# UNITED STATES

## SECURITIES AND EXCHANGE COMMISSION

**Washington, D.C. 20549**

# FORM 10-Q

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

OR

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

Commission File Number: 000-51004

# PortalPlayer, Inc.

**(Exact name of registrant as specified in its charter)**

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

**(408) 521-7000**

**(Registrant s telephone number, including area code)**

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

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

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

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

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

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## PART I. FINANCIAL INFORMATION

**Item 1. Financial Statements**

### PORTALPLAYER, INC.

### CONDENSED CONSOLIDATED BALANCE SHEETS

**(In thousands, except per share amounts, unaudited)**

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

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

See accompanying Notes to Condensed Consolidated Financial Statements.

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**PORTALPLAYER, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

**(In thousands, except per share amounts, unaudited)**

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

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

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

See accompanying Notes to Condensed Consolidated Financial Statements.

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**PORTALPLAYER, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**

**(In thousands, unaudited)**

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

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

See accompanying Notes to Condensed Consolidated Financial Statements.

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**PORTALPLAYER, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

## 1. Description of Business and Basis of Presentation

### *The Company*

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

### *Principles of Consolidation and Basis of Presentation*

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

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

### *Concentration of Credit Risk*

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

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

### *Reportable Segments*

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

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**2. Stock-Based Compensation**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

400,000 shares;

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

the number of shares determined by our board.

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

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

**3. Net Income Per Share**

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

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

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

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**4. Balance Sheet Components (in thousands)**

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

**5. Commitments and Contingencies**

***Litigation***

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

***Guarantees***

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

***Warranty***

The Company provides a warranty on its products for a period of twelve to fifteen months from the date of delivery or manufacture, and provides for warranty costs at the time of sale based on historical activity for the prior 12 months. The determination of such provisions requires the Company to make estimates of the frequency and extent of warranty activity and estimated future costs to replace the products under warranty. If actual warranty activity and/or repair and replacement costs differ significantly from these estimates, adjustments to recognize additional cost of revenue may be required in future periods. The following table summarizes the activity related to the warranty reserve in the three-month and nine-month periods ended September 30, 2006 and 2005 (in thousands):

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

***Lease Commitments***

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

***Commitments***

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

**6. Comprehensive Income**

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

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Net income | $ 1,493 | $ 10,275 | $ 9,409 | $ 24,417 |
| Net change in unrealized gain (loss) on investments | 256 | (45) | 295 | (187) |
| Net comprehensive income | $ 1,749 | $ 10,230 | $ 9,704 | $ 24,230 |

**7. Intangible Assets**

In March 2006, the Company obtained a five-year license to a certain patent portfolio, which consist of US and international patents. The Company also purchased additional patents from the same third party. The combined transaction amount, including certain costs directly related to entering into this transaction, was approximately $8.4 million. These patents and patent rights are amortized on a straight-line basis over their expected weighted average life of 7.3 years. Amortization expense of $0.3 million and $0.8 million was recorded in the three-month and nine-month periods ended September 30, 2006. Intangible assets, net, consisted of the following (in thousands):

| | September 30, 2006 | December 31, 2005 |
|---|---|---|
| Patents and patent rights | $ 8,435 | $ |
| Less: accumulated amortization | (802) | |
| | $ 7,633 | $ |

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Future amortization expense related to patents and patent rights is as follows (in thousands):

| Years ending December 31, | |
|---|---|
| 2006 | $ 344 |
| 2007 | 1,375 |
| 2008 | 1,375 |
| 2009 | 1,375 |
| 2010 | 1,375 |
| Thereafter | 1,789 |
| | $ 7,633 |

**8. Restructuring Charges**

Due to a product transition setback as announced in April 2006, the Company re-organized its operations in June 2006 to focus on its key initiatives. As a result, the Company reduced its workforce by involuntarily terminating 32 employees. All functional areas were affected by the reduction. During the three-month period ended June 30, 2006, the Company recorded $0.6 million in charges associated with the restructuring plan, comprised of $0.5 million in research and development expense and $0.1 million in selling, general and administrative expense.

During the three-month period ended September 30, 2006, the Company recorded $18,000 in charges associated with the restructuring plan, comprised of $15,000 in research and development expense and $3,000 in selling, general and administrative expense.

The following summarizes the Company s restructuring activity (in thousands):

| | Employee Severance | Other | Total |
|---|---|---|---|
| Restructuring charges | $ 555 | $ 59 | $ 614 |
| Cash payments | (478) | (6) | (484) |
| Accrued balance June 30, 2006 | $ 77 | $ 53 | $ 130 |
| Restructuring charges | 5 | 13 | 18 |
| Cash payments | (82) | (66) | (148) |
| Accrued balance September 30, 2006 | $ | $ | $ |

All payments related to the restructuring expenses were disbursed by September 30, 2006.

**9. Income Taxes**

The Company s provision for income taxes was $427,000 in the three months ended September 30, 2006, compared to $3.4 million in the three months ended September 30, 2005. The tax provision for the three months ended September 30, 2006 is the result of applying an annualized rate of 40.1% to the Company s year-to-date earnings. The Company recorded a tax provision in the same period of the prior year that represented an annualized effective tax rate of 25.0%. The Company has a higher rate in the current year-to-date period due to non-deductible stock-based compensation being recorded under the provisions of SFAS 123R during the current year, as well as the release of certain valuation allowances related to Net Operating Loss carryforwards and a benefit from research and development activities being recorded in the prior year.

**10. Recent Accounting Pronouncements**

In July 2006, the Financial Accounting Standards Board, or FASB, issued FASB Interpretation No. 48 Accounting for Uncertain Tax Positions an interpretation of FASB Statement No. 109, or FIN 48, which clarifies the accounting for uncertainty in income taxes in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 contains a two-step process to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining whether it is more likely than not that a tax position will be sustained upon examination, including resolution of related appeals or litigation processes, based on the technical merits of the position. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. The Company is currently evaluating the effect that the adoption of FIN 48 will have on its consolidated financial statements.

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**11. Subsequent Event**

On November 6, 2006, the Company entered into a definitive merger agreement with NVIDIA Corporation, or NVIDIA. The merger agreement provides that, upon the terms and subject to the conditions set forth in the merger agreement, at the effective time of the merger: (i) the Company will become a wholly owned subsidiary of NVIDIA; and (ii) each outstanding share of the Company s common stock will be converted into the right to receive $13.50 in cash without interest. In connection with the merger, NVIDIA will also, in its discretion, assume or substitute outstanding options to purchase the Company s common stock pursuant to the terms of the Merger Agreement. Additionally, immediately upon the effective time of the merger, unvested shares of the Company s Restricted Stock will become the right to receive restricted cash consideration on the same vesting terms and schedule. Consummation of the merger is subject to certain customary closing conditions, including antitrust approvals and adoption of the merger agreement by the Company s stockholders. The merger, which is expected to close in December 2006 or early 2007 may not be completed if any of the closing conditions are not satisfied or waived. Unless otherwise indicated, the discussions in this document relate to the Company as a standalone entity and do not reflect the impact of the proposed merger with NVIDIA.

**Item 2. 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 together with the condensed consolidated financial statements and the related notes contained in this report and with the information included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005 and subsequent reports filed with the Securities and Exchange Commission. This quarterly report on Form 10-Q contains forward-looking statements, including, but not limited to, our proposed merger with NVIDIA, the anticipated effects of Apple Computer, Inc. s decision not to use our platform in certain of its iPods, Apple Computer, Inc. s continued use of our platform, use of our products in the iPod family, the anticipated availability of the follow-on to our PP5021, statements relating to anticipated trends and challenges in our business, technology and the markets in which we operate, our ability to develop and to sell our products, such as our PP5022, the features, benefits and availability of current and future products, geographic concentration of our revenues, customer concentration and demand, our dependency on certain employees, the intended departure of our current president and chief executive officer, increasing internal operations historically performed by third-parties, customer shipment logistics, the impact and availability of customer components, our customer strategy, our growth rates, elements of our growth strategy including sales and marketing and product development efforts and international operations, seasonality of our business, fluctuation in our operating results, our gross margins, our revenues and sources of revenues, including timing of revenue, our provisions for income taxes, our expenses, average selling prices, inventory management and adjustments, the evaluation of our intangible assets, estimates regarding our capital expenditures, anticipated capital requirements, the adequacy of our capital resources, our anticipated cash needs, our needs for additional financing, future acquisitions or investments, competition, our intellectual property, costs of being a public company, internal controls, our disclosure controls and procedures, our critical accounting policies, market risk sensitive instruments, including currency fluctuations, and potential legal proceedings. These statements may be identified by such terms as anticipate, believe, will, would, plan, estimate, expect, may, might, intend, allow, could, can, or the negative of those terms or similar expressions intended to identify forward-looking statements. These forward-looking statements are subject to risks and uncertainties that may cause actual results to differ materially from those expressed or implied by the forward-looking statements. These risks and uncertainties include, but are not limited to, the seasonality of the buying patterns of our customers, the concentration of sales to large customers, dependence upon and trends in consumer spending on personal electronics, the difficulty of designing and testing new products, the reluctance of customers to consider new product offerings, fluctuations in general economic conditions, increased competition, costs related to expansion of our operations, and other risks discussed in Part II, Item 1A Risk Factors in this report. These forward-looking statements represent our estimates and assumptions only as of the date of this report. Unless required by law, we undertake no responsibility to update these forward-looking statements.*

**General**

We are a fabless semiconductor company that designs, develops and markets comprehensive platform solutions, including a system-on-chip, firmware and software, for manufacturers of feature-rich personal media players and secondary display-enabled computers. Personal media players are battery-powered, hard disk drive and flash memory-based portable devices that capture, store and play digital media such as audio, photos and video. Our platform solutions are designed to enable personal media players and other devices to manage thousands of digital media files and allow our customers to build intuitive and customizable user interfaces. Our customers use our platforms to produce high-performance, feature-rich, differentiated products in a cost-effective manner with fast time to market. Our key personal media player customers include leading manufacturers such as Inventec and Hon Hai, who manufacture products for Apple Computer, Inc. and other companies. In the nine months ended September 30, 2006 and fiscal year 2005, Inventec accounted for 33.5% and 56.7% of our revenue, respectively. During the first quarter of 2005, we began shipping in volume to Hon Hai, which accounted for 58.9% and 36.3% of our revenue in the nine months ended September 30, 2006 and fiscal year 2005, respectively. In recent fiscal quarters, Hon Hai has accounted for a larger percentage of our revenue than Inventec.

On April 19, 2006 we announced that we had recently been advised that the follow-on to our PP5021 System-on-Chip, or SoC, has not been selected by Apple Computer, Inc. for use in their mid-range and high-end flash based iPods. We expect that this development will continue to result in a significant reduction in orders from our primary customers and consequently will continue to impact our financial performance in the near term.

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Due to this product transition setback, we announced in June 2006 that we re-organized our operations to focus on our key initiatives. As a result, our workforce was reduced by approximately 45 employees, or approximately 14 percent, which included 32 involuntary terminations and 13 voluntary terminations. Most functional areas were affected by the reduction. For the nine months ended September 30, 2006, we recorded $0.6 million in charges associated with the restructuring plan, comprised of $0.5 million in research and development expense and $0.1 million in selling, general and administrative expense. As of September 30, 2006, all payments related to restructuring expenses have been disbursed.

Some of our customer relationships, other than Inventec and Hon Hai, have been developed over a short period of time and are generally in the preliminary stages. There can be no assurance that these customers will continue to generate significant revenue, that we will be able to retain these customers or that we will continue to be successful in attracting new customers. We expect that we will continue to depend upon a relatively limited number of customers for substantially all of our revenue for the foreseeable future.

**Merger of PortalPlayer, Inc. with NVIDIA**

On November 6, 2006, we entered into a definitive merger agreement with NVIDIA Corporation, or NVIDIA. The merger agreement provides that, upon the terms and subject to the conditions set forth in the merger agreement, at the effective time of the merger: (i) we will become a wholly owned subsidiary of NVIDIA; and (ii) each outstanding share of our common stock will be converted into the right to receive $13.50 in cash without interest. In connection with the merger, NVIDIA will also, in its discretion, assume or substitute outstanding options to purchase our common stock pursuant to the terms of the Merger Agreement. Additionally, immediately upon the effective time of the merger, unvested shares of our Restricted Stock will become the right to receive restricted cash consideration on the same vesting terms and schedule. Consummation of the merger is subject to certain customary closing conditions, including antitrust approvals and adoption of the merger agreement by our stockholders. The merger, which is expected to close in December 2006 or early 2007 may not be completed if any of the closing conditions are not satisfied or waived. Unless otherwise indicated, the discussions in this document relate to us as a standalone entity and do not reflect the impact of the proposed merger with NVIDIA.

