

Edgar Filing: VIALTA INC - Form 10-Q

VIALTA INC  
Form 10-Q  
November 13, 2001

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the quarterly period ended September 30, 2001.

OR

Transitional Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

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

Commission file number 0-32809

VIALTA, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

Delaware 94-3337326  
(State or Other Jurisdiction of (I.R.S. Employer Identification No.)  
Incorporation or Organization)

48461 Fremont Boulevard  
Fremont, California 94538  
(Address, including zip code, of Registrant's principal executive offices)

(510) 870-3088  
(Registrant's telephone number, including area code)

Indicate by check whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

The number of outstanding shares of the registrant's Class A common stock, par value \$0.001 per share, on November 7, 2001 was 46,656,636 shares. The number of outstanding shares of the registrant's Class B common stock, par value \$0.001 per share, on November 7, 2001 was 40,580,375 shares.

VIALTA, INC.

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## PART I. FINANCIAL INFORMATION

### ITEM 1: FINANCIAL STATEMENTS

VIALTA, INC.  
(A Development Stage Company)  
CONSOLIDATED BALANCE SHEETS  
(UNAUDITED)  
(in thousands, except per share amounts)

	SEPTEMBER 30, 2001	DECEMBER 31, 2000
	-----	-----
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 72,722	\$ 109,378
Short-term investments	4,806	27,112
Receivables from related party	--	650
Inventories	3,443	2,057
Prepaid expenses and other current assets	6,044	4,207
	-----	-----
Total current assets	87,015	143,404

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Property and equipment, net	9,279	9,230
Long term investments	4,582	--
Other assets	324	1,057
	-----	-----
Total assets	\$ 101,200	\$ 153,691
	=====	=====
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS' EQUITY (DEFICIT)		
Current liabilities:		
Accounts payable	\$ 927	\$ 1,376
Accrued expenses and other current liabilities	2,750	2,218
Payable to related party	901	30,000
	-----	-----
Total current liabilities	4,578	33,594
	-----	-----
Redeemable convertible preferred stock, \$0.001 par value; 30,000 shares authorized, 0 and 91,000 shares issued and outstanding, at September 30, 2001 and December 31, 2000, respectively		
	--	142,600
	-----	-----
Stockholders' equity (deficit):		
Common stock \$0.001 par value, 400,000 shares authorized, 91,536 and 6,231 shares issued, 90,048 and 6,231 shares outstanding at September 30, 2001 and December 31, 2000 respectively	92	6
Additional paid in capital	144,160	1,629
Treasury stock	(290)	--
Other comprehensive income	155	--
Deficit accumulated during the development stage	(47,495)	(24,138)
	-----	-----
Total stockholders' equity (deficit)	96,622	(22,503)
	-----	-----
Total liabilities, redeemable convertible preferred stock and stockholders' equity (deficit)	\$ 101,200	\$ 153,691
	=====	=====

The accompanying notes are an integral part of these Consolidated Financial Statements.

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	Three Months Ended		Nine Months Ended	
	September 30, 2001	September 30, 2000	September 30, 2001	September 30, 2000
Operating expenses:				
Research and development	\$ 5,446	\$ 3,733	\$ 15,337	\$ 13,446
Selling and marketing	838	816	2,995	1,944
General and administrative	2,412	1,935	7,016	4,844
Operating expenses:	8,696	6,484	25,348	20,234
Operating loss	(8,696)	(6,484)	(25,348)	(20,234)
Interest income	801	1,944	3,086	5,944
Interest expense	--	--	--	--
Operating expenses (net)	(1,097)	(1,679)	(1,101)	(1,334)
Loss before income tax benefit	(8,992)	(6,219)	(23,363)	(15,734)
Income tax benefit	--	65	--	1,000
Net loss	\$ (8,992)	\$ (6,154)	\$ (23,363)	\$ (15,534)
Net loss per share attributable to common shares -- basic and diluted	\$ (0.13)	\$ (0.99)	\$ (0.35)	\$ (2.00)
Weighted average common shares outstanding	67,497	6,220	67,201	6,220

The accompanying notes are an integral part of these Consolidated Financial Statements.

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VIALTA, INC.  
(A Development Stage Company)  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(UNAUDITED)  
(in thousands)

	NINE MONTHS ENDED	
	SEPTEMBER 30, 2001	SEPTEMBER 2000
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net loss	\$ (23,363)	\$ (15,534)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	3,941	1,700

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Write-down of long-term investment	1,083	1,6
Income tax benefit on disqualifying disposition of common stock options	(77)	
Unrealized gain on marketable securities	155	
Non-cash interest receivable	158	
Changes in assets and liabilities:		
Prepaid expenses and other current assets	(1,972)	(1,6
Receivable from ESS	1,551	4
Receivable/payable from/to other related party	60	(
Inventories	(1,386)	(4,4
Other assets	--	
Accounts payable and accrued liabilities	62	3,0
Net cash used in operating activities	(19,711)	(14,8
 CASH FLOWS FROM INVESTING ACTIVITIES:		
Acquisition of property and equipment	(1,754)	(4,1
Purchase of marketable securities	(9,389)	(44,0
Proceeds from sale of marketable securities	27,113	22,3
Purchase of long-term investments	(2,641)	(4,0
	-----	-----
Net cash provided by investing activities	13,329	(29,9
	-----	-----
 CASH FLOWS FROM FINANCING ACTIVITIES:		
Repayment of notes payable to related party	(30,000)	
Proceeds from issuance of preferred stock-	--	27,8
Proceeds from issuance of common stock	16	1,4
Repurchase of common stock	(290)	(2
	-----	-----
Net cash provided by financing activities	(30,274)	29,2
	-----	-----
 Net increase (decrease) in cash and cash equivalents	(36,656)	(15,4
Cash and cash equivalents at beginning of period	109,378	90,5
	-----	-----
Cash and cash equivalents at end of period	\$ 72,722	\$ 75,0
	-----	-----
 SUPPLEMENTAL NONCASH FINANCING ACTIVITY:		
Issuance of note receivable in connection with issuance of common stock		
 SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid for interest	194	
	=====	

The accompanying notes are an integral part of these Consolidated Financial Statements.

NOTE 1. THE COMPANY

Vialta, Inc. ("Vialta or The Company") was incorporated in California in April 1999. Vialta has developed a multi-purpose DVD player ("ViDVD") that offers Internet access and other features, such as CD, MP3, karaoke, and support for other audio and video formats. These features differentiate it from most DVD players currently available in the U.S. consumer market. This ViDVD player is the first product offering from Vialta's "Digital Home System" platform, which

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the Company anticipates will grow to support a family of multimedia Internet appliances. Vialta commenced shipments of the ViDVD through retail distribution channels in the third quarter of 2001, but no revenue will be recognized until contractual obligations under the sales agreements have been satisfied.

On April 21, 2001, the board of directors of ESS Technology, Inc. ("ESS") approved the spin-off of ESS's interest in Vialta to ESS's shareholders. The transaction was completed on August 21, 2001 when ESS distributed approximately 50,560,328 shares of Class A common stock of Vialta, Inc., resulting in Vialta operating as a stand alone business, independent from ESS.

On May 25, 2001, Vialta was reincorporated in the State of Delaware. As part of the reincorporation, Vialta was authorized to issue 180,000,000 shares of preferred stock, \$0.001 par value per share, and 300,000,000 shares of common stock, \$0.001 par value per share. All common stock and preferred stock amounts in the accompanying financial statements have been restated to give effect to the reincorporation.

Since its inception, Vialta has been in the development stage. Vialta has been successful in completing its private equity financing with its last round totaling approximately \$132.6 million. However, Vialta has incurred substantial losses and negative cash flows from operations in every fiscal period since inception. For the cumulative period ended September 30, 2001, Vialta incurred a loss from operations of approximately \$57.1 million (unaudited) and negative cash flows from operations of \$41.6 million (unaudited). Management expects operating losses and negative cash flows to continue for the foreseeable future and anticipates that losses will increase significantly from current levels because of additional costs and expenses related to marketing activities, continued expansion of operations, continued development of Vialta's web site and information technology infrastructure, expansion of product offerings and development of relationships with other businesses. Management believes that Vialta has sufficient cash, cash equivalents, and short term investments to fund its development and growth. However, in the longer term, failure to generate sufficient revenues, raise additional capital or reduce certain discretionary spending could have a material adverse effect on Vialta's ability to achieve its intended business objectives

### NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

#### Basis of presentation

The accompanying financial statements include the consolidated accounts of Vialta and its wholly owned subsidiaries. The accompanying unaudited Financial Statements have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles ("GAAP") have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the financial statements reflect only those normal recurring adjustments necessary for a fair statement of the financial position, operating results and cash flows of the Company for the periods presented. These Consolidated Financial Statements should be read in conjunction with the Consolidated Financial Statements and notes thereto for the year ended December 31, 2000 and the period from April 1999 (date of inception) through December 31, 1999, included in the Company's Form 10. The results of operations for this interim period are not necessarily indicative of the results that may be expected for any other period or for the fiscal year, which ends December 31, 2001.

#### Interim unaudited information

Preparing the Company's financial statements in accordance with GAAP requires

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management to make estimates and assumptions that affect the reported amount of assets and liabilities, disclosure of contingent assets and liabilities at the close of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates. Certain reclassifications have been made to present the financial statements on a consistent basis.

### Recent accounting pronouncements

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In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 141 ("SFAS 141"), "Business Combinations." SFAS 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interests method. The adoption of SFAS 141 does not have a significant impact on our financial statements.

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets", which is effective for fiscal years beginning after December 15, 2001. SFAS 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the standard includes provisions upon adoption for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the testing for impairment of existing goodwill and other intangibles. The adoption of SFAS 142 will not have a significant impact on our financial position and results of operations.

On October 3, 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". SFAS 144 supercedes SFAS 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30. SFAS 144 develops one accounting model for long-lived assets that are to be disposed of by sale. SFAS 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, SFAS 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS 144 is effective for the Company for all financial statements issued in fiscal 2002. We are currently assessing the impact of SFAS 144 on our financial position and results of operations.

