

AGERE SYSTEMS INC  
Form 10-K  
December 08, 2003

As filed with the Securities and Exchange Commission on December 8, 2003

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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-K**

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

For the fiscal year ended September 30, 2003

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

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

Commission File Number 001-16397

**Agere Systems Inc.**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of incorporation or organization)

**22-3746606**  
(I.R.S. Employer  
Identification No.)

**1110 American Parkway N.E.**  
**Allentown, Pennsylvania**  
(Address of principal executive offices)

**18109**  
(Zip Code)

Registrant's telephone number, including area code: **610-712-1000**

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

<b>Title of Each Class</b>	<b>Name of Each Exchange on Which Registered</b>
Class A Common Stock, \$.01 par value	New York Stock Exchange
Class B Common Stock, \$.01 par value	New York Stock Exchange

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Securities registered pursuant to Section 12(g) of the Act: None.

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).  
Yes [X] No [ ]

The aggregate market value of voting common equity held by non-affiliates of the registrant as of March 31, 2003 was approximately \$2.6 billion, based on the reported last sale prices on the New York Stock Exchange of such equity on such date.

As of December 1, 2003, 791,038,216 shares of Class A common stock and 907,994,888 shares of Class B common stock were outstanding.

## DOCUMENTS INCORPORATED BY REFERENCE

Certain information required by Part III of this report (Items 10, 11, 12, 13 and 14) is incorporated by reference from the registrant's proxy statement to be filed pursuant to Regulation 14A with respect to the registrant's 2004 annual meeting of stockholders.

### Agere Systems Inc. Form 10-K For the Year Ended September 30, 2003

#### PART I

<u>Item 1.</u>	<u>Business</u>	<u>1</u>
<u>Item 2.</u>	<u>Properties</u>	<u>9</u>
<u>Item 3.</u>	<u>Legal Proceedings</u>	<u>9</u>
<u>Item 4.</u>	<u>Submission of Matters to a Vote of Security Holders</u>	<u>9</u>
	<u>Executive Officers of the Registrant</u>	<u>10</u>

#### PART II

<u>Item 5.</u>	<u>Market for Registrant's Common Equity and Related Stockholder Matters</u>	<u>11</u>
<u>Item 6.</u>	<u>Selected Financial Data</u>	<u>12</u>
<u>Item 7.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>13</u>
<u>Item 7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>31</u>
<u>Item 8.</u>	<u>Financial Statements and Supplementary Data</u>	<u>32</u>
<u>Item 9.</u>	<u>Change in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>69</u>
<u>Item 9A.</u>	<u>Controls and Procedures</u>	<u>69</u>

**PART III**

<u>Item 10.</u>	<u>Directors and Executive Officers of the Registrant</u>	<u>69</u>
<u>Item 11.</u>	<u>Executive Compensation</u>	<u>69</u>
<u>Item 12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>70</u>
<u>Item 13.</u>	<u>Certain Relationships and Related Transactions</u>	<u>70</u>
<u>Item 14.</u>	<u>Principal Accountant Fees and Services</u>	<u>70</u>

**PART IV**

<u>Item 15.</u>	<u>Exhibits, Financial Statement Schedules, and Reports on Form 8-K</u>	<u>71</u>
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**FORWARD-LOOKING STATEMENTS**

Certain statements in this Form 10-K are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933, and Section 21E of the Securities Exchange Act of 1934. The words estimate, plan, intend, expect, anticipate, believe and similar expressions are intended to identify forward-looking statements. These forward-looking statements are found at various places throughout this report and in the documents incorporated herein by reference. Agere disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise. Although we believe that our expectations are based on reasonable assumptions, we can give no assurance that our goals will be achieved. Important factors that could cause our actual results to differ from estimates or projections contained in the forward-looking statements are described under Factors Affecting Our Future Performance in Item 7.

**PART I****Item 1. Business****General**

We design, develop, manufacture and sell integrated circuit solutions for applications such as high-density storage, multiservice networking, wireless data and personal computer connectivity applications. These solutions form the building blocks for a broad range of computing and communications applications. Some of our solutions include related software and reference designs. Our customers include manufacturers of hard disk drives, high-speed communications systems, personal computers and mobile phones.

Integrated circuits, or chips, are made using semiconductor wafers imprinted with a network of electronic components. They are designed to perform various functions such as processing electronic signals, controlling electronic system functions and processing and storing data. Reference designs are complete specifications for products that a customer can use to build an end product, including components, board layouts and software. By using a reference design, a customer can reduce the amount of product design it must perform and the amount of time to introduce a new product into the market.

Our business operations are organized into two market-focused groups, the Client Systems group, which serves the computing and consumer communications market, and the Infrastructure Systems group, which serves the networking equipment market. Each of these two groups is a reportable operating segment. Each segment includes revenue from the licensing of intellectual property.

The Client Systems group delivers integrated circuits, software and reference designs for applications including storage, wireless data and personal computer connectivity, including hard disk drives and modems for computers, data-enabled mobile phones and wireless local area networking. The Infrastructure Systems group delivers integrated circuit solutions for multiservice networking to network equipment customers.

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During fiscal 2003, we substantially completed a restructuring of our business in response to significant declines in our revenue, particularly from our telecommunications network equipment customers. We believe that these customers were themselves experiencing significant declines in demand from their customers. As part of this restructuring, we:

Sold our optoelectronic components business, including the manufacturing facilities associated with that business;

Reduced our headcount;

Consolidated our operations into fewer facilities; and

Closed two integrated circuit wafer manufacturing facilities.

Of our total revenue of \$1.8 billion in the fiscal year ended September 30, 2003, \$1.3 billion, or 72%, was generated by our Client Systems segment and \$518 million, or 28%, was generated by our Infrastructure Systems segment. In fiscal 2003, 20% of our revenue was generated in the United States and 80% outside the United States. Of our total revenue of \$1.9 billion in the fiscal year ended September 30, 2002, \$1.3 billion, or 65%, was generated by our Client Systems segment and \$664 million, or 35%, was generated by our Infrastructure Systems segment.

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In fiscal 2002, 27% of our revenue was generated in the United States and 73% outside the United States. See note 19 to our financial statements in Item 8 for additional information about our Client Systems and Infrastructure Systems segments and We conduct a significant amount of our sales activity and manufacturing efforts outside the United States, which subjects us to additional business risks and may adversely affect our results of operations due to increased costs. in Item 7.

As of September 30, 2003, we had approximately 6,800 active employees worldwide. We have major research and development and manufacturing sites in the United States, India, Singapore, Thailand and the United Kingdom.

We were incorporated in Delaware in 2000 as part of Lucent Technologies Inc. s plan to spin off its microelectronics business to its stockholders. Lucent completed our spin-off on June 1, 2002.

We maintain an Internet website at <http://www.agere.com>. We make available free of charge on our website our annual report on Form 10-K, our quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) of the Securities Exchange Act of 1934 as soon as practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission. Information on our website is not incorporated by reference into this report.

### **Client Systems**

Through our Client Systems group, we offer integrated circuits, software and reference designs for a variety of consumer-purchased products such as hard disk drives, personal computers and mobile phones.

Many of our products convert analog signals into digital signals and vice versa. Analog refers to a transmission technique employing a continuous signal that varies in amplitude, frequency or phase of the transmission. Digital refers to a method of transmitting, storing and processing data that uses distinct electronic or optical pulses to represent the binary digits 0 and 1.

### **Storage Products**

We sell integrated circuits for use in hard disk drives. Within the storage products area we sell read channels, disk controllers, pre-amplifiers, or preamps, and motor controllers. Read channels convert an analog signal that is generated by reading the stored data on the hard disk into digital signals. Preamps are used to amplify the initial signal from the hard disk so the signal can be processed by the read channel. Together, these are key components that are critical to determining the overall performance of a hard disk drive. We also develop and sell disk drive controllers, which are used to control signal processing and communications functions within the disk drive. When a read channel and a disk controller are integrated into a single solution, this is referred to as a system on a chip. We also sell motor controllers, which are used to control functions related to the spinning of the physical storage media.

### **Mobile Phones**

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We sell integrated circuits for use in digital mobile phones, and other wireless data and voice communications products. We also offer comprehensive integrated circuit wireless product solutions that include:

Digital signal processors for speech compression and encoding and transmission of voice and data;

Conversion signal processors to convert signals between frequencies used in digital signal processors and frequencies used for radio transmission; and

Software that controls the communication process.

We also license hardware and software designs for mobile phones that use our integrated circuits.

Most of our mobile phone products support General Packet Radio Service, or GPRS, and operate on the Global System for Mobile Communications, or GSM, standard. GPRS provides enhanced data transmission capabilities for GSM mobile phones. We are providing customers with samples of integrated circuits for an extension of GPRS called EDGE and are selling products that support the wideband CDMA, or 3G, standard.

### ***Computing Connectivity Devices***

***Modem Products.*** We sell integrated circuits and associated software for modem products primarily to leading manufacturers of personal computers, modems and other electronic equipment. We also offer integrated circuits and software for use in digital telephony products. Digital telephony products provide access to merged

2

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voice and data communications networks. We sell our digital telephony solutions to manufacturers of business telephone equipment.

***Input/Output Products.*** Input/output refers to the transfer of data within and between computers; peripheral equipment, such as printers, scanners and digital cameras; and data networks. We sell input/output products primarily to manufacturers of computers, peripheral equipment and communications equipment. A majority of our sales are customized solutions that combine our intellectual property with that of our customers in the design of our integrated circuits. Our products support Universal Serial Bus, or USB, and IEEE-1394 industry standards, which are both established connectivity and transmission standards.

### ***Wireless Local Area Networking Products***

We sell integrated circuits and network access cards for wireless networks, along with associated software.

Our network access cards are used primarily to connect computers, especially laptop computers, with wireless networks. Our customers can use our integrated circuits to build network access cards or other wireless local area networking equipment of their own design.

Our wireless local area networking solutions currently support data transmission speeds of up to 54 megabits per second. During fiscal 2003, we entered into an agreement with Infineon Technologies AG to jointly develop high-speed wireless local area networking products. These products use circuit elements previously designed by us and by Infineon as well as components jointly designed by both companies.

We sell our wireless local area networking products to personal computer manufacturers and wireless networking equipment manufacturers who integrate our products into their own products.

### ***Media Connectivity Devices***

We have begun development of integrated circuits and software to support a variety of media distribution requirements designed for consumer electronics applications. These products will build on our wireless networking experience and add functionality specifically designed to enable wireless delivery of audio and video between consumer electronics equipment.

### ***Infrastructure Systems***

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Through our Infrastructure Systems group, we offer solutions for high-speed communications systems that encompass integrated circuits, software and reference designs. Our products facilitate the transmission and switching of voice, video and data signals within communications networks and are used primarily in the following types of equipment:

Network communications equipment, which facilitates the transmission, switching and management of data and voice traffic within communications networks;

Network access equipment, such as data communications equipment, which allows devices to connect with communications networks;

Enterprise networking equipment, which switches and routes data traffic in businesses local area networks and storage area networks; and

Wireless infrastructure equipment, such as cellular base stations, which transmits and receives data and voice communications through radio waves.

Our Infrastructure Systems product offerings support three primary applications:

Enterprise networking;

Wireline communications infrastructure; and

Wireless communications infrastructure.

We sell integrated circuit solutions that include physical layer devices, integrated circuits supporting SONET/SDH communication standards, multiservice switching fabrics and network processing devices and broadband access devices, each of which is described below.

### ***Enterprise Networking***

We sell integrated circuit solutions that are used in data networking systems. These systems include local area networks for communicating data within businesses. We are also currently designing products that will be used in storage area networks.

3

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The majority of our revenue from products used in enterprise networking applications is derived from the sale of integrated circuits that are custom developed for our customers. These integrated circuits incorporate our intellectual property or combine our intellectual property with the intellectual property of our customers or other third parties to create a customized solution for these customers. For some customers, we design and manufacture the integrated circuit while the key intellectual property belongs solely to our customers.

Our systems-level knowledge and integrated circuit design methodologies allow us to turn our customers design concepts into a systems solution quickly and effectively. Our intellectual property gives our customers the flexibility to customize their products to meet their individual cost and performance objectives.

We have begun development of a new family of standard products for high-speed networking applications. Our entry into this product area was made possible through our acquisition of Massana Limited during fiscal 2003. These products are intended to address both enterprise and client applications for gigabit Ethernet, a high-speed data networking standard that operates at data rates of one gigabit per second.

### ***Wireline Communications Infrastructure***

We sell products designed for wired communications infrastructure. These products are used in high-speed transport networks and in the equipment used to access and interconnect these networks.

***Multiservice Switching Fabrics and Network Processing Devices.*** Switching devices guide data to different communications networks based on the intended destination. Multiservice switching devices support the transmission of voice and video signals as well as data. We sell switch

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fabrics and programmable network processors to communications equipment manufacturers. A switch fabric directs the data within a switching device. A network processor is a component that controls how data is sent over a network or over a switch fabric such that the data retains its quality of service without interfering with other data traffic. We also offer supporting software with our switching products.

We currently offer switching products for asynchronous transfer mode, or ATM, and Internet protocol, or IP. Asynchronous transfer mode and Internet protocol refer to different procedures for the formatting and timing of data transmission between two pieces of equipment. Our switching integrated solutions reduce the number of required integrated circuits needed in a switching device.

*Broadband Access Devices.* Broadband is a general term that refers to high-speed data transmission. Our broadband access integrated circuits, or mappers, support data transport between central offices and enterprise sites by aggregation and termination. Aggregation refers to the combining of many low-speed, or tributary, data signals from enterprises into higher speed, or trunk, data signals for transmission to a central office. Termination refers to the separation of trunk data signals into lower-speed, tributary data signals.

Our products support data transport for T-carrier data transport in North America. T-carrier is a digital transmission service from a common carrier. We support similar services worldwide. These services are referred to as J-carrier in Japan and E-carrier in Europe. T-carrier services such as T1 and T3 lines are widely used to create point-to-point networks for use by enterprises. T1 and T3 lines refer to different levels of T-carrier service that transmit data at 1.5 megabits per second and 44.7 megabits per second, respectively. A megabit is a unit of measurement for data and is equal to approximately one million bits.

*SONET/SDH Network Devices.* Synchronous optical networks, which are typically referred to as SONET, and synchronous digital hierarchy standard networks, or SDH, carry data, voice and video traffic through a network by combining lines carrying traffic at slower speeds with lines carrying traffic at higher speeds. This process is known as multiplexing, and involves directing traffic from the individual lines into designated time slots in the higher speed lines, and those lines into still higher speed lines. The SONET/SDH equipment that handles the directing of traffic into slower speed and faster speed lines is the add-drop multiplexor, or ADM. Add-drop multiplexors handle the addition and removal of traffic from a SONET/SDH communication transmission. We offer single-chip integrated circuit solutions, or framers, for add-drop multiplexing of data and voice traffic. In addition, our framers are used in high-speed routers within an optical network. A router is an interface, or link, between two networks.

*Physical Layer Devices.* High-speed physical layer devices are key elements in the conversion between optical signals and electronic signals in communications networks. High-speed physical layer devices accept the output from an optical receiver and convert it into a digital data signal that can be used in communications switching

4

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and processing functions. Our products include integrated circuit components for physical layer devices that provide a complete product offering for transmission up to and including 10 gigabits per second.

### ***Wireless Communications Infrastructure***

*Wireless Infrastructure Devices.* We sell integrated circuit solutions used in wireless infrastructure products, which are primarily cellular base stations and cellular base transceiver stations. These devices include digital signal processors for speech compression and encoding and transmission of voice and data and networking products that connect cellular equipment to the wired communications network. Some of these products are standard offerings that are sold to multiple customers and some are customized for a particular customer. The customized offerings may combine our intellectual property with intellectual property from our customer. Many of the multiservice networking devices used in wireline communications infrastructure, including network processors and ATM traffic management devices, are also used in wireless infrastructure.

We have also introduced a new family of radio frequency power products for wireless base station power amplifier applications. These products can be applied to existing and new wireless communications standards. These products are currently being evaluated by multiple potential customers.

### **Customers, Sales And Distribution**

#### ***Customers***

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We have a globally diverse base of customers, consisting primarily of manufacturers of computer and communications equipment. We generally target as customers the leaders in the market segments in which our products are used as well as the companies we believe will be future leaders in these segments. In fiscal 2003, we sold our products directly to approximately 260 end customers and indirectly, through distributors, to approximately 630 end customers. For some end customers, we deliver the product to, and are paid by, a third party associated with the customer, such as their contract manufacturer. Our top 20 end customers in fiscal 2003, based on revenue, accounted for approximately 74% of our revenue and our top 10 end customers in fiscal 2003, based on revenue, accounted for approximately 60% of our revenue. Our top ten end customers in fiscal 2003 were:

Apple Computer, Inc.	NEC Corporation
Cisco Systems, Inc.	Nokia Corporation
Hewlett Packard	Samsung Electronics Co., Ltd.
Lucent Technologies Inc.	Seagate Technology, Inc.
Maxtor Corp.	Western Digital Corp.

Our sales to Maxtor represented 16% and 14% of our revenue in fiscal 2003 and 2002. Our sales to Seagate Technology represented 12% of sales in fiscal 2003, and our sales to Lucent represented 15% of sales in fiscal 2001. No other customer accounted for 10% or more of our revenue in fiscal 2003, 2002 or 2001.

### ***Sales and Distribution***

We have a worldwide sales organization with approximately 330 employees as of September 30, 2003, located in nine U.S. sales offices and 15 sales offices outside the U.S. We sell our products globally primarily through our direct sales force. To complement our direct sales force, we also sell our products through distributors, which sales in fiscal 2003 represented approximately 11% of our revenue.

We aim to have our customers incorporate our products into the end products they design and develop. Typically, manufacturers of computer and communications equipment conduct a competitive process to select suppliers for the parts that they will include in their end products. Our sales, marketing and technical personnel work with customers to demonstrate our products' ability to satisfy any specific requirements. We call winning the competitive process a design win. A design win is important because it allows us to establish a long-term relationship with the customer, at least through the life cycle of the product. We generally do not, however, enter into written agreements with our customers after achieving a design win. A customer could terminate its relationship with us or discontinue developing the product. Most of our revenue originates from sales that are the result of design wins.

After we achieve a design win and negotiate the terms of the sale, we deliver our products to our end customers in a number of ways. Our end customers typically have us ship our products to their facilities directly. In some

5

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instances, however, our customer uses a contract manufacturer to manufacture and assemble their end product. When our product is being incorporated into an end product being manufactured by a contract manufacturer, we often ship our product directly to the contract manufacturer and receive payment from that contract manufacturer. To determine our sales to particular customers, however, we recognize this type of transaction as a sale to, and revenue from, the end customer. Sometimes a customer for whom we have achieved a design win will have us sell that product to a distributor or trading company from whom the customer then buys our product. We recognize these transactions as indirect sales.

### **Manufacturing**

Our operations support organization is responsible for our supply chain management and manufacturing activities. As of September 30, 2003, we had approximately 3,150 employees devoted to manufacturing and related support activities.

We had three facilities located in three countries devoted to manufacturing integrated circuits as of September 30, 2003. These sites utilized approximately 2.1 million square feet of space dedicated to manufacturing. As of September 30, 2003, our company-owned and joint venture wafer fabrication operations were in the United States and Singapore, while our assembly and test operations were in Singapore and Thailand. During fiscal 2003, we completed the consolidation of our United States integrated circuit manufacturing operations to our facility in Orlando, Florida. We are seeking a buyer for that facility.