**Overview**

We were founded in 1999 and introduced our first-generation SoC in 2000. To date, we have introduced five SoC product generations and multiple versions of our firmware and software development kits. Our platforms include an SoC, firmware and software, and we do not market, sell or recognize revenue on these components separately. We began generating revenue in 2001, and have since increased our annual revenue from $1.9 million in 2001 to $225.2 million in 2005. We recorded revenue of $141.6 million in the nine months ended September 30, 2006. We generated annual net income of $10.4 million in 2004, our first profitable year, and generated annual net income of $48.2 million in 2005 and net income of $9.4 million in the nine months ended September 30, 2006.

We have grown our employee base from six at inception to 266 people as of September 30, 2006 in five countries, with approximately 53% of our employees, primarily engineering staff, located in India.

In addition to seeking to expand relationships with our existing customers, our strategy is to pursue new customers and diversify our customer base by focusing on leading global consumer electronics companies and their original design manufacturer, or ODM, partners. Historically, our products were only incorporated into hard disk drive-based personal media players. However, in 2005, we introduced the PP5022/5021 and the PP5024. The PP5022/5021, our fifth generation SoC, is designed for use in both hard disk drive and flash-based personal media players, and the PP5024 is a flash memory-specific product. These new platforms have enabled us to target a larger percentage of the personal media player market, and we began recognizing revenue from flash-based platforms in the third quarter of 2005. Many of our competitors have offered flash memory-specific products for some time and may have better established products or more expertise with flash memory-specific solutions. For example, we recently announced that the follow-on to our PP5021 SoC has not been selected by Apple Computer, Inc. for use in their mid-range and high-end flash based iPods. We intend to continue to focus primarily on customers that produce small form factor, feature-rich personal media players and to leverage our personal media player capabilities to address adjacent market opportunities such as secondary displays in computers.

The personal media player segment that we sell into is largely dominated by one original equipment manufacturer, or OEM, Apple Computer, Inc. Historically, the majority of our revenue has been derived from shipments of product that are incorporated into Apple Computer s products. As the feature-rich personal media player market matures, the capabilities our platform solutions provide may be subject to commoditization, similar to the commoditization which has occurred in the more mature, non-feature-rich flash-based personal media player market. Many of our current and potential competitors have longer operating histories, greater name recognition, access to larger customer bases and significantly greater financial, sales and marketing, manufacturing, distribution, technical and other resources than us. As a result, they may be able to respond more quickly to changing customer demands or to devote greater resources to the development, promotion and sales of their products than we can.

We market and sell our platforms worldwide through a combination of direct sales personnel, independent sales representatives and distributors. Substantially all of our revenue comes from ODM customers in Asia. A significant amount of the systems designed and manufactured by these customers are then sold to OEMs and consumer electronics companies outside of Asia. Our sales to the Asia/Pacific region, including Japan, accounted for approximately 94.4% in the nine months ended September 30, 2006. We anticipate that a significant amount of our revenue will continue to be generated by sales to customers in that region. All of our sales are denominated in United States dollars.

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We outsource to independent third parties substantially all of the implementation of certain design aspects of our SoCs and the majority of our manufacturing logistics, including the manufacturing, test, packaging, warehousing and shipping of our SoCs. By outsourcing these functions, we are able to focus more of our financial resources on product design and eliminate the high cost of owning and operating a semiconductor fabrication facility. We also have a logistics warehouse in Hong Kong, which is managed by a local third party, from which location we expect the majority of future shipments to our customers to continue to be made. We have recently started working directly with third-party manufacturing vendors, and we expect that in the future we may gradually increase our level of managing certain logistical aspects associated with a traditional fabless semiconductor business model.

Our financial results are subject to our customers use of our products. Additionally, because our platforms are designed for use in consumer electronics products, such as personal media players, we expect our business to be subject to seasonality. We believe that end user demand is typically higher during the year-end holiday season. Due to the recent decision by Apple Computer, Inc. not to use our products in their mid-range and high-end flash based iPods, we expect that the loss of these sales into certain Apple Computer products will offset any positive seasonal factors in fiscal 2006.

Our internal forecasting and planning is based in part on our customer forecasts. As we are currently operating in a relatively new industry segment, availability of current market forecasts for feature-rich personal media players is limited. Because industry practice allows customers to reschedule or cancel orders on relatively short notice, backlog is not a good indicator of our future sales. Cancellations of customer orders or changes in product specifications could result in the loss of anticipated sales without allowing us sufficient time to reduce our inventory and operating expenses.

**Financial Operations Overview**

The following describes certain line items in our statements of operations:

***Revenue***

We generate revenue from sales of our platforms. The main factors that impact our revenue are unit volumes shipped and average selling prices. Our revenue recognition policy is described in more detail under Critical Accounting Policies and Estimates.

***Cost of Revenue***

Cost of revenue consists primarily of the cost of finished goods and, to a lesser extent, certain technology license fees, freight charges, personnel and occupancy associated with manufacturing support, quality assurance and internal inventory handling costs, including a component of stock-based compensation charges. The cost of finished goods includes the cost for fully packaged and tested semiconductors. Cost of revenue may additionally include write-offs of certain inventories based on declines in forecasted demand in future periods.

***Gross Profit and Gross Margin***

Gross profit results from deducting cost of revenue from revenue. The gross margin is the percentage derived from dividing gross profit by revenue. Our gross margin each quarter is affected by a number of factors, including product pricing and our product mix, as well as the negotiated price for our finished goods and potential adjustment to our inventory valuation. In the three and nine months ended September 30, 2006, we recorded revenue, and accordingly, gross profit of approximately $18,000 and $0.2 million related to the sale of inventory that had been previously written-off due to changes in customer demand for older generations of SoC platforms, compared to $0.1 million and $0.6 million, respectively, for the comparable periods in the prior year.

***Operating Expenses***

Research and development expense consists primarily of salaries, bonuses, stock-based compensation charges, benefits and related overhead costs for engineering personnel, non-recurring engineering costs, costs of outside engineering services from contractors and consultants and depreciation of engineering equipment. Some of our development costs have been offset by amounts we receive from our customers on non-recurring engineering services arrangements where we are reimbursed for a portion of our engineering costs. Typically, these services are for the development of customized product designs for customers during the early pre-production stage. The costs of these development projects are expensed as incurred and the reimbursement is recognized when the development is accepted and paid for by the customer. The reimbursements against research and development expense on these research activities were approximately $0 and $0.1 million in the three and nine months ended September 30, 2006, respectively, compared to $0.1 million and $0.2 million, respectively, in the comparable periods for the prior year. In the future, we do not expect reimbursements from engineering services to be significant.

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Selling, general and administrative expense consists primarily of salaries, bonuses, stock-based compensation charges, benefits and related overhead costs for sales, marketing and administrative personnel, legal and accounting services, as well as marketing activities.

Amortization of purchased intangibles primarily relate to various patents and patent rights acquired during the first three months of fiscal 2006.

***Interest and Other Income, Net***

Interest and other income, net, consists mostly of interest earned on our cash and short-term investments.

***Provision for Income Taxes***

We are required to estimate our income taxes in each federal, state and international jurisdiction in which we operate. This process requires that we estimate the current tax exposure as well as assess temporary differences between the accounting and tax treatment of assets and liabilities, including items such as accruals and allowances not currently deductible for tax purposes. The income tax effects of the differences we identify are classified as current or long-term deferred tax assets. Deferred tax assets are recognized based on the expected realization of available net operating loss carryforwards. A valuation allowance is recorded to reduce a deferred tax asset to an amount that we expect to realize in the future. We continually review the adequacy of the valuation allowance and recognize a benefit if a reassessment indicates that it is more likely than not that these benefits will be realized. In addition, we continuously evaluate our tax contingencies and will recognize a liability when we believe that it is probable that a liability exists. Further, our use of the net operating loss carryforwards and credit carryforwards is limited by the annual limitations described in Internal Revenue Code Sections 382 and 383.

**Critical Accounting Policies and Estimates**

Our discussion and analysis of our financial condition and results of operations are based on our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions. Our most critical policies include: (a) revenue recognition, which impacts the recording of revenue; (b) valuation of inventory, which impacts cost of revenue and gross margin; (c) stock option valuation, which impacts the disclosure and recognition of stock-based compensation; and (d) income taxes, which impacts the disclosure and recording of income tax valuation and expense. We also have other key accounting policies that are less subjective, and therefore, their application would not have a material impact on our reported results of operations. The following is a discussion of our most critical policies, as well as the estimates and judgments involved.

***Revenue Recognition***

We sell our platforms to OEMs, ODMs and distributors and recognize revenue in accordance with the Securities and Exchange Commission s Staff Accounting Bulletin No. 104, or SAB 104, when persuasive evidence of an arrangement exists, delivery of the product has occurred, the sales price is fixed and determinable, collectibility of the resulting receivable is reasonably assured, and the rights and risks of ownership have passed to the customer. Revenue to customers is recorded at the later of the time of shipment when title and risk of loss passes to the customer or when customer acceptance periods expire, generally within 15 days of receipt by the customer. In such instances, we record a trade receivable for the selling price since there is a legally enforceable right to payment, reduce inventory for the carrying value of goods shipped since legal title has passed to the customer, and record the gross margin as  Deferred income  on the consolidated balance sheet until expiration of the acceptance period. To date, management has not reserved for product returns as customer returns have been insignificant.

***Inventory***

We continually assess the recoverability of our inventory based on assumptions about customer demand and market conditions. Our policy calls for writing off inventory on-hand and inventory for which we have placed non-cancelable orders for estimated lower of cost or market, obsolescence or unmarketable inventory. The write-offs are equal to the difference between the cost of inventory and the estimated market value based upon assumptions about future demand and market conditions. If actual market conditions are less favorable than those projected by management, additional inventory write-offs may be required that could adversely affect our operating results. If actual market conditions are more favorable, we may have higher gross margins when products incorporating inventory that was previously written down are sold. In the three and nine months ended September 30, 2006, we recorded revenue, and accordingly, gross profit of $18,000 and $0.2 million related to the sale of this inventory, compared to $0.1 million and $0.6 million, respectively, in the comparable periods for the prior year.

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***Stock-Based Compensation***

Effective January 1, 2006, we adopted the provisions of SFAS 123R, *Share-Based Payment.* SFAS 123R establishes accounting for stock-based awards exchanged for employee services. Accordingly, stock-based compensation cost is measured at grant date, based on the fair value of the award, and is recognized as expense over the employee requisite service period. We determine fair value using the Black-Scholes valuation model. In calculating such fair value, there are certain assumptions that we use, as disclosed in Note 2 of our consolidated financial statements, consisting of the expected life of the option, risk-free interest rate, volatility and dividend yield. Prior to SFAS 123R adoption, we accounted for share-based payments under the intrinsic value-based method prescribed by APB 25, *Accounting for Stock Issued to Employees* , and related interpretations and provided the required pro forma disclosures of SFAS 123, *Accounting for Stock-Based Compensation.*

We elected to adopt SFAS 123R using the modified prospective method. Accordingly, in the three and nine months ended September 30, 2006, we recorded stock-based compensation that includes: a) compensation cost related to share-based payments granted prior to the filing of our initial registration statement, but not yet vested as of January 1, 2006, based on the grant-date intrinsic value estimated in accordance with the provisions of APB 25; b) compensation cost related to share-based payments granted subsequent to the filing of our initial registration statement, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS 123; and c) compensation cost related to share-based payments granted subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123R.

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

We grant options and warrants to employees, directors and consultants. Stock-based compensation includes the fair value of instruments issued to consultants and directors. The fair value of instruments to consultants is based on management s estimates using Black-Scholes option pricing models. Instruments to consultants that are not fully vested are subject to periodic revaluation (variable accounting), over the vesting term. These fair value estimates are based on a number of variables, including the fair value of the stock underlying the instrument, which are subject to change over the lives of the instruments.

In 2005, our board of directors approved the granting of shares of restricted stock. The value of our restricted stock awards is based on the closing market price of our common stock on the date of grant. Shares related to these restricted stock awards were included in the calculation of diluted earnings per share utilizing the treasury stock method.

The measurement of stock-based compensation cost is based on several criteria including, but not limited to, the valuation model used and associated assumptions such as the expected life of the share-based payment awards, stock price volatility, dividend rate and risk free interest rate. The factors used in the valuation model are based on subjective future expectations combined with management judgment. As a result, if factors change and we use different assumptions, our stock-based compensation expense could be materially different in the future. Additionally, we are required to estimate the expected forfeiture rate and only recognize expense for those shares expected to vest. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period.

