

SILICON IMAGE INC

FORM 10-Q/A (Amended Quarterly Report)

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Address	1060 EAST ARQUES AVE SUNNYVALE, California 94085
Telephone	408-616-4000
CIK	0001003214
Industry	Semiconductors
Sector	Technology
Fiscal Year	12/31

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q/A

- QUARTERLY REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2002

OR

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

For the transition period from _____ to _____

Commission file number: 000-26887

Silicon Image, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

77-0396307
(I.R.S. Employer
Identification No.)

1060 East Arques Avenue
Sunnyvale, California 94086
(Address of principal executive offices and zip code)

(408) 616-4000
(Registrant's telephone number, including area code)

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

The number of shares of the registrant's Common Stock, \$0.001 par value per share, outstanding as of April 30, 2002 was 65,002,311 shares.

Silicon Image, Inc.
Quarterly Report on Form 10-Q
Three Months Ended
March 31, 2002

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Part I. Financial Information

Item 1. Financial Statements

Silicon Image, Inc.
Condensed Consolidated Statements of Operations
(in thousands, except per share amounts)
(unaudited)

	Three Months Ended March 31,	
	2002	2001
Revenue	\$ 17,087	\$ 10,451
Cost and operating expenses:		
Cost of revenue (1)	8,486	4,372
Research and development (2)	7,378	4,408
Selling, general and administrative (3)	4,934	4,167
Stock compensation and warrant expense	10,451	2,719
Amortization of goodwill and intangible assets	909	2,221
Patent defense and acquisition integration costs	706	—

Restructuring	2,193	—
Total cost and operating expenses	35,057	17,887
Loss from operations	(17,970)	(7,436)
Interest income and other, net	270	897
Net loss	\$ (17,700)	\$ (6,539)
Net loss per share:		
Basic and diluted	\$ (0.28)	\$ (0.13)
Weighted average shares	63,360	51,965

- (1) Excludes stock compensation and warrant expense of \$923,000 and \$69,000 for the three months ended March 31, 2002 and 2001, respectively.
- (2) Excludes stock compensation and warrant expense of \$5.9 million and \$2.3 million for the three months ended March 31, 2002 and 2001, respectively.
- (3) Excludes stock compensation and warrant expense of \$3.6 million and \$400,000 for the three months ended March 31, 2002 and 2001, respectively.

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements

Silicon Image, Inc.
Condensed Consolidated Balance Sheets
(in thousands, except share and per share amounts)

	March 31, 2002	Dec. 31, 2001
	(unaudited)	
Assets		
Current Assets:		
Cash and cash equivalents	\$ 20,007	\$ 18,946
Short-term investments	18,795	22,272
Accounts receivable, net of allowance for doubtful accounts of \$481 at March 31 and \$450 at December 31	7,452	7,475
Inventories, net	6,913	6,536
Prepaid expenses and other current assets	2,406	2,969
Total current assets	55,573	58,198
Property and equipment, net	7,899	8,694
Goodwill and intangible assets, net	20,794	21,628
Other assets	1,628	1,642
Total assets	\$ 85,894	\$ 90,162
Liabilities and Stockholders' Equity		
Current Liabilities:		
Accounts payable	\$ 4,583	\$ 5,165
Accrued liabilities	8,742	8,762

Capital lease and other obligations, current	4,195	4,690
Deferred margin on sales to distributors	4,308	3,402
Total current liabilities	21,828	22,019
Capital lease and other obligations, long-term	651	819
Total liabilities	22,479	22,838
Stockholders' Equity:		
Convertible preferred stock, par value \$0.001; 5,000,000 shares authorized; no shares issued or outstanding	—	—
Common stock, par value \$0.001; shares authorized: 150,000,000—March 31 and December 31; shares issued and outstanding: 64,727,118—March 31 and 63,515,742—December 31	65	64
Additional paid-in capital	210,795	194,280
Notes receivable from stockholders	(174)	(167)
Unearned compensation	(9,819)	(7,101)
Accumulated deficit	(137,452)	(119,752)
Total stockholders' equity	63,415	67,324
Total liabilities and stockholders' equity	\$ 85,894	\$ 90,162

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements

Silicon Image, Inc.
Condensed Consolidated Statements of Cash Flows
(in thousands)
(unaudited)

	Three Months Ended March 31,	
	2002	2001
Cash flows from operating activities:		
Net loss	\$ (17,700)	\$ (6,539)
Adjustments to reconcile net loss to cash used in operating activities:		
Stock compensation and warrant expense	10,451	2,719
Amortization of goodwill and intangible assets	909	2,221
Non-cash restructuring	818	—
Depreciation and amortization	997	378
Changes in assets and liabilities:		
Accounts receivable	23	2,890
Inventories	(377)	(205)
Prepaid expenses and other assets	570	1
Accounts payable	(582)	(1,591)
Accrued liabilities	(95)	(1,103)
Deferred margin on sales to distributors	906	(1,590)
Cash used in operating activities	(4,080)	(2,819)
Cash flows from investing activities:		

Proceeds from sales of short-term investments	3,477	16,240
Purchases of property and equipment	(702)	(493)
	<u> </u>	<u> </u>
Cash provided by investing activities	2,775	15,747
	<u> </u>	<u> </u>
Cash flows from financing activities:		
Proceeds from issuances of common stock, net	3,029	927
Repayments of capital lease and other obligations	(663)	(271)
	<u> </u>	<u> </u>
Cash provided by financing activities	2,366	656
	<u> </u>	<u> </u>
Net increase in cash and cash equivalents	1,061	13,584
Cash and cash equivalents — beginning of period	18,946	23,224
	<u> </u>	<u> </u>
Cash and cash equivalents — end of period	\$ 20,007	\$ 36,808
	<u> </u>	<u> </u>
Non-cash investing and financing activities:		
Financing arrangements for insurance premiums	\$ —	\$ 435
	<u> </u>	<u> </u>

See accompanying Notes to Unaudited Condensed Consolidated Financial Statements

Silicon Image, Inc.
Notes to Unaudited Condensed Consolidated Financial Statements
March 31, 2002

1. Basis of Presentation

In the opinion of management, the unaudited condensed consolidated financial statements of Silicon Image, Inc. included herein have been prepared on a basis consistent with the December 31, 2001 audited financial statements and include all material adjustments, consisting of normal recurring adjustments, necessary to fairly state the consolidated financial position of Silicon Image and its subsidiaries (collectively, the "Company") at March 31, 2002 and the consolidated results of the Company's operations and cash flows for the three months ended March 31, 2002 and 2001. All intercompany accounts and transactions have been eliminated. These interim financial statements should be read in conjunction with the audited financial statements and notes thereto included in our Form 10-K for the fiscal year ended December 31, 2001. Results of operations for the three months ended March 31, 2002 are not necessarily indicative of future operating results.

2. Recent Accounting Pronouncements

On January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142 (SFAS No. 142), "Goodwill and Other Intangible Assets." SFAS No. 142 supersedes Accounting Principles Board Opinion No. 17, "Intangible Assets," and discontinues the amortization of goodwill. In addition, SFAS No. 142 includes provisions regarding: 1) reclassification of amounts between goodwill and identifiable intangible assets in accordance with the new definition of identifiable intangible assets set forth in Statement of Financial Accounting Standards No. 141, "Business Combinations;" 2) reassessment of the useful lives of existing recognized intangibles; and 3) testing for impairment of existing goodwill and other intangibles using the discounted cash flows method. In accordance with SFAS No. 142, beginning January 1, 2002, goodwill is no longer amortized, but is reviewed periodically for impairment. We have completed the first step of the transitional goodwill impairment test as of the beginning of fiscal 2002, and the results of that test indicated that our goodwill and other intangible assets are not impaired. We identified \$1.7 million of net identifiable intangible assets (acquired workforce) to be reclassified to goodwill pursuant to the new definition of intangible assets. Acquired technology, patents and other intangible assets are being amortized over their estimated useful lives of 18 to 42 months using the straight-line method. No changes were made to the useful lives of amortizable intangible assets in connection with the adoption of SFAS No. 142. Components of intangible assets including the reclassification of amortized goodwill to unamortized intangible assets as of January 1, 2002 were as follows (in thousands):

	March 31, 2002		December 31, 2001	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible assets:				

Acquired technology	\$	11,475	\$	8,457	\$	11,475	\$	7,724
Patents and other		1,924		1,554		4,429		2,194
Goodwill		—		—		13,341		8,562
	\$	13,399	\$	10,011	\$	29,245	\$	18,480
Intangible assets not subject to amortization:								
Goodwill	\$	17,406	\$	—	\$	10,863	\$	—

Amortization of intangible assets was \$909,000 for the three months ended March 31, 2002 and amortization of goodwill and intangible assets was \$2.2 million for the three months ended March 31, 2001. Future amortization expense is expected to be \$2.6 million for the remainder of 2002 (a total of

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\$3.5 million for 2002), \$500,000 for 2003 and \$313,000 for 2004. Our net loss, excluding goodwill amortization expense, would have been as follows had we adopted SFAS No. 142 on January 1, 2001 (in thousands, except per share amounts):

	Three Months Ended March 31,	
	2002	2001
Net loss—as reported	\$ (17,700)	\$ (6,539)
SFAS 142 amortization adjustment	—	1,123
Net loss—adjusted	\$ (17,700)	\$ (5,416)
Basic and diluted net loss per share—as reported	\$ (0.28)	\$ (0.13)
Impact of SFAS 142 amortization adjustment	—	0.03
Basic and diluted net loss per share—adjusted	\$ (0.28)	\$ (0.10)

In October 2001, the FASB issued Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", which supersedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of," and the accounting and reporting provisions of Accounting Principles Board ("APB") No. 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions". SFAS No. 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets, including amortizable and non-amortizable intangible assets, and is effective for our fiscal year beginning on January 1, 2002, as well as for interim periods within 2002. The adoption of SFAS No. 144 did not have a material effect on our results of operations or financial position.

On January 1, 2002, we adopted Emerging Issues Task Force ("EITF") No. 01-09, "Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor's Products." This EITF requires us to record certain consideration paid to distributors of our products as a reduction of revenue, whereas we previously recorded this consideration as a sales and marketing expense. The adoption of this EITF did not have a material effect on our results of operations or financial position.