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We have a joint venture, called Silicon Manufacturing Partners, with Chartered Semiconductor Manufacturing Ltd., that operates an integrated circuit manufacturing facility in Singapore. We have agreed to purchase 51% of the venture's managed wafer capacity and Chartered Semiconductor has agreed to purchase the remaining 49% of the managed wafer capacity. Silicon Manufacturing Partners determines its managed wafer capacity each year based on forecasts provided by Agere and Chartered Semiconductor. If we fail to purchase our commitments, we will be required to pay the joint venture for the fixed costs associated with the unpurchased wafers. Chartered Semiconductor is similarly obligated with respect to the wafers allotted to it. The joint venture agreement may be terminated by either party upon two years' written notice, but may not be terminated prior to February 2008. The agreement may also be terminated for material breach, bankruptcy or insolvency of either party.

Currently, we manufacture most of our integrated circuits in facilities that we either own or operate through a joint venture. We also have third-party manufacturing relationships to improve our manufacturing efficiency and flexibility and to allow us to focus on developing leading products. In the future, we expect to increase the amount of integrated circuits we buy at market prices.

### Competition

We sell products designed for communications and computer equipment manufacturers. Our customers' products are sold in market segments that are intensely competitive and characterized by:

- Rapid technological change;
- Evolving standards;
- Short product life cycles; and
- Price erosion.

There are many competitors for our products. We expect the intensity of competition in the market segments we serve to continue to increase in the future as existing competitors enhance and expand their product offerings and as our customers attempt to limit the number of suppliers from which they buy. Increased competition may result in price reductions, reduced revenues and loss of market share. We cannot assure you that we will be able to compete successfully against existing or future competitors. Some of our customers and companies with which we have strategic relationships also are, or may be in the future, competitors of ours.

6

Our primary competitors within our client product areas are listed in the table below.

<u>Storage</u>	<u>Mobile Phones</u>	<u>Computing Connectivity</u>	<u>Wireless Local Area Networking</u>
Infineon Technologies AG	Koninklijke Philips Electronics N.V.	Broadcom Corp.	Broadcom Corp.
LSI Logic Corp.	Motorola, Inc.	Conexant Systems, Inc.	GlobespanVirata, Inc.
Marvell Technology Group Ltd.	QUALCOMM Inc.	Infineon Technologies AG	Texas Instruments Incorporated
STMicroelectronics N.V.	Skyworks Solutions, Inc.	Koninklijke Philips Electronics N.V.	
Texas Instruments Incorporated	STMicroelectronics N.V. Texas Instruments Incorporated	PCTel, Inc.	

Our primary competitors within our infrastructure product areas are listed in the table below.

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Enterprise Networking	Wireline Communications Infrastructure	Wireless Communications Infrastructure
Broadcom Corp.	Applied Micro Circuits Corp.	Applied Micro Circuits Corp.
IBM Corp.	Intel Corp.	Intel Corp.
Intel Corp.	Motorola, Inc.	PMC-Sierra, Inc.
LSI Logic Corp.	PMC-Sierra, Inc.	Texas Instruments Incorporated
Marvell Technology Group Ltd.	Vitesse Semiconductor Corporation	Vitesse Semiconductor Corporation

Our competitive position varies depending on the market segment and product areas within these segments. For example, we are number one or two, based on revenue, in many of our product areas, including analog modems, baseband integrated circuits for wireless infrastructure, SONET/SDH integrated circuits and wired communications integrated circuits. However, our competitive position is not as strong in the mobile phones and network processor product areas. While improving our position in many of the product areas where our position is less well-established is an objective of ours, we cannot assure you that we will be able to accomplish this goal. Further, because we expect to face increasing competitive pressures from both current and future competitors in the product areas we serve, we may not be able to maintain our position in the product areas in which we are currently a leader.

We believe competition in our industry is based on the following factors:

Performance and reliability;

Price;

Compatibility of products with other products and communications standards used in communications networks;

Product size;

Ability to offer integrated solutions;

Time to market;

Breadth of product line;

Logistics and planning systems; and

Quality of manufacturing processes.

While we believe we are competitive on the basis of all the factors listed above, we believe some of our competitors compete more favorably on the basis of price and on delivering products to market more quickly. However, we feel we are particularly strong in offering integrated solutions, our broad product lines and our logistics and planning systems.

### **Research and development**

As of September 30, 2003, our product development team consisted of approximately 2,150 development engineers and scientists. Approximately 85 percent of these development engineers and scientists design and implement product solutions. The remaining 15 percent work primarily on integrated circuit design methodology and common circuit elements that can be used in a number of products.

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Our research and development expenditures were \$467 million, \$625 million and \$815 million for fiscal 2003, 2002 and 2001, respectively. We anticipate that we will continue to make significant research and development expenditures to maintain our competitive position with a continuing flow of innovative products and technology.

### Patents, Trademarks And Other Intellectual Property

We own or have rights to a number of patents, trademarks, copyrights, trade secrets and other intellectual property directly related to and important to our business. We have approximately 5,650 U.S. patents and patent applications and their corresponding foreign patents and patent applications. These patents include patents related to the following technologies:

Integrated circuit and optoelectronic manufacturing processes;

Integrated circuits for use in products such as modems, digital signal processors, wireless communications, network processors and communication protocols; and

Optoelectronic products including lasers, optical modulators, optical receivers and optical amplifiers.

The patents described above include patents of all ages ranging from pending applications, which will have a duration of 20 years from their filing dates, through patents soon to expire.

We indemnify our customers for some of the costs and damages of patent infringement in circumstances where our product is the primary factor creating the customer's infringement exposure. We generally exclude coverage where infringement arises out of the combination of our products with products of others.

We expect to protect our products and processes by asserting our intellectual property rights where appropriate and prudent. We also will obtain patents, copyrights and other intellectual property rights used in connection with our business when practicable and appropriate.

### Government Regulation

Many of our customers' end products that include our products are subject to extensive telecommunications-based regulation by the United States and foreign laws and international treaties. We must design and manufacture our products to ensure that our customers are able to satisfy a variety of regulatory requirements and protocols established to, among other things, avoid interference among users of radio frequencies and to permit interconnection of equipment.

Each country has different regulations and a different regulatory process. In order for our customers' products to be used in some jurisdictions, regulatory approval and, in some cases, specific country compliance testing may be required. The delays inherent in this regulatory approval process may force our customers to reschedule, postpone or cancel the incorporation of our products into their products, which may result in significant reductions in our sales. The failure to comply with current or future regulations or changes in the interpretation of existing regulations in a particular country could result in the suspension or cessation of sales in that country by us or our customers. It also may require us to incur substantial costs to modify our products to aid our customers in complying with the regulations of that country. Changes in our regulatory environment that generally result from our expansion into new areas or changes in current regulations could increase the cost of manufacturing our products because we must continually modify our products to respond to these changes.

In addition, domestic and international authorities continue to regulate the allocation and auction of the radio frequency spectrum. These regulations have a direct impact on us because many of our customers' licensed products can be marketed only if permitted by suitable frequency allocations, auctions and regulations. The implementation of these regulations may delay our end-users in deploying their systems, which could, in turn, lead to delays in orders of our products by our customers and end users. Further, when we license hardware and software designs for mobile phones that use our integrated circuits, we work with our customers to help them achieve full certification approval for their mobile phones, which is a prerequisite for them to be able to sell their mobile phones.

### Employees

As of September 30, 2003, we employed approximately 6,800 active full-time employees, including approximately 6,100 management and non union-represented employees, and approximately 700 U.S. union-represented employees covered by collective bargaining agreements.

On May 27, 2003, we entered into a collective bargaining agreement with local unions 1522, 1560, 1898 and 2000 of the International Brotherhood of Electrical Workers. This agreement, which covers our U.S. union-represented employees, will be effective until May 31, 2006, unless the parties reach a mutual agreement to amend the terms.

We believe that we generally have good relationships with our employees and the unions that represent them.

### **Backlog**

Our backlog, which represents the aggregate of the sales price of orders received from customers for delivery within six months, but not yet recognized as revenue, was approximately \$612 million and \$356 million on September 30, 2003 and September 30, 2002, respectively. The majority of these orders are fulfilled within three months. All orders, however, are subject to possible rescheduling by customers. Our customers often change their orders two or three times between initial order and delivery. Our customers' frequent changes usually relate to quantities or delivery dates, but sometimes relate to the specifications of the products we are shipping. Although we believe that the orders included in the backlog are firm, generally orders may be cancelled by the customer without penalty. We also may elect to permit cancellation of orders without penalty where we believe it is in our best interests to do so. For these reasons, we believe that our backlog at any given date may not be a reliable indicator of future revenues.

### **Environmental, Health And Safety Matters**

We are subject to a wide range of laws and regulations relating to protection of the environment and employee health and safety. Our manufacturing facilities have undergone regular internal audits relating to environmental, health and safety requirements. Most of those facilities also are regularly audited and certified by an independent and accredited third party registrar, such as Lloyd's Register Quality Assurance, as conforming to the internationally recognized ISO 14001 standard relating to environmental management. In addition, our non-U.S. manufacturing facilities conform to BS 8800, the British standard for occupational health and safety management systems. Based upon these reviews, we believe that our manufacturing facilities are in substantial compliance with all applicable environmental, health and safety requirements.

We are subject to environmental laws, including the Comprehensive Environmental Response, Compensation and Liability Act, also known as Superfund, that require the cleanup of soil and groundwater contamination at sites currently or formerly owned or operated by us, or at sites where we may have sent waste for disposal. These laws often require parties to fund remedial action at sites regardless of fault. We are a potentially responsible party at a number of Superfund sites and sites otherwise requiring cleanup action. Specifically, we have liabilities for costs associated with five Superfund sites and two facilities formerly owned by Lucent.

### **Item 2. Properties**

As of September 30, 2003, we operated three manufacturing facilities and three warehouse locations in the United States and three other countries. We also operated an additional 61 facilities, including research and development facilities and design centers. We operated facilities in a total of 18 countries. Our manufacturing facilities were located in the United States, Singapore and Thailand. We also have a 51% interest in our Silicon Manufacturing Partners joint venture located in Singapore, which is predominantly used as a manufacturing site.

Our facilities have an aggregate floor space of approximately 6.7 million square feet, of which approximately 4.7 million square feet, including all of our manufacturing facilities other than our assembly and test facility in Singapore, is owned and approximately 2.0 million square feet is leased. Our lease terms range from monthly leases to 13 years. We believe that all of our facilities and equipment are in good condition and are well maintained and able to operate at present levels.

### **Item 3. Legal Proceedings**

The information required by this Item is included in Item 7 under the heading "Legal Proceedings."

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

During the fourth quarter of fiscal 2003, no matter was submitted to a vote of our security holders.

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### Executive Officers of the Registrant

Our executive officers as of December 1, 2003 were as follows:

<u>Name</u>	<u>Age</u>	<u>Position</u>
John T. Dickson	57	President and Chief Executive Officer
Ronald D. Black	39	Executive Vice President, Client Systems Group
John W. Gamble, Jr.	40	Executive Vice President and Chief Financial Officer
Peter Kelly	46	Executive Vice President, Operations Group
Sohail A. Khan	49	Executive Vice President, Infrastructure Systems Group
Ahmed Nawaz	54	Executive Vice President, Worldwide Sales Group

*John T. Dickson* has been our President and Chief Executive Officer since August 2000. Previously, Mr. Dickson was Executive Vice President and Chief Executive Officer of Lucent's Microelectronics and Communications Technologies Group since October 1999. He joined AT&T in 1993 as Vice President of its Integrated Circuit business unit, moved to Lucent following its spin-off in 1996, and was named Chief Operating Officer of Lucent's Microelectronics Group in 1997. Before joining AT&T, Mr. Dickson was Chairman and Chief Executive Officer of Shographics from 1992 until 1993, was President and Chief Executive Officer of Headland Technology Incorporated from 1991 to 1992, held various management positions at ICL plc from 1983 until 1991 and held various management positions at Texas Instruments from 1969 until 1983. Mr. Dickson is currently a director of the Semiconductor Industry Association, or SIA, and Mettler-Toledo International Inc. and a member of the board of trustees of Lehigh Valley Health Network.

*Ronald D. Black* has been our Executive Vice President, Client Systems Group, since October 2001. Previously, Mr. Black had been Senior Vice President, Strategy and Business Development at Agere from March 2001 to October 2001. Before joining Agere, Mr. Black was Vice President and General Manager, Next-Generation Networks Business Unit of Gemplus, a provider of smart card solutions, from 1998 to 2001. Prior to Gemplus, Mr. Black was the General Manager of the Networking and Communications Systems Division of Motorola's Semiconductor Products Sector.

*John W. Gamble, Jr.* has been our Executive Vice President and Chief Financial Officer since February 2003. Between January 2003 and February 2003, Mr. Gamble was our Senior Vice President and Business Controller and, between January 2001 and January 2003, he was our Senior Vice President and Treasurer. Between 1996 and 2001, Mr. Gamble held a number of finance positions at Honeywell International (formerly Allied Signal), including vice president and chief financial officer of Honeywell Industrial Controls, vice president of business planning and analysis and assistant treasurer. Prior to joining Allied Signal, Mr. Gamble held a number of positions with General Motors, including treasurer of General Motors of Canada and director of international acquisitions and divestitures.

*Peter Kelly* has been our Executive Vice President, Operations Group, since October 2001. Previously, Mr. Kelly had been Agere's Vice President of Operations for Integrated Circuits from September 2000 to October 2001. Mr. Kelly joined Lucent Microelectronics in September 2000 from Fujitsu-ICL Systems Inc., a joint venture of ICL and Fujitsu that provided computer systems and services to retailers and banks, where he was Executive Vice President and Chief Operating Officer. Mr. Kelly had been with Fujitsu-ICL for six years.

*Sohail A. Khan* has been our Executive Vice President, Infrastructure Systems Group, since October 2001. Previously, Mr. Khan had been Executive Vice President of Integrated Circuits since March 2001. Mr. Khan was President of the Integrated Circuits business of Lucent's Microelectronics and Communications Technologies Group from April 2000 to March 2001. Mr. Khan was the strategy and business development Vice President of Lucent's Microelectronics and Communications Technologies Group from September 1996 to April 2000. From April 1996 to September 1996, Mr. Khan was Vice President of Marketing for MMC Networks, a developer and supplier of network processing platforms and services. Mr. Khan joined AT&T in 1990 as the director of marketing and applications engineering for the digital signal processing product line and moved to Lucent following its spin-off in 1996. While at AT&T, he held a variety of positions, including Vice President and General Manager of the Wireless and Multimedia business unit of AT&T from February 1994 to April 1996.

*Ahmed Nawaz* has been our Executive Vice President, Worldwide Sales Group, since March 2001. Mr. Nawaz was President of Worldwide Sales, Strategy and Business Development, from April 2000 to March 2001, and President, Integrated Circuits Division, from July 1998 to April 2000, of Lucent's Microelectronics and Communications Technologies Group. He joined AT&T in 1992 and moved to Lucent following its spin-off in 1996. Mr. Nawaz was Vice President of Lucent's Network Communications business unit from January 1996 to July 1998.

While at AT&T, he was Vice President of the Applications business unit from 1994 to 1995. Prior to joining AT&T, Mr. Nawaz was at Texas Instruments, where he was responsible for the personal computer business unit from 1990 to 1992 and also held various marketing and product management positions.

Officers are not elected for a fixed term of office but hold office until their successors have been elected.

## PART II

### Item 5. Market for Registrant's Common Equity and Related Stockholder Matters

#### *Price Range of Common Stock*

Our Class A common stock trades on the New York Stock Exchange under the symbol AGR.A. The high and low sale prices for our Class A common stock for each quarter during our last two full fiscal years are set forth below, as reported in the consolidated transaction reporting system:

<u>Fiscal 2002</u>	<u>High</u>	<u>Low</u>
Quarter Ended December 31, 2001	\$6.30	\$4.06
Quarter ended March 31, 2002	\$6.10	\$3.60
Quarter ended June 30, 2002	\$4.49	\$1.40
Quarter ended September 30, 2002	\$2.70	\$0.95
<u>Fiscal 2003</u>		
Quarter ended December 31, 2002	\$1.74	\$0.50
Quarter ended March 31, 2003	\$2.04	\$1.35
Quarter ended June 30, 2003	\$2.70	\$1.29
Quarter ended September 30, 2003	\$3.71	\$2.28

All of our outstanding Class B common stock was held by Lucent until June 1, 2002, when Lucent completed our spin-off, distributing to its stockholders all of our Class A common stock and Class B common stock that it held on that date.

Our Class B common stock has traded on the New York Stock Exchange under the symbol AGR.B since June 3, 2002. The following table sets forth, for the indicated periods, the quarterly high and low sale prices of our Class B common stock, as reported in the consolidated transaction reporting system:

<u>Fiscal 2002</u>	<u>High</u>	<u>Low</u>
Quarter ended June 30, 2002 (trading began June 3, 2002)	\$3.32	\$1.35
Quarter ended September 30, 2002	\$2.72	\$0.94
<u>Fiscal 2003</u>		
Quarter ended December 31, 2002	\$1.74	\$0.51
Quarter ended March 31, 2003	\$2.01	\$1.33

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### Fiscal 2003

Quarter ended June 30, 2003	\$2.60	\$1.19
Quarter ended September 30, 2003	\$3.52	\$2.19

As of December 1, 2003, there were 652,124 holders of record of the Class A common stock and 1,330,634 holders of record of the Class B common stock. We believe that the number of beneficial owners is substantially greater than the number of record holders, because a large portion of our common stock is held of record through brokerage firms in street name.

#### *Dividend Policy*

We do not anticipate paying any dividends on our common stock in the foreseeable future. We currently intend to retain our future earnings for use in the operation and expansion of our business.

#### *Unregistered Sales of Common Stock*

On August 22, 2003, we acquired Massana Limited, a developer of Gigabit Ethernet-over-copper physical layer device technologies. As part of the acquisition, we issued 9,108,125 shares of Class A common stock to the Massana stockholders in exchange for all the outstanding shares of Massana. The shares were issued in a private, directly

11

negotiated transaction not involving a public offering in reliance on the exemption from registration provided by Section 4(2) of the Securities Act of 1933. Our reliance on this exemption was based in principal part on certain factual representations received from the former Massana stockholders who received the shares.

See Item 12 for information about our equity compensation plans.

### **Item 6. Selected Financial Data**

The following table sets forth selected financial information for our company. The financial information for the years ended September 30, 2003, 2002, and 2001, and as of September 30, 2003 and 2002, has been derived from our audited financial statements included elsewhere in this report. The financial information as of September 30, 2001, 2000 and 1999 has been derived from our audited financial statements not included in this report. The financial information for the years ended September 30, 2000 and 1999 has been reclassified to reflect our former optoelectronic components business as discontinued operations and was derived from our unaudited financial statements not included in this report. The historical selected financial information may not be indicative of our future performance and should be read in conjunction with the information contained in Management's Discussion and Analysis of Financial Condition and Results of Operations and the consolidated and combined financial statements and the related notes included in Items 7 and 8, respectively.

