 |
| Total liabilities | 57,365 | 55,075 |
| | | |
| Commitments and contingencies (Note 10) | | |
| | | |
| Shareholders' equity: | | |
| Preferred stock | — | — |
| Common stock and additional paid-in capital | 425,337 | 421,109 |
| Treasury stock | (85,941) | (85,941) |
| Accumulated other comprehensive income | 781 | 1,189 |
| Retained earnings | 33,579 | 32,465 |
| Total shareholders' equity | 373,756 | 368,822 |

| | | | | |
|---|---|---|---|---|
| Total liabilities and shareholders' equity | $ | 431,121 | $ | 423,897 |

See accompanying notes to the unaudited condensed consolidated financial statements

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SIGMA DESIGNS, INC.
UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

| | Three Months Ended | |
|---|---|---|
| | May 1, 2010 | May 2, 2009 |
| Net revenue | $ 65,179 | $ 51,243 |
| Cost of revenue | 33,028 | 26,856 |
| Gross profit | 32,151 | 24,387 |
| | | |
| Operating expenses: | | |
| Research and development | 18,758 | 11,517 |
| Sales and marketing | 7,322 | 3,211 |
| General and administrative | 4,935 | 3,131 |
| Total operating expenses | 31,015 | 17,859 |
| Income from operations | 1,136 | 6,528 |
| | | |
| Interest and other income, net | 724 | 778 |
| Income before income taxes | 1,860 | 7,306 |
| Provision for income taxes | 746 | 4,563 |
| Net income | $ 1,114 | $ 2,743 |
| | | |
| Net income per share: | | |
| Basic | $ 0.04 | $ 0.10 |
| Diluted | $ 0.04 | $ 0.10 |
| | | |
| Share used in computing net income per share: | | |
| Basic | 30,995 | 26,592 |
| Diluted | 31,586 | 27,196 |

See accompanying notes to the unaudited condensed consolidated financial statements

SIGMA DESIGNS, INC.

UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

| | Three Months Ended | |
|---|---|---|
| | May 1, 2010 | May 2, 2009 |
| Cash flows from operating activities: | | |
| Net income | $ 1,114 | $ 2,743 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 6,704 | 2,258 |
| Share-based compensation | 3,124 | 1,158 |
| Provision for sales returns and discounts | 32 | 99 |
| Deferred income taxes | (67) | 3,648 |
| Loss on disposal of equipment | 14 | — |
| Tax benefit from employee stock option plan | — | 179 |
| Excess tax benefit from share-based compensation | — | (179) |
| Accretion of contributed leasehold improvements | (44) | (42) |
| Goodwill adjustment | — | 15 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 1,686 | 9,631 |
| Inventories | 297 | 6,252 |
| Prepaid expenses and other current assets | (729) | 893 |
| Other non-current assets | (6) | (27) |
| Accounts payable | 2,506 | 4,244 |
| Accrued liabilities | (801) | (952) |
| Other long-term liabilities | 501 | 267 |
| Net cash provided by operating activities | 14,331 | 30,187 |
| | | |
| Cash flows from investing activities: | | |
| Restricted cash | (83) | — |
| Purchases of marketable securities | (18,015) | (18,984) |
| Sales and maturities of marketable securities | 10,811 | 23,773 |
| Purchases of software, equipment and leasehold improvements | (7,153) | (1,386) |
| Purchases of long-term investments | — | (524) |
| Net cash provided by (used in) investing activities | (14,440) | 2,879 |
| | | |
| Cash flows from financing activities: | | |
| Net proceeds from exercises of employee stock options | 1,104 | 316 |
| Excess tax benefit from share-based compensation | — | 179 |
| Net cash provided by financing activities | 1,104 | 495 |
| | | |
| Effect of foreign exchange rate changes on cash and cash equivalents | (160) | 256 |
| Increase in cash and cash equivalents | 835 | 33,817 |
| | | |
| Cash and cash equivalents at beginning of period | 81,947 | 90,845 |
| Cash and cash equivalents at end of period | $ 82,782 | $ 124,662 |
| | | |
| Supplemental disclosure of cash flow information: | | |

| | | | | |
|---|---|---|---|---|
| Cash paid for interest | $ | — | $ | 75 |
| Cash paid for income taxes | $ | 551 | $ | 172 |

See accompanying notes to the unaudited condensed consolidated financial statements

SIGMA DESIGNS, INC.
NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and summary of significant accounting policies

Organization and nature of operations: Sigma Designs, Inc. (referred to collectively in these unaudited condensed consolidated financial statements as “Sigma,” “we,” “our” and “us”) specializes in integrated system-on-chip, or SoC solutions for the internet protocol television, or IPTV, connected home technologies, connected media player, prosumer and industrial audio/video, and other markets. We sell our products to manufacturers, designers and to a lesser extent, to distributors who, in turn, sell to manufacturers.

Basis of presentation: The unaudited condensed consolidated financial statements include Sigma Designs, Inc. and its wholly-owned subsidiaries. All intercompany balances and transactions are eliminated upon consolidation.

The unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America, or US GAAP, for interim financial information and the rules and regulations of the Securities and Exchange Commission, or SEC. They do not include all disclosures required by US GAAP for complete financial statements. However, we believe that the disclosures are adequate and fairly present the information. The information included in this Quarterly Report on Form 10-Q should be read in conjunction with our audited consolidated financial statements and notes thereto for the year ended January 30, 2010 included in our Annual Report on Form 10-K.

The condensed consolidated financial statements included herein are unaudited; however, they contain all normal recurring accruals and adjustments that, in our opinion, are necessary to present fairly our consolidated financial position at May 1, 2010 and January 30, 2010, the consolidated results of our operations for the three months ended May 1, 2010 and May 2, 2009, and the consolidated cash flows for the three months ended May 1, 2010 and May 2, 2009. The results of operations for the three months ended May 1, 2010 are not necessarily indicative of the results to be expected for future quarters or the year.

Accounting period: Each of our fiscal quarters presented herein includes 13 weeks and ends on the last Saturday of the period. The first quarter of fiscal 2011 ended on May 1, 2010. The first quarter of fiscal 2010 ended on May 2, 2009.

Use of Estimates: The preparation of the condensed consolidated financial statements in conformity with US GAAP requires us to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosures of contingent liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reporting period. We base our estimates on historical experience and various other assumptions that we believe to be reasonable under the circumstances. Actual results could differ from those estimates, and such differences may be material to the condensed consolidated financial statements.

Income taxes: Income taxes are accounted for under an asset and liability approach in accordance with Accounting Standard Codification, or ASC 740, Income Taxes (formerly Statement of Financial Accounting Standard, or SFAS 109, Accounting for Income Taxes). Deferred income taxes reflect the net tax effects of any temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts reported for income tax purposes, and any operating losses and tax credit carryforwards. Deferred tax liabilities are recognized for future taxable amounts and deferred tax assets are recognized for future deductions, net of any valuation allowance, to reduce deferred tax assets to amounts that are considered more likely than not to be realized.

Under ASC 740, Income Taxes (formerly FASB Interpretation No. 48, or FIN48, Accounting for Uncertainty in Income Tax), the impact of an uncertain income tax position on the income tax return must be recognized as the largest amount that is more-likely-than-not to be sustained upon audit by the relevant taxing authority. An uncertain income tax position will not be recognized if it has less than a 50% likelihood of being sustained. Additionally, ASC 740 provides guidance on de-recognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. For the three months ended May 1, 2010, there was an increase of $0.6 million in unrecognized tax benefits.

On February 20, 2009, the California Budget Act of 2008 was signed into law which revised certain provisions of the California State Tax Code, including the option to elect an alternative method to attribute taxable income to California for tax years beginning on or after January 1, 2011. We now expect that in years 2011 and beyond, our income subject to tax in California will be lower than under prior tax law and that our California deferred tax assets are therefore less likely to be realized. As a result, we recorded a $3.6 million charge in the three months ended May 2, 2009 to reduce our previously recognized California deferred tax assets.

Recent accounting pronouncements: There have been no significant changes in accounting pronouncements as compared to the recent accounting pronouncements described in our audited consolidated financial statements included in our Annual Report on Form 10-K for the fiscal year ended January 30, 2010.

2. Cash, cash equivalents and marketable securities

Cash, cash equivalents and marketable securities consist of the following (in thousands):

| | May 1, 2010 | | | January 30, 2010 | | |
|---|---|---|---|---|---|---|
| | Book Value | Net Unrealized Gain | Fair Value | Book Value | Net Unrealized Gain | Fair Value |
| Money market funds | $ 31,013 | $ — | $ 31,013 | $ 32,911 | $ — | $ 32,911 |
| Auction rate securities | 37,650 | — | 37,650 | 40,750 | — | 40,750 |
| Corporate bonds | 27,973 | 107 | 28,080 | 17,143 | 195 | 17,338 |
| US agency discount notes | 5,500 | 6 | 5,506 | 4,500 | 5 | 4,505 |
| Municipal bonds and notes | 335 | — | 335 | 1,834 | 6 | 1,840 |
| Total cash equivalents and marketable securities | $ 102,471 | $ 113 | $ 102,584 | $ 97,138 | $ 206 | $ 97,344 |
| | | | | | | |
| Cash on hand held in the United States | | | 25,811 | | | 15,444 |
| Cash on hand held overseas | | | 25,958 | | | 33,592 |
| Total cash on hand | | | 51,769 | | | 49,036 |
| Total cash, cash equivalents and marketable securities | | | $ 154,353 | | | $ 146,380 |
| | | | | | | |
| Reported as: | | | | | | |
| Cash and cash equivalents | | | $ 82,782 | | | $ 81,947 |
| Short-term marketable securities | | | 51,926 | | | 51,176 |
| Long-term marketable securities | | | 19,645 | | | 13,257 |
| | | | $ 154,353 | | | $ 146,380 |

The amortized cost and estimated fair value of cash equivalents and marketable securities, by contractual maturity as measured on the date of purchase, are as follows (in thousands):

| | May 1, 2010 | | January 30, 2010 | |
|---|---|---|---|---|
| | Book Value | Fair Value | Book Value | Fair Value |
| Due in 1 year or less | $ 82,840 | $ 82,939 | $ 83,967 | $ 84,087 |
| Due in greater than 1 year | 19,631 | 19,645 | 13,171 | 13,257 |
| Total | $ 102,471 | $ 102,584 | $ 97,138 | $ 97,344 |

Our marketable securities include primarily auction rate securities, or ARS, corporate bonds and US agency discount notes. We classify our marketable securities as available-for-sale and report them at fair market value with the related unrealized gains and losses included in accumulated other comprehensive income. We monitor all of our marketable securities for impairment and if these securities are reported to have had a decline in fair value, use significant judgment to identify events or circumstances that would likely have a significant adverse effect on the future value of each investment including: (i) the nature of the investment; (ii) the cause and duration of any impairment; (iii) the financial condition and near term prospects of the issuer; (iv) for securities with a reported decline in fair value, our ability to hold the security for a period of time sufficient to allow for any anticipated recovery of fair value; (v) the extent to which fair value may differ from cost; and (vi) a comparison of the income generated by the securities compared to alternative investments.  We would recognize an impairment charge if a decline in the fair value of the marketable securities is judged to be other-than-temporary.

At May 1, 2010, we held nine auction rate securities with an adjusted cost and par value of $37.7 million, which is net of $3.1 million and $2.2 million of redemptions by the issuers at par value during the three months ended May 1, 2010 and the year ended January 30, 2010, respectively. Auction rate securities are bought and sold in the marketplace through a bidding process sometimes referred to as a “Dutch auction.” Historically, the fair value of our ARS has been determined by the frequent auction periods, generally every 7 to 28 days, which provided liquidity at par value for these investments. However, subsequent to February 2008, all auctions involving such securities held by us have failed. The result of a failed auction is that these ARS will continue to pay interest in accordance with their terms at each respective auction date; however, liquidity of the securities will continue to be limited until there is a successful auction, the issuer redeems the securities, the securities mature or until such time as other markets for these ARS develop. We cannot be certain regarding the amount of time it will take for an auction market or other markets to develop for these securities. In October 2008, our cash investment advisor, UBS, acknowledged our acceptance of its proposal of a comprehensive settlement agreement, in which all the ARS currently in our portfolio could be redeemed at par value. The offer to redeem will be at our option during a two year period beginning June 30, 2010. The offer also gives UBS the discretion to buy any or all of these securities from us at par value at any time. Additionally, the proposed solution by UBS to the lack of liquidity of our ARS included a commitment effective October 2008 through June 2010 to loan an amount up to 75% of the par value of the ARS. The interest charged on such loan would be equal to the proportional amount of interest being paid by the issuers of the ARS borrowed against. At May 1, 2010, UBS provided an estimated value for the nine ARS of approximately $32.9 million, which reflects an unrealized loss of $4.8 million from our original cost. We have not adopted UBS’ estimated value of our ARS for the reasons described below.

We have reviewed the prospectuses for each of the nine ARS in our investment portfolio as of May 1, 2010 and determined that the unprecedented disruption in the auction process and resulting pattern of interest payments was in accordance with their established rules of operation under these circumstances. The default mechanism called for in the operating rules of these instruments is designed to adjust their interest payments to a limit based on the income generated by their underlying student loans. The most significant consequences of this mechanism are the preservation of their AAA credit rating while adjusting to a continuing stream of interest payments to the security holders at a rate correlating to contemporary credit market rates.

As a result of this review, we reached the conclusion that the securities do have a strong underlying principle value and that any potential adjustment in their carrying value would be based upon our ability to endure their lack of liquidity, the degree of certainty of continuing interest payments and the rate of return on these securities. Given that we expect considerable liquidity from our other assets, foresee continuing positive cash flow and have accepted our investment advisor’s offer to purchase all of our ARS at par value beginning June 30, 2010, we do not consider the remaining possible liquidity risk and UBS’ default risk to be significant enough to justify a reduction in the carrying value. The remaining valuation factor that we considered was the rate of return evidenced by the interest received. We used a discounted cash flow calculation that reached a valuation that was similar to other of our recent investments with comparably high credit ratings.

As a result of this judgment process and in accordance with the various accounting pronouncements in this area, we reached the conclusion that the $37.7 million carrying value of our nine ARS has not been impaired and that we have no expectation of any material adverse impact on our future results of operations, liquidity or capital resources associated with holding these securities.

3. Fair values of assets and liabilities

ASC 820, Fair Value Measurements and Disclosures (formerly, SFAS 157, Fair Value Measurement), defines fair value as “the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price).” The standard establishes a consistent framework for measuring fair value and expands disclosure requirements about fair value measurements. ASC 820, among other things, requires us to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

Fair value hierarchy

ASC 820 discusses valuation techniques, such as the market approach (comparable market prices), the income approach (present value of future income or cash flow), and the cost approach (cost to replace the service capacity of an asset or replacement cost). The statement utilizes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The following is a brief description of those three levels:

Level 1 - Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 - Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 - Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect our estimate of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Determination of Fair Value

Our cash equivalents and marketable securities, with the exception of our ARS, are classified within Level 1 of the fair value hierarchy because they are valued using quoted market prices, broker or dealer quotations or alternative pricing sources with reasonable levels of price transparency. The types of marketable securities valued based on quoted market prices in active markets include most U.S. government and agency securities, sovereign government obligations, money market securities and certain corporate obligations with high credit ratings and an ongoing trading market.

Our ARS holdings and convertible note receivable are classified within Level 3. We have valued the ARS through a discounted cash flow model which requires making a significant assumption as to the expectation of UBS's offer to redeem all of the ARS at par value in June 2010 and future interest income from those securities which is not observable in the market. During the three months ended May 1, 2010, we recorded no impairment loss relating to the value of ARS and recorded no realized gains or losses for these ARS. In August 2009, we purchased a convertible note receivable from a privately-held venture capital funded technology company with a face value which is equal to its cost of $3.0 million, is convertible into the issuer's preferred stock under certain circumstances, bears interest at a rate of 9% per annum and became callable after November 30, 2009. At May 1, 2010, the convertible note receivable was valued at $3.2 million equaling its cost plus accrued interest, as the necessary inputs to the fair value measurements are unobservable.

Our foreign currency derivative instruments are classified as Level 2 because they are valued using quoted prices and other observable data of similar instruments in active markets.

In connection with our acquisition of CopperGate in November 2009, we agreed to pay up to an aggregate of $5.0 million in cash to specified CopperGate employees if certain milestones are achieved over a specified period. The estimated acquisition contingent consideration of our CopperGate acquisition was based on the probability that certain milestones will be met and the payments will be made on the targeted dates outlined in the acquisition agreement. In developing these estimates, we considered the revenue projections and historical results of CopperGate. This fair value measurement is based on significant inputs not observed in the market and thus represents a Level 3 measurement as defined by ASC 820. Level 3 instruments are valued based on unobservable inputs that are supported by little or no market activity and reflect our assumptions in measuring fair value.