3. Net Loss Per Share

The following table sets forth the computation of basic and diluted net loss per share of common stock (in thousands, except per share data):

	Three Months Ended March 31,	
	2002	2001
Numerator:		
Net loss	\$ (17,700)	\$ (6,539)
Denominator:		
Weighted average shares	64,163	54,117

Less: unvested common shares subject to repurchase	(803)	(2,152)
	<u>63,360</u>	<u>51,965</u>
Net loss per share:		
Basic and diluted net loss per share	\$ (0.28)	\$ (0.13)

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As a result of the Company's net losses, all common share equivalents would have been anti-dilutive and have therefore been excluded from the diluted net loss per share calculation. The following table summarizes securities outstanding as of each period end that were anti-dilutive and excluded from our calculation of diluted net loss per share for the three months ended March 31, 2002 and 2001 (in thousands):

	March 31,	
	2002	2001
Unvested common shares subject to repurchase	803	2,152
Stock options	20,488	9,693
Common stock warrants	—	571

4. Balance Sheet Components

	March 31, 2002	Dec. 31, 2001
	(in thousands)	
Inventories:		
Raw materials	\$ 1,018	\$ 1,911
Work in process	897	1,337
Finished goods	4,998	3,288
	<u>\$ 6,913</u>	<u>\$ 6,536</u>
Property and equipment:		
Computers and software	\$ 8,200	\$ 8,041
Equipment	4,447	4,582
Furniture and fixtures	1,440	1,262
	<u>14,087</u>	<u>13,885</u>
Less: accumulated depreciation	<u>(6,188)</u>	<u>(5,191)</u>
	<u>\$ 7,899</u>	<u>\$ 8,694</u>
Accrued liabilities:		
Customer rebates and accrued sales returns	\$ 1,186	\$ 1,073
Accrued payroll and related expenses	2,932	3,053
Restructuring (Note 8)	1,730	843
Other accrued liabilities	2,894	3,793
	<u>\$ 8,742</u>	<u>\$ 8,762</u>

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5. Stock-Based Compensation

The following table summarizes the components of our stock compensation and warrant expense for the three months ended March 31, 2002 and 2001 (in thousands):

	Three Months Ended March 31,	
	2002	2001
Options granted prior to our initial public offering	\$ 437	\$ 900
Options granted to non-employees	601	570
Option repricings	7,932	—
Options assumed in connection with acquisitions	1,481	1,249
	<u>\$ 10,451</u>	<u>\$ 2,719</u>

During the three months ended March 31, 2002, we recognized \$7.9 million of expense relating to stock options that were repriced in December 2000 and April 2001. Expense for the increase in the fair market value of our stock in excess of the exercise price is recognized immediately for vested options and is recognized over the vesting period using an accelerated method for employees. As a result, we also recorded unearned compensation of \$4.7 million in the first quarter of 2002 in connection with our stock option repricings.

6. Restructuring Activities

During the third quarter of 2001, we began a program to focus our business on products and technology, including those obtained through acquisitions, in which we have, or believe we can achieve, a leadership position. As part of this program, we decided to cancel numerous products under development and to remove certain projects from our development plan, to phase out or de-emphasize certain existing products and to integrate the operations of our two recently acquired companies—CMD and Silicon Communication Lab (SCL).

In connection with this program, in the fourth quarter of 2001, we reduced our workforce by approximately 60 people, or 20% of our workforce. This workforce reduction was the initial step in eliminating duplicate positions that resulted from our acquisitions, and also represented the elimination of other positions based on our new product and technology focus. Positions were eliminated from all functional areas—operations, R&D and SG&A. Because of this workforce reduction, we recorded a restructuring expense of \$1.5 million in the fourth quarter of 2001, consisting of cash severance-related costs of \$599,000, non-cash severance-related costs of \$303,000 representing the intrinsic value of modified stock options, an expected loss on leased facilities of \$500,000 and fixed asset write-downs of \$50,000. In addition, we reversed \$286,000 of unearned compensation, a component of stockholders' equity, for unvested stock options that were cancelled in connection with employee terminations.

In the first quarter of 2002, we implemented a second workforce reduction in connection with the program discussed above, eliminating an additional 35 positions, or 13% of our workforce. Positions were eliminated from all functional areas. This reduction resulted from the continued integration of acquired companies, as well as continued execution of our product and technology strategy, whereby we decided to phase out the legacy storage subsystem board products we acquired from CMD and to develop new board products only if we believed it would facilitate or accelerate the use of our storage semiconductor products. In connection with this workforce reduction, we recorded a restructuring expense of \$2.2 million in the first quarter of 2002, consisting of cash severance-related costs of \$198,000, non-cash severance-related costs of \$318,000 representing the intrinsic value of modified stock options, an expected loss on leased facilities of \$1.2 million and fixed asset write-downs of \$500,000. In addition, we reversed \$76,000 of unearned compensation, a component of stockholders'

equity, for unvested stock options that were cancelled in connection with employee terminations. Since some of the affected employees have termination dates in the second quarter of 2002, we expect to record additional expenses at that time for the modification of their stock options.

In April 2002, we implemented a third workforce reduction in connection with the program we began during the third quarter of 2001, eliminating 12 positions, or 5%, of our workforce. This reduction resulted primarily from our decision to transition to a licensing model for our storage subsystem board products, whereby instead of developing, manufacturing and selling board products to facilitate or accelerate the use of our storage semiconductor products, we will develop and license board designs in exchange for license fees, royalties and the use of our semiconductor products. Since some of the affected employees have termination dates in the third quarter of 2002, we will incur cash and non-cash restructuring expenses in the second and third quarters of 2002 in connection with this workforce reduction. The amount of expense to be incurred is difficult to predict due to the volatility of our stock price and its effect on non-cash severance-related expenses for stock option modifications.

Severance related costs were determined based on the amount of pay people received that was not for services performed and by

measuring the intrinsic value of stock options that were modified to the benefit of terminated employees. The expected loss on leased facilities resulted from our plan to consolidate our remaining workforce to the extent practicable and sublease any excess space. To determine the expected loss, we compared our lease and operating costs for the space to our estimate of the net amount we would be able to recover by subleasing the space. This estimate was based on a number of assumptions, including the length of time it will take to secure a tenant, the sublease rate per square foot, the cost of necessary improvements or modifications and real estate broker commissions. The fixed asset write-down was determined based on the estimated fair value of assets, primarily computer hardware and software, that would no longer be utilized after the employees' termination date.

We expect the headcount reductions and related payments to be completed by the second quarter of 2003. Lease payments will be made through the end of the related lease terms of July 2003 and November 2005.

The following table presents restructuring activity for 2001 and through March 31, 2002 (in thousands).

	Severance and Benefits	Leased Facilities	Fixed Assets	Total
Fourth quarter 2001 provision	\$ 902	\$ 500	\$ 50	\$ 1,452
Cash payments	(191)	—	—	(191)
Non-cash charges	(303)	(115)	—	(418)
December 31, 2001 Balance	408	385	50	843
First quarter 2002 provision	516	1,177	500	2,193
Cash payments	(289)	(149)	—	(438)
Non-cash charges	(318)	—	(550)	(868)
March 31, 2002 Balance	\$ 317	\$ 1,413	\$ —	\$ 1,730

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7. Customer and Geographic Information

Revenue by geographic area was as follows (in thousands):

	Three Months Ended March 31,	
	2002	2001
Taiwan	\$ 6,085	\$ 2,708
Japan	2,167	2,407
United States	4,527	1,265
Hong Kong	1,571	318
Korea	1,068	2,438
Other	1,669	1,315
	\$ 17,087	\$ 10,451

For each period presented, substantially all long-lived assets were located within the United States.

For the three months ended March 31, 2002, three customers generated 17%, 14%, and 11% of our revenue and, as of March 31, 2002, two customers each represented 19% of gross accounts receivable. For the three months ended March 31, 2001, two customers generated 18% and 14% of our revenue. At December 31, 2001, three customers represented 17%, 16% and 12% of gross accounts receivable.

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

This report contains forward-looking statements within the meaning of Section 21E of the Securities and Exchange Act of 1934 and

Section 27A of the Securities Act of 1933. These forward-looking statements involve a number of risks and uncertainties, including those identified in the section of this Form 10-Q entitled "Factors Affecting Future Results," that may cause actual results to differ materially from those discussed in, or implied by, such forward-looking statements. Forward-looking statements within this Form 10-Q are in many cases identified by words such as "believes," "anticipates," "expects," "intends," "may," "will" and other similar expressions. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. We undertake no obligation to publicly release revisions to these forward-looking statements that may be made to reflect events or circumstances occurring subsequent to the filing of this Form 10-Q with the SEC. Readers are urged to carefully review and consider the various disclosures made by us in this report and in our other reports filed with the SEC that attempt to advise interested parties of the risks and factors that may affect our business.

Overview

Silicon Image designs, develops and markets semiconductors, including transmitters, receivers, monitor controllers and video processors, for applications that require high-bandwidth, cost-effective solutions for high-speed data communications. Sales of our transmitters, which are used in graphic cards or motherboards, and of our receivers, which are used in flat panel and other digital displays, generated 68% of our revenue in the first quarter of 2002, 70% of our 2001 revenue and substantially all of our revenue in 2000 and 1999. Market share for receivers eroded during the latter half of 2000, throughout 2001 and into 2002, as many OEMs began using an integrated dual-mode monitor controller, which is a chip that incorporates a digital receiver, a video scaler, and an analog to digital converter. This dual-mode chip has become popular for flat panel displays that are designed to accept both an analog and digital signal. We believe this dual-mode design represents a transitional technology and therefore we do not offer an integrated dual-mode monitor controller. We continue to sell to flat panel display manufacturers by partnering with other companies to supply a three chip discrete solution that we believe is cost-effective relative to the integrated chip solution. We expect to see continued growth in this market, although analyst projections are that the discrete solution will grow at about half the rate of the integrated controller market. We also remain fully committed to the pure digital solution that is popular in markets like Japan and currently used in Apple Computer's iMac.

With respect to transmitters, there was additional competition from Thine and Texas Instruments in 2001, but we continue to maintain our leading position in the market for discrete transmitters. We believe that the biggest potential risk to our market position is the ability of graphic card manufacturers, like ATI, nVidia, and Matrox, to integrate transmitters into their graphic chips, thus eliminating the need for our discrete transmitters. We believe this will happen to some degree, but that for the next year or two it will likely be limited to frequency rates associated with lower resolutions like SGA and XGA. We believe higher resolutions like SXGA and UXGA, particularly associated with larger displays, will continue to require discrete transmitters during this period because of their ability to deliver the extremely high level of quality required for high resolutions.

