UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2006

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ________ to ________

Commission File Number: 000-51004

PortalPlayer, Inc.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of** **incorporation or organization)**	**77-0513807** **(I.R.S. Employer** **Identification No.)**
70 W. Plumeria Drive **San Jose, California** **(Address of principal executive offices)**	**95134** **(zip code)**

(408) 521-7000

(Registrant s telephone number, including area code)

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

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

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

As of November 3, 2006, there were 25,500,219 shares of the registrant s Common Stock, $0.0001 par value, outstanding.

Table of Contents

PORTALPLAYER, INC.

INDEX

Table of Contents

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PORTALPLAYER, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except per share amounts, unaudited)

	September 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 49,588	$ 48,074
Short-term investments	145,919	131,435
Accounts receivable net	15,364	46,678
Inventory net	2,921	7,212
Deferred tax assets	940	3,577
Prepaid expenses and other current assets	4,561	4,862
Total current assets	219,293	241,838
Property and equipment net	7,027	3,766
Deferred tax assets	4,948	5,025
Purchased intangible assets net	7,633	
Other assets	959	1,497
Total assets	$ 239,860	$ 252,126
LIABILITIES AND STOCKHOLDERS EQUITY		
Liabilities:		
Current liabilities:		
Accounts payable	$ 10,073	$ 29,352
Accrued liabilities	6,446	12,083
Deferred income	4,515	10,850
Deferred rent		5
Income taxes payable	410	2,047
Total current liabilities	21,444	54,337
Deferred rent, long-term	467	331
Total liabilities	21,911	54,668
Commitments and contingencies (Note 5)		
Stockholders equity:		
Common stock, $.0001 par value 250,000 shares authorized; issued and outstanding: 25,435 shares and 24,377 shares at September 30, 2006 and December 31, 2005, respectively	224,493	219,446
Deferred stock-based compensation	(2,027)	(7,767)
Accumulated other comprehensive income (loss)	31	(264)
Accumulated deficit	(4,548)	(13,957)
Total stockholders equity	217,949	197,458

Total liabilities and stockholders equity	$ 239,860	$ 252,126

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

PORTALPLAYER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts, unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Revenue	$ 34,795	$ 57,906	$ 141,647	$ 146,941
Cost of revenue (1)	19,923	31,586	82,015	82,279
Gross profit	14,872	26,320	59,632	64,662
Operating expenses:				
Research and development (1)	10,516	9,586	34,256	24,292
Selling, general and administrative (1)	4,568	4,349	15,443	11,156
Amortization of purchased intangibles	344		803	
Total operating expenses	15,428	13,935	50,502	35,448
Operating income (loss)	(556)	12,385	9,130	29,214
Interest income	2,477	1,321	6,731	3,338
Interest and other income (expense) net	(1)	(6)	(142)	4
Income before income taxes	1,920	13,700	15,719	32,556
Provision for income taxes	427	3,425	6,310	8,139
Net income	$ 1,493	$ 10,275	$ 9,409	$ 24,417
Basic net income per share	$ 0.06	$ 0.44	$ 0.39	$ 1.05
Diluted net income per share	$ 0.06	$ 0.40	$ 0.37	$ 0.97
Shares used in computing basic net income per share	24,576	23,491	24,426	23,299
Shares used in computing diluted net income per share	25,428	25,541	25,425	25,226

(1) Amounts include stock-based compensation, as follows:

Cost of revenue	$ 100	$	$ 320	$
Research and development	1,790	349	4,492	804
Selling, general and administrative	944	350	2,716	749
	$ 2,834	$ 699	$ 7,528	$ 1,553

See accompanying Notes to Condensed Consolidated Financial Statements.