The table below presents the balances of our assets and liabilities measured at fair value on a recurring basis as of May 1, 2010 and January 30, 2010 (in thousands):

| | As of May 1, 2010 | | | |
|---|---|---|---|---|
| | Fair Value | Quoted Prices In Active Markets for Identical Assets (Level 1 ) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Money market funds | $ 31,013 | $ 31,013 | $ — | $ — |
| Auction rate securities | 37,650 | — | — | 37,650 |
| Corporate bonds | 28,080 | 28,080 | — | — |
| US agency discount notes | 5,506 | 5,506 | — | — |
| Municipal bonds and notes | 335 | 335 | — | — |
| Total cash equivalent and marketable securities | 102,584 | 64,934 | — | 37,650 |
| Restricted cash | 1,583 | 1,583 | — | — |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Convertible note receivable | | 3,203 | | — | | — | | 3,203 |
| Derivative instruments | | 113 | | — | | 113 | | — |
| Total assets measured at fair value | $ | 107,483 | $ | 66,517 | $ | 113 | $ | 40,853 |
| | | | | | | | | |
| Accrued contingent payment for CopperGate acquisition | $ | 3,238 | | — | | — | $ | 3,238 |

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| | As of January 30, 2010 | | | |
|---|---|---|---|---|
| | Fair Value | Quoted Prices In Active Markets for Identical Assets (Level 1 ) | Significant Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Money market funds | $ 32,911 | $ 32,911 | $ — | $ — |
| Auction rate securities | 40,750 | — | — | 40,750 |
| Corporate bonds | 17,338 | 17,338 | — | — |
| US agency discount notes | 4,505 | 4,505 | — | — |
| Municipal bonds and notes | 1,840 | 1,840 | — | — |
| Total cash equivalent and marketable securities | 97,344 | 56,594 | — | 40,750 |
| Restricted cash | 1,500 | 1,500 | — | — |
| Convertible note receivable | 3,135 | — | — | 3,135 |
| Derivative instruments | 156 | — | 156 | — |
| Total assets measured at fair value | $ 102,135 | $ 58,094 | $ 156 | $ 43,885 |
| | | | | |
| Accrued contingent payment for CopperGate acquisition | $ 3,249 | — | — | $ 3,249 |

The table below presents a summary of the changes in Level 3 assets measured at fair value on a recurring basis (in thousands):

| | Fair Value Measurements Using Significant Unobservable Inputs (Level 3) |
|---|---|
| Beginning balance at January 31, 2010 | $43,885 |
| Total realized gains or losses included in net income | 68 |
| Purchases, sales and settlements, net | (3,100 ) |
| Ending balance at May 1, 2010 | $40,853 |

The following table represents a reconciliation of the change in the fair value measurement of the contingent liability for the three months ended May 1, 2010:

| | Contingent Liability |
|---|---|
| Beginning balance at January 31, 2010 | $ 3,249 |
| Payment made | (11) |
| Ending balance at May 1, 2010 | $ 3,238 |

4. Derivative financial instruments

Effective November 10, 2009, we adopted ASC 815, Derivatives and Hedging (formerly SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities). Foreign exchange contracts are recognized either as assets or liabilities on the balance sheet at fair value at the end of each reporting period.

Cash flow hedges

We have used and from time to time in the future may use foreign currency derivatives such as forward and option contracts as hedges against anticipated transactions denominated in foreign currencies. We enter into these contracts to protect ourselves against the risk that the eventual net cash flows will be adversely affected by changes in foreign exchange rates.

For derivative instruments that are designated and qualify as a cash flow hedge under ASC 815, the effective portion of the gain or loss on the derivative is reported as a component of accumulated other comprehensive income and reclassified into earnings in the same period or periods during which the hedged transaction affects earnings. Gains and losses on the derivative representing either hedge ineffectiveness or hedge components excluded from the assessment of effectiveness are recognized in current earnings.

As of May 1, 2010, we had foreign exchange contracts to sell up to approximately $6.1 million for a total amount of approximately New Israeli Shekel, or NIS, 22.8 million, that would mature on or before January 31, 2011. In the three months ended May 1, 2010, we recognized profit of $82,000 as a result of derivative instruments. As of January 30, 2010, we had foreign exchange contracts to sell up to approximately $4.5 million for a total amount of approximately NIS 17.0 million, that would mature on or before January 29, 2011. In fiscal 2010, we recognized profit of $41,000 as a result of derivative instruments.

The following table presents the fair value of our outstanding derivative instruments as of May 1, 2010 and January 30, 2010 (in thousands):

| | Balance Sheet Location | Fair Value of Financial Instruments May 1, 2010 | Fair Value of Financial Instruments January 30, 2010 |
|---|---|---|---|
| Derivative Asset | | | |
| Foreign exchange contracts designated as cash flow hedges | Prepaid expenses and other current assets | $ 113 | $ 156 |

The effects of derivative instruments designated as cash flow hedges on income and accumulated other comprehensive income for the three months ended May 1, 2010 are summarized below (in thousands):

| | Gains recognized in accumulated other comprehensive income on derivatives (Effective Portion) Amount | Gains reclassified from accumulated other comprehensive income into earnings Amount | Gains reclassified from accumulated other comprehensive income into earnings Location | Gains recognized in earnings on derivatives (Ineffective Portion) Amount | Gains recognized in earnings on derivatives (Ineffective Portion) Location |
|---|---|---|---|---|---|
| Derivatives designated as cash flow hedges: | | | | | |
| Foreign exchange contracts | $ 117 | $ 80 | Operating expenses and cost of revenue | $ 2 | Interest and other income, net |

5. Restricted cash

As of May 1, 2010, we had $1.6 million of restricted cash related to a deposit pledged to a financial institution with regard to our foreign exchange hedging transactions and an office operating lease.

## 6. Investments in privately held companies

During fiscal 2009, we purchased shares of preferred stock in two privately-held venture capital funded technology companies at a cost of $3.0 million. In the fourth quarter of fiscal 2010, we purchased additional shares of preferred stock in one of these issuers at a cost of $1.0 million. Additionally, in August 2009, we purchased a convertible note from one of these issuers with a face value which is equal to its cost of $3.0 million, is convertible into the issuer's preferred stock under certain circumstances and bears interest at a rate of 9% per annum, and became callable after November 30, 2009. At May 1, 2010 and January 30, 2010, the convertible note was valued at $3.2 million and $3.1 million, respectively, equaling its cost plus accrued interest and the equity investments were valued at their cost totaling $4.0 million. This convertible note receivable is recorded in prepaid expenses and other current assets. The preferred stock is recorded in long-term investments. Three of our four directors hold equity interests in the issuer of the convertible note receivable and one of these directors is also a director of the issuer. In the aggregate, these equity and debt interests do not rise to the level of a material or a controlling interest in the issuer. Our board of directors appointed our director who has no interest in the issuer to evaluate each investment in this issuer and recommend appropriate action to the board of directors. All investment transactions with this issuer were approved and recommended by this independent director and made as the result of a negotiation process.

7. Inventories

Inventories consist of the following (in thousands):

| | May 1, 2010 | January 30, 2010 |
|---|---|---|
| Wafers and other purchased materials | $ 5,869 | $ 8,045 |
| Work-in-process | 3,806 | 2,720 |
| Finished goods | 8,215 | 7,422 |
| Total | $ 17,890 | $ 18,187 |

8. Intangible assets

Acquired intangible assets, subject to amortization, were as follows as of May 1, 2010 and January 30, 2010 (in thousands, except for years):

| | As of May 1, 2010 | | | |
|---|---|---|---|---|
| | Gross Value | Accumulated Amortization | Net Value | Weighted average remaining amortization period (years) |
| Developed technology | $ 72,510 | $ 11,002 | $ 61,508 | 6.5 |
| Trademarks | 2,677 | 583 | 2,094 | 5.3 |
| Noncompete agreements | 1,400 | 1,400 | — | — |
| Customer relationships | 50,423 | 3,743 | 46,680 | 6.7 |
| | 127,010 | 16,728 | 110,282 | 6.6 |
| In-process research and development | 10,700 | — | 10,700 | |
| | $ 137,710 | $ 16,728 | $ 120,982 | |

| | As of January 30, 2010 | | | |
|---|---|---|---|---|
| | Gross Value | Accumulated Amortization | Net Value | Weighted average remaining amortization period (years) |
| Developed technology | $ 72,510 | $ 8,411 | $ 64,099 | 6.7 |
| Trademarks | 2,677 | 389 | 2,288 | 5.3 |
| Noncompete agreements | 1,400 | 1,400 | — | — |
| Customer relationships | 50,423 | 1,942 | 48,481 | 7.0 |
| | 127,010 | 12,142 | 114,868 | 6.8 |
| In-process research and development | 10,700 | — | 10,700 | |
| | $ 137,710 | $ 12,142 | $ 125,568 | |

We acquired in-process research and development, or IPR&D valued at $10.7 million in connection with our acquisition of CopperGate in November 2009. The fair value of the IPR&D was determined through estimates and valuation techniques based on the terms and details of the acquisition. The amounts allocated to IPR&D will not begin to be expensed until completion of the related project, as it was determined that the underlying project had not reached technological feasibility at the date of acquisition. The IPR&D project represents our next generation HomePNA product which is expected to provide backward compatibility to our current HomePNA and HomePlug AV products and increased data rates, ease of use and quality of service. Upon completion of development, the acquired IPR&D will be amortized over its useful life.

Amortization expense related to acquired intangible assets was $4.6 million and $0.8 million for the three months ended May 1, 2010 and May 2, 2009, respectively. As of May 1, 2010, we expect the amortization expense in future periods to be as follows (in thousands):

| Fiscal year | Developed Technology | Customer Relationships | Trademarks | Total |
|---|---|---|---|---|
| Remainder of 2011 | $ 7,759 | $ 5,402 | $ 584 | $ 13,745 |
| 2012 | 10,346 | 7,203 | 639 | 18,188 |
| 2013 | 10,346 | 7,203 | 178 | 17,727 |
| 2014 | 9,621 | 7,203 | 119 | 16,943 |
| 2015 | 8,257 | 7,203 | 118 | 15,578 |
| Thereafter | 15,179 | 12,466 | 456 | 28,101 |
| | $ 61,508 | $ 46,680 | $ 2,094 | $ 110,282 |

9. Product warranty

In general, we sell our products with a one-year limited warranty that our products will be free from defects in materials and workmanship. Warranty cost is estimated at the time revenue is recognized, based on historical activity and additionally for any specific known product warranty issues. Accrued warranty cost includes hardware repair and/or replacement and software support costs and is included in accrued liabilities on the condensed consolidated balance sheets.

Details of the change in accrued warranty as of May 1, 2010 and May 2, 2009 are as follows (in thousands):

| Three Months Ended | Balance Beginning of Period | Additions | Deductions | Balance End of Period |
|---|---|---|---|---|
| May 1, 2010 | $ 1,100 | $ 199 | $ (149) | $ 1,150 |
| May 2, 2009 | 1,330 | 150 | (180) | 1,300 |

10. Commitments and contingencies

Commitments

Leases

Our primary facility in Milpitas, California is leased under a non-cancelable lease which expires in September 2012. We also lease facilities in Canada, Denmark, France, Hong Kong, Israel, Japan, Singapore and Taiwan, and vehicles in Israel under non-cancelable leases. Future minimum annual payments under operating leases are as follows (in thousands):

| Fiscal years | Operating Leases |
|---|---|
| Remainder of 2011 | $ 2,334 |
| 2012 | 2,348 |
| 2013 | 1,661 |
| 2014 | 742 |
| 2015 | 747 |
| Thereafter | 2,108 |

| | | |
|---|---|---|
| Total minimum lease payments | $ | 9,940 |

Purchase commitments

We place non-cancelable orders to purchase semiconductor products from our suppliers on an eight to twelve week lead-time basis. As of May 1, 2010, the total amount of outstanding non-cancelable purchase orders was approximately $40.2 million.

Indemnifications

Our standard terms and conditions of sale include a patent infringement indemnification provision for claims from third parties related to our intellectual property. The terms and conditions of sale generally limit the scope of the available remedies to a variety of industry-standard methods including, but not limited to, a right to control the defense or settlement of any claim, procure the right for continued usage, and a right to replace or modify the infringing products to make them non-infringing. Such indemnification provisions are accounted for in accordance with ASC 450, Contingencies (formerly SFAS No. 5, Accounting for Contingencies). To date, we have not incurred or accrued any costs related to any claims under such indemnification provisions.

Royalties

We pay royalties for the right to sell certain products under various license agreements. During the three months ended May 1, 2010 and May 2, 2009, we recorded royalty expense of $0.8 million and $0.6 million, respectively, which was recorded to cost of revenue.

We participated in programs sponsored by the Office of the Chief Scientist of Israel's Ministry of Industry, Trade and Labor, or the OCS, for the support of research and development activities that we conduct in Israel. Through May 1, 2010, we had obtained grants from the OCS aggregating to $4.8 million for certain of our research and development projects that we conduct in Israel. We are obligated to pay royalties to the OCS, amounting to 3.5% to 4.5% of the sales of certain products up to an amount equal to 120% of the grants received. As of May 1, 2010, we have a contingent payments obligation of $0.3 million under these programs.

Contingencies

Litigation

We are not currently a party to any material legal proceedings. From time to time, we are involved in claims and legal proceedings that arise in the ordinary course of business. We expect that the number and significance of these matters will increase as our business expands. In particular, we could face an increasing number of patent and other intellectual property claims as the number of products and competitors in our industry grows. Any claims or proceedings against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of management time, result in the diversion of significant operational resources, or cause us to enter into royalty or licensing agreements which, if required, may not be available on terms favorable to us or at all. If an unfavorable outcome were to occur against us, there exists the possibility of a material adverse impact on our financial position and results of operations for the period in which the unfavorable outcome occurs and, potentially, in future periods.

11. Comprehensive income

Components of our comprehensive income for the three months ended May 1, 2010 and May 2, 2009 are as follows (in thousands):

| | Three Months Ended | |
|---|---|---|
| | May 1, 2010 | May 2, 2009 |
| Net income | $ 1,114 | $ 2,743 |
| Unrealized gains (loss) on marketable securities | (67) | 23 |
| Currency translation adjustment | (342) | (209) |
| Comprehensive income | $ 705 | $ 2,557 |

12. Net income per share

Basic net income per share for the periods presented is computed by dividing net income by the weighted average number of common shares outstanding. Diluted net income per share is computed by including shares subject to repurchase as well as dilutive options.

The following table sets forth the basic and diluted net income per share computed for the three months ended May 1, 2010 and May 2, 2009 (in thousands, except per share amounts):

| | Three Months Ended | |
|---|---|---|
| | May 1, 2010 | May 2, 2009 |
| Numerator: | | |
| Net income, as reported | $ 1,114 | $ 2,743 |
| Denominator: | | |
| Weighted average common shares outstanding - basic | 30,995 | 26,592 |
| Effect of dilutive securities: | | |
| Stock options | 591 | 604 |
| Shares used in computation - diluted | 31,586 | 27,196 |
| Net income per share: | | |
| Basic | $ 0.04 | $ 0.10 |
| Diluted | $ 0.04 | $ 0.10 |

A summary of the excluded potentially dilutive securities for the three months ended May 1, 2010 and May 2, 2009 is as follows (in thousands):

| | Three Months Ended | |
|---|---|---|
| | May 1, 2010 | May 2, 2009 |
| Stock options excluded because exercise price is in excess of average stock price | 4,682 | 3,020 |

13. Equity incentive plans and employee benefits

Stock option plans

We have adopted equity incentive plans that provide for the grant of stock option awards to employees, directors and consultants which are designed to encourage and reward their long-term contributions to us and provide an incentive for them to remain with us. These plans also align our employees' interest with the creation of long-term shareholder value. As of May 1, 2010, we have three stock option plans: the 2003 Director Stock Option Plan (the "2003 Director Plan"), the 2001 Stock Plan (the "2001 Plan") and the 2009 Stock Incentive Plan (the "2009 Incentive Plan"). The 2009 Incentive Plan was approved by our shareholders in July 2009 along with the approval of a one-time stock option exchange program.