In 2000, we began focusing our resources on entering two new markets—storage and consumer electronics. These are emerging markets that play well to our core competencies of high-speed intelligent serial interfaces and are projected to experience significant growth rates over the next three years. In the third quarter of 2001, we began a program to focus our business on products and technology, including those obtained through acquisitions, in which we have, or believe we can achieve, a leadership position. As part of this program, we decided to cancel numerous products under development, to remove certain projects from our development plan, to phase out or de-emphasize certain existing products and to integrate the operations of our two recently-acquired companies—

CMD and SCL. In particular, we intend to concentrate on our discrete transmitter and receiver products for PCs and displays, and on developing products and establishing industry standards for the consumer electronics and storage markets.

In connection with this program, we reduced our workforce by approximately 60 people in the fourth quarter of 2001 and recorded restructuring expense of \$1.5 million. This workforce reduction was the initial step in eliminating duplicate positions that resulted from our acquisitions, and also represented the elimination of other positions based on our new product and technology focus. In the first quarter of 2002, we implemented a second workforce reduction in connection with this program, eliminating an additional 35 positions, and recorded restructuring expense of \$2.2 million. This reduction resulted from the continued integration of acquired companies, as well as continued execution of our product and technology strategy, whereby we decided to phase out the legacy storage subsystem board products we acquired from CMD and to develop new board products only if we believed it would facilitate or accelerate the use of our storage semiconductor products. In April 2002, we implemented a third workforce reduction in connection with this program, eliminating an additional 12 positions. This reduction resulted primarily from our decision to transition to a licensing model for our storage subsystem board products, whereby instead of developing, manufacturing and selling board products to facilitate or accelerate the use of our storage semiconductor products, we will develop and license board designs in exchange for license fees, royalties and the use of our semiconductor products. The amount of expense to be incurred is difficult to predict due to the volatility of our stock price and its effect on non-cash severance-related expenses for stock option modifications.

Also in 2001, we decided to leverage our intellectual property portfolio by licensing our PanelLink core technology to companies that participate in markets we have chosen not to participate in directly. We have signed several license contracts and expect to sign additional contracts over time.

In February 2002, we announced our initial product for the storage market—a fully integrated PCI-to-Serial ATA host controller. We will continue to concentrate on product offerings for Serial ATA, 2 Gigabit Fibre Channel and Serial-Attached SCSI interfaces.

In April 2002, we announced the formation of a working group to define the next-generation digital interface specification for consumer electronics products. The High Definition Multimedia Interface (HDMI) specification will combine high-definition video and multi-channel audio in one digital interface and will be based largely on our DVI and HDCP technology. We hope to gain adoption of an HDMI standard for the high-speed serial connection of DVD players, digital TVs, set-top boxes and other consumer devices. The HDMI working group includes Hitachi, Matsushita Electric (Panasonic), Philips, Silicon Image, Sony, Thomson, and Toshiba.

Acquisitions

In 2001 and 2000, we made four strategic acquisitions that were directed at diversifying our product offerings and accelerating our entrance into the storage and consumer electronics markets. In 2000, we acquired Zillion, a developer of high-speed transmission technology for data storage applications, and DVDO, a provider of digital video processing systems for the consumer electronics industry. In 2001, we acquired CMD Technology (CMD), a provider of storage subsystems and semiconductors designed for storage area networks, and Silicon Communication Lab (SCL), a provider of mixed-signal and high-speed circuit designs, including analog-to-digital converters. We will continue to consider acquisitions that we believe can strengthen our business.

Outlook

We expect sequential quarterly revenue growth throughout 2002 of approximately 8-12% and believe our revenue in the second quarter of 2002 will be approximately \$18.5 to \$19.0 million. We anticipate overall increased unit volume as we focus on high-growth markets like storage ICs and CE.

Also contributing to this anticipated increase in revenue is our new strategy of licensing our technology to companies competing in markets that we do not address. We expect licensing to contribute up to \$1.0 million of revenue in the second quarter of 2002.

Our expectation of revenue growth in 2002 is based primarily on four assumptions. First, it assumes a projected increase in demand for DVI units in the PC industry. Second, we achieved several design wins in the Fibre Channel market late in 2001. Although we began volume shipments of our Fibre Channel product in the first quarter of 2002, it is difficult to predict exactly when and how aggressively revenue from this product will ramp during 2002. However, we expect revenue from this product to grow quarter-over-quarter throughout the remainder of 2002. Third, we expect that the release of our SATALink product family should allow us to win several motherboard designs that could begin to ship late in the second half of 2002. We believe that interest is high in our recently announced SATALink products. Several potential customers are currently evaluating these products, but to date we have not achieved any design wins. Fourth, DVI is beginning to be utilized in various CE products like DVD players, TVs, and set-top boxes. We have won some designs already and expect to win more throughout the year.

Factors that may cause our actual results to differ materially from those anticipated by our assumptions include the rate at which OEMs adopt DVI, consumer demand in the PC and CE markets, whether and how quickly OEMs use integrated transmitters rather than our discrete transmitters, and our ability to achieve design wins in the CE and storage markets and the rate at which new interfaces, such as Serial ATA and Fibre Channel, are adopted by OEMs. In addition, the amount and timing of any revenue from new products for the CE and storage markets, including our recently announced SATALink products, will depend on our ability to achieve design wins with OEMs for these new products, and will be affected by any delays in our completion of product development and by the ability of a semiconductor foundry to manufacture these products in commercial volumes at an acceptable yield and cost. In addition, our future revenue remains dependent on general economic and market conditions and will be affected by competition, including competition from integrated transmitter and storage products. We cannot predict the duration or severity of the current downturn in the PC and display market, or in the general economy, or their effect on our revenue and operating results. In addition, please see the section "Factors Affecting Future Results."

We expect our gross margin in the second quarter of 2002 to increase slightly from the first quarter of 2002 as a result of expense controls and an increase in revenue, including revenue from licensing which has nominal associated costs.

Due to the volatility and lack of predictability of our stock price, and its effect on the amount of stock compensation and warrant expense that we are required to record each period, we do not forecast stock compensation and warrant expense. Certain operating expenses that we incur infrequently, such as impairment of long-lived assets, in-process research and development, and restructuring, cannot be anticipated and therefore we do not attempt to forecast them, nor do we consider them when evaluating our operating performance or allocating resources. We also do not forecast or analyze operating expenses that we expect to incur infrequently and over a limited period of time, such as amortization of intangible assets and patent defense and acquisition integration costs. These expenses are not at management's discretion and are not part of our long-term expense structure; therefore, we do not consider these expenses when evaluating our operating performance or allocating resources.

We expect our second quarter R&D expense to increase in the range of \$200,000 to \$400,000 from the first quarter of 2002 as we support a higher level of planned new product introductions, and to return to first quarter levels during the second half of the year. The savings in the second half of the year result from planned company shutdowns of one week in each of these quarters. We expect second quarter SG&A expense to approximate SG&A expense for the first quarter of 2002. We expect R&D

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and SG&A expenses to decrease sequentially as a percentage of revenue in each quarter of 2002, and we plan to control such expenses with a goal of reaching 36% of revenue over the next several years.

The amount of stock compensation and warrant expense recognized in any given period is dependent upon numerous variables, most of which are beyond our control and are extremely difficult to accurately predict. These variables include the fair market value of our common stock at future points in time, employee terminations, and new issuances of or modifications to stock options. Assuming that we incur no additional expense associated with the stock option repricings we have done, which assumes that the market price of our stock does not exceed \$5.63 at the end of any of our fiscal quarters in 2002, we expect our stock compensation and warrant expense to be approximately \$15.5 million to \$17.0 million in 2002. The expected increase from the \$12.4 million of expense incurred in 2001 is primarily due to the option repricings we did in 2001 and 2000 and since the market price of our stock exceeded \$5.63 per share at March 31, 2002.

We expect intangible asset amortization expense to be approximately \$3.5 million in 2002, assuming such assets do not become impaired and no other acquisitions are made. Beginning January 1, 2002, goodwill amortization will cease in accordance with SFAS 142, 'Goodwill and Other Intangible Assets.'

Patent defense costs are related to the lawsuit we filed against Genesis Microchip in April 2001, and acquisition integration costs represent costs incurred to integrate acquired companies. We expect to incur approximately \$3.0 million of expense for patent defense and acquisition integration costs in 2002. The increase from 2001 can be attributed to a full year's worth of patent defense costs in 2001, versus a partial year in 2001.

We may incur additional operating expenses in 2002 for impairment of goodwill and intangible assets and in-process research and development, and we will incur expenses, the amount of which is not known or estimable, for headcount reductions and exit costs in connection with restructuring activities. Expenses incurred in connection with any of these activities will be incremental to our expense estimates for 2002 as discussed above.

Commitments, Contingencies and Concentrations

We will incur substantial non-cash stock compensation expense in future periods as a result of the issuance of, or modifications to, restricted stock awards and stock option grants to employees and non-employees, as well as the stock option repricings we did in 2000 and 2001. We may also incur non-cash stock compensation expense in connection with future acquisitions. The amount of stock compensation expense in each period will fluctuate with changes in our stock price and volatility. We will also incur non-cash expenses in future periods for the amortization of intangible assets and may also incur non-cash expenses for the impairment of intangible assets.

In September 1998, we entered into an agreement with Intel to develop and promote the adoption of a digital display interface specification. In connection with this agreement, we granted Intel a warrant to purchase 285,714 shares of our common stock at \$1.75 per share. Under the same agreement, we granted Intel a warrant to purchase 285,714 shares of our common stock at \$0.18 per share upon achievement of a specified milestone that was reached during the first quarter of 1999. Both of these warrants were exercised in May 2001. We recorded expense of \$346,000 in 1998 and \$595,000 in 1999 associated with these warrants. Additionally, if a second specified milestone is achieved, which we do not believe is likely, we would be required to grant Intel a third warrant to purchase 285,714 shares of our common stock at \$0.18 per share. Upon issuance of the third warrant, we would record an expense equal to its fair value, which was estimated to be \$2.4 million at March 31, 2002.

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Historically, a relatively small number of customers and distributors have generated a significant portion of our revenue. Our top five customers, including distributors, generated 56% and 55% of our revenue in the first quarters of 2002 and 2001, respectively. The percentage of revenue generated through distributors tends to be significant, since many OEM's rely upon third party manufacturers or distributors to provide inventory management and purchasing functions, and was 41% of revenue in the first quarter of 2002, compared to 51% in the first quarter of 2001. We expect that the percentage of revenue generated through distributors will increase as our IC business grows.