Table of Contents

PORTALPLAYER, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands, unaudited)

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Cash flows from operating activities:		
Net income	$ 9,409	$ 24,417
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	2,485	602
Amortization of discounts and premiums on investments, net	(7)	31
Non-cash stock-based compensation	7,507	1,553
Deferred income taxes	2,714	
Tax benefits on exercise of stock options	625	2,829
Excess tax benefits from stock-based compensation	(1,011)	
Changes in assets and liabilities:		
Accounts receivable	31,314	(20,368)
Inventory	4,334	(2,574)
Prepaid expenses and other current assets	318	(2,236)
Other assets	538	(140)
Accounts payable	(19,201)	18,796
Accrued liabilities	(4,792)	5,329
Deferred income	(6,335)	6,895
Income taxes payable	(626)	59
Deferred rent	26	261
Net cash provided by operating activities	27,298	35,454
Cash flows from investing activities:		
Proceeds from sales or maturities of investments	128,140	81,180
Purchase of investments	(142,322)	(129,932)
Purchase of intangibles	(8,435)	
Purchase of property and equipment	(5,779)	(2,138)
Net cash used in investing activities	(28,396)	(50,890)
Cash flows from financing activities:		
Proceeds from issuance of stock, net of issuance costs	1,601	1,260
Excess tax benefits from stock-based compensation	1,011	
Net cash provided by financing activities	2,612	1,260
Net increase (decrease) in cash and cash equivalents	1,514	(14,176)
Cash and cash equivalents beginning of period	48,074	58,892
Cash and cash equivalents end of period	$ 49,588	$ 44,716
Supplemental disclosure of noncash investing and financing activities Deferred stock-based compensation, net	$ (163)	$ 3,894

Liabilities accrued for the purchase of property and equipment	$	(32)	$

See accompanying Notes to Condensed Consolidated Financial Statements.

5

Table of Contents

PORTALPLAYER, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

1. Description of Business and Basis of Presentation

The Company

PortalPlayer, Inc. (the Company) was incorporated in California on May 17, 1999 and reincorporated in Delaware in October 2004. The Company develops semiconductor, firmware and software platforms for portable multimedia products such as personal media players and secondary display-enabled computers.

Principles of Consolidation and Basis of Presentation

The unaudited condensed consolidated financial statements included herein have been prepared in accordance with the published rules and regulations of the Securities and Exchange Commission, or SEC, applicable to interim financial information. Certain information and footnote disclosures included in financial statements prepared in accordance with generally accepted accounting principles in the United States have been omitted in these interim statements as allowed by such SEC rules and regulations. Management believes that the disclosures herein are adequate to make the information presented not misleading. The unaudited condensed consolidated financial statements included in this Form 10-Q have been derived from and should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2005, included in the Company s Annual Report on Form 10-K, filed with the SEC on March 10, 2006.

The unaudited condensed consolidated financial statements include the accounts of PortalPlayer, Inc. and its subsidiaries. All significant intercompany balances and transactions have been eliminated. The unaudited condensed consolidated financial statements contained herein reflect all adjustments (which include only normal, recurring adjustments), which are, in the opinion of management, necessary to state fairly the results for the periods presented. The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. The results for the three-month and nine-month periods ended September 30, 2006 are not necessarily indicative of the results to be expected for the entire fiscal year ending December 31, 2006.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to a concentration of credit risk consist primarily of trade receivables. The Company provides credit, in the normal course of business, to a number of companies and performs credit evaluations of its customers. As of September 30, 2006 and December 31, 2005, approximately 73% and 38%, respectively, of gross accounts receivable were concentrated with a group of affiliated companies, collectively referred to as Inventec. For the three-month and nine-month periods ended September 30, 2006, Inventec accounted for 40% and 34%, respectively, of revenue, compared to 41% and 62% for the comparable periods in the prior year. In connection with contracts related to shipments made to this customer, the Company is required to be prepared to ship additional quantities of inventory in excess of existing orders within specified periods in the future. Additionally, as of September 30, 2006 and December 31, 2005, less than 10% and approximately 59%, respectively, of the Company s gross accounts receivable were concentrated with Hon Hai Precision Industry Co., Ltd., or Hon Hai. For the three-month and nine-month periods ended September 30, 2006, Hon Hai accounted for 50% and 59%, respectively, of revenue, compared to 53% and 30% for the comparable periods in the prior year. The Company also had two other customers that each accounted for 11% and less than 10%, respectively, of gross accounts receivable as of September 30, 2006 and December 31, 2005. These customers accounted for less than 10% of the Company s revenue for the three-month and nine-month periods ended September 30, 2006 and the comparable periods in the prior year.