Our 2009 Incentive Plan provides for the grant of stock options, restricted stock, restricted stock units, other stock-related awards and performance awards that may be settled in cash, stock or other property. In July 2009, 2,900,000 shares of common stock were reserved for issuance under the 2009 Incentive Plan. In addition, up to 1,000,000 shares of common stock subject to stock awards outstanding under the 2001 Plan but terminated prior to exercise and would otherwise be returned to the share reserves under our 2001 Plan will become available for issuance under the 2009 Incentive Plan.

As of May 1, 2010, 1,795,137 shares were available for future grants under the 2009 Incentive Plan. As of September 23, 2009, the 2001 Plan and the 2003 Director Plan were closed for future grants, however, these plans will continue to govern all outstanding options that we originally granted from each plan.

The total stock option activities and balances of our stock option plans are summarized as follows:

| | Number of Shares Outstanding | | Weighted Average Exercise Price Per Share | Weighted Average Remaining Contractual Term (Years) | | Aggregate Intrinsic Value (in thousands) |
|---|---|---|---|---|---|---|
| Balance, January 30, 2010 | 5,745,795 | $ | 11.96 | 7.35 | $ | 9,100,620 |
| Granted | 783,700 | | 11.13 | | | |
| Cancelled | (54,658) | | 15.07 | | | |
| Exercised | (233,665) | | 4.73 | | | |
| | | | | | | |
| Balance, May 1, 2010 | 6,241,172 | $ | 12.10 | 7.48 | $ | 10,944,344 |
| | | | | | | |
| Ending Vested and Expected to Vest | 5,899,532 | $ | 12.12 | 7.40 | $ | 10,575,281 |
| Ending Exercisable | 2,334,255 | $ | 12.19 | 5.65 | $ | 6,365,732 |

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on our closing stock price of $11.86 as of May 1, 2010, which would have been received by the option holders had all options holders exercised their options as of that date. The aggregate exercise date intrinsic value of options that were exercised under our stock option plans was $1.7 million and $0.2 million for the three months ended May 1, 2010 and May 2, 2009, respectively, determined as of the date of option exercise. The total fair value of options which vested during the three months ended May 1, 2010 and May 2, 2009 was $2.1 million and $2.4 million, respectively.

The options outstanding and currently exercisable at May 1, 2010 were in the following exercise price ranges:

| Range of Exercise Prices Per Share | | | | Options Outstanding | | | | Options Exercisable | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Number of Shares Outstanding at May 1, 2010 | Weighted Average Remaining Life (Years) | | Weighted Average Exercise Price Per Share | Number of Shares Exercisable at May 1, 2010 | | Weighted Average Exercise Price Per Share |
| $ | 0.92 | $ | 5.79 | 630,289 | 4.25 | $ | 2.54 | 455,435 | $ | 2.70 |
| $ | 6.31 | $ | 9.89 | 618,672 | 5.89 | $ | 8.48 | 391,932 | $ | 8.06 |
| $ | 10.59 | $ | 10.59 | 674,000 | 9.71 | $ | 10.59 | - | $ | - |
| $ | 10.87 | $ | 10.87 | 782,116 | 8.49 | $ | 10.87 | 223,139 | $ | 10.87 |
| $ | 11.06 | $ | 11.06 | 531,232 | 6.32 | $ | 11.06 | 378,409 | $ | 11.06 |
| $ | 11.07 | $ | 11.07 | 733,200 | 9.37 | $ | 11.07 | - | $ | - |
| $ | 11.09 | $ | 12.02 | 645,396 | 6.94 | $ | 11.34 | 374,893 | $ | 11.38 |
| $ | 12.08 | $ | 15.25 | 877,831 | 7.81 | $ | 13.88 | 101,932 | $ | 12.78 |
| $ | 15.32 | $ | 41.58 | 692,736 | 7.50 | $ | 24.48 | 380,201 | $ | 27.83 |
| $ | 45.83 | $ | 45.83 | 55,700 | 7.16 | $ | 45.83 | 28,314 | $ | 45.83 |
| $ | 0.92 | $ | 45.83 | 6,241,172 | 7.48 | $ | 12.10 | 2,334,255 | $ | 12.19 |

As of May 1, 2010, the unrecorded share-based compensation balance related to stock options outstanding excluding estimated forfeitures was $38.5 million and will be recognized over an estimated weighted average amortization period of 3.77 years. The amortization period is based on the expected remaining vesting term of the options.

Employee stock purchase plan

Under our 2001 Employee Stock Purchase Plan (the "2001 Purchase Plan"), employees are granted the right to purchase shares of common stock at a price per share that is 85% of the fair market value at the beginning or end of each six-month offering period, whichever is lower. As of May 1, 2010, 392,823 shares under the 2001 Purchase Plan remain available for future purchase.

Valuation of share-based compensation

The fair value of share-based compensation awards is estimated at the grant date using the Black-Scholes option valuation model. The determination of fair value of share-based compensation awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, our expected stock price volatility over the term of the awards and actual employee stock option exercise behavior.

The weighted-average estimated values of employee stock options granted during the three month ended May 1, 2010 and May 2, 2009 was $5.96 and $6.71, per share, respectively. The weighted-average estimated fair value of employee stock purchase plan shares issued during three month ended May 1, 2010 and May 2, 2009 was $3.91 and $3.93, per share, respectively. The fair value of each option and employee stock purchase right was estimated on the date of grant using the Black-Scholes option pricing model with the following weighted-average assumptions:

| | Three Months Ended | | | |
|---|---|---|---|---|
| | May 1, 2010 | | May 2, 2009 | |
| | Stock Option Plan | Employee Stock Purchase Plan | Stock Option Plan | Employee Stock Purchase Plan |
| Expected volatility | 55.07% | 52.92% | 65.81% | 86.68% |
| Risk-free interest rate | 2.75% | 0.23% | 2.34% | 0.36% |
| Expected term (in years) | 5.94 | 0.50 | 5.91 | 0.50 |
| Dividend yield | None | None | None | None |

The computation of the expected volatility assumptions used in the Black-Scholes calculations for new grants and purchase rights is based on the historical volatility of our stock price, measured over a period equal to the expected term of the grants or purchase rights. The risk-free interest rate is based on the yield available on U.S. Treasury STRIPS with an equivalent remaining term. The expected term life of employee stock options represents the weighted-average period that the stock options are expected to remain outstanding and was determined based on historical experience of similar awards, giving consideration to the contractual terms of the share-based awards and vesting schedules. The expected term of purchase rights is the period of time remaining in the then current offering period. The dividend yield assumption is based on our history of not paying dividends and assumption of not paying dividends in the future.

The following table sets forth the share-based compensation expense for the three months ended May 1, 2010 and May 2, 2009 (in thousands):

| | Three Months Ended | |
|---|---|---|
| | May 1, 2010 | May 2, 2009 |
| Cost of revenue | $ 131 | $ 85 |
| Research and development expenses | 1,700 | 1,258 |
| Sales and marketing expenses | 452 | 299 |
| General and administrative expenses | 841 | (484) |
| Total share-based compensation | $ 3,124 | $ 1,158 |

401(k) tax deferred savings plan

We maintain a 401(k) tax deferred savings plan for the benefit of qualified employees who are U.S. based. Under the 401(k) tax deferred savings plan, U.S. based employees may elect to reduce their current annual taxable compensation up to the statutorily prescribed limit, which is $16,500 in calendar year 2010. Employees age 50 or over may elect to contribute an additional $5,500. We have a matching contribution program whereby we match employee contributions made by each employee at a rate of $0.25 per $1.00 contributed. The matching contributions to the 401(k) tax deferred savings plan totaled $0.2 million and $0.2 million for the three months ended May 1, 2010 and May 2, 2009, respectively.

Group registered retirement savings plan

We maintain a Group Registered Retirement Savings Plan, or GRRSP, for the benefit of qualified employees who are based in Canada. Under the GRRSP, Canadian based employees may elect to reduce their annual taxable compensation up to the statutorily prescribed limit which is $22,000 Canadian in calendar year 2010. We have a matching contribution program under the GRRSP whereby we match employee contributions made by each employee up to 2.5% of their annual salary. The matching contributions to the GRRSP totaled $24,000 and $21,000 for the three months ended May 1, 2010 and May 2, 2009, respectively.

Retirement pension plan

We maintain a Retirement Pension Plan for the benefit of qualified employees who are based in Denmark. Under the Retirement Pension Plan, Denmark-based employees may elect to reduce their annual taxable compensation up to their annual salary. We have a matching contribution program whereby we will contribute 3.0% of our employee's annual salary and may elect to terminate future contributions at our option at any time. The matching contribution to the Retirement Pension Plan totaled $30,000 and $21,000 for the three months ended May 1, 2010 and May 2, 2009, respectively.

Severance plan

We maintain a severance plan for Israeli employees pursuant to Israel's Severance Pay Law based on the most recent salary of the employees multiplied by the number of years of employment. Employees are entitled to one month salary for each year of employment or a portion thereof. As of May 1, 2010, we have an accrued severance liability of $1.4 million.

## 14. Segment and geographical information

ASC 280, Segment Reporting (formerly SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information), provides annual and interim reporting standards for an enterprise's business segments and related disclosures about its products, services, geographical areas and major customers.

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision-maker in deciding how to allocate resources and in assessing performance. We are organized as, and operate in, one reportable segment. Our operating segment consists of our geographically based entities in the United States, Hong Kong, Israel and Singapore. Our chief operating decision-maker reviews consolidated financial information, accompanied by information about revenue by product group, target market and geographic region. We do not assess the performance of our geographic regions on other measures of income or expense, such as depreciation and amortization or net income.

Prior to the first quarter of fiscal 2011, we reported our net revenue by geographic region based on billing location. We believe reporting based on ship-to location provides more relevant information about our customer base. Our net revenue by geographic region for the comparative period has been reclassified based on the ship-to location of our customers. The following table sets forth net revenue for each geographic region based on the ship-to location of customers (in thousands):

| | Three Months Ended | |
|---|---|---|
| | May 1, 2010 | May 2, 2009 |
| Asia | $ 60,903 | $ 42,834 |
| Europe | 1,857 | 6,659 |
| North America | 2,370 | 1,744 |
| Other regions | 49 | 6 |
| Net revenue | $ 65,179 | $ 51,243 |

The following table sets forth net revenue to each significant country based on the ship-to location of customers (in thousands):

| | Three Months Ended | |
|---|---|---|
| | May 1, 2010 | May 2, 2009 |
| China | $ 52,971 | $ 39,388 |
| Rest of the world | 12,208 | 11,855 |
| | $ 65,179 | $ 51,243 |

The following table sets forth the major customers that accounted for 10% or more of our net revenue:

| | Three Months Ended | |
|---|---|---|
| Customer | May 1, 2010 | May 2, 2009 |
| Motorola | 25% | 19% |
| Gemtek | 19% | * |
| Cowin Worldwide Corporation | * | 18% |

* Net revenue from customer was less than 10% of our total net revenue in these periods.

Four international customers accounted for 24%, 19%, 12% and 11% each of total accounts receivable at May 1, 2010. Three international customers accounted for 24%, 24% and 11%, of total accounts receivable at January 30, 2010.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

You should read the following discussion in conjunction with our unaudited condensed consolidated financial statements and related notes in this Form 10-Q and our Form 10-K previously filed with the Securities and Exchange Commission. Except for historical information, the following discussion contains forward-looking statements within the meaning of Section 27A of the Securities Exchange Act of 1933 and Section 21E of the Securities Exchange Act of 1934. In some cases, you can identify forward-looking statements by terms such as "may," "expect," "might," "will," "intend," "should," "could," and "estimate," or the negative of these terms, and similar expressions intended to identify forward-looking statements. These forward-looking statements, include, among other things, statements regarding our capital resources and needs, including the adequacy of our current cash reserves, revenue, our expectations that our operating expenses will increase in absolute dollars as our revenue grows and our expectations that our gross margin will vary from period to period. These forward-looking statements involve risks and uncertainties. Our actual results may differ significantly from those projected in the forward-looking statements. Factors that might cause future results to differ materially from those discussed in the forward-looking statements include, but are not limited to, those discussed under Part II, Item 1A "Risk Factors" in this Form 10-Q as well as other information found in the documents we file from time to time with the Securities and Exchange Commission. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this Form 10-Q. Unless required by U.S. federal securities laws, we do not intend to update any of these forward-looking statements to reflect circumstances or events that occur after the statement is made.

Overview

We are a leading fabless provider of highly integrated SoC solutions that are used to deliver multimedia entertainment throughout the home. We currently offer four separate product lines: media processors, home networking solutions, video image processors and home automation solutions. Each of these product lines contributes to our fully integrated SoC offerings. We sell our products into four primary markets, which are the internet protocol television, or IPTV market, the connected home technologies market, the connected media player market and the prosumer and industrial audio/video market. We also sell our products, to a lesser extent, into several other markets, such as the high definition television, or HDTV and PC-based add-in markets, which we refer to collectively as our other market.

Our primary target markets are IPTV, connected home technologies, connected media player, and prosumer and industrial audio/video. The IPTV set-top box market consists of consumer and commercial products that distribute and receive streaming video using IP. The connected home technologies market is served by our home networking and home automation product lines. Our home networking products are used in IPTV set-top boxes as well as residential gateways, optical network terminals, multi-dwelling unit masters and network adapters. Our home automation products are used in a wide variety of home control products such as thermostats, light switches and door locks. Our Ultra-wideband, or UWB, products target high definition audio/video, or HDAV, speaker and home networking solutions over coax and wireless. The connected media player market consists primarily of digital media adapters, portable media devices and Blu-ray DVD players that perform playback of digital media stored in optical or hard disk formats. The prosumer and industrial audio/video market consists of studio quality audio/video receivers and monitors, digital projectors and medical video monitors. We also sell products into other markets such as the HDTV, PC-based add-in and connectivity markets. We derive minor net revenue from sales of our products into these other markets.

We target the connected home technologies market with our CopperGate, Z-Wave and UWB products. To date, we have not generated significant revenue from our UWB products.

We believe we are the leading provider of digital media processor SoCs as well as home network chipsets for set-top boxes in the IPTV market in terms of units shipped. Our products are used by leading IPTV set-top box providers, such as Cisco Systems/Scientific-Atlanta, Motorola, Netgem and UTStarcom. IPTV set-top boxes incorporating our chipsets are deployed by telecommunications carriers globally including carriers in Asia, Europe and North America such as AT&T, Deutsche Telekom and Freebox. We work with these carriers and set-top box providers as well as with systems software providers, such as Microsoft, to design solutions that address the carriers' specific requirements regarding features and performance.

Our media processor SoCs are also used by consumer electronics providers, such as Netgear, Sharp, Sony and Western Digital in applications such as digital media adaptors, or DMAs, Blu-ray DVD players, HDTVs and other connected media player devices. Our CopperGate products are used by leading IPTV set-top box and residential gateway providers, such as 2Wire, Cisco Systems/Scientific-Atlanta and Motorola. These solutions are deployed by telecommunications carriers globally, but primarily in North America, such as AT&T, Telus and Bell Aliant. Our VXP video image processor products are one of the leading solutions for studio-quality video image processing and are used by leading industry participants such as Polycom, Sony, Harris and Panasonic. Our Z-Wave home automation products are used by leading industry participants such as Danfoss, Ingersoll-Rand (Schlage and Trane) and Leviton.

For each of the three months ended May 1, 2010 and May 2, 2009, we derived 99% of our net revenue from our SoC solutions. Our SoC solutions consist of highly integrated semiconductors and software that process digital video and audio content.

We do not enter into long-term commitment contracts with our customers and receive substantially all of our net revenue based on purchase orders. We forecast demand for our products based not only on our assessment of the requirements of our direct customers, but also on the anticipated requirements of the telecommunications carriers that our customers serve. We work with both our direct customers and these carriers to address the market demands and the necessary specifications for our technologies. However, our failure to accurately forecast demand can lead to product shortages that can impede production by our customers and harm our relationship with these customers or lead to excess inventory, which could negatively impact our gross margins in a particular period.

Many of our target markets are characterized by intense price competition. In addition, the semiconductor industry is highly competitive and, as a result, we expect our average selling prices to decline over time. However, on occasion, we have reduced our prices for individual customer volume orders as part of our strategy to obtain a competitive position in our target markets. The willingness of customers to design our SoCs into their products depends to a significant extent upon our ability to sell our products at competitive prices. If we are unable to reduce our costs sufficiently to offset any declines in product selling prices or are unable to introduce more advanced products with higher margins in a timely manner, we could see declines in our market share or gross margins. We expect our gross margins will vary from period to period due to changes in our average selling prices, volume order discounts, mix of product sales, our costs, the extent of development fees and provisions for inventory obsolescence.