A significant portion of our revenue is generated from products sold overseas. Sales to customers in Asia, including distributors, generated 66% and 75% of our revenue in the first quarters of 2002 and 2001, respectively. The reason for our geographical concentration in Asia is that our products are often used as part of flat panel displays, graphic cards and motherboards, the majority of which are produced in Asia. The

percentage of our revenue derived from any country is dependent upon where our end customers choose to manufacture their products. Accordingly, variability in our geographic revenue is not necessarily indicative of any geographic trends, but rather is the combined effect of new design wins and changes in customer manufacturing locations. All revenue to date has been denominated in U.S. dollars.

Historically, a relatively small number of customers and distributors have generated a significant portion of our revenue and represent a significant portion of our accounts receivable. For the first quarter of 2002, shipments to Weikeng, an Asian distributor, generated 17% of our revenue, shipments to World Peace International, an Asian distributor, generated 14% of our revenue and shipments to Samsung, a Korean customer, generated 11% of our revenue. For the year 2001, shipments to Samsung and Compaq, a global customer, each generated 12% of our revenue, and shipments to World Peace International generated 11% of our revenue. As of March 31, 2002, Weikeng and World Peace each represented 19% of gross accounts receivable.

Substantially all of our sales are made on the basis of purchase orders, rather than long-term agreements. The sales cycle for our products is long, which may cause a delay between the time we incur expenses and the time we generate revenue from these expenditures. The rate of product orders can vary significantly from quarter to quarter. Consequently, if anticipated sales and shipments in any quarter do not occur when expected, expenses could be disproportionately high, seriously harming our operating results for that quarter and, potentially, future quarters.

Recent Accounting Pronouncements

On January 1, 2002, we adopted Statement of Financial Accounting Standards No. 142 (SFAS No. 142), "Goodwill and Other Intangible Assets." SFAS No. 142 supersedes Accounting Principles Board Opinion No. 17, "Intangible Assets," and discontinues the amortization of goodwill. In addition, SFAS No. 142 includes provisions regarding: 1) reclassification of amounts between goodwill and identifiable intangible assets in accordance with the new definition of identifiable intangible assets set forth in Statement of Financial Accounting Standards No. 141, "Business Combinations;" 2) reassessment of the useful lives of existing recognized intangibles; and 3) testing for impairment of existing goodwill and other intangibles. In accordance with SFAS No. 142, beginning January 1, 2002, goodwill is no longer amortized, but is reviewed periodically for impairment. We have completed the first step of the transitional goodwill impairment test as of the beginning of fiscal 2002, and the results of that test indicated that our goodwill and other intangible assets are not impaired. We identified \$1.7 million of net identifiable intangible assets to be reclassified to goodwill pursuant to the new definition of intangible assets. Purchased technology and other intangible assets are being amortized over their estimated useful lives of 18 to 42 months using the straight-line method. No changes were made to the useful lives of amortizable intangible assets in connection with the adoption of SFAS No. 142.

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In October 2001, the FASB issued Statement No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets", which supercedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of," and the accounting and reporting provisions of Accounting Principles Board ("APB") No. 30, "Reporting the Results of Operations—Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions". SFAS No. 144 addresses financial accounting and reporting for the impairment or disposal of long-lived assets, including amortizable and non-amortizable intangible assets, and is effective for our fiscal year beginning on January 1, 2002, as well as for interim periods within 2002. The adoption of SFAS No. 144 did not have a material effect on our results of operations or financial position.

On January 1, 2002, we adopted Emerging Issues Task Force ("EITF") No. 01-09, "Accounting for Consideration Given by a Vendor to a Customer or a Reseller of the Vendor's Products." This EITF requires us to record certain consideration paid to distributors of our products as a reduction of revenue, whereas we previously recorded this consideration as a sales and marketing expense. Since application of this EITF results only in a reclassification between financial statement line items, it did not have a material effect on our results of operations or financial position.

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Results of Operations for the Three Months Ended March 31, 2002 Compared to Results of Operations for the Three Months Ended March 31, 2001

Revenue. Revenue was \$17.1 million for the first quarter of 2002, an increase of 63% from the year ago quarter. A substantial portion of this increase can be attributed to a 58% increase in unit volume (excluding products obtained through our acquisition of CMD). To a lesser extent, the addition of products obtained through our acquisition of CMD also contributed to the increase in revenue. The effect of these increases has been partially offset by increased competition which has led to decreases in our average selling prices.

Cost of revenue. Cost of revenue consists primarily of costs incurred to manufacture, assemble and test our products, as well as related overhead costs. Gross margin (revenue minus cost of revenue, as a percentage of revenue), excluding non-cash stock compensation and warrant expense, decreased to 50.3% for the first quarter of 2002, from 58.2% for the first quarter of 2001. The decrease in gross margin was primarily due to the effect of lower average selling prices during the first quarter of 2002 and, to a lesser extent, the acquisition of CMD, which has lower

margin board products. Cost of revenue excludes non-cash stock compensation and warrant expense of \$923,000 and \$69,000 for the first quarter of 2002 and 2001, respectively. Including stock compensation and warrant expense, our gross margin would have been 44.9% and 57.5% for the first quarters of 2002 and 2001, respectively.

Research and Development. R&D consists primarily of compensation and related costs for employees, fees for independent contractors and prototypes. R&D, excluding non-cash stock compensation and warrant expense, was \$7.4 million, or 43% of revenue, for the first quarter of 2002, and \$4.4 million, or 42% of revenue, for the first quarter of 2001. The increase in absolute dollars was primarily due to additional personnel, as headcount increased from 54 at March 31, 2001 to 102 at March 31, 2002. Additionally, R&D spending has increased as a result of our expansion into the storage and consumer electronics markets. R&D excludes non-cash stock compensation and warrant expense of \$5.9 million and \$2.3 million for the first quarters of 2002 and 2001, respectively. Including stock compensation and warrant expense, R&D would have been \$13.3 million and \$6.7 million, or 78% and 64%, of revenue for the first quarters of 2002 and 2001, respectively.

Selling, General and Administrative. SG&A consists primarily of employee compensation and benefits, sales commissions, and marketing and promotional expenses. Excluding non-cash stock compensation and warrant expense, SG&A was \$4.9 million, or 29% of revenue, for the first quarter of 2002, and \$4.2 million, or 40% of revenue, for the first quarter of 2001. The increase in absolute dollars was primarily due to additional personnel, as headcount increased from 72 at March 31, 2001 to 99 at March 31, 2002, and, to a lesser extent, an increase in commission expense. Lower SG&A expense as a percentage of revenue is due to our ability to support a higher level of revenue without a comparable increase in SG&A expense. SG&A excludes non-cash stock compensation and warrant expense of \$3.6 million for the first quarter of 2002 and \$400,000 for the first quarter of 2001. Including stock compensation and warrant expense, SG&A expense would have been \$8.5 million and \$4.6 million, or 50% and 44% of revenue, for the first quarters of 2002 and 2001, respectively.

Stock Compensation and Warrant Expense. Stock compensation and warrant expense was \$10.5 million, or 61% of revenue, for the first quarter of 2002, and \$2.7 million, or 26% of revenue, for the first quarter of 2001. The increase in expense can be attributed primarily to our stock option repricing programs, which generated an expense for the first time in the first quarter of 2002. The

following table summarizes the components of our stock compensation and warrant expense for the first quarters of 2002 and 2001 (in thousands).

	Three Months Ended March 31,	
	2002	2001
Options granted prior to our initial public offering	\$ 437	\$ 900
Options granted to non-employees	601	570
Option repricings	7,932	—
Options assumed in connection with acquisitions	1,481	1,249
	<u>\$ 10,451</u>	<u>\$ 2,719</u>

We will incur substantial non-cash stock compensation expense in future periods as a result of (1) the issuance of, or modifications to, restricted stock awards and stock option grants to employees and non-employees, (2) the repricing programs we implemented in 2000 and 2001, and (3) amortization of our existing unearned compensation balance.

Amortization of Goodwill and Intangible Assets. For the first quarter of 2002, we recorded \$909,000 of expense for the amortization of intangible assets recorded in connection with our acquisitions. This compares to expense of \$2.2 million for the first quarter of 2001. A substantial portion of the decrease can be attributed to \$29.9 million of impairment expense we recorded in 2001, which reduced the remaining balance subject to future amortization. To a lesser extent, the application of SFAS No. 142, under which goodwill is no longer amortized, but is reviewed periodically for impairment, contributed to the decrease in expense.

Restructuring. During the first quarter of 2002, we implemented a second workforce reduction in connection with the program we began in the third quarter of 2001, eliminating 35 positions or 13% of our workforce. Positions were eliminated from all functional areas—operations, R&D and SG&A. This reduction resulted from the continued integration of recently acquired companies, as well as continued execution of our product and technology strategy, whereby we decided to phase out the legacy storage subsystem board products we acquired from CMD and to develop new board products only if we believed it would facilitate or accelerate the use of our storage semiconductor products. In connection with this workforce reduction, we recorded restructuring expense in the first quarter of 2002 of \$2.2 million, consisting of cash severance-related costs of \$198,000, non-cash severance-related costs of \$318,000 representing the intrinsic value of modified stock options, an expected loss on leased facilities of \$1.2 million and fixed asset write-downs of \$500,000. In addition, we reversed \$76,000 of unearned compensation, a component of stockholders' equity, for unvested stock options that were cancelled in connection with employee terminations. Since some of the affected employees have termination dates in the second quarter of 2002, we expect to record additional expense at that time for the modification of their stock options.

Severance-related costs were determined based on the amount of pay people received that was not for services performed and by measuring the intrinsic value of stock options that were modified to the benefit of terminated employees. The expected loss on leased facilities resulted from our plan to consolidate our remaining workforce to the extent practicable and sublease any excess space. To determine the expected loss, we compared our lease and operating costs for the space to our estimate of the net amount we would be able to recover by subleasing the space. This estimate was based on a number of assumptions, including the length of time it will take to secure a tenant, the sublease rate per square foot, the cost of necessary improvements or modifications and real estate broker commissions. The fixed asset write-down was determined based on the estimated fair value of assets, primarily computer hardware and software, that would no longer be utilized after the employees' termination date.