	Year Ended September 30,				
	2003	2002 (1)	2001 (2)	2000 (3)	1999
				(unaudited)	(unaudited)
<i>(Dollars in millions except per share amounts)</i>					
<b>Statement of operations information:</b>					
Revenue	\$1,839	\$1,923	\$2,886	\$3,515	\$3,064
Gross profit	579	494	915	1,574	1,492
Income (loss) from continuing operations	(371)	(803)	(1,454)	104	159
<b>Basic and diluted earnings (loss) per share: (4)</b>					
Income (loss) from continuing operations	\$ (0.22)	\$ (0.49)	\$ (1.09)	\$ 0.10	\$ 0.15
Weighted average shares outstanding - basic and diluted (millions)	1,667	1,637	1,334	1,035	1,035

	September 30,				
	2003	2002 (1)	2001 (2)	2000 (3)	1999
<b>Balance sheet information:</b>					
Total assets	2,388	2,864	6,562	7,067	3,020
Short-term debt	195	197	2,516	14	14
Long-term debt	451	486	33	46	64

- (1) During fiscal 2002, our short-term debt decreased significantly as we repaid \$2.5 billion of borrowings under a credit facility. Also, our total assets decreased significantly as we used \$1.6 billion of cash on hand to repay the credit facility and recorded significant impairments of property, plant and equipment, as well as goodwill and other acquired intangibles.
- (2) During fiscal 2001, we received approximately \$3.4 billion of net proceeds from our initial public offering and recorded a \$2.8 billion impairment of goodwill and other acquired intangibles. We also assumed \$2.5 billion of debt from Lucent, consisting of short-term borrowings under a credit facility provided by financial institutions. We did not receive any of the proceeds of this short-term debt.
- (3) During fiscal 2000, goodwill and other acquired intangibles increased by \$3.4 billion due to the acquisitions of Ortel Corporation, Herrmann Technology Inc., Agere, Inc. and substantially all the assets of VTC Inc.
- (4) Basic and diluted earnings (loss) per common share are calculated by dividing income (loss) by the weighted average number of common shares outstanding during the period. The weighted average number of common shares outstanding on a historical basis includes the retroactive recognition to October 1, 1998 of the 1,035,100,000 shares owned by Lucent prior to our initial public offering.

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

*The following discussion of our financial condition and results of operations should be read in conjunction with our financial statements and the related notes in Item 8. This discussion contains forward-looking statements. Please see *Forward-Looking Statements and Factors Affecting Our Future Performance* for a discussion of the uncertainties, risks and assumptions associated with these statements.*

### Overview

We provide advanced integrated circuit solutions for applications such as high-density storage, multi-service networking, wireless data and personal computer connectivity. These solutions form the building blocks for a broad range of communications and computing applications. Integrated circuits are made using semiconductor wafers imprinted with a network of electronic components. They are designed to perform various functions such as processing electronic signals, controlling electronic system functions and processing and storing data.

Our business operations are divided into two market-focused groups, Client Systems and Infrastructure Systems. The Client segment targets the computer and consumer communications market and the Infrastructure segment targets the network equipment market. Each of these two groups is a reportable operating segment. The segments each include revenue from the licensing of intellectual property. The Client segment provides integrated circuit solutions for a variety of end-user applications such as hard disk drives and modems for computers, data-enabled mobile phones and wireless local area networking. The Infrastructure segment provides integrated circuit solutions to makers of high-speed communications systems. In addition, the Infrastructure segment formerly provided optoelectronic components; however, we have sold those operations and have reflected them as discontinued operations for all periods presented. See *Sale of Optoelectronic Components Business* for additional details.

In fiscal 2003, we refined our methodology for allocating shared information technology expenses to our operating segments and between costs, selling, general and administrative expenses, and research and development expenses. We believe that this methodology provides a better assignment of these expenses based on additional information about the components and underlying drivers which has been developed since our



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separation from Lucent Technologies Inc. in fiscal 2001. We have conformed historical amounts for all periods presented to the current presentation. As a result of this change, we reclassified \$58 million and \$39 million of expenses previously reflected in costs to operating expenses for fiscal 2002 and 2001, respectively.

### ***Separation from Lucent***

We were incorporated under the laws of the State of Delaware on August 1, 2000, as a wholly owned subsidiary of Lucent. On February 1, 2001, Lucent transferred to us the assets and liabilities related to our business, other than pension and postretirement assets and liabilities, which have subsequently been transferred. In April 2001, we completed our initial public offering. On June 1, 2002, Lucent completed our spin-off by distributing all of the Agere common stock it then owned to its stockholders.

Prior to the completion of the spin-off on June 1, 2002, we were a majority-owned subsidiary and a related party of Lucent. Revenue from products sold to Lucent during fiscal 2002, prior to the spin-off, was \$162 million, of which \$43 million is recorded within income (loss) from operations of discontinued business. Revenue from products sold to Lucent for fiscal 2001 was \$606 million, of which \$165 million is recorded within income (loss) from operations of discontinued business.

Our financial statements include amounts prior to February 1, 2001 that have been derived from the financial statements and accounting records of Lucent using the historical results of operations and historical basis of the assets and liabilities of our businesses. We believe the assumptions underlying our financial statements are reasonable. However, our financial statements that were derived from Lucent's financial records may not necessarily reflect what our results of operations, financial position and cash flows would have been had we been a stand-alone company. Because a direct ownership relationship did not exist among all the various units comprising Agere, Lucent's net investment in us is shown in lieu of stockholders' equity in our financial statements for periods prior to February 1, 2001. We began accumulating retained earnings (losses) on February 1, 2001, the date on which Lucent transferred to us substantially all the assets and liabilities of our business. For periods prior to February 1, 2001, our financial statements include allocations of Lucent's expenses, assets and liabilities.

13

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### ***Sale of Optoelectronic Components Business***

During the second quarter of fiscal 2003, we sold a substantial portion of our optoelectronic components business to TriQuint Semiconductor, Inc. for \$40 million in cash. The transaction included the products, product warranty liabilities, technology and certain facilities related to this business; and included lasers, detectors, modulators, passive components, arrayed waveguide-based components, amplifiers, transmitters, receivers, transceivers, transponders and micro electro-mechanical systems.

During the second quarter of fiscal 2003, we also sold the remainder of our optoelectronic components business, which provided cable television transmission systems, telecom access and satellite communications components, to EMCORE Corporation for \$25 million in cash. The transaction included the assets, products, product warranty liabilities, technology and intellectual property related to this business.

Our exit from the optoelectronic components business was completed as a result of these two sales. The consolidated financial statements have been reclassified for all periods presented to reflect the optoelectronic components business as discontinued operations. See Note 4 to our financial statements in Item 8 for additional details.

### ***Operating Environment***

In fiscal 2001 and 2002, we saw significant declines in our revenue, particularly from our telecommunications equipment manufacturing customers. We believe that these customers were themselves experiencing significant declines in demand from their customers. As our revenue declined, we determined on several occasions that we needed to reduce our cost structure. As a result, we implemented programs to reduce our headcount, consolidate our operations into fewer facilities and reduce our owned manufacturing capacity, including exiting our optoelectronic components business, selling several non-core businesses and reducing our capital spending.

We have now substantially completed our planned restructuring activities, including headcount reductions and facility consolidations. We have also ceased operations at our integrated circuit manufacturing facilities located in Allentown and Reading, Pennsylvania. Our remaining restructuring activities, primarily the decommissioning of these manufacturing facilities, will take several more quarters to complete.

Our revenue has increased in each of the last three quarters, after reaching a low-point in the first quarter of fiscal 2003. As a result of our actions to reduce costs and expenses and our stabilizing revenue, we have seen improvements in our gross profit and net income (loss) in each of

the last three quarters.

Our business depends in large part on demand for personal computers and associated equipment, wireless communications equipment such as mobile phones and wireless local area networking equipment and telecommunications infrastructure equipment. Our revenues can be affected by changes in demand for any of these types of products. These markets are competitive and rapidly changing and significant technological changes, new customer requirements, changes in customer buying behavior or the emergence of competitive products with new capabilities or technologies could adversely affect revenues and operating results. Also, portions of our revenues have been derived from customers that individually accounted for greater than 10% of our revenues. In fiscal 2003, sales to Maxtor and Seagate represented 16% and 12%, respectively, of our revenue. In fiscal 2002, sales to Maxtor represented 14% of our revenue and in fiscal 2001, sales to Lucent represented 15% of our revenue. Maxtor and Seagate are customers of our Client segment and Lucent is a customer of our Infrastructure segment.

#### ***Restructuring Activities***

As a result of our restructuring activities, we recorded net restructuring and related charges within continuing operations of \$131 million, \$503 million and \$486 million for fiscal 2003, 2002 and 2001, respectively, which are classified within restructuring and other charges net. For additional details regarding our net restructuring and other charges, see Note 5 to our financial statements in Item 8.

We also recorded restructuring related costs within continuing operations within gross profit of \$103 million and \$59 million for fiscal 2003 and 2002, respectively, of which \$71 million and \$34 million, respectively, resulted from increased depreciation. The increased depreciation is due to the shortening of estimated useful lives of certain manufacturing assets in connection with our restructuring activities. There were no restructuring related costs recorded within gross profit for fiscal 2001.

To complete our remaining restructuring and consolidation actions, we estimate we will incur additional expenses of approximately \$40 to \$50 million in the first quarter of fiscal 2004, primarily for the decommissioning

of our manufacturing sites in Allentown and Reading. We also expect to spend approximately \$20 million for capital expenditures in fiscal 2004 and fiscal 2005 related to our restructuring and consolidation actions. These are expected to be the last major expenditures under our previously announced restructuring initiatives.

#### ***Application of Critical Accounting Policies and Estimates***

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements and revenues and expenses during the period reported. The following accounting policies involve a critical accounting estimate because they are particularly dependent on estimates and assumptions made by management about matters that are highly uncertain at the time the accounting estimates are made. In addition, while we have used our best estimates based on facts and circumstances available to us at the time, different estimates reasonably could have been used in the current period, and changes in the accounting estimates we used are reasonably likely to occur from period to period which may have a material impact on the presentation of our financial condition and results of operations. We review these estimates and assumptions periodically and reflect the effects of revisions in the period that they are determined to be necessary. We have reviewed our critical accounting policies with our audit committee.

#### ***Property, Plant and Equipment***

Property, plant and equipment that is held and used is generally reflected in our financial statements at historical cost less an allocation for depreciation that may not be reflective of its fair market value. However, we have impaired property, plant and equipment in connection with our restructuring initiatives. Property, plant and equipment is reviewed for impairment whenever events such as a significant industry downturn, product discontinuance, plant closures, product dispositions, technological obsolescence or other changes in circumstances indicate that their carrying amount may not be recoverable. We perform impairment tests on groups of assets that are related and have separately identifiable cash flows. In some cases, it may not be practical to measure the cash flows associated with a group of assets due to the integrated nature of our production process. As a result, we may need to shorten the useful lives related to these assets, which would cause us to recognize increased depreciation. If separate identifiable cash flows can be identified, we compare the carrying amount of the assets to their undiscounted expected future cash flows. If an impairment exists, assets classified as held and used are written-down to fair value and assets classified as held for sale are written-down to fair value less costs to sell. It is reasonably likely that the actual fair value may differ from our current estimate, in which case we may under- or over-value our property, plant and equipment and under- or over- value the related impairment charge.

*Tax Valuation Allowance*

A tax valuation allowance is established, as needed, to reduce net deferred tax assets to the amount for which recovery is probable. Commencing with the quarter ended June 30, 2001, we established a full valuation allowance against our U.S. net deferred tax assets because our lack of history as an independent company, recent losses and the uncertainty of the timing of the recovery of our industry, cause our long term financial forecast to have enough uncertainty that we do not meet the standard of *more likely than not* that is required for measuring the likelihood of realization of net deferred tax assets. In the event it becomes more likely than not that some or all of the deferred tax assets will be realized, we will adjust our valuation allowance. Depending on the amount and timing of taxable income we ultimately generate in the future, as well as other factors, we could recognize no benefit from our deferred tax assets, in accordance with our current estimate, or we could recognize their full value.

*Tax Contingencies*

Tax contingencies are recorded to address potential exposures involving tax positions we have taken that could be challenged by taxing authorities. These potential exposures result from the varying application of statutes, rules, regulations and interpretations. Our estimate of the value of our tax contingencies contains assumptions based on past experiences and judgments about potential actions by taxing jurisdictions. The majority of our tax contingencies were transferred to us from Lucent as part of the separation transaction and reflect our potential exposures under the tax sharing agreement. We believe these tax contingencies are reasonable. It is likely that the ultimate resolution of these matters may be greater or less than the amount that we have accrued.

15

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*Retirement Benefits*

Postretirement liabilities are for benefits that we expect to pay to eligible former employees who are retired. We consider various factors in determining our postretirement liability, including the number of employees who will receive benefits, the type and length of benefits they will receive, trends in health care costs and other actuarial assumptions. If the actual postretirement benefits paid differ from our current estimate we may be over- or under-accrued.

We also have pension plans covering substantially all U.S. employees, excluding management employees hired after June 30, 2003. We consider various factors in determining our pension liability, including the number of employees who will be paid, their salary levels and years of service, the expected return on plan assets, the discount rate used to determine the benefit obligation, the timing of the payment of benefits, and other actuarial assumptions. If the actual results and events of our pension plan differ from our current assumptions, our benefit obligations may be over- or under-valued.

We reassess our retirement benefit plan assumptions on a regular basis. The three key benefit plan assumptions are the discount rate, salary increase assumptions and the expected rate of return on plan assets. The discount rate we use reflects the prevailing market rate of a portfolio of fixed-income debt instruments rated AA or better and with maturities matching the expected maturities of the benefit obligations. During the latter part of fiscal 2003, we recorded a curtailment as a result of actions taken under our recent restructuring related initiatives. This caused us to re-evaluate our assumptions and we changed the discount rate to 6.25% from 6.75% for our U.S. retirement benefit plans. We base our salary increase assumptions on historical experience and future expectations. The expected rate of return for our retirement benefit plans represents the average rate of return expected to be earned on plan assets over the period the benefits included in the benefit obligation are expected to be paid. In developing the expected rate of return, we consider long-term compound annualized returns based on historical market data as well as historical and expected returns on the various categories of plan assets. For fiscal 2003, the weighted-average long-term rate of return on assets assumption remains at 8% for our U.S. retirement benefit plans. The target investment portfolio allocation for our U.S. pension plans is 40% in equities and 60% in fixed income investments. The portfolio's equity weighting is consistent with the long-term nature of the plans' benefit obligation.

Actuarial assumptions are based upon management's best estimates and judgment. Material changes may occur in retirement benefit costs in the future if these assumptions differ from actual events or experience. Each change of 25 basis points in the discount rate assumption would have an estimated \$0.5 million impact on net retirement benefit costs and a \$44 million impact on benefit obligations. Each change of 25 basis points in the expected rate of return assumption would have an estimated \$3.2 million annual impact on net retirement benefit costs.

**Results of Operations**

*Fiscal year ended September 30, 2003 compared to fiscal year ended September 30, 2002*

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The following table shows the change in revenue, both in dollars and in percentage terms by segment:

	Year Ended September 30,		Change	
	2003	2002	\$	%
(dollars in millions)				
<b>Operating Segment:</b>				
Client Systems	\$ 1,321	\$ 1,259	\$ 62	5%
Infrastructure Systems	518	664	(146)	(22)
Total Revenue	\$ 1,839	\$ 1,923	\$ (84)	(4)%

*Revenue.* Revenue decreased 4% or \$84 million, to \$1,839 million in fiscal 2003 from \$1,923 million in fiscal 2002. The increase of \$62 million within the Client segment reflects strength in the sales of GPRS solutions used in mobile phones and system-on-a-chip solutions used in hard disk drives, as well as a \$37 million increase in intellectual property licensing revenues. These increases were partially offset by the absence of \$62 million in revenues from our wireless local area network equipment business which we sold in fiscal 2002. Also offsetting the increase was a decline in revenues related to our wireless local area networking solutions as we experienced price pressures and a transition from a board-based to a chipset-based solution.

The decrease of \$146 million within the Infrastructure segment reflects the absence of \$66 million in revenues from our analog line card and field-programmable gate array businesses which we sold in fiscal 2002, as well as

16

a \$25 million decrease in intellectual property licensing revenues. The remaining decrease was caused by decreased volume, which resulted from lower demand from telecommunications equipment manufacturers as their customers, communication service providers, reduced capital expenditures.

*Costs and gross margin.* Costs decreased 12%, or \$169 million, to \$1,260 million in fiscal 2003 from \$1,429 million in fiscal 2002. Gross margin increased 5.8 percentage points to 31.5% in fiscal 2003 from 25.7% in fiscal 2002. Gross margin for the Client segment decreased to 21.3% in fiscal 2003 from 29.3% in fiscal 2002. Gross margin for the Infrastructure segment increased to 57.3% in fiscal 2003 from 18.8% in fiscal 2002. The changes in gross margin on a segment basis were caused in part by a change in the allocation of certain shared manufacturing costs. We update at the beginning of each fiscal year the allocation of our shared integrated circuit fabrication costs based on the demand forecasts by month from our two operating segments. This essentially creates a take-or-pay relationship between our manufacturing facilities and the operating segments. As a result, the dramatic decline in the telecommunications markets in fiscal 2002 negatively impacted Infrastructure gross margin due to excess manufacturing capacity, as sales volumes were less than we had anticipated. With the update of our demand forecast for fiscal 2003, the costs allocated to our Client segment for fiscal 2003 increased by approximately \$80 million when compared to fiscal 2002. Accordingly, the costs allocated to the Infrastructure segment decreased by the same amount. This change in allocation is partly responsible for the decrease in Client gross margin and the increase in Infrastructure gross margin, although it has no effect on our total gross margin.

In addition to the change in allocation described above, the Client segment gross margin was negatively impacted by a \$79 million increase in restructuring related costs, as well as the absence of gross margin from our wireless local area network equipment business which we sold in fiscal 2002. These decreases to gross margin were partially offset by a \$34 million increase in gross margin from the licensing of intellectual property and improved expense management related to the actions taken under our restructuring and cost saving initiatives. In addition to the change in allocation described above, the Infrastructure segment gross margin was positively impacted by improved expense management related to the actions taken under our restructuring and cost saving initiatives, a \$35 million decrease in restructuring related costs, \$22 million of lower inventory provisions in fiscal 2003 and the sale of our analog line card business in fiscal 2002, offset in part by lower sales volumes and a \$20 million decrease in gross margin from the licensing of intellectual property.

*Selling, general and administrative.* Selling, general and administrative expenses decreased 10% or \$32 million from \$326 million in fiscal 2002 to \$294 million in fiscal 2003. The decrease was primarily driven by reduced salary, benefit and other expenditures as a result of our restructuring and cost saving initiatives and the absence of expenditures related to our analog line card, field-programmable gate array and wireless local area network equipment businesses which we sold in fiscal 2002. The decrease was partially offset by \$16 million related to annual meeting expenses, as there was a significant increase in the number of Agere stockholders as a result of the distribution of Agere

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common stock by Lucent to its stockholders on June 1, 2002.

*Research and development.* Research and development expenses decreased 25% or \$158 million from \$625 million in fiscal 2002 to \$467 million in fiscal 2003. The majority of the decrease was due to reduced expenditures as we focused our product development efforts and realized savings from our restructuring and cost saving initiatives. We also reduced our research and development efforts related to silicon fabrication research and other manufacturing processes as we transition to a fab-lite model, which resulted in a decrease of approximately \$45 million. In addition, approximately \$26 million of the decrease is due to the absence of expenses from the three businesses that we sold in fiscal 2002.

*Amortization of goodwill and other acquired intangibles.* Amortization expense decreased 76% or \$26 million from \$34 million in fiscal 2002 to \$8 million in fiscal 2003, primarily due to the absence of amortization of goodwill in fiscal 2003. Effective October 1, 2002, we adopted Statement 142, Goodwill and Other Intangible Assets, and are no longer permitted to amortize goodwill. We continue to amortize acquired intangible assets with finite lives over their useful life.

*Restructuring and other charges net.* Net restructuring and other charges decreased 74% or \$372 million to \$131 million in fiscal 2003 from \$503 million in fiscal 2002. See Restructuring Activities for additional details.

*(Gain) loss on sale of operating assets net.* (Gain) loss on sale of operating assets net decreased \$278 million from a gain of \$299 million in fiscal 2002 to a gain of \$21 million in fiscal 2003. The fiscal 2002 gain consists principally of a \$243 million gain on the sale of our field-programmable gate array business and a

17

\$58 million gain on the sale of our wireless local area network equipment business, while the fiscal 2003 gain consists principally of the recognition of a \$16 million gain on the sale of the analog line card business, which had previously been deferred. See Note 9 to our financial statements in Item 8 for additional information.

