Raptor Pharmaceutical Corp
Form S-3
April 26, 2011

As filed with the Securities and Exchange Commission on April 25, 2011

Registration No. 333-[ ]

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

# FORM S-3
REGISTRATION STATEMENT
Under
The Securities Act of 1933

RAPTOR PHARMACEUTICAL CORP.
(Exact name of Registrant as specified in its charter)

| | |
|---|---|
| Delaware<br>(State or other jurisdiction of incorporation or organization) | 86-0883978<br>(I.R.S. Employer Identification Number) |

9 Commercial Blvd., Suite 200
Novato, CA 94949
(415) 382-8111
(Address, including zip code, and telephone number, including area code, of Registrant’s principal executive offices)

Christopher M. Starr, Ph.D.
Chief Executive Officer
Raptor Pharmaceutical Corp.
9 Commercial Blvd., Suite 200

Novato, CA 94949
(415) 382-8111
(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:

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Walker LLP
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Approximate date of commencement of proposed sale to the public: From time to time after the effectiveness of this registration statement.

If the only securities being registered on this Form are being offered pursuant to dividend or interest reinvestment plans, please check the following box. ¨

If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, other than securities offered only in connection with dividend or interest reinvestment plans, check the following box. x

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, please check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering. ¨

If this Form is a registration statement pursuant to General Instruction I.D. or a post-effective amendment thereto that shall become effective upon filing with the Commission pursuant to Rule 462(e) under the Securities Act, check the following box.

If this Form is a post-effective amendment to a registration statement filed pursuant to General Instruction I.D. filed to register additional securities or additional classes of securities pursuant to Rule 413(b) under the Securities Act, check the following box.

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

Large accelerated filer Accelerated filer Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company x

CALCULATION OF REGISTRATION FEE

| Title of Each Class of Securities to be Registered (1) | Amount to be Registered (1) | Proposed Maximum Offering Price Per Security (2) | Proposed Maximum Aggregate Offering Price | Amount of Registration Fee(3) |
|---|---|---|---|---|
| Common stock, $0.001 par value per share(4) | | | | |
| Preferred stock, $0.001 par value per share | | | | |
| Debt securities (5) | | | | |
| Warrants | | | | |
| Units (6) | | | | |
| Total | | | $50,000,000 | $5,805 |

(1) There are being registered hereunder such indeterminate number of shares of common stock and preferred stock, such indeterminate principal amount of debt securities, such indeterminate number of warrants to purchase common stock, preferred stock and/or debt securities, and such indeterminate number of units as may be sold by the registrant from time to time, which together shall have an aggregate initial offering price not to exceed $50,000,000. If any debt securities are issued at an original issue discount, then the offering price of such debt securities shall be in such greater principal amount at maturity as shall result in an aggregate offering price not to exceed $50,000,000, less the aggregate dollar amount of all securities previously issued hereunder. Any securities registered hereunder may be sold separately or as units with the other securities registered hereunder. The proposed maximum offering price per unit will be determined, from time to time, by the registrant in connection with the issuance by the registrant of the securities registered hereunder. Separate consideration may or may not be received for securities that are issuable on exercise, conversion, or exchange of other securities or that are issued in units. The securities registered hereunder also includes such indeterminate number of shares of common stock and preferred stock and amount of debt securities as may be issued upon conversion of or exchange for preferred stock or debt securities that provide for conversion or exchange, upon exercise of warrants or pursuant to the antidilution provisions of any such securities. In addition, this registration statement relates to an indeterminate amount of shares of common stock and preferred stock that may be issued as a result of stock splits, stock dividends or similar transactions in accordance with Rule 416 under the Securities Act.

(2) The proposed maximum aggregate offering price per class of security will be determined from time to time by the registrant in connection with the issuance by the registrant of the securities registered hereunder and is not specified as to each class of security pursuant to General Instruction II.D. of Form S-3 under the Securities Act.

(3) The registration fee for the unallocated securities registered hereby has been estimated solely for the purpose of computing the registration fee calculated pursuant to Rule 457(o) under the Securities Act.

(4) Includes associated rights to purchase shares of the registrant’s Series A participating preferred stock, or Purchase Rights, that are attached to all shares of our common stock, in accordance with the Rights

Agreement, dated as of May 13, 2005, as amended, by and between the registrant and American Stock Transfer & Trust Company, LLC, as rights agent, called the Rights Agreement. The Purchase Rights are not exercisable until the occurrence of certain events specified in the Rights Agreement, are evidenced by the stock certificates representing common stock and are transferrable only with the common stock. The value attributable to the Purchase Rights, if any, is reflected in the value of the common stock.

(5) The debt securities may consist of one or more series of senior debt securities or subordinated debt securities as described in the applicable prospectus supplement.

(6) Each unit will be issued under a unit agreement or indenture and will represent an interest in two or more securities listed above, which may or may not be separable from one another.

The Registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the Registrant shall file a further amendment that specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until the registration statement shall become effective on such date as the Securities and Exchange Commission, acting pursuant to said Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. We may not sell these securities until the Registration Statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

Subject to completion, dated April 25, 2011

PROSPECTUS

$50,000,000
Common Stock
Preferred Stock
Debt Securities
Warrants
Units

From time to time, we may offer, issue and sell up to $50,000,000 of any combination of the securities described in this prospectus, either individually or in units and in one or more transactions. We may also offer common stock or preferred stock upon conversion of debt securities, common stock upon conversion of preferred stock, or common stock, preferred stock or debt securities upon the exercise of warrants.

We will provide the specific terms of these offerings and securities in one or more supplements to this prospectus. We may also authorize one or more free writing prospectuses to be provided to you in connection with these offerings. The prospectus supplement and any related free writing prospectus, and any documents incorporated by reference therein, may also add, update or change information contained in this prospectus. You should carefully read this prospectus, the applicable prospectus supplement and any related free writing prospectus, as well as any documents incorporated by reference, carefully before buying any of the securities being offered.

Our common stock is traded on the NASDAQ Capital Market under the symbol "RPTP." On April 21, 2011, the last reported sale price of our common stock on the NASDAQ Capital Market was $3.45. The applicable prospectus supplement will contain information, where applicable, as to any other listing, if any, on the NASDAQ Capital Market or any securities market or other exchange of the securities covered by the applicable prospectus supplement. The aggregate market value of our outstanding common equity held by non-affiliates on April 21, 2011, was approximately $106 million.

Investing in our securities involves a high degree of risk. You should review carefully the risks and uncertainties described under the heading "Risk Factors" on page 2 and contained in the applicable prospectus supplement and any related free writing prospectus, and under similar headings in the other documents that are incorporated by reference into this prospectus.

This prospectus may not be used to consummate a sale of any securities unless accompanied by a prospectus supplement.

The securities may be sold directly by us to investors, through agents designated from time to time or to or through underwriters or dealers, on a continuous or delayed basis. For additional information on the methods of sale, you should refer to the section titled "Plan of Distribution" in this prospectus. If any agents or underwriters are involved in the sale of any securities with respect to which this prospectus is being delivered, the names of such agents or underwriters and any applicable fees, commissions, discounts and over-allotment options will be set forth in a prospectus supplement. The price to the public of such securities and the net proceeds that we expect to receive from such sale will also be set forth in a prospectus supplement.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is ____________, 2011.

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## ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement on Form S-3 that we filed with the Securities and Exchange Commission, or the SEC, utilizing a "shelf" registration process. Under this shelf registration process, we may offer shares of our common stock or preferred stock, various series of debt securities and/or warrants to purchase any of such securities, either individually or in units, in one or more offerings, up to a total dollar amount of $50,000,000. This prospectus provides you with a general description of the securities we may offer. Each time we offer a type or series of securities under this prospectus, we will provide a prospectus supplement that will contain more specific information about the terms of those securities. We may also authorize one or more free writing prospectuses to be provided to you that may contain material information relating to these offerings. We may also add or update in the prospectus supplement (and in any related free writing prospectus that we may authorize to be provided to you) any of the information contained in this prospectus or in the documents we have incorporated by reference into this prospectus. We urge you to carefully read this prospectus, any applicable prospectus supplement and any related free writing prospectus, together with the information incorporated herein by reference as described under the heading "Where You Can Find More Information," before buying any of the securities being offered. THIS PROSPECTUS MAY NOT BE USED TO CONSUMMATE A SALE OF SECURITIES UNLESS IT IS ACCOMPANIED BY A PROSPECTUS SUPPLEMENT.

You should rely only on the information that we have provided or incorporated by reference in this prospectus, any applicable prospectus supplement and any related free writing prospectus that we may authorize to be provided to you. We have not authorized anyone to provide you with different information in addition to or different from that contained in this prospectus, any applicable prospectus supplement and any related free writing prospectus. No dealer, salesperson or other person is authorized to give any information or to represent anything not contained in this prospectus, any applicable prospectus supplement or any related free writing prospectus that we may authorize to be provided to you. You must not rely on any unauthorized information or representation. If anyone provides you with different or inconsistent information, you should not rely on it. This prospectus is an offer to sell only the securities offered hereby, but only under circumstances and in jurisdictions where it is lawful to do so. We will not make an offer to sell our securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information in this prospectus, any applicable prospectus supplement, any related free writing prospectus, is accurate only as of the date on the front cover of this prospectus and that any information we have incorporated by reference is accurate only as of the date of the document incorporated by reference, regardless of the time of delivery of this prospectus, any applicable prospectus supplement or any related free writing prospectus, or any sale of a security. Our business, financial condition, results of operations and prospects may have changed since that date.

This prospectus contains summaries of certain provisions contained in some of the documents described herein, but reference is made to the actual documents for complete information. All of the summaries are qualified in their entirety by the actual documents. The registration statement containing this prospectus, including exhibits to the registration statement, provides additional information about us and the securities offered under this prospectus. Copies of some of the documents referred to herein have been filed, will be filed or will be incorporated by reference as exhibits to the registration statement of which this prospectus is a part, and you may obtain copies of those documents as described below under the heading "Where You Can Find More Information."

## RAPTOR PHARMACEUTICAL CORP.

Raptor Pharmaceutical Corp., or Raptor, was initially incorporated in Nevada on July 29, 1997 as Axonyx Inc. In October 2006, Axonyx Inc. and its then-wholly-owned subsidiary completed a reverse merger, business combination with TorreyPines Therapeutics, Inc., reincorporated in Delaware and changed its name to TorreyPines Therapeutics, Inc. In September 2009, we and our wholly-owned subsidiary completed a reverse merger, business combination with Raptor Pharmaceuticals Corp. pursuant to which Raptor Pharmaceuticals Corp. became our wholly-owned subsidiary. Immediately prior to the merger, we changed our corporate name from TorreyPines Therapeutics, Inc. to Raptor Pharmaceutical Corp. Our principal executive offices are located at 9 Commercial Blvd., Suite 200, Novato, CA 94949, and our telephone number is (415) 382-8111. We are a NASDAQ-listed development-stage biotechnology company dedicated to speeding the delivery of new treatment options to patients by working to improve existing therapeutics through the application of highly specialized drug targeting platforms and formulation expertise. We focus on underserved patient populations where we believe that we can have the greatest potential impact. We are developing drug therapies for the potential treatment of: genetic diseases including nephropathic cystinosis, or cystinosis, and Huntington's Disease, or HD; metabolic diseases including non-alcoholic steatohepatitis, or NASH, and aldehyde dehydrogenase, or ALDH2, deficiency, or Ethanol Intolerance; and liver diseases including primary liver cancer or hepatocellular carcinoma, or HCC. We are also researching a potential anti-platelet agent to treat thrombotic disorder.

We obtained statistical data, market data and other industry data and forecasts used throughout, or incorporated by reference in, this prospectus from market research, publicly available information and industry publications. Industry publications generally state that they obtain their information from sources that they believe to be reliable, but they do not guarantee the accuracy and completeness of the information. Similarly, while we believe that the statistical data, industry data and forecasts and market research are reliable, we have not independently verified the data, and we do not make any representation as to the accuracy of the information. We have not sought the consent of the sources to refer to their reports appearing or incorporated by reference in this prospectus.

As described elsewhere in this prospectus under the heading "Where You Can Find More Information," this prospectus and the information incorporated herein by reference include trademarks, service marks and trade names owned by us or other companies. All trademarks, service marks and trade names included or incorporated by reference into this prospectus, any applicable prospectus supplement or any related free writing prospectus are the property of their respective owners.

In this prospectus, we refer to common stock, preferred stock, debt securities, warrants and units collectively as "securities." Unless otherwise mentioned or unless the context requires otherwise, all references in this prospectus to "we," "us," "our," the "Company," "Raptor" and similar references refer to Raptor Pharmaceutical Corp., a Delaw corporation, and its wholly-owned subsidiaries; except that in the description of the securities we may offer these terms refer solely to Raptor Pharmaceutical Corp. and not to any of our subsidiaries.

## RISK FACTORS

Investing in our securities involves a high degree of risk. You should carefully review the risks and uncertainties described under the heading "Risk Factors" contained in, or incorporated into, the applicable prospectus supplement and any related free writing prospectus, and under similar headings in the other documents, including our most recent annual report on Form 10-K, any subsequent quarterly reports on Form 10-Q or any current reports on Form 8-K we file after the date of this prospectus, that are incorporated by reference into this prospectus. The occurrence of any of these risks might cause you to lose all or part of your investment in the offered securities. Additional risks not presently known to us or that we currently believe are immaterial may also significantly impair our business operations and financial condition.