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The following table presents restructuring activity for 2001 and through March 31, 2002 (in thousands). All cash payments are expected to be made by June 30, 2003.

	Severance and Benefits	Leased Facilities	Fixed Assets	Total
Fourth quarter 2001 provision	\$ 902	\$ 500	\$ 50	\$ 1,452
Cash payments	(191)	—	—	(191)
Non-cash charges	(303)	(115)	—	(418)
December 31, 2001 Balance	408	385	50	843
First quarter 2002 provision	516	1,177	500	2,193
Cash payments	(289)	(149)	—	(438)
Non-cash charges	(318)	—	(550)	(868)
March 31, 2002 Balance	\$ 317	\$ 1,413	\$ —	\$ 1,730

Patent defense and acquisition integration costs. Patent defense and acquisition integration costs were \$706,000 for the first quarter of 2002. Patent defense costs are related to the lawsuit we filed against Genesis Microchip in April 2001, and acquisition integration costs represent costs incurred to integrate CMD and SCL. We do not expect to incur additional integration costs for CMD and SCL, but do expect to incur patent defense costs at least until the middle of 2003.

Interest Income and other, net. Interest income and other, net decreased to \$270,000 for the first quarter of 2002, from \$897,000 for the first quarter of 2001. The decrease is primarily due to a \$18.7 million decrease in our cash and investment balances, and, to a lesser extent, to a decrease in interest rates.

Provision for Income Taxes. We did not record a provision for income taxes in the first quarter of 2002, as we do not expect to generate book or taxable income in 2002. There was no provision for income taxes in the first quarter of 2001.

At March 31, 2002, we had a net operating loss carryforward for federal income tax purposes of approximately \$37.6 million that expires in various years through 2022. These future tax benefits have not been recognized as an asset on our balance sheet due to uncertainties surrounding our ability to generate sufficient taxable income in future periods to realize the benefits. Under the Tax Reform Act of 1986, the amounts of, and benefits from, net operating loss carryforwards may be restricted or limited in certain circumstances. We do not expect to be subject to these restrictions or limitations.

Liquidity and Capital Resources

At March 31, 2002, we had \$33.7 million in working capital and \$38.8 million in cash, cash equivalents and short-term investments.

Operating activities used \$4.1 million of cash during the first quarter of 2002 and \$2.8 million of cash during the first quarter of 2001. During the first quarter of 2002, net loss excluding depreciation, stock compensation and warrant expense, amortization of intangible assets, and the non-cash portion of our restructuring charges was \$4.5 million, which accounts for most of the cash used in operating activities. Decreases in accounts payable and accrued liabilities used \$677,000 of cash, an increase in inventories used \$377,000 of cash and an increase in deferred margin provided \$906,000 of cash. During the first quarter of 2001, net loss excluding depreciation, stock compensation and warrant expense and amortization of goodwill and intangible assets was \$1.2 million. Decreases in accounts payable, accrued expenses and deferred margin used \$4.3 million of cash. These uses of cash were partially offset by cash provided through collection of accounts receivable of \$2.9 million.

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We generated \$2.8 million of cash from investing activities during the first quarter of 2002 and \$15.7 million during the first quarter of 2001. The source of cash in both periods was net proceeds from sales of short-term investments, partially offset by capital expenditures.

Financing activities provided \$2.4 million of cash in the first quarter of 2002 and \$656,000 in the first quarter of 2001. Cash provided by financing activities in both periods was primarily from stock option exercises and proceeds from sales of shares under our employee stock purchase plan, partially offset by repayments of our capital leases and other obligations.

In April 2002, we extended the term of our \$3.1 million loan through July 2002. This loan is secured by a certificate of deposit totaling \$3.1 million, and bears interest at 2% above the rate in effect under this certificate of deposit (1.6% at March 31, 2002). We intend to refinance this note over a longer term.

Our contractual obligations at March 31, 2002, and the effect such obligations are expected to have on our liquidity and cash flow in future periods have not changed materially since December 31, 2001 as described in our Form 10-K.

Based on our expected cash usage, we believe our existing cash balance is sufficient to meet our capital and operating requirements for at least the next 12 months. Operating and capital requirements depend on many factors, including the levels at which we generate revenue and maintain margins, inventory and accounts receivable, the cost of securing access to adequate manufacturing capacity and our operating expenses. To the extent existing resources and cash from operations are insufficient to support our activities, we may need to raise additional funds through public or private equity or debt financing. These funds may not be available, or if available, we may not be able to obtain them on terms favorable to our stockholders or us.

Factors Affecting Future Results

You should carefully consider the following risk factors, together with all other information contained or incorporated by reference in this filing, before you decide to purchase shares of our common stock. These factors could cause our future results to differ materially from those expressed in or implied by forward-looking statements made by us. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also harm our business. The trading price of our common stock could decline due to any of these risks, and you may lose all or part of your investment.

We have a limited operating history and operate in rapidly evolving markets, which make it difficult to evaluate our future prospects.

We were founded in 1995 and have a limited operating history, which makes an evaluation of our future success difficult. In addition, the revenue and income potential of our business and the markets we serve is unproven. We began volume shipments of our first display products in the third quarter of 1997. The Digital Visual Interface, or DVI, specification, which is based on technology developed by us and used in many of our products, was first published in April 1999. The DVI specification defines a high-speed data communication link between computers and digital displays, such as flat panel displays, projectors and cathode ray tubes. We have only recently completed our first generation of consumer electronics and storage IC products. Accordingly, we face risks and difficulties frequently encountered by early-stage companies in new and rapidly-evolving markets. If we do not successfully address these risks and difficulties, our results of operations could be negatively affected.

We have a history of losses and may not become profitable.

We have incurred net losses in each quarter since our inception, including losses of \$17.8 million in the first quarter of 2002, \$76.1 million in 2001, \$23.2 million in 2000, and \$7.6 million in 1999. We expect to continue to incur net losses for the foreseeable future. Accordingly, we may not achieve and sustain profitability.

Our quarterly operating results may fluctuate significantly and are difficult to predict.

Our quarterly operating results are likely to vary significantly in the future based on a number of factors over which we have little or no control. These factors include, but are not limited to:

- the growth and evolution of industry standards for our key markets, including digital-ready PCs and displays, consumer electronics and storage devices;
- competitive pressures, including the ability of competitors to successfully introduce products that are more cost-effective or that offer greater functionality than our products;

- the availability of other semiconductors or other key components that are required to produce a complete solution for the customer. Usually, we supply one of many necessary components;
- the cost of components for our products and prices charged by the third parties who manufacture, assemble and test our products; and
- fluctuations in the price of our stock which drive a portion of our non-cash stock compensation and warrant expense.

Because we have little or no control over these factors, our operating results are difficult to predict. Any substantial adverse change in any of these factors could negatively affect our business and results of operations.

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Our future quarterly operating results are highly dependent upon achieving success in targeted new markets of storage and consumer electronics.

Our quarterly operating results may fluctuate based on how well we manage our business. Some of the factors that may affect how well we manage our business include the following:

- our ability to manage product introductions and transitions;
- our ability to successfully manage our entry into new markets such as storage and consumer electronics;
- the success of the distribution channels through which we choose to sell our products; and
- our ability to manage expense and inventory levels.

If we fail to effectively manage our business, this could adversely affect our results of operations.

Our strategic restructuring program may not be successful.

During the third quarter of 2001, we began a program to focus our business on products and technology, including those obtained through acquisitions, in which we have, or believe we can achieve, a leadership position. As part of this program, we decided to cancel numerous products under development and to remove certain projects from our development plan, to phase out or de-emphasize certain existing products and to integrate the operations of our two recently acquired companies—CMD and SCL. In particular, we intend to concentrate on our discrete transmitter and receiver products for PCs and displays, and on developing products and establishing industry standards for the consumer electronics and storage markets. We expect that we will continue to generate revenue from sales of products being phased out or de-emphasized for a limited period of time and that costs for selling and marketing these products will be minimal due to the limited resources allocated for this purpose. Products to be phased out or de-emphasized represented approximately 6% of our revenue in 2001 and 3% of our revenue for the three months ended March 31, 2002. In connection with this program, we reduced our workforce by approximately 60 people, in connection with this program and recorded restructuring expense of \$1.5 million. In the first quarter of 2002, we implemented a second workforce reduction in connection with this program, eliminating an additional 35 positions and recorded restructuring expense of \$2.2 million. In April 2002, we implemented a third workforce reduction in connection with this program, eliminating an additional 12 positions. We will incur cash and non-cash restructuring expenses in the second and third quarters of 2002 in connection with this workforce reduction. The amount of expense to be incurred is difficult to predict due to the volatility of our stock price and its effect on non-cash severance-related expenses.

There is no guarantee that our strategic restructuring program will be successful. The consumer electronics market and storage market for devices using a Fibre Channel or Serial ATA interface are still developing and evolving and we are still developing our first generation of products for these markets. We have only recently begun to achieve design wins in both CE devices, such as set-top boxes and digital televisions, and storage devices using the Fibre Channel interface, such as Fibre Channel Host Bus Adapters and Switches, and have yet to achieve a design win for storage devices using the Serial ATA interface. Consequently, we may not achieve a leadership position in these markets. We may face customer dissatisfaction and negative publicity due to our decision to phase out or de-emphasize certain existing products and to cancel development projects. This could increase our costs, damage our reputation and distract our management. We have limited experience marketing and selling our technology on a licensing basis. We signed our first two license contracts during the first quarter of 2002; however, there can be no assurance that additional companies will be interested in licensing our PanelLink core on commercially favorable terms or at all. We also cannot ensure that companies who license our technology will pay agreed upon royalties, will not infringe upon or misappropriate our intellectual property and will maintain the confidentiality of our proprietary

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information. If we are ineffective at implementing or managing our strategic restructuring program, our business could be harmed.

We face intense competition in our markets, which may lead to reduced revenue from sales of our products and increased losses.

The high-speed communication, display and storage semiconductor industries are intensely competitive. These markets are characterized by rapid technological change, evolving standards, short product life cycles and declining selling prices. Our current display products face competition from a number of sources, including analog solutions, DVI-based solutions, dual (analog- and DVI-based) solutions and other digital interface solutions. We expect competition in the display market to increase. For example, Analog Devices, ATI, Broadcom, Chrontel, Genesis Microchip, Macronix, Matrox, National Semiconductor, nVidia, Phillips, Pixelworks, Sage (now owned by Genesis), SIS, Smart ASIC, ST Microelectronics, Texas Instruments and Thine have all begun shipping products or announced intentions to introduce products that we expect will compete with our PanelLink products. Other companies have announced DVI-based solutions and we expect that additional companies are likely to enter the market. In the future, our current or potential customers may also develop their own proprietary solutions that would likely be the integration of a DVI transmitter or receiver into one of their products.