The Company is dependent on two suppliers for substantially all of its inventory requirements. The inability of these suppliers to fulfill the production requirements of the Company on a timely basis could negatively impact future results. Although there are other suppliers that could provide similar services, a change in suppliers could cause delays in the Company s products and possible loss of revenue.

Reportable Segments

The Company currently operates in one reportable segment, the designing, developing and marketing of advanced semiconductor, firmware and software solutions for manufacturers of feature-rich media players and secondary display-enabled computers. The Company s chief operating decision maker is the CEO.

Table of Contents

2. Stock-Based Compensation

Effective January 1, 2006, the Company adopted the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment,* or SFAS 123R. SFAS 123R establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the employee requisite service period.

Prior to the adoption of SFAS 123R, the Company accounted for its stock-based awards to employees in accordance with Accounting Principles Board, or APB, Opinion No. 25, *Accounting for Stock Issued to Employees,* and its related interpretations and provided the required pro forma disclosures of SFAS No. 123, *Accounting for Stock-Based Compensation,* as amended by SFAS 148, *Accounting for Stock-Based Compensation Transition and Disclosures.* The pro forma information for the three-month and nine-month periods ended September 30, 2005, respectively, is as follows (in thousands, except per share amounts):

	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2005
Net income as reported	$ 10,275	$ 24,417
Add: Total stock-based employee compensation included in reported net income, net of tax	422	1,130
Less: Fair value of stock-based employee compensation, net of tax	(1,233)	(3,227)
Pro forma net income	$ 9,464	$ 22,320
Earnings per share:		
Basic Reported	$ 0.44	$ 1.05
Pro forma	$ 0.40	$ 0.96
Diluted Reported	$ 0.40	$ 0.97
Pro forma	$ 0.38	$ 0.89

The Company adopted SFAS 123R using the modified prospective transition method, under which compensation expense related to unvested stock options and restricted stock is recorded at the beginning of the first quarter of adoption of SFAS 123R. Accordingly, in the three-month and nine-month periods ended September 30, 2006, the Company recorded stock-based compensation that includes: a) compensation cost related to share-based payments granted prior to the Company s filing of its initial registration statement, but not yet vested as of January 1, 2006, based on the grant-date intrinsic value estimated in accordance with the provisions of APB 25; b) compensation cost related to share-based payments granted subsequent to the Company s filing of its initial registration statement, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123; and c) compensation cost related to share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R.

Upon the adoption of SFAS 123R, the Company continues to account for forfeitures as they occur for share-based payments valued under APB 25, as described in the previous paragraph. Additionally, the Company recognizes compensation costs for share-based payments valued under the provisions of SFAS 123 and SFAS 123R on a straight-line basis over the requisite service period of the award, which is generally the vesting period of the award, net of an estimated forfeiture rate. SFAS 123R requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. When estimating the forfeiture rate, the Company considers voluntary termination behaviors as well as trends of actual forfeitures. Prior to the adoption of SFAS 123R, the Company accounted for forfeitures as they occurred. Previously reported amounts have not been restated.

In accordance with the adoption of SFAS 123R, as of January 1, 2006, deferred stock-based compensation of $4.6 million recorded on the balance sheet was eliminated by being charged to paid-in capital. Of this amount, $4.5 million related to grants of restricted stock awards and $0.1 million related to grants of stock options at exercise prices less than the deemed fair value of the underlying common stock on the grant date. As of September 30, 2006, the Company had a balance of $2.0 million in deferred stock-based compensation related to options granted before the Company filed for its initial registration statement and, accordingly, is accounted for under APB 25 as described above.