### NOTE 3: RECAPITALIZATION OF EQUITY

On July 24, 2001, Vialta was re-capitalized, pursuant to which it separated its common stock into Class A common stock with 3.8 votes per share and Class B common stock with one vote per share. Upon exchange of 5,891,000 shares of common stock for Class B common stock, Vialta issued 589,000 additional shares of Class B common stock to non-ESS common stockholders. Besides the voting power, Class A and Class B stockholders have the same rights. Vialta authorized 30,000,000 shares of preferred stock and 400,000,000 shares of common stock, 100,000,000 shares of which are designated Class A common stock, 50,000,000 of which are designated Class B common stock and 250,000,000 of which are designated non-classified common stock.

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As part of the spin-off transaction, all preferred stock owned by ESS converted to Class A common stock based on a ration of 1 to 1. All other preferred stock converted to Class B common stock based on a ratio of 1.1 to 1. As a result, 91,000,000 shares of preferred stock were converted to 60,000,000 shares of Class A common stock and 34,100,000 shares of Class B common stock.

As part of the spin-off transaction, ESS returned 9,818,000 shares of Class A common stock to Vialta at no cost. These shares are reserved by Vialta for issuance upon exercise of stapled stock options that were granted by Vialta to ESS optionees as part of the spin-off transaction. In accordance with FIN 44, no compensation expense will result from these stock option grants.

### NOTE 4. BALANCE SHEET COMPONENTS (IN THOUSANDS)

	September 30, 2001 -----	December 31, 2000 -----
INVENTORY		
Raw Materials	\$ 3,327	\$ 1,853
Finished Goods	116	204
	-----	-----
	\$ 3,443	\$ 2,057
	=====	=====
PROPERTY AND EQUIPMENT		
Machinery and equipment	\$ 6,973	\$ 6,275
Furniture and fixtures	1,723	1,212
Software and web site development cost	5,026	4,246
	-----	-----
	13,722	11,733
Less: Accumulated Depreciation	(4,443)	(2,503)
	-----	-----
	\$ 9,279	\$ 9,230
	=====	=====

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	September 30, 2001 -----	December 31, 2000 -----
ACCRUED EXPENSES AND OTHER CURRENT LIABILITIES		
Accrued payroll and compensation expenses	\$ 2,422	\$ 2,178
Other	328	40
	-----	-----
	\$ 2,750	\$ 2,218
	=====	=====
OTHER ASSETS		
Investment	\$ 321	\$ 997
Deposit	3	--
Receivable from related party	--	60
	-----	-----



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\$ 324  
=====

\$ 1,057  
=====

NOTE 5. EARNINGS PER SHARE

EPS are calculated in accordance with the provisions of Statement of Financial Accounting Standards No. 128 "Earnings per Share" ("SFAS No. 128"). SFAS No. 128, requires the Company to report both basic EPS, which are based on the weighted-average number of common shares outstanding, and diluted earnings per share, which are based on the weighted average number of common shares outstanding and all dilutive potential common shares outstanding. Diluted EPS reflects the potential dilution that would occur if securities or other contracts to issue common stock were exercised or converted into common stock.

	Three Months Ended			
	September 30, 2001		September 30, 2000	
	Net Income	Shares	Per Share Amount	Net Income
Basic and Diluted EPS	\$ (8,992)	67,497	\$ (0.13)	\$ (6,154)

	Nine Months Ended			
	September 30, 2001		September 30, 2000	
	Net Income	Shares	Per Share Amount	Net Income
Basic and Diluted EPS	\$ (23,363)	67,201	\$ (0.35)	\$ (15,510)

The following table sets forth potential shares of common stock that are not included in the diluted net loss per share calculation above because to do so would be antidilutive for the periods indicated (in thousands):

	As of September 30, 2001
Effect of common stock equivalents:	
Options outstanding	13,581
Shares resulting from the conversion of the preferred stock	--

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Total common stock equivalents excluded from the computation of basic and diluted earnings per share as their effect was antidilutive

13,581  
=====

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NOTE 6. TRANSACTIONS WITH AFFILIATES

Effective August 1, 1999, the Company entered into a Research and Development Service Agreement with ESS whereby ESS provides certain research and development services to the Company in exchange for a service fee. In addition, the Company signed a reciprocal agreement with ESS whereby Vialta provides certain non-recurring expense services for the design and development of Internet related products and technologies to ESS in exchange for a service fee. In the periods presented, the Company did not provide such services to ESS.

Effective August 1, 1999, the Company entered into an Administrative and Management Service Agreement with ESS whereby ESS provides certain administrative and managerial services to Vialta including, without limitation, sales support, marketing support, production and logistical support, financial oversight, accounting assistance, contract review, personnel services (including training of employees) and such other general and administrative services as Vialta requires. ESS performs these services in consideration for a service fee. In addition, Vialta signed a reciprocal agreement whereby Vialta provides the services mentioned above to ESS in exchange for a service fee. In the periods presented, Vialta did not provide such services to ESS.

Effective August 1, 1999, the Company entered into a Purchase Agreement with ESS whereby Vialta will purchase certain products from ESS.

In January 2000, Vialta entered into an Assignment of Intellectual Property Agreement with ESS whereby Vialta paid ESS \$2.0 million for the transfer of the Videophone and EnReach-based web browser technologies. Such transfer was done based on actual costs incurred.

On August 20, 2001, Vialta re-executed certain existing agreements with ESS as a result of the spin-off of Vialta from ESS.

On August 20, 2001, Vialta entered into a Commercial Lease Agreement with ESS whereby ESS will lease a freestanding building in Fremont, California to Vialta for a fixed monthly fee. The terms of the lease expire on December 31, 2003.

On August 20, 2001, Vialta entered into an Employee Matters Agreement with ESS whereby Vialta will continue to provide employment and employee benefits to all active employees and former employees subject to certain limitations.

The Company anticipates that it will continue to receive such services from ESS under the terms of the agreements. The following is a summary of major transactions that resulted in charges by ESS to Vialta for the periods presented (in thousands):

	Three Months Ended	
Intercompany Agreements	September 30,	September 30,
	2001	2000

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Research and Development Service Agreement	\$ 626	\$ 672
Administrative and Management Service Agreement	848	745
Assignment of Intellectual Property Agreement	--	--
Purchase Agreement	--	245
Commercial Lease Agreement	\$ 155	\$ --
	-----	-----
Total	\$1,629	\$1,662
	=====	=====

NOTE 7. SEGMENT AND GEOGRAPHIC INFORMATION

Vialta operates as one segment. Information about long-lived assets is as follows (amounts in thousands):

	September 30, 2001	December 31, 2000
	-----	-----
United States	\$8,661	\$ 9,362
Hong Kong	40	32
Canada	902	833
	-----	-----
Total long-lived assets, excluding investments	\$9,603	\$10,227
	=====	=====

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

THE FOLLOWING DISCUSSION INCLUDES FORWARD-LOOKING STATEMENTS WITH RESPECT TO OUR FUTURE FINANCIAL PERFORMANCE. ACTUAL RESULTS MAY DIFFER MATERIALLY FROM THOSE CURRENTLY ANTICIPATED DEPENDING ON A VARIETY OF FACTORS, INCLUDING THOSE DESCRIBED BELOW UNDER THE SUB-HEADING, "FUTURE PERFORMANCE AND RISK FACTORS" AND DISCUSSED MORE FULLY IN OUR REGISTRATION STATEMENT ON FORM 10 FILED MAY 25, 2001 AND LAST AMENDED ON AUGUST 6, 2001. THIS FOLLOWING DISCUSSION SHOULD BE READ IN CONJUNCTION WITH THE UNAUDITED FINANCIAL STATEMENTS AND NOTES THERETO IN ITEM 1 OF THIS QUARTERLY REPORT AND THE AUDITED CONSOLIDATED FINANCIAL STATEMENTS AND NOTES THERETO AND MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS FOR THE FISCAL YEARS ENDED DECEMBER 31, 2000 AND 1999 CONTAINED IN SUCH FORM 10.

OVERVIEW

We were incorporated as a wholly-owned subsidiary of ESS on April 20, 1999. We have developed a multi-featured DVD player that offers Internet access and other features that differentiate it from most DVD players currently available in the U.S. consumer market. Our ViDVD player is the first product offering from our "Digital Home System" platform, which we anticipate will grow to support a family of multimedia Internet appliances, as well as a complementary system for the delivery of home entertainment content. The ViDVD is a multi-purpose home entertainment device that enables consumers to play DVD, CD, MP3, karaoke, Kodak Picture CD and other audio and video formats and to

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browse the Internet through their television. The ViDVD also will be compatible with our proprietary, encrypted ViMedia discs, which will provide consumers with the opportunity to select and purchase one or more selections from a variety of videos, karaoke titles and other home entertainment content. Our goal is to make the ViDVD the centerpiece of consumers' home entertainment systems, combining Internet access with the features of several current consumer electronics devices into a single affordable product.

We have had no revenues from operations and have historically used vendor credit and private offerings of convertible preferred stock and common stock to fund our operations and provide for capital requirements during our development stage. For the three months ended September 30, 2001 and September 30, 2000, we had net losses of \$9.0 million and \$6.2 million, respectively, and expect to continue to incur losses in the fourth quarter of 2001. The losses reflect our cash burn rate for the periods indicated. From inception through September 30, 2001, we had a net loss of \$47.5 million. We commenced shipments of the ViDVD during the third quarter of 2001 and, as a result, experienced a significant increase in working capital requirements due to internal and channel inventory requirements, which were partially offset by extended credit terms from suppliers.

### RESULTS OF OPERATIONS

THREE MONTHS ENDED SEPTEMBER 30, 2001 COMPARED WITH THE THREE MONTHS ENDED SEPTEMBER 30, 2000

The following table discloses key elements of the statements of operations, expressed as a percentage of total operating expenses.