***Income Taxes***

We account for income taxes under the asset and liability method, under which deferred tax assets, including the tax effects attributable to net operating loss carryforwards, and deferred tax liabilities are determined based on temporary differences between the book and tax bases of assets and liabilities. We believe sufficient uncertainty exists regarding the realizability of some of our deferred tax assets such that a valuation allowance is required for those assets. Under certain conditions related to our future profitability and other business factors, we believe it is possible that, as in 2005, our results could yield sufficient positive evidence to support the conclusion that it is more likely than not that we will realize the tax benefit of all or part of our net operating losses and other reserved deferred tax assets. If that is the case, subject to review of other qualitative factors and uncertainties, in the period that such a determination is made, we would reverse some or all of our deferred tax asset valuation allowance into income as a reduction of tax expense. The portion of the valuation allowance reversal that relates to net operating losses associated with stock option transactions is taken as a credit to stockholders equity. The determination of our effective tax rate as well as the valuation allowance for our deferred tax assets is based upon a number of assumptions, judgments and estimates, including forecasted earnings, future taxable income, and the relative proportions of revenue and income before taxes in the various tax jurisdictions in which we operate.

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**Results of Operations**

The following table sets forth, for the periods indicated, the percentage of revenue represented by selected items from our consolidated statements of operations.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2006 | 2005 | 2006 | 2005 |
| Revenue | 100.0% | 100.0% | 100.0% | 100.0% |
| Cost of revenue | 57.3 | 54.5 | 57.9 | 56.0 |
| Gross profit | 42.7 | 45.5 | 42.1 | 44.0 |
| Operating expenses: | | | | |
| Research and development | 30.2 | 16.6 | 24.2 | 16.5 |
| Selling, general and administrative | 13.1 | 7.5 | 10.9 | 7.7 |
| Amortization of purchased intangibles | 1.0 | | 0.6 | |
| Total operating expenses | 44.3 | 24.1 | 35.7 | 24.2 |
| Operating income (loss) | (1.6) | 21.4 | 6.4 | 19.8 |
| Interest and other income, net | 7.1 | 2.3 | 4.7 | 2.3 |
| Net income before income taxes | 5.5 | 23.7 | 11.1 | 22.1 |
| Provision for income taxes | 1.2 | 5.9 | 4.5 | 5.5 |
| Net income | 4.3% | 17.8% | 6.6% | 16.6% |

***Three Months Ended September 30, 2006 and 2005***

*Revenue*. Revenue decreased to $34.8 million in the three months ended September 30, 2006 from $57.9 million in the three months ended September 30, 2005, a 40% decrease. This decrease was primarily due to an approximately 28% decline in our overall average selling prices as certain products matured and an approximately 17% decrease in unit shipments of our platforms, partially offset by revenue of $0.1 million associated with certain royalty revenue. We expect the trend of declining average selling prices for existing products to continue as these products mature further in the market. This decline may have a negative impact on our future margins if we cannot reduce our associated costs accordingly. Our decreased sales volumes were primarily due to Apple Computer, Inc. s decision not to use our next generation platforms in certain of its iPods. Revenue on sales to the Asia/Pacific region, including Japan, was 91.6% and 99.9% in the three months ended September 30, 2006 and 2005, respectively. Sales to Inventec and Hon Hai represented 89.5% of our revenue in the three months ended September 30, 2006, compared to 94.0% for the same period in the prior year. Both Inventec and Hon Hai manufacture products for Apple Computer, Inc. On April 19, 2006 we announced that we had recently been advised that the follow-on to our PP5021 SoC has not been selected by Apple Computer, Inc. for use in their mid-range and high-end flash based iPods. We expect that this development will continue to result in a significant reduction in orders from our primary customers and consequently will continue to impact our financial performance in the near term.

*Cost of revenue and gross margin*. Cost of revenue decreased to $19.9 million in the three months ended September 30, 2006 from $31.6 million in the three months ended September 30, 2005, a 37% decrease. This decrease was primarily due to an approximately 25% decline in our average unit cost as we were able to negotiate more favorable pricing from our manufacturing logistics partners, and an approximately 17% decrease in unit shipments of our platforms and the associated costs of these shipments.

Gross margin was 42.7% in the three months ended September 30, 2006 and 45.5% in the three months ended September 30, 2005. We recognized revenue of approximately $18,000 and $0.1 million, respectively, in the three months ended September 30, 2006 and 2005 on the sale of previously written-off older-generation inventory. Additionally, we recorded revenue of $0.1 million associated with certain royalty revenue in the three months ended September 30, 2006. We expect that we may need to record adjustments to our inventory valuation from time to time and that our gross margin may fluctuate as we introduce new platforms and products and as the market for our platforms becomes more competitive. We expect that future sales, if any, of our current balance of written-off inventory would not have a material impact on our future gross profits.

*Research and development*. Research and development expense, including stock-based compensation, increased to $10.5 million in the three months ended September 30, 2006 from $9.6 million in the three months ended September 30, 2005, a 9% increase. We had an increase of $1.4 million related to stock-based compensation recognized as research and development expense, mostly as a result of the adoption of SFAS 123R. We further had increased expenses of approximately $0.4 million related to equipment and software, as we continued to invest in technology to support our current and future products. These increases were offset by a decrease of approximately $1.1 million in engineering-related expenses, including non-recurring engineering charges paid to our vendors, as well as certain license fees. Most of our engineering expenses related to design work on future product generations as well as supporting hardware and software modifications to our current product.

*Selling, general and administrative*. Selling, general and administrative expense, including stock-based compensation, increased to $4.6 million in the three months ended September 30, 2006 from $4.3 million in the three months ended September 30, 2005, a 7% increase. We had an increase of $0.6 million related to stock-based compensation recognized as selling, general and administrative expense, mostly as a result of the adoption of SFAS 123R. We further had increased expenses of approximately $0.2 million related to equipment and software, primarily due to upgrades in our systems. These increases were offset by an approximately $0.7 million decrease in personnel-related expenses, resulting from a 13% decrease in selling, general and administrative headcount at September 30, 2006 compared to September 30, 2005.

*Amortization of purchased intangibles*. Amortization of purchased intangibles was $0.3 million in the three months ended September 30, 2006. We had no similar expenses in the comparable period for the prior year. Amortization of purchased intangibles relates to various patents and patent rights acquired during the three months ended March 31, 2006. We will continue to evaluate our intangible assets for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable.

*Interest and other income, net*. Interest and other income, net, increased to $2.5 million in the three months ended September 30, 2006, compared to $1.3 million in the three months ended September 30, 2005. This increase was primarily due to an increase in interest income related to our increased balance of cash, cash equivalents and short-term investments as well as an increase in interest rates compared to the same period in the prior year.

*Provision for (benefit from) income taxes*. Our provision for income taxes was $0.4 million in the three months ended September 30, 2006, compared to a provision for income taxes of $3.4 million in the three months ended September 30, 2005. The tax provision for the three months ended September 30, 2006 is the result of applying an annualized rate of 40.1% to our year-to-date earnings. We recorded a tax provision in the same period of the prior year that represented an annualized effective tax rate of 25.0%. We have a higher rate this period due to non-deductible stock-based compensation being recorded under the provisions of SFAS 123R during the current year, as well as the release of certain valuation allowances related to Net Operating Loss carryforwards and a benefit from research and development activities being recorded in the prior year. The determination of our effective tax rate as well as the valuation allowance for our deferred tax assets is based upon a number of assumptions, judgments and estimates, including forecasted earnings, future taxable income, and the relative proportions of revenue and income before taxes in the various tax jurisdictions in which we operate. As of September 30, 2006, we had recorded net deferred tax assets of $5.9 million, the realization of which is primarily dependent on our ability to generate sufficient U.S. taxable income in future years. Although realization is not assured, we believe that it is more likely than not that these deferred tax assets will be realized. The amount of deferred tax assets considered realizable, however, may increase or decrease in subsequent quarters, when we reevaluate the underlying basis for our estimates of future U.S. taxable income.

***Nine Months Ended September 30, 2006 and 2005***

*Revenue*. Revenue decreased to $141.6 million in the nine months ended September 30, 2006 from $146.9 million in the nine months ended September 30, 2005, a 4% decrease. This decrease was primarily due to an approximately 26% decline in our overall average selling prices as certain products matured, partially offset by an approximately 29% increase in unit shipments of our platforms, $0.3 million in revenue associated with a customer s payment related to the cancellation of certain orders, as well as $0.1 million in revenue associated with certain royalty revenue. We expect the trend of declining average selling prices for existing products to continue as these products mature further in the market. This decline may have a negative impact on our future margins if we cannot reduce our associated costs accordingly. Our increased sales volumes were primarily due to the continued growth of the personal media player market, and an increase in market share for products manufactured by our primary customers. This continued growth was partially offset by the impact in the third quarter of fiscal 2006 resulting from Apple Computer Inc. s decision not to use our next generation platforms in certain of its products. We expect that this decision will continue to result in significant reduction in orders from our primary customers and consequently will continue to impact our financial performance in the near term. Revenue on sales to the Asia/Pacific region, including Japan, was 94.4% and 98.6% in the nine months ended September 30, 2006 and 2005, respectively. Sales to Inventec and Hon Hai represented 92.4% of our revenue in the nine months ended September 30, 2006, compared to 91.7% for the same period in the prior year.

*Cost of revenue and gross margin*. Cost of revenue decreased to $82.0 million in the nine months ended September 30, 2006 from $82.3 million in the nine months ended September 30, 2005. This decrease was primarily due to an approximately 24% decline in our average unit cost as we were able to negotiate more favorable pricing from our manufacturing logistics partners, partially offset by an approximately 29% increase in unit shipments of our platforms.

Gross margin was 42.1% in the nine months ended September 30, 2006 and 44.0% in the nine months ended September 30, 2005. We recognized revenue of approximately $0.2 million and $0.6 million, respectively, in the nine months ended September 30, 2006 and 2005 on the sale of previously written-off older-generation inventory. Additionally, we recorded revenue of $0.3 million associated with a customer s payment related to the cancellation of certain orders and $0.1 million associated with another customer for certain royalty revenue in the nine months ended September 30, 2006. Each of these customers accounted for less than 10% of our revenue for that period. Gross margin in the nine months ended September 30, 2006 was negatively impacted by $0.2 million in

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warranty and rework charges and $0.2 million related to expedite fees, compared to $0.2 million in warranty and rework charges and $0.1 million related to in expedite fees in the nine months ended September 30, 2005. We expect that we may need to record adjustments to our inventory valuation from time to time and that our gross margin may fluctuate as we introduce new platforms and products and as the market for our platforms becomes more competitive. We expect that future sales, if any, of our current balance of written-off inventory would not have a material impact on our future gross profits.

*Research and development*. Research and development expense, including stock-based compensation, increased to $34.3 million in the nine months ended September 30, 2006 from $24.3 million in the nine months ended September 30, 2005, a 41% increase. Approximately $3.7 million of the increase was related to stock-based compensation recognized as research and development expense, mostly as a result of the adoption of SFAS 123R. In addition, we had an increase of approximately $3.5 million due to an increase in personnel-related expenses, resulting from a higher average research and development headcount during the nine-months ended September 30, 2006 compared to the same period in the prior year. We also had increased expenses of approximately $1.3 million related to equipment and software, as we continued to invest in technology to support our current and future products. Travel expenses also increased by approximately $0.7 million, as a result of increased technical support activities for our customers in the current year. In the nine months ended September 30, 2006, we further had approximately $0.5 million of severance related charges in connection with the re-organization of our operations that resulted from a product transition setback. We did not have similar charges for the same period in the prior year.

*Selling, general and administrative*. Selling, general and administrative expense, including stock-based compensation, increased to $15.4 million in the nine months ended September 30, 2006 from $11.2 million in the nine months ended September 30, 2005, a 38% increase. We had an increase of $2.0 million related to stock-based compensation recognized as selling, general and administrative expense, mostly as a result of the adoption of SFAS 123R. Travel and marketing expenses increased by approximately $0.8 million, which was primarily associated with the promotion of our products. Professional services-related expenses, including accounting and legal expenses, increased by $0.8 million, primarily due to costs for certain tax-related services and certain patent related expenses. In addition, in the nine months ended September 30, 2006, we had approximately $0.1 million of severance related charges in connection with the re-organization of our operations that resulted from a product transition setback. We did not have similar charges for the same period in the prior year.

*Amortization of purchased intangibles*. Amortization of purchased intangibles was $0.8 million in the nine months ended September 30, 2006. We had no similar expenses in the comparable period for the prior year. Amortization of purchased intangibles relates to various patents and patent rights acquired during the three months ended March 31, 2006.