*Operating loss.* We reported an operating loss of \$300 million in fiscal 2003, compared with an operating loss of \$695 million in fiscal 2002. The improvement in operating loss is primarily attributable to lower expenses and a higher gross margin in the current year, partially offset by lower gains on the sale of operating assets in the current year. Although performance measurement and resource allocation for the reportable segments are based on many factors, the primary financial measure used is operating income (loss) by segment, exclusive of amortization of goodwill and other acquired intangibles, net restructuring and other charges and (gain) loss on sale of operating assets net, which is shown in the following table:

	Year Ended September 30,		Change	
	2003	2002	\$	%
	(dollars in millions)			
<b>Operating Segment: (1)</b>				
Client Systems	\$(148)	\$ (73)	\$ (75)	(103)%
Infrastructure Systems	(34)	(384)	350	91
Total Operating Loss by Segment	\$(182)	\$(457)	\$275	60%

(1) A reconciliation of operating loss by segment to total operating loss is provided in Note 19 to our financial statements in Item 8.

*Other income net.* Other income net decreased 71% or \$54 million to \$22 million in fiscal 2003 compared to \$76 million in the prior year. The change is primarily due to a \$27 million decrease in income from our equity investment in Silicon Manufacturing Partners Pte, Ltd. and a \$20 million decrease in interest income as a result of lower average cash balances.

*Interest expense.* Interest expense decreased 61% or \$74 million to \$47 million in fiscal 2003 from \$121 million in fiscal 2002. This decrease is due to having significantly lower debt in fiscal 2003 primarily as a result of repayments on our credit facility, which matured on September 30, 2002, partially offset by interest incurred on our convertible subordinated notes.

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*Provision for income taxes.* For fiscal 2003, we recorded a provision for income taxes of \$46 million on a pre-tax loss from continuing operations of \$325 million, yielding an effective tax rate of (14.2)%. This rate differs from the U.S. statutory rate primarily due to the recording of a full valuation allowance of \$91 million against U.S. net deferred tax assets and the tax effect of non-U.S. operations. For fiscal 2002, we recorded a provision for income taxes of \$63 million on a pre-tax loss from continuing operations of \$740 million, yielding an effective tax rate of (8.5)%. This rate differs from the U.S. statutory rate primarily due to the impact of recording a full valuation allowance of \$259 million against U.S. net deferred tax assets and the tax effect of non-U.S. operations.

*Income (loss) from discontinued operations.* For fiscal 2003, income from discontinued operations was \$38 million, or \$0.02 per share, and consisted of income from operations of \$8 million and a gain on disposal of \$30 million. The gain from disposal reflects an \$11 million gain from the sale to TriQuint and a \$19 million gain from the sale to EMCORE. For fiscal 2002, loss from discontinued operations was \$1,008 million, or \$0.62 per share.

### *Fiscal year ended September 30, 2002 compared to fiscal year ended September 30, 2001*

The following table shows the change in revenue, both in dollars and in percentage terms by segment:

	Year Ended September 30,		Change	
	2002	2001	\$	%
	(dollars in millions)			
<b>Operating Segment:</b>				
Client Systems	\$ 1,259	\$ 1,406	\$ (147)	(10)%
Infrastructure Systems	664	1,480	(816)	(55)
Total Revenue	\$ 1,923	\$ 2,886	\$ (963)	(33)%

*Revenue.* Revenue decreased 33%, or \$963 million, to \$1,923 million in fiscal 2002 from \$2,886 million in fiscal 2001 due primarily to volume decreases. The decrease of \$147 million within the Client segment was driven

18

by price erosion across the entire segment, particularly in the wireless local area networking market, and volume decreases across the majority of the segment, except for the hard disk drive market which experienced substantial volume growth. The decrease of \$816 million within the Infrastructure segment was due to depressed market conditions and reduced expenditures by communication service providers and communication equipment manufacturers, which drove volume decreases across the entire segment.

*Costs and gross margin.* Costs decreased 27%, or \$542 million, to \$1,429 million in fiscal 2002 from \$1,971 million in fiscal 2001. Gross margin decreased to 25.7% in fiscal 2002 from 31.7% in fiscal 2001, a decrease of 6.0 percentage points. Gross margin for the Client segment increased to 29.3% in fiscal 2002 from 24.7% in fiscal 2001. This increase was primarily due to improved manufacturing capacity utilization as a result of actions taken under our restructuring and cost saving initiatives and lower inventory provisions of \$22 million, partially offset by the effects of product price reductions. Gross margin for the Infrastructure segment decreased to 18.8% in fiscal 2002 from 38.4% in fiscal 2001. The decrease was due to excess manufacturing capacity as a result of the decline in sales volume, which was partially offset by lower inventory provisions of \$30 million.

*Selling, general and administrative.* Selling, general and administrative expenses decreased 38%, or \$197 million, from \$523 million in fiscal 2001 to \$326 million in fiscal 2002. The decrease was primarily due to reduced salary, benefit and other expenditures as a result of our restructuring and cost saving initiatives.

*Research and development.* Research and development expenses decreased 23%, or \$190 million, from \$815 million in fiscal 2001 to \$625 million in fiscal 2002. The decrease was primarily due to reduced expenditures as we focused our product development efforts and realized savings from our restructuring and cost saving initiatives.

*Amortization of goodwill and other acquired intangibles.* Amortization expense decreased 55%, or \$42 million, from \$76 million in fiscal 2001 to \$34 million in fiscal 2002. The decrease is principally due to an impairment of goodwill and other acquired intangibles of \$267 million

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recognized in the second half of fiscal 2001. This impairment reduced our goodwill and other acquired intangibles and therefore, fiscal 2002 amortization.

*Restructuring and other charges net.* Net restructuring and other charges increased 3%, or \$17 million, to \$503 million in fiscal 2002 from \$486 million in fiscal 2001. Net restructuring and related expenses increased 28%, or \$109 million, to \$496 million in fiscal 2002 from \$387 million in the prior fiscal year. Expenses associated with the separation from Lucent decreased 93%, or \$92 million, to \$7 million in fiscal 2002 from \$99 million in fiscal 2001, as the separation was mostly completed in fiscal 2001.

*Impairment of goodwill and other acquired intangibles.* Prior to the adoption in fiscal 2003 of Statement 142, we reviewed our long-lived assets for impairment in accordance with Statement 121. Statement 121 required that a long-lived asset be assessed for impairment whenever events or changes in circumstances indicated the carrying amount of the asset may not be fully recoverable. We performed assessments because of weakening economic conditions and decreased current and expected future demand for products in the markets in which we operate. As a result of these assessments, we determined that an impairment of goodwill and other acquired intangibles existed related to certain of our acquisitions. During fiscal 2001, we recorded a charge of \$267 million to reduce goodwill and other acquired intangibles, consisting of \$240 million and \$27 million related to Agere, Inc. and Enable Semiconductor Inc., respectively. There were no impairment charges for goodwill and other acquired intangibles related to continuing operations in fiscal 2002.

*(Gain) loss on sale of operating assets net.* (Gain) loss on sale of operating assets net increased \$301 million, to a gain of \$299 million in fiscal 2002 from a loss of \$2 million in fiscal 2001. The fiscal 2002 amount consists principally of a \$243 million gain related to the sale of our field-programmable gate array business and a \$58 million gain related to the sale of our wireless local area network equipment business.

*Operating loss.* We reported an operating loss of \$695 million for fiscal 2002 compared to an operating loss of \$1,254 million for fiscal 2001. The improvement in operating loss is primarily attributable to expense reductions, gains on sale of operating assets and a reduction in the impairment of goodwill and other acquired intangibles, partially offset by a decrease in gross profit. Although performance measurement and resource allocation for the reportable segments are based on many factors, the primary financial measure used is operating income (loss) by segment, exclusive of amortization of goodwill and other acquired intangibles, restructuring and other charges

19

net, the impairment of goodwill and other acquired intangibles, and (gain) loss on sale of operating assets net, which is shown in the following table:

	Year Ended September 30,		Change	
	2002	2001	\$	%
	(dollars in millions)			
<b>Operating Segment: (1)</b>				
Client Systems	\$ (73)	\$(187)	\$ 114	61%
Infrastructure Systems	(384)	(236)	(148)	(63)
Total Operating Loss by Segment	\$(457)	\$(423)	\$ (34)	(8)%

(1) A reconciliation of operating loss by segment to total operating loss is provided in Note 19 to our financial statements in Item 8.

*Other income net.* Other income net increased 23% or \$14 million to \$76 million in fiscal 2002 from \$62 million in fiscal 2001. The \$76 million in fiscal 2002 was comprised primarily of \$40 million of income from our equity investment in Silicon Manufacturing Partners Pte, Ltd., \$30 million of interest income and \$6 million of other miscellaneous income. The \$62 million in fiscal 2001 was comprised primarily of \$69 million of interest income and \$42 million of income from our equity investment, partially offset by \$22 million for impairments of non-consolidated investments, \$14 million of foreign exchange losses and \$13 million of other miscellaneous losses.

*Interest expense.* Interest expense decreased 20%, or \$30 million, from \$151 million in fiscal 2001 to \$121 million in fiscal 2002. During fiscal 2002, our interest expense was principally related to our credit facility, which we significantly reduced throughout the year and fully repaid by the end of the fiscal year and the convertible notes we issued in June of 2002. During fiscal 2001, our interest expense primarily reflects four months of allocations from Lucent and interest on the \$2,500 million credit facility we assumed from Lucent in April 2001.

*Provision for income taxes.* For fiscal 2002, we recorded a provision for income taxes of \$63 million on a pre-tax loss from continuing operations of \$740 million, yielding an effective tax rate of (8.5)%. This rate differs from the U.S. statutory rate primarily due to the recording of a full valuation allowance of \$259 million against U.S. net deferred tax assets and the tax effect of non-U.S. operations. For fiscal 2001, we recorded a provision for income taxes of \$111 million on a pre-tax loss from continuing operations of \$1,343 million, yielding an effective tax rate of (8.3)%. This rate differs from the U.S. statutory rate primarily due to the impact of recording a full valuation allowance of \$412 million against U.S. net deferred tax assets and the tax effect of non-U.S. operations.

*Income (loss) from discontinued operations.* For fiscal 2002, loss from discontinued operations was \$1,008 million, or \$0.62 per share, and included \$475 million of restructuring charges and a \$220 million impairment for goodwill and other acquired intangibles. For fiscal 2001, loss from discontinued operations was \$3,158 million, or \$2.37 per share, and included a \$2,495 million impairment for goodwill and other acquired intangibles.

## Liquidity and Capital Resources

On September 30, 2003, our cash in excess of short-term debt was \$549 million, which reflects \$744 million in cash and cash equivalents less \$154 million of borrowings under our accounts receivable securitization facility, \$34 million from the current portion of our capitalized lease obligations and \$7 million from the current portion of our installment note. In addition, we have \$21 million of cash held in trust that primarily supports obligations of our captive insurance company and is not immediately available to fund on-going operations. On September 30, 2003, our long-term debt was \$451 million, which consists of \$410 million of convertible subordinated notes due December 15, 2009, \$31 million from the non-current portion of our capitalized lease obligations and \$10 million from the non-current portion of our installment note.

Net cash used in operating activities from continuing operations was \$23 million in fiscal 2003 compared with \$428 million in fiscal 2002. This improvement in cash used in operating activities reflects the impact of our steps to reduce our cost structure, including restructuring and consolidation actions, and the streamlining of our product portfolio. Net cash used in operating activities from discontinued operations was \$86 million in fiscal 2003 compared with \$232 million in fiscal 2002.

Net cash used in operating activities from continuing operations was \$428 million in fiscal 2002 compared with net cash provided by operating activities of \$228 million in fiscal 2001. Although cash used for costs and operating expenses decreased in fiscal 2002 when compared to fiscal 2001, this was more than offset by lower revenues in fiscal 2002 when compared to fiscal 2001. Net cash used in operating activities from discontinued

operations was \$232 million in fiscal 2002 compared with net cash provided by discontinued operations of \$41 million in fiscal 2001.

Investing activities used net cash of \$11 million in fiscal 2003 compared to net cash provided of \$368 million in fiscal 2002, and net cash used of \$723 million in fiscal 2001. The decrease in cash flow from investing activities in fiscal 2003 versus fiscal 2002 is primarily due to lower proceeds from the disposition of businesses and sales of assets. In fiscal 2003, we received \$64 million from the sale of our optoelectronic components business and \$38 million from the sale of property, plant and equipment. In fiscal 2002, we received \$382 million from the sale of the field-programmable gate array, wireless local area networking equipment and analog line card businesses, \$142 million from the sale of property, plant and equipment and \$55 million from the sale of investments. In addition, capital expenditures decreased by \$79 million to \$116 million in fiscal 2003 from \$195 million in fiscal 2002. Prior to fiscal 2002, capital expenditures had historically been the primary component of our investing activities and were \$723 million in fiscal 2001. However, in response to adverse market conditions that began in fiscal 2001, we significantly reduced our capital expenditures and we expect them to continue at current levels.

Financing activities used net cash of \$28 million and \$1,970 million in fiscal 2003 and 2002, respectively, and provided net cash of \$3,607 million in fiscal 2001. The fiscal 2003 use of cash primarily reflects the repayment of \$65 million in long-term debt, the majority of which is related to capital leases, and the net repayment of \$9 million under our accounts receivable securitization facility, partially offset by borrowings of \$20 million under an installment note and proceeds of \$26 million from the issuance of common stock. The fiscal 2002 use of cash includes the repayment of \$2,500 million under our credit facility, partially offset by \$396 million of net proceeds from the issuance of convertible subordinated notes and \$163 million of net short-term borrowings under our accounts receivable securitization facility. The fiscal 2001 proceeds primarily reflect \$3,448 million of net cash proceeds from the sale of our common stock in our initial public offering. Prior to our initial public offering, we relied on Lucent to provide financing for our operations.

We have entered into a securitization transaction with certain financial institutions, pursuant to which the financial institutions agreed to make loans secured by certain of our accounts receivable. The financial institutions have commitments under the related loan agreement of up to \$200 million; however, the amount that can be borrowed at any time depends on the amount and nature of our accounts receivable. The loan



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agreement expires on October 1, 2004. As of September 30, 2003, \$154 million was outstanding under this agreement. See Note 7 to our financial statements in Item 8 for a description of the structure of the transaction and additional details.

The majority of our accounts receivable are required to be pledged as security for the outstanding loans even though some of those receivables may not qualify for borrowings. As of September 30, 2003, \$228 million of gross receivables was pledged as security for the outstanding loans. We pay interest on amounts borrowed under the agreement based on one-month LIBOR. In addition, we pay an annual commitment fee, which varies depending on our credit rating, on the \$200 million total loan commitment. As of November 5, 2003, our credit ratings were BB- from Standard & Poor's and B1 from Moody's, both with a stable outlook.

The loan agreement has a financial covenant which requires us to achieve a minimum level of earnings before interest, taxes, and depreciation and amortization each quarter. A violation of this covenant will end our ability to obtain further loans under the agreement, but will not accelerate payment or require an immediate cash outlay to cover amounts previously loaned under the accounts receivable securitization.

On June 19, 2002, we issued \$410 million of 6.5% Convertible Subordinated Notes due December 15, 2009 and received net proceeds of \$396 million. Interest on the notes accrues at the rate of 6.5% per annum and is payable semi-annually on June 15 and December 15 of each year, beginning on December 15, 2002. Investors can convert the notes into shares of Class A common stock at an initial price of \$3.3075 per share, subject to adjustment in certain events, at any time prior to maturity, unless previously redeemed or repurchased by us. We may redeem the notes in whole or in part at any time on or after June 20, 2007. In addition, upon a fundamental change in our company, we may be required to repurchase the notes at a price equal to 100% of the principal amount of the notes plus any accrued and unpaid interest.

We have pension plans covering substantially all U.S. employees hired prior to July 1, 2003. The funding requirements related to our pension plans are dependent on many factors, including actuarial assumptions and the actual performance of our plan assets. On March 14, 2003, we voluntarily contributed 18,750,000 shares of our Class A common stock to our pension plan for represented employees. The value of the stock at the time of the contribution was \$30 million. We do not expect that we will be required to make any contributions to our pension plans in fiscal 2004.

21

Our primary source of liquidity is our cash and cash equivalents. We believe our cash and cash equivalents will be sufficient to meet our projected cash requirements for at least the next 12 months.

### *Contractual Obligations*

The following table summarizes the payments due for specific contractual obligations. These amounts are as of September 30, 2003, with the exception of the accounts receivable securitization, which has been adjusted to reflect the extended maturity of that facility to October 1, 2004.

	Fiscal Years				
	Total	2004	2005 and 2006	2007 and 2008	2009 and Later
	(dollars in millions)				
<b>Contractual obligations:</b>					
Convertible subordinated notes	\$ 410	\$	\$	\$	\$410
Accounts receivable securitization	154		154		
Installment note	17	7	10		
Capital leases	76	42	34		
Operating leases	204	79	53	31	41
Purchase obligations (1)	182	78	91	13	
Other long-term liabilities (2)	10		10		
<b>Total</b>	<b>\$1,053</b>	<b>\$206</b>	<b>\$352</b>	<b>\$ 44</b>	<b>\$451</b>

(1)

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Purchase obligations are defined as agreements to purchase goods or services that are enforceable and legally binding and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable pricing provisions; and the approximate timing of the transactions. These obligations primarily relate to software licenses and services, wafer production and equipment maintenance services. The amounts are based on our contractual commitments; however, it is possible we may be able to negotiate lower payments if we choose to exit these contracts earlier.

(2) Other long-term liabilities consist of miscellaneous taxes.

Our material contractual obligations also include a commitment with Silicon Manufacturing Partners Pte, Ltd., or SMP, a joint venture with Chartered Semiconductor, a leading manufacturing foundry for integrated circuits. SMP operates a 54,000 square foot integrated circuit manufacturing facility in Singapore. We own a 51% equity interest in this joint venture, and Chartered Semiconductor owns the remaining 49% equity interest. We have an agreement with SMP under which we have agreed to purchase 51% of the managed wafer capacity and Chartered Semiconductor has agreed to purchase the remaining 49% of the managed wafer capacity. SMP determines its managed wafer capacity each year based on forecasts provided by Agere and Chartered Semiconductor. If we fail to purchase our commitments, we will be required to pay SMP for the fixed costs associated with the unpurchased wafers. Chartered Semiconductor is similarly obligated with respect to the wafers allotted to it. The agreement may be terminated after February 2008 by either party upon two years' written notice. The agreement may also be terminated for material breach, bankruptcy or insolvency of either party. Based on forecasted demand, we believe it is unlikely that we would have to pay any significant amounts for underutilization in the near future. However, if our purchases under this agreement are less than anticipated, our cash obligation to SMP may be significant.

### Recent Pronouncements

In November 2002, the Financial Accounting Standards Board issued Interpretation No. 45 Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. Interpretation 45 is principally a clarification and elaboration of Statement of Financial Accounting Standards No. 5 Accounting for Contingencies, under which companies were required to recognize a liability for guarantees only when it became likely that the company would have to honor its guarantee. Interpretation 45 prescribes the disclosures required by a guarantor about its obligations under certain guarantees it has issued, including loan guarantees and standby letters of credit. It also requires a guarantor to recognize a liability, at the inception of a guarantee, for the fair value of the obligations it has assumed under the guarantee, even if it is not probable that payments will be required under that guarantee. The initial recognition and measurement provisions of Interpretation

22

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45 are required only on a prospective basis for guarantees issued or modified after December 31, 2002. Previous accounting for guarantees issued prior to application of Interpretation 45 will not need to be revised or restated. The disclosure requirements in Interpretation 45 are effective for annual and interim periods ending after December 15, 2002. The adoption of the recognition and measurement provisions of Interpretation 45 did not have an impact on our financial condition or results of operations.