	THREE MONTHS ENDED	
	SEPTEMBER 30, 2001	SEPTEMBER 30, 2000
Operating expenses:		
Research and development	62.6 %	57.6 %
Sales and marketing	9.7	12.6
General and administrative	27.7	29.8
	-----	-----
Operating loss	100.0 %	100.0 %
Non-operating income (expense), net	(3.4)	4.1
	-----	-----
Loss before income tax benefit	103.4	95.9
Income tax benefit	--	1.0
	-----	-----
Net loss	103.4 %	94.9 %
	=====	=====

Research and Development. Research and development expenses were \$5.4 million for the three months ended September

30, 2001, or 62.6% of operating expenses, compared to \$3.7 million, or 57.6% of operating expenses for the three months ended September 30, 2000. The increase was primarily in payroll and related expenses due to increased headcount and operating supplies as we have expanded development efforts. We expect research

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and development spending to be lower in future periods since we have completed the core development of our first series of products.

**Sales and Marketing.** Sales and marketing expenses were \$0.8 million for the three months ended September 30, 2001, or 9.7% of operating expenses, compared to approximately \$0.8 million, or 12.6% of operating expenses, for the three months ended September 30, 2000. Increases in payroll and marketing expenses due to increased headcount and product introduction were offset by lower infrastructure allocations. We expect sales and marketing spending to increase in future periods as we increase our sales and marketing activities for brand and channel development.

**General and Administrative.** General and administrative expenses were \$2.4 million for the three months ended September 30, 2001, or 27.7% of operating expenses, compared to \$1.9 million, or 29.8% of operating expenses, for the three months ended September 30, 2000. The increase was primarily due to increases in payroll and other expenses due to increased headcount and administrative fees as we have supported expanded development efforts. We expect general and administrative expense spending to increase in future periods as we continue to build our infrastructure to meet our administrative and operational needs as a stand-alone company.

**Non-operating Income (Expense).** Net non-operating expense was \$0.3 million for the three months ended September 30, 2001 compared to net non-operating income of \$0.3 million for the three months ended September 30, 2000. Net non-operating income consists primarily of net interest income and loss on investments. Net interest income totaled \$0.8 million and \$1.9 million for the quarters ending September 30, 2001 and 2000, respectively. The decrease in net interest income was due to lower cash balances for the three months ended September 30, 2001.

Interest income was offset by a write off of investments in the amount of \$1.1 million in the third quarter of 2001. In the third quarter of 2000, we wrote off an investment in the amount of \$1.7 million. In both instances, we wrote off investments because we concluded that the investments had suffered an other than temporary decline in value based on our assessment of the financial condition of the companies in which we had invested and the markets that they serve.

**Income Tax Provision (Benefit).** Because of pre-tax losses, there was no provision for income taxes for the three months ended September 30, 2001 compared to recording an income tax benefit of \$65,000 for the three months ended September 30, 2000. The income tax benefit for the three months ended September 30, 2000 was a reimbursement of \$65,000 from ESS pursuant to tax arrangements between ESS and us as a result of ESS realizing a tax benefit for utilizing our net operating losses in the three months ended September 30, 2000. No tax benefit has been recognized during the three months ended September 30, 2001 since ESS does not expect to benefit during 2001 from our net operating losses. Also, we do not expect any tax expenses during 2001 because we do not anticipate any net taxable income during this year.

**Net Loss.** We incurred a net loss of \$9.0 million for the three months ended September 30, 2001, compared to \$6.2 million for the three months ended September 30, 2000. The \$2.8 million increase in net loss was primarily due to increased operating expenses associated with our going into production with ViDVD, increased development in ViMedia and internal infrastructure.

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The following table discloses key elements of the statements of operations, expressed as a percentage of total operating expenses.

	NINE MONTHS ENDED	
	-----	
	SEPTEMBER 30, 2001	SEPTEMBER 30, 2000
Operating expenses:		
Research and development	60.5 %	66.3 %
Sales and marketing	11.8	9.8
General and administrative	27.7	23.9
	----	----
Operating loss	100.0 %	100.0 %
 Non-operating income, net	 7.8	 22.5
	----	----
Loss before income tax benefit	92.2	77.5
Income tax benefit	--	1.0
	----	----
Net loss	92.2 %	76.5 %
	====	====

**Research and Development.** Research and development expenses were \$15.3 million for the nine months ended September 30, 2001, or 60.5% of operating expenses, compared to \$13.4 million, or 66.3% of operating expenses for the nine months ended September 30, 2000. The increase was primarily due to increases in payroll and related expenses due to increased headcount and operating supplies as we have expanded development efforts. The increase was offset by a nonrecurring purchase of technology from ESS, then a related party, in the amount of \$2.0 million in the first quarter of 2000. We expect research and development spending to be lower in future periods since we have completed the core development of our first series of products.

**Sales and Marketing.** Sales and marketing expenses were \$3.0 million for the nine months ended September 30, 2001, or 11.8% of operating expenses, compared to \$2.0 million, or 9.8% of operating expenses, for the nine months ended September 30, 2000. The increase was primarily due to increases in payroll and marketing expenses due to increased headcount and product introduction. We expect sales and marketing spending to increase in future periods as we increase our sales and marketing activities for brand and channel development.

**General and Administrative.** General and administrative expenses were \$7.0 million for the nine months ended September 30, 2001, or 27.7% of operating expenses, compared to \$4.9 million, or 23.9% of operating expenses, for the nine months ended September 30, 2000. The increase was primarily due to increases in payroll and other expenses due to increased headcount and administrative fees as we have supported expanded development efforts. We expect general and administrative expense spending to increase in future periods as we have built our infrastructure to meet our administrative and operational needs as a stand-alone company.

**Non-operating Income.** Net non-operating income was \$2.0 million for the nine months ended September 30, 2001 compared to \$4.6 million for the nine months ended September 30, 2000. Net non-operating income consists primarily of net interest income and loss on investments. Net interest income fell to \$3.1 million for the nine months ended September 20, 2001 from \$5.9 million for the nine months ended September 30, 2000. The decrease in net interest income was due to lower cash balances for the nine months ended June 30, 2001.

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Partially offsetting interest income were investment write offs in an amount of \$1.1 million for the nine months ending September 30, 2001 and \$1.7 million for the nine months ending September 30, 2000. We wrote these investments off because we concluded that the investments had suffered an other than temporary decline in value based on our assessment of the financial condition of the companies in which we had invested and the markets that they serve.

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Income Tax Provision (Benefit). Because of pre-tax losses, there was no provision for income taxes for the nine months ended September 30, 2001 compared to recording an income tax benefit of \$195,000 for the nine months ended September 30, 2000. The income tax benefit for the nine months ended September 30, 2000 was a reimbursement of \$195,000 from ESS pursuant to tax arrangements between ESS and us as a result of ESS realizing a tax benefit for utilizing our net operating losses in the nine months ended September 30, 2000. No tax benefit has been recognized during the nine months ended September 30, 2001 since ESS does not expect to benefit during 2001 from our net operating losses. Also, we do not expect any tax expenses during 2001 because we do not anticipate any net taxable income during this year.

Net Loss. We incurred a net loss of \$23.4 million for the nine months ended September 30, 2001, compared to \$15.5 million for the nine months ended September 30, 2000. The \$7.9 million increase in net loss was primarily due to increased operating expenses associated with our going into production with ViDVD, increased development of ViMedia and internal infrastructure coupled with lower interest income associated with lower cash balances for the nine months ending September 30, 2001.

### LIQUIDITY AND CAPITAL RESOURCES

As of September 30, 2001, we had \$82.1 million in cash, cash equivalents and marketable securities compared to \$136.5 million as of December 31, 2000, representing a decrease of \$54.4 million. The December 31, 2000 figure includes proceeds from a \$30.0 million loan from a related party controlled by Annie M.H. Chan, the spouse of Fred S.L. Chan, our Chairman. The \$30.0 million short-term loan along with \$194,000 in accrued interest was repaid in January 2001.

Our principal sources of liquidity were cash, cash equivalents and short-term investments. Net cash used in operating activities was approximately \$19.7 million and \$14.8 million for the nine months ended September 30, 2001 and September 30, 2000, respectively, representing an increase of approximately \$4.9 million. The increase was primarily due to increased operating expenses incurred by us in our efforts to complete development of our first commercial products and prepare for the product launch by September 2001. For the nine months ended September 30, 2001 and 2000, we incurred net losses of \$23.4 million and \$15.5 million, respectively, and we expect to continue to incur losses in the fourth quarter of 2001. The losses reflect our cash burn rate for the periods indicated. We began shipment of our first product during the third quarter of 2001 and, as a result, we experienced a significant increase in working capital requirements due to internal and channel inventory requirements, which increases were partially offset by extended credit terms from suppliers.

The Company generated \$13.3 million net cash through its investing activities for the nine months ended September 30, 2001. The Company's cash increased by \$27.1 million through its sale of marketable securities and decreased by \$9.4 million through its purchase of marketable securities.

The Company used \$30.3 million net cash through its financing activities

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for the nine months ended September 30, 2001. The Company's cash decreased by \$30.0 million due to repayment of a note payable to related party and by \$290,000 due to repurchase of common stock.

We believe that our existing cash and cash equivalents as of September 30, 2001 will be sufficient to fund acquisitions of inventory, property and equipment and provide adequate working capital through at least the 12-month period ending September 30, 2002. However, to achieve our longer term goals of introducing additional products and services to consumers beyond September 30, 2002, we believe we will need to raise additional capital, which may not be available on acceptable terms, if at all. Capital expenditures for the 12-month period ending September 30, 2002 are anticipated to be approximately \$24.0 million to be used primarily for the acquisition of media content licenses and capital equipment. Net inventory build requirements are expected to be approximately \$25.5 million during the 12-month period ending September 30, 2002. We may also utilize cash to acquire or invest in complementary businesses or products or to obtain the right to use complementary technologies and media content which may significantly increase our planned requirements for capital. In addition, from time to time, in the ordinary course of business, we may evaluate potential acquisitions of or investments in such businesses, products or technologies owned by third parties.