Critical Accounting Policies and Estimates

Management's discussion and analysis of financial condition and results of operations are based on our unaudited condensed consolidated financial statements which have been prepared in accordance with United States generally accepted accounting principles. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts and disclosures of the assets and liabilities at the date of the unaudited condensed consolidated financial statements and also revenue and expenses during the period reported. By their nature, these estimates and judgments are subject to an inherent degree of uncertainty. Management bases its estimates and judgments on historical experience, market trends and other factors that are believed to be reasonable under the circumstances. These estimates form the basis for judgments about the carrying value of assets and liabilities that are not readily apparent from other sources. Actual results may differ from what we anticipate and different assumptions or estimates about the future could change our reported results. Management believes the critical accounting policies as disclosed in our Annual Report on Form 10-K for the year ended January 30, 2010 reflect the more significant judgments and estimates used in preparation of our annual and interim financial statements.

Results of Operations

The following table is derived from our unaudited condensed consolidated financial statements and sets forth our historical operating results as a percentage of net revenue for each of the periods indicated (in thousands, except percentages):

| | Three Months Ended | | | |
|---|---|---|---|---|
| | May 1, 2010 | % of Net Revenue | May 2, 2009 | % of Net Revenue |
| Net revenue | $ 65,179 | 100% | $ 51,243 | 100% |
| Cost of revenue | 33,028 | 51% | 26,856 | 52% |
| Gross profit | 32,151 | 49% | 24,387 | 48% |
| Operating expenses: | | | | |
| Research and development | 18,758 | 29% | 11,517 | 22% |

| | | | | |
|---|---|---|---|---|
| Sales and marketing | 7,322 | 11% | 3,211 | 6% |
| General and administrative | 4,935 | 8% | 3,131 | 6% |
| Total operating expenses | 31,015 | 48% | 17,859 | 34% |
| Income from operations | 1,136 | 1% | 6,528 | 14% |
| Interest and other income, net | 724 | 1% | 778 | 2% |
| Income before income taxes | 1,860 | 2% | 7,306 | 16% |
| Provision for income taxes | 746 | 1% | 4,563 | 9% |
| Net income | $ 1,114 | 1% | $ 2,743 | 7% |

Net revenue

Our net revenue for the three months ended May 1, 2010 increased $13.9 million, or 27%, compared to the corresponding period in the prior fiscal year. The increase was due primarily to a 104% increase in units shipped partially offset by a 38% decrease in average selling price, or ASP. Both the decline in ASP and the increase in units shipped were primarily the result of shipments of our CopperGate products which we added to our product line in the fourth quarter of fiscal 2010 and which have lower ASPs than our media processor and VXP products.

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Net revenue by target market

We sell our products into four primary target markets, which are the IPTV market, the connected home technologies market, the connected media player market and the prosumer and industrial audio/video market. We also sell our products, to a lesser extent, into several other markets, such as the HDTV and PC-based add-in markets, which we refer to collectively as our other market. Net revenue from sales into the connected home technologies market has increased in absolute dollars and as a percentage of total net revenue as we began to sell new products acquired in connection with the acquisition of CopperGate in the fourth quarter of fiscal 2010 into this target market. The following table sets forth our net revenue by target market and the percentage of net revenue represented by our product sales to each target market (in thousands, except percentages):

| | Three Months Ended | | | |
|---|---|---|---|---|
| | May 1, 2010 | % of Net Revenue | May 2, 2009 | % of Net Revenue |
| IPTV | $ 31,052 | 48% | $ 34,416 | 67% |
| Connected home technologies | 20,977 | 32% | 672 | 1% |
| Connected media players | 9,903 | 15% | 14,039 | 28% |
| Prosumer and industrial audio/video | 3,163 | 5% | 1,537 | 3% |
| Other | 84 | * | 579 | 1% |
| Net revenue | $ 65,179 | 100% | $ 51,243 | 100% |

* This market provided less than 1% of our net revenue in this period.

IPTV: For the three months ended May 1, 2010, net revenue from sales of our SoC solutions, primarily our SMP8630 SoC series, into the IPTV market decreased $3.4 million, or 10%, from the corresponding period in the prior fiscal year. This decline was attributable to a decline in both units shipped and ASPs as a result of reduced demand in the IPTV market that we have experienced since the beginning of the second half of fiscal 2009 due to general economic downturn and the impact of declining ASPs which was caused by certain customers achieving cumulative volume pricing discounts on purchases of our products. Our revenue from the IPTV market as a percentage of our total net revenue for the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year decreased by 19% primarily as a result of the increase in net revenue from our connected home technologies market. We expect our revenue from the IPTV market to fluctuate in future periods as this revenue is based on IPTV service deployments by telecommunication service providers, changes in inventory levels at the contract manufacturers that supply them and competitive market pressures.

Connected home technologies: Prior to the second quarter of fiscal 2010, we referred to our connected home technologies target market as our wireless target market. We believe the connected home technologies market that we currently address with our CopperGate, Z-Wave and UWB product lines more accurately describes our target market. For the three months ended May 1, 2010, net revenue from sales of our products into the connected home technologies market increased $20.3 million from the corresponding period in the prior fiscal year. This increase was primarily the result of our acquisition of CopperGate in November 2009. For the same reason, our percentage of net revenue from sales into the connected home technologies market increased to 32% as a percentage of our total net revenue. We expect revenue from our connected home technologies market to fluctuate in future periods based on changes in inventory levels at contract manufacturers who manufacture equipment incorporating our products for deployment by telecommunication providers.

Connected media players: For the three months ended May 1, 2010, net revenue from sales of our products to the connected media players market decreased $4.1 million, or 29%, from the corresponding period in the prior fiscal year. The decrease was primarily attributable to a decline in units shipped and ASP for sales of our SoCs to customers who incorporate our SoCs into digital media adapters due to the timing of our customers' product launches and our customers' achievement of cumulative volume pricing discounts on purchases of our products. Our revenue from the connected media players market as a percentage of our total net revenue for the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year decreased by 13% primarily as a result of the increase in net revenue from our connected home technologies market.

Prosumer and industrial audio/video: For the three months ended May 1, 2010, net revenue from sales of our products into the prosumer and industrial audio/video market increased $1.6 million, or 106%, from the corresponding period in the prior fiscal year. The increase was attributable to an increase in units shipped and ASP for our products primarily due to strengthening demand from our existing customers and our continued effort to expand into this market. Our revenue from sales into the prosumer and industrial audio/video market as a percentage of total net revenue increased by 2% for the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year.

Other: Our other markets consist of HDTV, PC add-in boards, development kits, development contracts, services and other ancillary markets. For the three months ended May 1, 2010, net revenue decreased $0.5 million, or 85%, compared to the corresponding period in the prior fiscal year. The decrease was primarily due to lower engineering development fees for customization of our SoCs and a decline in sales of our SoCs to customers who incorporate our products into HDTVs.

Net revenue by product group

Our primary product group consists of our SoC solutions. To a lesser extent, we derive net revenue from other products and services. The following table sets forth net revenue in each of our product groups and the percentage of net revenue represented by each product group (in thousands, except percentages):

| | Three Months Ended | | | |
|---|---|---|---|---|
| | May 1, 2010 | % of Net Revenue | May 2, 2009 | % of Net Revenue |
| SoCs | $ 64,768 | 99% | $ 50,802 | 99% |
| Other | 411 | 1% | 441 | 1% |
| Net revenue | $ 65,179 | 100% | $ 51,243 | 100% |

SoCs: Our SoCs are targeted toward manufacturers and large volume designer and manufacturer customers building products for the IPTV, connected home technologies, connected media player and prosumer and industrial audio/video consumer electronic markets. The increase of $14.0 million, or 27%, in the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year was due primarily to a 104% increase in units shipped partially offset by a 38% decrease in ASP. Both the decline in ASP and the increase in units shipped were primarily the result of shipment of our CopperGate products which we added to our product line in the fourth quarter of fiscal 2010 and which have a lower ASP than our media processor and VXP products.

Other: We derive revenue from other products and services, including engineering support services for hardware and software, engineering development for customization of SoCs and other accessories. The decrease in our net revenue from other products of $30,000, or 7%, for the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year was primarily due to a reduction in nonrecurring engineering fees.

Net revenue by geographic region

Prior to the first quarter of fiscal 2011, we reported our net revenue by geographic region based on billing location. We believe reporting based on ship-to location provides more relevant information about our customer base. Our net revenue by geographic region for the comparative period has been reclassified based on the ship-to location of our customers. The following table sets forth our net revenue by geographic region and the percentage of total net revenue represented by each geographic region based on the ship-to location of each customer (in thousands, except percentages):

| | Three Months Ended | | | |
|---|---|---|---|---|
| | May 1, 2010 | % of Net Revenue | May 2, 2009 | % of Net Revenue |
| Asia | $ 60,903 | 93% | $ 42,834 | 84% |
| Europe | 1,857 | 3% | 6,659 | 13% |
| North America | 2,370 | 4% | 1,744 | 3% |
| Other regions | 49 | * | 6 | * |
| Net revenue | $ 65,179 | 100% | $ 51,243 | 100% |

* The percentage of net revenue is less than one percent.

Asia: Our net revenue in absolute dollars from Asia increased $18.1 million, or 42%, for the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year. Our net revenue from Asia increased 9% as a percentage of our total net revenue for the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year. The increase in net revenue from Asia in both absolute dollars and as a percentage of our total net revenue was primarily attributable to an increase in revenue from China which is primarily due to more shipments of our connected home technologies products to China as a result of our CopperGate acquisition in November 2009 and certain customers moving their production from Europe to Asia.

As a percentage of total net revenue by country in the Asia region, China represented 81% and 77% in the three months ended May 1, 2010 and May 2, 2009, respectively.

Europe: Our net revenue in absolute dollars from Europe decreased $4.8 million, or 72%, for the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year. Our net revenue from Europe decreased 10% as a percentage of our total net revenue for the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year. The decrease in our net revenue from Europe in both absolute dollars and as a percentage of our total net revenue was primarily attributable to certain European customers moving their production to Asia.

No individual country in Europe accounted for 10% or more of our net revenue in the three months ended May 1, 2010 and May 2, 2009.

North America: Our net revenue in absolute dollars from North America increased $0.6 million, or 36% for the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year. Our net revenue from North America increased 1% as a percentage of our net revenue for the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year. The increase in our net revenue from North America in both absolute dollars and as a percentage of our net revenue was primarily attributable to increased demand for our SoC solutions for the prosumer and industrial audio/video markets.

For the three months ended May 1, 2010, our net revenue generated outside North America was 96% of our net revenue compared to 97% in the corresponding period in the prior fiscal year.

Major Customers

The following table sets forth the major customers that accounted for 10% or more of our net revenue:

| | Three Months Ended | |
|---|---|---|
| Customer | May 1, 2010 | May 2, 2009 |
| Motorola | 25% | 19% |
| Gemtek | 19% | * |
| Cowin Worldwide Corporation | * | 18% |

* Net revenue from customer was less than 10% of our total net revenue.

Gross Profit and Gross Margin

The following table sets forth our gross profit and gross margin (in thousands, except percentages):

| | Three Months Ended | | |
|---|---|---|---|
| | May 1, 2010 | % change | May 2, 2009 |
| Gross profit | $ 32,151 | 32% | $ 24,387 |
| Gross margin | 49.3% | | 47.6% |

The $7.8 million increase in gross profit, or 1.7 percentage point increase in gross margin, for the three months ended May 1, 2010, compared to the corresponding period in the prior fiscal year was due primarily to a 40% decline in our average cost per SoC during the three months ended May 1, 2010, which was mostly offset by a 38% decline in our ASP per SoC. The decline in our average cost per SoC was primarily due to the addition of products with lower average costs in our CopperGate product lines. The improvements in our average cost per unit were partially offset by an increase in operations overhead costs of $1.9 million for the three months ended May 1, 2010 compared to the corresponding period in the prior fiscal year, due to an increase in amortization of acquired intangibles as a result of our acquisition of CopperGate in November 2009. The decline in ASPs was primarily due to the addition of products with lower ASPs in our CopperGate product lines.

Research and development expense

Research and development expense consists primarily of compensation and benefits for our employees engaged in research, design and development activities, share-based compensation expense, engineering design tools, mask and prototyping costs, testing and subcontracting costs, and costs for facilities, equipment and other items.

The following table sets forth details of research and development expense for the three months ended May 1, 2010 and May 2, 2009 (in thousands, except percentages):

| | Three Months Ended May 1, 2010 | % of Net Revenue | Three Months Ended May 2, 2009 | % of Net Revenue | Increase (Decrease) | % Change |
|---|---|---|---|---|---|---|
| Compensation and benefits | $ 11,006 | 17% | $ 6,817 | 13% | $ 4,189 | 61% |
| Share-based compensation | 1,700 | 3% | 1,258 | 2% | 442 | 35% |
| Development and design costs | 3,101 | 5% | 1,315 | 3% | 1,786 | 136% |
| Depreciation and amortization | 1,612 | 2% | 1,288 | 3% | 324 | 25% |
| Other | 1,339 | 2% | 839 | 2% | 500 | 60% |
| Total research and development expenses | $ 18,758 | 29% | $ 11,517 | 23% | $ 7,241 | 63% |

For the three months ended May 1, 2010, compensation and benefits, and share-based compensation increased primarily due to an overall increase in headcount, including personnel added from our acquisition of CopperGate in November 2009. The increase in research and development expenses is also attributable to an increase in development and design costs for supporting new product development and depreciation and amortization expenses due to higher amortization of design tool software. Other expenses increased primarily as a result of the additional facility in Israel associated with our acquisition of CopperGate.

Sales and marketing expense

Sales and marketing expense consists primarily of compensation and benefit costs, including commissions to our direct sales force, share-based compensation expense, trade shows, travel and entertainment expenses, external commissions and depreciation and amortization.

The following table set forth details of sales and marketing expense for the three months ended May 1, 2010 and May 2, 2009 (in thousands, except percentages):

| | Three Months Ended May 1, 2010 | % of Net Revenue | Three Months Ended May 2, 2009 | % of Net Revenue | Increase (Decrease) | % Change |
|---|---|---|---|---|---|---|
| Compensation and benefits | $ 3,105 | 5% | $ 1,663 | 3% | $ 1,442 | 87% |
| Share-based compensation | 452 | 1% | 299 | 1% | 153 | 51% |
| Depreciation and amortization | 2,051 | 3% | 120 | * | 1,931 | 1,609% |
| Trade shows, travel and entertainment | 642 | 1% | 265 | 1% | 377 | 142% |
| External commissions | 390 | 1% | 480 | 1% | (90) | (19%) |
| Other | 682 | 1% | 384 | 1% | 298 | 78% |
| Total sales and marketing expenses | $ 7,322 | 12% | $ 3,211 | 7% | $ 4,111 | 128% |

* The percentage of net revenue is less than one percent.

For the three months ended May 1, 2010, compensation and benefits, and share-based compensation increased primarily due to an overall increase in headcount, including personnel added through our acquisition of CopperGate in November 2009. The increase in depreciation and amortization was primarily due to amortization of acquired intangibles associated with the CopperGate acquisition. Trade show, travel and entertainment expenses increased as a result of our increased participation in trade shows primarily as a result of our added product lines. External commissions decreased due to lower net revenues of products sold through external sales representatives. Other expenses increased primarily due to an increase in rent and facilities costs as a result of the added facility in Israel.

General and administrative expense

General and administrative expense consists primarily of compensation and benefit costs, share-based compensation expense, legal, accounting and outside service fees and facilities expenses.

The following table set forth details of general and administrative expense for the three months ended May 1, 2010 and May 2, 2009 (in thousands, except percentages):

| Three Months Ended May 1, | % of Net | Three Months Ended May 2, | % of Net | Increase | % |
|---|---|---|---|---|---|

| | 2010 | Revenue | 2009 | Revenue | (Decrease) | Change |
|---|---|---|---|---|---|---|
| Compensation and benefits | $ 1,606 | 2% | $ 1,148 | 2% | $ 458 | 40% |
| Share-based compensation | 841 | 1% | (484) | (1%) | 1,325 | 274% |
| Legal and accounting fees | 1,305 | 2% | 1,386 | 3% | (81) | (6%) |
| Outside service fees | 348 | 1% | 418 | 1% | (70) | (17%) |
| Other | 835 | 1% | 663 | 1% | 172 | 26% |
| Total general and administrative expenses | $ 4,935 | 7% | $ 3,131 | 6% | $ 1,804 | 58% |

For the three months ended May 1, 2010, compensation and benefits increased primarily due to an overall increase in headcount, primarily for personnel added through our acquisition of CopperGate in November 2009. The increase in share-based compensation expenses is primarily due to a specific option cancelation during the three months ended May 2, 2009. The increase in other expenses is primarily due to the increase in rent and facilities costs and depreciation as a result of added facilities arising from our acquisition of CopperGate.