Table of Contents

The Company issues restricted stock awards, the value of which is based on the closing market price of the Company common stock on the grant date. In calculating the compensation cost related to stock options subsequent to the Company s filing of its initial registration statement, the Company estimates the fair value using the Black-Scholes option pricing model, consistent with the provisions of SFAS 123R, the SEC s Staff Accounting Bulletin No. 107 and the Company s prior period pro forma disclosures of stock-based compensation (determined under a fair value method as prescribed by SFAS 123). The fair value of each of these option grants is estimated on the date of grant using the Black-Scholes option valuation model with the following assumptions:

	Three Months Ended September 30, 2006	Three Months Ended September 30, 2005	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Options:				
Risk-free interest rate	4.84% 4.87%	4.04%	4.55% 5.00%	3.93%
Expected life (in years)	3.5 5.4	5	3.5 5.4	5
Expected volatility	58.4% 68.8%	71.1%	58.4% 73.6%	71.1%
Expected dividends	$	$	$	$
Employee Stock Purchase Plan:				
Risk-free interest rate	5.09% 5.17%	3.70%	4.25% -5.17%	3.25%
Expected life (in years)	0.5 1.0	0.5	0.5 1.0	0.5
Expected volatility	55.4% 58.7%	71.1%	50.3% - 58.7%	71.1%
Expected dividends	$	$	$	$

The impact of recording stock-based compensation on the results of operations for the three-month and nine-month periods ended September 30, 2006, was as follows (in thousands, except per share amounts):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Cost of revenue	$ 100	$ 320
Research and development	1,790	4,492
Selling, general and administrative	944	2,716
Stock-based compensation before income taxes	2,834	7,528
Income tax benefit	(1,305)	(2,018)
Total stock-based compensation after income taxes	$ 1,529	$ 5,510
Effect on earnings per share		
Basic	$ 0.06	$ 0.22
Diluted	$ 0.06	$ 0.21

The Company capitalized approximately $19,000 in stock-based compensation into inventory as of September 30, 2006. Prior to the adoption of SFAS 123R, the Company presented all tax benefits resulting from the exercise of stock options as operating cash flows in the Statement of Cash Flows. SFAS 123R requires cash flows resulting from excess tax benefits to be classified as a part of cash flows from financing activities. Excess tax benefits are realized tax benefits from tax deductions for exercised options in excess of the deferred tax asset attributable to stock compensation costs for such options. As a result of adopting SFAS 123R, $1.0 million of excess tax benefits for the nine-month period ended September 30, 2006 has been classified as a financing cash inflow.

As of September 30, 2006, the Company had the following share-based payment arrangements:

2004 Stock Incentive Plan The 2004 Stock Incentive Plan, or 2004 Plan, was adopted in 2004 and as of September 30, 2006, 3,710,916 shares of common stock have been authorized for issuance under the plan. In addition, any shares subject to outstanding options under our 1999 stock option plan that expire unexercised or any unvested shares that are forfeited will be available for issuance under our 2004 stock incentive plan. As a result of this provision, 76,954 shares were added to the 2004 Plan as of September 30, 2006. The number of shares authorized for issuance under the 2004 Plan will be increased on the first day of each of our fiscal years from 2007 through 2014 by the lesser of:

- 2,333,333 shares;
- 5% of our outstanding common stock on the last day of the immediately preceding fiscal year through 2009 and 3% of our outstanding common stock on the last day of the immediately preceding fiscal year for 2010 through 2014; or
- the number of shares determined by the board of directors.

Under the 2004 Plan, options granted to optionees will generally vest as to 25% of the shares one year after the date of grant and as to 1/48th of the shares each month thereafter and expire six or ten years from the date of grant. The majority of restricted stock granted under the 2004 Plan will vest as to 75% of the shares approximately 18 months after the date of grant, with the remaining shares vesting approximately 18 month later. Certain restricted shares vest 20% annually for a period of 5 years. As of September 30, 2006, the Company had a net issuance of 872,819 shares of restricted stock under the 2004 Plan. The value of the restricted stock awards was based on the closing market price of the Company s common stock on the date of grant. Unvested shares related to these restricted stock awards were included in the calculation of diluted earnings per share utilizing the treasury stock method.