We have historically used vendor credit as well as private offerings of convertible preferred stock and common stock to fund operations and provide for capital requirements during the development stage. We believe our current cash and cash equivalents together with future private and public equity offerings, as well as private debt offerings including bank financing and credit lines and leases will be sufficient to fund future operations plus planned and unplanned capital and investment activities. However, the price per share of any future equity-related financing will be determined at about the time the offering is made and cannot be determined or anticipated at this time. If additional funds are raised through the issuance of equity securities, the percentage ownership of current stockholders may be reduced and such equity securities may have rights, preferences or privileges senior to those of current stockholders. We cannot assure you that additional financing will be available or that, if available, it can be obtained on terms favorable to us and our stockholders. If adequate funds are not available if and when needed, we would be required to delay, limit or eliminate some or all of our proposed operations.

### RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 141 ("SFAS 141"), "Business Combinations." SFAS 141 requires the purchase method of accounting for business combinations initiated after June 30, 2001 and eliminates the pooling-of-interests method. The adoption of SFAS 141 does not have a significant impact on our financial statements.

In July 2001, the FASB issued Statement of Financial Accounting Standards No. 142 ("SFAS 142"), "Goodwill and Other Intangible Assets", which is effective for fiscal years beginning after December 15, 2001. SFAS 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the standard includes provisions upon adoption for the reclassification of certain existing recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and the testing for impairment of existing goodwill and other intangibles. The adoption of SFAS 142 will not have a significant impact on our financial position and results of operations.

On October 3, 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets". SFAS 144 supercedes SFAS 121,



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"Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to Be Disposed Of." SFAS 144 applies to all long-lived assets (including discontinued operations) and consequently amends Accounting Principles Board Opinion No. 30. SFAS 144 develops one accounting model for long-lived assets that are to be disposed of by sale. SFAS 144 requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, SFAS 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS 144 is effective for the Company for all financial statements issued in fiscal 2002. We are currently assessing the impact of SFAS 144 on our financial position and results of operations.

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### FUTURE PERFORMANCE AND RISK FACTORS

Our future business, operating results and financial condition are subject to various risks and uncertainties, including those described below.

IF OUR RETAIL LAUNCH IS UNSUCCESSFUL, OR IF THE ViDVD DOES NOT ACHIEVE BROAD MARKET ACCEPTANCE, WE MAY NOT BE ABLE TO CONTINUE OPERATING OUR BUSINESS.

Our success is highly dependent upon a successful retail launch of our initial Digital Home System product, the ViDVD, which began shipping in the third quarter of 2001. A successful retail launch requires, among other things, that we:

- coordinate all of the logistical elements necessary to complete the launch in a timely manner;
- educate consumers on the benefits of the ViDVD;
- commit a substantial amount of human and financial resources to secure partnerships supporting the retail distribution of the ViDVD and our related ViMedia content delivery service;
- develop our own sales, marketing and support activities with targeted customers; and
- develop consumer acceptance of the ViDVD and our related ViMedia content delivery service.

We may not achieve any or all of these objectives. Moreover, we expect the ViDVD initially will be sold through a limited number of regional consumer electronics retail stores, and not through mass merchant and national consumer electronics retail stores. As a result, even after our retail launch, consumers may be less aware of the ViDVD than the product offerings of our competitors, and our ability to achieve broad market acceptance of the ViDVD could be harmed. Any failure to launch the ViDVD successfully or achieve broad market acceptance of the ViDVD after launch would impair our ability to continue operating our business.

WE ARE A DEVELOPMENT STAGE ENTERPRISE, HAVE NOT RECOGNIZED ANY REVENUE, HAVE INCURRED SIGNIFICANT NET LOSSES AND MAY NEVER ACHIEVE SIGNIFICANT REVENUES OR PROFITABILITY.

We are a development stage enterprise that is still in the process of developing and introducing our first product. We have not recognized any

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revenue, have incurred significant losses and have had substantial negative cash flow. As of September 30, 2001, we had an accumulated deficit of \$47.5 million. We expect to incur significant operating expenses over the next several years in connection with the continued development and expansion of our business. As a result, we expect to continue to lose money for the foreseeable future. Although the size of these net losses will depend in part on the success of our product launch, the growth in sales of our products and services and the rate of increase in our expenses, our losses have been increasing and are expected to continue to increase in future periods. With increased expenses, our need to generate significant revenues to achieve profitability. Several factors, including market acceptance, competitive factors and our ability to successfully develop and market our ViMedia content delivery service, make it impossible to predict with any degree of assurance when or whether we will generate sufficient revenues to attain profitability. Consequently, we may never achieve significant revenues or profitability, and even if we do, we may not sustain or increase profitability on a quarterly or annual basis in the future.

IF THE INTERNAL REVENUE SERVICE DETERMINES THAT ESS' DISTRIBUTION OF OUR STOCK TO ITS SHAREHOLDERS DOES NOT QUALIFY AS A TAX-FREE DISTRIBUTION, THEN ESS WILL TREAT THE DISTRIBUTION AS A TAXABLE DISTRIBUTION AND RECIPIENTS OF OUR STOCK IN THE DISTRIBUTION MAY BE REQUIRED TO PAY INCOME TAXES AS A RESULT OF RECEIVING THE STOCK.

Unless the Internal Revenue Service determines that the distribution qualifies as a tax-free distribution for U.S. federal income tax purposes, recipients of our stock in distribution may be required to pay income taxes as a result of the distribution, with the amount of ordinary income and gain dependent upon the value of the stock they received, their share of ESS' earnings and profits, and their adjusted tax basis in their ESS stock. Determining whether or not the distribution will qualify for tax-free status requires a complex analysis of many factors, including, among others, the business purpose for the distribution, the nature of the business to be engaged in by ESS and us following the distribution, and the extent to which ESS remains in control of us following the distribution. Because of the fact-intensive nature of this analysis, there will be substantial uncertainty as to whether the distribution will qualify for tax-free treatment until the IRS makes a determination as to the tax status of the transaction.

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Although ESS has applied for a ruling from the IRS, it is not anticipated that the IRS will make its determination until several months after the distribution has been completed. In addition, ESS has not obtained an opinion of its tax advisors regarding the tax treatment of the transaction. ACCORDINGLY, WE CANNOT ASSURE RECIPIENTS OF OUR STOCK IN THE DISTRIBUTION THAT A FAVORABLE RULING FROM THE IRS WILL BE OBTAINED. MOREOVER, EVEN IF A FAVORABLE IRS DETERMINATION IS OBTAINED, SUCH RECIPIENTS STILL MAY BE TAXED BY THE STATE, LOCAL OR FOREIGN JURISDICTION IN WHICH THEY RESIDE. Accordingly, all recipients of our stock in the distribution are strongly urged to consult with their own financial advisors regarding the potential tax impact to them of the distribution and to prepare for the significant possibility that the transaction will be taxable to them.

If the distribution is taxable to them, the value of the shares they receive will be treated as taxable ordinary income, return of cost or as taxable capital gain up to the value of the stock distributed. Absent a favorable ruling from the IRS, they will incur this tax whether or not they decide to sell the shares they receive in the distribution. Unless a recipient of shares in the distribution is required to make quarterly estimated tax payments to the IRS, this tax would generally have to be paid on or before the April 15, 2002 due date for the 2001 tax return. If such recipients do not have cash available to

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pay the tax at or before the time it is due, they may have to sell all or a portion of their shares of our stock to pay the tax or risk incurring interest and penalties imposed by the IRS. If holders of a significant percentage our stock are also forced to sell in order to pay their taxes, or if there is for any other reason a decline in the trading price of our shares following the distribution, recipients of our stock in the distribution may have to sell their shares of our stock at a lower price than they might otherwise have obtained. Moreover, if such recipients continue to hold all of their shares of our stock until after the IRS ruling is obtained and the market price of those shares declines, the proceeds from the subsequent sale of all of those shares may not be sufficient to cover the tax due if the transaction is determined to be taxable to them.

IF WE ARE UNABLE TO RAISE ADDITIONAL CAPITAL ON ACCEPTABLE TERMS, OUR ABILITY TO DEVELOP AND MARKET OUR PRODUCTS AND SERVICES AND GROW AND OPERATE OUR BUSINESS COULD BE HARMED.

To emerge from the development stage, introduce our follow-on products and services and sustain and grow our business, we must continue to make significant investments in research and development to develop, enhance and market our products and services. We will also need significant working capital to take advantage of future opportunities and to respond to competitive pressures or unanticipated requirements. We expect that our existing capital resources will be sufficient to meet our cash requirements through September 30, 2002, although our current resources could be exhausted more quickly depending on the payment terms that we are able to negotiate with our vendors and suppliers and our success in collecting on accounts receivable. The magnitude of our future capital requirements will depend on many factors, including, among others, product development expense levels, investments in working capital, and the amount of income generated by operations. When we do need to raise additional capital, that capital may not be available on acceptable terms, or at all. If we cannot raise necessary additional capital on acceptable terms, we may not be able to develop or enhance our products and services, take advantage of future opportunities, respond to competitive pressures or unanticipated requirements or even continue operating our business.

If additional capital is raised through the issuance of equity securities, the percentage ownership of our existing stockholders will decline, stockholders may experience dilution in net book value per share, and these equity securities may have rights, preferences or privileges senior to those of the holders of our common stock. Any debt financing, if available, may involve covenants limiting or restricting our operations or future opportunities.

SINCE THE DISTRIBUTION OF OUR STOCK BY ESS TECHNOLOGY, INC. TO ITS SHAREHOLDERS, WE WILL NO LONGER BE ABLE TO RELY ON ESS AS A MAJOR SOURCE OF CAPITAL FUNDING, WHICH COULD LIMIT OUR ABILITY TO GROW OR SUSTAIN OUR BUSINESS.