In December 2002, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 148 Accounting for Stock-Based Compensation Transition and Disclosure, which amends the transition and disclosure provisions of Statement of Financial Accounting Standards No. 123 Accounting for Stock-Based Compensation. Statement 148 provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation and amends the disclosure requirements of Statement 123 to require more prominent and more frequent disclosures in financial statements about the effects of stock-based compensation. The transition provisions are effective for fiscal years ending after December 15, 2002. The disclosure provisions are effective for interim periods beginning after December 15, 2002, with early application encouraged. We early adopted the interim period disclosure provisions of Statement 148 beginning with the first quarter of fiscal 2003 and adopted the annual disclosure requirements effective with the fiscal year ended September 30, 2003. The adoption of Statement 148 had no effect on our financial condition or results of operations.

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46 Consolidation of Variable Interest Entities, which clarifies the application of Accounting Research Bulletin No. 51, Consolidated Financial Statements. Interpretation 46 requires certain variable interest entities to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not provide sufficient equity at risk for the entity to support its activities. Interpretation 46 is effective for all new variable interest entities acquired or created after January 31, 2003. For variable interest entities acquired or created prior to February 1, 2003, the provisions of Interpretation 46 were required to be applied to the first interim or annual period beginning after June 15, 2003. That effective date was subsequently deferred until the first interim or annual period ending after December 15, 2003. We early adopted Interpretation 46 and this adoption had no effect on our financial condition or results of operations since we currently do not have any financial interests in

variable interest entities.

### **Environmental, Health and Safety Matters**

We are subject to a wide range of U.S. and non-U.S. governmental requirements relating to employee safety and health and to the handling and emission into the environment of various substances used in our operations. We are also subject to environmental laws, including the Comprehensive Environmental Response, Compensation and Liability Act, also known as Superfund, that require the cleanup of soil and groundwater contamination at sites currently or formerly owned or operated by us, or at sites where we may have sent waste for disposal. These laws often require parties to fund remedial action at sites regardless of fault. We are a potentially responsible party at a number of Superfund sites and sites otherwise requiring cleanup action. Specifically, we have liabilities for costs associated with five Superfund sites and two facilities formerly owned by Lucent.

It is often difficult to estimate the future impact of environmental matters, including potential liabilities. We have established financial reserves to cover environmental liabilities where they are probable and reasonably estimable. This practice is followed whether the claims are asserted or unasserted. Management expects that the amounts reserved will be paid out over the period of remediation for the applicable site, which typically ranges from five to thirty years. Reserves for estimated losses from environmental remediation are, depending upon the site, based primarily upon internal or third party environmental studies, estimates as to the number, participation level and financial viability of all potentially responsible parties, the extent of the contamination and the nature of required remedial actions. Accruals are adjusted as further information develops or circumstances change. The amounts provided for in our financial statements for environmental reserves are the gross undiscounted amount of such reserves, without deductions for insurance or third party indemnity claims. Although we believe that our reserves are adequate, including those covering our potential liabilities at Superfund sites, there can be no assurance that expenditures which will be required relating to remedial actions and compliance with applicable environmental laws will not exceed the amounts reflected in these reserves or will not have a material adverse impact on our financial condition, results of operations or cash flows. Any possible loss or range of loss that may be incurred in excess of that provided for as of September 30, 2003, cannot be estimated.

23

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### **Legal Proceedings**

On October 17, 2002, we filed a patent infringement lawsuit against Intersil Corporation in the United States District Court in Delaware. We alleged that Intersil had infringed six of our patents related to integrated circuits for wireless networking using the IEEE 802.11 standard and are seeking monetary damages for Intersil's infringement of these patents and an injunction prohibiting Intersil from using the patents in the future. On November 6, 2002, Intersil filed a counterclaim in this matter, alleging that ten patents of Intersil are infringed by unspecified Agere products. Two of the patents relate to system-level circuits, and eight patents relate to semiconductor processing. The complaint seeks an injunction and damages. On July 22, 2003, we filed a second patent infringement lawsuit against Intersil in the United States District Court in Delaware, alleging that Intersil had infringed four additional patents—three covering semiconductor processing and one covering integrated circuits for wireless networking. We are seeking an injunction and damages. Intersil counterclaimed with four additional patents relating to semiconductor processing. We believe that Intersil's claims are without merit.

On October 30, 2002, Choice-Intersil Microsystems, Inc., filed a lawsuit against us in the United States District Court for the Eastern District of Pennsylvania. The amended complaint alleges misappropriation of trade secrets and copyrights that were jointly developed and jointly owned by Digital Ocean, Inc. (which, following several acquisitions and corporate reorganizations, is now Choice-Intersil) and Lucent. The trade secrets and copyrights relate to media access controller technology for wireless local area networks. The complaint seeks an injunction and damages. We counterclaimed for misappropriation of trade secrets and breach of contract. On September 2, 2003, the court issued a decision denying Choice-Intersil's motion for a preliminary injunction and holding that we had lawfully obtained the trade secrets and copyrights alleged to have been infringed. Choice-Intersil has appealed. We believe that Choice-Intersil's claims are without merit.

On November 19, 2002, we filed a lawsuit against Choice-Intersil, Intersil and Intersil Americas Inc. in state court in Delaware. We alleged, among other things, misappropriation of trade secrets and breach of contract relating to the trade secrets that were jointly developed and jointly-owned by Digital Ocean, Inc. and Lucent. We are seeking an injunction against further use and disclosure of the trade secrets and damages for past disclosure and misuse. This matter has been consolidated with the Pennsylvania Choice-Intersil proceeding described above.

We intend to vigorously defend ourselves against the claims of the Intersil parties.

On August 28, 2003, GlobespanVirata, Inc. acquired Intersil's wireless networking product group.

### **Factors Affecting Our Future Performance**

Set forth below and elsewhere in this report and in other documents we file with the Securities and Exchange Commission are risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this report and other public statements we make.

***Risks Related To Our Business***

**If we fail to keep pace with technological advances in our industry or if we pursue technologies that do not become commercially accepted, customers may not buy our products and our revenue may decline.**

The demand for our products can change quickly and in ways we may not anticipate because our industry is generally characterized by:

Rapid, and sometimes disruptive, technological developments;

Evolving industry standards;

Changes in customer requirements;

Limited ability to accurately forecast future customer orders;

Frequent new product introductions and enhancements; and

Short product life cycles with declining prices over the life cycle of the product.

If we fail to make sufficient investments in research and development programs in order to develop new and enhanced products and solutions, or if we focus on technologies that do not become widely adopted, new

technologies could render our current and planned products obsolete, resulting in the need to change the focus of our research and development and product strategies and disrupting our business significantly.

**The integrated circuit industry is intensely competitive, and our failure to compete effectively could hurt our revenue.**

The market for integrated circuits is intensely competitive and subject to rapid and disruptive technological change. We expect the intensity of competition to continue to increase as existing competitors enhance and expand their product offerings and as new participants enter the market. Increased competition may result in price reductions, reduced gross margins and loss of market share. We may not be able to compete successfully against existing or future competitors, which may hurt our revenue.

The size and number of our competitors vary across our product areas, as do the resources we have allocated to the segments we target. Therefore, many of our competitors have greater financial, personnel, production capacity and other resources than we have in a particular market segment or overall. Competitors with greater financial resources may be able to offer lower prices, additional products or services or other incentives that we cannot match or offer. These competitors may be in a stronger position to respond quickly to new technologies and may be able to undertake more extensive marketing campaigns. They also may adopt more aggressive pricing policies and make more attractive offers to potential customers, employees and strategic partners. These competitors may make strategic acquisitions or establish cooperative relationships among themselves or with third parties to increase their ability to gain market share.

Further, some of our competitors are currently selling commercial quantities of products that we are sampling to our customers, that are still in the initial stages of development or that we may develop in the future. By being able to offer these products in commercial quantities before we do, our competitors can establish significant market share, acquire design wins in customer equipment programs and create a market position that we may be unable to overcome once we have completed development and testing of that product.

**Joint ventures and other third parties manufacture some of our products for us. If these manufacturers are unable to fill our orders on a timely and reliable basis, our revenue may be adversely affected.**

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We currently manufacture our integrated circuits through a combination of internal capability, joint ventures and external sourcing with contract manufacturers. The integrated circuit manufacturing industry has a history of developing new manufacturing processes. We believe that the costs associated with implementing new processes, including acquiring the necessary equipment and building appropriate facilities, are increasing with each generation of manufacturing processes. Because we do not want to make the financial investments necessary for future processes, we plan to rely on third-party contract manufacturers to make integrated circuits for us using any manufacturing processes that we do not currently use internally. In fiscal 2003, approximately 46% of our revenue was derived from integrated circuits manufactured at joint ventures or through other external sourcing arrangements, and we expect this percentage to increase over time. To the extent we rely on joint ventures and third-party manufacturing relationships, we face the following risks:

That they may not be able to develop manufacturing methods appropriate for our products;

That manufacturing costs will be higher than planned;

That reliability of our products will decline;

That they may be unwilling to devote adequate capacity to produce our products;

That they may not be able to maintain continuing relationships with our suppliers; and

That we may have reduced control over delivery schedules and costs of our products.

If any of these risks were to be realized, we could experience an interruption in supply or an increase in costs, which could adversely affect our results of operations.

We have recently reduced our owned manufacturing capacity. In the event of an increase in demand, failure to increase our manufacturing volumes or obtain capabilities from third parties may result in our not being able to meet customer demand for our products, which could hurt our relationships with our customers and result in our recording lower revenues than would be the case if we had greater manufacturing capacity.

25

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**A widespread outbreak of an illness such as severe acute respiratory syndrome, or SARS, could negatively affect our manufacturing, assembly and test, design or other operations, making it more difficult and expensive to meet our obligations to our customers, and could result in reduced demand from our customers.**

A widespread outbreak of an illness could adversely affect our operations as well as demand from our customers. A number of countries in the Asia/Pacific region have experienced outbreaks of SARS. As a result of outbreaks such as these, businesses can be shut down temporarily and individuals can become ill or quarantined.

We have manufacturing and back-office operations in Singapore, assembly and test and back-office operations in Thailand and design operations in China, countries where outbreaks of SARS have occurred. If our operations are curtailed because of SARS or other health issues, we may need to seek alternate sources of supply for manufacturing or other services and alternate sources can be more expensive. Alternate sources may not be available or may result in delays in shipments to our customers, each of which would adversely affect our results of operations. In addition, a curtailment of our design operations could result in delays in the development of new products. If our customers' businesses are affected by SARS, they might delay or reduce purchases from us, which could adversely affect our results of operations.

**Our revenue and operating results may fluctuate because we expect to derive most of our revenue from semiconductor devices and the integrated circuits industry is highly cyclical, and because of other characteristics of our business, and these fluctuations may cause our stock price to fall.**

We expect to derive most of our revenue from the sale of integrated circuits. Because the integrated circuits market segment is highly cyclical, we may experience declines in our revenue that are primarily related to industry conditions and not our products. This industry has experienced significant downturns, often in connection with, or in anticipation of, excess manufacturing capacity worldwide, maturing product cycles and declines in general economic conditions.

We focus primarily on winning competitive selection processes to develop products for use in our customers' equipment. These selection processes can be lengthy. After winning and beginning a product design for a customer, that customer may not begin volume production of their equipment for a period of up to two years, if at all. Due to this lengthy design and development cycle, we may experience delays from the time we begin incurring expenses until the time we generate revenue from our products. We have no assurances that our customers will ultimately market and sell their equipment or that such efforts by our customers will be successful. Thus, we may never generate any revenue from our products after incurring significant design and development expenditures.

If we are not selected by a customer to provide a product, we may experience significantly lower revenue later, as compared to prior periods with more revenue from earlier design wins. In addition, sales of our products for specific customer projects often begin and end abruptly, so revenue may increase rapidly and later decrease just as quickly. The relative timing of the beginning and end of our sales and design processes can make our revenues less predictable.

Fluctuations in our revenue or operating results could cause our stock price to decline, even if our results meet expectations. Further, stock prices in our industry have recently been highly volatile for reasons that sometimes are unrelated to the performance of the companies in the industry. These broad fluctuations could adversely affect our stock price.

**Because many of our current and planned products are highly complex, they may contain defects or errors that are detected only after deployment in commercial applications, and if this occurs, it could harm our reputation and result in reduced revenues or increased expenses.**

Our products are highly complex and may contain undetected defects, errors or failures. These products can only be fully tested when deployed in commercial applications and other equipment. Consequently, our customers may discover errors after the products have been deployed. The occurrence of any defects, errors or failures could result in:

Cancellation of orders;

Product returns, repairs or replacements;

Diversion of our resources;

26

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Legal actions by our customers or our customers' end-users;

Increased insurance costs; and

Other losses to us or to our customers or end-users.

Any of these occurrences could also result in the loss of or delay in market acceptance of our products and loss of sales, which would harm our business and adversely affect our results of operations. We have from time to time experienced defects and expect to experience defects in the future. Because the trend in our industry is moving toward even more complex products in the future, this risk will intensify over time and may result in increased expenses.

**Because our sales are concentrated on a limited number of key customers, our revenue may materially decline if one or more of our key customers do not continue to purchase our existing and new products in significant quantities.**

Our customer base is highly concentrated. Our top 10 end-customers accounted for approximately 60% of our revenue in fiscal 2003. If any one of our key customers decides to purchase significantly less from us or to terminate its relationship with us, our revenue may materially decline. Because our strategy has generally been to develop long-term relationships with a few key customers in the product areas in which we focus and we have a long product design and development cycle for most of our products, we may be unable to replace these customers quickly or at all. We could lose our key customers or significant sales to our key customers because of factors beyond our control, such as a significant disruption in our customers' businesses generally or in a specific product line.

**The demand for components in the communications equipment industry has declined in recent years, and we cannot predict the duration or extent of this decline. Our revenue will depend in part on demand for these types of components.**

We derive, and expect to continue to derive, a significant portion of our revenue from the sale of integrated circuits used in communications networks. Communications equipment makers are purchasing significantly less components for their products, including the components we sell, than they did before 2001. If demand for these components declines further, our results of operations may be adversely affected.

**We are expanding, and may seek in the future to expand, into new areas, and if we are not successful, our results of operations may be adversely affected.**

We are currently developing products in new areas, including wireless communications infrastructure, high-speed networking and consumer electronics. We may seek to expand into additional areas in the future. We may expand through internal development efforts, through acquisitions of companies or technologies, or a combination of these methods.

Our efforts may not result in sales that are sufficient for us to recoup our investment, and we may experience higher costs than we anticipated. For example, we may not be able to manufacture our product at a competitive cost, may need to rely on new suppliers or may find that the development efforts are more costly or timing consuming than we had anticipated. Our products may support protocols that are not widely adopted. Where we choose to develop capabilities by acquiring another company, we may not be able to integrate the other company successfully into our operations, which may mean that we have difficulty retaining employees from the acquired company or integrating its technology into our products. We may have difficulties entering markets where competitors have strong market positions.

**If we fail to attract, hire and retain qualified personnel, we may not be able to develop, market or sell our products or successfully manage our business.**

In some of our fields of operation, there are only a limited number of people in the job market who possess the requisite skills. In the past we have experienced difficulty in identifying and hiring sufficient numbers of qualified engineers in many areas of our business as well as in retaining employees. The loss of the services of any key personnel or our inability to hire new personnel with the requisite skills could restrict our ability to develop new products or enhance existing products in a timely manner, sell products to our customers or manage our business effectively.

**Because we are subject to order and shipment uncertainties, any significant cancellations or deferrals could cause our revenue to decline or fluctuate.**

We generally sell products pursuant to purchase orders that customers may cancel or defer on short notice without incurring a significant penalty. Cancellations or deferrals could cause us to hold excess inventory, which could adversely affect our results of operations. If a customer cancels or defers product shipments, we may incur unanticipated reductions or delays in our revenue. If a customer refuses to accept shipped products or does not pay for these products in a timely manner, we could incur significant charges against our income, which could materially and adversely affect our results of operations.

**If we do not achieve adequate manufacturing utilization, yields, volumes or sufficient product reliability, our gross margins will be reduced.**

Because the manufacturing costs at our owned and joint venture manufacturing facilities are relatively fixed, efficient utilization of manufacturing facilities and manufacturing yields are critical to our results of operations. If we do not experience adequate utilization of our manufacturing facilities, our results of operations may be adversely affected. Lower than expected manufacturing yields could adversely affect our results of operations and delay product shipments.

The manufacture of our products involves highly complex and precise processes, requiring production in highly controlled and clean environments. Changes in our manufacturing processes or those of our suppliers or contractors, or their inadvertent use of defective or contaminated materials, could significantly reduce our manufacturing yields and product reliability.

**We have relatively high gross margin on the revenue we derive from the licensing of our intellectual property, and a decline in this revenue would have a greater impact on our net income than a decline in revenue from our integrated circuits products.**

The revenue we generate from the licensing of our intellectual property has a higher gross margin compared to the revenue we generate from the sale of our integrated circuits products. Although we have derived less than 7% of our total revenue in recent years from the licensing of intellectual property, a decline in this licensing revenue would have a greater impact on our profitability than a similar decline in revenues from the sale of our integrated circuits products.

**If our customers do not qualify our products or manufacturing lines or the manufacturing lines of our third-party suppliers for volume shipments, our results of operations may be adversely affected.**

Some customers will not purchase any of our products, other than limited numbers of evaluation units, until they qualify the manufacturing line for the product. We may not always be able to satisfy the qualifications. Delays in qualification may cause a customer to discontinue use of our products and result in a significant loss of revenue.

**We conduct a significant amount of our sales activity and manufacturing efforts outside the United States, which subjects us to additional business risks and may adversely affect our results of operations due to increased costs.**

In fiscal 2003, we derived approximately 80% of our revenue from sales of our products shipped to locations outside the United States. We also manufacture a significant portion of our products outside the United States and are dependent on non-U.S. suppliers for many of our parts. We intend to continue to pursue growth opportunities in both sales and manufacturing outside the United States. Operations outside the United States are subject to a number of risks and potential costs, which could adversely affect our revenue and results of operations, including:

Our brand may not be locally recognized, which may cause us to spend significant amounts of time and money to build a brand identity;

Unexpected changes in regulatory requirements;

Inadequate protection of intellectual property in some countries outside of the United States;

Currency exchange rate fluctuations;

28

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International trade disputes;

Political and economic instability; and

Disruptions in international air transport systems.

**We are subject to environmental, health and safety laws, which could increase our costs and restrict our operations in the future.**

We are subject to a variety of laws relating to the use, disposal, clean-up of, and human exposure to, hazardous chemicals. Any failure by us to comply with present and future environmental, health and safety requirements could subject us to future liabilities or the suspension of production. In addition, compliance with these or future laws could restrict our ability to expand our facilities or require us to acquire costly pollution control equipment, incur other significant expenses or modify our manufacturing processes. If additional contaminants are discovered or additional cleanup obligations imposed at these or other sites, we could be adversely affected.

**We may be subject to intellectual property litigation and infringement claims, which could cause us to incur significant expenses or prevent us from selling our products. If we are unable to protect our intellectual property rights, our business and prospects may be harmed.**

Like other companies in the semiconductor industry, we are frequently involved in litigation regarding patent and other intellectual property rights. From time to time, we receive notices from third parties of potential infringement and receive claims of potential infringement when we attempt to license our intellectual property to others. Defending these claims could be costly and time consuming and would divert the attention of management and key personnel from other business issues. The complexity of the technology involved and the uncertainty of intellectual property litigation increase these risks. Claims of intellectual property infringement also might require us to enter into costly royalty or license



agreements. However, we may be unable to obtain royalty or license agreements on terms acceptable to us or at all. In addition, third parties may attempt to appropriate the confidential information and proprietary technologies and processes used in our business, which we may be unable to prevent and which would harm our business and prospects.