## FORWARD-LOOKING STATEMENTS

This prospectus and the documents incorporated by reference contain “forward-looking statements” of Raptor within the meaning of Section 27A of the Securities Act of 1933, as amended (the “Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (the “Exchange Act”). These statements involve known and unknown risks, uncertainties and other important factors that may cause our actual results, performance or achievements to be materially different from any future results, performances or achievements expressed or implied by the forward-looking statements. Forward-looking statements may include statements relating to:

- projections of our results of operations and financial condition and businesses;
- anticipated development, regulatory submissions, regulatory approval and commercialization of our drug candidates;
- the efficacy, safety and intended utilization of our drug candidates;
- competition and consolidation in the markets in which we compete;
- existing and future collaborations and partnerships;
- our ability to comply with government regulations;
- our ability to expand and protect our intellectual property portfolio;
- anticipated future losses;
- the conduct and results of our research, discovery and preclinical efforts and clinical trials; and
- our plans regarding future research, discovery and preclinical efforts and clinical activities and collaborative, intellectual property and regulatory activities.

Words such as “anticipates,” “believes,” “forecast,” “potential,” “contemplates,” “expects,” “intends,” “plans,” “believ “estimates,” “could,” “would,” “will,” “may,” “can” and negative versions of these and other similar expressions ide forward-looking statements. These forward-looking statements are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results to differ materially from the results contemplated by the forward-looking statements. Many of the important factors that will determine these results and values are beyond our ability to control or predict. You are cautioned not to put undue reliance on any forward-looking statements. Except as otherwise required by law, we do not assume any obligation to update any forward-looking statements. In evaluating an investment in our securities, you should carefully consider the discussion of risks and uncertainties described under the heading “Risk Factors” contained in this prospectus and the applicable prospectus supplement and any related free writing prospectus, and under similar headings in the other documents, including our most recent annual report on Form 10-K, any subsequent quarterly reports on Form 10-Q or any current reports on Form 8-K we file after the date of this prospectus that are incorporated by reference into this prospectus, as well as any amendments to any of the foregoing reflected in subsequent filings with the SEC. You should carefully read this prospectus, the applicable prospectus supplement and any related free writing prospectus, together with the information incorporated herein by reference as described under the heading “Where You Can Find More Information,” completely and with the understanding that our actual future results may be materially different from what we expect.

## THE SECURITIES WE MAY OFFER

We may offer shares of our common stock or preferred stock, various series of debt securities and/or warrants to purchase any of such securities, either individually or in units, in one or more offerings, with a total value of up to $50,000,000 from time to time under this prospectus at prices and on terms to be determined by market conditions at the time of any offering. This prospectus provides you with a general description of the securities we may offer. Each time we offer a type or series of securities under this prospectus, we will provide a prospectus supplement that will describe the specific amounts, prices and other important terms of the securities including, to the extent applicable:

- designation or classification;
- aggregate principal amount or aggregate offering price;
- maturity, if applicable;
- original issue discount, if any;
- rates and times of payment of interest or dividends, if any;
- redemption, conversion, exercise, exchange or sinking fund terms, if any;
- ranking;
- restrictive covenants, if any;
- voting or other rights, if any;
- conversion prices, if any; and
- important United States federal income tax considerations.

The prospectus supplement and any related free writing prospectus that we may authorize to be provided to you may also add or update information contained in this prospectus or in documents we have incorporated by reference. However, no prospectus supplement or free writing prospectus will offer a security that is not registered and described in this prospectus at the time of the effectiveness of the registration statement of which this prospectus is a part.

THIS PROSPECTUS MAY NOT BE USED TO CONSUMMATE A SALE OF SECURITIES UNLESS IT IS ACCOMPANIED BY A PROSPECTUS SUPPLEMENT.

We may sell the securities directly to investors or to or through agents, underwriters or dealers. We, and our agents or underwriters, reserve the right to accept or reject all or part of any proposed purchase of securities. If we do offer securities to or through agents or underwriters, we will include in the applicable prospectus supplement:

- the names of those agents or underwriters;

- the terms of the offering;
- applicable fees, discounts, concessions and commissions to be paid to them;
- the anticipated date of delivery of the securities;
- details regarding over-allotment options, if any; and
- the net proceeds to us.

Common Stock. We may issue shares of our common stock from time to time. The holders of common stock are entitled to one vote for each share held of record on all matters submitted to a vote of stockholders and do not have cumulative voting rights. Subject to preferences that may be applicable to any outstanding shares of preferred stock, the holders of common stock are entitled to receive ratably only those dividends as may be declared by our board of directors out of legally available funds. Upon our liquidation, dissolution or winding up, holders of our common stock are entitled to share ratably in all assets remaining after payment of liabilities and the liquidation preferences of any outstanding shares of preferred stock.

Preferred Stock. We may issue shares of our preferred stock from time to time, in one or more series. Under our certificate of incorporation, as amended, our board of directors has the authority, without further action by stockholders, to designate up to 15,000,000 shares of preferred stock in one or more series and to fix the rights, preferences, privileges, qualifications and restrictions granted to or imposed upon the preferred stock, including dividend rights, conversion rights, voting rights, rights and terms of redemption, liquidation preference and sinking fund terms, any or all of which may be greater than the rights of the common stock.

If we sell any series of preferred stock under this prospectus, we will fix the designations, powers, preferences and rights of such series of preferred stock, as well as the qualifications, limitations or restrictions thereon, in the certificate of designation relating to that series. We will file as an exhibit to the registration statement of which this prospectus is a part, or will incorporate by reference from reports that we file with the SEC, the form of any certificate of designation that describes the terms of the series of preferred stock we are offering before the issuance of the related series of preferred stock. We urge you to read the applicable prospectus supplement (and any free writing prospectus that we may authorize to be provided to you) related to the series of preferred stock being offered, as well as the complete certificate of designation that contains the terms of the applicable series of preferred stock.

Debt Securities. We may issue debt securities from time to time, in one or more series, as either senior or subordinated debt or as senior or subordinated convertible debt. The senior debt securities will rank equally with any other unsecured and unsubordinated debt. The subordinated debt securities will be subordinate and junior in right of payment, to the extent and in the manner described in the instrument governing the debt, to all of our senior indebtedness. Convertible debt securities will be convertible into or exchangeable for our common stock or our other securities. Conversion may be mandatory or at your option and would be at prescribed conversion rates.

The debt securities will be issued under one or more indentures, which are contracts between us and a national banking association or other eligible party, as trustee. In this prospectus, we have summarized certain general features of the debt securities. We urge you, however, to read the applicable prospectus supplement (and any free writing prospectus that we may authorize to be provided to you) related to the series of debt securities being offered, as well as the complete indentures that contain the terms of the debt securities. Forms of indentures have been filed as exhibits to the registration statement of which this prospectus is a part, and supplemental indentures and forms of debt securities containing the terms of the debt securities being offered will be filed as exhibits to the registration statement of which this prospectus is a part or will be incorporated by reference from reports that we file with the SEC.

Warrants. We may issue warrants for the purchase of common stock, preferred stock and/or debt securities in one or more series. We may issue warrants together with common stock, preferred stock and/or debt securities, and the warrants may be attached to or separate from these securities. In this prospectus, we have summarized certain general features of the warrants. We urge you, however, to read the applicable prospectus supplement (and any free writing prospectus that we may authorize to be provided to you) related to the particular series of warrants being offered, as well as the complete warrant agreements and warrant certificates that contain the terms of the warrants. We will file as an exhibit to the registration statement of which this prospectus is a part, or will incorporate by reference from reports that we file with the SEC, forms of the warrant agreements and forms of warrant certificates containing the terms of the warrants being offered.

We will evidence each series of warrants by warrant certificates that we will issue. Warrants may be issued under an applicable warrant agreement that we enter into with a warrant agent. We will indicate the name and address of the warrant agent, if applicable, in the prospectus supplement relating to the particular series of warrants being offered.

Units. We may issue, in one or more series, units consisting of common stock, preferred stock, debt securities and/or warrants for the purchase of common stock, preferred stock and/or debt securities in any combination. In this prospectus, we have summarized certain general features of the units. We urge you, however, to read the applicable prospectus supplement (and any free writing prospectus that we may authorize to be provided to you) related to the series of units being offered, as well as the complete unit agreement that contains the terms of the units. We will file as exhibits to the registration statement of which this prospectus is a part, or will incorporate by reference from reports that we file with the SEC, the form of unit agreement and any supplemental agreements that describe the terms of the series of units it is offering before the issuance of the related series of units.

## USE OF PROCEEDS

Except as described in any prospectus supplement or in any related free writing prospectus that we may authorize to be provided to you, we currently intend to use the net proceeds from the sale of the securities offered hereby for general corporate purposes, including, among other things, working capital to support our potential commercial launch of our lead drug candidate, development of our other clinical and preclinical stage drug candidate programs and potential re-payment of indebtedness that may be outstanding at the time of any offering under this prospectus. We have not specifically allocated the proceeds to those purposes as of the date of this prospectus. We may also use a portion of the net proceeds to acquire or invest in businesses, services and technologies that are complementary to our own. Pending these uses, we expect to invest the net proceeds in short-term, investment-grade securities. The precise amount and timing of the application of proceeds from the sale of securities will depend on our funding requirements and the availability and cost of other funds at the time of sale. Allocation of proceeds of a particular series of securities, or the principal reason for the offering if no allocation has been made, will be described in the applicable prospectus supplement or in any related free writing prospectus.

## DESCRIPTION OF OUR CAPITAL STOCK

In January 2000, we entered into a non-cancelable lease agreement for our headquarters that will expire in 2003. Under the terms of this and other leases, with various expiration dates through 2006, our future minimum rental payments are as follows (in thousands):

| | **Amounts** |
|---|---|
| Years Ending December 31, | |
| 2003 | $2,265 |
| 2004 | 349 |
| 2005 | 147 |
| 2006 | 110 |
| | $2,871 |

We believe that our existing cash and cash equivalents, and short-term investments will be sufficient to fund our operations through December 31, 2003. However, to continue our operations beyond 2003 or to achieve our longer-term goals of introducing additional products to consumers, we believe we will need to raise additional capital, which may not be available on acceptable terms, if at all. We have historically used vendor credit as well as private offerings of convertible preferred stock and common stock to fund operations and provide for capital requirements. However, the price per share of any future equity-related financing will be determined at the time the offering is made and cannot be anticipated at this time. If additional funds are raised through the issuance of equity securities, the percentage ownership of current stockholders are likely to or will be reduced and such equity securities may have rights, preferences or privileges better than those of current stockholders. We cannot assure you that any additional financing will be available or that, if available, it will be sufficient or it can be obtained on terms favorable to us or our stockholders. If adequate funds are not

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available if and when needed, we would be required to delay, limit or eliminate some or all of our proposed operations.

**Critical Accounting Policies**

The preparation of financial statements and the related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances. On an ongoing basis, we evaluate our estimates to ensure that our estimates remain reasonable under current conditions. Actual results may differ from these estimates, which may have a material impact on our results of operations and financial condition.

Critical accounting policies that require significant judgments and estimates for the preparation of our consolidated financial statements are as follows:

***Revenue Recognition***

We generally recognize revenue on products sold to end customers upon shipment provided that we have no post-sale obligations, can reliably estimate and accrue warranty and sales returns, the price is fixed or determinable and collection of the resulting receivable is reasonably assured. For sales to end customers that do not meet the above criteria, revenue is deferred until such criteria are met. Due to our limited history of warranty and sales returns, we have not recognized revenues on sales of Beamer pending the expiration of the warranty period.

Products sold to retailers and distributors are subject to rights of return. Subject to our warranty reserves, we defer recognition of revenue on products sold to retailers and distributors until the retailers and distributors sell the products to their customers. We recognize revenues from retailers and distributors according to information on shipments to their customers as provided by those retailers and distributors. If information on shipments to their customers is not provided to us on a timely and accurate manner, there may be a material impact on our reported results of operations and financial condition.

***Allowances for Sales Return***

Allowances are provided for estimated returns. Provision for return allowances will be recorded at the time when revenue is recognized based on our historical returns, current economic trends and changes in customer demand. Such allowances will be adjusted periodically to reflect actual and anticipated experience. Material differences may result in the amount and timing of our revenue for any period if management were to make different judgments or utilize different estimates. As of December 31, 2002, we did not have sufficient history and experience with respect to sales returns. As a result, we did not recognize any revenues on sales of Beamer pending the expiration of the warranty period.

***Warranty***

We provide a limited warranty on our products for periods ranging from 90 days to 12 months from the date of sale to the end customers. Through December 31, 2002, we did not recognize any revenue. A key factor in the decision not to recognize revenue is that as of December 31, 2002, we did not have sufficient history to reasonably estimate warranty costs, and the warranty period had not lapsed from our first significant shipments. We will estimate warranty costs based on historical experience and will accrue for estimated costs as a charge to cost of sales when revenue is recognized. In the future, actual warranty costs may be higher than our estimates.

***Valuation of Inventories***

Inventories are stated at the lower of cost or market, with cost being determined by the first-in, first-out method. We record our inventory reserve for estimated losses based on assumptions about future demand and market conditions. If actual demand or market conditions are less favorable than those projected by management, additional inventory reserves may be required.