*Interest and other income, net*. Interest and other income, net, increased to $6.6 million in the nine months ended September 30, 2006, compared to $3.3 million in the nine months ended September 30, 2005. This increase was primarily due to an increase in interest income related to our significantly increased balance of cash, cash equivalents and short-term investments as well as an increase in interest rates compared to the same period in the prior year.

*Provision for income taxes*. Our provision for income taxes was $6.3 million in the nine months ended September 30, 2006, compared to $8.1 million in the nine months ended September 30, 2005. The tax provision for the nine months ended September 30, 2006 is the result of applying an annualized rate of 40.1% to our year-to-date earnings. We recorded a tax provision in the same period of the prior year that represented an annualized effective tax rate of 25.0%. We have a higher rate this period due to non-deductible stock-based compensation being recorded under the provisions of SFAS 123R during the current year, as well as the release of certain valuation allowances related to NOL carryforwards as well as a benefit from research and development activities being recorded in the prior year. The determination of our effective tax rate as well as the valuation allowance for our deferred tax assets is based upon a number of assumptions, judgments and estimates, including forecasted earnings, future taxable income, and the relative proportions of revenue and income before taxes in the various tax jurisdictions in which we operate. As of September 30, 2006, we had net deferred tax assets of $5.9 million, the realization of which is primarily dependent on our ability to generate sufficient U.S. taxable income in future years. Although realization is not assured, we believe that it is more likely than not that these deferred tax assets will be realized. The amount of deferred tax assets considered realizable, however, may increase or decrease in subsequent quarters, when we reevaluate the underlying basis for our estimates of future U.S taxable income.

**Liquidity and Capital Resources**

We have historically financed our operations primarily through sales of equity securities and, to a lesser extent, through our bank borrowings. Additionally, during our fiscal year 2005 we generated $54.9 million of cash from our operating activities, and in the nine months ended September 30, 2006 we generated $27.3 million of cash from our operating activities. As of September 30, 2006, we had approximately $195.5 million in cash, cash equivalents and short-term investments. We outsource our design implementation and almost all of our manufacturing logistics, semiconductor fabrication, assembly and test. By outsourcing these functions, we are able to focus more of our financial resources on product design and eliminate the high fixed cost of owning and operating a semiconductor fabrication facility.

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*Operating Activities*

Net cash provided by operating activities was $27.3 million in the nine months ended September 30, 2006, compared to $35.5 million in the nine months ended September 30, 2005. In the nine months ended September 30, 2006, net cash generated by operating activities resulted primarily from net income of $9.4 million, as well as decreases in accounts receivable and inventory, which more than offset the decreases in accounts payable, accrued liabilities and deferred income. The decrease in accounts receivable was due to lower activity in the later months of the third fiscal quarter of 2006, while the decrease in inventory was due to continued inventory management. In the nine months ended September 30, 2005, net cash generated by operating activities resulted primarily from net income and the increases in accounts payable, deferred income and accrued liabilities, which more than offset the growth in accounts receivable, inventory and other current assets. The increase in accounts payable and other accrued liabilities during the nine months ended September 30, 2005 was mainly due to non-recurring engineering-related expenses incurred but not paid as of the end of the period, as well as a significantly higher amount of payables due to the timing of inventory receipts and their related payments to our inventory vendors compared to the prior period.

*Investing Activities*

In the nine months ended September 30, 2006, we expanded our patent portfolio with the purchase and license of $8.4 million in patents and patent rights. Cash payments related to capital expenditures were approximately $5.8 million and $2.1 million in the nine months ended September 30, 2006 and 2005, respectively. These expenditures were primarily for the purchase of computer equipment and development tools and test equipment for engineering development, which has increased due to increased levels of activity. We also anticipate an increase in our capital expenditures in the current year related to development costs for facilities in India. Net cash used in investing activities also consisted of the net purchases of $14.2 million and $48.8 million of short-term marketable securities in the nine months ended September 30, 2006 and 2005, respectively.

*Financing Activities*

Net cash provided by financing activities was $2.6 million in the nine months ended September 30, 2006, consisting of $1.6 million in net proceeds from the issuance of our common stock from stock option exercises and employee stock purchases, as well as $1.0 million in excess tax benefit from share-based arrangements, which was presented as a financing activity in accordance with the provisions of SFAS 123R. In the nine months ended September 30, 2005, net proceeds from the issuance of our common stock as a result of stock option exercises and employee stock purchases were $1.3 million.

As of September 30, 2006, we did not have any amounts outstanding against a total of $15.0 million of bank borrowings available. We have a revolving bank line of credit, which accrues interest at a floating annual rate equal to the bank s prime interest rate and expires in May 2007.

We intend to fund our research and development, sales and marketing and general and administrative activities with cash generated from operations, but we may not be able to do so. These activities may not result in an increase in our revenue and our anticipated revenue may not be sufficient to support these activities. We anticipate that operating expenses, working capital as well as planned capital expenditures will constitute a material use of our cash resources.

We believe that our current cash and short term investment balances and cash generated from operations, along with our available line of credit, will be sufficient to meet our working capital and capital expenditure requirements for at least the next 12 months. If we require additional capital resources to grow our business internally or to acquire complementary technologies and businesses at any time in the future, we may seek to sell additional equity or debt securities or obtain other debt financing. The sale of additional equity or convertible debt securities could result in more dilution to our stockholders. Financing arrangements may not be available to us, or may not be available in amounts or on terms acceptable to us.

*Contractual Obligations*

As of September 30, 2006, we had the following contractual obligations:

| | Payments Due by Period | | | |
|---|---|---|---|---|
| | | Less than | 1 3 | |
| **Contractual Obligations** | **Total** | **1 Year** | **Years** | **After 3 years** |

| | | | | |
|---|---|---|---|---|
| | (in thousands) | | | |
| Operating Leases (1) | $ 3,082 | $ 954 | $ 2,128 | $ |
| Unconditional Purchase Obligations (2) | $ 15,652 | $ 15,120 | $ 532 | $ |
| Total | $ 18,734 | $ 16,074 | $ 2,660 | $ |

(1) Operating leases, primarily agreements for building facilities.

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(2) Unconditional purchase obligations include agreements to purchase goods or services that are enforceable and legally binding on PortalPlayer and that specify all significant terms, including: fixed or minimum quantities to be purchased; fixed, minimum or variable price provisions; and the approximate timing of the transaction. Purchase obligations also include agreements for design tools and software for use in product development and land and building development costs. Of the unconditional purchase obligations noted above, $11.3 million relates to commitments for inventory.

**Recent Accounting Pronouncements**

In July 2006, the Financial Accounting Standards Board, or FASB, issued FASB Interpretation No. 48 Accounting for Uncertain Tax Positions an interpretation of FASB Statement No. 109, or FIN 48, which clarifies the accounting for uncertainty in income taxes in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes. FIN 48 contains a two-step process to recognizing and measuring uncertain tax positions. The first step is to evaluate the tax position for recognition by determining whether it is more likely than not that a tax position will be sustained upon examination, including resolution of related appeals or litigation processes, based on the technical merits of the position. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement. The provisions of FIN 48 are effective for fiscal years beginning after December 15, 2006. We are currently evaluating the effect that the adoption of FIN 48 will have on our consolidated financial statements.

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

***Interest Rate Risk***

We do not use derivative financial instruments in our investment portfolio. Our investments are in debt instruments of the U.S. Government and its agencies, commercial paper, and high-quality corporate issuers and, by policy, limit the amount of credit exposure to any one issuer. We have investments in fixed income securities that are classified as available-for-sale securities. These securities, like all fixed income instruments, are subject to interest rate risk and will fall in value if market interest rates increase. We currently attempt to limit this exposure by investing primarily in short-term securities. Due to the short-term nature of our investment portfolio, we do not believe that an immediate 10% increase in interest rates would have a material effect on the fair market value of our portfolio. Since we believe we have the ability to liquidate this portfolio, we do not expect our operating results or cash flows to be materially affected to any significant degree by a sudden change in market interest rates on our investment portfolio.

***Foreign Currency Exchange Risk***

Our exposure to adverse movements in foreign currency exchange rates is primarily related to our wholly owned subsidiary s operating expenses in India and Taiwan, denominated in the respective local currency. A hypothetical change of 10% in foreign currency exchange rates would not have a material impact on our consolidated financial statements or results of operations. All of our sales are transacted in U.S. dollars.

## Item 4. Controls and Procedures

***Evaluation of disclosure controls and procedures***

We maintain disclosure controls and procedures, as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934, or the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this report, our Chief Executive Officer and Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

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***Changes in internal controls***

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) identified in connection with management s evaluation described above during the period covered by this quarterly report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

## PART II. OTHER INFORMATION

**Item 1. Legal Proceedings**

We are not currently a party to any material legal proceeding. We may be subject to various claims and legal actions arising in the ordinary course of business.

**Item 1A. Risk Factors**

*You should carefully consider the risks described below before making a decision to buy our common stock. If any of the following risks actually occur, our business, financial condition and results of operations could be harmed. In that case, the trading price of our common stock could decline and you might lose all or part of your investment in our common stock. You should also refer to the other information set forth in this Report, including our consolidated financial statements and the related notes.*

**Failure to complete, or delays in completing, the merger with NVIDIA could materially and adversely affect our results of operations and our stock price.**

On November 6, 2006, we entered into a definitive merger agreement with NVIDIA. Consummation of the merger is subject to customary closing conditions such as the adoption of the merger agreement by our stockholders and various regulatory approvals. We cannot assure you that the necessary approvals will be obtained, or that regulatory approvals will not subject us to additional regulatory obligations, or that we will be able to consummate the merger as currently contemplated under the merger agreement. Risks related to the proposed merger include the following:

- We will remain liable for significant transaction costs, including legal, accounting, financial advisory and other costs relating to the merger;

- Under specified circumstances, we may have to pay a termination fee to NVIDIA in the amount of $12,500,000;

- The attention of our management and our employees may be diverted from day-to-day operations;

- The customer sales process may be disrupted by customer and salesperson uncertainty over when or if the merger will be consummated;

- Our supply chain process may be disrupted by the uncertainty of our third party service providers, including eSilicon Corporation and LSI Logic Corporation, as well as our outside foundries, Taiwan Semiconductor Manufacturing Company and United Microelectronics Corporation, over when or if the merger will be consummated;

Our customers may seek to modify or terminate existing agreements, or prospective customers may delay entering into new agreements or purchasing our products and services as a result of the announcement of the merger; and

Our ability to attract new employees and retain existing employees may be difficult as a result of uncertainties associated with the merger.

The occurrence of any of these events individually or in combination could reduce our revenues, increase our expenses, and harm our stock price.

**We currently depend on two customers for substantially all of our revenue and the loss of, or a significant reduction in, orders from either of these customers would significantly reduce our revenue and adversely impact our operating results.**

Two customers account for substantially all of our revenue. Inventec Appliances (Shanghai) Co., Ltd., Inventec Appliances (Pudong) Co., Ltd. and Inventec Appliances Corp., which are affiliated with each other and which we refer to collectively as Inventec, accounted for approximately 33.5% and 56.7% of our revenue in the nine months ended September 30, 2006 and fiscal 2005, respectively. In addition, Hon Hai Precision Industry Co., Ltd., or Hon Hai, accounted for 58.9% and 36.3% of our revenue in the nine months ended September 30, 2006 and fiscal 2005, respectively. The loss of sales to either of these customers would have a significant negative impact on our business. For example, in April 2006, we were advised by Apple Computer, Inc. that our next generation platform, due out in the second half of 2006, will not be used in their mid-range and high-end flash-based iPods. As a result, we expect the significant drop in our sales to our primary customers to continue. Because our sales to our customers are made pursuant to standard purchase orders rather than contracts, orders may be cancelled or reduced more readily than if we had long-term purchase commitments with these customers. Purchase orders can be cancelled or rescheduled on relatively short notice. Cancellations of customer orders could result in the loss of anticipated sales without allowing us sufficient time to reduce our inventory and operating expenses. In addition, changes in forecasts or the timing of orders from these customers expose us to the risks of inventory shortages or excess inventory, particularly during end product transitions that require a new generation of our platforms. This in turn could cause our operating results to fluctuate.

We believe that nearly all of our platforms sold to these customers are incorporated into various models within the Apple iPod product family. Apple may choose to use platforms in addition to ours for its products, use a different platform than ours altogether or develop an in-house solution. We anticipate that Apple s recent decision not to use our next generation platform in certain of its iPods will significantly harm our business. Further, because such a large portion of our revenue is tied to the Apple iPod product family, our success depends on Apple s continued success with these products.