**We believe that financing has at times been difficult to obtain for companies in our industry and if we need additional cash to fund our operations or to finance future strategic initiatives, we may not be able to obtain it on acceptable terms or at all.**

We believe that lenders have at times been less willing to extend credit to companies in the telecommunications and semiconductor industries, making debt financing difficult to obtain. As described below under *Risks Related to Our Separation from Lucent Technologies* we are limited in the amount of stock that we can issue to raise capital because of potential adverse tax consequences, in connection with our spin-off from Lucent Technologies, we are restricted in our ability to issue stock in order to raise capital.

If we are not able to obtain sufficient funds on acceptable terms, we may not have sufficient funds to take advantage of market opportunities or to finance future strategic initiatives.

**Because of differences in voting power and liquidity between our Class A common stock and Class B common stock, the market price of the Class A common stock may be different from the market price of the Class B common stock.**

The Class B common stock has greater voting power per share for the election and removal of directors than the Class A common stock, and, as a result, some investors may prefer the Class B common stock as a means of investing in our company. The greater potential voting power may cause the Class B common stock to trade at a higher market price than the Class A common stock. On the other hand, the Class A common stock has historically had a higher daily trading volume than the Class B common stock. As a result, the Class A common stock may be more liquid than the Class B common stock and more attractive to investors, which may cause the price of the Class A common stock to be higher than the price of the Class B common stock.

**The development and evolution of markets for our integrated circuits are dependent on factors over which we have no control. For example, if our customers adopt new or competing industry standards with which our products are not compatible or fail to adopt standards with which our products are compatible, our existing products would become less desirable to our customers and our sales would suffer.**

The emergence of markets for our integrated circuits is affected by a variety of factors beyond our control. In particular, our products are designed to conform to current specific industry standards. Our customers may not

adopt or continue to follow these standards, which would make our products less desirable to our customers and reduce our sales. Also, competing standards may emerge that are preferred by our customers, which could reduce our sales and require us to make significant expenditures to develop new products. To the extent that we are not able to effectively and expeditiously adapt to new standards, our business will suffer.

**Class action litigation due to stock price volatility or other factors could cause us to incur substantial costs and divert our management's attention and resources.**

In the past, securities class action litigation often has been brought against a company following periods of volatility in the market price of its securities. Companies in the integrated circuit industry and other technology industries are particularly vulnerable to this kind of litigation due to the high volatility of their stock prices. Accordingly, we may in the future be the target of securities litigation. Any securities litigation could result in substantial costs and could divert the attention and resources of our management.

#### *Risks Related to Our Separation From Lucent Technologies*

**We are limited in the amount of stock that we can issue to raise capital because of potential adverse tax consequences.**

In June 2002, Lucent Technologies completed our spin-off by distributing to its stockholders all of our common stock it then owned. Under Section 355(e) of the Internal Revenue Code, Lucent will recognize a taxable gain on that distribution if there are one or more acquisitions of our stock representing 50% or more of our stock (by vote or value) and the stock acquisitions are part of a plan or series of related transactions that includes the spin-off. Any shares of our stock acquired within two years before or after the spin-off are presumed to be part of such a plan

unless we can rebut that presumption. If an issuance of our stock causes the distribution to be taxable to Lucent under Section 355(e), we would be required to indemnify Lucent against that tax under our tax sharing agreement with Lucent.

The shares of our Class A common stock issued in our initial public offering are considered to be part of a plan that includes the spin-off, and the shares of our Class A common stock that may be issued upon the conversion of our 6.5% convertible subordinated notes may also be considered to be part of a plan that includes the spin-off. Assuming that all of the convertible notes were converted, approximately 45% of our outstanding shares may be treated as acquired as part of such a plan.

Treasury Regulations issued in April 2002 provide safe harbors that may be used to rebut the presumption that shares issued less than two years after the spin-off are part of a plan that includes the spin-off. However, the application of the safe harbors is not clear in many respects, and they might not be available to us for future share issuances. As a result, Section 355(e) limits our ability to issue shares to raise capital for at least two years after the spin-off. However, the safe harbors in these new Treasury Regulations generally provide that issuances of our stock pursuant to ordinary course employee compensation arrangements (such as employee stock purchase plans) will not be treated as acquisitions of our stock pursuant to a plan that includes the spin-off.

**We could incur significant tax liabilities and payment obligations if Lucent fails to pay the tax liabilities attributable to Lucent under our tax sharing agreement.**

We have entered into a tax sharing agreement with Lucent that allocates responsibility for tax liabilities between them and us. Under U.S. federal income tax laws, Lucent and we are jointly and severally liable for Lucent's federal income taxes attributable to periods prior to and including Lucent's taxable year ended September 30, 2001. This means that if Lucent were to fail to pay the taxes attributable to it under the tax sharing agreement for those periods, we may be liable for all or any part of these liabilities.

**Because the Division of Enforcement of the Securities and Exchange Commission is investigating matters brought to its attention by Lucent, our business may be affected in a manner we cannot foresee at this time.**

In late 2000, Lucent brought to the attention of the staff of the U.S. Securities and Exchange Commission matters relating to its recognition of revenue. Although Lucent has informed us that it has no reason to believe that the investigation by the Division of Enforcement of the Securities and Exchange Commission into these matters concerns our business and we are not aware of any reason why the investigation would affect us, it is possible that

30

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the results of the investigation may have an impact on us. Although the investigation could result in no action being taken by the Securities and Exchange Commission, if an action were taken and the investigation were found to concern our business, the action could result in monetary fines or changes in some of our financial and other practices and procedures that we are unable to foresee at this time. In February 2003, Lucent announced that it had reached a tentative settlement with the Securities and Exchange Commission regarding these revenue recognition issues. To date, we believe that a final settlement agreement has not been executed, and there can be no assurances that a final settlement will be reached.

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

**Risk Management**

We are exposed to market risk from changes in foreign currency exchange rates and interest rates that could impact our results of operations and financial position. We manage our exposure to these market risks through our regular operating and financing activities and, when deemed appropriate, through the use of derivative financial instruments. We use derivative financial instruments as risk management tools and not for speculative purposes. In addition, derivative financial instruments are entered into with a diversified group of major financial institutions in order to manage our exposure to nonperformance on such instruments. Our risk management objective is to minimize the effects of volatility on our cash flows by identifying the recognized assets and liabilities or forecasted transactions exposed to these risks and appropriately hedging the risks.

We may use foreign currency forward contracts to manage the volatility of non-functional currency cash flows resulting from changes in exchange rates. Foreign currency exchange contracts are designated for recorded, firmly committed or anticipated purchases and services. The use of these derivative financial instruments allows us to reduce our overall exposure to exchange rate movements, since the gains and losses on these contracts substantially offset losses and gains on the assets, liabilities and transactions being hedged. As of September 30, 2003, no foreign currency forward contracts were outstanding.

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While we hedge certain foreign currency transactions, any decline in value of non-U.S. dollar currencies may, if not reversed, adversely affect our ability to contract for product sales in U.S. dollars because our products may become more expensive to purchase in U.S. dollars for local customers doing business in the countries of the affected currencies.

As of September 30, 2003, we had \$154 million of short-term variable rate debt outstanding. To manage the cash flow risk associated with this debt, we may from time to time enter into interest rate swap agreements. We had no interest rate swap agreements in effect during fiscal 2003 or fiscal 2002. As of September 30, 2003, a variation of 100 basis points in the interest rate charged on the short-term debt would result in a change of approximately \$2 million in annual interest expense.

As of September 30, 2003, we had outstanding \$410 million of fixed rate long-term convertible notes. Interest rate changes and changes in the value of our Class A common stock would likely result in changes in the market value of these notes. The fair value of these notes was \$537 million at September 30, 2003. We perform a sensitivity analysis on our fixed rate long-term convertible debt to assess the risk of changes in fair value. The model to determine interest rate sensitivity assumes a hypothetical 150 basis point shift in interest rates, while keeping the price of our Class A common stock constant. At September 30, 2003, assuming a 150 basis point increase in interest rates, the fair value of the notes would decrease by \$8 million. Conversely, a 150 basis point decrease in interest rates at September 30, 2003, would increase the fair value of the notes by \$10 million. The model to determine equity price sensitivity assumes a hypothetical 10% change in the price of our Class A common stock, while keeping the interest rate constant. At September 30, 2003, assuming a 10% increase in the price of our Class A common stock, the fair value of the notes would increase by \$34 million. Conversely, a 10% decrease in the price of our Class A common stock would result in the fair value of the notes decreasing by \$33 million.

### Item 8. Financial Statements and Supplementary Data

#### INDEX TO FINANCIAL STATEMENTS AND FINANCIAL STATEMENT SCHEDULE

##### Consolidated and Combined Financial Statements:

Report of Independent Auditors	33
Consolidated and Combined Statements of Operations for the years ended September 30, 2003, 2002 and 2001	34
Consolidated Balance Sheets as of September 30, 2003 and 2002	35
Consolidated and Combined Statements of Changes in Stockholders' Equity/Invested Equity and Total Comprehensive Loss for the years ended September 30, 2003, 2002 and 2001	36
Consolidated and Combined Statements of Cash Flows for the years ended September 30, 2003, 2002 and 2001	37
Notes to Consolidated and Combined Financial Statements	38
<b>Financial Statement Schedule:</b>	
Schedule II Valuation and Qualifying Accounts for the years ended September 30, 2003, 2002 and 2001	68

#### Report of Independent Auditors

To the Board of Directors and  
Stockholders of Agere Systems Inc.:

In our opinion, the consolidated and combined financial statements listed in the accompanying index present fairly, in all material respects, the financial position of Agere Systems Inc. and its subsidiaries at September 30, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended September 30, 2003 in conformity with accounting principles generally accepted in the

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United States of America. In addition, in our opinion, the financial statement schedule listed in the accompanying index presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated and combined financial statements. These financial statements and financial statement schedule are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements and financial statement schedule based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

Prior to its separation from Lucent Technologies Inc. ( Lucent ) on February 1, 2001 the Company was comprised of businesses which were integrated with the businesses of Lucent; consequently, as indicated in Note 1, the financial statement amounts prior to this date have been derived from the consolidated financial statements and accounting records of Lucent, and reflect significant assumptions and allocations. Moreover, as indicated in Note 1, the Company relied on Lucent and its other businesses for administrative, management, research and other services. Accordingly, the financial statements for the year ended September 30, 2001, do not necessarily reflect the results of operations and cash flows of the Company had it been a stand-alone company.

As discussed in Notes 3, 5 and 17 to the consolidated and combined financial statements, the Company has changed certain of its accounting methods as required upon the adoption of promulgated accounting principles.

**PricewaterhouseCoopers LLP**

Florham Park, New Jersey  
October 28, 2003

33

### AGERE SYSTEMS INC. AND SUBSIDIARIES

#### CONSOLIDATED AND COMBINED STATEMENTS OF OPERATIONS (dollars in millions except per share amounts)

	Year Ended September 30,		
	2003	2002	2001
<b>REVENUE</b>	\$ 1,839	\$ 1,923	\$ 2,886
<b>COSTS</b>	1,260	1,429	1,971
<b>GROSS PROFIT</b>	579	494	915
<b>OPERATING EXPENSES:</b>			
Selling, general and administrative	294	326	523
Research and development	467	625	815
Amortization of goodwill and other acquired intangibles	8	34	76
Restructuring and other charges net	131	503	486
(Gain) loss on sale of operating assets net	(21)	(299)	(13,717)
Gain from settlement of long term note	---	(8,968)	)
Accrued interest and exchange rate differences of long-term debt	(23,853)	1,685	
Accrued interest and exchange rate differences on refundable deposits for the purchase of a business	(33,148)	(15,320)	
<b>Changes in assets and liabilities:</b>			
Decrease (increase) in accounts receivable	(281,140)	942,143	

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Year Ended September 30,

Decrease (increase) in inventories	(1,421,726)	134,069
(Increase) decrease in trading securities	123,424	(24,221 )
Decrease in related parties accounts	(121,499 )	(15,177 )
(Increase) decrease in other current assets	103,473	(17,600 )
Increase in funds in respect of employee rights upon retirement	(53,247 )	(20,288 )
Increase in accounts payable	1,208,464	170,580
(Decrease) increase in other current liabilities	923,853	(82,935 )
Increase in liability for employee rights upon retirement	41,712	29,219
Net cash (used in) provided by Operating Activities	(241,881 )	942,767

## CASH FLOWS FROM INVESTING ACTIVITIES:

Purchases of property, plant and equipment	(495,361 )	(107,817 )
Reimbursable deposits for purchase of a business	---	(13,782 )
Net cash used in Investing Activities	(495,361 )	(121,599 )

## CASH FLOWS FROM FINANCING ACTIVITIES:

Short-term debt, net	368,873	(219,301 )
Proceeds from long-term debt	---	85,920
Repayment of long-term debt	(51,759 )	(78,161 )
Net cash used in Financing Activities	317,114	(211,542 )

## EFFECT OF CHANGES IN EXCHANGE RATES ON CASH AND CASH EQUIVALENTS

	(18,295 )	106,621
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## NET INCREASE IN CASH AND CASH EQUIVALENTS

	(438,423 )	716,247
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## CASH AND CASH EQUIVALENTS – BEGINNING OF PERIOD

	3,502,461	3,783,631
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## CASH AND CASH EQUIVALENTS – END OF PERIOD

	\$ 3,064,038	\$ 4,499,878
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INTEREST PAID	\$ 25,919	\$ 13,480
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TAXES PAID	\$ 39,751	\$ 91,879
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The accompanying notes are an integral part of the condensed consolidated financial statements

DEFENSE INDUSTRIES INTERNATIONAL, INC.  
AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENT  
FOR THE THREE MONTHS ENDED MARCH 31, 2011 AND 2010 (UNAUDITED)

NOTE 1 BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

- A. The accompanying unaudited interim consolidated financial statements as of March 31, 2011 and for the three-month period then ended (the “interim financial statements”) were prepared in a condensed form in accordance with the instructions for Form 10-Q and, therefore, do not include all disclosures necessary for a complete presentation of financial condition, results of operations, changes in shareholders’ equity, cash flows and all the data and notes which are required when preparing annual financial statements, in conformity with generally accepted accounting principles accepted in the United States.
- B. The accounting principles used in the presentation of the interim financial statements are consistent with those principles used in the presentation of the Company's latest annual financial statements. All significant accounting policies have been applied consistently with the year ended December 31, 2010.
- C. The preparation of the interim financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, the disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates. In the opinion of management, all adjustments considered necessary for fair presentation of the interim financial statements have been included. The results of operations for the three-month period ended March 31, 2011, are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. The interim financial statements should be read in conjunction with the Company’s annual financial statements as of December 31, 2010 and for the year then ended and the accompanying notes thereto.

D. Principles of Consolidation

The interim financial statements include the accounts of Defense Industries International, Inc., its wholly owned subsidiaries, Export Erez USA, Inc., Rizzo Inc. (doing business as Owen Mills Company), Export Erez, Ltd. (“Export Erez”), Mayotex, Ltd. (“Mayotex”), Mayosar Technologies Ltd. (“Mayosar”), Philcar Ltd. (“Philcar”), and Achidatex Nazareth Elite (1977) Ltd. (“Achidatex”). In addition, the Company holds 82% of the issued and outstanding share capital of Isorad IR Optics Ltd. (“Optics”).

All significant inter-company accounts and transactions have been eliminated in consolidation.

DEFENSE INDUSTRIES INTERNATIONAL, INC.  
AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENT  
FOR THE THREE MONTHS ENDED MARCH 31, 2011 AND 2010 (UNAUDITED)

E. Per share data

Basic net income (loss) per share of common stock is computed based on the weighted average number of shares of common stock outstanding during the period. Diluted net income per share of common stock is computed based on the weighted average number of shares of common stock and common stock equivalents outstanding during the period. For the three months ended March 31, 2011 and 2010, respectively, common stock equivalents to purchase 202,500 shares of common stock were not included in diluted loss per share because their effect is anti-dilutive.

F. Fair value

The Company categorizes the fair value of its financial assets and liabilities according to the hierarchy of the Financial Accounting Standard Board ("FASB") Accounting Standards Codification ("ASC") No. 820 "Fair Value Measurements and Disclosures" ("FASB ASC 820"), which establishes a framework for measuring fair value and requires enhanced disclosures about fair value measurements.

FASB ASC 820 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. FASB ASC 820 also requires disclosure about how fair value is determined for assets and liabilities and establishes a hierarchy for which these assets and liabilities must be grouped, based on significant levels of inputs, as follows:

- Level 1 Quoted prices in active markets for identical assets or liabilities;
- Level 2 Quoted prices in active markets for similar assets and liabilities and inputs that are observable for the asset or liability; or
- Level 3 Unobservable inputs, such as discounted cash flow models or valuations.

The Company's trading securities and bank deposits are measured at fair value based on quoted market prices in active markets for identical assets (Level 1).

The Company funds in respect to employees' rights upon retirement are measured at fair value based upon unobservable inputs (Level 3).

In addition to the assets and liabilities described above, our financial instruments also include cash, accounts receivable, other receivables, accounts payable, accounts payable to related parties, accrued expenses and other payables. The fair value of these financial instruments was not materially different from their carrying value at March 31, 2011 and December 31, 2010 due to the short-term maturity of these instruments.

DEFENSE INDUSTRIES INTERNATIONAL, INC.  
AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENT  
FOR THE THREE MONTHS ENDED MARCH 31, 2011 AND 2010 (UNAUDITED)

NOTE 2            BUSINESS COMBINATION AND CERTAIN TRANSACTIONS

1. On December 21, 2008, Mayosar, through its wholly owned subsidiary, Optics, entered into an agreement (the "Isorad Agreement") to purchase the Germanium Crystals Business of Isorad Ltd. ("Isorad"), an Israeli governmental company. The Isorad Agreement provided for the purchase of certain know-how, equipment, inventories and production activities of Germanium Crystals for lenses used in infra-red night vision system applications. After a period of uncertainty, in August 2010, Mayosar, Optics and Isorad executed an addendum to the 2008 agreement, according to which the parties confirmed the validity of the Isorad Agreement under certain conditions. On December 19, 2010 (the "Effective Date"), the Isorad Agreement was approved and became effective. Pursuant to the Isorad Agreement, Optics is to pay annual royalties to Isorad of 3% out of sales for a period of 15 years commencing the effective date of the Isorad Agreement (the "Effective Date"), with a minimum of approximately \$133,000, payable on an annual basis during the first 18 months or until the date of completion of the transfer of the site of the Germanium Crystals Business, whichever is earlier (this payment includes a reimbursement of costs for the usage of the site and equipment in this initial period), and approximately \$53,000 per year during the years following the above initial period. Isorad also has the right to acquire 5% of the share capital of Optics on a fully diluted basis for a nominal value during an original 24-month period beginning on the Effective Date. Such right was extended until January 1, 2012. In the event of an allotment of shares representing 5% of Optics' share capital to Isorad upon the exercise by Isorad of its option, Optics will issue additional shares of Optics to Mayotex on a pro rata basis, in order for Mayotex to retain a 82% interest in Optics' share capital.

If the Israeli Government does not approve the 5% purchase of the Optics shares by Isorad within the above period, the right to acquire the shares will expire and Isorad will be entitled to a payment of \$75,000 from Optics. Optics has the right during the four-year period following the Effective Date to redeem its commitment to pay royalties and the right by the Israeli government to purchase 5% of Optics for a fixed payment of \$750,000, less all royalties paid to Isorad through that date.

In order to complete this transaction, the Company incurred \$1,058,814 in acquisition costs. These costs were expensed in 2010.