Since our inception through December 31, 2001, we expensed inventory costs related to ViDVD of $9.0 million, as commercial shipments of ViDVD were limited. No additional ViDVD inventories were purchased during the year ended December 31, 2002, and we had discontinued marketing ViDVD.

We expensed $10.4 million inventory costs on our new product Beamer through September 30, 2002. We began capitalizing our inventory costs in the fourth quarter of 2002 because we experienced an increase in shipments since Beamer was commercially introduced nationwide in the third quarter of 2002. Additional inventory reserves may be needed if actual demand or market conditions are less favorable than management s projection.

***Valuation of Long-Lived Assets***

We review long-lived assets based upon an undiscounted cash flow basis and will record an impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be fully recoverable. If an asset is considered impaired, the asset is written down to carrying value based on undiscounted cash flows. During the fourth quarter of 2002, we wrote the remaining unamortized balance of $8.3 million of content licenses down to zero. Future cash flows could be different from those estimated by our management.

**Recent Accounting Pronouncements**

In June 2002, the Financial Accounting Standards Board, or FASB, issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). This Statement requires that a liability for costs associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. SFAS No. 146 is effective for exit or disposal activities initiated after December 31, 2002. Our adoption of FAS 146 did not have a material effect on our consolidated financial statements.

In November 2002, the FASB issued Interpretation No. 45 (FIN No.45), Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN No. 45 requires that a liability be recorded in the guarantor s balance sheet upon issuance of a guarantee. In addition, FIN No. 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity s product warranty liabilities. The initial recognition and initial measurement provisions of FIN No. 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor s fiscal year-end. The disclosure requirements of FIN No. 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. We do not expect our adoption of FIN No. 45 to have a material impact on our consolidated financial statements.

In January 2003, the FASB issued Interpretation No. 46 ( FIN No. 46 ) Consolidation of Variable Interest Entities. Until this interpretation, a company generally included another entity in its consolidated financial statements only if it controlled the entity through voting interests. FIN No. 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity s activities or entitled to receive a majority of the entity s residual returns. We do not expect our adoption of FIN No. 46 to have material impact on our consolidated financial statements.

**Other Factors That May Affect Our Business and Future Results**

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

***If Beamer does not achieve broad market acceptance, we may not be able to continue operating our business.***

We are currently marketing only one product. As a result, our success is highly dependent upon consumer acceptance of Beamer, which began shipping in the third quarter of 2002. Consumer acceptance requires, among other things, that we:

- educate consumers on the advantages of Beamer;
- commit a substantial amount of human and financial resources to support the retail distribution of Beamer;
- continue to develop our sales, marketing and support activities to consumers and retailers; and
- expand the number and location of retailers carrying Beamer.

We may not achieve any or all of these objectives. As a result, despite our initial national retail launch, consumers may not be aware of Beamer. This could delay or prevent our ability to achieve broad market acceptance of Beamer. The failure of Beamer to achieve sufficient consumer and retailer acceptance would impair our ability to continue operating our business.

***We are a development stage enterprise, have not recognized any revenue, have incurred significant net losses and may never achieve significant revenues or profitability.***

We are a development stage company with a limited commercial operating history. We have not recognized any revenue, have incurred significant losses and have had substantial negative cash flow. As of December 31, 2002, we had $32.7 million in cash, cash equivalents and short-term investments. For the fiscal year ended December 31, 2002, we had a net loss of $42.6 million. We expect to continue to incur significant operating and non-operating expenses over the next several years as part of the continued development and potential expansion of our business. As a result, we expect to continue to lose money for the foreseeable future. The size of these net losses will depend in part on our recent and any future product launches, any growth in sales of our products and the rate of increase in our expenses. As a result, we will need to generate significant revenues to achieve profitability. Several factors, including consumer acceptance, retailer arrangements and competitive factors make it impossible to predict when or whether we will generate significant revenues or attain profitability. Consequently, we may never achieve significant revenues or profitability, and even if we do, we may not sustain or increase profitability on a quarterly or annual basis in the future.

***It may take a substantial amount of time and resources to achieve broad market acceptance of Beamer, and we cannot be sure that these efforts will generate the level of broad market acceptance of Beamer necessary to generate sufficient revenues to sustain our business.***

The current videophone end-user market is relatively small and primarily focused on business-to-business video conferencing applications. Although videophones have been commercially available for many years, previous videophone models have had high retail prices, limited retail distribution, limited functionality, poor video quality and have been integrated with a handset. Even though we believe Beamer has addressed many of the limitations associated with videophones and videophone technology, consumer demand remains low and may not increase. Even after educating consumers on the features of Beamer, consumers may still perceive little or no benefit from Beamer or may already own other products that provide similar benefits or functionality, such as PC-based Internet video or digital camera cellular telephones. As a result, consumers may not value, or be unwilling to purchase Beamer at profitable prices. We also do not have an established brand image, and the expense of a national advertising campaign to build and sustain brand awareness is not within our reach. Accordingly, to develop market acceptance of Beamer and any future products, we will need to devote a substantial amount of resources to educate consumers about the features and benefits of Beamer via alternative means including targeted public relations and extensive retail distribution. However, we cannot assure you that this commitment of resources will be successful in generating the revenues required to sustain our business. If we are unsuccessful, the future of our Company will be in doubt.

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***If we are unable to raise additional capital on acceptable terms, our ability to develop and market our products and operate our business could be harmed.***

To emerge from the development stage, introduce follow-on products and sustain and grow our business, we must continue to make significant investments to develop, enhance and market our products. We will also need significant working capital to take advantage of future opportunities and to respond to competitive pressures or unanticipated requirements. We expect that our existing capital resources will be sufficient to meet our cash requirements through December 31, 2003, although our current resources could be exhausted more quickly depending on the payment terms that we are able to negotiate with our vendors and suppliers and our success in generating and collecting on accounts receivable. The magnitude of our future capital requirements will depend on many factors, including, among others, product development expense levels, investments in working capital, and the amount of income, if any, generated by operations.

When we do need to raise additional capital, that capital may not be available on acceptable terms, or at all. If we cannot raise necessary additional capital on acceptable terms, we may not be able to develop or enhance our products, take advantage of future opportunities, respond to competitive pressures or unanticipated requirements or even continue operating our business.

If additional capital is raised through the issuance of equity securities, the percentage ownership of our existing stockholders will decline. Also, if any securities are issued, our stockholders may experience dilution in net book value per share, and these securities may have rights, preferences or privileges superior to those of the holders of our common stock. Any debt financing, if available, may also require limitations or restrictions on our operations or future opportunities.

***Our limited operating history may make it difficult for us or investors to evaluate trends and other factors that affect our business.***

We were incorporated in April 1999 and have a limited operating history. As a result of our limited operations, our historical financial and operating information is of limited value in evaluating our future potential operating results. In addition, any evaluation of our business and prospects must be made in light of the risks and difficulties encountered by start-up companies developing products in new and rapidly evolving markets. For example, it may be difficult to accurately predict our future revenues, costs of revenues, expenses or results of operations. Beamer and any other future products represent new products for most consumers. It may be difficult to predict the creation of any market or the growth rate, if any, or size of the market for Beamer or other new products we may develop. We may be unable to accurately forecast customer needs or behavior or recognize or respond to emerging trends, changing preferences or competitive factors facing us. As a result, we may be unable to make accurate financial forecasts or adjust our spending in a timely manner to compensate for any unexpected changes or revenue shortfall. This inability could cause our results of operations in a given quarter to be worse than expected, and could cause the price of our stock to decline.

***We face intense competition from participants in the consumer electronics market, which may impair our revenues and ability to generate customers.***

The consumer electronics market is intensely competitive and rapidly evolving. Existing participants and new entrants in this market currently offer and may develop and offer additional products that will compete directly with Beamer or future products that we may develop.

The consumer electronics industry in particular is characterized by rapid technological innovation and intense price competition. The competition for consumer spending and acceptance is also intense. Beamer competes directly with several other companies in the videophone market. All of these companies currently offer videophone products to consumers that operate over standard (analog) phone lines with no additional cost to the user, similar to Beamer. In addition to these companies we face competition from a competitively priced videophone product that utilizes a consumers broadband connection (as opposed to a standard phone line) to deliver a video image over a consumer s television during a phone call. Beamer also faces competition from PC-based Internet video and from digital camera cellular telephones manufacturers and potential future offerings from current telephone manufacturers.

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If we choose to market the ViDVD or another enhanced DVD player, we would compete directly with several other currently available or soon to be introduced DVD players from major consumer electronics manufacturers, specialized manufacturers, and with products developed by smaller companies. Like the ViDVD, nearly all of these products accommodate media in DVD, CD, MP3 and JPEG formats, many offer Internet connectivity, and some include karaoke playback.

In addition, many of the manufacturers and distributors of these competing products have substantially greater brand recognition, market presence, distribution channels, financial resources and promotional and other strategic partners than us.

***If we fail to create consumer demand and consumer acceptance of Beamer, as the standard for the videophone category, we may not be able to generate sufficient revenues to sustain our business.***

The success of Beamer, as well as product line extensions to develop and define an entire videophone product category depends on a number of factors, including, but not limited to, strategic allocation of our limited financial and technical resources, accurate forecasting of consumer demand, timely completion of product development and introduction to market, and market and industry acceptance of our future and existing products. Most of our planned product and feature introductions are still in various stages of development and will require engineering and technical resources to bring to market. The success of some of our planned products may also require industry acceptance of new proprietary technologies or the adaptation of our products and technologies to accommodate the use of existing industry-accepted technologies. If we fail to develop and market new products and features, we may not be able to sustain our business.

***We depend on a single contract manufacturer and a limited number of other third parties, including ESS, to manufacture and supply critical components for Beamer, and we may be unable to operate our business if those parties do not perform their obligations.***

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

***We may have potential business conflicts of interest with ESS with respect to the companies ongoing relationships, and we may not be able to resolve these conflicts on terms favorable to us.***

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

- Although we entered into agreements with ESS that govern our business relationship after the distribution of our stock to ESS shareholders, ESS has no obligation to extend the terms of those agreements to us beyond the stated duration of those agreements;
- ESS may supply semiconductors to competitors, which may affect ESS capacity to supply semiconductors to us;
- We may compete with ESS with respect to business opportunities that are attractive to both companies, and ESS is not restricted from competing with our business.

***If we are unable to maintain satisfactory relationships with, or increase the number of, retailers and distributors that sell our products, our business will suffer.***

In order to maintain our relationships with retailers and distributors we may be required to accept arrangements and terms, which may not be favorable to us. Such terms may include consignment arrangements, pricing concessions, marketing incentives, aggressive return allowances, commissions and other requirements, which could adversely affect the profitability of our products. In addition, we expect that our retailers and distributors will sell products offered by our competitors. If our competitors offer retailers and distributors more favorable terms or have more products available to meet their needs, those retailers and distributors may decline to carry or may not adequately promote our products. Although we are aggressively attempting to increase the number of retailers that market Beamer to consumers, there can be no assurance that we will be able to do so. If we are unable to maintain successful relationships with distributors and retailers or to expand our distribution channels, our business may fail.

***We may need to expand our operations for future growth, and our failure to manage any such growth could disrupt business and impair our ability to generate revenues.***

We may need to expand our headcount, facilities and infrastructure to support potential sales growth and to allow us to pursue market opportunities. This potential expansion could place a significant strain on our management, operational and financial resources and systems. Specific risks we face as our business expands include:

- We may need to attract and retain qualified personnel, and any failure to do so may impair our ability to offer new products or grow our business. We may be unable to successfully attract, integrate or retain sufficiently qualified personnel. If we are unable to hire, train, retain or manage the necessary personnel, we may be unable to successfully introduce new products or otherwise implement our business strategy.
- We may need to provide acceptable customer support, and any inability to do so will impair our ability to develop consumer acceptance of our products. We expect that some of our customers will require support when using Beamer. We also anticipate that purchasers of any future products will require support in their use of such products. We do not have experience with widespread deployment of Beamer to a diverse customer base, and we may not have adequate personnel to provide the levels of support that our customers will require. Our failure to provide adequate customer support for our products will damage our reputation in the consumer electronics marketplace and strain our relationships with customers and strategic partners. This could prevent us from gaining new or retaining existing customers and could harm our reputation and brand.
- We may need to improve our operational and financial systems, procedures and controls to support our expected growth, and any inability to do so will adversely impact our ability to grow our business. Our current and planned systems, procedures and controls may not be adequate to support our future

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operations and expected growth. Delays or problems associated with any improvement or expansion of our operational systems and controls could adversely impact our relationships with customers and harm our reputation and brand.

***Product defects, system failures or interruptions may have a negative impact on our revenues, damage our reputation and decrease our ability to attract new customers.***

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

***Our future results could be harmed by economic, political, regulatory and other risks associated with our reliance on international sales and operations.***

Beamer is currently manufactured, assembled and tested by a single contract manufacturer located in China. In addition, most of our suppliers are located in China, Hong Kong and Taiwan. We also anticipate that, starting in 2003, revenue from international sales could represent a significant portion of our total revenue. Because of our international operations and relationships, and our reliance on foreign third-party manufacturing, assembly and testing operations, we are subject to the risks of conducting business outside of the United States, including:

changes in political and strategic relations between China, Taiwan and the U.S.;

changes in foreign currency exchange rates;

changes in a specific country s or region s political or economic conditions, particularly in China, Taiwan and other emerging Asian markets;

trade protection measures and import or export licensing requirements;

potentially negative consequences from changes in tax laws;

difficulty in managing widespread sales and manufacturing operations; and

less effective protection of intellectual property.