Share-based compensation expense

The following table sets forth the total share-based compensation expense that is included in each functional line item in the unaudited condensed consolidated statements of operations (in thousands):

| | Three Months Ended | |
|---|---|---|
| | May 1, 2010 | May 2, 2009 |
| Cost of revenue | $ 131 | $ 85 |
| Research and development expenses | 1,700 | 1,258 |
| Sales and marketing expenses | 452 | 299 |
| General and administrative expenses | 841 | (484) |
| Total share-based compensation | $ 3,124 | $ 1,158 |

The expensing of employee stock options grants will continue to have an adverse impact on our results of operations.

Amortization of intangible assets

Amortization expense of $2.6 million and $0.7 million for acquired developed technology for the three months ended May 1, 2010 and May 2, 2009, respectively, is classified as cost of sales. Amortization expense of zero and $20,000 for acquired noncompete agreements for the three months ended May 1, 2010 and May 2, 2009, respectively, is classified as research and development expense. This is due to an acquired noncompete agreement becoming fully amortized in the first quarter of fiscal 2010. Amortization expense of $2.0 million and $0.1 million for customer relationships and acquired trademarks for the three months ended May 1, 2010 and May 2, 2009, respectively, is classified as sales and marketing expense. At May 1, 2010, the unamortized balance from purchased intangible assets was $121.0 million which will be amortized to future periods based on their respective remaining estimated useful lives. If we purchase additional intangible assets in the future, our cost of revenue or other operating expenses may increase from the amortization of those assets.

Acquired intangible assets, subject to amortization, were as follows as of May 1, 2010 (in thousands, except for years):

| | Gross Value | Accumulated Amortization | Net Value | Weighted average remaining amortization period (years) |
|---|---|---|---|---|
| Developed technology | $ 72,510 | $ 11,002 | $ 61,508 | 6.5 |
| Trademarks | 2,677 | 583 | 2,094 | 5.3 |
| Noncompete agreements | 1,400 | 1,400 | — | — |
| Customer relationships | 50,423 | 3,743 | 46,680 | 6.7 |
| | $ 127,010 | $ 16,728 | $ 110,282 | 6.6 |
| In-process research and development | 10,700 | — | 10,700 | |

| | | | | |
|---|---|---|---|---|
| | $ | 137,710 | 16,728 | 120,982 |

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We acquired IPR&D valued at $10.7 million in connection with our acquisition of CopperGate. The fair value of the IPR&D was determined through estimates and valuation techniques based on the terms and details of the acquisition. The amounts allocated to IPR&D will not begin to be expensed until completion of the related project, as it was determined that the underlying project had not reached technological feasibility at the date of acquisition. The IPR&D project represents our next generation HomePNA product which is expected to provide backward compatibility to our current HomePNA and HomePlug AV products and increased data rates, ease of use and quality of service, or QoS. Upon completion of development, the acquired IPR&D will be amortized over its useful life.

Interest and other income, net

The following table sets forth net interest and other income and the related percentage change (in thousands, except percentages):

| | Three Months Ended | | |
|---|---|---|---|
| | May 1, 2010 | % change | May 2, 2009 |
| Interest and other income, net | $ 724 | (7%) | $ 778 |

Our other income and expense primarily consisted of interest income from marketable securities, income from refundable research and development credits, gain or loss on foreign exchange transactions, gain or loss on sales of marketable securities and interest expense. The decrease of $55,000, or 7%, in the three months ended May 1, 2010 compared to the three months ended May 2, 2009 was due primarily to a decrease in interest rates earned on our marketable securities portfolio and the reduction of investible funds due to the cash used in the purchase of CopperGate. Our foreign exchange exposure, primarily in the Canadian dollar, Danish krone, Israeli shekel and Euro, has increased compared to the corresponding period in the prior fiscal year as a result of our further expansion into international locations and volatility of the U.S. dollar in relation to those currencies.

Provision for income taxes

We recorded a provision for income taxes of $0.7 million for the three months ended May 1, 2010. For the three months ended May 2, 2009, we recorded a provision for income taxes of $4.6 million, which included a $3.6 million valuation allowance recorded against California deferred tax assets.

On February 20, 2009, the California Budget Act of 2008 was signed into law which revised certain provisions of the California State Tax Code, including the option to elect an alternative method to attribute taxable income to California for tax years beginning on or after January 1, 2011. We now expect that in years 2011 and beyond, our income subject to tax in California will be lower than under prior tax law and that our California deferred tax assets are therefore no longer more likely than not to be realized. As a result of this change, we recorded a $3.6 million charge in the first quarter of fiscal 2010 to reduce our previously recognized California deferred tax assets.

Liquidity and Capital Resources

The following table sets forth the balances of cash and cash equivalents and short-term marketable securities (in thousands):

| | May 1, 2010 | January 30, 2010 |
|---|---|---|
| Cash and cash equivalents | $ 82,782 | $ 81,947 |
| Short-term marketable securities | 51,926 | 51,176 |

| | | | | |
|---|---|---|---|---|
| | $ | 134,708 | $ | 133,123 |

As of May 1, 2010, our principal sources of liquidity consisted of cash and cash equivalents and short-term marketable securities of $134.7 million, which represents an increase of $1.6 million from $133.1 million at January 30, 2010. The increase in cash and cash equivalents and short-term marketable securities was primarily the result of $14.3 million of cash generated from our operating activities, $3.1 million of redemptions of ARS and $1.1 million in net proceeds from the sale of our common stock through our stock option plans and employee stock purchase plan. These inflows of cash, cash equivalents and short-term marketable securities were partially offset by $9.6 million of net purchases of marketable securities and $7.2 million in purchases of software, equipment and leasehold improvements. In October 2008, we accepted an offer of a comprehensive settlement agreement from our cash investment advisor, UBS, in which all the ARS currently held in our UBS portfolio could be redeemed at par value. The offer to redeem will be at our option during a two year period beginning June 30, 2010. As a result of this offer, we expect to sell all of our auction rate securities to UBS after June 2010. Accordingly, we have classified our auction rate securities as short-term marketable securities.

The following table sets forth the primary net cash inflows and outflows (in thousands):

| | Three Months Ended | |
|---|---|---|
| | May 1, 2010 | May 2, 2009 |
| Net cash provided by (used in): | | |
| Operating activities | $ 14,331 | $ 30,187 |
| Investing activities | (14,440) | 2,879 |
| Financing activities | 1,104 | 495 |
| Effect of foreign exchange rate changes on cash and cash equivalents | (160) | 256 |
| Net increase in cash and cash equivalents | $ 835 | $ 33,817 |

Cash flows from operating activities

Net cash provided by operating activities of $14.3 million for the three months ended May 1, 2010 was primarily due to net income of $1.1 million, non-cash expenses of $9.7 million, a $2.5 million increase in accounts payable, a $1.7 million decrease in accounts receivable, a $0.5 million increase in other long-term liabilities and a $0.3 million decrease in inventories. These amounts were partially offset by a $0.8 million decrease in accrued liabilities and a $0.7 million increase in prepaid expenses and other current assets. Non-cash expenses included in net income in the three months ended May 1, 2010 consisted primarily of $6.7 million in depreciation and amortization and $3.1 million in share-based compensation expense.

The decrease in accounts receivable was primarily the result of a decrease in revenue. The decrease in inventories was the result of reductions in the level of our wafers and other purchased materials during the first quarter of fiscal 2011 which resulted in an increase in our annualized rate of inventory turns to 11.0 for the fiscal quarter ended May 1, 2010 compared to 7.8 for the fiscal quarter ended January 30, 2010. The increase in accounts payable was primarily due to the timing of payments for inventories.

Net cash provided by operating activities was $30.2 million for the three months ended May 2, 2009. The cash provided by our operating activities for the three months ended May 2, 2009 was primarily due to net income of $2.7 million, non-cash expenses of $7.1 million, a $9.6 million decrease in accounts receivable, a $6.3 million decrease in inventories, a $4.2 million increase in accounts payable, a $0.9 million decrease in prepaid expenses and other current assets and a $0.3 million increase in other long-term liabilities. These amounts were partially offset by a $1.0 million decrease in accrued liabilities. Non-cash expenses included in net income in the three months ended May 2, 2009 consisted primarily of $3.6 million in deferred income taxes, $2.3 million in depreciation and amortization and $1.2 million in share-based compensation expense.

The decrease in accounts receivable was primarily the result of timing of product shipments during the first quarter of fiscal 2009. The decrease in inventories was the result of a reduction of our die bank as well as increased demand. Our annualized rate of inventory turns increased to 3.3 for the quarter ended May 2, 2009 compared to 2.6 for the quarter ended January 31, 2009. The increases in accounts payable, accrued liabilities and other long-term liabilities were primarily due to the timing of payments for inventories, commissions, rebates, tax liabilities, software licenses and the final payment to settle the employment tax audit related to our historical stock option grant practices. The decrease in prepaid expenses and other assets was primarily due to the receipt of a research and development credit refund and timing of certain payments.

Cash flows from our operating activities will continue to fluctuate based upon our ability to grow net revenues while managing the timing of payments to us from customers and from us to vendors, the timing of inventory purchases and subsequent manufacture and sale of our products.

Cash flows from investing activities

Net cash used in investing activities was $14.4 million for the three months ended May 1, 2010 which was primarily due to purchases of software, equipment and leasehold improvements of $7.2 million and net purchases of marketable securities of $7.2 million.

Net cash provided by investing activities was $2.9 million for the three months ended May 2, 2009 which was primarily due to net sales or maturity of marketable securities of $4.8 million, offset by purchases of software, equipment and leasehold improvements of $1.4 million and a private equity investment for $0.5 million.

Cash flows from financing activities

Net cash provided by financing activities was $1.1 million in the three months ended May 1, 2010 which was due to proceeds from the exercise of employee stock options.

Net cash provided by financing activities was $0.5 million in the three months ended May 2, 2009, which was due to $0.3 million of proceeds from the exercise of employee stock options and $0.2 million of excess tax benefit from share-based compensation.

While we generated cash from operations in fiscal 2010, 2009 and 2008 and in the first three months of fiscal 2011, it is possible that our operations will consume cash in future periods. Based on our currently anticipated cash needs, we believe that our current reserve of cash, cash equivalents and short-term marketable securities will be sufficient to meet our anticipated working capital requirements, obligations, capital expenditures, strategic investments and other cash needs for at least the next twelve months. However, it is possible that we may need to raise additional funds to finance our activities during or beyond the next 12 months and our future capital requirements may vary significantly from those currently planned. Our cash, cash equivalent and marketable security balances will continue to fluctuate based upon our ability to grow revenue, the timing of payments to us from customers and to vendors from us and the timing of inventory purchases and subsequent manufacture and sale of our products.

Our marketable securities consist primarily of auction rate securities, corporate bonds and US agency notes. We monitor all our marketable securities for impairment and if these securities are reported to have had a decline in fair value, we use significant judgment to identify events or circumstances that would likely have a significant adverse effect on the future value of each investment including: (i) the nature of the investment; (ii) the cause and duration of any impairment; (iii) the financial condition and near term prospects of the issuer; (iv) for securities with a reported decline in fair value, our ability to hold the security for a period of time sufficient to allow for any anticipated recovery of fair value; (v) the extent to which fair value may differ from cost; and (vi) a comparison of the income generated by the securities compared to alternative investments. We would recognize an impairment charge if a decline in the fair value of our marketable securities is judged to be other-than-temporary.

At May 1, 2010, we held nine ARS, with an adjusted cost and par value of $37.7 million, which are all classified as short-term marketable securities. Auction rate securities are bought and sold in the marketplace through a bidding process sometimes referred to as a “Dutch auction.” Historically, the fair value of our ARS had been determined by the frequent auction periods, generally every 28 days, which provided liquidity at par value for these investments. However, subsequent to February 2008, all auctions involving such securities held by us have failed. The result of a failed auction is that these ARS will continue to pay interest in accordance with their terms at each respective auction date; however, liquidity of the securities will continue to be limited until there is a successful auction, the issuer redeems the securities, the securities mature or until such time as other markets for these ARS develop. We cannot be certain regarding the amount of time it will take for an auction market or other markets to develop for these securities. In October 2008, our cash investment advisor, UBS, acknowledged our acceptance of its proposal of a comprehensive settlement agreement, in which all the ARS currently in our portfolio could be redeemed at par value. The offer to redeem will be at our option during a two year period beginning June 30, 2010. The offer also gives UBS the discretion to buy any or all of these securities from us at par value at any time. Additionally, the proposed solution by UBS to the lack of liquidity of our ARS included a commitment effective October 2008 through June 2010 to loan an amount up to 75% of the par value of the ARS. The interest charged on such loan would be equal to the proportional amount of interest being paid by the issuers of the ARS borrowed against. At May 1, 2010, UBS provided an estimated value for the nine ARS of approximately $32.9 million, which reflects an unrealized loss of $4.8 million from our adjusted cost. We have not adopted UBS' estimated value of our ARS for the reasons described below.

We have reviewed the prospectuses for each of the nine ARS in our investment portfolio as of May 1, 2010 and determined that the unprecedented disruption in the auction process and resulting pattern of interest payments was in accordance with their established rules of operation under these circumstances. The default mechanism called for in the operating rules of these instruments is designed to adjust their interest payments to a limit based on the income generated by their underlying student loans. The most significant consequences of this mechanism are the preservation of their AAA credit rating while adjusting to a continuing stream of interest payments to the security holders at a rate correlating to contemporary credit market rates.

As a result of this review, we reached the conclusion that the securities do have a strong underlying principle value and that any potential adjustment in their carrying value would be based upon our ability to endure their lack of liquidity, the degree of certainty of continuing interest payments and the rate of return on these securities. Given that we expect considerable liquidity from our other assets, foresee continuing positive cash flow and have accepted our investment advisor's offer to purchase all of our ARS at par value beginning June 30, 2010, we do not consider the remaining possible liquidity risk and UBS default risk to be significant enough to justify a reduction in their carrying value. The remaining valuation factor that we considered was the rate of return evidenced by the interest received. We used a discounted cash flow calculation that reached a valuation that was similar to other of our recent investments with comparably high credit ratings.

As a result of this judgment process and in accordance with the various accounting pronouncements in this area, we reached the conclusion that the carrying value of our ARS has not been impaired and that we have no expectation of any material adverse impact on our future results of operations, liquidity, or capital resources associated with holding these securities.

Contractual obligations and commitments

We generally do not have guaranteed price or quantity commitments from any of our suppliers. Additionally, we generally acquire products for sale to our customers based on purchase orders received as well as forecasts from such customers. Purchase orders with delivery dates greater than twelve weeks are typically cancelable without penalty to our customers. We currently place non-cancelable orders to purchase semiconductor wafers, other materials and finished goods from our suppliers on an eight to twelve week lead-time basis.

The following table sets forth the amounts of payments due under specified contractual obligations as of May 1, 2010 (in thousands):

| | Payments Due by Period | | | | |
|---|---|---|---|---|---|
| Contractual Obligations | Remainder of Fiscal 2011 | Fiscal 2012 - 2013 | Fiscal 2014 - 2015 | Fiscal 2016 and Thereafter | Total |
| Operating leases | $ 2,334 | $ 4,009 | $ 1,489 | $ 2,108 | $ 9,940 |
| Non-cancelable purchase orders | 40,242 | — | — | — | 40,242 |
| | $ 42,576 | $ 4,009 | $ 1,489 | $ 2,108 | $ 50,182 |

Recent accounting pronouncements:

See Note 1, “Recent Accounting Pronouncements,” of the Notes to unaudited condensed consolidated financial statements of this Form 10-Q.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The following discussion about our market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. We face exposure to market risk from adverse movements in interest rates and foreign currency exchange rates, which could impact our operations and financial condition. To mitigate some of the foreign currency exchange rate risk, we utilize derivative financial instruments to hedge certain foreign currency exposures. We do not use derivative financial instruments for speculative or trading purposes.

Interest rate sensitivity: At May 1, 2010 and January 30, 2010, we held approximately $154.4 million and $146.4 million, respectively, of cash, cash equivalents and short term and long term marketable securities. If short-term interest rates were to decrease 10%, the decreased interest income associated with these cash, cash equivalents and marketable securities would not have a significant impact on our net income and cash flows.