In addition, if our primary customers relationships with Apple is disrupted for inability to deliver sufficient products or for any other reason, it could have a significant negative impact on our business. We do not know the terms of either of these customers business relationships with Apple. Apple may choose to work with other manufacturers. The loss by either of these customers of sales to Apple could also harm our business and financial position.

There are a relatively small number of potential customers for our platforms. Therefore, our operating results will likely continue to depend on sales to a relatively small number of customers, as well as the ability of these customers to sell products that incorporate our platforms. In addition, we may from time to time enter into customer agreements providing for exclusivity periods during which we may only sell a specified product to that customer or only sell a limited amount of a specified product to other customers. Except for Inventec and Hon Hai, our customer relationships have been developed over a short period of time and are generally in their preliminary stages. We cannot be certain that these customers will generate significant revenue in the future. If our relationships with our newer customers do not continue to develop, we may not be able to expand our customer base or maintain or increase our revenue.

**We depend on one product family for all of our revenue, and if sales of our platforms decline, our business and financial position will suffer.**

We have one product family, which currently consists of platforms primarily for feature-rich personal media players. Our platforms consist of a system-on-chip, firmware and software. We currently derive, and expect to continue to derive in the near term, all of our revenue from sales of our platforms. Continued market acceptance of our platforms is critical to our future success. Because we have only one product family, we do not have alternate sources of revenue if sales of our platforms decline.

**We do not expect to sustain our recent growth rate.**

We have experienced significant growth in a short period of time. For example, our revenue has increased from $1.9 million in 2001 to $225.2 million in 2005. We do not anticipate achieving similar revenue growth rates in future periods. You should not rely on the results of any prior quarterly or annual periods as an indication of our future operating performance. If we are unable to maintain adequate revenue growth, our financial results could suffer.

**If we are unable to develop successful new platforms or other products to keep pace with rapid technological change or develop business models to address new market segments, we will be unable to expand our business and our operating results and competitive position would be harmed.**

The consumer electronics market is characterized by rapidly changing technology. This requires us to continuously develop new platforms or other products and enhancements for existing platforms to keep pace with evolving industry standards and rapidly changing customer requirements. For example, although our platforms historically were used only in hard disk drive-based personal media players, in 2005 we began deriving revenue from flash memory-based applications and, in 2006, we announced a new technology platform targeted at the computer market that enables a secondary display. In addition, our products have recently been designed into personal media players that utilize satellite radio capabilities. However, if feature-rich personal media player capabilities are adopted by adjacent markets such as wireless and mobile phones, we may need to develop platforms that can operate with these devices. We may not have the technological capabilities to develop, or the financial resources necessary to fund, these future innovations. Even if we are able to develop future innovations, if our future innovations produce technology that is behind that of our competitors, we may lose customers. Similarly, if our future innovations are ahead of the then-current technological standards in our industry, customers may be unwilling to purchase our platforms until the consumer electronics market is ready to accept them. If we are unable to successfully define, develop and introduce competitive new platforms or other products and enhance existing platforms, we may not be able to compete successfully. In addition, if we, or our customers, are unable to manage product transitions, our business and results of operations would be negatively affected.

Development of new platforms and products may also require us to obtain rights to use intellectual property that we currently do not have. If we are unable to obtain or license the necessary intellectual property on reasonable terms or at all, our product development may be delayed and the gross margins on our planned products may be less than anticipated, and our business and results of operations would be negatively affected.

In addition, we recently licensed our technology to a manufacturing partner and have recorded royalty revenue from sales of products by this manufacturing partner that incorporate our licensed technology. We expect revenue from licensing and royalties to increase in future periods. We have limited experience in managing a licensing and royalty based business. Our business, revenue and results of operations could be negatively affected if we are unsuccessful in managing our licensing business, including the timing and implementation of licensing arrangements.

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**If our Preface technology platform does not achieve broad market acceptance or is not otherwise successful, our business and operating results may suffer.**

We recently announced our new technology platform, Preface , initially targeted at the computer market. This technology platform, using a secondary display, is designed to give computer users access to data, music and photos. As of September 30, 2006, we have made only limited sample shipments of this platform and have not yet derived significant revenue from this platform. The success of our Preface technology platform depends on several factors, including, but not limited to, the market for computers in general and the demand for computers with the Preface technology platform by computer manufacturers and consumers. Computer manufacturers may choose to only include the Preface technology into their computer designs in combination with computers planned for introduction with Microsoft s Windows Vista. The planned launch of Windows Vista and Windows Sideshow (a feature set in Microsoft Windows Vista) has been delayed until at least early 2007. This delay has given our competitors in this market an opportunity to further develop their platforms and may provide them with an opportunity to introduce their products before or concurrent with our introduction. If the timing and introduction of Windows Vista or Windows Sideshow is further delayed or does not happen when anticipated, then demand for Preface will be severely impaired. In addition, the development and introduction of a new technology platform such as Preface involves additional risks, including intellectual property risks as discussed above, the risk of product defects which in turn could harm our reputation, sales of our platforms and cause unexpected costs, and the reliance on third-party technology incorporated into the platform. If our Preface technology platform does not achieve market acceptance or is not otherwise successful, or if we encounter product defects or delays or other difficulties in the introduction, sales and marketing of this platform, our business and operating results may suffer.

**Our quarterly revenue and operating results are difficult to predict, and if we do not meet quarterly financial expectations, our stock price will likely decline.**

Our quarterly revenue and operating results are difficult to predict and have in the past, and may in the future, fluctuate from quarter to quarter. It is possible that our operating results in some quarters will be below market expectations or our guidance. This would likely cause the market price of our common stock to decline. Our quarterly operating results are affected by a number of factors, including:

- unpredictable volume and timing of customer orders, which are not fixed by contract but vary on a purchase order basis;
- the loss of one or more key customers or the significant reduction or postponement of orders from these customers;
- the timing of new product announcements or introductions by us, by Apple or by our competitors;
- decreases in the overall average selling prices of our platforms;
- changes in the relative sales mix of our platforms;
- changes in our cost of finished goods;
- the availability, pricing and timeliness of delivery of other components, such as hard disk drives or flash memory chips, used in our customers products;
- our customers sales outlook, purchasing patterns and inventory adjustments based on consumer demands and general economic conditions;

- unplanned additional expenses such as mask set revisions;
- our effective tax rate and the use of available tax carryforwards;
- product obsolescence and our ability to manage product transitions; and
- our ability to successfully develop, introduce and sell new or enhanced platforms in a timely manner.

We base our planned operating expenses in part on our expectations of future revenue, and a significant portion of our expenses is relatively fixed in the short term. As we are operating in a relatively new industry segment, we have limited historical financial data from which to predict future sales for our platforms. As a result, it is difficult for us to forecast our future revenue and budget our operating expenses accordingly. Our operating results would be adversely affected to the extent customer orders are cancelled or rescheduled. If revenue for a particular quarter is lower than we expect, we likely will be unable to proportionately reduce our operating expenses for that quarter, which would harm our operating results for that quarter.

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**We have only recently achieved profitability and may incur losses in the future. We may not be able to generate sufficient revenue in the future to sustain profitability.**

At September 30, 2006, we had an accumulated deficit of approximately $4.5 million. Although we have achieved profitability in the past nine quarters, we cannot be certain that we will sustain profitability in the future. To be profitable, we will need to continue to sustain or grow our revenue to support our current expense levels. We may not be able to sustain or increase profitability on a quarterly or an annual basis, especially in light of Apple s decision not to use our next generation platform in certain iPods. If we are not profitable or otherwise fail to meet the expectations of securities analysts or investors, the market price of our common stock will likely decline.

**Because the markets in which we compete are highly competitive and many of our competitors have greater resources than us, we may not be able to compete successfully and we may lose or be unable to gain market share.**

We face competition from a large number of competitors, including austriamicrosystems, Broadcom, Freescale Semiconductor, Intel, Samsung Semiconductor, Sharp, SigmaTel, Telechips, and Texas Instruments. We expect to face increased competition in the future. We may also face competition from some of our customers who have developed or may develop products or technologies internally which are competitive with our platforms, or who may enter into strategic relationships with or acquire existing semiconductor providers. In addition, because our platforms are compatible with flash memory-based applications, we face competition from companies that produce platforms for both hard disk drive and flash memory-based applications. Many of our competitors have offered flash memory-specific products for some time and may have better established products or more expertise with flash memory-specific solutions. We may also face competition from companies whose products are included in end-products that also incorporate our platforms. Should these companies try to increase the presence of their products in such end-products to the detriment of our platforms, our business may be harmed. In addition, to the extent we move into adjacent markets such as wireless and mobile phones, we will face new competitors and the difficulty and cost of developing new technology.

In addition, the consumer electronics market, which is the principal end-market for our platforms, has historically been subject to intense price competition. In many cases, low-cost, high-volume producers have entered this market and driven down gross margins. If a low-cost, high-volume producer should develop products that are competitive with our platforms, our sales and gross margins may suffer. For example, as the feature-rich personal media player market matures, the capabilities our platform solutions provide may be subject to commoditization, similar to the commoditization which has occurred in the more mature, non-feature-rich flash-based personal media player market. Similarly, we may lose existing customers if any of them go out of business or are unable to effectively compete in the highly competitive personal media player market.

Many of our current and potential competitors have longer operating histories, greater name recognition, access to larger customer bases and significantly greater financial, sales and marketing, manufacturing, distribution, technical and other resources than us. As a result, they may be able to respond more quickly to changing customer demands or to devote greater resources to the development, promotion and sales of their products than we can. Our potential competitors may develop and introduce new products that have lower prices, provide superior performance, provide greater processing power or achieve greater market acceptance than our platforms. In addition, in the event of a manufacturing capacity shortage, these competitors may be able to obtain capacity when we are unable to do so. Our competitors may also be able to provide greater incentives to customers through rebates and marketing development funds and similar programs. It is possible that new competitors or alliances among existing competitors could emerge and rapidly acquire significant market share, which would harm our business. Some of our competitors with multiple product lines may bundle their products to lower prices or to offer a broader product portfolio or integrate processing capacity similar to or greater than ours into other products that we do not sell, which may make it difficult for us to gain or maintain market share. If we fail to compete successfully, our business would suffer and we may lose or be unable to gain market share.

We believe that nearly all of our platforms sold to Inventec and Hon Hai are incorporated into various models within the Apple iPod product family. As a result, our business is also affected by competition in the market for personal media players. If competing products are not based on our platform solution it could harm our business and cause our revenue to decline.

**If we fail to adequately forecast demand for our platforms, we may incur product shortages or excess product inventory.**

Most of our revenue is derived from customers who require us to be able to provide products in excess of existing orders on relatively short notice. If these customers do not order more of our platforms than they forecast, then we could have excess inventory if we do not have other purchasers for this inventory. In this instance, we would be required to write-off excess inventory in accordance with our inventory policy. On the other hand, if we are unable to supply platforms at the levels required by Inventec or Hon Hai, our major customers, they are entitled to seek alternative supply arrangements to meet their needs. In the event of a supply shortage, we may be unable to meet the demands of our other customers. Any of these events could harm our operating results and our business.

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We may place binding manufacturing orders with our manufacturing logistics partners in advance of receiving purchase orders from our customers. Changes in forecasts or timing of orders expose us to risks of inventory shortages or excess product inventory, particularly during end-product transitions. Obtaining additional supply in the face of increased demand or supply shortages may be costly or impossible, particularly in the short-term, which could prevent us from fulfilling orders. As a result, an incorrect forecast may result in substantial inventory that is aged and obsolete, which could result in write-downs of excess, aged or obsolete inventory. In addition, our platforms have rapidly declining average selling prices. Therefore, our failure to adequately estimate demand for our platforms could cause our quarterly operating results to fluctuate and cause our stock price to decline.

**Because of the lengthy sales cycles for our platforms and the relatively fixed nature of a significant portion of our expenses, we may incur substantial expenses before we earn associated revenue and may not ultimately achieve our forecasted sales for our platforms.**

Our sales cycles from design to manufacture of our platforms can typically take nine to 12 months. Sales cycles for our platforms are lengthy for a number of reasons, including:

- our customers usually complete an in-depth technical evaluation of our platforms before they place a purchase order;
- the commercial adoption of our platforms by original equipment manufacturers and original device manufacturers is typically limited during the initial release of their products to evaluate performance and consumer demand;
- new product introductions often center around key trade shows and selling seasons and failure to deliver a product in a timely manner can seriously delay or cancel introduction; and
- the development and commercial introduction of products incorporating complex technology frequently are delayed or canceled.