***Our success partly depends on our ability to secure and protect our proprietary rights.***

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

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

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***We may be subject to claims that our intellectual property infringes upon the proprietary rights of others, and a successful claim could harm our ability to sell and develop our products.***

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

***If we lose key management personnel, we may not be able to successfully operate our business.***

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

***Any future business acquisitions may disrupt our business, dilute stockholder value or distract management attention.***

As part of our ongoing business strategy, we may consider acquisitions of, or significant investments in, additional businesses that offer or develop products and technologies complementary to our own. Such acquisitions could materially adversely affect our operating results and/or the price of our stock. Acquisitions also entail numerous risks, including:

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

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

***Laws or regulations that govern the consumer electronics industry, the telecommunications industry, copyrighted works or the internet could expose us to legal action if we fail to comply or could require us to change our business.***

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

- Federal Communications Commission regulations relating to the electronic emissions of consumer products;
- Federal Communications Commission regulations relating to consumer products that connect to the public telephone network;

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federal export regulations relating to the export of sensitive computer technologies such as encryption and authentication software.

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

***Our stock may be subject to the requirements for penny stocks, which could adversely affect your ability to sell and the market price of our shares.***

Our stock may fit the definition of a penny stock. The Securities and Exchange Act of 1934 defines a penny stock as any equity security that is not traded on a national securities exchange or authorized for quotation on The NASDAQ National Market and that has a market price of less than $5.00 per share, with certain exceptions. Penny stocks are subject to Rule 15g under the Securities and Exchange Act of 1934, which imposes additional sales practice requirements on broker-dealers who sell such securities. In general, a broker-dealer, prior to a transaction in a penny stock, must deliver a standardized risk disclosure document that provides information about penny stocks and the risks in the penny stock market. The broker-dealer must provide the customer with current bid and offer quotations for the penny stock, information about the commission payable to the broker-dealer and its salesperson in the transaction and monthly statements that disclose recent price information for each penny stock in the customer s account. Finally, prior to any transaction in a penny stock, the broker-dealer must make a special written suitability determination for the purchaser and receive the purchaser s written consent to the transaction prior to sale. All of these requirements may restrict your ability to sell our stock and could limit the trading volume of our stock and adversely affect the price investors are willing to pay for our stock.

***Our quarterly operating results may fluctuate significantly, which may adversely affect the market prices of our stock and could lead to us becoming the target of costly securities class action litigation.***

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

consumer awareness and demand for Beamer;

ongoing demand and supply for Beamer;

seasonality and other consumer and advertising trends;

changes in the economic terms of our relationships with our strategic partners;

shortfalls in the supply of components necessary for the manufacture of our products;

changes in our pricing policies, the pricing policies of our competitors and general pricing trends in the consumer electronics market;

unanticipated shortfalls in revenue due to the fact that our expenses precede associated revenues;

changes in estimates of our financial performance or changes in recommendations by securities analysts;

release of new or enhanced products or services or introduction of new marketing initiatives by us or our competitors;

announcements by us or our competitors of the creation or termination of significant strategic partnerships, joint ventures, significant contracts, or acquisitions;

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the market price generally for consumer electronics and retail industry stocks;

market conditions affecting the consumer electronics industry;

additions or departures of key personnel;

demand for and consumer acceptance of other anticipated future products offerings; and

general economic conditions.

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

***Seasonal trends may cause our quarterly operating results to fluctuate, which may adversely affect the market price of our stock.***

Domestic consumer electronic product sales have traditionally been much higher during the holiday shopping season than during other times of the year. Although predicting consumer demand for Beamer and any future products will be very difficult, we believe that sales of Beamer will be higher during the holiday shopping season when compared to other times of the year. We believe we have adequate capital to continue to operate for the 12-month period ending December 31, 2003. However, if we are unable to generate sufficient revenues during the 2003 holiday shopping season, or any future season, we may not be able to continue our business

***Our historical financial information may not be representative of our future operating results as a separate company.***

Our historical financial information does not necessarily reflect what our financial position, operating results and cash flows would have been had we been a stand-alone entity during the periods presented. In addition, our historical information is not necessarily indicative of what our operating results, financial position and cash flows will be in the future.

***Conflicts of interest may arise because our Chairman is also the Chairman of ESS and both he and another director own securities of both companies.***

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

***Our agreement to indemnify ESS for tax liabilities under certain circumstances may affect our cash flow, discourage potential acquisition proposals or delay or prevent a change in control of us, and limit the size of any future offerings of our stock.***

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

***ESS submitted a request to the Internal Revenue Service (IRS) to rule that its distribution of our shares to ESS shareholders was tax-free. The IRS determined that it would not provide such a ruling.***

The IRS decision not to provide a ruling on the distribution does not mean that the distribution is taxable. We believe that the distribution is tax-free. ESS has advised us that they intend to report the distribution as tax-free in its federal income tax filings. ESS has also advised us that it is seeking an opinion from its tax advisors that the distribution is tax-free. No assurance can be given that such an opinion will be obtained or the level of assurance such opinion will provide.

Even if such an opinion is obtained, no assurance can be given that the IRS will not determine at a later date that the distribution is taxable. If the IRS determines that the distribution is taxable, recipients of our stock in distribution may be required to pay income taxes as a result of the distribution, with the amount of ordinary income and gain dependent upon the value of the stock they received and their share of ESS earnings and profits. Determining whether or not the distribution will qualify for tax-free status requires a complex analysis of many factors, including, among others, the business purpose for the distribution, the nature of the business to be engaged in by ESS and us following the distribution, and the extent to which ESS remains in control of us following the distribution. Because of the fact-intensive nature of this analysis, there will be substantial uncertainty as to whether the distribution will qualify for tax-free treatment.

ACCORDINGLY, WE CANNOT ASSURE RECIPIENTS OF OUR STOCK IN THE DISTRIBUTION THAT THE IRS WILL NOT SUCCESSFULLY ASSERT THAT THE DISTRIBUTION IS TAXABLE. IN ADDITION, SUCH RECIPIENTS MAY BE TAXED BY THE STATE, LOCAL OR FOREIGN JURISDICTION IN WHICH THEY RESIDE. ACCORDINGLY, ALL RECIPIENTS OF OUR STOCK IN THE DISTRIBUTION ARE STRONGLY URGED TO CONSULT WITH THEIR OWN FINANCIAL ADVISORS REGARDING THE POTENTIAL TAX IMPACT TO THEM OF THE DISTRIBUTION AND TO PREPARE FOR THE SIGNIFICANT POSSIBILITY THAT THE TRANSACTION WILL BE TAXABLE TO THEM.

If the distribution is taxable to them, the value of the shares they received will be treated as taxable ordinary income, return of cost or as taxable capital gain up to the value of the stock distributed. If the distribution is taxable, they will incur this tax whether or not they decide to sell the shares they receive in the distribution. Unless a recipient of shares in the distribution is required to make quarterly estimated tax payments to the IRS, this tax would generally have to be paid on or before the April 15, 2002 due date for the 2001 tax return. If such recipients do not have the cash available to pay the tax at or before the time it is due, they may have to sell all or a portion of their shares of our stock to pay the tax or risk incurring interest and penalties imposed by the IRS. If holders of a significant percentage our stock are also forced to sell in order to pay their taxes, or if there is for any other reason, a decline in the trading price of our shares following the distribution, recipients of our stock in the distribution may have to sell their shares of our stock at a lower price than they might otherwise have obtained.

***Provisions in our charter documents and Delaware law may delay or prevent acquisition of us, which could decrease the value of our shares.***

Our amended and restated certificate of incorporation, amended and restated bylaws and Delaware law contain provisions that could make it more difficult for a third party to acquire us without the consent of our board of directors. Delaware law also imposes some restrictions on mergers and other business combinations between us and any holder of 15% or more of our outstanding shares. Although we believe these provisions provide for an opportunity to receive a higher bid by requiring potential acquirers to negotiate with our board of directors, these provisions apply even if the offer may be considered beneficial by some stockholders.

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**Item 7a:** ***Quantitative and Qualitative Disclosure About Market Risk***

*Interest Rate Risks.* We invest in short-term investments. Consequently, we are exposed to fluctuation in interest rates on these investments. Increases or decreases in interest rates generally translate into decreases and increases in the fair value of these investments. In addition, the credit worthiness of the issuer, relative values of alternative investments, the liquidity of the instrument, and other general market conditions may affect the fair values of interest rate sensitive investments. In order to reduce the risk from fluctuation in rates, we invest in highly liquid governmental notes and bonds with contractual maturities of less than two years. All of the investments have been classified as available for sale, and at December 31, 2002, are recorded at market values.

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

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**Item 8:** ***Financial Statements and Supplementary Data***

The following documents are filed as part of this Report:

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**REPORT OF INDEPENDENT ACCOUNTANTS**

To the Board of Directors and Stockholders of Vialta, Inc.:

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of operations, of redeemable convertible preferred stock and stockholders equity and of cash flows present fairly, in all material respects, the financial position of Vialta, Inc. (a development stage company) and its subsidiaries at December 31, 2002 and 2001, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002 and for the period from April 20, 1999 (date of inception) through December 31, 2002, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company s management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with auditing standards generally accepted in the United States of America, which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

PricewaterhouseCoopers LLP

San Jose, California
February 21, 2003

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**VIALTA, INC.**

**(A Development Stage Company)**

**CONSOLIDATED BALANCE SHEETS**

| | December 31, 2002 | December 31, 2001 |
|---|---|---|
| | (In thousands, except per share amounts) | |
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 21,863 | $ 61,886 |
| Short-term investments | 10,838 | 5,542 |
| Accounts receivable, net | 1,362 | |
| Inventories | 2,834 | |
| Prepaid expenses and other current assets | 1,253 | 2,989 |
| Total current assets | 38,150 | 70,417 |
| Property and equipment, net | 2,132 | 7,831 |
| Long term investments | | 4,064 |
| Content licenses | | 1,342 |
| Other assets | 45 | 212 |
| Total assets | $ 40,327 | $ 83,866 |
| **LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 1,164 | $ 760 |
| Accrued expenses and other current liabilities | 3,555 | 2,712 |
| Deferred profit | 3,230 | 115 |
| Total current liabilities | 7,949 | 3,587 |
| Commitments (Notes 15 and 16) | | |
| Redeemable convertible preferred stock, $0.001 par value; 30,000 shares authorized, no shares issued and outstanding | | |
| Stockholders equity: | | |
| Common stock, $0.001 par value, 400,000 shares authorized, 93,961 and 92,473 shares issued, 82,756 and 85,625 shares outstanding | 94 | 92 |
| Additional paid-in capital | 144,105 | 144,164 |
| Treasury stock | (9,163) | (4,046) |
| Deficit accumulated during the development stage | (102,666) | (60,087) |
| Accumulated other comprehensive income | 8 | 156 |
| Total stockholders equity | 32,378 | 80,279 |
| Total liabilities, redeemable convertible preferred stock and stockholders equity | $ 40,327 | $ 83,866 |

The accompanying notes are an integral part of these consolidated financial statements.

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**VIALTA, INC.**

**(A Development Stage Company)**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

| | Years Ended December 31, | | | Period from April 20, 1999 (Date of Inception) through December 31, |
|---|---|---|---|---|
| | 2002 | 2001 | 2000 | 2002 |
| | (In thousands, except per share amounts) | | | |
| Operating expenses: | | | | |
| Product costs | $ 10,421 | $ | $ | $ 10,421 |
| Research and development | 13,264 | 25,250 | 19,558 | 59,441 |
| Amortization and impairment of content licenses | 11,395 | | | 11,395 |
| Sales and marketing | 3,100 | 3,738 | 2,927 | 10,427 |
| General and administrative | 5,643 | 9,301 | 6,699 | 22,153 |
| Operating loss | (43,823) | (38,289) | (29,184) | (113,837) |
| Interest income, net | 1,244 | 3,606 | 7,688 | 13,050 |
| Other expense | | (1,266) | (1,682) | (2,939) |
| Loss before income tax benefit | (42,579) | (35,949) | (23,178) | (103,726) |
| Income tax benefit | | | 260 | 1,060 |
| Net loss | $(42,579) | $(35,949) | $(22,918) | $(102,666) |
| Net loss per share: | | | | |
| Basic and diluted | $ (0.51) | $ (0.83) | $ (3.68) | $ (2.83) |
| Weighted average common shares outstanding: | | | | |
| Basic and diluted | 83,578 | 43,248 | 6,222 | 36,311 |

The accompanying notes are an integral part of these consolidated financial statements.