Table of Contents

1999 Stock Option Plan The Company s 1999 Stock Option Plan, or 1999 Plan, was terminated upon completion of the Company s initial public offering of common stock in 2004. No shares of common stock are available under the 1999 Plan other than to satisfying exercises of stock options granted under this plan prior to its termination. Previously authorized yet unissued shares under the 1999 Plan were cancelled upon completion of the Company s initial public offering.

Under the 1999 Plan, incentive stock options were granted at a price that was not less than 100% of the fair market value of the Company s common stock, as determined by the board of directors, on the date of grant. Non-statutory stock options were granted at a price that is not less than 85% of the fair market value of the Company s common stock, as determined by the board of directors, on the date of grant.

Generally, options granted under the 1999 Plan are exercisable for a period of ten years after the date of grant, and shares vest at a rate of 25% on the first anniversary of the grant date of the option, and an additional 1/48th of the shares upon completion of each succeeding full month of continuous employment thereafter.

The following table summarizes stock option activity during the nine-month period ended September 30, 2006 under the 1999 Plan and the 2004 Plan:

	Number of Shares	Weighted Average Exercise Price Per Share	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2005	3,320,443	$ 12.43		
Granted	391,641	20.71		
Exercised	(374,933)	2.69		
Cancelled	(454,971)	20.69		
Outstanding at September 30, 2006	2,882,180	$ 13.52	7.99	$ 10,487
Exercisable at September 30, 2006	975,085	$ 10.63	7.53	$ 5,620

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company s closing price of $11.28 as of September 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. The total intrinsic value of options exercised in the three-month and nine-month periods ended September 30, 2006 was $0.6 million and $7.0 million, respectively. The total cash received from option exercises was $0.1 million and $1.0 million, respectively, in the three-month and nine-month periods ended September 30, 2006. In connection with these exercises, the tax benefits realized by the Company were $0.1 million and $0.8 million, respectively. The estimated weighted-average fair value of options granted to employees was $6.19 and $10.95, respectively, for the three-month and nine-month periods ended September 30, 2006. As of September 30, 2006, $19.6 million of total unrecognized compensation cost related to stock options is expected to be recognized over a weighted average period of 1.16 years. The amount of share-based liabilities paid was approximately $0 and $26,000, respectively, for the three-month and nine-month periods ended September 30, 2006.

The following table summarizes the nonvested restricted stock award activity during the nine-month period ended September 30, 2006:

	Number of Shares	Weighted Average Grant Date Fair Value
Nonvested at December 31, 2005	253,828	$ 19.70

Granted	699,508		10.80
Vested	(50,341)		17.76
Cancelled	(80,517)		17.73
Outstanding at September 30, 2006	822,478	$	12.45

The total fair value of restricted shares vested during the three-month and nine-month periods ended September 30, 2006 was $0.2 million and $0.6 million, respectively. As of September 30, 2006, $9.0 million of total unrecognized compensation cost related to restricted stock awards is expected to be recognized over a weighted average period of 1.69 years. To satisfy the tax-withholding obligations upon vesting of restricted stock, employees may elect to deliver shares back to the Company. Such shares that the Company repurchases are not part of an authorized stock repurchase plan.

The Company settles employee stock options exercised and restricted stock awards vested with newly issued common shares.

2004 Employee Stock Purchase Plan The Company s 2004 Employee Stock Purchase Plan, or ESPP, was adopted by the board of directors and was approved by the Company s stockholders and became effective in October 2004. As of September 30, 2006, a total of 808,015 shares of common stock have been authorized for issuance under the ESPP. The number of shares authorized for issuance under the employee stock purchase plan will be increased on the first day of each fiscal year from 2007 through 2014 by the lesser of:

400,000 shares;

Table of Contents

1% of our outstanding common stock on the last day of the immediately preceding fiscal year; or

the number of shares determined by our board.