As a result of our lengthy sales cycles, we may incur substantial expenses before we earn associated revenue because a significant portion of our operating expenses is relatively fixed and based on expected revenue. If customer cancellations or product changes occur, this could result in the loss of anticipated sales without allowing us sufficient time to reduce our operating expenses. For example, we recently announced that the follow-on to our PP5021 SoC has not been selected by Apple Computer, Inc. for use in their mid-range and high-end flash based iPods. Apple s decision not to use our next generation platform in certain of its iPods will result in the loss of anticipated sales, and we may not be able to timely reduce our operating expenses, which may negatively affect our financial results.

**We are subject to the risk of supply problems with other components of the end products of our customers and components packaged with ours and if our customers cannot obtain sufficient supplies of these components, sales of our platforms could suffer.**

In addition to our platforms, the end products of our customers that are sold to consumers also incorporate other components outside of our control, such as hard disk drives or flash memory chips. If our customers cannot obtain sufficient supplies of these or other components, sales of our platforms could suffer because our customers may purchase fewer platforms from us than they would have otherwise purchased. For example, small form factor hard disk drive supply was constrained during 2003 and 2004. We believe that these supply constraints may have caused our customers to purchase fewer platforms than they might otherwise have purchased, thus negatively impacting our revenue. Although we cannot estimate the impact on our revenue from these supply constraints, we believe that future supply problems with the other components of the end products of our customers, including small form factor hard disk drives and flash memory chips, may negatively impact our business and revenue in the future. As a result, demand for our platforms depends on the availability of other components that we do not control. In addition, our PP5024 is sold as a System-in-Package (SiP) together with a semiconductor supplied by a third-party vendor. If such third-party vendor can not meet our sales forecasts or if the vendor s semiconductor has any manufacturing or design problems, then sales of our SiP will be negatively affected and as a result would have a negative impact on our business and financial results.

**We depend on third-party service providers to implement certain aspects of the design of our semiconductors, and to manage our foundry, test, packaging, warehouse and shipping relationships.**

We primarily rely on third-party service providers, including eSilicon Corporation, or eSilicon, and LSI Logic Corporation, or LSI Logic, to implement certain aspects of the design of our semiconductors, and to manage the manufacture, test, packaging, warehousing and shipping of our semiconductors. eSilicon and LSI Logic either provide these services directly or engage and manage other parties to provide them. As a result, we have significantly less control over certain aspects of the design and manufacture of our semiconductors and do not directly control our product delivery schedules, assembly and testing costs or quality assurance and control. We do not have long-term agreements with eSilicon or LSI Logic. We typically procure services from these suppliers on a purchase order basis. If the operations of eSilicon or LSI Logic were disrupted or their financial stability impaired, if eSilicon or LSI

Logic were unable to properly manage the service providers that they retain for us or if they should choose not to devote capacity to our semiconductors in a timely manner, our business would suffer as we would be unable to produce finished platforms on a timely basis.

Because we use manufacturing logistics partners who in turn use independent foundries and subcontractors to manufacture, assemble and test our semiconductors, we may face risks such as insufficient allocation of assembly and test capacity and limited control over the associated costs and semiconductor output, or yield. Damages to third-party facilities caused by natural or man-made disasters could result in the loss of production material and a disruption in the flow of material.

In addition, the cyclicality of the semiconductor industry has periodically resulted in shortages of manufacturing assembly and test capacity and other disruptions of supply of raw materials incorporated into our SoCs, such as substrates. We may not be able to find sufficient suppliers at a reasonable price or at all if these disruptions occur. If we do not manage these risks adequately, our business and results of operations would be harmed.

**We have started to perform internally some of the services of our third-party service providers, we will need to devote a substantial amount of time and resources to this effort, and our relationships with such third-party service providers may be damaged.**

We have recently started to perform internally some of the services that our third-party service providers currently perform for us. These functions include direct engagements with foundries, setting up our own product and test engineering functions and managing the quality and failure analysis of our SoCs. In order to fully perform these services internally, we will need to incur a significant amount of expense to provide the necessary infrastructure to support these activities. We also will need to devote a substantial amount of time and resources to acquiring the necessary tools, implementing these activities into our overall company structure and hiring additional employees to manage the operations. In addition, we will most likely be required to invest a higher level of financial resources into inventory, increasing at a minimum our raw materials and work in process inventory levels. Because we have not previously performed such activities, we may not be able to successfully manage this process. This expansion could place significant strain on our management, personnel, systems and resources as we develop these capabilities in-house rather than relying on an experienced third-party provider. In addition, we may damage our relationships with our current third-party service providers if, on a larger scale, we begin performing some of their services internally. Any damage to these relationships could hinder our ability to procure our semiconductors on a timely and cost efficient basis, or at all, which could in turn harm our relationships with our customers and negatively affect our business and results of operations.

**Independent foundries manufacture the semiconductors used in our platforms, and any failure to obtain sufficient foundry capacity could significantly delay our ability to ship our platforms and damage our customer relationships.**

We do not own or operate a semiconductor fabrication facility. Instead, we rely on third parties to manufacture our semiconductors. Two outside foundries, Taiwan Semiconductor Manufacturing Company, or TSMC, in Taiwan, and United Microelectronics Corporation, or UMC, in Taiwan, currently manufacture substantially all of our semiconductors, and no single foundry manufactures more than one model of our semiconductors. As a result, we face several significant risks, including:

- lack of manufacturing capacity and higher wafer prices;
- limited control over delivery schedules, quality assurance and control, manufacturing yields and production costs; and
- delays resulting from an inability to interchange production between different foundries.

The ability of each foundry to provide us with semiconductors is limited by its available capacity. Neither we, nor our manufacturing logistics partners have a guaranteed level of production capacity with any of these foundries and it is difficult to accurately forecast our capacity needs. In addition, neither we nor our manufacturing logistics partners have long-term agreements with either of these foundries and place orders on a purchase order basis. We place our orders on the basis of our customers purchase orders and sales forecasts; however, the foundries can allocate capacity to the production of other companies products and reduce deliveries to our manufacturing logistics partners on short notice. It is possible that foundry customers that are larger and better financed than us or our manufacturing logistics partners, or that have long-term agreements with these foundries, may induce these foundries to reallocate capacity to them. Any reallocation could impair our ability to secure the supply of semiconductors that we need for our platforms. In addition, interruptions to the wafer manufacturing processes caused by a natural or man-made disaster could result in partial or complete disruption in supply until we or our manufacturing logistics partners are able to shift manufacturing to another fabrication facility. It may not be possible to obtain sufficient capacity or comparable production costs at another foundry. We might at any time decide to migrate our design methodology to a new third-party foundry which could result in increased costs, resources and development and customer qualification time for new or transferred products. Any reduction in the supply of semiconductors for our platforms could significantly delay our ability to ship our platforms and potentially damage our relationships with existing customers.

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**If the foundries that manufacture our semiconductors do not achieve satisfactory yields or quality, our sales could decrease and our relationships with our customers and our reputation may be harmed.**

The manufacture of semiconductors is a highly complex process. Minor deviations in the manufacturing process can cause substantial decreases in yield and in some cases, cause production to be suspended or yield no output. The foundries that manufacture our semiconductors have from time to time experienced lower than anticipated manufacturing yields, including yields for our semiconductors. This often occurs during the production of new products or architectures or the installation and start-up of new process technologies or equipment. We may also experience yield problems as we migrate our manufacturing processes to smaller geometries. If the foundries that manufacture our semiconductors do not achieve planned yields, our product costs could increase, and product availability would decrease. Although to date we have not experienced unsatisfactory yields that have had a significant negative impact on our business, we believe we may face risks of unsatisfactory yields in the future.

Our semiconductors are qualified with the foundries that manufacture our semiconductors, at which time a minimum acceptable yield is established. If actual yield is below the minimum, the foundry or our manufacturing logistics partner incurs the cost of the wafers. If actual yield is above the minimum, we may incur the cost of the wafers. The manufacturing yields for our new platforms tend to be lower initially. Our platform pricing is based on the assumption that an increase in manufacturing yields will continue, even with the increasing complexity of our semiconductors. Short product life cycles require us to quickly develop new platforms and to manufacture these platforms for short periods of time. In many cases, these short product life cycles will not lead to the higher manufacturing yields and declining costs typically associated with longer, high-volume manufacturing periods. As a result, if our foundries fail to deliver fabricated silicon wafers of satisfactory quality in the volume and at the price required, we will be unable to meet our customers demand for our platforms or to sell those platforms at an acceptable profit margin, which would adversely affect our sales and margins and damage our customer relationships.

**Failure to comply with certain environmental regulations could harm our business, operating results and financial condition.**

We may be subject to various state, federal and international laws and regulations governing the environment, including those restricting the presence of certain substances in electronic products and making producers of those products financially responsible for the collection, treatment, recycling and disposal of those products. Such laws and regulations have been passed in several jurisdictions in which our customers may operate, including various European Union member countries. For example, the European Union has enacted the Waste Electrical and Electronic Equipment directive, which directs member states to enact laws, regulations, and administrative provisions to ensure that producers of electrical and electronic equipment are financially responsible for the collection, recycling, treatment, and environmentally sound disposal of certain products placed on the market after August 13, 2005, and from products in use prior to that date that are being replaced. In addition, the European Union has enacted the Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment Directive, or RoHS. RoHS prohibits the use of certain substances, including lead, in certain products put on the market after July 1, 2006. Similar legislation may be enacted in other locations where we sell our products, such as Japan. Our customers, regardless of their geographic locations, are likely to require full compliance with these regulations. We will need to ensure that we comply with such laws and regulations as they are enacted, and that our component suppliers also comply on a timely basis with such laws and regulations. If we are not in compliance with such legislation, our customers may refuse to purchase our products, which would harm our business, financial condition and results of operations.

We could incur substantial costs in connection with our compliance with such environmental laws and regulations, and we could also be subject to governmental fines and liability to our customers if we were found to be in violation of these laws. If we have to make significant capital expenditures to comply with environmental laws, or if we are subject to significant capital expenses in connection with a violation of these laws, our financial condition or operating results could suffer.

**The facilities of the independent foundries upon which we rely to manufacture our semiconductors are located in regions that are subject to earthquakes and other natural disasters, as well as geopolitical risk and social upheaval.**

The outside foundries and their subcontractors upon which we rely to manufacture all of our semiconductors are located in countries that are subject to earthquakes and other natural disasters, as well as geopolitical risk and social upheaval. Two foundries, TSMC and UMC, both in Taiwan, currently manufacture substantially all of our semiconductors. Any earthquake or other natural disaster in Taiwan could materially disrupt these foundries production capabilities and could result in our experiencing a significant delay in delivery, or substantial shortage, of our platforms. In addition, some of these facilities are subject to risks associated with uncertain political, economic and other conditions in Asia, such as political turmoil in the region and the outbreak of epidemics such as avian flu or severe acute respiratory syndrome, or SARS, which could disrupt the operation of these foundries and in turn harm our business. Increased instability in these regions may also negatively impact the desire of our employees and customers to travel and the reliability and cost of transportation, thus harming our business.

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**Defects in our platforms could result in a decrease in customers and revenue, unexpected expenses and loss of market share.**

Our platforms are complex and must meet stringent quality requirements. Products as complex as ours may contain undetected hardware or software errors or defects, especially when first introduced or when new versions are released. For example, our platforms may contain errors that are not detected until after they are shipped because we cannot test for all possible scenarios. These errors could cause us to incur significant re-engineering costs, divert the attention of our engineering personnel from product development efforts and significantly affect our customer relations and business reputation. If we deliver platforms with errors, defects or bugs, our credibility and the market acceptance and sales of our platforms could be harmed. Defects could also trigger warranty obligations and lead to product liability as a result of lawsuits against us or against our customers. We have agreed to indemnify our customers in some circumstances against liability from defects in our platforms. A successful product liability claim against us could require us to make significant damage payments, which would negatively affect our financial results. In addition, we might incur additional costs to meet the specifications of our customers.

**We may not obtain sufficient patent protection, which could harm our competitive position and increase our expenses.**

Our success and ability to compete depends to a significant degree upon the protection of our proprietary technology. Our patent applications may not result in issued patents, and we cannot be certain that any issued patents will not be challenged, invalidated or declared unenforceable. Furthermore, any patents issued may provide only limited protection for our technology and the rights that may be granted under any future patents may not provide competitive advantages to us. For example, competitors could successfully challenge any issued patents or, alternatively, could develop similar technologies on their own or design around our patents. Also, patent protection in foreign countries may be limited or unavailable in areas where we would like to obtain this protection. It may be difficult for us to protect our intellectual property from misuse or infringement by other companies in these countries. For example, if our manufacturing logistics partners or the foundries which manufacture our semiconductors lose control of our intellectual property, it would be more difficult for us to take remedial measures because some of our foundries are located in countries that do not have the same protection for intellectual property that is provided in the United States. Our inability to enforce our intellectual property rights in some countries may harm our business.