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**VIALTA, INC.**

**(A Development Stage Company)**

**CONSOLIDATED STATEMENTS OF REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY**

| | Redeemable Convertible Preferred Stock | | Common Stock (See Note 8) | | Additional Paid in Capital | Receivable from Stockholders | Treasury Stock | Deficit Accumulated During the Development Stage | Accumulated Other Comprehensive Income | Total Stockholders Equity (Deficit) | Comprehensive Loss |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | | | | | | | |
| | | | | | | (In thousands) | | | | | |
| Issuance of common stock, at $0.25 per share | | $ | 6,220 | $ 6 | $ 1,549 | $ | $ | $ | $ | $ 1,555 | |
| Issuance of Series A redeemable convertible preferred stock, at $0.25 per share in September 1999 | 40,000 | 10,000 | | | | | | | | | |
| Issuance of Series B redeemable convertible preferred stock, at $2.60 per share in December 1999 | 40,300 | 104,780 | | | | | | | | | |
| Issuance of note receivable in connection with issuance of common stock | | | | | | (1,475) | | | | (1,475) | |
| Net loss | | | | | | | | (1,220) | | (1,220) | $ (1,220) |
| Balance at December 31, 1999 | 80,300 | 114,780 | 6,220 | 6 | 1,549 | (1,475) | | (1,220) | | (1,140) | |
| Issuance of Series B redeemable convertible preferred stock, at $2.60 per share | 10,700 | 27,820 | | | | | | | | | |
| Exercise of stock options | | | 11 | | 3 | | | | | 3 | |
| Income tax benefit on disqualified disposition of stock options | | | | | 77 | | | | | 77 | |
| Repayment of note receivable from stockholder | | | | | | 1,475 | | | | 1,475 | |
| Net loss | | | | | | | | (22,918) | | (22,918) | $ (22,918) |
| Balance at December 31, 2000 | 91,000 | 142,600 | 6,231 | 6 | 1,629 | | | (24,138) | | (22,503) | |
| Exercise of stock options before recapitalization | | | 61 | | 16 | | | | | 16 | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Conversion of preferred stock to common stock A | (60,000) | (62,000) | 60,000 | 60 | 61,940 | | 62,000 |
| Conversion of preferred stock to common stock B | (31,000) | (80,600) | 34,100 | 34 | 80,566 | | 80,600 |
| Conversion of common stock to Common B | | | 589 | 1 | (1) | | |
| Shares transferred by ESS Technology, Inc. at spin-off | | | (612) | | | | |
| Return of common stock reserved for issuance upon exercise of stapled options | | | (9,840) | (10) | 10 | | |
| Exercise of stapled stock options | | | 1,312 | 1 | (1) | | |
| Exercise of stock options | | | 20 | | 5 | | 5 |
| Repurchase of common stock | | | (6,236) | | | (4,046) | (4,046) |

The accompanying notes are an integral part of these consolidated financial statements.

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**VIALTA, INC.**

**(A Development Stage Company)**

**CONSOLIDATED STATEMENTS OF REDEEMABLE CONVERTIBLE PREFERRED STOCK AND STOCKHOLDERS EQUITY (CONTINUED)**

| | Redeemable Convertible Preferred Stock | | Common Stock (See Note 8) | | Additional | Receivable | | Deficit Accumulated During the | Accumulated Other | Total Stockholders | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Paid in Capital | from Stockholders | Treasury Stock | Development Stage | Comprehensive Income | Equity (Deficit) | Comprehensive Loss |
| | | | | | (In thousands) | | | | | | |
| Components of comprehensive loss: | | | | | | | | | | | |
| Net loss | | $ | | $ | $ | $ | $ | $ (35,949) | $ | $ (35,949) | $ (35,949) |
| Unrealized gains on available-for- sale investments | | | | | | | | | 156 | 156 | 156 |
| Total comprehensive loss | | | | | | | | | | | $ (35,793) |
| Balance at December 31, 2001 | | | 85,625 | 92 | 144,164 | | (4,046) | (60,087) | 156 | 80,279 | |
| Shares transferred to ESS Technology, Inc. | | | 612 | | | | | | | | |
| Exercise of stapled stock options | | | 1,419 | 1 | (1) | | | | | | |
| Exercise of stock options | | | 69 | 1 | 19 | | | | | 20 | |
| Repurchase of common stock | | | (4,969) | | | | (5,117) | | | (5,117) | |
| Income tax benefit on disqualified disposition of stock options | | | | | (77) | | | | | (77) | |
| Components of comprehensive loss: | | | | | | | | | | | |
| Net loss | | | | | | | | (42,579) | | (42,579) | $ (42,579) |
| Unrealized losses on available-for- sale investments | | | | | | | | | (148) | (148) | (148) |
| Total comprehensive loss | | | | | | | | | | | $ (42,727) |
| Balance at December 31, 2002 | | $ | 82,756 | $ 94 | $ 144,105 | $ | $ (9,163) | $ (102,666) | $ 8 | $ 32,378 | |

The accompanying notes are an integral part of these consolidated financial statements.

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**VIALTA, INC.**

**(A Development Stage Company)**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

| | Years Ended December 31, | | | Period from April 20, 1999 (Date of Inception) through December 31, |
|---|---|---|---|---|
| | 2002 | 2001 | 2000 | 2002 |
| | (In thousands) | | | |
| Cash flows from operating activities: | | | | |
| Net loss | $(42,579) | $ (35,949) | $ (22,918) | $(102,666) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | | | |
| Depreciation and amortization | 6,036 | 5,834 | 3,887 | 15,695 |
| Amortization and impairment of content license fees | 11,395 | | | 11,395 |
| Write-down of investments | | 1,083 | 1,667 | 2,750 |
| Changes in assets and liabilities: | | | | |
| Accounts receivables, net | (1,362) | | | (1,362) |
| Related party receivables/payables, net | 97 | 646 | (919) | 33 |
| Inventories | (2,834) | 2,057 | (2,057) | (2,834) |
| Prepaid expense and other assets | 1,672 | 1,335 | (4,244) | (1,298) |
| Deferred profit | 3,115 | 115 | | 3,230 |
| Accounts payable and accrued liabilities | 1,137 | (122) | 2,940 | 4,686 |
| Net cash flows used in operating activities | (23,323) | (25,001) | (21,644) | (70,371) |
| Cash flows from investing activities: | | | | |
| Purchase of short-term investments | (32,277) | (15,988) | (98,444) | (169,053) |
| Proceeds from sales of short-term investments | 30,897 | 33,650 | 93,676 | 158,223 |
| Purchase of other long-term investment | | (2,100) | (4,000) | (6,100) |
| Purchase of content licenses | (10,053) | (1,342) | | (11,395) |
| Acquisition of property and equipment | (170) | (2,686) | (10,008) | (14,477) |
| Net cash flows provided by (used in) investing activities: | (11,603) | 11,534 | (18,776) | (42,802) |
| Cash flows from financing activities: | | | | |
| Proceeds from (repayment) of notes payable to related party | | (30,000) | 30,000 | |
| Issuance of preferred stock | | | 27,820 | 142,600 |
| Issuance of common stock | 20 | 21 | 1,478 | 1,599 |
| Repurchase of common stock | (5,117) | (4,046) | | (9,163) |
| Net cash flows provided by (used in) financing activities: | (5,097) | (34,025) | 59,298 | 135,036 |
| Net increase (decrease) in cash and cash equivalents | (40,023) | (47,492) | 18,878 | 21,863 |
| Cash and cash equivalents, beginning of the period | 61,886 | 109,378 | 90,500 | |
| Cash and cash equivalents, end of the period | $ 21,863 | $ 61,886 | $109,378 | $ 21,863 |

| | | | | |
|---|---|---|---|---|
| Supplemental disclosure of cash flow information: | | | | |
| Unrealized gains (losses) on available-for-sale investments | $ (148) | $ 156 | $ | $ 8 |
| Cash paid for interest | $ | $ 194 | $ | $ 194 |
| Supplemental disclosure of noncash financing activity: | | | | |
| Issuance of notes receivable in connection with issuance of common stock | $ | $ | $ 1,475 | $ 1,475 |

The accompanying notes are an integral part of these financial statements.

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements**

**Note 1 The Company**

Vialta, Inc. was incorporated in California in April 1999 and reincorporated in the State of Delaware in May 2001.

Vialta designs, develops and markets consumer electronics products. The Company has recently developed and introduced a personal videophone, known as Beamer . Beamer adds color video to phone calls, enabling Beamer users to see the person they are calling. Beamer works with any home phone over any standard (analog) home phone line, and at no additional cost to a regular phone call. Beamers are primarily sold in pairs, since the party receiving the video call must also have a Beamer (or compatible videophone). In addition to Beamer, the Company has developed a multimedia DVD player (ViDVD) that offers additional features such as CD, MP3 and karaoke disc playback, Internet connectivity and the ability to view digital photographs. The Company is not marketing ViDVD.

**Note 2 Summary of Significant Accounting Policies**

***Use of Estimates***

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

***Principles of Consolidation***

The consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany accounts and transactions have been eliminated in consolidation.

***Cash Equivalents and Investments***

Vialta considers all highly liquid investments with an initial maturity of 90 days or less to be cash equivalents. Cash equivalents primarily represent money market funds.

Short-term and long-term investments are comprised primarily of debt instruments that have been classified as available-for-sale. Management determines the appropriate classification of securities at the time of purchase and re-evaluates the classification at each reporting date. Marketable equity and debt securities are carried at their fair market value based on quoted market prices as of the balance sheet date. Realized gains or losses are determined on the specific identification method and are reflected in income. Net unrealized gains or losses are recorded directly in stockholders equity except those unrealized losses that are deemed to be other than temporary, which are reflected in investment losses.

***Fair Value of Financial Instruments***

The reported amounts of certain of Vialta s financial instruments, including cash and cash equivalents, short and long-term investments, accounts receivable, and accounts payable approximated fair value due to their short maturities.

***Inventories***

Inventories are stated at the lower of cost or market, with cost being determined by the first-in, first-out method.

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

***Property and Equipment***

Property and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is generally computed using the straight-line method over the estimated useful lives of the assets.

| | |
|---|---|
| Computer equipment | 3-5 years |
| Furniture and fixtures | 5 years |
| Software and web site development costs | 1-3 years |

Repairs and maintenance costs are expensed as incurred.

***Long-Lived Assets***

Vialta reviews long-lived assets based upon an undiscounted cash flow basis and will record an impairment whenever events or changes in circumstances indicate the carrying amount of the assets may not be fully recoverable. If an asset is considered impaired, the asset is written down to carrying value based on undiscounted cash flows.

***Comprehensive Income (Loss)***

Comprehensive income (loss), as defined, includes all changes in equity during a period from non-owner sources. Comprehensive loss is disclosed in the consolidated statements of redeemable preferred stock and stockholders equity.

***Revenue Recognition***

Vialta generally recognizes revenue on products sold to end customers upon shipment provided that Vialta has no post-sale obligations, can reliably estimate and accrue warranty and sales returns, the price is fixed or determinable and collection of the resulting receivable is reasonably assured. For sales to end customers that do not meet the above criteria, revenue is deferred until such criteria are met.

Products sold to retailers and distributors are subject to rights of return. Subject to the Company s warranty reserve, it defers recognition of revenue on products sold to retailers and distributors until the products are sold by the retailers and distributors to their customers.

***Allowances for Sales Return***

Allowances are provided for estimated returns. Provision for return allowances will be recorded at the time when revenue is recognized based on historical returns, current economic trends and changes in customer demand. Such allowances will be adjusted periodically to reflect actual and anticipated experience. As of December 31, 2002, Vialta did not have sufficient history and experience with respect to sales returns. As a result, the Company did not recognize any revenues on sales of Beamer pending the expiration of the warranty period.

***Warranty***

Vialta provides a limited warranty on its products for periods ranging from 90 days to 12 months from the date of sale to the end customers. The Company will estimate warranty costs based on historical experience and will accrue for estimated costs as a charge to cost of sales when revenue is recognized. Through December 31, 2002, the Company did not recognize revenue. A key factor in the decision not to recognize revenue is that as of December 31, 2002, the Company did not have sufficient history to reasonably estimate warranty costs as the warranty period has not lapsed from the Company s first significant shipments.

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

***Research and Development***

Research and development costs are expensed as incurred.

***Advertising Costs***

Advertising production costs are expensed as incurred. Total advertising and promotional expenses were approximately $430,000 for the year ended December 31, 2002 and were not material for the years ended December 31, 2001 and 2000.

***Income Taxes***

Vialta accounts for income taxes under the asset and liability approach that requires the recognition of deferred tax liabilities and assets for the expected future tax consequences of timing differences between the carrying amounts and the tax bases of assets and liabilities.

***Foreign Currency Translation***

The functional currencies of the Company s foreign subsidiaries are the local currencies. Accordingly, all assets and liabilities of the foreign operations are translated to U.S. dollars at current period end exchange rates, and revenues and expenses are translated to U.S. dollars using average exchange rates in effect during the period. Currency transaction and translation gains and losses have not been significant.

***Net Income (Loss) Per Share***

Basic net income (loss) per share excludes dilution and is computed by dividing net income (loss) by the weighted average number of common shares outstanding for the period. Diluted net income per share reflects the potential dilution that would occur if securities or other contracts to issue common stock were exercised or converted into common stock.

***Stock-Based Compensation***

Vialta accounts for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, or APB No. 25, Accounting for Stock Issued to Employees. Under APB No. 25, compensation cost is measured as the excess, if any, of the quoted market price of its stock at the date of grant over the exercise price of the option granted. Compensation cost for stock options, if any, is recognized ratably over the vesting period. Vialta provides additional pro forma disclosures as required under SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure .

SFAS No. 148 amends SFAS No. 123 in December 2002 to require that disclosures of the pro forma effect of using the fair value method of accounting for stock-based employee compensation be displayed more prominently and in a tabular format. The following table illustrates the effect on Vialta s net loss and net loss

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

per share if Vialta had recorded compensation costs based on the estimated grant date fair value as defined by SFAS No. 123 for all granted stock-based awards (in thousands, except per share amounts).

| | Years Ended December 31, | | | Period from April 20, 1999 (Date of Inception) through December 31, |
|---|---|---|---|---|
| | 2002 | 2001 | 2000 | 2002 |
| Net loss, as reported | $(42,579) | $(35,949) | $(22,918) | $(102,666) |
| Deduct: Stock-based employee compensation expense determined under fair value based method for all awards | (3,208) | (6,335) | (158) | (9,706) |
| Pro forma net loss | $(45,787) | $(42,284) | $(23,076) | $(112,372) |
| Net loss per share basic and diluted: | | | | |
| As reported | $ (0.51) | $ (0.83) | $ (3.68) | $ (2.83) |
| Pro forma | $ (0.55) | $ (0.98) | $ (3.71) | $ (3.10) |

***Reclassification***

The Company has reclassified certain prior years information to conform to the current financial statement.

***Recent Accounting Pronouncements***

In June 2002, the Financial Accounting Standards Board, or FASB, issued SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities. SFAS No. 146 addresses financial accounting and reporting for costs associated with exit or disposal activities and nullifies EITF Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). This Statement requires that a liability for costs associated with an exit or disposal activity be recognized and measured initially at fair value only when the liability is incurred. SFAS No. 146 is effective for exit or disposal activities initiated after December 31, 2002. The Company s adoption of SFAS No. 146 did not have a material effect on its consolidated financial statements.

In November 2002, the FASB issued Interpretation No. 45, ( FIN No. 45 ) Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN No. 45 requires that a liability be recorded in the guarantor s balance sheet upon issuance of a guarantee. In addition, FIN No. 45 requires disclosures about the guarantees that an entity has issued, including a reconciliation of changes in the entity s product warranty liabilities. The initial recognition and initial measurement provisions of FIN No. 45 are applicable on a prospective basis to guarantees issued or modified after December 31, 2002, irrespective of the guarantor s fiscal year-end. The disclosure requirements of FIN No. 45 are effective for financial statements of interim or annual periods ending after December 15, 2002. The Company does not expect its adoption of FIN 45 to have a material impact on its consolidated financial statements.

In January 2003, the FASB issued Interpretation No. 46 ( FIN No. 46 ) Consolidation of Variable Interest Entities. Until this interpretation, a company generally included another entity in its consolidated financial statements only if it controlled the entity through voting interests. FIN No. 46 requires a variable interest entity to be consolidated by a company if that company is subject to a majority of the risk of loss from

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

the variable interest entity s activities or entitled to receive a majority of the entity s residual returns. The Company does not expect its adoption of FIN 46 to have a material impact on its consolidation financial statements.

**Note 3 Risks and Uncertainties**

Since its inception, Vialta has been in the development stage and has incurred losses of approximately $102.7 million and cumulative negative cash flows from operations of $70.4 million. Management expects operating losses and negative cash flows to continue for the foreseeable future and anticipates that losses may increase from current levels because of additional costs and expenses related to marketing activities, expansion of operations, expansion of product offerings and development of relationships with other businesses. Management believes that Vialta has sufficient cash, cash equivalents and short-term investments to fund its operations through December 31, 2003. However, in the longer term, failure to generate sufficient revenues, raise additional capital or reduce spending would have a material adverse effect on Vialta s ability to achieve its intended business objectives.

Vialta operates in a single business segment that is characterized by rapid technological advances, changes in customer requirements and evolving industry standards. Any failure by Vialta to anticipate or respond to changes in demand could have a material adverse effect on its business and operating results.

Certain of the Company s products contain critical components supplied by a single or a limited number of third parties. The Company has been required to purchase and inventory certain of the components around which it designs its products to ensure an available supply of products for customers. Any significant shortage of critical components or the failure of the third party suppliers to maintain or enhance these products could materially adversely affect the Company s results of operations.

Currently, the Company relies on a single third party to manufacture its products. Reliance on third-party manufacturers involves a number of risks, including the lack of control over the manufacturing process and the potential absence or unavailability of adequate capacity. If the Company s third party manufacturer cannot or will not manufacture its products in required volumes, on a cost-effective basis, in a timely manner, or at all, the Company will have to secure additional manufacturing capacity. Even if the additional capacity is available at commercially acceptable terms, the qualification process could be lengthy and could cause interruptions in product shipments.

Four customers comprise 72% of Vialta s gross accounts receivable balance of $1.4 million at December 31, 2002. Each of these customers represents between 11% and 26% of total accounts receivable.

**Note 4 Revenue Recognition**

***Beamer***

Vialta did not have significant shipments of Beamer until the quarter ended December 31, 2002. For most of the shipments, the standard warranty period had not been completed as of December 31, 2002. Due to limited history of warranty and sales returns, Vialta did not recognize revenues through December 31, 2002. Vialta deferred revenue on Beamer shipments of $3.2 million (the costs for which were expensed in prior periods) as of December 31, 2002, the majority of which is expected to be recognized during the quarter ending March 31, 2003.

***ViDVD***

Starting in 2001, Vialta began to market ViDVD. Through December 31, 2002, shipments on ViDVD products were not significant. As of December 31, 2002, Vialta had discontinued marketing ViDVD.

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

**Note 5 Content Licenses**

During 2002 and 2001,Vialta entered into licensing agreements with various entertainment content providers in connection with ViMagazine, a proprietary, encrypted, magazine-style DVD-format disk, which was designed to contain a wide variety of entertainment that can be used exclusively with ViDVD products. Starting in January 2002, Vialta amortized prepaid content licenses based on the greater of the royalty amounts due or amortization on a straight-line basis over an estimated life of three years. In December 2002 the Company concluded that content licenses had suffered a permanent decline in value, as a result of its decision not to market ViMagazine, and the remaining unamortized balance was written down to zero. The total amortization and impairment charge on content licenses recognized by Vialta during the year ended December 31, 2002 was $11.4 million.

**Note 6 Inventories**

Because of uncertainties regarding realization of the costs, Vialta expensed $10.4 million of inventory costs for Beamer through September 30, 2002. The Company began capitalizing its inventory costs for Beamer in the fourth quarter of 2002 because the Company experienced an increase in shipments. The following table summarizes the activities of inventories and the related reserves (in thousands):

| | ViDVD and Other | | | Beamer | | |
|---|---|---|---|---|---|---|
| | Gross | Reserve | Net | Gross | Reserve | Net |
| Purchase of inventories from April 20, 1999 (date of inception) through December 31, 2001 | $ 8,973 | $ (8,973) | $ | $ | $ | $ |
| As of December 31, 2001 | 8,973 | (8,973) | | | | |
| Purchase of inventories | | | | 10,421 | (10,421) | |
| Use or disposal of inventories | (2,089) | 2,089 | | | | |
| Shipments for which revenues were deferred | | | | (163) | 163 | |
| As of September 30, 2002 | 6,884 | (6,884) | | 10,258 | (10,258) | |
| Purchase of inventories | | | | 2,834 | | 2,834 |
| Use or disposal of inventories | (1,731) | 1,731 | | (408) | 408 | |
| ViDVD parts transferred to Beamer inventories | (835) | 835 | | 835 | (835) | |
| Shipments for which revenues were deferred | | | | (1,653) | 1,653 | |
| As of December 31, 2002 | $ 4,318 | $ (4,318) | $ | $ 11,866 | $ (9,032) | $ 2,834 |
| Raw materials | $ 4,255 | $ (4,255) | $ | $ 6,026 | $ (3,791) | $ 2,235 |
| Finished goods | 63 | (63) | | 5,840 | (5,241) | 599 |
| | $ 4,318 | $ (4,318) | $ | $ 11,866 | $ (9,032) | $ 2,834 |

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

**Note 7 Other Balance Sheet Components:**

| | December 31, | |
|---|---|---|
| | 2002 | 2001 |
| | (In thousands) | |
| **Short-term and long-term investments:** | | |
| U.S. Government debt securities | $ 1,509 | $ 4,274 |
| Corporate debt securities | 9,329 | 5,332 |
| | 10,838 | 9,606 |
| Due between one and two years | | 4,064 |
| Due within one year | $ 10,838 | $ 5,542 |
| **Accounts receivable, net:** | | |
| Accounts receivable | $ 1,392 | $ 665 |
| Less: Allowance for doubtful accounts | (30) | (665) |
| | $ 1,362 | $ |
| **Prepaid expenses and other current assets:** | | |
| Advances to subcontractors | $ 429 | $ 2,004 |
| Receivables from a related party | | 64 |
| Other current assets | 824 | 921 |
| | $ 1,253 | $ 2,989 |
| **Property and equipment, net:** | | |
| Machinery and equipment | $ 7,155 | $ 7,149 |
| Furniture and fixtures | 569 | 607 |
| Software and web site development cost | 5,173 | 6,663 |
| | 12,897 | 14,419 |
| Less: Accumulated depreciation | (10,765) | (6,588) |
| | $ 2,132 | $ 7,831 |

Depreciation expense was approximately $5.9 million, $3.6 million and $3.9 million for the years ended December 31, 2002, 2001 and 2000, respectively.

| | | |
|---|---|---|
| **Accrued expenses and other current liabilities:** | | |
| Accrued compensation costs | $1,613 | $2,440 |
| Customer deposits | 893 | |
| Accrued facility charges | 402 | |
| Payables to a related party | 33 | |

| | | |
|---|---|---|
| Other current liabilities | 614 | 272 |
| | $3,555 | $2,712 |

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

**Note 8 Spin-Off and Recapitalization of Equity**

Prior to August 21, 2001, Vialta was a subsidiary of ESS Technology, Inc. ( ESS ). On July 24, 2001, Vialta was re-capitalized, pursuant to which it separated its common stock into Class A common stock with 3.8 votes per share and Class B common stock with one vote per share. Upon exchange of 5,892,000 shares of common stock for Class B common stock, Vialta issued 589,000 additional shares of Class B common stock to non-ESS common stockholders. Except for the voting power, Class A and Class B stockholders had the same rights. Vialta authorized 30,000,000 shares of preferred stock and 400,000,000 shares of common stock, 100,000,000 shares of which are designated Class A common stock, 50,000,000 of which are designated Class B common stock and 250,000,000 of which are designated non-classified common stock.

As part of the August 21, 2001 spin-off transaction, all preferred stock owned by ESS converted to Class A common stock based on a conversion ratio of 1 to 1. All other preferred stock converted to Class B common stock at a ratio of 1 to 1.1. As a result, 91,000,000 shares of preferred stock were converted to 60,000,000 shares of Class A common stock and 34,100,000 shares of Class B common stock.

As part of the spin-off transaction, ESS returned approximately 9,840,000 shares of Class A common stock to Vialta at no cost. These shares are reserved by Vialta for issuance upon exercise of stapled options that were granted by Vialta to ESS optionees as part of the spin-off transaction. In accordance with FIN No. 44, no compensation expense has been or will be recorded in conjunction with these stock option grants.

The table below summarizes the effect of the these conversions of common stock outstanding at December 31, 2001 (in thousands):

| Capital Stock | Preferred Shares | Conversion Ratio | Class A Common Stock | Class B Common Stock | Outstanding Total |
|---|---|---|---|---|---|
| Series A ESS owned | 40,000 | 1 to 1 | 40,000 | | 40,000 |
| Series B ESS owned | 20,000 | 1 to 1 | 20,000 | | 20,000 |
| Series B third party owned | 31,000 | 1.1 to 1 | | 34,100 | 34,100 |
| | 91,000 | | 60,000 | 34,100 | 94,100 |
| Shares returned to Vialta by ESS, reserved for issuance upon exercise of stapled options | | | (9,840) | | (9,840) |
| Additional shares transferred by ESS as part of the spin-off transaction | | | (612) | | (612) |
| Issuance of common stock upon exchange of third party owned common stock for Class B common stock | | | | 589 | 589 |
| Conversion of original common stock to Class A and Class B common stock | | | 400 | 5,892 | 6,292 |
| Total effect of re-capitalization and spin-off transaction on Class A and Class B common stock outstanding | | | 49,948 | 40,581 | 90,529 |

In July 2002, each share of Vialta s outstanding Class A and Class B common stock converted into a single class of common stock in accordance with the provisions of Vialta s Articles of Incorporation. As a result of the above conversion, approximately 53,141,000 shares, including 10,169,000 of shares held by the Company as treasury stock, of issued Class A common stock and approximately 40,580,000 shares of issued Class B common stock were converted into approximately 93,721,000 shares of the non-classified common stock. Holders of the non-classified common stock are entitled to one vote per share on all matters.

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

In November 2002, Vialta returned approximately 612,000 shares to ESS at no cost. These shares were originally returned by ESS to Vialta as part of spin-off transaction in August 2001.