In the consumer electronics market, our video processing products face competition from products sold by AV Science, Focus Enhancements, Genesis, nDSP, N/S Mediamatics, Micronas Semiconductor, Phillips Semiconductor, Pixelworks, Sage (now owned by Genesis) and Trident. We also compete, in some instances, against in-house processing solutions designed by large original equipment manufacturers.

In the storage market, our Fibre Channel product faces competition from companies selling similar discrete products, including Agilent and Vitesse, from other Fibre Channel SerDes providers who license their core technology such as LSI Logic, and from companies that sell HBA controllers with integrated SerDes, such as QLogic and Agilent.

We expect that our Serial ATA products will compete with similar products from Marvell. In addition, other companies have developed or announced intentions to develop SATA controllers such as Adaptec, APT, Intel, LSI Logic, Promise and Vitesse. We also may compete against Intel and other motherboard chip-set makers that may integrate SATA functionality into their chipsets.

Our Parallel ATA products compete with IC vendors including Promise and Highpoint. Our RAID controller board products face competition from Mylex, Infortrend, and Chaparral.

Some of these competitors have already established supplier or joint development relationships with current or potential customers and may be able to leverage their existing relationships to discourage these customers from purchasing products from us or persuade them to replace our storage products with theirs. Many of our competitors have longer operating histories, greater presence in key markets, better name recognition, access to larger customer bases and significantly more financial, sales and marketing, manufacturing, distribution, technical and other resources than we do. In addition, some of our competitors could merge which may enhance their market presence. As a result, they may be able to adapt more quickly to new or emerging technologies and customer requirements, or devote more resources to the promotion and sale of their products. We cannot assure you that we can compete successfully against current or potential competitors, or that competition will not reduce our revenue and increase our losses.

Growth of the market for our products for both computers and digital displays depends on the widespread adoption and use of the DVI specification.

Our success is largely dependent upon the rapid and widespread adoption of the DVI specification, which defines a high-speed data communication link between computers and digital displays. We cannot predict the rate at which manufacturers of computers and digital displays will adopt the DVI specification. To date, relatively few systems implementing all of the electrical and mechanical aspects of the DVI specification have been shipped. Adoption of the DVI specification may be affected by the availability of computer components able to communicate DVI-compliant signals, such as transmitters, receivers, connectors and cables necessary to implement the specification. Other specifications may also emerge that could adversely affect the acceptance of the DVI specification. For example, a number of companies have promoted alternatives to the DVI specification using other interface technologies, such as low voltage differential signaling, or LVDS. Delays in the widespread adoption of the DVI specification could reduce acceptance of our products, limit or reduce our revenue growth and increase our losses.

Our ability to increase sales of our products for display systems depends on host system manufacturers including DVI-compliant transmitters in their systems.

Our success depends on increasing sales of our receiver products to display manufacturers. To increase sales of our receiver products, we need computer manufacturers to incorporate DVI-compliant transmitters in their systems, making these systems digital-ready. If computers are not digital-ready, they will not operate with their digital displays, which will limit and may reduce the demand for our digital receiver products.

Our success depends on the growth of the new and emerging digital display market.

Our business depends on the growth of the new and emerging digital display market. The potential size of the digital display market and its rate of development are uncertain and will depend on many factors, including:

- the number of digital-ready computers that are being produced and consumer demand for these computers;
- the rate at which display manufacturers replace analog or non-compliant DVI interfaces with fully DVI-compliant interfaces;
- the availability of cost-effective semiconductors that implement a fully DVI-compliant interface; and
- improvements to analog technology, which may decrease consumer demand for our digital display products.

In order for the digital display market to grow, digital displays must be widely available and affordable to consumers. In the past, the supply of digital displays, such as flat panels, has been cyclical and consumers have been very price sensitive. In addition, although there has been initial interest in cathode ray tubes with a digital interface, to date only a few manufacturers have announced intentions to manufacture digital cathode ray tubes and very few manufacturers have made such displays available for purchase. Also, some manufacturers have implemented DVI interfaces that are not fully DVI-compliant. These interfaces often interfere with the operability of our products which function best with a fully DVI-compliant interface. Our ability to sustain or increase our revenue may be limited should there not be an adequate supply of, or demand for, affordable digital displays with fully DVI-compliant interfaces.

Our success depends on the development and growth of markets for products based on new and emerging storage technologies.

Our product development efforts in the storage market are focused on the development of products using new interface technologies such as Fibre Channel and Serial ATA. The markets for these new interface technologies are at an early stage of development, and there can be no assurance that they will replace other storage interfaces that are now widely used, such as Parallel ATA and SCSI. The potential size and rate of development of these markets are uncertain and will depend on many factors, including:

- the rate at which manufacturers of storage subsystems adopt new interface technologies, which are currently more costly to implement than existing interface technologies;
- the availability of cost-effective semiconductors for storage subsystems that implement new interface technologies for the storage market; and
- improvement to existing storage interface technologies such as Parallel ATA and SCSI, or the introduction of other new storage interface technologies, either of which may decrease consumer demand for our storage products.

In particular, the rate of implementation of the Serial ATA interface will depend on how quickly drive manufacturers, motherboard and PC providers and chipmakers are able to resolve technical communication and functionality issues to enable a "plug and play" environment where a computer system is automatically able to recognize and configure storage devices. Resolution of these issues could be time-consuming, and will depend in good measure on the ability of chipmakers to incorporate the required high-speed serial data transfer capabilities into their semiconductors without sacrificing manufacturing yields.

Any delay in acceptance of new interface technologies, or a reduction in the growth or size of the market for systems based on Serial ATA or Fibre Channel technologies would limit sales of our storage products and reduce our revenue.

To date, we have not achieved any design wins for our recently announced Serial ATA products, and only a limited number of design wins for our Fibre Channel storage products. Even after we have achieved a design win from an OEM, we may not realize any revenue, or significant revenue, from that OEM since a design win is not a binding commitment to purchase our products and the OEM may not achieve market acceptance for their product.

A substantial amount of our revenue is generated by products for the PC industry, which is an industry that has slowed in growth.

Since inception, we have derived substantially all of our revenue from our products for PCs and PC-related displays. Accordingly, we are highly dependent on the PC industry, which experienced a slowdown in growth during the second half of 2000 that continued throughout 2001, and into 2002. We cannot predict the duration or severity of the this downturn in the PC and display market, or in the general economy, or its effect on our revenue and operating results. If the market for PCs and PC-related displays continues to grow at a slow rate or contracts whether due to reduced demand from end users, macroeconomic conditions or other factors, our business and results of operations could be negatively affected.

Although we are attempting to broaden our product offerings to include products for the consumer electronics and storage markets, there can be no guarantee that we will succeed in this effort. To date, we have only achieved limited design wins in the consumer electronics

industry. If we fail to consistently achieve design wins in the consumer electronics and storage markets, we will remain highly dependent on the PC industry.

Our lengthy sales cycle can result in a delay between incurring expenses and generating revenue, which could harm our operating results.

Because our products, including our Serial ATA products announced in February 2002, are based on new technology and standards, a lengthy sales process, typically requiring several months or more, is often required before potential customers begin the technical evaluation of our products. This technical evaluation can exceed nine months, and it can then be an additional nine months before a customer commences volume shipments of systems incorporating our products, if at all. Given our lengthy sales cycle, we may experience a delay between the time we incur expenditures and the time we generate revenue, if any. As a result, our operating results could be seriously harmed if a significant customer reduces or delays orders, or chooses not to release products incorporating our products.

We depend on a few key customers and the loss of any of them could significantly reduce our revenue.

Historically, a relatively small number of customers and distributors have generated a significant portion of our revenue. For the first quarter of 2002, shipments to Weikeng, an Asian distributor, generated 17% of our revenue, shipments to World Peace International, an Asian distributor, generated 14% of our revenue and shipments to Samsung, a Korean customer, generated 11% of our revenue. For the year 2001, shipments to Samsung and Compaq, a global customer, each generated 12% of our revenue, and shipments to World Peace International generated 11% of our revenue. We cannot be certain that customers and key distributors that have accounted for significant revenue in past periods, individually or as a group, will continue to sell our products and generate revenue. As a result of this concentration of our customers, our results of operations could be negatively affected if any of the following occurs:

- one or more of our key customers or distributors significantly reduces, delays or cancels orders; or
- one or more significant customers selects products manufactured by one of our competitors for inclusion in their future product generations.

Due to our recent acquisitions and entrance into new markets, our customer base has broadened significantly and we therefore anticipate being less dependent on a relatively small number of customers to generate revenue. However, as product mix may fluctuate from quarter to quarter, we may become more dependent on a small number of customers or a single customer for a significant portion of our revenue in a particular quarter, the loss of which could adversely affect our operating results.

We sell our products through distributors, which limits our direct interaction with our customers, therefore reducing our ability to forecast sales and increasing the complexity of our business.

Many original equipment manufacturers rely on third-party manufacturers or distributors to provide inventory management and purchasing functions. Distributors generated 41% of our revenue for the first quarter of 2002 and 40% of our revenue for 2001. We expect the percentage of revenue generated through distributors in 2002 to increase as our IC business grows at a faster rate than our storage sub-systems business. Selling through distributors reduces our ability to forecast sales and increases the complexity of our business, requiring us to:

- manage a more complex supply chain;
- monitor and manage the level of inventory of our products at each distributor;
- estimate the impact of credits, return rights, price protection and unsold inventory at distributors; and

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- monitor the financial condition and credit-worthiness of our distributors, the majority of which are not publicly traded.

Any failure to manage these challenges could disrupt or reduce sales of our products.

We are sometimes required to maintain certain levels of our inventory at a customer's or intermediary's site in line with a customer's projection of their requirements. These customer projections are generally non-binding and we risk excess and obsolete inventory in the event that the customer's projections decrease or do not materialize and we cannot re-allocate the inventory to other customers. Any of these events may adversely affect our results of operations.

Our success depends on the development and introduction of new products, which we may not be able to do in a timely manner because the process of developing high-speed semiconductor products is complex and costly.