The following table summarizes the consideration transferred and estimated fair values of the assets acquired and liabilities assumed at the date of acquisition:

Cash payment to Isorad (in the form of a deposit paid in January 2009)	\$ 698,570
Minimum guaranteed royalty payments	750,000
<b>Total consideration</b>	<b>1,448,570</b>
<b>Recognized amounts of identifiable assets acquired and liabilities assumed:</b>	
Current assets (including cash and cash equivalents of \$82,947)	196,539
Property and equipment	152,284
Intellectual properties and technology	817,000
Non-compete agreement	50,000
Customer relationships	100,000



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Trade name	300,000
Accounts payable and other current liabilities	(92,253 )
Deferred income taxes liabilities	(75,000 )
Total identifiable net assets acquired	\$ 1,448,570

10

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DEFENSE INDUSTRIES INTERNATIONAL, INC.  
AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENT  
FOR THE THREE MONTHS ENDED MARCH 31, 2011 AND 2010 (UNAUDITED)

The allocation of purchase price for customer relationships, non-compete agreement, trade name, intellectual property and technology are provisional pending receipt of the final valuations of those assets. These assets have an expected future life of 10 years, 3 years, 10 years, and 6 years, respectively.

Amortization cost for the three months ended March 31, 2011 for the customer relationships, non-compete agreement, trade name, intellectual property and technology are \$2,500, \$4,167, \$7,500 and \$34,042, respectively.

The unaudited pro forma information below assumes that the acquisition of the Isorad business was consummated on January 1, 2009, and includes the effect of amortization of intangible assets from that date. This data is presented for information purposes only and is not necessarily indicative of the results of future operations or the results that would have been achieved had the acquisition taken place at those dates.

The pro forma information is as follows:

	For the Three Months Ended March 31, 2011	For the Three Months Ended March 31, 2010
	Unaudited	
Net revenues	3,593,437	3,238,788
Net loss	(916,646 )	(396,971 )
Basic net loss per share	(0.033 )	(0.014 )
Diluted net loss per share	(0.033 )	(0.014 )

2. In December 2008, Mayotex entered into an investment agreement (the "Sarino Agreement") with Sarino Crystal Technologies Ltd. and Sarino Optronics Ltd. (together, "Sarino"), to form an entity which would acquire part of Isorad (see Note 1.B.2). Pursuant to the Sarino Agreement, Mayotex and Sarino incorporated Mayosar, in which Mayotex held 50.1% of the outstanding shares and Sarino held the remaining 49.9% of the outstanding shares. Mayotex paid Sarino (the "Sarino Payment") \$1,000,000 (recorded as refundable deposit on purchase of business on the balance sheet as of December 31, 2009). The completion of the agreement was contingent on the completion of the Isorad Agreement (see Note 1.B.2). This agreement was finally approved in December 2010.

After this period of uncertainty, in December 2010, Sarino and Mayotex entered into a settlement agreement (the "December Agreement") according to which Mayotex was registered as the holder of 100% of the issued and outstanding share capital of Mayosar and Mayosar in turn transferred 82% of its ownership interest in its then wholly owned subsidiary, Optics, to Mayotex and 18% of its ownership interest in Optics to Sarino. In the December Agreement, the parties agreed to amend the terms and conditions of the Sarino Payment to provide for: (i) repayment of the Sarino Payment plus interest at LIBOR plus 1% per year, commencing as of December 19, 2010 and due on

December 19, 2020; or (ii) Sarino could require Mayotex to acquire its interest in Optics as repayment of the Sarino Payment and accrued interest. As of December 31, 2010 the Company's accumulated amount for accrued interest on the Sarino Payment was \$58,814 and the value recorded for the put option granted to Sarino was \$ 1,058,814. The entire value of the put option was recorded as an acquisition expense during 2010.

In accordance with the December Agreement, Optics shall distribute as dividends, once per calendar year, at least 30 % of its distributable profits to its shareholders, pro rata to their holdings in Optics as at the date of such distribution. The remaining 70% of Optics distributable profits shall be used to repay any and all amounts granted or deemed granted by Mayotex to Optics, until their full repayment.

As of March 31, 2011 amount granted or deemed granted by Mayotex to Optics was \$1,027,339 of which no amount has been repaid as of March 31, 2011.

3. On February 22, 2010, Mayotex entered into a contract for the acquisition of the business of Vacutec Industries Ltd., a manufacturer of fiberglass product products for the automotive industry. Pursuant to the agreement Mayotex acquired certain fixed assets, inventories, customer list and backlog in consideration of \$23,000, of which \$13,243 was paid prior to December 31, 2010.

Management allocated the purchase price to the following assets on the basis of their fair value:

Fixed assets	\$22,205
Inventory	1,830
Customer list and backlog	28,445

Accordingly the excess fair value of the assets purchased over the purchase price (bargain gain), in the amount of \$25,994 was recognized in to the income statement at the date of the acquisition.

4. In March 2011, Mayotex entered into an agreement with Rabintex Industries Ltd. ("Rabintex"), to purchase Philcar Ltd. ("Philcar"), a company that specializes in equipping and protecting vehicles, for an amount of \$214,304. Under the terms of the agreement, Mayotex may pay Rabintex additional compensation of up to \$160,728, depending on the amount of orders that Philcar receives from certain customers during the six-month period following the closing of the transaction. The transaction was completed on May 3, 2011.

DEFENSE INDUSTRIES INTERNATIONAL, INC.  
AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENT  
FOR THE THREE MONTHS ENDED MARCH 31, 2011 AND 2010 (UNAUDITED)

NOTE 4 INVENTORIES

Consist of:

	March 31, 2011	December 31, 2010
Raw materials (1)	3,512,076	3,030,442
Work in progress	1,177,470	607,328
Finished goods	987,810	764,747
	5,677,356	4,402,517

(1) As of March 31, 2011 and December 31, 2010, raw materials include advanced payments to purchase inventory of \$156,097 and \$52,894, respectively.

DEFENSE INDUSTRIES INTERNATIONAL, INC.  
AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENT  
FOR THE THREE MONTHS ENDED MARCH 31, 2011 AND 2010 (UNAUDITED)

NOTE 5            SEGMENT INFORMATION AND CONCENTRATIONS

The Company has two strategic business segments: sales to the civilian market and sales to the military market.

The military and the civilian markets are further broken down between Israel (local) and other (export) sales in order to better analyze trends in sales and profit margins. The Company does not allocate assets between segments because assets are used equally in both segments and any allocation would not be practical.

A. Sales and Income from Operations:

	Civilian		Military		
	Local	Export	Local	Export	Consolidated
For the three months ended March 31, 2011:					
Revenue from sales	573,182	436,431	1,014,989	1,568,835	3,593,437
Gross Profits (Loss)	216,953	(16,383 )	126,809	336,141	663,520
Corporate unallocated costs					1,498,939
Loss from operations					(835,419 )
For the three months ended March 31, 2010:					
Revenue from sales	\$ 1,033,658	\$ 229,631	\$ 1,165,142	\$ 565,300	\$ 2,993,731
Gross Profits	179,200	25,294	272,308	126,577	603,379
Corporate unallocated costs					813,181
Loss from operations					(209,802 )

DEFENSE INDUSTRIES INTERNATIONAL, INC.  
AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENT  
FOR THE THREE MONTHS ENDED MARCH 31, 2011 AND 2010 (UNAUDITED)

B. Geographic Areas – Revenues:

	Three Months Ended March 31,	
	2011	2010
Israel	1,588,172	\$ 2,198,800
South America	290,184	218,360
North America	469,355	230,945
Europe and Asia	458,976	343,449
Africa	786,750	2,177
<b>Total Revenue</b>	<b>3,593,437</b>	<b>\$ 2,993,731</b>

C. Single Customer Exceeding 10% of Sales:

	For the three months ended March 31, 2011	For the three months ended March 31, 2010
Customer A (Military Local)	926,801	\$ 1,139,476
Customer B (Military Export)	---	\$ 939,219

DEFENSE INDUSTRIES INTERNATIONAL, INC.  
AND SUBSIDIARY COMPANIES

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENT  
FOR THE THREE MONTHS ENDED MARCH 31, 2011 AND 2010 (UNAUDITED)

NOTE 6 COMMITMENTS AND CONTINGENCIES

- A. On February 11, 2009, a lawsuit was filed in the Jerusalem District Court (the "Court"), against the Company's subsidiary, Achidatex, Mr. Avraham Haztor, its then chief executive officer, and the Company's subsidiary Export Erez USA Inc. ("Export Inc."), and an additional subsidiary Export Erez was subsequently added as a defendant in the action. The suit alleges that Achidatex materially breached its February 22, 2000 agreement with the plaintiff, relating to the development of inflatable mine-field crossing enabling sandals, by failing to register patents for the technology underlying the sandals, worldwide as it only registered patents in the United States. The plaintiff further claims that the defendants, jointly and severally, committed a breach of trust. The plaintiff is seeking damages in the amount of NIS 10 million (approximately \$2.8 million) at March 31, 2011. The defendants filed a statement of defense rejecting the plaintiff's claims and asserted a claim against the plaintiff and others for a declaratory judgment that the plaintiff breached his contractual undertakings towards Achidatex. The petition to consolidate the counter-claim with the plaintiff's claim was ordered by the Court and the claims are now being heard together. The proceedings are currently at the stage at which the parties have to submit affidavits stating evidence to support their case. The Company believes that the exposure under the above lawsuit is not material to the business of our subsidiaries. The Company intends to vigorously defend its position against the lawsuit. Recently the plaintiff requested that the court permit the plaintiff to amend its statement of claims to increase the amount of damages sought to NIS 20 million (approximately \$5.6 million). This motion is pending.
- B. On July 12, 2010, a lawsuit was filed in the Tel-Aviv Regional Labor Court (the "Labor Court") against the Company, its subsidiaries, Mayotex Ltd. and Export Erez, and against an officer of the Company, by a former employee. The plaintiff alleges that the above breached her employment agreement and violated certain Israeli labor related legislation by not paying her severance payment in lieu of vacation, recuperation payments, contribution to a study fund, payments due during a prior notice period and compensation for unpaid overtime. The plaintiff also claimed that she was the subject of sexual harassment and consequently the Company violated certain applicable Israeli legislation. The plaintiff is seeking damages of \$414,775. Management believes that the damages sought are exaggerated and that the exposure, if any, is not material to the Company's and its subsidiaries' business. The defendants have filed their statement of defense rejecting the former employee's claims and initiated a counter claim for \$28,129 in respect of libel and slander. The Company intends to vigorously defend its position. The Labor Court has imposed a gag order on the parties to the lawsuit.

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

This discussion should be read in conjunction with the condensed consolidated financial statements and notes included in Item 1 of Part I 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 Year Ended December 31, 2010 contained in our 2010 Annual Report on Form 10-K. The discussion and analysis which follows may contain trend analysis and other forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934 which reflect our current views with respect to future events and financial results. These include statements regarding our earnings, projected growth and forecasts, and similar matters that are not historical facts.

We remind shareholders that forward-looking statements are merely predictions and therefore are inherently subject to uncertainties and other factors that could cause the future results to differ materially from those described in the forward-looking statements.

The following is management's discussion and analysis of certain significant factors which have affected our financial position and operating results during the periods included in the accompanying consolidated financial statements, as well as information relating to the plans of our current management.

### Overview

We are a manufacturer and global provider of personal military and civilian protective equipment and supplies. Our products are used by military, law enforcement, border patrol enforcement, and other special security forces, corporations, non-governmental organizations and individuals throughout the world. Our main products include body armor, bomb disposal suits, bullet proof vests and jackets, ballistic wall coverings, bullet proof ceramic and polyethylene panels, V.I.P. car armoring and lightweight armor kits for vehicles, personal military equipment, dry storage systems, liquid logistic products, tents and other camping and travel gear.

We believe that current international tensions, the continuing war on terrorism and conflicts in Iraq and Afghanistan are all likely to result in additional interest in our products, and that the demand for our products will continue to grow. We expect to address this growth by offering a comprehensive array of high quality branded security products that meet our customers' increasingly complex security products requirements.

As a supplier of products to the civilian and military markets, our business is affected by economic conditions. The volatile economic conditions of 2010 have continued into 2011 and slowed down our sales process and complicated our ability to conduct transactions. The economic climate and ongoing uncertainty in global economic conditions could impact the ability of our customers, including governmental entities, to make capital expenditures, which would affect their ability to purchase our products. Our business and financial performance, including collection of our accounts receivable, realization of inventory and recoverability of assets (including investments), may be adversely affected if economic conditions continue to be volatile or weaken further. Our profitability may also be adversely affected by our fixed costs and the possibility that we would be unable to scale back other costs within a time frame sufficient to match any decreases in revenue relating to changes in market and economic conditions.

We develop our products in Israel and sell them in Israel, North and South America, Asia, Africa and several European countries. Our sales in Israel are denominated in NIS, while most of our export sales are denominated in U.S. dollars. Under U.S. GAAP we report all of our sales in U.S. dollars. Accordingly, the appreciation of the U.S. dollar against the NIS reduces the U.S. dollar value of our NIS denominated sales, while the depreciation of the U.S. dollar against the NIS increases the U.S. dollar value of our NIS denominated sales.





Our cost of sales and operating expenses are affected in the same manner. Most of our purchases of raw material are made in U.S. dollars, while most of our labor and other operating expenses are in NIS, however, under U.S. GAAP we report our cost of sales and operating expenses in U.S. dollars. Accordingly, the appreciation of the U.S. dollar against the NIS reduces the U.S. dollar value of our NIS denominated cost of sales and operating expenses, while the depreciation of the U.S. dollar against the NIS increases the U.S. dollar value of our NIS denominated cost of sales and operating expenses.

Exchange rate fluctuations also affect our financial results in other ways. Most of our deposits and a portion of our tradable securities are linked to the rate of exchange between the U.S. dollar and the NIS. Accordingly, a depreciation of the U.S. dollar against the NIS is reflected as comprehensive income in our consolidated statement.

In the quarter ended March 31, 2011, the NIS appreciated against the U.S. dollar by approximately 1.9% and our financial results were negatively impacted. Exchange rates between the U.S. dollar and the NIS fluctuate continuously. Exchange rate fluctuations and especially larger periodic devaluations will have an impact on our profitability and period-to-period comparisons of our results. We cannot assure you that in the future our results of operations will not be materially adversely affected by currency fluctuations.

#### Material Trends

**Local Military Market.** During the end of 2010 and the first quarter of 2011, the demand for our products decreased. We believe that the demand for our products from the Israeli Ministry of Defense will continue at the current levels during the remainder of 2011.

As of May 6, 2011, we had a backlog of firm orders from the Israeli Ministry of Defense of approximately \$930,000, including orders of approximately \$47,000 that we received subsequent to March 31, 2011. In the three month periods ended March 31, 2011 and 2010, sales to the Israeli Ministry of Defense were approximately \$960,000 and \$1.1 million, accounting for 25.8% and 38% of our total sales, respectively.

**Export Military Market.** Our customers in this market are military and law enforcement organizations mostly in South America, North America, Africa and Europe. Their budgets fluctuate, and as a result, we cannot identify definite trends in these markets. In the three months ended March 31, 2011 and 2010, we had sales of \$290,184 and \$218,360 in South America, sales of \$32,924 and \$230,945 in North America, sales of \$458,976 and \$343,449 in Europe and Asia, and sales of \$786,750 and \$2,177 in Africa, respectively.

The following table presents details of our export military sales during the three month periods ended March 31, 2011 and 2010:

	Three Months Ended March 31,	
	2011	2010
Sales to South America	\$ 290,184	\$ 218,360
Sales to North America	32,924	230,945
Sales to Europe and Asia	458,976	343,449
Sales to Africa	786,750	2,177
Total Export Military Sales	\$ 1,568,835	\$ 794,931



**Local Civilian Market.** Our product range for the civilian market is diversified. In the three months ended March 31, 2011, our local market business decreased to \$573,182 compared to \$1,033,658 for the three months ended March 31, 2010. We expect to maintain the same level of revenues in the next quarter, due to marketing efforts and increased demand for armor of civilian facilities.

**Backlog.** We had approximately \$4.4 million of unfilled customer orders at March 31, 2011, compared to approximately \$3.5 million of unfilled customer orders at March 31, 2010. Of our \$4.4 million of unfilled customer orders at March 31, 2011, approximately \$900,000 was attributable to orders from military customers in South America, approximately \$100,000 was attributable to orders from military customers in Europe and Asia, approximately \$1.3 million was attributable to orders from military customers in Africa, approximately \$600,000 was attributable to the local civilian market, approximately \$400,000 was attributable to the U.S. civilian market and approximately \$1 million was attributable to the Israeli Ministry of Defense.

**Current Economic Overview.** We generate revenues from sales of our products to the civilian and military markets. Accordingly, our business is affected by economic conditions. The economic climate and uncertainty in global economic conditions could impact the ability of our customers, including governmental entities, to make capital expenditures, which would affect their ability to purchase our products. In addition, turmoil in financial markets may limit our ability to obtain financing for our working capital requirements. Our business and financial performance, including collection of our accounts receivable, realization of inventory and recoverability of assets (including investments), may be adversely affected if economic conditions continue to be uncertain or weaken further. Our profitability may also be adversely affected by our fixed costs and the possibility that we would be unable to scale back other costs within a time frame sufficient to match any decreases in revenue relating to changes in market and economic conditions.

**Exchange rate fluctuation.** Exchange rate fluctuations affect our financial results in several ways. Most of our deposits and a portion of our tradable securities are linked to the rate of exchange between the U.S. dollar and the NIS. Accordingly, the depreciation of the U.S. dollar against the NIS is reflected as comprehensive income in our consolidated statement.

We develop products in Israel and sell them in Israel, North and South America, Asia, Africa and several European countries. Our sales in Israel are denominated in NIS, while most of our export sales are denominated in U.S. dollars. Under U.S. GAAP, we report all of our sales in U.S. dollars. Accordingly, the appreciation of the U.S. dollar against the NIS reduces the U.S. dollar value of our NIS denominated sales, while the depreciation of the U.S. dollar against the NIS increases the U.S. dollar value of our NIS denominated sales.

Our cost of sales and operating expenses are affected in the same manner. Most of our purchases of raw material are made in U.S. dollars while most of our labor and other operating expenses are in NIS, however, under U.S. GAAP we report our cost of sales and operating expenses in U.S. dollars. Accordingly, the appreciation of the U.S. dollar against the NIS reduces the U.S. dollar value of our NIS denominated cost of sales and operating expenses, while the depreciation of the U.S. dollar against the NIS increases the U.S. dollar value of our NIS denominated reported cost of sales and operating expenses.

In the quarter ended March 31, 2011, the NIS appreciated against the U.S. dollar by approximately 1.9%, and our financial results were negatively impacted. Exchange rates between the U.S. dollar and the NIS fluctuate continuously. Exchange rate fluctuations and especially larger periodic devaluations will have an impact on our profitability and period-to-period comparisons of our results. We cannot assure you that in the future our results of operations may not be materially adversely affected by currency fluctuations.



## The Sarino Agreement

On December 17, 2008, our subsidiary, Mayotex Ltd., or Mayotex, entered into an agreement with Sarino Crystal Technologies Ltd. and Sarino Optronics Ltd., or Sarino, to form an entity which will cooperate in the manufacture of optical grade germanium crystals and sales of lenses to be used in optical and infra-red night vision products utilizing the germanium crystals, or the Sarino Agreement.

On December 21, 2008, Mayosar Ltd., or Mayosar, which was incorporated by Mayotex and Sarino, through its wholly owned subsidiary Optics, entered into an agreement, or the Isorad Agreement, to purchase the Germanium Crystals Business of Isorad Ltd., an Israeli governmental company, or Isorad. The Isorad Agreement provided for the purchase of certain know-how, equipment, inventories and production activities of germanium crystals for lenses used in infra-red night vision system applications.

After a period of uncertainty, in August 2010, Mayosar, Optics and Isorad executed an addendum to the 2008 agreement, according to which the parties confirmed the validity of the Isorad Agreement under certain conditions.