**Note 9 Related Party Transactions**

Prior to the August 21, 2001 spin-off transaction, Vialta was a subsidiary of ESS. The Chairman of Vialta is also the Chairman of ESS. The following is a summary of major transactions between Vialta and ESS (in thousands):

| | Years Ended December 31, | | | Period from April 20, 1999 (Date of Inception) through December 31, |
|---|---|---|---|---|
| | 2002 | 2001 | 2000 | 2002 |
| Net receivables at beginning of period | $ 64 | $ 650 | $ | $ |
| Charges by Vialta to ESS: | | | | |
| Administrative and management service fees | 223 | 98 | | 321 |
| Other | 77 | 74 | 650 | 801 |
| Charges by ESS to Vialta: | | | | |
| Research and development service fees | | (1,895) | (3,077) | (5,205) |
| Administrative and management service fees | (201) | (3,140) | (3,361) | (7,004) |
| Assignment of intellectual property | | | (2,000) | (2,000) |
| Purchase of products | (1,403) | (1,127) | (1,004) | (3,534) |
| Building lease | (1,852) | (640) | | (2,492) |
| Cash receipts from ESS | (424) | (700) | | (1,124) |
| Cash payments made to ESS | 3,483 | 6,744 | 9,442 | 20,204 |
| Net receivables (payables) at end of period | $ (33) | $ 64 | $ 650 | $ (33) |

**Note 10 Net Income (Loss) Per Share**

Basic net loss per share is computed by dividing the net loss for the period by the weighted average number of shares of common stock outstanding during the period. Diluted net loss per share is the same as the basic net loss per share for the periods presented. Potential common equivalent shares outstanding during the periods are excluded from the calculation of diluted net loss as the effect is anti-dilutive.

| | Years Ended December 31, | | | Period from April 20, 1999 (Date of Inception) through December 31, |
|---|---|---|---|---|
| | 2002 | 2001 | 2000 | 2002 |
| | (In thousands, except per share amounts) | | | |
| Net loss | $(42,579) | $(35,949) | $(22,918) | $(102,666) |
| Basic and diluted weighted average common shares outstanding | 83,578 | 43,248 | 6,222 | 36,311 |
| Basic and diluted net loss per share | $ (0.51) | $ (0.83) | $ (3.68) | $ (2.83) |

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

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

| | Years Ended December 31, | | | Period from April 20, 1999 (Date of Inception) through December 31, |
|---|---|---|---|---|
| | 2002 | 2001(1) | 2000 | 2002(1) |
| Effect of common stock equivalents: | | | | |
| Options outstanding | 11,255 | 13,107 | 2,156 | 11,255 |
| Preferred stock outstanding | | 91,000 | 91,000 | |
| Total common stock equivalents excluded | 11,255 | 104,107 | 93,156 | 11,255 |

(1) The dilutive net loss per share calculation excludes the effect of the preferred stock outstanding through July 24, 2001, the date of the re-capitalization. Subsequent to this date, these stocks were included within the weighted basic shares outstanding calculation.

**Note 11 Common Stock and Stock Options**

***Common Stock Repurchases***

In September 2001, the Board of Directors authorized Vialta to repurchase up to 10 million shares of its common stock in the open market. During fiscal 2001, Vialta repurchased a total of 6,236,000 shares of common stock for an aggregate cost of $4.0 million.

In June 2002, the Board of Directors authorized an additional 10 million shares for repurchase. During fiscal 2002, Vialta repurchased a total of 4,969,000 shares of common stock for an aggregate cost of $5.1 million.

From January 1, 2003 through February 21, 2003, Vialta repurchased 716,000 shares of common stock for an aggregate cost of $0.3 million, and 8,079,000 remaining shares are authorized for repurchase.

***1999 Stock Incentive Plan***

In August 1999, the Company adopted the 1999 stock incentive plan. Under the 1999 Plan, the Company s incentive stock options may be granted to its employees, directors, non-employee directors and consultants. The aggregate number of shares reserved for awards under the 1999 Plan shall not exceed 10,000,000 shares. The exercise price of the 1999 Plan shall not be less than 100% of the fair market value (110% for 10 percent shareholders); the exercise price of a non-incentive stock option shall not be less than 85% of the fair market value (110% for 10 percent shareholders). Options shall generally vest over a four-year period.

***2000 Directors Stock Option Plan***

In February 2000, the Company adopted the 2000 Directors Stock Option Plan. Under the 2000 Director Plan, the Company s nonqualified stock options may be granted to nonemployee members of the board of directors of the Company. The aggregate number of shares reserved for issuance is 300,000 shares subject to adjustment as provided in this 2000 Director Plan. Each optionee who becomes a member of the board of

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

directors will automatically be granted an option for 32,000 shares. The exercise price of the option shall be the fair market value at the time the option is granted. Options shall generally vest over a four-year period.

***2001 Non-Statutory Stock Option Plan***

In August 2001, the Company adopted the 2001 non-statutory option plan. Under the 2001 Plan, the Company s non-statutory stock options may be granted to its employees, directors, non-employee directors and consultants. The aggregate number of shares reserved for awards under the 2001 Plan shall not exceed 10,000,000 shares. The exercise price of a non-statutory stock option shall not be less than 85% of the fair market value (110% for 10 percent shareholders). Options shall generally vest over a four-year period.

A summary of the activities in the 1999 Plan, the 2000 Director Plan and the 2001 Plan is as follows:

| | | Options Outstanding | |
|---|---|---|---|
| | Available for Grant | Numbers of Options | Weighted Average Exercise Price |
| Adoption of the 1999 Plan | 10,000,000 | | $ |
| Granted | (1,693,000) | 1,693,000 | 0.26 |
| Cancelled | 60,000 | (60,000) | 0.25 |
| Balance at December 31, 1999 | 8,367,000 | 1,633,000 | 0.26 |
| Adoption of the 2000 Director Plan | 300,000 | | |
| Granted | (903,200) | 903,200 | 1.98 |
| Cancelled | 369,500 | (369,500) | 0.92 |
| Exercised | | (10,500) | 0.25 |
| Balance at December 31, 2000 | 8,133,300 | 2,156,200 | 0.87 |
| Adoption of the 2001 Plan | 10,000,000 | | |
| Granted | (13,640,137) | 13,640,137 | 0.25 |
| Cancelled | 1,296,832 | (1,296,832) | 1.22 |
| Exercised | | (1,392,899) | 0.02 |
| Balance at December 31, 2001 | 5,789,995 | 13,106,606 | 0.29 |
| Granted | (913,957) | 913,957 | 0.85 |
| Cancelled | 1,277,205 | (1,277,205) | 0.79 |
| Exercised | | (1,488,670) | 0.01 |
| Balance at December 31, 2002 | 6,153,243 | 11,254,688 | $0.31 |

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VIALTA, INC.

**Notes To Consolidated Financial Statements (continued)**

The options outstanding and currently exercisable at December 31, 2002 are detailed as follows:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Exercise Price | Number Outstanding | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number Exercisable | Weighted Average Exercise Price |
| $0.00 | 6,353,274 | 5.54 | $ | 3,379,132 | $ |
| $0.25 $0.42 | 2,701,058 | 7.86 | 0.35 | 530,857 | 0.37 |
| $0.47 $1.62 | 1,938,927 | 8.93 | 1.04 | 382,698 | 1.23 |
| $1.95 | 46,731 | 7.12 | 1.95 | 33,938 | 1.95 |
| $2.01 | 214,698 | 6.71 | 2.01 | 144,209 | 2.01 |
| | 11,254,688 | 6.71 | $0.31 | 4,470,834 | $0.23 |

The weighted average fair value of options granted in fiscal years 2002, 2001, 2000, and for period from April 20, 1999 (date of inception) through December 31,1999 was $0.59, $0.90, $0.34 and $0.05, respectively. Options exercisable were 4,470,834, 2,301,642, 150,250 and 0 as of December 31, 2002, 2001, 2000 and 1999, respectively.

***Fair Value Disclosures***

The fair value of each employee stock option grant is estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions:

| | Years Ended December 31, | | | |
|---|---|---|---|---|
| | 2002 | 2001 | 2000 | 1999 |
| Expected dividend yield | 0.00% | 0.00% | 0.00% | 0.00% |
| Risk-free interest rate | 3.50% | 4.45% | 6.25% | 6.25% |
| Expected volatility | 96% | 90% | 0% | 0% |
| Expected life (in years) | 4 | 4 | 4 | 4 |

For the fiscal year ended December 31, 2001, the Company calculated all option grants previous to August 21, 2001 using a 0% volatility and a 90% volatility thereafter, in order to give effect to the spin-off transaction.

The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options, which have no vesting restrictions and are fully transferable. In addition, option-pricing models require the input of highly subjective assumptions, including expected stock price volatility. Because the Company s employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

**Note 12 Income Taxes**

The components of the benefit from income taxes are as follows (in thousands):

| | Years Ended December 31, | | | Period from April 20, 1999 (Date of Inception) through December 31, |
|---|---|---|---|---|
| | 2002 | 2001 | 2000 | 2002 |
| Current: | | | | |
| Federal | $ | $ | $ | $ 707 |
| State | | | 260 | 353 |
| Total benefit from income taxes | $ | $ | $ 260 | $ 1,060 |

There was no federal or state income tax provision in 2002, 2001 and 2000 because the Company s operations resulted in pre-tax losses. The Company filed consolidated federal tax return with ESS in 1999 and a consolidated state tax return with ESS in 2000 and 1999. As a result, ESS realized a tax benefit of $0, $0 and $260,000 for utilizing the Company s net operating losses in 2002, 2001 and 2000, respectively. ESS reimbursed the Company for this tax benefit in accordance with the tax sharing arrangements between ESS and the Company.

A reconciliation between the benefit from income taxes computed at the federal statutory rate of 35% for the years ended December 31, 2002, 2001 and 2000, and for the period from April 20, 1999 (date of inception) through December 31, 2002 and the benefit from income taxes is as follows (in thousands):

| | Years Ended December 31, | | | Period from April 20, 1999 (Date of Inception) through December 31, |
|---|---|---|---|---|
| | 2002 | 2001 | 2000 | 2002 |
| Benefit from income taxes at statutory rate | $ 14,903 | $ 12,584 | $ 7,830 | $ 36,024 |
| State income taxes net of federal tax benefit | 1,971 | 2,066 | 1,032 | 5,162 |
| Other | 359 | 391 | 883 | 1,636 |
| Tax losses not benefited | (17,233) | (15,041) | (9,485) | (41,762) |
| Benefit from income taxes | $ | $ | $ 260 | $ 1,060 |

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**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

Deferred income taxes reflect the net effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and those used for federal and state income tax purposes. Significant components of deferred tax assets for federal and state income taxes are as follows (in thousands):

| | December 31, | |
|---|---|---|
| | 2002 | 2001 |
| Net operating loss carryforwards | $ 26,068 | $ 15,506 |
| Depreciation and amortization | 7,663 | 3,271 |
| Accruals and reserves | 7,456 | 4,563 |
| Federal and state credits carryforward | 1,801 | 1,607 |
| Other | (58) | 751 |
| Gross deferred tax assets | 42,930 | 25,698 |
| Valuation allowance | (42,930) | (25,698) |
| Net deferred tax assets | $ | $ |

Deferred tax assets at December 31, 2002 and 2001 primarily relate to net operating losses, depreciation and amortization, and accruals. Due to the uncertainly surrounding the realization of the deferred tax asset in future tax returns, the Company has established a full valuation allowance against its deferred tax assets. Management evaluates on a periodic basis the recoverability of deferred tax assets and the need for a valuation allowance. At such time as it is determined that it is more likely than not that the deferred tax assets are realizable, the valuation allowance will be reduced.

As at December 31, 2002, Vialta had approximately $69.1 million and $33.0 million of federal and state net operating loss carryforward, respectively. These losses will begin expiring in 2020 and 2007, respectively.

The Company has approximately $800,000 of federal and $900,000 of state research and development tax credits available to offset future tax, respectively. If not utilized, the federal carryforwards will expire in various amounts beginning in 2020. The California credits can be carried forward indefinitely.

Under the Tax Reform Act of 1986, the amounts of benefits from net operating loss and credit carryforwards may be impaired or limited in certain circumstances. Events which cause limitations in the amount of net operating losses and credits that Vialta may utilize in any one year include, but are not limited to, a cumulative ownership change of more than 50%, as defined, over a three-year period. If Vialta should have an ownership change, as defined by tax law, utilization of the carryforwards could be restricted.

**Note 13 Employee Benefit Plans**

In August 2001, the Vialta, Inc. 401(k) Plan was adopted. Under the terms of the 401(k) plan, eligible employees may elect to contribute a portion of their compensation as salary deferral contributions to the 401(k) plan, subject to certain statutorily prescribed limits. The 401(k) plan also permits, but does not require, Vialta to make discretionary matching contributions and discretionary profit-sharing contributions. As a tax-qualified plan, contributions to the 401(k) plan are generally deductible by Vialta when made, and are not taxable to participants until distributed from the 401(k) plan. Under the 401(k) plan, participants may direct the trustees to invest their accounts in selected investment options. Vialta did not make any matching contributions or discretionary profit-sharing contributions in the years ended December 31, 2002, 2001 and 2000 .

**VIALTA, INC.**

**Notes To Consolidated Financial Statements (continued)**

**Note 14 Segment and Geographic Information**

Vialta operates as one segment since its inception on April 20, 1999 through December 31, 2002. As of December 31, 2002 and 2001, long-lived assets held outside the United States of America were not material.