Foreign currency exchange rate sensitivity: We transact our revenues in U.S. dollars. The U.S. dollar is our functional and reporting currency except for our foreign locations in Canada, Denmark, France, Japan and Taiwan where the Canadian dollar, Danish krone, Euro, Japanese Yen and Taiwan dollar are the primary financial currencies, respectively. Additionally, a significant portion of our Israeli subsidiary payroll related expenses, consisting principally of salaries and related personnel expenses are denominated in Israeli shekels. This foreign currency exposure gives rise to market risk associated with exchange rate movements of the U.S. dollar against the Israeli shekel. We engage in hedging activity to mitigate the risk that to the extent the U.S. dollar weakens against the Israeli shekel, our Israel subsidiary would experience a negative impact on its results of operations.

As of May 1, 2010, we had not entered into foreign exchange forward contracts to hedge certain balance sheet exposures and inter-company balances against future movements in foreign exchange rates. However, for our Israel operation, we do hedge portions of our forecasted expenses that are denominated in the Israeli shekel with foreign exchange forward contracts. As of May 1, 2010, we had foreign exchange forward and option contracts with notional amounts of $5.5 million and $0.6 million, respectively, in place to hedge certain forecasted Israeli shekels denominated operating expenses, primarily payroll related expenses of our Israel operation. These contracts are designated as cash flow hedges pursuant to ASC 815, Derivatives and Hedging. These hedges of cash flow exposures will only mitigate a portion of our foreign exchange exposure. We will remain exposed to the currency risk of our cash flow exposures.

We maintain certain cash balances denominated in the Canadian dollar, Danish krone, Euro, Hong Kong dollar, Israeli shekel, Singapore dollar and Taiwan dollar. If foreign exchange rates were to weaken against the U.S. dollar immediately and uniformly by 10% from the exchange rate at May 1, 2010, the fair value of these foreign currency amounts would decline by $0.2 million.

ITEM 4. CONTROLS AND PROCEDURES

We are committed to maintaining disclosure controls and procedures designed to ensure that information required to be disclosed in our periodic reports filed under the Securities and Exchange Act of 1934 as amended (the “Exchange Act”), is recorded, processed, summarized and reported within the time periods specified in the SEC’s rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow for timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and management necessarily is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures and implementing controls and procedures.

As of May 1, 2010, the end of the period covered by this quarterly report on Form 10-Q, we have, with the participation of our Chief Executive Officer and our Chief Financial Officer, evaluated the effectiveness of the design and effectiveness of our disclosure controls and procedures, as such terms are defined in Rule 13a-15(e) and Rule 15d-15(e) under the Exchange Act. Based on this evaluation, we have concluded that our disclosure controls and procedures were effective at a reasonable assurance level as of May 1, 2010.

During the first quarter ended May 1, 2010, there were no changes in our internal control over financial reporting (as defined in Rule 13(a) – 15(f) under the Exchange Act) that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. We are continuously seeking to improve the efficiency and effectiveness of our operations and of our internal controls. This results in refinements to processes throughout our organization.

PART II. OTHER INFORMATION

## ITEM 1. LEGAL PROCEEDINGS

From time to time, we are involved in claims and legal proceedings that arise in the ordinary course of business. We expect that the number and significance of these matters will increase as our business expands. In particular, we could face an increasing number of patent and other intellectual property claims as the number of products and competitors in our industry grows. Any claims or proceedings against us, whether meritorious or not, could be time consuming, result in costly litigation, require significant amounts of our time, result in the diversion of significant operational resources, or require us to enter into royalty or licensing agreements which, if required, may not be available on terms favorable to us or at all. Were an unfavorable outcome to occur against us, there exists the possibility of a material adverse impact on our financial position and results of operations for the period in which the unfavorable outcome occurs, and potentially in future periods.

ITEM 1A. RISK FACTORS

If any of the following risks actually occurs, our business, financial condition and results of operations could be harmed. In that case, the trading price of our common stock could decline and you might lose all or part of your investment in our common stock. The risks and uncertainties described below are not the only ones we face. You should also refer to the other information set forth in this Form 10-Q, including our unaudited condensed consolidated financial statements and the related notes. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also impair our business operations.

Risks Related to Our Business and Our Industry

If we do not successfully anticipate market needs and develop products and product enhancements in a timely manner that meet those needs, or if those products do not gain market acceptance, we may not be able to compete effectively and our ability to generate revenue will suffer.

We may not be able to accurately anticipate future market needs or be able to develop new products or product enhancements to meet such needs or to meet them in a timely manner. Our ability to develop and deliver new products successfully will depend on various factors, including our ability to:

- accurately predict market requirements and evolving industry standards;
- accurately design new SoC products;
- timely complete and introduce new product designs;
- timely qualify and obtain industry interoperability certification of our products and the equipment into which our products will be incorporated;
- ensure that our subcontractors have sufficient foundry, assembly and test capacity and packaging materials and achieve acceptable manufacturing yields;
- shift our products to smaller geometry process technologies to achieve lower cost and higher levels of design integration; and
- gain market acceptance of our products and our customers' products.

If we fail to anticipate market requirements or to develop new products or product enhancements to meet those needs in a cost-effective and timely manner, it could substantially decrease market acceptance and sales of our present and future products and we may be unable to attract new customers or retain our existing customers, which would significantly harm our business and financial results.

Even if we are able to anticipate, develop and commercially introduce new products and enhancements, our new products or enhancements may not achieve widespread market acceptance. Any failure of our products to achieve market acceptance could adversely affect our business and financial results.

Our industry is highly competitive and we may not be able to compete effectively, which would harm our market share and cause our revenue to decline.

The markets in which we operate are extremely competitive and are characterized by rapid technological change, continuously evolving customer requirements and declining average selling prices. We may not be able to compete successfully against current or potential competitors. Most of our products compete with large semiconductor providers that have substantial experience and expertise in video, audio and multimedia technology and in selling to consumer equipment providers. Many of these companies have substantially greater engineering, marketing and financial resources than we have. As a result, our competitors may be able to respond better to new or emerging technologies or standards and to changes in customer requirements. Further, some of our competitors are in a better financial and marketing position from which to influence industry acceptance of a particular industry standard or competing technology than we are. Our competitors may also be able to devote greater resources to the development, promotion and sale of products, and may be able to deliver competitive products at a lower price. We also may face competition from newly established competitors, suppliers of products based on new or emerging technologies and customers who choose to develop their own SoCs. Additionally, some of our competitors operate their own fabrication facilities or may have stronger manufacturing partner relationships than we have. We expect our current customers, particularly in the IPTV and connected media player markets, to seek additional suppliers of SoCs for inclusion in their products, which will increase competition and could reduce our market share. If we do not compete successfully, our market share and net revenue could decline.

If we fail to achieve initial design wins for our products, we may be unable to recoup our investments in our products and revenue could decline.

We expend considerable resources in order to achieve design wins for our products, especially our new products and product enhancements, without any assurance that a customer will select our product. Once a customer designs a semiconductor into a product, it is likely to continue to use the same semiconductor or enhanced versions of that semiconductor from the same supplier across a number of similar and successor products for a lengthy period of time due to the significant costs and risks associated with qualifying a new supplier and potentially redesigning the product to incorporate a different semiconductor. As a result, if we fail to achieve an initial design win in a customer's qualification process, we may lose the opportunity for significant sales to that customer for a number of its products and for a lengthy period of time, or we would only be able to sell our products to these customers as a second source, which usually means we would only be able to sell a limited amount of product to them. Also, even if we achieve new design wins with customers, these manufacturers may not purchase our products in sufficient volumes to recoup our development costs, and they can choose at any time to stop using our products, for example, if their own products are not commercially successful. This may cause us to be unable to recoup our investments in the development of our products and cause our revenue to decline.

We base orders for inventory on our forecasts of our customers' demand and if our forecasts are inaccurate, our financial condition and liquidity would suffer.

We place orders with our suppliers based on our forecasts of our customers' demand. Our forecasts are based on multiple assumptions, each of which may introduce errors into our estimates. When the demand for our customers' products increases significantly, we may not be able to meet demand on a timely basis and we may need to expend a significant amount of time working with our customers to allocate a limited supply and maintain positive customer relations. If we underestimate customer demand, we may forego revenue opportunities, lose market share and damage our customer relationships. Conversely, if we overestimate customer demand, we may allocate resources to manufacturing products that we may not be able to sell when we expect to or at all. As a result, we would have excess or obsolete inventory, resulting in a decline in the value of our inventory, which would increase our cost of revenue and create a drain on our liquidity.

We depend on a limited number of customers and any reduction, delay or cancellation of an order from these customers or the loss of any of these customers could cause our revenue to decline.

Our dependence on a limited number of customers means that the loss of a major customer or any reduction in orders by a major customer could materially reduce our net revenue and adversely affect our results of operations. We expect that sales to relatively few customers will continue to account for a significant percentage of our net revenue for the foreseeable future. We have no firm, long-term volume commitments from any of our major customers and we generally accept purchase commitments from our customers based upon their purchase orders. Customer purchase orders may be cancelled and order volume levels can be changed, cancelled or delayed with limited or no penalties. We have experienced fluctuations in order levels from period to period and expect that we will continue to experience such fluctuations and may experience cancellations in the future. We may not be able to replace the cancelled, delayed or reduced purchase orders with new orders. Any difficulty in the collection of receivables from key customers could also harm our business.

For the three months ended May 1, 2010, Motorola and Gemtek accounted for 25% and 19%, respectively, of our net revenue. For the three months ended May 2, 2009, Motorola and Cowin Worldwide Corporation accounted for 19% and 18%, respectively, of our net revenue.

Our business also depends on demand for our SoC solutions from companies, such as large telecommunication carriers, who are not our direct customers but deploy IPTV set-boxes that incorporate our SoC solutions. These companies use multiple set-top box providers, who in turn sometimes use multiple contract manufacturers to purchase our SoCs and manufacture set-top boxes. Even though we do not sell our products directly to these companies that ultimately deploy set-top boxes to consumers, these companies have a significant impact on the demand for our SoC solutions. For example, a significant number of our SoCs are incorporated into set-top boxes deployed by AT&T. This significant concentration on AT&T set-top boxes was increased by our recent acquisition of CopperGate. A significant percentage of the SoC solutions sold by CopperGate are also used in set-top boxes as well as gateways deployed by AT&T. In the past, companies that deploy set-top boxes incorporating our SoC solution have had significant fluctuations in demand which has resulted in a decline in our business from our direct customers, such as original equipment manufacturers and contract manufacturers. Any decrease in the demand from the companies that deploy IPTV set-top boxes incorporating our SoC solutions, and in particular AT&T, could have a material and adverse effect on our net revenue and results of operation.

If demand for our SoCs declines or does not grow, we will be unable to increase or sustain our net revenue.

We expect our SoCs to account for a substantial majority of our net revenue for the foreseeable future. For the three months ended May 1, 2010, sales of our SoCs represented 99% of our net revenue. Even if the consumer electronic markets that we target continue to expand, manufacturers of consumer products in these markets may not choose to utilize our SoCs in their products. The markets for our products are characterized by frequent introduction of new technologies, short product life cycles and significant price competition. If we or our customers are unable to manage product transitions in a timely and cost effective manner, our net revenue would suffer. In addition, frequent technological changes and introduction of next generation products may result in inventory obsolescence which would increase our cost of revenue and adversely affect our operating performance. If demand for our SoCs declines or fails to grow or we are unable to develop new products to meet our customers' demand, our net revenue could be harmed.

The timing of our customer orders and product shipments can adversely affect our operating results and stock price.

Our net revenue and operating results depend upon the volume and timing of customer orders received during a given period and the percentage of each order that we are able to ship and recognize as net revenue during each period. Customers may change their cycle of product orders from us, which would affect the timing of our product shipments. For example, we experienced declines in orders from certain significant customers in the first two quarters of fiscal 2009 compared to the third and fourth quarters of fiscal 2008. Any failure or delay in the closing of orders expected to occur within a quarterly period, particularly from significant customers, would adversely affect our operating results. Further, to the extent we receive orders late in any given quarter, we may not be able to ship products to fill those orders during the same period in which we received the corresponding order which could have an adverse impact on our operating results for that period.

We may face intellectual property claims that could be costly to defend and result in our loss of significant rights.

The semiconductor industry is characterized by frequent litigation regarding patent and intellectual property rights. We believe that it may be necessary, from time to time, to initiate litigation against one or more third parties to preserve our intellectual property rights. From time to time, we have received, and may receive in the future, notices that claim we have infringed upon, misappropriated or misused other parties' proprietary rights. Any of the foregoing events or claims could result in litigation. Any such litigation could result in significant expense to us and divert the efforts of our technical and management personnel. In the event of an adverse result in any such litigation, we could be required to pay substantial damages, cease the manufacture, use and sale of certain products or expend significant resources to develop non-infringing technology or to obtain licenses to the technology that is the subject of the litigation, and we may not be successful in such development or in obtaining such licenses on acceptable terms, if at all. In addition, patent disputes in the electronics industry have often been settled through cross-licensing arrangements. Because we do not yet have a large portfolio of issued patents, we may not be able to settle an alleged patent infringement claim through a cross-licensing arrangement.

To remain competitive, we need to continue to transition our SoCs to increasingly smaller sizes while maintaining or increasing functionality, and our failure to do so may harm our business.

We periodically evaluate the benefits, on a product-by-product basis, of migrating to more advanced technology to reduce the size of our SoCs. The smaller SoC size reduces our production and packaging costs, which enables us to be competitive in our pricing. We also continually strive to increase the functionality of our SoCs, which is essential to competing effectively in our target markets. The transition to smaller geometries while maintaining or increasing functionality requires us to work with our contractors to modify the manufacturing processes for our products and to redesign some products. This effort requires considerable development investment and a risk of reduced yields as a new process is brought to acceptable levels of operating and quality efficiency. In the past, we have experienced some difficulties in shifting to smaller geometry process technologies or new manufacturing processes, which resulted in reduced manufacturing yields, delays in product deliveries and increased expenses. We may face similar difficulties, delays and expenses as we continue to transition our products to smaller geometry processes, all of which could harm our relationships with our customers, and our failure to do so would impact our ability to provide competitive prices to our customers, which would have a negative impact on our sales.

We may not be able to realize all of the anticipated benefits of our acquisition of CopperGate if we fail to integrate CopperGate successfully, which could reduce our profitability.

Our ability to realize the anticipated benefits of our acquisition of CopperGate will depend, in part, on our ability to integrate the business of CopperGate successfully and efficiently with our business. The combination of two independent companies is a complex, costly and time-consuming process. The integration process may disrupt the business of either or both of the companies and, if implemented ineffectively, preclude realization of the full benefits expected by us. If we are not successful in this integration, our financial results could be adversely impacted. We will be required to dedicate significant time and effort to this integration process, which could divert their attention from other business concerns. In addition, the overall integration of the two companies may result in unanticipated problems, expenses, liabilities, competitive responses, loss of customer and other relationships, a loss of key employees and diversion of our attention and may cause our stock price to decline. The difficulties of combining the operations of the two companies include, among others:

- challenges associated with minimizing the diversion of our attention from ongoing business concerns;
- addressing differences in the business cultures;
- coordinating geographically separate organizations which may be subject to additional complications resulting from being geographically distant from our other operations;
- coordinating and combining international operations relationships and facilities and eliminating duplicative operations;
- retaining key employees and maintaining employee moral;
- unanticipated changes in general business or market conditions that might interfere with our ability to carry out all of our integration plans;
- unanticipated issues in integrating information, communications and other systems; and
- preserving important strategic and customer relationships.

In addition, even if CopperGate's operations are integrated successfully with ours, we may not realize the full potential benefits of the transaction, including the leveraging of manufacturing know-how and combined wafer sourcing, further SoC integration and combined research and development that are expected. Such benefits may not be achieved within the anticipated time frame, or at all.

The complexity of our products could result in unforeseen delays or expenses and in undetected defects, which could damage our reputation with current or prospective customers, adversely affect the market acceptance of new products and result in warranty claims.

Highly complex products, such as those that we offer, frequently contain defects, particularly when they are first introduced or as new versions are released. Our SoCs contain highly sophisticated silicon technology and complex software. In the past we have experienced, and may in the future experience, defects in our products, both with our SoCs and the related software products we offer. If any of our products contain defects or have reliability, quality or compatibility problems, our reputation may be damaged and our customers may be reluctant to buy our products, which could harm our ability to retain existing customers and attract new customers. In addition, these defects could interrupt or delay sales or shipment of our products to our customers. Manufacturing defects may not be detected by the testing process performed by our subcontractors. If defects are discovered after we have shipped our products, it could result in unanticipated costs, order cancellations or deferrals and product recalls, harm to our reputation and a decline in our net revenue, income from operations and gross margins.