The development of new products is highly complex, and we have experienced delays, some of which exceeded one year, in the development and introduction of new products on several occasions in the past. In February 2002, we announced our SATALink storage product family and we expect to introduce new consumer electronics, storage, transmitter and receiver products in the future. As our products integrate new, more advanced functions, they become more complex and increasingly difficult to design and debug. Successful product development and introduction depends on a number of factors, including, but not limited to:

- accurate prediction of market requirements and evolving standards, including enhancements to existing standards such as DVI, HDCP and SATA;
- development of advanced technologies and capabilities, and new products that satisfy customer requirements;
- timely completion and introduction of new product designs;
- use of leading-edge foundry processes and achievement of high manufacturing yields; and
- market acceptance.

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Accomplishing all of this is extremely challenging, time-consuming and expensive. We cannot assure you that we will succeed. Product development delays may result from unanticipated engineering complexities, changing market or competitive product requirements or specifications, difficulties in overcoming resource limitations, the inability to license third party technology or other factors. If we are not able to develop and introduce our products successfully and in a timely manner, our costs could increase or our revenue could decrease, both of which would adversely affect our operating results.

We plan to introduce new products for the storage market, including our recently announced Serial ATA products. We do not expect to begin generating revenue from these products before the second half of 2002, and it is possible that we may experience delays beyond this period in generating revenue from these products. To date, we have not achieved any design wins for our new Serial ATA products. We are still working with a semiconductor foundry and with potential customers to complete product development and to validate manufacturing methods and processes to support volume production. Each of these steps may involve unanticipated difficulties, which could delay product introduction and reduce market acceptance of the product. There can be no assurance that we will be able to achieve design wins for these or any of our planned new products, that we will be able to complete development of these products when anticipated, or that these products can be manufactured in commercial volumes at acceptable yields. Failure to develop and introduce Serial ATA products successfully and in a timely manner may adversely affect our results of operations.

We have made acquisitions in the past and may make acquisitions in the future, if advisable, and these acquisitions involve numerous risks.

Our growth depends upon market growth and our ability to enhance our existing products and introduce new products on a timely basis. One of the ways we develop new products and enter new markets is through acquisitions of other companies. In 2000, we completed the acquisitions of Zillion Technologies, LLC and DVDO, Inc., and in 2001, we completed the acquisitions of CMD Technology Inc. and Silicon Communication Lab, Inc. (SCL). Acquisitions of high-technology companies involve numerous risks, including, but not limited to, the following:

- difficulty and increased costs in assimilating employees, including our possible inability to keep and retain key employees of the acquired business;
- disruption of our ongoing business;
- inability to successfully incorporate acquired technology and operations into our business and maintain uniform standards, controls, policies and procedures; and
- inability to commercialize acquired technology.

No assurance can be given that our acquisitions of Zillion, DVDO, CMD or SCL, or our future acquisitions, if any, will be successful and will not adversely affect our business, operating results or financial condition. Failure to manage growth effectively and to successfully integrate acquisitions made by us could materially harm our business and operating results.

The cyclical nature of the semiconductor industry may create fluctuations in our foundry, test and assembly capacity.

In the past, the semiconductor industry has been characterized by significant downturns and wide fluctuations in supply and demand. For example, demand in the semiconductor industry rose to record levels in 1999, but is currently in a downward cycle. The industry has also experienced significant fluctuations in anticipation of changes in general economic conditions. This cyclical nature has led to significant fluctuations in product demand and in the foundry, test and assembly capacity of third party suppliers. Production capacity for semiconductors fabricated using 0.18 micron technology, currently the most advanced technology used in mass production, is somewhat limited. This may impact our ability to

meet demand and could also increase our production costs. We expect that less than 5% of our 2002 revenue will be generated by products that are manufactured using 0.18 micron technology. Cyclical nature has also accelerated decreases in average selling prices per unit. We may experience fluctuations in our future financial results because of changes in industry-wide conditions.

We depend on third-party sub-contractors to manufacture, assemble and test nearly all of our products, which reduces our control over the production process.

We do not own or operate a semiconductor fabrication facility. We rely almost entirely on TSMC, an outside foundry, to produce all of our display-related semiconductor products. We also rely on Kawasaki and Atmel, who are also outside foundries, to produce our storage semiconductor products. Our reliance on independent foundries involves a number of significant risks, including, but not limited to:

- reduced control over delivery schedules, quality assurance, manufacturing yields and production costs;
- lack of guaranteed production capacity or product supply; and
- lack of availability of, or delayed access to, next-generation or key process technologies.

For example, production capacity for semiconductors fabricated using 0.18 micron technology, currently the most advanced technology used in mass production, is somewhat limited. This may impact our ability to meet demand and could also increase our production costs. We expect that approximately 3% of our 2002 revenue will be generated by products that are manufactured using 0.18 micron technology.

In addition, our semiconductor products are assembled and tested by several independent sub-contractors. We do not have a long-term supply agreement with our sub-contractors, and instead obtain production services on a purchase order basis. Our outside sub-contractors have no obligation to supply products to us for any specific period of time, in any specific quantity or at any specific price, except as set forth in a particular purchase order. Our requirements represent a small portion of the total production capacity of our outside foundries, assembly and test facilities and our sub-contractors may reallocate capacity to other customers even during periods of high demand for our products. If our sub-contractors are unable or unwilling to continue manufacturing our products in the required volumes, at acceptable quality, yields and costs, and in a timely manner, our business would be substantially harmed. As a result, we would have to identify and qualify substitute contractors, which would be time-consuming, costly and difficult. This qualification process may also require significant effort by our customers. In addition, if competition for foundry, assembly and test capacity increases, our product costs may increase and we may be required to pay significant amounts or make significant purchase commitments to secure access to production services.

The nature of our production process is complex, which reduces identification of problems until well into the production cycle.

The manufacture of semiconductors is a complex process, and it is often difficult for semiconductor foundries to achieve acceptable product yields. Product yields depend on both our product design and the manufacturing process technology unique to the semiconductor foundry. Since low yields may result from either design or process difficulties, identifying yield problems can only occur well into the production cycle, when an actual product exists that can be analyzed and tested.

Further, we only test our products after they are assembled, as their high-speed nature makes earlier testing difficult and expensive. As a result, defects are not discovered until after assembly. This could result in a substantial number of defective products being assembled and tested, thus lowering

our yields and increasing our costs. These risks could result in product shortages or increased costs of assembling and testing our products.

Although we test our products before shipment, they are complex and may contain defects and errors. In the past, we have encountered defects and errors in our products. Because our products are sometimes integrated with products from other vendors, it may be difficult to identify the source of any particular problem. Delivery of products with defects or reliability, quality or compatibility problems, may damage

our reputation and our ability to retain existing customers and attract new customers. In addition, product defects and errors could result in additional development costs, diversion of technical resources, delayed product shipments, increased product returns, and product liability claims against us that may not be fully covered by insurance.

We face foreign business, political and economic risks because a majority of our products and our customers' products are manufactured and sold outside of the United States.

A substantial portion of our business is conducted outside of the United States, and as a result, we are subject to foreign business, political and economic risks. Nearly all of our products are manufactured in Taiwan or elsewhere in Asia, and for the first quarter of 2002 and the year 2001, 74% and 79%, respectively, of our revenue was generated from customers and distributors located outside of the United States, primarily in Asia. We anticipate that sales outside of the United States will continue to account for a substantial portion of our revenue in future periods. Accordingly, we are subject to international risks, including, but not limited to:

- difficulties in managing from afar;
- political and economic instability;
- difficulties in collecting accounts receivable;
- difficulties in complying with multiple, conflicting and changing laws and regulations, including export requirements, tariffs, import duties, visa restrictions and other barriers; and
- competition from foreign-based suppliers and the existence of protectionist laws and business practices that favor these suppliers, such as withholding taxes on payments made to us.

These risks could adversely affect our business and our results of operations. In addition, original equipment manufacturers who design our semiconductors into their products sell them outside of the United States. This exposes us indirectly to foreign risks. Because sales of our products are denominated exclusively in United States dollars, increases in the value of the United States dollar will increase the foreign currency price equivalent of our products, which could lead to a reduction in sales and profits in that country.

The success of our business depends upon our ability to adequately protect our intellectual property.

We rely on a combination of patent, copyright, trademark, mask work and trade secret laws, as well as nondisclosure agreements and other methods, to protect our proprietary technologies. We have been issued patents and have a number of pending patent applications. However, we cannot assure you that any patents will be issued as a result of any applications or, if issued, that any claims allowed will protect our technology. In addition, we do not file patent applications on a worldwide basis, meaning we do not have patent protection in some jurisdictions. It is possible that existing or future patents may be challenged, invalidated or circumvented and effective patent, copyright, trademark and trade secret protection may be unavailable or limited in foreign countries. It may be possible for a third party to copy or otherwise obtain and use our products or technology without authorization, develop similar technology independently or design around our patents in the United States and in other jurisdictions. It is also possible that some of our existing or new licensing relationships will enable other parties to

use our intellectual property to compete against us. Legal actions to enforce intellectual property rights tend to be lengthy and expensive, and the outcome often is not predictable. As a result, despite our efforts and expenses, we may be unable to prevent others from infringing upon or misappropriating our intellectual property, which could harm our business.

Our participation in the Digital Display Working Group requires us to license some of our intellectual property for free, which may make it easier for others to compete with us.

We are a promoter of the Digital Display Working Group, which published and promotes the DVI specification. Our strategy includes establishing the DVI specification as the industry standard, promoting and enhancing this specification and developing and marketing products based on this specification and future enhancements. As a result:

- we must license for free specific elements of our intellectual property to others for use in implementing the DVI specification; and
- we may license additional intellectual property for free as the Digital Display Working Group promotes enhancements to the DVI specification.

Accordingly, companies that implement the DVI specification in their products can use specific elements of our intellectual property for

free to compete with us.

We have granted Intel rights with respect to our intellectual property, which could allow Intel to develop products that compete with ours or otherwise reduce the value of our intellectual property.

We have entered into a patent cross-license agreement with Intel in which each of us granted the other a license to use the grantor's patents, except for identified types of products. We believe that the scope of our license to Intel excludes our current products and anticipated future products. Intel could, however, exercise its rights under this agreement to use our patents to develop and market other products that compete with ours, without payment to us. Additionally, Intel's rights to our patents could reduce the value of our patents to any third party who otherwise might be interested in acquiring rights to use our patents in such products. Finally, Intel could endorse a competing digital interface, or develop its own proprietary digital interface. Any of these actions could substantially harm our business and results of operations.