We have traditionally relied on ESS as a major source of capital funding. Following the completion of the distribution (which occurred on August 21, 2001), ESS ceased being a majority stockholder of us and may choose to no longer provide funding to us. Even if ESS were to choose to provide additional funding to us in the future, ESS may not have funds available to provide such funding or may not choose to provide such funding on terms favorable to us and our stockholders. As our business continues to grow, we will need to raise additional capital, which may not be available on acceptable terms, or at all. If we cannot raise necessary additional capital on acceptable terms, we may not be able to grow or sustain our business.

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MAY AFFECT OUR CASH FLOW, DISCOURAGE POTENTIAL ACQUISITION PROPOSALS OR DELAY OR PREVENT A CHANGE IN CONTROL OF US, AND LIMIT THE SIZE OF ANY FUTURE OFFERINGS OF OUR STOCK.

Even if ESS' distribution of our stock to its shareholders is otherwise a tax-free distribution, ESS may, under certain circumstances, recognize gain for U.S. federal and state income tax purposes with respect to the distribution if a 50% or greater interest in us is acquired during the two-year period following the distribution. Certain sales of shares by us that occurred during the two-year period immediately prior to the distribution may be counted towards the 50% threshold. The amount of such gain would be the difference between the fair market value of the stock distributed, as of the date of distribution, and ESS' adjusted tax basis in the stock. Under a tax sharing and indemnity agreement, we have agreed under certain circumstances to indemnify ESS for ESS' U.S. federal and state income tax liability which results as a direct consequence of any acquisition of a 50% or greater interest in us after the distribution. This indemnity obligation, if triggered, could have a substantial effect on our available cash. In addition, the existence of the indemnity obligation may discourage potential acquisition proposals and could delay or prevent an acquisition of a 50% or greater interest in us. Because future sales of stock could be deemed to be part of a related transaction that results in an acquisition of a 50% or greater interest in us, our desire to avoid triggering the indemnity obligation could limit the size of any offerings of stock by us during the two-year period following the distribution.

OUR LIMITED OPERATING HISTORY MAY MAKE IT DIFFICULT FOR US OR INVESTORS TO EVALUATE TRENDS AND OTHER FACTORS THAT AFFECT OUR BUSINESS.

We were incorporated in April 1999 and our operations to date have consisted primarily of product development efforts. To date, we have only manufactured and shipped a limited number of commercial ViDVD units. In addition, we have only entered into a limited number of agreements to acquire the content to be delivered as part of our ViMedia content delivery service, and no ViMedia discs have been distributed. As a result of our limited operating history, our historical financial and operating information is of limited value in evaluating our future operating results. In addition, any evaluation of our business and prospects must be made in light of the risks and difficulties encountered by companies offering products or services in new and rapidly evolving markets. For example, it may be difficult to accurately predict our future revenues, costs of revenues, expenses or results of operations. The ViDVD, the ViMedia content delivery service and our other anticipated Digital Home System products and services represent new product and service offerings for most consumers, and it may be difficult to predict the future growth rate, if any, or size of the market for those products and services. We may be unable to accurately forecast customer behavior and recognize or respond to emerging trends, changing preferences or competitive factors facing us. As a result, we may be unable to make accurate financial forecasts and adjust our spending in a timely manner to compensate for any unexpected revenue shortfall. This inability could cause our net losses in a given quarter to be greater than expected, which could cause the price of our stock to decline.

OUR HISTORICAL FINANCIAL INFORMATION MAY NOT BE REPRESENTATIVE OF OUR FUTURE OPERATING RESULTS AS A SEPARATE COMPANY.

Our historical financial information does not necessarily reflect what our financial position, operating results and cash flows would have been had we been a stand-alone entity during the periods presented. In addition, our historical information is not necessarily indicative of what our operating results, financial position and cash flows will be in the future. We may have to make significant changes to our cost structure, funding and operations as a result of our no longer being a majority-owned subsidiary of ESS after its distribution of our stock to its shareholders, including changes to our employee base, costs

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associated with establishing and maintaining a separate administrative infrastructure, costs associated with reduced economies of scale, and costs associated with being a stand-alone company.

WE FACE INTENSE COMPETITION FROM PARTICIPANTS IN BOTH THE MULTIMEDIA APPLIANCE AND THE HOME ENTERTAINMENT MARKETS, WHICH MAY IMPAIR OUR REVENUES AND ABILITY TO GENERATE CUSTOMERS.

The multimedia appliance and home entertainment markets are intensely competitive and rapidly evolving. In addition, there are few barriers to entry into the multimedia appliance and home entertainment markets, and new entrants to these markets may develop and offer products that will compete directly with our products and services.

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The multimedia appliance industry in particular is characterized by rapid technological innovation and intense price competition, and the competition for consumer spending and acceptance is intense. The ViDVD will compete directly with several other currently available or soon to be introduced multimedia appliance offerings from major consumer electronics manufacturers, such as Compaq, Hewlett Packard and Samsung, and with products developed by smaller companies, including the Neon, nReady and TVPC products. Like the ViDVD, nearly all of these products accommodate media in DVD, CD and MP3 format, many offer Internet access capabilities, and some include a karaoke feature.

In addition, as a home entertainment product, we expect that the ViDVD will also compete with:

- standard DVD and CD players;
- the Sony PlayStation 2, the Microsoft Xbox and other web-enabled, multi-function game players;
- personal computers;
- WebTV and other television-based Internet appliances;
- Web-enabled wireless telephones and PDAs;
- karaoke machines; and
- video cassette recorders and laser disc players.

As a home entertainment content delivery medium, we also expect that our ViMedia content delivery service will compete with:

- video-on-demand services;
- traditional broadcast, cable or satellite television programming; and
- video cassette, DVD and video game cartridge rental stores and retailers.

Most of these products and services are already widely available through retail distribution channels, and many of these products are already familiar to and accepted by consumers. In addition, most of the manufacturers and distributors of these competing home entertainment products and services have substantially greater brand recognition, market presence, distribution channels, advertising and marketing budgets and promotional and other strategic partners

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than us.

WE HAVE NOT OBTAINED ALL OF THE LICENSES OF INTELLECTUAL PROPERTY REQUIRED FOR THE OPERATION OF OUR BUSINESS AND ANY FAILURE TO OBTAIN REQUIRED LICENSES ON ACCEPTABLE TERMS COULD ADVERSELY AFFECT OUR OPERATING RESULTS.

We rely on licenses of intellectual property from third parties for use in our business. We have identified all of the licenses we believe are necessary for the manufacture and distribution of the ViDVD. We have yet to obtain all of these licenses. While we have contacted each of the entities from which we could obtain these licenses, the licenses may not be available on favorable terms and may require us to pay new or additional royalties on the sale of the ViDVD. Also, we will have to negotiate to acquire any licenses required for the development, manufacture and sale of our future Digital Home System products and services. In addition, although we have already licensed selected audio and video content to be distributed as part of the ViMedia content delivery service, we will need to obtain licenses to a substantially greater volume of content for the ViMedia service to be successful. Any failure to obtain the licenses of intellectual property required for the operation of our business on acceptable terms could adversely affect our operating results.

WE EXPECT THE AVERAGE SELLING PRICES OF OUR DIGITAL HOME SYSTEM PRODUCTS TO DECREASE, WHICH MAY REDUCE OUR GROSS MARGINS AND/OR REVENUE.

The prices of multimedia appliance products are expected to decline rapidly as more products enter retail distribution and competition and volume increase. In particular, we expect significant price reductions and increased sales discounts in the fourth quarter of 2001 as numerous competing manufacturers attempt to establish their microprocessors as the standard in the industry in

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connection with the holiday selling season. We anticipate that the average selling prices of our Digital Home System products will decrease in response to these competitive pricing pressures as well as in response to new product introductions by us or our competitors and increasing availability of relatively inexpensive products that can perform some of our products' functions. If we are unable to sufficiently reduce costs and increase sales volumes, this decline in average selling prices will reduce our revenue and gross margins.

IF WE FAIL TO OVERCOME TECHNICAL CHALLENGES ASSOCIATED WITH THE FULL DEVELOPMENT AND IMPLEMENTATION OF OUR VIMEDIA CONTENT DELIVERY SERVICE OR OBTAIN SUFFICIENT CONTENT TO ATTRACT CUSTOMERS, THE VIMEDIA CONTENT DELIVERY SERVICE MAY NOT ACHIEVE MARKET ACCEPTANCE OR GENERATE SUFFICIENT REVENUE TO SUSTAIN ITS OPERATION.

The success of the ViMedia content delivery service depends in part on our ability to acquire and deliver content that interests our customers. Most of the major producers of audio and video content in the entertainment industry will only permit their content to be distributed at commercially attractive prices if it is protected using approved encryption technologies. Our own proprietary encryption system has not yet been adopted by the entertainment industry as an approved encryption technology, and, unless or until that occurs, we may not be able to distribute content licensed from major entertainment companies in our proprietary ViMedia format. Although discs that include content in DVD and CD format may be played on a ViDVD player, content that is encoded in those conventional formats takes significantly more disc space, and we are still in the process of conducting research and development to enable certain aspects of our encryption technology to work with those other formats. Unless we are able to either obtain entertainment industry acceptance of our proprietary encryption

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system or overcome the technical challenges associated with using our encryption with conventional formats, the ViMedia content delivery service may not achieve market acceptance or generate sufficient revenue to sustain its operation.

IF WE FAIL TO DEVELOP AND MARKET NEW DIGITAL HOME SYSTEM PRODUCTS OR TO ADD FEATURES TO OUR EXISTING DIGITAL HOME SYSTEM PRODUCT, WE MAY NOT BE ABLE TO GENERATE SUFFICIENT REVENUES TO SUSTAIN OUR BUSINESS.