**We also rely upon trademark, copyright and trade secret laws and contractual restrictions to protect our proprietary rights, and, if these rights are not sufficiently protected, our ability to compete and generate revenue could suffer.**

We also rely on a combination of trademark, copyright and trade secret laws, and contractual restrictions, such as confidentiality agreements and licenses, to establish and protect our proprietary rights. We seek to protect our source and object codes for our software, and design code for our platforms, documentation and other written materials under trade secret and copyright laws. We also typically require employees and consultants with access to our proprietary information to execute confidentiality agreements. The steps taken by us to protect our proprietary information may not be adequate to prevent misappropriation of our technology. In addition, our proprietary rights may not be adequately protected because:

- laws and contractual restrictions may not prevent misappropriation of our technologies or deter others from developing similar technologies; and

- policing unauthorized use of our intellectual property is difficult, expensive and time-consuming, and we may be unable to determine the extent of any unauthorized use.

The laws of other countries in which we market our platforms, such as some countries in the Asia/Pacific region, may offer little or no protection for our proprietary technologies. Reverse engineering, unauthorized copying or other misappropriation of our proprietary technologies could enable third parties to benefit from our technologies without paying us for doing so. Any inability to adequately protect our proprietary rights could harm our ability to compete, generate revenue and to grow our business.

**Our intellectual property indemnification practices may adversely impact our business.**

We may be required to indemnify our customers and our third-party intellectual property providers for certain costs and damages of patent infringement in circumstances where our platforms are a factor creating the customer s or these third-party providers infringement exposure. This practice may subject us to significant indemnification claims by our customers and our third-party providers. In some instances, our platforms are designed for use in devices manufactured by our customers that comply with international standards, such as the MP3 compression standard. These international standards are often covered by patent rights held by third parties, which may include our competitors. The combined costs of identifying and obtaining licenses from all holders of patent rights essential to such international standards could be high and could reduce our profitability or increase our losses. The cost of not obtaining these licenses could also be high if a holder of the patent rights brings a claim for patent infringement. We are aware that some of our customers have received a notice from a third party seeking to grant a royalty bearing patent license to those customers and claiming that those customers manufacture and sale of products capable of decoding MP3 files violates patents which the third party has the right to enforce. In the contracts under which we distribute MP3 decoding products, we generally have agreed to indemnify our customers with respect to patent claims related to MP3 decoding technology. At least one of our key customers has requested indemnification relating to notices received from this third party. As we expand our technology platforms, we increase our exposure to claims for indemnification for patent infringement. For example, the Company has received a claim for indemnification from a customer based upon a notice of patent infringement received from a third party, unrelated to MP3 decoding products. We cannot assure you that additional claims for indemnification will not be made or that these claims would not harm our business, operating results or financial condition.

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

From time to time, we and our customers receive letters, including letters from various industry participants, alleging infringement of patents. Although we are not currently aware of any parties pursuing or intending to pursue infringement claims against us, we cannot assure you that we will not be subject to such claims in the future. In some cases, a company can avoid or settle litigation on favorable terms because it possesses patents that can be asserted against or licensed to the plaintiff. Due to the limited number of patents that we hold or license, we may not be in a favorable bargaining position in these situations. Our third-party suppliers may also become subject to infringement claims, which in turn could negatively impact our business. We may also initiate claims to defend our intellectual property. Intellectual property litigation is expensive and time-consuming and could divert management s attention from our business and could have a material adverse effect on our business, operating results or financial condition. If there is a successful claim of infringement against us, our customers or our third-party intellectual property providers, we may be required to pay substantial damages to the party claiming infringement, develop non-infringing technology, stop selling products or using technology that contains the allegedly infringing intellectual property or enter into royalty or license agreements that may not be available on acceptable terms, if at all. Our failure to develop non-infringing technologies or license the proprietary rights on a timely basis could harm our business. Also, we may be unaware of pending patent applications that relate to our platforms. Parties making infringement claims may be able to obtain an injunction, which could prevent us from selling our platforms or using technology that contains the allegedly infringing intellectual property which could have a material negative effect on our business. Parties making infringement claims may also be able to bring an action before the International Trade Commission that could result in an order stopping the importation into the United States of our platforms.

**Our platforms incorporate third-party technology and if we were unable to continue to use this technology or if this technology is delayed or has defects, our business could suffer.**

We incorporate into our platforms third-party technology which we obtain pursuant to license and other agreements. We rely on third-party technology in our platforms and there may not be suitable alternate sources for this technology if we were to lose rights to use this technology. If these license or other agreements were terminated by the third parties or we otherwise lost rights to use this technology, this termination or loss could materially harm our business. In addition, if such third-party technology is delayed or has defects, we may not be able to incorporate it into our platforms and our business could suffer.

**We have significant international activities and customers, and plan to continue these efforts, which subject us to additional business risks, including logistical complexity, political instability and currency fluctuations.**

Our sales to the Asia/Pacific region, including Japan, accounted for approximately 94.4% and 99.0% of our revenue in the nine months ended September 30, 2006 and fiscal 2005, respectively. We anticipate that a significant amount of our revenue will continue to be represented by sales to customers in that region. A large percentage of our sales outside the United States are made to original design manufacturer customers in Asia, who may ultimately sell their products to original equipment manufacturers outside of Asia. We also maintain an engineering facility in India, where we conduct a significant portion of our engineering activities, and may expand our international operations, such as in Asia. Increased instability in the Asia/Pacific region may adversely impact the desire of our employees and customers to travel, as well as the reliability and cost of transportation, which in turn would harm our business. Risks we face in conducting business internationally include:

- multiple, conflicting and changing laws and regulations, export and import restrictions, employment laws, regulatory requirements and other governmental approvals, permits and licenses;

- difficulties and costs in staffing and managing foreign operations such as our engineering facility in India, as well as cultural differences;

trade restrictions or high tariffs that favor local competition in some countries;

laws and business practices favoring local companies;

potentially adverse tax consequences;

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- potentially reduced protection for intellectual property rights, for example, in China;
- inadequate local infrastructure;
- financial risks, such as longer sales and payment cycles, greater difficulty collecting accounts receivable and exposure to foreign currency exchange and rate fluctuations;
- failure by us or our customers to gain regulatory approval for use of our platforms; and
- political and economic instability, including wars, acts of terrorism, political unrest, a recurrence of avian flu or SARS outbreaks in Asia, boycotts, curtailments of trade and other business restrictions.

Specifically, in the Asia/Pacific region, we face risks associated with a recurrence of avian flu or SARS, tensions between countries in that region, such as political tensions between China and Taiwan and the ongoing discussions with North Korea regarding its nuclear weapons program, potentially reduced protection for intellectual property rights, government-fixed foreign exchange rates, relatively uncertain legal systems and developing telecommunications infrastructures. In addition, some countries in this region, such as China, have adopted laws, regulations and policies which impose additional restrictions on the ability of foreign companies to conduct business in that country or otherwise place them at a competitive disadvantage in relation to domestic companies.

To date, all of our sales to international customers and purchases of components from international suppliers have been denominated in U.S. dollars. As a result, an increase in the value of the U.S. dollar relative to foreign currencies could make our platforms more expensive for our international customers, thus potentially leading to a reduction in our sales and profitability. Furthermore, many of our competitors are foreign companies that could benefit from such a currency fluctuation, making it more difficult for us to compete with those companies. To date, we have not experienced any significant reductions in sales and profitability as a result of foreign currency fluctuations. However, we believe that we may have continued risks associated with such currency fluctuations in the future.

**Our business will suffer if we cannot meet increases in demand due to seasonality.**

Because our platforms are designed for use in consumer electronic products, such as personal media players, our business is subject to seasonality, with increased revenue typically in the third and fourth quarters of each year, when customers place orders to meet year-end holiday demand, and lower revenue in the first and second quarters of each year. However, our recent revenue growth and Apple s recent decision to not incorporate our next generation platform into certain of its products make it difficult for us to accurately assess the impact of seasonal factors on our business. If we or our customers are unable to forecast the impact of seasonality on the end user demand for portable media players, our sales and operating results would suffer.

**The average selling prices of our platforms have historically decreased and will likely do so in the future, which could harm our revenue and gross profits.**

The average selling price of consumer electronics products historically have declined significantly over a product s life. As a result, in the past, we have reduced the average selling prices of our platforms in anticipation of future competitive pricing pressures, new product introductions by us or our competitors and other factors. We expect that we will have to similarly reduce prices in the future for mature products. In addition, a reduction in our average selling prices to one or more customers could also impact our average selling prices to other customers. A decline in overall average selling prices would harm our gross margins, and we have and may in the future enter into agreements providing for maximum prices that would limit our gross margins. Our financial results will suffer if we are unable to offset any reductions in our average selling prices by increasing our sales volumes, reducing our costs, adding new features to our existing platforms or developing new or enhanced platforms or products on a timely basis with higher selling prices or gross margins.

**Because competition for qualified personnel is intense in our industry, we may not be able to recruit and retain necessary personnel, which could negatively impact the development and sales of our platforms.**

We rely heavily on the services of our key executive officers. In addition, our technical personnel represent a significant asset and serve as the source of our technological and product innovations. We believe our future success will depend upon our ability to retain these key employees and our ability to attract and retain other skilled managerial, engineering and sales and marketing personnel. Any of our current employees, including our senior management, may terminate their employment with us at any time. In addition, we have an engineering facility in India, where the employee turnover rate has traditionally been significantly higher than in the United States. The competition for qualified personnel is intense in our industry. We may not be successful in attracting and retaining sufficient numbers of qualified personnel. The loss of any of our key employees or our inability to attract or retain qualified personnel, including engineers, could delay the development and introduction of, and negatively impact our ability to sell, our

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platforms. We may also incur increased operating expenses and be required to divert the attention of other senior executives to recruit replacements for the loss of any key personnel.

**Our recent announcement of changes to our senior management could negatively affect our operations and relationships with manufacturers, customers and employees.**

Our president and chief executive officer has announced that he intends to resign by year end. We have engaged in a search for a new chief executive officer. This change could negatively affect our operations and our relationships with our manufacturers, customers, employees and those companies to which our customers sell our products. We may be unable to attract qualified candidates or appoint Mr. Johnson s successor prior to his departure. In addition, if we are not successful in the integration of this new member to our senior management team or the integration does not go smoothly, it could negatively affect our business.

**Our headquarters are located in California and, as a result, are subject to earthquakes and other catastrophes.**

Our business operations depend on our ability to maintain and protect our facilities, computer systems and personnel, which are primarily located in San Jose, California. San Jose is situated on or near known earthquake fault zones. Should an earthquake or other catastrophe, such as a fire, flood, power loss, communication failure or similar event, disable our facilities, we do not have readily available alternative facilities from which to conduct our business.

**Changes in our tax rates could affect our future results.**

Our future effective tax rates could be favorably or unfavorably affected by changes in the mix of our earnings in countries with differing statutory tax rates, changes in the valuation of our deferred tax assets and liabilities, our estimated future earnings and taxable income or by changes in tax laws or their interpretation. These factors may affect our business, results of operations and financial condition. In addition, we are subject to the examination of our income tax returns by the Internal Revenue Service and other tax authorities. The outcomes of these examinations, if they occur, could result in an adjustment to our tax provision, which could harm our net income and financial condition.

**Changes to financial accounting standards may affect our results of operations and cause us to change our business practices.**

We prepare our financial statements to conform with accounting principles generally accepted in the United States, or GAAP. These accounting principles are subject to interpretation by the American Institute of Certified Public Accountants, the Securities and Exchange Commission and various bodies formed to interpret and create appropriate accounting policies. A change in those policies can have a significant effect on our reported results and may affect our reporting of transactions completed before a change is announced. Changes to those rules or the questioning of current practices may adversely affect our reported financial results or the way we conduct our business. For example, accounting policies affecting many aspects of our business, including rules relating to employee stock option grants, have recently been revised. The Financial Accounting Standards Board and other agencies have made changes to U.S. GAAP that require us to record a charge to earnings for employee stock option grants and other equity incentives. We will have significant and ongoing accounting charges resulting from option grant and other equity incentive expensing that will reduce our overall net income. In addition, since we historically have used equity-related compensation as a component of our total employee compensation program, the accounting change could make the use of equity-related compensation less attractive to us and therefore make it more difficult to attract and retain employees.