In addition, our agreements with some customers contain warranty provisions, which provide the customer with a right to damages if a defect is traced to our products or if we cannot correct errors in our product reported during the warranty period. However, any contractual limitations to our liability may be unenforceable in a particular jurisdiction. We do not have insurance coverage for any warranty or product liability claims and a successful claim could require us to pay substantial damages. A successful warranty or product liability claim against us, or a requirement that we participate in a product recall, could have adverse effects on our business results.

If our third-party manufacturers do not achieve satisfactory yields or quality, our relationships with our customers and our reputation will be harmed, which in turn would harm our operating results and financial performance.

The fabrication of semiconductors is a complex and technically demanding process. Minor deviations in the manufacturing process can cause substantial decreases in yields and, in some cases, cause production to be stopped or suspended. Although we work closely with our third-party manufacturers to minimize the likelihood of reduced manufacturing yields, their facilities have from time to time experienced lower than anticipated manufacturing yields that have resulted in our inability to meet our customer demand. It is not uncommon for yields in semiconductor fabrication facilities to decrease in times of high demand, in addition to reduced yields that may result from normal wafer lot loss due to workmanship or operational problems at these facilities. When these events occur, especially simultaneously, as happens from time to time, we may be unable to supply our customers' demand. Many of these problems are difficult to detect at an early stage of the manufacturing process and may be time consuming and expensive to correct. Poor yields from the wafer foundries or defects, integration issues or other performance problems in our products could cause us significant customer relations and business reputation problems or force us to sell our products at lower gross margins and therefore harm our financial results.

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

The semiconductor industry, in general, and the consumer electronics markets that we target, specifically, are characterized by intense price competition, frequent introductions of new products and short product life cycles, which can result in rapid price erosion in the average selling prices for semiconductor products. A decline in the average selling prices of our products could harm our revenue and gross margins. The willingness of customers to design our SoCs into their products depends to a significant extent upon our ability to sell our products at competitive prices. In the past, we have reduced our prices to meet customer requirements or to maintain a competitive advantage. Reductions in our average selling prices to one customer could impact our average selling prices to all customers. If we are unable to reduce our costs sufficiently to offset declines in product prices or are unable to introduce more advanced products with higher margins in a timely manner, we could experience declines in our net revenue and gross margins.

We rely upon patents, trademarks, copyrights and trade secrets to protect our proprietary rights and if these rights are not sufficiently protected, it could harm our ability to compete and to generate revenue.

Our ability to compete may be affected by our ability to protect our proprietary information. As of May 1, 2010, we held 85 patents and these patents will expire within the next four to nineteen years. These patents cover the technology underlying our products. We have filed certain patent applications and are in the process of preparing others. We cannot assure you that any additional patents for which we have applied will be issued or that any issued patents will provide meaningful protection of our product innovations. Like other semiconductor companies, we rely primarily on trade secrets and technological know-how in the conduct of our business. We use measures such as confidentiality agreements to protect our intellectual property. However, these methods of protecting our intellectual property may not be sufficient.

If the growth of demand in the consumer electronics market does not continue, our ability to increase our revenue could suffer.

Our business is highly dependent on developing sectors of the consumer electronics market, including IPTV, connected media player, prosumer and industrial audio/video and connected home technologies. The consumer electronics market is highly competitive and is characterized by, among other things, frequent introductions of new products and short product life cycles. The consumer electronics market may also be negatively impacted by a slowdown in overall consumer spending. The worldwide economy, generally, and consumer spending, specifically, has significantly declined, which has negatively impacted our target markets. If our target markets do not grow as rapidly or to the extent we anticipate, our business could suffer. We expect the majority of our revenue for the foreseeable future to come from the sale of our SoC solutions for use in emerging consumer applications. Our ability to sustain and increase revenue is in large part dependent on the continued growth of these rapidly evolving market sectors, whose future is largely uncertain. Many factors could impede or interfere with the expansion of these consumer market sectors, including consumer demand in these sectors, general economic conditions, other competing consumer electronic products, delays in the deployment of telecommunications video services and insufficient interest in new technology innovations. In addition, if market acceptance of the consumer products that utilize our products does not occur as expected, our business could be harmed.

We have a history of fluctuating operating results, including a net loss in fiscal 2006 and we may not be able to sustain or increase profitability in the future, which may cause the market price of our common stock to decline.

We have a history of fluctuating operating results. We reported net income of $70.2 million in fiscal 2008, net income of $26.4 million in fiscal 2009, net income of $2.5 million in fiscal 2010 and net income of $1.1 million in the first quarter of fiscal 2011. To sustain or increase profitability, we will need to successfully develop new products and product enhancements and sustain higher revenue while controlling our cost and expense levels. In recent years, we made significant investments in our product development efforts and have expended substantial funds to enhance our sales and marketing efforts and otherwise operate our business. However, we may not realize the benefits of these investments. Although we were profitable in first quarter of fiscal 2011, we may not continue to be profitable. For example, our net income decreased from $2.7 million in the first quarter of fiscal 2010 to $1.1 million in the first quarter of fiscal 2011. We may incur operating losses in future quarterly periods or fiscal years, which in turn could cause the price of our common stock to decline.

We have engaged, and may in the future engage in acquisitions of other businesses and technologies which could divert our attention and prove difficult to integrate with our existing business and technology.

We continue to consider investments in and acquisitions of other businesses, technologies or products, to improve our market position, broaden our technological capabilities and expand our product offerings. For example, in November 2009, we completed the acquisition of CopperGate Communications Ltd., an Israeli company. As a result, we added substantial operations, including 124 employees located in Israel and an additional 17 employees located outside of Israel. We also completed the acquisition of Zensys Holdings Corporation in December 2008, the acquisition of certain assets and 44 new employees of the VXP Group from Gennum Corporation in February 2008 and the acquisition of Blue7 Communications in February 2006. In the future, we may not be able to acquire or successfully identify companies, products or technologies that would enhance our business. Once we identify a strategic opportunity, the process to consummate a transaction could divert our attention from the operation of our business causing our financial results to decline.

Acquisitions may require large one-time charges and can result in increased debt or contingent liabilities, adverse tax consequences, additional stock-based compensation expense, and the recording and subsequent amortization of amounts related to certain purchased intangible assets, any of which items could negatively impact our results of operations. We may also record goodwill in connection with an acquisition and incur goodwill impairment charges in the future. In addition, in order to complete acquisitions, we may issue equity securities and incur debt, which would result in dilution to our existing shareholders and could negatively impact profitability.

We may experience difficulties in integrating acquired businesses. Integrating acquired businesses involves a number of risks, including:

- potential disruption of our ongoing business and the diversion of management resources from other business concerns;
- unexpected costs or incurring unknown liabilities;
- difficulties relating to integrating the operations and personnel of the acquired businesses;
- adverse effects on the existing customer relationships of acquired companies; and
- adverse effects associated with entering into markets and acquiring technologies in areas in which we have little experience.

If we are unable to successfully integrate the businesses we acquire, our operating results could be harmed.

The recent global economic downturn could negatively affect our business, results of operations and financial condition.

Current uncertainty in global economic conditions pose a risk to the overall economy as consumers and businesses may defer purchases in response to tighter credit and negative financial news, which could negatively affect demand for our products and other related matters. Consequently, demand for our products could be different from our expectations due to factors including:

- changes in business and economic conditions, including conditions in the credit market that could affect consumer confidence;
- customer acceptance of our products and those of our competitors;

- changes in customer order patterns including order cancellations; and
- changes in the level of inventory our customers are willing to hold.

There could also be a number of secondary effects from the current uncertainty in global economic conditions, such as insolvency of suppliers resulting in product delays, an inability of our customers to obtain credit to finance purchases of our products or a desire of our customers to delay payment to us for the purchase of our products. The effects, including those mentioned above, of the current global economic environment could negatively impact our business, results of operations and financial condition.

Due to the cyclical nature of the semiconductor industry, our operating results may fluctuate significantly, which could adversely affect the market price of our common stock.

The semiconductor industry is highly cyclical and subject to rapid change and evolving industry standards and, from time to time, has experienced significant downturns. These downturns are characterized by decreases in product demand, excess customer inventories and accelerated erosion of prices. These factors have caused, and could cause, substantial fluctuations in our net revenue and in our operating results. Any downturns in the semiconductor industry may be severe and prolonged, and any failure of this industry to fully recover from downturns could harm our business. The semiconductor industry also periodically experiences increased demand and production capacity constraints, which may affect our ability to ship products. Accordingly, our operating results have varied and may vary significantly as a result of the general conditions in the semiconductor industry, which could cause our stock price to decline.

The complexity of our international operations may increase our operating expenses and disrupt our business.

We transact business and have operations worldwide. For example, we derive a substantial portion of our net revenue from our customers outside of North America and we plan to continue expanding our business in international markets in the future. For the first quarter of fiscal 2011, we derived 96% of our revenue from customers outside of North America. We also have significant international operations, including a significant operation in Singapore, research and development facilities in France, Canada, Denmark and Japan, and a sales and distribution facility in Hong Kong. In November 2009, we completed the acquisition of CopperGate Communications Ltd., and as a result, added substantial operations in Israel. Our substantial operations in Israel and the Middle East expose us to increased risks, including a disruption to our business as a result of political, economic and military instability.

As a result of our international business, we are affected by economic, regulatory and political conditions in foreign countries, including the imposition of government controls, changes or limitations in trade protection laws, unfavorable changes in tax treaties or laws, varying statutory equity requirement, difficulties in collecting receivables and enforcing contracts, natural disasters, labor unrest, earnings expatriation restrictions, misappropriation of intellectual property, changes in import/export regulations, tariffs and freight rates, economic instability, public health crises, acts of terrorism and continued unrest in many regions and other factors, which could have a material impact on our international revenue and operations. In particular, in some countries we may experience reduced intellectual property protection. Our results of operations could also be adversely affected by exchange rate fluctuations, which could increase the sales price in local currencies of our products in international markets. Overseas sales and purchases to date have been denominated in U.S. dollars. Although we engage in some hedging of our foreign currency exposures, we do not hedge all such exposures and our hedging arrangements may not always be effective. See “Foreign currency exchange rate sensitivity” under Part I Item 3“Quantitative and Qualitative Disclosures about Market Risk” in this Form 10-Q. Moreover, local laws and customs in many countries differ significantly from those in the United States. We also face challenges in staffing and managing our global operations. If we are unable to manage the complexity of our global operations successfully, our financial performance and operating results could suffer.

Our sales cycle can be lengthy, which could result in uncertainty and delays in generating net revenue.

Because our products are based on constantly evolving technologies, we have experienced a lengthy sales cycle for some of our SoCs, particularly those designed for set-top box applications in the IPTV market. After we have qualified a product with a customer, the customer will usually test and evaluate our product with its service provider prior to the customer completing the design of its own equipment that will incorporate our product. Our customers and the telecommunications carriers our customers serve may need from three to more than nine months to test, evaluate and adopt our product and an additional three to more than nine months to begin volume production of equipment that incorporates our product. Our complete sales cycle typically ranges from nine to eighteen months, but could be longer. As a result, we may experience a significant delay between the time we increase expenditures for research and development, sales and marketing efforts and inventory and the time we generate net revenue, if any, from these expenditures. In addition, because we do not have long-term commitments from our customers, we must repeat our sales process on a continual basis even for current customers looking to purchase a new product. As a result, our business could be harmed if a customer reduces or delays its orders, chooses not to release products incorporating our SoCs or elects not to purchase a new product or product enhancements from us.

We rely on a limited number of independent third-party manufacturers for the fabrication, assembly and testing of our SoCs and the failure of any of these third-party manufacturers to deliver products or otherwise perform as requested could damage our relationships with our customers, decrease our sales and limit our growth.

We are a fabless semiconductor company and thus we do not own or operate a fabrication or manufacturing facility. We depend on independent manufacturers, each of whom is a third-party manufacturer for numerous companies, to manufacture, assemble and test our products. We currently rely on Taiwan Semiconductor Manufacturing Corporation, and Faraday Technology Company, or Faraday, to produce substantially all of our SoCs. We rely on Advanced Semiconductor Engineering, Inc., to assemble, package and test substantially all of our products. These third-party manufacturers may allocate capacity to the production of other companies' products while reducing product deliveries or the provision of services to us on short notice or they may increase the prices of the products and services they provide to us with little or no notice. In particular, other clients that are larger and better financed than we are or that have long-term agreements with TSMC or ASE may cause either or both of them to reallocate capacity to those clients, decreasing the capacity available to us.

If we fail to effectively manage our relationships with the third-party manufacturers, if we are unable to secure sufficient capacity at our third-party manufacturers' facilities or if any of them should experience delays, disruptions or technical or quality control problems in our manufacturing operations or if we had to change or add additional third-party manufacturers or contract manufacturing sites, our ability to ship products to our customers could be delayed, our relationships with our customers would suffer and our market share and operating results would suffer. If our third-party manufacturers' pricing for the products and services they provide increases and we are unable to pass along such increases to our customers, our operating results would be adversely affected. Also, the addition of manufacturing locations or additional third-party subcontractors would increase the complexity of our supply chain management. Moreover, all of our product manufacturing, assembly and packaging is performed in Asian countries and is therefore subject to risks associated with doing business in these countries such as quarantines or closures of manufacturing facilities due to the outbreak of viruses such as swine flu, SARS, avian flu or any similar outbreaks. Each of these factors could harm our business and financial results.

We may not be able to effectively manage our growth or develop our financial and managerial control and reporting systems, and we may need to incur significant expenditures to address the additional operational and control requirements of our growth, either of which could harm our business and operating results.

To continue to grow, we must continue to expand and improve our operational, engineering, accounting and financial systems, procedures, controls and other internal management systems. This may require substantial managerial and financial resources and our efforts in this regard may not be successful. Our current systems, procedures and controls may not be adequate to support our future operations. For example, we implemented a new enterprise resource management system in 2008. We must integrate the operations of CopperGate into our enterprise resource management system, which could be costly and time consuming. If we fail to adequately manage our growth or to improve and develop our operational, financial and management information systems or fail to effectively motivate or manage our current and future employees, the quality of our products and the management of our operations could suffer, which could adversely affect our operating results.

Our ability to develop, market and sell products could be harmed if we are unable to retain or hire key personnel.

Our future success depends upon our ability to recruit and retain the services of key executive, engineering, finance and accounting, sales, marketing and support personnel. The supply of highly qualified individuals, in particular engineers in very specialized technical areas, or sales people specializing in the semiconductor industry, is limited and competition for such individuals is intense. None of our officers or key employees is bound by an employment agreement for any specific term. The loss of the services of any of our key employees, the inability to attract or retain key personnel in the future or delays in hiring required personnel, particularly engineers and sales people, and the complexity and time involved in hiring and training new employees, could delay the development and introduction of new products, and negatively impact our ability to market, sell or support our products.

If the recent worsening of credit market conditions continues or increases, it could have a material adverse impact on our investment portfolio.

Recent U.S. sub-prime mortgage defaults have had a significant impact across various sectors of the financial markets, causing global credit and liquidity related difficulties. Beginning mid 2007, global short-term funding markets have experienced credit issues, leading to liquidity issues and failed auctions in the auction rate securities, or ARS market. If the global credit market continues to be weak or deteriorates further, the liquidity of our investment portfolio may be impacted and we could determine that some of our investments are impaired. This could materially adversely impact our results of operations and financial condition.

Included in our marketable securities portfolio at May 1, 2010 were nine ARS that we purchased for their par value, $43.0 million, and during the three months ended May 1, 2010 and fiscal 2010, the issuers of these ARS redeemed limited portions at par value in the amount of $3.1 million and $2.2 million, respectively, from us. As a result, as of May 1, 2010, we held nine ARS with an adjusted cost and par value of $37.7 million. Subsequent to February 2008, all auctions involving the ARS in our investment portfolio have failed due to insufficient bids from buyers. If these auctions continue to fail and the credit ratings of these investments deteriorate, the fair value of these ARS may decline and we may incur impairment charges in connection with these securities which would negatively affect our reported earnings, cash flow and financial condition. Although our cash management advisor, UBS, has indicated that, absent other solutions to the limited market for our ARS, it will redeem all these securities at par value upon our request after June 30, 2010, there is a risk that their intention may not be achieved for reasons outside our control.

Litigation due to stock price volatility or other factors could cause us to incur substantial costs and divert our attention and resources.