Our success is highly dependent upon the continued successful development and timely introduction of new Digital Home System products and new models of our existing Digital Home System product containing additional features. The success of new products and new models with additional features depends on a number of factors, including strategic allocation of limited financial and technical resources, accurate forecasting of consumer demand, timely completion of product development, and market and industry acceptance of our existing Digital Home System product. Many of our planned product and feature introductions are still in the early stages of development and will require substantial engineering and technical resources to bring to market. The success of some of our planned products may also require industry acceptance of our proprietary technologies or the adaptation of our products and technologies to accommodate the use of existing industry-accepted technologies. If we fail to develop and market new products and features, we may not be able to generate sufficient revenues from our initial Digital Home System product to sustain our business.

IT MAY TAKE A SUBSTANTIAL AMOUNT OF TIME AND RESOURCES TO ACHIEVE BROAD MARKET ACCEPTANCE OF OUR PRODUCTS AND SERVICES, AND WE CANNOT BE SURE THAT THESE EFFORTS WILL GENERATE THE LEVEL OF BROAD MARKET ACCEPTANCE OF OUR PRODUCTS AND SERVICES NECESSARY TO GENERATE SUFFICIENT REVENUES TO SUSTAIN OUR BUSINESS.

Although many consumers are familiar with standard DVD players, our ViDVD player initially will be one of only a few DVD products to include Internet access and MP3 and karaoke player capability. Consumers may perceive little or no benefit from combining these functionalities in one unit or may already own other products that provide one or more of these functionalities. As a result, consumers may not value, and may be unwilling to pay for the ViDVD. In addition, the ViMedia content delivery service is expected to be the first home entertainment content provider to enable consumers to purchase the specific content that interests them from a variety of content made available to the consumer on a previously distributed disc. Potential customers may not perceive a benefit in purchasing content in this manner and may already subscribe to or otherwise have access to similar content from other sources. We also do not have an established brand image, nor do we expect to spend significant marketing expenses to build and promote a brand image. Accordingly, to develop market acceptance of the ViDVD player, the ViMedia content delivery service and our anticipated future Digital Home System products and services, we will need to devote a substantial amount of resources to educate consumers about the features and benefits of our products and services, and broad market acceptance of the ViDVD may not be obtained for a period of two years or more from the launch date of the ViDVD, if at all. Moreover, we cannot assure you that this commitment of time and resources will be successful in developing the broad market acceptance of our Digital Home System products and services necessary to generate the revenues required to sustain our business.

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WE MAY NOT BE ABLE TO GENERATE SUFFICIENT REVENUE FROM THE VIMEDIA CONTENT DELIVERY SERVICE TO SUPPORT ITS CONTINUED OPERATION, AND ANY TERMINATION OF THE VIMEDIA SERVICE COULD REDUCE DEMAND FOR THE VIDVD PLAYER.

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In the future, we expect to charge customers content access fees for access to portions of the content distributed via our ViMedia content delivery service. Many potential ViMedia end users already pay monthly fees for cable or satellite television services. When we begin to charge customers for specific content, we must convince these consumers to pay additional fees to gain access to the content delivered on our ViMedia discs. The availability of competing services that do not require subscription or other access fees will harm our ability to effectively attract paying end users. In addition, the ViDVD player that enables the consumer to access the content provided by our ViMedia service can be used to view or listen to other DVDs and CDs or to access material on the Internet without payment for any of our ViMedia content. If a significant number of purchasers of our ViDVD players use these devices without purchasing ViMedia content, the ViMedia service may not generate sufficient revenue to support its continued operation, which could reduce demand for the ViDVD player.

WE EXPECT TO DEPEND ON ESS AND A LIMITED NUMBER OF OTHER THIRD PARTIES TO MANUFACTURE AND SUPPLY CRITICAL COMPONENTS FOR OUR DIGITAL HOME SYSTEM PRODUCTS AND SERVICES, AND WE MAY BE UNABLE TO OPERATE OUR BUSINESS IF THOSE PARTIES DO NOT PERFORM THEIR OBLIGATIONS.

We expect to rely on ESS and a limited number of other third party suppliers for a number of key components of our Digital Home System products, including DRAM chips and flash memory chips. We do not have long-term agreements in place with our suppliers. We also expect to rely on a limited number of third party content providers to supply the content to be distributed as part of the ViMedia content delivery service. We do not control the time and resources that these third parties devote to our business. We cannot be sure that these parties will perform their obligations as expected or that any revenue, cost savings or other benefits will be derived from the efforts of these parties. Our need for semiconductors as a key component of our Digital Home System products indirectly subjects us to a number of risks relating to ESS' and any future semiconductor suppliers' reliance on independent foundries to produce those semiconductors, including the absence of adequate capacity, the unavailability of, or interruption in access to, certain process technologies and reduced control over delivery schedules, manufacturing yields and costs, and risks related to the international location of most major foundries. If any of our third party suppliers or content providers breaches or terminates its agreement with us or otherwise fails to perform its obligations in a timely manner, we may be delayed or prevented from commercializing our products and services. Because our relationships with these parties are non-exclusive, they may also support products or services that compete directly with ours, or offer similar or greater support to our competitors. Any of these events could require us to undertake unforeseen additional responsibilities or devote additional resources to commercialize our products and services. This outcome would harm our ability to compete effectively and quickly achieve market acceptance and brand recognition.

WE MAY HAVE POTENTIAL BUSINESS CONFLICTS OF INTEREST WITH ESS WITH RESPECT TO THE COMPANIES' ONGOING RELATIONSHIPS, AND WE MAY NOT BE ABLE TO RESOLVE THESE CONFLICTS ON TERMS FAVORABLE TO US.

Conflicts of interest may arise between ESS and us in a number of areas relating to ongoing relationships between the companies, including:

- Although we will be entering into agreements with ESS that will govern our business relationship after the completion of ESS' distribution of our stock to its shareholders, ESS will have no obligation to extend the terms of those agreements to us beyond the stated duration of those agreements;
- ESS will be supplying semiconductors to our competitors, which may affect ESS' capacity to supply semiconductors to us;



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- we will be competing with ESS in employee recruiting; and
- we may compete with ESS with respect to business opportunities that are attractive to both companies, and ESS is not restricted from competing with our business.

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IF WE ARE UNABLE TO ESTABLISH AND MAINTAIN SATISFACTORY RELATIONSHIPS WITH THE DISTRIBUTORS AND RETAILERS THAT WE EXPECT TO SELL OUR PRODUCTS AND SERVICES, OUR BUSINESS WILL SUFFER.

With the exception of one retailer, we have not yet entered into agreements with the distributors and retailers that we expect to sell our products and services, and we may not be able to retain or attract a sufficient number of qualified distributors and retailers. In establishing relationships with distributors and retailers, we may be forced to accept arrangements under which we will not receive payment for our products until these products are sold to end users. Even though product shipments began in the third quarter of 2001, under Staff Accounting Bulletin No. 101 issued by the Securities and Exchange Commission, the recording of revenues will be delayed depending on the terms of such shipments and our ability to estimate potential returns and future price adjustments. We may also have to enter into revenue sharing or other arrangements with these distributors and retailers in order to provide additional incentives for such entities to actively market our products. In addition, we expect that our distributors and retailers will sell products and services offered by our competitors. If our competitors offer our distributors and retailers more favorable terms or have more products available to meet their needs, those distributors and retailers may decline to carry our products and services. Other retailers may decline to carry our products because they believe the ViDVD and the potential complementary ViMedia content delivery service will decrease their sales of content such as DVDs and CDs. Further, even if they do carry our products, distributors and retailers may not recommend, or continue to recommend, those products. If we are unable to maintain successful relationships with distributors and retailers or to expand our distribution channels, our business will suffer.

WE PLAN TO EXPAND OUR BUSINESS, AND OUR FAILURE TO MANAGE GROWTH COULD DISRUPT BUSINESS AND IMPAIR OUR ABILITY TO GENERATE REVENUES.

Since we began our business in April 1999, we have significantly expanded our headcount, facilities and infrastructure. We anticipate continued expansion in these areas to support potential sales growth and to allow us to pursue market opportunities. This expansion has placed, and will continue to place, a significant strain on our management, operational and financial resources and systems. Specific risks we face as our business expands include:

- We will need to attract and retain qualified personnel, and any failure to do so may impair our ability to offer new products or grow our business. Our success will depend on our ability to attract, retain and motivate managerial, technical, marketing, administrative and customer support personnel. Competition for such employees is intense, and we may be unable to successfully attract, integrate or retain sufficiently qualified personnel. If we are unable to hire, train, retain and manage required personnel, we may be unable to successfully introduce new products or otherwise implement our business strategy.
- Any inability of our systems to accommodate growth in the number of users of the ViMedia content delivery service may cause service

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interruptions. We have internally developed or are in the process of developing the systems that will be used to run the ViMedia content delivery service and perform other processing functions. The ability of these systems to scale as we add new subscribers is unproven. We will have to continually improve these systems to accommodate growth in the number of users. Any inability by us to add additional software and hardware or to upgrade our technology, systems or network infrastructure in response to subscriber growth could adversely affect our business or cause service interruptions.

- We will need to provide acceptable customer support, and any inability to do so will impair our ability to develop consumer acceptance of our products. We expect that some of our customers will require significant support when installing the ViDVD player and becoming acquainted with the features and functionality of the ViDVD and its interface. In addition, our customers who elect to use us as their Internet service provider may require frequent support when accessing the Internet. We also anticipate that purchasers of future Digital Home System products and services will require support in their use of such products and services. We do not have experience with widespread deployment of our products and services to a diverse customer base, and we may not have adequate personnel to provide the levels of support that our customers will require. Our failure to provide adequate customer support for our Digital Home System products or services will damage our reputation in the consumer electronics marketplace and strain our relationships with customers and strategic partners. This could prevent us from gaining new or retaining existing customers and could harm our reputation and brand.
- We will need to build an infrastructure to support the anticipated sale of ViDVD players over the Internet. This infrastructure will include the operational systems and controls necessary to conduct sales over the Internet, including transaction processing, inventory management and payment processing functions. Any failure by us to develop and

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maintain this infrastructure could hurt our ability to successfully conduct sales over the Internet, which could prevent us from establishing and maintaining customer relationships and increasing our sales volume.