**We are exposed to risks from legislation requiring companies to evaluate their internal controls.**

Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud. Section 404 of the Sarbanes-Oxley Act of 2002 required our management to report on, and our independent registered public accounting firm to attest to, the effectiveness of our internal control structure and procedures for financial reporting, commencing with our annual report for the year ended December 31, 2005. As a result, we have experienced increased expense and have devoted additional management resources to Section 404 compliance. We have completed our assessment and obtained our independent registered public accounting firm s attestation as to the effectiveness of our internal control over financial reporting as of December 31, 2005. In future years, if we fail to timely complete this assessment, or if our independent registered public accounting firm cannot timely attest to our assessment, we could be subject to regulatory sanctions and a loss of public confidence in our internal control. In addition, any failure to implement required new or improved controls, or difficulties encountered in their implementation, could harm our operating results or cause us to fail to timely meet our regulatory reporting obligations. In the future, if our chief executive officer, chief financial officer or independent registered public accounting firm determines that our internal controls over financial reporting are not effective as defined under Section 404, investor perceptions of our company may be adversely affected and could cause a decline in the market price of our stock.

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**The demand for personal media players is affected by general economic conditions, which could impact our business.**

The United States and international economies have from time to time experienced a period of slow economic growth. In particular, terrorist acts and similar events, turmoil in the Middle East or war in general, and rising oil prices could contribute to a slowdown of the market demand for luxury consumer electronic products, including demand for personal media players. If the economic growth slows down as a result of the recent economic, political and social turmoil, or if there are further terrorist attacks in the United States or elsewhere, we may experience decreases in the demand for our platforms, which may harm our operating results. Our business has been adversely affected by previous economic downturns. For example, during the global economic downturn in 2002 to 2003, demand for many semiconductor and consumer electronics products suffered as consumers delayed purchasing decisions or changed or reduced their discretionary spending. As a result, demand for our products suffered and we had to implement headcount reductions and restructuring initiatives to align our corporate spending with a slower than anticipated revenue growth during that timeframe.

**If the personal media player market does not continue to grow, our operating results will suffer.**

Our platforms are primarily designed for use in feature-rich personal media players that aim to provide consumers with the ability to capture, store and play audio, photo or video content. The success of our platforms depends in part on consumers desire to purchase personal media players that integrate a variety of media, as well as on other companies willingness to design and produce personal media players and provide the necessary content. The continued growth of the personal media player market will depend in part on:

- their price;
- their functionality and quality;
- the availability of downloadable content;
- consumer demands and preferences;
- support for a broad range of digital media compression standards; and
- the development of digital rights management standards to enable the sophisticated protection of the intellectual property rights of others.

If the personal media player market fails to continue to grow for any reason, we may not be able to generate significant revenue from the sales of our platforms, and our financial results would suffer. In addition, if competing devices such as mobile phones become able to perform many of the functions of personal media players, such competing devices may reduce the market for personal media players. If we are unable to adapt our platforms for incorporation into these devices, our sales and financial results would suffer.

**We currently sell platforms primarily for feature-rich personal media players and sales of our platforms may decline if consumer preferences shift away from such feature-rich devices.**

One of the main competitive advantages of feature-rich personal media players is that they provide the consumer with a variety of media content and feature options. Our business strategy assumes that a substantial portion of consumers will want personal media players that provide a large number of features and access to a very large number of songs or photos or to very memory intensive content, such as video. If consumers are unwilling to carry very large libraries of music or photos or very memory-intensive content, or are unwilling to pay the higher costs associated with more feature-rich devices, then demand for our platforms may decrease, which would negatively affect the sales of our platforms and our revenue for those platforms accordingly.

**The industry standards in the personal media player market are continually evolving, and our success depends on our ability to adapt our platforms to meet these changing industry standards.**

Our ability to compete depends on our ability to adapt our platforms to support relevant industry standards, such as compression algorithms, digital rights management and delivery standards. We may be required to invest significant time and effort and to incur significant expense to redesign our platforms to address relevant standards. If our platforms do not meet relevant industry standards for a significant period of time, we could miss opportunities to achieve crucial design wins.

**The emergence of alternative models for downloading digital music content may impact our business in ways we cannot anticipate.**

Currently, most purchased music content is available through a pay-per-download model in which consumers purchase and own the song file, which they can download and play on their personal media player. In 2004, Microsoft introduced its digital rights management software, which is designed to provide personal media players access to music content on a subscription basis in which

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consumers can pay a subscription fee to rent, rather than own, the song file. We cannot predict the impact on our business should this or other similar technology or other content distribution models become widely adopted. In addition, to the extent other providers of digital content or providers of platforms or components for personal media players take market share away from Apple s iPod and iTunes products and services, our business and results of operations could be materially harmed.

**Our ability to expand our business depends on the availability of digital content.**

The demand for portable audio and video products may be adversely impacted by the adoption or enforcement of limits on file sharing and downloadable music and video or new copy protection techniques. It is still unclear how the access and distribution of video content will be regulated. Owners of digital content rights may seek to restrict uses of digital content, attempt to block new functionalities through lawsuits or additional regulation, or attempt to renegotiate terms of existing licenses, any of which could limit the availability of digital content. If music or video content is not readily available, the demand for personal media players that use our platforms may decline, which in turn could harm our business, financial condition and results of operations.

**Our stock price may decline because of stock market fluctuations that affect the prices of technology stocks. A decline in our stock price may lead to securities class action litigation against us that could result in substantial costs, divert management s attention and harm our business.**

The stock market has experienced significant price and trading volume fluctuations that have adversely affected the market prices of common stock of technology companies. These broad market fluctuations may reduce the market price of our common stock. In addition, the market price of our common stock may be affected by other factors outside our control such as developments or announcements affecting our industry, Apple or our competitors. For example, during the time in which our common stock has been publicly traded, the sale prices of our common stock as reported on The NASDAQ Global Market ranged from $33.45 on November 29, 2004 to $8.76 on July 18, 2006. In the past, securities class action litigation has often been brought against a company after periods of volatility in the market price of its securities, and in the future, we may be a target of similar litigation. Any lawsuits to which we become a party, whether ultimately resolved in our favor or not, may not be resolved quickly, and coverage limits of our insurance or our ability to pay such amounts may not be adequate to cover the fees and expenses and any ultimate resolution associated with such litigation. The size of these payments, if any, individually or in the aggregate, could seriously impair our cash reserves and financial condition. The defense of these lawsuits also could result in continued diversion of our management s time and attention away from business operations, which could cause our financial results to decline. A failure to resolve definitively any future material litigation in which we are involved or in which we may become involved in the future, regardless of the merits of the respective cases, could also cast doubt as to our prospects in the eyes of customers, potential customers, analysts and investors, which could cause our revenues and stock price to decline. In addition, the anti-takeover provisions we have adopted in the past, such as prohibiting stockholder action by written consent, or may adopt in the future, may be perceived negatively by the market causing a decline in our stock price or litigation against us.

**Our ability to raise capital in the future when needed could prevent us from executing our growth strategy.**

We believe that our existing cash and short-term investments and additional amounts available under our bank line of credit will be sufficient to meet our anticipated cash needs for at least the next 12 months. The timing and amount of our working capital and capital expenditure requirements may vary significantly depending on numerous factors, including:

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

If our capital resources are insufficient to satisfy our liquidity requirements, we may seek to sell additional equity securities or debt securities or obtain other debt financing. The sale of additional equity securities or convertible debt securities would result in additional dilution to our stockholders. Additional debt would result in increased expenses and could result in covenants that would restrict our operations. There is no assurance that financing, if required, will be available in amounts or on terms acceptable to us, if at all.

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**We may be unable to consummate future potential acquisitions or investments or successfully integrate acquired businesses or investments or foreign operations with our business, which may disrupt our business, divert management s attention and slow our ability to expand the range of our technologies and products.**

We intend to continue to expand the range of our technologies and products, and we may acquire or make investments in additional complementary businesses, technologies or products, if appropriate opportunities arise. For example, in early October 2006, we acquired AVCcore, Inc., with which we expect to accelerate the development of our future HD-enabled technologies. We may be unable to identify additional suitable acquisition or investment candidates at reasonable prices or on reasonable terms, or consummate future acquisitions or investments, each of which could slow our growth strategy. We have limited experience with investing in or acquiring and integrating complementary businesses and therefore may have difficulties completing such transactions or realizing the benefits of such transactions, or they may have a negative effect on our business. Such investments or acquisitions could require us to devote a substantial amount of time and resources and could place a significant strain on our management and personnel. To finance any acquisitions, we may choose to issue shares of our common stock, which would dilute your interest in us. Any future acquisitions by us also could result in significant write-offs or the incurrence of debt and contingent liabilities, any of which could harm our operating results.

**If securities or industry analysts downgrade their recommendations regarding our stock, our stock price and trading volume could decline.**

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

**Delaware law and our corporate charter and bylaws contain anti-takeover provisions that could delay or discourage takeover attempts that stockholders may consider favorable.**

Provisions in our certificate of incorporation may have the effect of delaying or preventing a change of control or changes in our management. These provisions include the following:

- the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors;
- the prohibition of cumulative voting in the election of directors, which would otherwise allow less than a majority of stockholders to elect director candidates;
- the requirement for advance notice for nominations for election to the board of directors or for proposing matters that can be acted upon at a stockholders meeting;
- the ability of the board of directors to alter our bylaws without obtaining stockholder approval;
- the ability of the board of directors to issue, without stockholder approval, up to 5,000,000 shares of preferred stock with terms set by the board of directors, which rights could be senior to those of common stock;
- the required approval of holders of at least two-thirds of the shares entitled to vote at an election of directors to adopt, amend or repeal our bylaws or amend or repeal the provisions of our certificate of incorporation regarding the election and removal of directors and the ability of stockholders to take action;

- the required approval of holders of at least two-thirds of the shares entitled to vote at an election of directors to remove directors without cause; and

- the elimination of the right of stockholders to call a special meeting of stockholders and to take action by written consent.

In addition, because we are incorporated in Delaware, we are governed by the provisions of Section 203 of the Delaware General Corporation Law. These provisions may prohibit large stockholders, in particular those owning 15% or more of our outstanding voting stock, from merging or combining with us. These provisions in our certificate of incorporation, bylaws and under Delaware law could discourage potential takeover attempts and could reduce the price that investors might be willing to pay for shares of our common stock in the future and result in the market price being lower than they would without these provisions. In addition, we may adopt additional antitakeover measures in the future, including the adoption of a stockholder rights plan.

**We incur increased costs as a result of being a public company.**

As a public company, we incur significant legal, accounting and other expenses. In addition, the Sarbanes-Oxley Act of 2002, as well as rules subsequently implemented by the Securities and Exchange Commission and NASDAQ, have required changes in corporate governance practices of public companies. These rules and regulations have increased our legal and financial compliance

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costs and made some activities more time consuming and costly. In addition, we incur additional costs associated with our public company reporting requirements. We also expect these rules and regulations to make it more difficult and more expensive for us to obtain director and officer liability insurance and we may be required to accept reduced policy limits and coverage or incur substantially higher costs to obtain the same or similar coverage. As a result, it may be more difficult for us to attract and retain qualified persons to serve on our board of directors or as executive officers.

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

***Issuer Purchases of Equity Securities***

| Period | Total Number of Shares Purchased | Average Price Paid Per Share |
|---|---|---|
| July 1, 2006 July 31, 2006 | 335 | $ 9.72 |
| August 1, 2006 August 30, 2006 | 1,230 | $ 12.30 |
| September 1, 2006 September 30, 2006 | 545 | $ 11.71 |
| | 2,110 | $ 11.74 |

The total number of shares repurchased corresponds with those shares of PortalPlayer common stock that employees deliver back to us to satisfy tax-withholding obligations at the settlement of restricted stock. We do not have a publicly announced plan to repurchase any of our shares of common stock.

**Item 3. Defaults upon Senior Securities**

Not Applicable.

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

Not Applicable.

**Item 5. Other Information**

Not Applicable.

**Item 6. Exhibits**

(a) *Exhibits.*

| Exhibit Number | Description of Exhibit |
|---|---|
| 10.1* | |

| | |
|---|---|
| | Separation Agreement dated July 27, 2006 by and between the Registrant and Gary Johnson (incorporated by reference to Exhibit 10.1 to the Registrant s Current Report on Form 8-K filed on August 2, 2006). |
| 31.1 | Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer. |
| 31.2 | Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer. |
| 32.1** | Section 1350 Certifications. |

* Indicates a management contract or compensatory plan or arrangement.

** The material contained in this Exhibit 32.1 is not deemed filed with the SEC and is not to be incorporated by reference into any filing of the Company under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date hereof and irrespective of any general incorporation language contained in such filing, except to the extent that the registrant specifically incorporates it by reference.

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## SIGNATURES

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

PortalPlayer, Inc.

By: /s/ SVEND-OLAV CARLSEN
Svend-Olav Carlsen
*Vice President and Chief Financial Officer*
(Duly authorized officer and principal financial and accounting officer)

Date: November 9, 2006

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