In the past, securities class action litigation has often been brought against a company following periods of volatility in the market price of its securities. Companies such as ours in the semiconductor industry and other technology industries are particularly vulnerable to this kind of litigation due to the high volatility of their stock prices. While we are not aware of any such contemplated class action litigation against us, we may in the future be the target of securities litigation. Any future lawsuits to which we may become a party will likely be expensive and time consuming to investigate, defend and resolve. Such costs, which include investigation and defense, the diversion of our attention and resources and any losses resulting from these claims, could significantly increase our expenses and adversely affect our profitability and cash flow.

Our business may become subject to seasonality, which may cause our revenue to fluctuate.

Our business may become subject to seasonality as a result of our target markets. We sell a significant number of our semiconductor products into the consumer electronics market. Our customers who manufacture products for the consumer market typically experience seasonality in the sales of their products which in turn may affect the timing and volume of orders for our SoCs. Although we have not experienced seasonality to date in sales of our products due to the overall growth in demand for our semiconductor products, we may, in the future, experience lower sales in our first fiscal quarter and higher sales in our second fiscal quarter as a result of the seasonality of demand associated with the consumer electronics markets into which we sell our products. As a result, our operating results may vary significantly from quarter to quarter.

In the event we seek or are required to use a new manufacturer to fabricate or to assemble and test all or a portion of our SoC products, we may not be able to bring new manufacturers on-line rapidly enough, which could damage our relationships with our customers, decrease our sales and limit our growth.

We use a single wafer foundry to manufacture substantially all of our products and a single source to assemble and test substantially all of our products, which exposes us to a substantial risk of delay, increased costs and customer dissatisfaction in the event our third-party manufacturers are unable to provide us with our SoC requirements. Particularly during times when semiconductor capacity is limited, we may seek to, and in the event that our current foundry were to stop producing wafers for us altogether, we would be required to, qualify one or more additional wafer foundries to meet our requirements, which would be time consuming and costly. In order to bring any new foundries on-line, we and our customers would need to qualify their facilities which process could take as long as several months. Once qualified, each new foundry would then require an additional number of months to actually begin producing SoCs to meet our needs, by which time our perceived need for additional capacity may have passed, or the opportunities we previously identified may have been lost to our competitors. Similarly, qualifying a new provider of assembly, packaging and testing services would be a lengthy and costly process and, in both cases, they could prove to be less reliable than our existing manufacturers, which could result in increased costs and expenses as well as delays in deliveries of our products to our customers.

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

We believe that our existing cash and cash equivalents, and short-term and long-term marketable securities will be sufficient to meet our anticipated cash needs for at least the next 12 months. The timing and amount of our working capital and capital expenditure requirements may vary significantly depending on numerous factors, including:

- market acceptance of our products;

- the need to adapt to changing technologies and technical requirements;
- the existence of opportunities for expansion; and
- access to and availability of sufficient management, technical, marketing and financial personnel.

If our capital resources are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity securities or debt securities or obtain debt financing. During fiscal 2009, we used an aggregate of $85.9 million to purchase 4.2 million shares of our common stock. In November 2009, we used approximately $116.0 million in cash (which includes approximately $28.0 million of acquired CopperGate cash) for the acquisition of CopperGate. The amount of cash we used for these repurchases and the acquisition of CopperGate could limit our ability to execute our business plans and require us to raise additional capital in the future in order to fund any further repurchases or for other purposes. The sale of additional equity securities or convertible debt securities would result in additional dilution to our shareholders. Additional debt would result in increased expenses and could result in covenants that would restrict our operations. We have not made arrangements to obtain additional financing and there is no assurance that financing, if required, will be available in amounts or on terms acceptable to us, if at all.

Regional instability in Israel may adversely affect business conditions and may disrupt our operations and negatively affect our revenues and profitability.

As a result of our acquisition of CopperGate, we have engineering facilities, corporate and sales support operations and, as of November 10, 2009, we had 124 employees located in Israel. Accordingly, political, economic and military conditions in Israel may directly affect our business. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors, as well as incidents of civil unrest. In addition, Israel and companies doing business with Israel have, in the past, been the subject of an economic boycott. Although Israel has entered into various agreements with Egypt, Jordan and the Palestinian Authority, Israel has been and is subject to civil unrest and terrorist activity, with varying levels of severity since September 2000. Any future armed conflicts or political instability in the region may negatively affect business conditions and adversely affect our results of operations.

In addition, our business insurance does not cover losses that may occur as a result of events associated with the security situation in the Middle East. Although the Israeli government currently covers the reinstatement value of direct damages that are caused by terrorist attacks or acts of war, we cannot assure you that this government coverage will be maintained. Any losses or damages incurred by us could have a material adverse effect on our business and financial results.

Changes in our effective tax rate or tax liability may have an adverse effect on our results of operations.

As a global company, we are subject to taxation in Israel, Singapore, the United States and various other countries and states. Significant judgment is required to determine and estimate worldwide tax liabilities. Any significant change in our future effective tax rates could adversely impact our consolidated financial position, results of operations and cash flows. Our future effective tax rates may be adversely affected by a number of factors including:

- changes in tax laws in the countries in which we operate or the interpretation of such tax laws;
- changes in the valuation of our deferred tax assets;
- increases in expenses not deductible for tax purposes, including write-offs of acquired in-process research and development and impairment of goodwill in connection with acquisitions;
- changes in share-based compensation expense;
- changes in generally accepted accounting principles; and
- our ability to use our tax attributes such as research and development tax credits and net operating losses of acquired companies to the fullest extent.

During the first quarter of fiscal 2010, the California Budget Act of 2008 was signed into law which revised certain provisions of the California State Tax Code, including the option to elect an alternative method to attribute taxable income to California for tax years beginning on or after January 1, 2011. We now expect that in years 2011 and beyond, our income subject to tax in California will be lower than under prior tax law and that our California deferred tax assets are therefore less likely to be realized. As a result, we recorded a $3.6 million charge in the first quarter of fiscal 2010 to reduce our previously recognized California deferred tax assets.

During fiscal 2009, we established a foreign operating subsidiary in Singapore. We anticipate that a portion of our consolidated pre-tax income will be subject to foreign tax at relatively lower tax rates when compared to the United States federal statutory tax rate and, as a consequence, our effective income tax rate is expected to be lower than the

United States federal statutory rate. Our future effective income tax rates could be adversely affected if tax authorities challenge our international tax structure or if the relative mix of United States and international income changes for any reason. Accordingly, there can be no assurance that our income tax rate will be less than the United States federal statutory rate.

The income tax benefits in Israel to which we are currently entitled from our approved enterprise program may be reduced or eliminated by the Israeli government in the future and also require us to satisfy specified conditions. If they are reduced or if we fail to satisfy these conditions, we may be required to pay increased taxes and would likely be denied these benefits in the future.

The Investment Center of the Ministry of Industry, Trade and Labor has granted “approved enterprise” status to certain product development programs at our facility in Tel Aviv. Our taxable income from these approved enterprise programs is exempt from tax for a period of two years and will be subject to a reduced tax for an additional eight years thereafter, depending on the percentage of our share capital held by non-Israelis. The Israeli government may reduce, or eliminate in the future, tax benefits available to approved enterprise programs. Our approved program and the resulting tax benefits may not continue in the future at their current levels or at any level. The termination or reduction of these tax benefits would likely increase our tax liability. Additionally, the benefits available to an approved enterprise program are dependent upon the fulfillment of conditions stipulated under applicable law and in the certificate of approval. If we fail to comply with these conditions, in whole or in part, or fail to get approval in whole or in part, we may be required to pay additional taxes for the period in which we benefited from the tax exemption or reduced tax rates and would likely be denied these benefits in the future. In either case, the amount by which our taxes would increase will depend on the difference between the then applicable tax rate for non-approved enterprises and the rate of tax, if any, that we would otherwise pay as an approved enterprise, and the amount of any taxable income that we may earn in the future. The current maximum enterprise tax rate in Israel is 25%.

We reported material weaknesses in our controls over financial reporting in fiscal 2005 through 2007. If we are unable to maintain effective internal control over financial reporting, our ability to report our financial results on a timely and accurate basis may be adversely affected, which in turn could cause the market price of our common stock to decline.

As of January 30, 2010, we, including our principal executive officer and principal financial officer, assessed the effectiveness of our internal control over financial reporting. Based on this assessment, we determined that our internal control over financial reporting was effective as of January 30, 2010. However, prior to fiscal 2008, we had ongoing material weaknesses in our internal control over financial reporting since fiscal 2005, the first year in which we were required to evaluate our internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002. Further, in September 2006, we announced that our historical financial statements should no longer be relied upon as a result of our preliminary determination of an internal review relating to our practices in administering stock option grants. We continued to have material weaknesses in our internal control over financial reporting, which resulted from ineffective internal controls over financial reporting for the year ended February 2, 2007.

As we add significant operations in locations other than our headquarters, our controls must be effectively extended to those locations which involves additional attention from us and expense to implement proper controls and monitor their effectiveness. For example, we added significant operations in Israel as a result of our acquisition of CopperGate in November 2009. We must integrate CopperGate’s operations and its substantial number of employees into our operations and transition their enterprise systems into our existing systems. We plan to utilize the one-year phase-in period for operations of a material acquisition under applicable internal control over financial reporting regulations. Until we have fully integrated CopperGate into our internal control over financial reporting, we may identify material weaknesses relating to CopperGate’s controls that existed at the time of the acquisition and we may not be able effectively integrate CopperGate’s internal control into our internal control framework, either of which could cause us to identify material weaknesses in our internal control over financial reporting in future periods.

Effective controls are necessary for us to provide reliable financial reports and effectively prevent fraud. If we cannot provide reliable financial reports or prevent fraud, our operating results could be harmed and the market price of our common stock could decline. We cannot be certain that we will be able to maintain adequate controls over our financial processes and reporting in the future. If we identify any material weaknesses in the future, our ability to report our financial results on a timely and accurate basis may be adversely affected. In addition, if we cannot maintain effective internal control over financial reporting and disclosure controls and procedures, investors may lose confidence in our reported financial information which could cause the market price of our common stock to decline.

The review of our historical stock option granting practices and the restatement of our prior financial statements may result in additional litigation, regulatory proceedings and government enforcement actions, which could harm our business, financial condition, results of operations and cash flows.

Our historical stock option granting practices and the related restatement of our historical financial statements, which we completed in connection with the audit of our financial statements for fiscal 2007, exposed us to greater risks associated with litigation, regulatory proceedings and government enforcement actions. We have provided the results of our internal review and investigation of our stock option practices to the SEC, and in that regard we have responded to informal requests for documents and additional information. While we do not believe that the SEC inquiry is still active, we intend to continue to cooperate with the SEC and any other governmental agency that may become involved in this matter. We cannot give any assurance regarding the outcomes from regulatory proceedings or government enforcement actions relating to our past stock option practices. These matters could be time consuming, expensive and may distract us from the conduct of our business. Furthermore, if we are subject to adverse findings in regulatory proceedings or government enforcement actions, we could be required to pay damages or penalties or have other remedies imposed, which could harm our business, financial condition, results of operations and cash flows.

Risks Related to Our Common Stock

Our operating results are subject to significant fluctuations due to many factors and any of these factors could adversely affect our stock price.

Our operating results have fluctuated in the past and may continue to fluctuate in the future due to a number of factors, including:

- the loss of one or more significant customers;
- changes in our pricing models and product sales mix;
- unexpected reductions in unit sales and average selling prices, particularly if they occur precipitously;
- new product introductions by us and our competitors;
- the level of acceptance of our products by our customers and acceptance of our customers' products by their end user customers;
- an interrupted or inadequate supply of semiconductor chips or other materials included in our products;
- availability of third-party manufacturing capacity for production of certain products;
- shifts in demand for the technology embodied in our products and those of our competitors;
- the timing of, and potential unexpected delays in, our customer orders and product shipments;
- write-downs of accounts receivable;
- inventory obsolescence;
- a significant increase in our effective tax rate in any particular period as a result of the exhaustion, disallowance or accelerated recognition of our net operating loss carryforwards or otherwise;
- technical problems in the development, production ramp up and manufacturing of products, which could cause shipping delays;
- the impact of potential economic instability in the United States and Asia-Pacific region, including the continued effects of the recent worldwide economic slowdown;
- expenses related to implementing and maintaining a new enterprise resource management system and other information technologies; and
- expenses related to our compliance efforts with Section 404 of the Sarbanes-Oxley Act of 2002.

In addition, the market prices of securities of semiconductor and other technology companies have been volatile. This volatility has significantly affected the market prices of securities of many technology companies for reasons frequently unrelated to the operating performance of the specific companies.

Accordingly, you may not be able to resell your shares of common stock at or above the price you paid. In the past, we and other companies that have experienced volatility in the market price of their securities have been, and in the future we may be, the subject of securities class action litigation.

Our stock price has demonstrated volatility and continued volatility in the stock market may cause further fluctuations or decline in our stock price.

The market for our common stock has been subject to significant volatility which is expected to continue. For example, the high and low selling prices per share of our common stock on the NASDAQ Global Market ranged from a high of $13.00 on March 4, 2010 to a low of $10.40 on February 10, 2010 during the three months ended May 1, 2010. During fiscal 2010, the high and low selling prices per share of our common stock on the NASDAQ Global Market ranged from a high of $17.63 on June 22, 2009 to a low of $9.59 on February 3, 2009. This volatility is often unrelated or disproportionate to our operating performance. These fluctuations, as well as general economic and market conditions, could cause the market price of our common stock to decline.

If securities or industry analysts do not publish research or reports about our business, or if they issue an adverse opinion regarding our stock, our stock price and trading volume could decline.

The trading market for our common stock is influenced by the research and reports that industry or securities analysts publish about us or our business. If one or more of the analysts who cover us issue an adverse opinion regarding our stock, our stock price would likely decline. If one or more of these analysts cease coverage of Sigma or fail to regularly publish reports on us, we could lose visibility in the financial markets which in turn could cause our stock price or trading volume to decline.

Provisions in our organizational documents, our shareholders rights agreement and California law could delay or prevent a change in control of Sigma that our shareholders may consider favorable.

Our articles of incorporation and bylaws contain provisions that could limit the price that investors might be willing to pay in the future for shares of our common stock. Our Board of Directors can authorize the issuance of preferred stock that can be created and issued by our Board of Directors without prior shareholder approval, commonly referred to as "blank check" preferred stock, with rights senior to those of our common stock. The rights of the holders of our common stock will be subject to, and may be adversely affected by, the rights of the holders of any preferred stock that we may issue in the future. The issuance of preferred stock could have the effect of delaying, deterring or preventing a change in control and could adversely affect the voting power of your shares. In addition, our Board of Directors has adopted a shareholder rights plan that provides each share of our common stock with an associated right to purchase from us one one-thousandth share of Series D participating preferred stock at a purchase price of $58.00 in cash, subject to adjustment in the manner set forth in the rights agreement. The rights have anti-takeover effects in that they would cause substantial dilution to a person or group that attempts to acquire a significant interest in Sigma on terms not approved by our Board of Directors. In addition, provisions of California law could make it more difficult for a third party to acquire a majority of our outstanding voting stock by discouraging a hostile bid or delaying or deterring a merger, acquisition or tender offer in which our shareholders could receive a premium for their shares or a proxy contest for control of Sigma or other changes in our management.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

ITEM 4. (Reserved and Removed)

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

(a) Exhibits

The following exhibits are filed herewith:

31.1 Certification of the President and Chief Executive Officer pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as adopted pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.

31.2 Certification of the Chief Financial Officer and Secretary pursuant to Exchange Act Rule 13a-14(a) or 15d-14(a), as adopted pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.

32.1 Certificate of President and Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (1)

32.2 Certificate of Chief Financial Officer and Secretary pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. (1)

(1) The certificates contained in Exhibits 32.1 and 32.2 are not deemed “filed” for purposes of Section 18 of the Securities and Exchange Act of 1934 and are not to be incorporated by reference into any filing of the registrant under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof irrespective of any general incorporation by reference language contained in any such filing, except to the extent that the registration specifically incorporates it by reference.

SIGNATURES

Pursuant to the requirement 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.

| | | |
|---|---|---|
| | SIGMA DESIGNS, INC. | |
| Date: June 9, 2010 | | |
| | By: | /s/ Thinh Q. Tran<br>Thinh Q. Tran<br><br>Chairman of the Board, President and Chief Executive Officer (Principal Executive Officer) |
| | By: | /s/ Thomas E. Gay III<br>Thomas E. Gay III<br><br>Chief Financial Officer and Secretary<br>(Principal Financial and Accounting Officer) |

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