- We will need to improve our operational and financial systems to support our expected growth, and any inability to do so will adversely impact our ability to grow our business. To manage the expected growth of our operations and personnel, we will need to improve our operational and financial systems, procedures and controls. Our current and planned systems, procedures and controls may not be adequate to support our future operations and expected growth. Delays or problems associated with any improvement or expansion of our operational systems and controls could adversely impact our relationships with customers and harm our reputation and brand.

PRODUCT DEFECTS, SYSTEM FAILURES OR INTERRUPTIONS MAY HAVE A NEGATIVE IMPACT ON OUR REVENUES, DAMAGE OUR REPUTATION AND DECREASE OUR ABILITY TO ATTRACT NEW CUSTOMERS.

Errors and product defects can result in significant warranty and repair

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problems, which could cause customer relations problems. Correcting product defects requires significant time and resources, which could delay product releases and affect market acceptance of our products. Any delivery by us of products with undetected material product defects could harm our credibility and market acceptance of our products.

Our ability to process purchases of content from our ViMedia content delivery service and to provide uninterrupted access to the Internet will depend on the efficient and uninterrupted operation of our computer and communications systems. Our computer hardware and other operating systems are vulnerable to damage or interruption from earthquakes, floods, fires, power loss, telecommunication failures and similar events. They are also subject to break-ins, sabotage, intentional acts of vandalism and similar misconduct. Although we have taken precautions against such damage, including installing backup servers as part of our network infrastructure, a natural disaster or other unanticipated problems at one or more of our facilities could result in interruptions in our business. These types of interruptions may reduce our revenues and profits. Our business also will be harmed if consumers believe our ViMedia content delivery service or our Internet service is unreliable. In addition to placing increased burdens on our technical staff, service outages may create a large number of customer questions and complaints that must be responded to by our customer support personnel. Any damage to, or failure of, our systems could result in reductions in, or terminations of, services supplied to our customers, which could have a material adverse effect on our business and irreparably damage our reputation and ability to attract new customers.

OUR FUTURE RESULTS COULD BE HARMED BY ECONOMIC, POLITICAL, REGULATORY AND OTHER RISKS ASSOCIATED WITH OUR RELIANCE ON INTERNATIONAL SALES AND OPERATIONS.

Substantially all of our products are anticipated to be manufactured, assembled and tested by independent third parties in China. In addition, most of our suppliers are located in China, Hong Kong and Taiwan. We also anticipate that revenue from international sales will represent a significant portion of our total revenue, as one of our strategic partners is also located in China and we expect that we will enter into sales and distribution arrangements with other firms located in China, Taiwan and other foreign countries. Because of our international operations and relationships, and our reliance on foreign third-party manufacturing, assembly and testing operations, we are subject to the risks of conducting business outside of the United States, including:

- changes in political and strategic relations between China, Taiwan and the U.S.;
- changes in foreign currency exchange rates;
- changes in a specific country's or region's political or economic conditions, particularly in China, Taiwan and other emerging Asian markets;
- trade protection measures and import or export licensing requirements;
- potentially negative consequences from changes in tax laws;
- difficulty in managing widespread sales and manufacturing operations; and
- less effective protection of intellectual property.

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OUR SUCCESS PARTLY DEPENDS ON OUR ABILITY TO SECURE AND PROTECT OUR PROPRIETARY RIGHTS.

Our success and ability to compete are partly dependent upon our internally developed technology. We rely on patent, trademark and copyright law, trade secret protection and confidentiality or license agreements with our employees, customers, partners and others to protect our proprietary rights. However, the steps we take to protect our proprietary rights may be inadequate. We have filed two U.S. patent applications, one to cover ViDVD proprietary functions and digital encoder and decoder solutions and another to cover digital audio signal compression and processing. In addition, we have filed corresponding applications in Taiwan and with the patent cooperation treaty, which reserves the right to file in foreign countries. To date, no patents have been issued, and we cannot assure you that any patents will ever be issued, that any issued patents will protect our intellectual property or that third parties will not challenge any issued patents. Moreover, other parties may independently develop similar or competing technologies designed around any patents that may be issued to us.

The laws of certain foreign countries in which our products are or may be designed, manufactured or sold, including various countries in Asia, may not protect our products or intellectual property rights to the same extent as do the laws of the U.S., and thus make the possibility of piracy of our technology more likely. We cannot assure you that the steps taken by us to protect our proprietary information will be adequate to prevent misappropriation of our technology or that our competitors will not independently develop technologies that are substantially equivalent or superior to our technology. Our failure to protect our proprietary rights could harm our business.

WE MAY BE SUBJECT TO CLAIMS THAT OUR INTELLECTUAL PROPERTY INFRINGES UPON THE PROPRIETARY RIGHTS OF OTHERS, AND A SUCCESSFUL CLAIM COULD HARM OUR ABILITY TO SELL AND DEVELOP OUR PRODUCTS.

If other parties claim that our products infringe upon their intellectual property, we could be forced to defend ourselves or our customers, manufacturers or suppliers against those claims. We could incur substantial costs to prosecute or defend those claims. A successful claim of infringement against us, or any failure or inability of us to develop non-infringing technology or license the infringed technology on acceptable terms and on a timely basis, could harm our business, financial condition and results of operations.

IF WE LOSE KEY MANAGEMENT PERSONNEL, WE MAY NOT BE ABLE TO SUCCESSFULLY OPERATE OUR BUSINESS.

Our future performance will be substantially dependent on the continued services of our senior management, especially our Chairman, Fred S.L. Chan, our President and Chief Executive Officer, Didier Pietri, and other key personnel. The loss of any members of our executive management team and our inability to hire additional executive management could harm our business and results of operations. We employ our key personnel on an at-will basis. We intend to obtain key person insurance for Mr. Chan, but we do not maintain key person insurance policies on any of the other members of our executive management team.

IF WE ARE UNABLE TO ATTRACT AND RETAIN THE QUALIFIED PERSONNEL REQUIRED TO TIMELY AND COST-EFFECTIVELY IMPLEMENT NEW ADMINISTRATIVE SYSTEMS TO REPLACE THE PORTIONS OF ESS' ADMINISTRATIVE INFRASTRUCTURE ON WHICH WE CURRENTLY RELY, OUR BUSINESS COULD BE HARMED.

We currently use duplicated versions of ESS' systems to support our operations, including systems to manage human resources, accounting, payroll and internal computing operations. Following ESS' distribution of our stock to its shareholders, ESS has no obligation to provide assistance to us other than the

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interim services which are provided by ESS pursuant to a transition services agreement between us and ESS. These interim services include, among others, information technology systems, human resources, administration, product order administration, customer service, buildings and facilities, and legal, finance and accounting services.

Over the next several months, we will be implementing new systems to replace the duplicated versions of ESS' systems, and we expect to have fully independent systems in place by the in 2002. The implementation of these new information systems will require the services of employees with extensive knowledge of these information systems and the business environment in which we operate. In order to successfully implement and operate our systems, we must be able to attract and retain a significant number of qualified employees. If we fail to attract and retain the qualified personnel required to implement, maintain and operate our information systems, our business could suffer. Even if we are able to attract and retain the required personnel, we may not be successful in implementing the new systems and transitioning data from the duplicated versions of ESS' systems to our new systems. Any failure or significant downtime in ESS' or our own information systems could harm our business.

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ANY FUTURE BUSINESS ACQUISITIONS MAY DISRUPT OUR BUSINESS, DILUTE STOCKHOLDER VALUE OR DISTRACT MANAGEMENT ATTENTION.

As part of our ongoing business strategy, we may consider additional acquisitions of, or significant investments in, businesses that offer products, services and technologies complementary to our own. In particular, we may pursue acquisitions and strategic alliances as a means of acquiring content to be included on our ViMedia discs. Such acquisitions could materially adversely affect our operating results and/or the price of our stock. Acquisitions also entail numerous risks, including:

- difficulty of assimilating the operations, products and personnel of the acquired businesses;
- potential disruption of our ongoing business;
- unanticipated costs associated with the acquisition;
- inability of management to manage the financial and strategic position of acquired or developed products, services and technologies;
- inability to maintain uniform standards, controls, policies and procedures; and
- impairment of relationships with employees and customers that may occur as a result of integration of the acquired business.

To the extent that shares of our stock or other rights to purchase stock are issued in connection with any future acquisitions, dilution to our existing stockholders will result and our earnings per share may suffer. Any future acquisitions or strategic investments may not generate additional revenue or provide any benefit to our business, and we may not achieve a satisfactory return on our investment in any acquired businesses.

LAWS OR REGULATIONS THAT GOVERN THE CONSUMER ELECTRONICS INDUSTRY, THE TELECOMMUNICATIONS INDUSTRY, COPYRIGHTED WORKS OR THE INTERNET COULD EXPOSE US TO LEGAL ACTION IF WE FAIL TO COMPLY OR COULD REQUIRE US TO CHANGE OUR BUSINESS.

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Because our Digital Home System products and services are expected to provide our customers with access to a variety of entertainment media and methods of electronic communication, it is difficult to predict what laws or regulations will be applicable to our business. Therefore, it is difficult to anticipate the impact of current or future laws and regulations on our business. Among the many regulations that may be applicable to our business are the following:

- Federal Communications Commission regulations relating to the electronic emissions of consumer products;
- Federal Communications Commission regulations relating to consumer products that connect to the public telephone network;
- regulations relating to the access and use of the Internet issued by various federal and state governmental agencies, legislative bodies and courts, including the Federal Communications Commission and the Federal Trade Commission;
- copyright laws relating to the use of copyrighted audio and video media; and
- federal export regulations relating to the export of sensitive computer technologies such as encryption and authentication software.