**Note 15 Commitments**

In January 2000, Vialta entered into a non-cancelable lease agreement for its headquarters that will expire in 2003. Under the terms of this and other leases, with various expiration dates through 2006, Vialta s future minimum rental payments are as follows (in thousands):

| Years Ending December 31, | Amounts |
|---|---|
| 2003 | $2,265 |
| 2004 | 349 |
| 2005 | 147 |
| 2006 | 110 |
| | $2,871 |

Rent expense was approximately $1.7 million, $2.1 million and $0.1 million for the years ended December 31, 2002, 2001 and 2000, respectively.

**Note 16 Legal Matters**

From time to time, Vialta is involved in litigation in the normal course of business. The outcome of matters to date will not have material adverse impact on Vialta s consolidated financial position, results of operations or cash flows.

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**Selected Quarterly Operation Results (unaudited):**

The following table presents un-audited quarterly financial information for each of the Company s last eight quarters. This information has been derived from the Company s un-audited financial statements and has been prepared on the same basis as the audited Consolidated Financial Statements appearing elsewhere in this Form 10-K. In the opinion of management, all necessary adjustments, consisting only of normal recurring adjustments, have been included to present fairly the quarterly results (in thousands, except per share amounts).

| | For the Three Months Ended | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | March 31, 2002 | June 30, 2002 | September 30, 2002 | December 31, 2002 | March 31, 2001 | June 30, 2001 | September 30, 2001 | December 31, 2001 |
| Operating expenses: | | | | | | | | |
| Product costs | $ | $ 1,137 | $ 9,284 | $ | $ | $ | $ | $ |
| Research and development | 4,223 | 3,992 | 2,928 | 2,121 | 4,528 | 5,363 | 5,446 | 9,913 |
| Amortization and impairment of content licenses | 253 | 947 | 948 | 9,247 | | | | |
| Sales and marketing | 614 | 732 | 777 | 977 | 995 | 1,163 | 838 | 743 |
| General and administrative | 1,812 | 1,427 | 1,216 | 1,188 | 2,357 | 2,247 | 2,412 | 2,290 |
| Operating loss | (6,902) | (8,235) | (15,153) | (13,533) | (7,880) | (8,773) | (8,696) | (12,946) |
| Interest income, net | 363 | 372 | 330 | 179 | 1,230 | 1,055 | 801 | 520 |
| Other income (expenses) | | (1) | | 1 | (19) | 15 | (1,097) | (165) |
| Loss before income tax benefit | (6,539) | (7,864) | (14,823) | (13,353) | (6,669) | (7,703) | (8,992) | (12,591) |
| Income tax benefit | | | | | | | | |
| Net loss | $ (6,539) | $ (7,864) | $ (14,823) | $ (13,353) | $ (6,669) | $ (7,703) | $ (8,992) | $ (12,591) |
| Net loss per share attributable to common shares basic & diluted | $ (0.08) | $ (0.09) | $ (0.18) | $ (0.16) | $ (1.07) | $ (1.23) | $ (0.13) | $ (0.15) |
| Weighted average common shares outstanding | 85,240 | 83,752 | 82,908 | 83,246 | 6,231 | 6,240 | 70,945 | 86,780 |

**Item 9:** ***Changes In and Disagreements with Accountants on Accounting and Financial Disclosure***

None

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## PART III

Certain information required by Part III is omitted from this Report since the Company plans to file with the Securities and Exchange Commission the definitive proxy statement for its 2003 Annual Meeting of Shareholders (the Proxy Statement ) not later than 120 days after the end of the fiscal year covered by this Report, and certain information included therein is incorporated herein by reference.

**Item 10:** ***Directors and Executive Officers of the Registrant***

The information required by this Item is incorporated by reference in our Proxy Statement, which we will file with the Commission not later than 120 days after our fiscal year-end.

**Item 11:** ***Executive Compensation***

The information required by this Item is incorporated by reference to the sections in our Proxy Statement entitled Executive Compensation, which we will file with the Commission not later than 120 days after our fiscal year-end.

**Item 12:** ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The information required by this Item is incorporated by reference in our Proxy Statement, which we will file with the Commission not later than 120 days after our fiscal year-end.

The following table summarizes information with respect to options under Vialta s equity compensation plans at December 31, 2002:

| | Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights (1) | Weighted Average Exercise Price of Outstanding Options, Warrants and Rights | Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column (a)) |
|---|---|---|---|
| | (a) | (b) | (c) |
| Equity compensation plans approved by security holders | 11,254,688 | $0.31 | 6,153,243 |
| Equity compensation plans not approved by security holders | | | |
| | 11,254,688 | $0.31 | 6,153,243 |

(1) Includes only options outstanding under Vialta s stock option plans, as no stock warrants or rights were outstanding as of December 31, 2002.

**Item 13:** ***Certain Relationships and Related Transactions***

The information required by this Item is incorporated by reference in our Proxy Statement, which we will file with the Commission not later than 120 days after our fiscal year-end.

**Item 14:** ***Controls and Procedures***

(a) *Evaluation of disclosure controls and procedures*. Our Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively) have concluded, based on their evaluation as of a date within 90 days prior to the date of filing of the annual report, that our disclosure controls and procedures are effective to ensure that material information required to be disclosed by

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us in report filed or submitted by us under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time period specified in the SEC s rules and forms, and includes controls and procedures designed to ensure that material information required to be disclosed by us in such reports 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.

(b) *Changes in internal controls.* There have been no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of our evaluation.

## PART IV

**Item 15:** ***Exhibits, Financial Statement Schedules, and Reports on Form 8-K***

(a)(1) **Financial Statements**

See the Consolidated Financial Statements and Supplementary Data at Item 8 of this report.

(2) **Financial Statement Schedules**

No schedules have been filed because the information required to be set forth therein is not applicable or is shown in the Consolidated Financial Statements and Supplementary Data or notes thereto at Item 8 of this report.

(3) **Exhibits**

See Exhibit Index for the exhibits filed as part of or incorporated by reference into this report.

(b) **Reports on Form 8-K**.

The Company did not file any Reports on Form 8-K during the fourth quarter of 2002.

With the exception of the information incorporated by reference to the Company s Proxy Statement for the 2003 Annual Meeting of Shareholders in Items 10, 11, 12 and 13 of Part III, the Proxy Statement is not deemed to be filed as part of this Report.

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## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

VIALTA, INC.

By: /s/ DIDIER PIETRI

Didier Pietri
*President and Chief Executive Officer*

Date: March 28, 2003

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

| Signature | Title | Date |
|---|---|---|
| /s/ DIDIER PIETRI<br>Didier Pietri | President and Chief Executive Officer (principal executive officer) | March 28, 2003 |
| /s/ WILLIAM M. SCHARNINGHAUSEN<br>William M. Scharninghausen | Chief Financial Officer (principal financial officer) | March 28, 2003 |
| /s/ FRED S.L. CHAN<br>Fred S.L. Chan | Chairman of the Board | March 28, 2003 |
| /s/ GEORGE M. CAIN<br>George M. Cain | Director | March 28, 2003 |
| /s/ HERBERT CHANG<br>Herbert Chang | Director | March 28, 2003 |
| /s/ MICHAEL S. DUBESTER<br>Michael S. Dubester | Director | March 28, 2003 |
| /s/ MATTHEW K. FONG<br>Matthew K. Fong | Director | March 28, 2003 |

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**CERTIFICATIONS**

I, Didier Pietri, President and Chief Executive Officer of Vialta, Inc., certify that:

1. I have reviewed this annual report on Form 10-K of Vialta, Inc. (the registrant );

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the Evaluation Date ); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of the registrant s board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and

6. The registrant s other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 28, 2003

/s/ DIDIER PIETRI
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Didier Pietri
*President and Chief Executive Officer*

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**CERTIFICATIONS**

I, William M. Scharninghausen, Chief Financial Officer of Vialta, Inc., certify that:

1. I have reviewed this annual report on Form 10-K of Vialta, Inc. (the registrant );

2. Based on my knowledge, this annual report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;

3. Based on my knowledge, the financial statements, and other financial information included in this annual report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this annual report;

4. The registrant s other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and have:

a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this annual report is being prepared;

b) evaluated the effectiveness of the registrant s disclosure controls and procedures as of a date within 90 days prior to the filing date of this annual report (the Evaluation Date ); and

c) presented in this annual report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant s other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant s auditors and the audit committee of the registrant s board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant s ability to record, process, summarize and report financial data and have identified for the registrant s auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant s internal controls; and

6. The registrant s other certifying officers and I have indicated in this annual report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: March 28, 2003

/S/ William M. Scharninghausen
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William M. Scharninghausen
*Chief Financial Officer*

Table of Contents

## EXHIBIT INDEX

| Exhibit Number | Description of Exhibit |
|---|---|
| 2.1 | Form of Master Distribution Agreement between the Registrant and ESS Technology, Inc. (Exhibit No. 2.1 to Form 10 File No. 000-32809) |
| 2.2 | Form of Master Technology Ownership and License Agreement between the Registrant and ESS Technology, Inc. (Exhibit No. 2.2 to Form 10 File No. 000-32809) |
| 2.3 | Form of Employee Matters Agreement between the Registrant and ESS Technology, Inc. (Exhibit No. 2.3 to Form 10 File No. 000-32809) |
| 2.4 | Form of Tax Sharing and Indemnity Agreement between the Registrant and ESS Technology, Inc. (Exhibit No. 2.4 to Form 10 File No. 000-32809) |
| 2.5 | Form of Real Estate Matters Agreement between the Registrant and ESS Technology, Inc. (Exhibit No. 2.5 to Form 10 File No. 000-32809) |
| 2.6 | Form of Master Confidential Disclosure Agreement between the Registrant and ESS Technology, Inc. (Exhibit No. 2.6 to Form 10 File No. 000-32809) |
| 2.7 | Form of Master Transitional Services Agreement between the Registrant and ESS Technology, Inc. (Exhibit No. 2.7 to Form 10 File No. 000-32809) |
| 3.1 | Amended and Restated Certificate of Incorporation of the Registrant (Exhibit No. 4.1 to Form S-8 File No. 333-65752) |
| 3.2 | Amended and Restated Bylaws of the Registrant (Exhibit No. 4.2 to Form S-8 File No. 333-65752) |
| 4.1 | Form of Class A Common Stock Certificate of the Registrant (Exhibit No. 4.1 to Form 10 File No. 000-32809) |
| 4.2 | Form of Class B Common Stock Certificate of the Registrant (Exhibit No. 4.2 to Form 10 File No. 000-32809) |
| 10.1 | 1999 Stock Incentive Plan (Exhibit No. 10.1 to Form 10 File No. 000-32809) * |
| 10.2 | 2000 Directors Stock Option Plan (Exhibit No. 10.2 to Form 10 File No. 000-32809) * |
| 10.3 | 2001 Nonstatutory Stock Option Plan, as amended on August 1, 2001 (Exhibit No. 10.3 to Form 10 File No. 000-32809) * |
| 10.4 | 2001 Employee Stock Purchase Plan (Exhibit No. 10.4 to Form 10 File No. 000-32809) * |
| 10.5 | Lease Agreement between the Registrant and ESS Technology, Inc. for the premises located at 48461 Fremont Boulevard, Fremont, California (Exhibit No. 10.5 to Form 10 File No. 000-32809) |
| 10.6 | Purchase Agreement between the Registrant and ESS Technology, Inc. (Exhibit No. 10.6 to Form 10 File No. 000-32809) |
| 10.7 | DVD Manufacturing License Agreement between the Registrant and Macrovision Corporation (Exhibit No. 10.7 to Form 10 File No. 000-32809) |
| 10.8 | Offer Letter Agreement between the Registrant and Charles Root (Exhibit No. 10.8 to Form 10 File No. 000-32809) * |
| 10.9 | Lease Agreement between the Registrant and 235 Investments Limited for the premises located at 235 Yorkland Boulevard, Ontario, Canada (Exhibit No. 10.9 to Form 10 File No. 000-32809) |
| 10.10 | Lease Agreement between Vialta.com Hong Kong Company Limited and Upcentre Investments Limited for the premises located at 238 Nathan Road, Kowloon, Hong Kong (Exhibit No. 10.10 to Form 10 File No. 000-32809) |
| 10.11 | Trademark License Agreement between the Registrant and Digital Theater Systems, Inc. (Exhibit No. 10.11 to Form 10 File No. 000-32809) |
| 10.12 | Software License Agreement between the Registrant and EnReach Technology, Inc. (Exhibit No. 10.12 to Form 10 File No. 000-32809) |
| 10.13 | Offer Letter Agreement between the Registrant and Didier Pietri (Exhibit No. 10.13 to Form 10 File No. 000-32809) * |

| Exhibit Number | Description of Exhibit |
|---|---|
| 10.14 | Offer Letter Agreement between the Registrant and Steve Charng (Exhibit No. 10.5 to Form 10 File No. 000-32809) |
| 10.15 | Offer Letter Agreement between the Registrant and Michael Wang (Exhibit No. 10.9 to Form 10 File No. 000-32809) |
| 21.1 | Subsidiaries of the Registrant (Exhibit No. 21.1 to Form 10 File No. 000-32809) |
| 23.1 | Consent of PricewaterhouseCoopers LLP |
| 23.3 | Consent of PricewaterhouseCoopers LLP (filed herewith) |
| 99.1 | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

* Indicates a management contract or compensatory plan.