The ESPP is intended to qualify shares sold for the benefits provided under Section 423 of the Internal Revenue Code. Employees, including officers and employee directors are eligible to participate if they are customarily employed for more than 20 hours per week and for more than five months in any calendar year. The ESPP permits eligible employees to purchase common stock through payroll deductions, which may not exceed 15% of an employee s total compensation. The maximum number of shares a participant may purchase during a single purchase period is 833 shares. The purchase price of the stock is equal to 85% of the fair market value per share of common stock on either the first trading day of the offering period or on the last trading day of the purchase period, whichever is less. As of September 30, 2006, 154,402 shares had been issued under the ESPP.

Stock-Based Compensation Related to Consultants During the three-month and nine-month periods ended September 30, 2006, the Company granted options to purchase zero and 10,000 shares, respectively, of common stock to consultants and advisors. Options to consultants and advisors which are not fully vested are subject to periodic revaluation over the vesting terms. The Company recorded an expense of approximately $23,000 and a benefit of $16,000 related to the fair value of such vested awards in the general and administrative expense line in the accompanying Statement of Operations for three-month and nine-month periods ended September 30, 2006, using the Black-Scholes option pricing model with the following assumptions: expected life of 10 years, risk free interest rate ranging from 4.35% to 5.07%, annualized volatility of 67.4% to 71.1% and no dividends during the expected term. Additionally, in June 2006, an employee of the Company became an advisor. His options will continue to vest for the six month period during which he will serve as an advisor. These options are also subject to periodic revaluation over the vesting terms. The Company recorded a general and administrative expense of $6,000 and $11,000 related to the fair value of such vested awards for the three-month and nine-month periods ended September 30, 2006, using the Black Sholes option pricing model with the following assumptions: expected life of 0.8 years, risk free interest rate of 5.03% to 5.27%, annualized volatility of 55.5% to 58.7% and no dividends during the expected term.

3. Net Income Per Share

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
	(in thousands, except per share amounts)			
Numerator:				
Net income	$ 1,493	$ 10,275	$ 9,409	$ 24,417
Denominator:				
Weighted average common shares used for basic calculation	24,576	23,491	24,426	23,299
Weighted average effect of dilutive securities:				
Warrants	16	25	18	32
Unvested restricted stock awards	97	50	62	21
Employee stock options	739	1,975	919	1,874
Denominator for diluted calculation	25,428	25,541	25,425	25,226
Basic net income per share	$ 0.06	$ 0.44	$ 0.39	$ 1.05
Diluted net income per share	$ 0.06	$ 0.40	$ 0.37	$ 0.97

Basic net income per share is computed using the weighted average number of common shares outstanding for the period, excluding unvested restricted stock. Diluted net income per share is based upon the weighted average common shares outstanding for the period plus dilutive potential common shares, including warrants, unvested restricted common stock and stock options using the treasury stock method. The calculation of diluted net income per share excludes all anti-dilutive shares, as calculated based on the average of the daily closing prices of the Company s common stock for the period. The following outstanding restricted stock awards and common stock options were excluded from the computation of diluted net income per share for the three-month and nine-month periods ended September 30, 2006 and 2005 as they had an antidilutive effect (in thousands):

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2006	2005	2006	2005
Unvested restricted stock awards	204	12	120	6
Common stock options	1,940	130	1,771	172

Table of Contents

4. Balance Sheet Components (in thousands)

	September 30, 2006	December 31, 2005
Inventory:		
Work in progress	$ 1,614	$ 757
Finished goods	1,691	6,727
Write-off of excess units	(384)	(272)
	$ 2,921	$ 7,212
Property and Equipment:		
Purchased software	$ 3,227	$ 2,911
Computer equipment	718	801
Building	1,325	112
Office equipment and furniture	6,701	3,609
Leasehold improvements and other property and equipment	930	573
	12,901	8,006
Less: accumulated depreciation and amortization	(5,874)	(4,240)
	$ 7,027	$ 3,766
Accrued Liabilities:		
Accrued compensation related	$ 2,443	$ 2,752
Accrued development fees	1,069	3,553
Accrued legal and accounting fees	739	754
Reimbursements received in advance		53
Other	2,195	4,971
	$ 6,446	$ 12,083

5. Commitments and Contingencies

Litigation

The Company is subject to various claims, which arise in the course of business. In the opinion of management, the ultimate disposition of these claims will not have a material adverse effect on the Company s consolidated financial position, liquidity or results of operations.