Changes in the regulatory climate or the enforcement or interpretation of existing laws could expose us to legal action if we fail to comply. In addition, any of these regulatory bodies could promulgate new regulations or interpret existing regulations in a manner that would cause us to incur significant compliance costs or force us to alter the features or functionality of our products and services.

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WE AND MANY OF OUR SUPPLIERS RELY ON A CONTINUOUS POWER SUPPLY TO CONDUCT OPERATIONS, AND CALIFORNIA'S CURRENT ENERGY CRISIS COULD DISRUPT OUR BUSINESS AND INCREASE OUR EXPENSES.

California is in the midst of an energy crisis that could disrupt our operations and increase our expenses. In the event of an acute power shortage, that is, when power reserves for California fall below certain levels, California has on some occasions implemented, and may in the future continue to implement, rolling blackouts throughout California. Some of our suppliers, particularly ESS, are also located in California. In addition, a significant portion of our non-manufacturing operations are located in California. If blackouts interrupt our power supply, we may be temporarily unable to continue operations at our California facilities. Any such interruption in our ability to continue operations at our California facilities could harm our business and results of operations.

OUR STOCK WILL MOST LIKELY BE SUBJECT TO THE REQUIREMENTS FOR PENNY STOCKS, WHICH COULD ADVERSELY AFFECT YOUR ABILITY TO SELL AND THE MARKET PRICE OF YOUR SHARES.

We currently expect that our stock will fit the definition of a penny stock. The Securities and Exchange Act of 1934 defines a penny stock as any equity security that is not traded on a national securities exchange or authorized for quotation on The Nasdaq National Market and that has a market price of less than \$5.00 per share, with certain exceptions. Penny stocks are

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subject to Rule 15g under the Securities and Exchange Act of 1934, which imposes additional sales practice requirements on broker-dealers who sell such securities. In general, a broker-dealer, prior to a transaction in a penny stock, must deliver a standardized risk disclosure document that provides information about penny stocks and the risks in the penny stock market. The broker-dealer must provide the customer with current bid and offer quotations for the penny stock, information about the commission payable to the broker-dealer and its salesperson in the transaction and monthly statements that disclose recent price information for each penny stock in the customer's account. Finally, prior to any transaction in a penny stock, the broker-dealer must make a special written suitability determination for the purchaser and receive the purchaser's written consent to the transaction prior to sale. All of these requirements may restrict your ability to sell our stock and could limit the trading volume of our stock and adversely affect the price investors are willing to pay for our stock.

IN THE FUTURE, OUR REVENUES AND QUARTERLY OPERATING RESULTS MAY FLUCTUATE SIGNIFICANTLY, WHICH MAY ADVERSELY AFFECT THE MARKET PRICES OF OUR STOCK AND COULD LEAD TO US BECOMING THE TARGET OF COSTLY SECURITIES CLASS ACTION LITIGATION.

We expect our revenues and operating results to fluctuate significantly due to a number of factors, many of which are outside of our control. Therefore, you should not rely on period-to-period comparisons of results of operations as an indication of our future performance. It is possible that in some future periods our operating results may fall below the expectations of market analysts and investors. In this event, the market prices of our stock would likely fall. Factors that may affect our quarterly operating results include:

- unsuccessful launch of the ViDVD;
- ongoing demand and supply for ViDVD players;
- seasonality and other consumer and advertising trends;
- changes in the economic terms of our relationships with our strategic partners;
- unanticipated shortfalls in the supply of components necessary for the manufacture of our products;
- changes in our pricing policies, the pricing policies of our competitors and general pricing trends in the multimedia appliance market;
- unanticipated shortfalls in revenue due to the fact that our expenses precede associated revenues;
- changes in estimates of our financial performance or changes in recommendations by securities analysts;
- release of new or enhanced products or services or introduction of new marketing initiatives by us or our competitors;
- announcements by us or our competitors of the creation or termination of significant strategic partnerships, joint

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- the market price generally for consumer electronics and home entertainment industry stocks;
- market conditions affecting the home entertainment industry;
- additions or departures of key personnel;
- demand for and consumer acceptance of other anticipated future Digital Home System product and services offerings; and
- general economic conditions.

In the past, securities class action litigation has often been brought against a company following stock price declines. We may be the target of similar litigation in the future if the price of our common stock declines. Securities litigation could result in substantial costs and diversion of management attention and resources, all of which could materially harm our business, financial condition and results of operations.

SEASONAL TRENDS MAY CAUSE OUR QUARTERLY OPERATING RESULTS TO FLUCTUATE, WHICH MAY ADVERSELY AFFECT THE MARKET PRICE OF OUR STOCK.

Domestic consumer electronic product sales have traditionally been much higher during the holiday shopping season than during other times of the year. Although predicting consumer demand for our products will be very difficult, we believe that sales of ViDVD players will be disproportionately high during these periods when compared to other times of the year. As a result, if we are unable to complete the launch of the ViDVD in advance of the 2001 holiday shopping season, our operating results for the fourth quarter of 2001 will be significantly lower than anticipated. Even if we are successful in completing the launch of the ViDVD in advance of the 2001 holiday shopping season, our quarterly operating results will still be affected by our success in the 2001 holiday season and in future holiday seasons. Any fluctuation in our quarterly operating results may cause the market price of our stock to decline, and that decline may be substantial if the fluctuation is caused by a delay in the launch of the ViDVD. Finally, if we are unable to accurately forecast and respond to consumer demand for our Digital Home System products, our reputation and brand will suffer, and the market price of our stock would likely fall.

CONFLICTS OF INTEREST MAY ARISE BECAUSE TWO OF OUR DIRECTORS, INCLUDING OUR CHAIRMAN, WHO WILL OWN SECURITIES OF BOTH ESS AND US AND THESE TWO DIRECTORS ALSO SERVE AS DIRECTORS OF ESS.

Fred S.L. Chan, our Chairman, owns a significant amount of ESS stock and our stock and options to purchase ESS stock and our stock. In addition, Matthew K. Fong, a member of our board of directors, owns ESS stock and options to purchase ESS stock. These individuals will receive additional shares of our stock in ESS' distribution of our stock to its shareholders. Mr. Chan is the Chairman and a board member of ESS. These factors could create, or appear to create, potential conflicts of interest when these directors and executive officers are faced with decisions that could have different implications for ESS and us.

PROVISIONS IN OUR CHARTER DOCUMENTS AND DELAWARE LAW MAY DELAY OR PREVENT ACQUISITION OF US, WHICH COULD DECREASE THE VALUE OF OUR SHARES.

Our amended and restated certificate of incorporation, amended and restated bylaws and Delaware law contain provisions that could make it more difficult for a third party to acquire us without the consent of our board of directors. Delaware law also imposes some restrictions on mergers and other business combinations between us and any holder of 15% or more of our outstanding shares. Although we believe these provisions provide for an



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opportunity to receive a higher bid by requiring potential acquirers to negotiate with our board of directors, these provisions apply even if the offer may be considered beneficial by some stockholders.

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### ITEM 3: QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

Interest Rate Risks. We invest in short-term investments. Consequently, we are exposed to fluctuation in interest rates on these investments. Increases or decreases in interest rates generally translate into decreases and increases in the fair value of these investments. In addition, the credit worthiness of the issuer, relative values of alternative investments, the liquidity of the instrument, and other general market conditions may affect the fair values of interest rate sensitive investments. In order to reduce the risk from fluctuation in rates, we invest in highly liquid governmental notes and bonds with contractual maturities of less than two years. All of the investments have been classified as available for sale, and at September 30, 2001, are recorded at market values.

Foreign Exchange Risks. Because our products are manufactured primarily in Asia, we are exposed to market risk from changes in foreign exchange rates, which could affect its results of operations and financial condition. In order to reduce the risk from fluctuation in foreign exchange rates, our product sales and all of our arrangements with our third party manufacturers and component vendors are denominated in U.S. dollars. We do not engage in any currency hedging activities.

### PART II: OTHER INFORMATION

#### ITEM 1: LEGAL PROCEEDINGS

In August 2001, Professional Staffing Corporation ("PSC") filed a lawsuit against the Company in The Superior Court of California, County of Alameda, Case No. 2001-22331, alleging causes of action for breach of contract and fraud. The Company has answered the complaint by way of a Demurrer, which is scheduled to be heard on December 4, 2001. In the past, PSC has provided temporary information technology workers to the Company on an ongoing basis, and prior to the suit being filed, the Company in July voluntarily withheld payment to PSC on \$92,095.00 of outstanding invoices pending the results of an in-house audit. The Company believes that PSC has in fact breached the contract and that the Company may have been substantially overcharged for services provided by PSC. This matter is in pre-trial discovery and currently there is no date set for trial. The Company will vigorously defend the litigation, and is engaging in settlement negotiations.

#### ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On July 20, 2001, holders of a majority of Vialta stock amended and restated the Company's certificate of incorporation such that (i) the Company has the authority to issue up to 400,000,000 shares of common stock at par value of \$0.001 per share, of which 100,000,000 shares shall be designated Class A common stock, 50,000,000 shares shall be designated Class B common stock and 250,000,000 shares shall be designated non-classified common stock and (ii) 30,000,000 shares of preferred stock at par value \$0.001. The majority of shareholders approved of the adoption of amended and restated bylaws. The majority of shareholders also adopted the 2001 employee stock purchase plan.

On July 23, 2001, holders of a majority of outstanding shares of capital stock approved the 2001 nonstatutory stock option plan whereby 8,939,219 shares

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of repurchased stock may be issued upon exercise of options granted under the plan.

### ITEM 6: EXHIBITS AND REPORTS ON FORM 8-K

- (a) Exhibits. None.
- (b) Reports on Form 8-K. No reports were filed on Form 8-K for the quarter ended September 30, 2001.

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### SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized.

VIALTA, INC. (Registrant)

Date: November 9, 2001

By: /s/ Fred S.L. Chan

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Fred S.L. Chan

Chairman

(Principal Financial and Accounting Officer)

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