Pursuant to the Isorad Agreement, Optics is to pay annual royalties of 3% out of sales for a period of 15 years commencing the effective date of the Isorad Agreement, or the Effective Date, with a minimum of approximately \$133,000 payable per year during the first 18 months, or until the date of completion of the transfer of the site of the Optics business from Isorad's premises, whichever is earlier (this payment includes a reimbursement of costs for the usage of the site and equipment in this initial period), and approximately \$53,000 per year during the years following the initial 18 month period.

Isorad has the right to acquire 5% of the share capital of Optics on a fully diluted basis for their nominal value during the 24 month period beginning on the Effective Date. Such right was extended for an additional 12-month period until January 1, 2012. If the Israeli Government does not approve the 5% purchase of the Optics shares by Isorad within the above period, the right to acquire the shares will expire and Isorad will be entitled to a payment of \$75,000.

Optics has the right during the four-year period following the Effective Date to redeem its commitment to pay royalties under the Isorad Agreement and to repurchase Isorad's shares (or Isorad's option above to acquire shares) in consideration of a fixed payment of \$750,000, less all royalties and the above \$75,000 payment (in the event Isorad waived its right to be issued Optics shares) paid to through that date.

Pursuant to the Sarino Agreement:

- Mayotex will have operational control of Mayosar.
- Mayotex paid Sarino Crystal Technologies Ltd. \$1 million, or the Sarino Payment, out of which \$300,000 is non-refundable to Mayotex and the remaining \$700,000 will be earned by Sarino based on 10% of sales over \$3 million and up to \$10 million during the first 36 months of operations. Amounts not earned are to be refunded to Mayotex, including interest of Libor + 2% per year. The refundable consideration is secured by Sarino's interest in Mayosar and personal guarantees provided by Sarino Crystal Technologies Ltd.'s controlling shareholders.
- Mayotex agreed to provide Mayosar with a loan in the aggregate amount of \$2 million under a timetable to be determined by Mayosar's board of directors. Such loan will bear interest at the rate of Libor + 2%, and is payable from profits generated by Mayosar.

In December 2010 Sarino and Mayotex entered into an agreement, or the December Agreement, pursuant to which the parties agreed to amend the terms and conditions of the Sarino Payment to provide for: (i) a loan term of 10 years,

commencing as of December 19, 2010; (ii) interest at LIBOR plus 1% per year commencing as of December 19, 2010; and (iii) the grant to Sarino Crystal Technologies Ltd. of a put option under which it could repay the Sarino Payment by selling its stake in Optics to Mayotex. Based on a purchase price allocation analysis, we recorded the Sarino loan as a liability against the minority interest.

In the event of an allotment of shares representing 5% of Optics' share capital to Isorad upon the exercise by Isorad of its option, Optics will issue additional shares of Optics to Mayotex on a pro rata basis, in order for Mayotex to retain a 82% interest in Optics' share capital.

#### The Acquisition of Philcar Ltd.

In March 2011, Mayotex entered into an agreement with Rabintex Industries Ltd., or Rabintex, to purchase Philcar Ltd., or Philcar, a company that specializes in equipping and protecting vehicles, for \$214,304. Under the terms of the agreement, Mayotex may have to pay Rabintex additional compensation of up to \$160,728, depending on the amount of orders that Philcar receives from certain customers during the six-month period following the closing of the transaction. The transaction was completed on May 3, 2011.

#### Results of Operations

##### Key Indicators

Our management views revenues, the sources of our revenues, gross profit margin and the level of inventory compared to revenues as the key performance indicators in assessing our company's financial condition and results of operations. While our management believes that demand for our products is stable, our business is subject to a high degree of volatility because of the impact of geopolitical events and government budgeting.

#### Three Months Ended March 31, 2011 Compared with Three Months Ended March 31, 2010

**Net Revenues.** Net revenues for the three months ended March 31, 2011 increased to \$3,593,437 from \$2,993,731 for the three months ended March 31, 2010, an increase of 20%. The increase is primarily attributable to an increase in our export military market segment, as well as due to an increase in our export civilian market segment. In the period ended March 31, 2011, revenues from our local military market segment decreased by approximately \$150,000 and revenues from our export military market segment increased by approximately \$1.0 million. The decrease in revenues from our local military market segment is attributable to a general decrease in demand for our products in the local market. The increase in revenues from our export military market segment is attributable to a general increase in demand for our products abroad, especially armored vehicles. The increase in total revenues was also partially offset by a decrease of \$460,000, or 45%, in the local civilian market, attributable to decreased sales to our existing customers in this market. We expect to maintain the same level of revenues in the next quarter.

The following table sets forth the breakdown of sales by segment for the three months ended March 31, 2011 and 2010.

	Three Months Ended March 31,	
	2011	2010
Local civilian market	\$ 573,182	\$ 1,033,658
Export civilian market	436,431	229,631
Local military market	1,014,989	1,165,142
Export military market	1,568,835	565,300
<b>Total</b>	<b>\$ 3,593,437</b>	<b>\$ 2,993,731</b>

**Gross Profit.** Gross profit for the three months ended March 31, 2011 was \$663,520 compared to \$603,379 for the three months ended March 31, 2010. This increase in gross profit is primarily attributable to the increase in revenues.



Our gross profit margin for the three months ended March 31, 2011 decreased to 18.5% compared to 20.15% for the three months ended March 31, 2010.

**Selling Expenses.** Selling expenses for the three months ended March 31, 2011 increased by 671% to \$777,044 from \$115,772 for the three months ended March 31, 2010. The increase in our selling expenses was attributable primarily to the increase in export sales and commissions paid on export sales.

**General and Administrative Expenses.** General and administrative expenses for the three months ended March 31, 2011 increased by 3.5% to \$721,895 from \$697,409 for the three months ended March 31, 2010. The increase in our general and administrative expenses was attributable primarily to a \$22,880 increase in salaries.

**Financial (Expenses) Income, Net.** We had financial expenses, net of \$85,149 for the three months ended March 31, 2011 compared to financial expenses, net of \$90,034 for the three months ended March 31, 2010. Our financial expenses are primarily due to the change in the U.S. dollar/NIS exchange rate, which resulted in a loss of \$41,871 for the three months ended March 31, 2011 compared to a loss of \$99,068 for the three months ended March 31, 2010.

**Other Income (Expense), Net.** We had other income, net for the three months ended March 31, 2011 of \$3,718 as compared to other income, net of \$50,372 for the three months ended March 31, 2010. Our other income in the three months ended March 31, 2011 is attributable primarily to realized and unrealized gains on trading securities of \$15,234 and loss due to changes in the fair market value of investments allocated to funds invested in respect of employee rights upon retirement of \$11,516, compared to realized and unrealized gains on trading securities of \$17,003 and gains due to changes in the fair market value of investments allocated to funds invested in respect of employee rights upon retirement of \$10,685 in the three months ended March 31, 2010.

**Income Tax Expense.** Our income tax expense for the three months ended March 31, 2011 was \$865 compared to income tax expense of \$5,125 for the three months ended March 31, 2010. The decrease in income tax expense is due to the decrease in our operating income in the three months ended March 31, 2011 compared to the comparable period in 2010.

**Net Income (Loss).** In the three months ended March 31, 2011 our net loss was \$916,646, compared to a net loss of \$254,589 for the three months ended March 31, 2010.

#### Liquidity and Capital Resources

We assess liquidity in terms of our ability to generate cash to fund our operating and investing activities. Of particular importance to management are cash flows generated by operating activities and cash used for capital and financing expenditures.

In the last few years we have financed our operating needs and capital expenditures through cash flows from our operations, payments from the Israeli government relating to the evacuation by our Erez Export and Mayotex subsidiaries from their manufacturing facilities in the Erez Industrial Zone in the Gaza Strip and existing cash. We expect to continue to finance current and planned operating requirements principally through cash from operations, as well as existing cash resources. We believe that these funds will be sufficient to meet our operating requirements for the foreseeable future. However, we may, from time to time, seek additional funding through a combination of equity and debt financings or from other sources. The economic climate and any uncertainty in the global financial markets resulting from the disruption in credit markets may affect our ability to raise additional funds in the future, if required. There can be no assurance that such additional financing will be available to us, or if available, will be on terms favorable to our company.

Most of our large contracts, which are Israeli Governmental contracts, are supported by letters of credit. As a result, we believe that we have limited exposure to doubtful accounts receivables. We have endeavored to balance our accounts payable and accounts receivable.



As of March 31, 2011, we had \$3,064,038 in cash and cash equivalents, \$1,788,598 in trading securities and working capital of \$6,818,597, as compared to \$3,502,461 in cash and cash equivalents, \$1,894,864 in trading securities and working capital of \$8,064,571 at December 31, 2010.

We believe that we have sufficient working capital and borrowing capability to sustain our current level of operations for the next twelve months.

#### Cash Flows

The following table summarizes our cash flows for the periods presented:

	Three months ended	
	March 31, 2011	March 31, 2010
Net cash (used in) provided by operating activities	\$(241,881 )	\$942,767
Net cash used in investing activities	(495,361 )	(121,599 )
Net cash provided by (used) in financing activities	317,114	(211,542 )
Net increase in cash and cash equivalents	(438,423 )	716,247
Cash and cash equivalents at beginning of period	3,502,461	3,783,631
Cash and cash equivalents at end of period	\$3,064,038	\$4,499,878

Operating activities. Net cash used in operating activities was \$241,881 for the three months ended March 31, 2011 as compared to \$942,767 provided by operating activities in the three months ended March 31, 2010. Net cash used in operating activities in the 2011 period was primarily attributable to our net loss of \$916,646 in the period, an increase in accounts receivable of \$281,140, an increase in inventories of \$1,421,726, offset by an increase in accounts payable of \$1,208,464, an increase in other current liabilities of \$923,853, a decrease in trading securities of \$123,424 and a decrease in other current assets of \$103,473.

Investing activities. Net cash used in investing activities was \$495,361 for the three months ended March 31, 2011 as compared to \$121,599 used in investing activities for the three months ended March 31, 2010. During the three months ended March 31, 2011, \$495,361 was used to purchase fixed assets.

Financing activities. Net cash provided by financing activities was \$317,114 for the three months ended March 31, 2011 as compared to \$211,542 used in financing activities for the three months ended March 31, 2010. During the three months ended March 31, 2011, our short-term debt increased by \$368,873 offset by a reduction of \$51,759 of long-term debt.

#### Foreign Currency Exchange Risk

We develop products in Israel and sell them in Israel, North and South America, Asia, Africa and several European countries. Our sales in Israel are denominated in NIS while most of our export sales are denominated in U.S. dollars. In addition, our labor expenses are primarily paid in NIS while our expenses for raw materials are paid primarily in U.S. dollars. As a result, our financial results could be affected by factors such as changes in foreign currency exchange rates or weak economic conditions in foreign markets.

Our foreign currency exposure is significant due to the fluctuations of the U.S. dollar against the NIS. We expect our exposure will continue to be significant, since a significant portion of the prices of our raw material purchases, as well as part of our sales are denominated in U.S. dollars.

In the year ended December 31, 2010, the inflation rate in Israel was 2.7% and the NIS appreciated against the U.S. dollar by 6%, from NIS 3.775 per \$1 on December 31, 2009 to NIS 3.549 per \$1 on December 31, 2010. In the period ended March 31, 2011, the inflation rate in Israel was 0.7% and the NIS appreciated against the U.S. dollar by 1.9%. If future inflation in Israel exceeds the devaluation of the NIS against the U.S. dollar or if the timing of such devaluation lags behind increases in inflation in Israel, our results of operations may be materially adversely affected

We did not enter into any foreign exchange contracts in the three months ended March 31, 2011.

#### Inflation and Seasonality

We do not believe that our operating results have been materially affected by inflation during the preceding two years. There can be no assurance, however, that our operating results will not be affected by inflation in the future. Our business is subject to minimal seasonal variations with slightly increased sales historically in the second and fourth quarters of fiscal year. We generally experience a slight increase in sales of our camping equipment during the second quarter and in sales of our protective clothing during the fourth quarter.

#### Off-balance Sheet Arrangements

None.

## Contractual Obligations

The following table summarizes our contractual obligations and commercial commitments as of March 31, 2011.

Contractual Obligations	Total	Payments due by Period			more than 5 years
		Less than 1 year	2 -3 years	4 -5 years	
Long-term debt obligations	\$ 376,509	\$ 169,874	\$ 185,785	\$ 20,850	
Estimated interest payments on long-term debt obligations	27,105	13,094	8,821	5,190	
Operating lease obligations	1,904,748	659,157	970,043	275,548	
Total	\$ 2,308,361	\$ 842,125	\$ 1,164,648	\$ 301,588	

## Critical Accounting Policies

A discussion of our critical accounting policies was provided in Item 7 of our Annual Report on Form 10-K for the year ended December 31, 2010. There were no significant changes to these policies in the three months ended March 31, 2011.

## Recent Accounting Pronouncements

See Note 1H to the unaudited condensed consolidated financial statements included in Part I, Item 1, Financial Statements, of this Quarterly Report on Form 10-Q.

## Item 3. Quantitative and Qualitative Disclosures About Market Risk

## Interest Rate Risk

We have variable rate loans that we borrow from Israeli banks which are based on the local Prime Rate. Each increase of 1% in the Prime Rate will increase our interest expense approximately \$21,600 on an annualized basis.

## Foreign Exchange Risk

Most of our sales are currently denominated in dollars, while the majority of our operating expenses are incurred in foreign currencies, principally the NIS. As a result, the depreciation of the U.S. dollar against these currencies increases the U.S. dollar value of our expenses denominated in such currencies. In 2008, 2009 and 2010, the U.S. dollar depreciated against the NIS by approximately 1%, 1% and 6%, respectively. In the first three months of 2011, the U.S. dollar depreciated against the NIS by approximately 1.9%.

#### Item 4. Controls and Procedures

**Evaluation of Disclosure Controls and Procedures.** As of March 31, 2011, our company's chief executive officer and chief financial officer conducted an evaluation regarding the effectiveness of our company's disclosure controls and procedures (as defined in Rules 13a-15(e) or 15d-15(e) under the Exchange Act. Based upon the evaluation of these controls and procedures, our chief executive officer and chief financial officer concluded that our disclosure controls and procedures were not effective as of March 31, 2011, due to the material weaknesses described below in our internal control over financial reporting.

**Disclosure Controls and Internal Controls.** As provided in Rule 13a-14 of the General Rules and Regulations under the Securities and Exchange Act of 1934, as amended, Disclosure Controls are defined as meaning controls and procedures that are designed with the objective of insuring that information required to be disclosed in our reports filed under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, designed and reported within the time periods specified by the SEC's rules and forms. Disclosure controls include, within the definition under the Exchange Act, and without limitation, controls and procedures to insure that information required to be disclosed by us in our reports is accumulated and communicated to our management, including our chief executive officer and principal financial officer, as appropriate to allow timely decisions regarding disclosure. Internal controls are procedures are designed with the objective of providing reasonable assurance that (1) our transactions are properly authorized; (2) our assets are safeguarded against unauthorized or improper use; and (3) our transactions are properly recorded and reported, all to permit the preparation of our financial statements in conformity with generally accepted accounting principles.

#### Management's Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting. Internal control over financial reporting is a process designed by, or under the supervision of the Chief Executive Officer and Chief Financial Officer and effected by our board of directors, management and other personnel, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management's evaluation of internal control over financial reporting includes using the Committee of Sponsoring Organizations of the Treadway Commission, or COSO, framework, an integrated framework for the evaluation of internal controls issued by COSO, to identify the risks and control objectives related to the evaluation of our control environment.

Based on their evaluation under the framework described above, our chief executive officer and chief financial officer have concluded that our internal control over financial reporting was ineffective as of March 31, 2011, due to material weaknesses related to our financial statement closing process resulting from insufficient knowledge of our financial staff regarding the application of U.S. GAAP to complex transactions.

#### Remediation Plan

We have taken the following steps to remediate the material weaknesses:

- we have recruited a new chief financial officer and continue to recruit and hire additional accounting staff with technical expertise to ensure the proper application of accounting principles generally accepted in the United States;



- we are implementing revised policies and procedures and enhancing our review of complex transactions to ensure consistent application of U.S. GAAP and enhanced internal control over financial reporting; and
- we are increasing the level of preparation and review of our financial statements, and in connection therewith, we are implementing additional control procedures as part of our quarter and year-end close processes as well as adding resources in connection with our review of key financial estimates.

#### Changes in Internal Control over Financial Reporting

No change in our internal control over financial reporting occurred during the three month period ended March 31, 2011, that materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. However, subsequent to March 31, 2011, we made changes to our internal control over financial reporting and took remedial actions, as described above.

#### PART II - OTHER INFORMATION:

##### Item 1. Legal Proceedings

On February 11, 2009, a lawsuit was filed in the Jerusalem District Court, or the Court, against our subsidiary, Achidatex Nazareth Elite (1977) Ltd., or Achidatex, Mr. Avraham Haztor, the then chief executive officer of Achidatex, and our subsidiary Export Erez USA Inc., or Export Inc. Our subsidiary Export Erez Ltd., or Export Erez, was subsequently added as a defendant in the action. The suit alleges that Achidatex materially breached its February 22, 2000 agreement with the plaintiff, relating to the development of inflatable mine-field crossing enabling sandals, by failing to register patents for the technology underlying the sandals, worldwide as it only registered patents in the United States. The plaintiff further claims that the defendants, jointly and severally, committed a breach of trust. The plaintiff is seeking damages in the amount of NIS 10 million (approximately \$2.8 million). We filed a statement of defense rejecting the plaintiff's claims and asserted a claim against the plaintiff and others for a declaratory judgment that the plaintiff breached his contractual undertakings towards Achidatex. The petition to consolidate the counter-claim with the plaintiff's claim was ordered by the Court and the claims are now being heard together. Our subsidiaries filed a statement of defense and the proceedings are currently at the stage at which the parties have to submit affidavits stating evidence to support their case. We believe that the risk under the above lawsuit is not material to the business of our subsidiaries. We intend to vigorously defend our position against the lawsuit. Recently the plaintiff requested that the court permit the plaintiff to amend its statement of claims to increase the amount of damages sought to NIS 20 million (approximately \$5.6 million). This motion is pending.

On July 12, 2010, a lawsuit was filed in the Tel-Aviv Regional Labor Court, or the Labor Court against our company, our subsidiaries, Mayotex Ltd. and Export Erez, and against an officer of our company, by a former employee. The plaintiff alleges that we breached her employment agreement and violated certain Israeli labor related legislation by not paying her severance payment in lieu of vacation, recuperation payments, contribution to a study fund, payments due during a prior notice period and compensation for unpaid overtime. The plaintiff also claimed that she was the subject of sexual harassment and consequently we violated certain applicable Israeli legislation. The plaintiff is seeking damages of \$414,775. Management believes that the amount sought is exaggerated and that the exposure, if any, is not material to our and our subsidiaries' business. We have filed our statement of defense rejecting the former employee's claims and initiated a counter claim for \$28,129 in respect of libel and slander. We intend to vigorously defend our position. The Labor Court has imposed a gag order on the parties to the lawsuit.



Item 1A. Risk Factors

There have been no material changes to our “Risk Factors” set forth in Item 1A. of our Annual Report on Form 10-K for the year ended December 31, 2010.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. (Removed and Reserved)

Item 5. Other Information

None.

Item 6. Exhibits

31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended.

31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act, as amended.

32.1 Certification of Chief Executive Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of Chief Financial Officer pursuant to 18 U.S.C. 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

In accordance with the requirements of the Exchange Act, the registrant caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DEFENSE INDUSTRIES INTERNATIONAL, INC.

Dated: May 16, 2011

/s/ Uri Nissani  
Uri Nissani  
Chief Executive Officer and President

/s/ Chaim Hadad  
Chaim Hadad  
Chief Accounting and Financial Officer

28

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