Guarantees

Certain of the Company s customer agreements contain infringement indemnification provisions for claims from third parties related to the Company s intellectual property. These indemnification provisions are accounted for in accordance with SFAS No. 5. The Company has entered into indemnification agreements with certain of its directors and officers in which the Company has agreed to indemnify such directors and officers to the fullest extent allowable under Delaware law if any such director or officer is made a party to any action or threatened with any action as a result of such person s service or having served as an officer, director, employee or agent of PortalPlayer, Inc. or having served, at the Company s request, as an officer, director, employee or agent of another company. The maximum potential amount of future payments that the Company could be required to make under the indemnification agreements is unlimited; however, the Company has directors and officers liability insurance policies that, in most cases, would mitigate the potential exposure and enable the Company to recover a portion of any future amounts paid. The estimated fair value of these indemnification provisions is minimal. To date, the Company has not incurred any costs related to any claims under these provisions and no amounts have been accrued in the accompanying financial statements.

Warranty

The Company provides a warranty on its products for a period of twelve to fifteen months from the date of delivery or manufacture, and provides for warranty costs at the time of sale based on historical activity for the prior 12 months. The determination of such provisions requires the Company to make estimates of the frequency and extent of warranty activity and estimated future costs to replace the products under warranty. If actual warranty activity and/or repair and replacement costs differ significantly from these

Table of Contents

estimates, adjustments to recognize additional cost of revenue may be required in future periods. The following table summarizes the activity related to the warranty reserve in the three-month and nine-month periods ended September 30, 2006 and 2005 (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Beginning balance	$ 349	$ 209	$ 288	$ 208
Adjustments related to current period sales	20	67	191	138
Warranty costs incurred in the current period	(87)	(35)	(197)	(105)
Ending balance	$ 282	$ 241	$ 282	$ 241

Lease Commitments

In February 2006, the Company entered into an amendment to an existing operating lease agreement of approximately 10,000 square feet of office space in Kirkland, Washington. The amended lease expires in December 2008 and expands our leased premises to a total of 17,700 square feet of office space as of March 1, 2006. The Company has an option to extend the lease for an additional two years. Under the agreement, the landlord will contribute to certain tenant improvements up to an agreed-upon amount. The total amount of rental payments due over the initial lease term, net of expected landlord contribution to the tenant improvements, is being charged to rent expense on the straight-line method over the term of the lease. The difference between rent expense recorded and the net amount paid each month is charged to deferred rent, which is included in liabilities in the accompanying balance sheets. The option to extend the lease is not included in the Company s calculation of monthly rent expense. In addition to the base rent on the facilities lease, the Company will be responsible for certain costs and charges specified in the lease.

Commitments

In May 2005, the Company entered into a loan agreement which provides a revolving line of credit of up to $15.0 million, accruing interest at a floating annual rate equal to the Bank s prime rate, payable monthly, and expires on May 31, 2007, at which time all outstanding principal and interest amounts are due. The Loan Agreement is secured by the Company s tangible assets and certain intangible assets other than intellectual property. The Loan Agreement contains certain financial and reporting covenants, including the maintenance of specified levels of quick ratio and tangible net worth, as well as non-financial covenants, including the Company s agreement not to sell, transfer, assign, mortgage, pledge, lease or grant a security interest in, or encumber any of its intellectual property, except as otherwise expressly permitted under the terms of the Loan Agreement. As of September 30, 2006, there were no amounts outstanding under the Loan Agreement.

6. Comprehensive Income

Comprehensive income is defined as the change in equity of a Company during a period from transactions and other events and circumstances excluding transactions resulting from investments from owners and distributions to owners. Comprehensive income includes the Company s net income (loss), as well as unrealized gain (loss) on available-for-sale investments. Comprehensive income for the three-month and nine-month periods ended September 30, 2006 and 2005, respectively, is as follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Net income	$ 1,493	$ 10,275	$ 9,409	$ 24,417
Net change in unrealized gain (loss) on investments	256			