We are and may continue to become the target of securities class action suits which could result in substantial costs and divert management attention and resources.

Securities class action suits are often brought against companies following periods of volatility in the market price of their securities. Defending against these suits, even if without merit, can result in substantial costs to us and could divert the attention of our management. We and certain of our officers and directors, together with certain investment banks, have been named as defendants in a securities class action suit filed against us on behalf of purchasers of our securities between October 5, 1999 and December 6, 2000. It is alleged that the prospectus related to our initial public offering was misleading because it failed to disclose that the underwriters of our initial public offering had solicited and received excessive commissions from certain investors in exchange for agreements by investors to buy our shares in the aftermarket for predetermined prices. Due to inherent uncertainties in litigation, we cannot accurately predict the outcome of this potential litigation. We believe that these claims are without merit and we intend to defend vigorously against them. However, these claims and any other that may be brought, even if not meritorious, could require us to incur expenses and could divert our management's attention and resources. In addition, any unfavorable outcome of this possible litigation could adversely impact our business, financial condition and results of operations.

We may become engaged in intellectual property litigation that could be time-consuming, may be expensive to defend, and could adversely affect our ability to sell our product.

In recent years, there has been significant litigation in the United States and in other jurisdictions involving patents and other intellectual property rights. This litigation is particularly prevalent in the semiconductor industry, in which a number of companies aggressively use their patent portfolios to bring infringement claims. In addition, in recent years, there has been an increase in the filing of so-called "nuisance suits," alleging infringement of intellectual property rights. These claims may be asserted as counterclaims in response to claims made by a company alleging infringement of intellectual property rights. These suits pressure defendants into entering settlement arrangements to quickly dispose of such suits, regardless of merit.

In April 2001, we filed suit against Genesis Microchip for infringement of one of our U.S. patents. At that time, we also filed a complaint against Genesis for unlawful trade practices related to the importation of articles infringing our patent. In February 2002, our motion to dismiss the unlawful trade practices complaint was granted and we filed an amended complaint against Genesis alleging infringement of two of our U.S. patents. These patents relate to our DVI receiver products, which generate a significant portion of our revenue. The amended complaint seeks a declaration that Genesis has infringed our patents, that Genesis' behavior is not licensed, an injunction to halt the importation, sale, manufacture and use of Genesis DVI receiver chips that infringe our patents, and monetary damages. In April 2002, Genesis answered and made counterclaims against us for non-infringement, license, patent invalidity, fraud, antitrust, unfair competition and patent misuse. Also in April 2002, we filed a motion to dismiss several of the counterclaims, and filed an answer that denied the remaining counterclaims. In addition, we filed a motion to bifurcate trial of the counterclaims to the extent the court does not dismiss them. In the opinion of management, the counterclaims are without merit. We intend to vigorously prosecute the case and to defend ourselves against the counterclaims. We expect that jury selection for trial will begin in January 2003.

There can be no assurance that we will prevail in this litigation. While this litigation is pending, Genesis can use the technology covered by these patents to develop products that might compete with ours. If we are unsuccessful in this litigation, we could be unable to prevent Genesis or others from using the technology covered by this patent. Even if we do prevail in this litigation, uncertainties regarding the outcome prior to that time may reduce demand for our products. In addition, further disputes may occur regarding the scope of the intellectual property license we have granted to Digital Display Working Group participants for use in implementing the DVI specification in their products. These disputes may result in additional costly and time-consuming litigation or the license of additional elements of our intellectual property for free.

Any potential intellectual property litigation against us could also force us to do one or more of the following:

- stop selling products or using technology that contain the allegedly infringing intellectual property;
- attempt to obtain a license to the relevant intellectual property, which license may not be available on reasonable terms or at all;

and

- attempt to redesign products that contain the allegedly infringing intellectual property.

If we are forced to take any of these actions, we may be unable to manufacture and sell our products. We may be exposed to liability for monetary damages, the extent of which would be very difficult to accurately predict. In addition, we may be exposed to customer claims, for potential indemnity obligations, and to customer dissatisfaction and a discontinuance of purchases of our products while the litigation is pending. Any of these consequences could substantially harm our business and results of operations.

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We must attract and retain qualified personnel to be successful, and competition for qualified personnel is increasing in our market.

Our success depends to a significant extent upon the continued contributions of our key management, technical and sales personnel, many of whom would be difficult to replace. The loss of one or more of these employees could harm our business. We do not have key person life insurance for any of our key personnel. Our success also depends on our ability to identify, attract and retain qualified technical, sales, marketing, finance and managerial personnel. Competition for qualified personnel is particularly intense in our industry and in our location. This makes it difficult to retain our key personnel and to recruit highly-qualified personnel. We have experienced, and may continue to experience, difficulty in hiring and retaining candidates with appropriate qualifications. To be successful, we need to hire candidates with appropriate qualifications and retain our key executives and employees.

Our recent workforce reductions may seriously harm our business.

In connection with the program we began in the third quarter of 2001 to focus our business on products and technology in which we have, or believe we can achieve, a leadership positions, we have implemented three workforce reductions eliminating a total of 107 positions since the inception of this program. As a result of the elimination of these positions, our marketing, sales and customer support capabilities could be reduced, our ability to respond to unexpected challenges may be impaired, and we may be unable to take advantage of new opportunities. These workforce reductions, or future workforce reductions, if any, may reduce employee morale and create concern among existing employees about job security, which could lead to increased turnover. Workforce reductions may also raise concerns among customers, suppliers and other corporate partners regarding our continued viability. Further, these workforce reductions may subject us to the risk of litigation, which could be costly to defend, divert the attention of management and subject us to possible liability for damages.

Industry cycles may strain our management and resources.

Cycles of growth and contraction in our industry may strain our management and resources. To manage these industry cycles effectively, we must:

- improve operational and financial systems;
- train and manage our employee base;
- successfully integrate operations and employees of businesses we acquire or have acquired;
- attract, develop, motivate and retain qualified personnel with relevant experience; and
- adjust spending levels according to prevailing market conditions.

If we cannot manage industry cycles effectively, our business could be seriously harmed.

Our operations and the operations of our significant customers, third-party wafer foundries and third-party assembly and test subcontractors are located in areas susceptible to natural disasters.

Our operations are headquartered in the San Francisco Bay Area, which is susceptible to earthquakes, and the operations of CMD, which we acquired, are based in the Los Angeles area, which is also susceptible to earthquakes. TSMC, the outside foundry that produces the majority of our semiconductor products, is located in Taiwan. Advanced Semiconductor Engineering, or ASE, one of the subcontractors that assembles and tests our semiconductor products, is also located in Taiwan. For the three months ended March 31, 2002, customers and distributors located in Taiwan generated 36% of our revenue and customers and distributors located in Japan generated 13% of our revenue. For 2001, customers and distributors located in Taiwan generated 25% of our revenue and customers and

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distributors located in Japan generated 16% of our revenue. Both Taiwan and Japan are susceptible to earthquakes, typhoons and other natural disasters.

Our business would be negatively affected if any of the following occurred:

- an earthquake or other disaster in the San Francisco Bay Area or the Los Angeles area damaged our facilities or disrupted the supply of water or electricity to our headquarters;
- an earthquake, typhoon or other disaster in Taiwan or Japan resulted in shortages of water, electricity or transportation, limiting the production capacity of our outside foundries or the ability of ASE to provide assembly and test services;
- an earthquake, typhoon or other disaster in Taiwan or Japan damaged the facilities or equipment of our customers and distributors, resulting in reduced purchases of our products; or
- an earthquake, typhoon or other disaster in Taiwan or Japan disrupted the operations of suppliers to our Taiwanese or Japanese customers, outside foundries or ASE, which in turn disrupted the operations of these customers, foundries or ASE and resulted in reduced purchases of our products or shortages in our product supply.

Our operations are located in areas susceptible to disruptions of electricity service and possibly severe increases in the costs of electric power and energy.

Our operations are primarily based in the San Francisco Bay Area and Los Angeles area, which like much of California are susceptible to disruptions of electricity service. California's Independent Systems Operator has ordered disruptions of electric services on a rotating basis. As much of our technology development and normal business activities require use of electric power, any, even short-term, interruption in electric service could damage our business. Moreover, we may face a significant increase in the cost of energy, which could increase our costs and adversely affect our operating results.

Provisions of our charter documents and Delaware law could prevent or delay a change in control, and may reduce the market price of our common stock.

Provisions of our certificate of incorporation and bylaws may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable. These provisions include:

- authorizing the issuance of preferred stock without stockholder approval;
- providing for a classified board of directors with staggered, three-year terms;
- prohibiting cumulative voting in the election of directors;
- requiring super-majority voting to amend some provisions of our certificate of incorporation and bylaws;
- limiting the persons who may call special meetings of stockholders; and
- prohibiting stockholder actions by written consent.

Provisions of Delaware law also may discourage, delay or prevent someone from acquiring or merging with us.

The price of our stock fluctuates substantially and may continue to do so.

The stock market has experienced extreme price and volume fluctuations that have affected the market valuation of many technology companies, including Silicon Image. These factors, as well as general economic and political conditions, may materially and adversely affect the market price of our

common stock in the future. The market price of our common stock has fluctuated significantly and may continue to fluctuate in response to a number of factors, including, but not limited to:

- actual or anticipated changes in our operating results;

- changes in expectations of our future financial performance;
- changes in market valuations of comparable companies in our markets;
- changes in our key executives and technical personnel; and
- announcements by us or our competitors of significant technical innovations, design wins, contracts, standards or acquisitions.

Due to these factors, the price of our stock may decline. In addition, the stock market experiences volatility that is often unrelated to the performance of particular companies. These market fluctuations may cause our stock price to decline regardless of our performance.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Interest Rate Risk

Our cash equivalents and short-term investments consist primarily of fixed-income securities that are subject to interest rate risk and will decline in value if interest rates increase. Due to the short duration of our cash equivalents and short-term investments, an immediate 10% change in interest rates would not be expected to have a material effect on our near-term results of operations or financial condition. Our long-term capital lease obligations bear interest at fixed rates; therefore, our results of operations would not be affected by immediate changes in interest rates. Also, components of our stock compensation expense are tied to our stock price. Changes in our stock price can have a significant affect on the amount recorded as stock compensation expense.

Foreign Currency Exchange Risk

All of our sales are denominated in U.S. dollars, and substantially all of our expenses are incurred in U.S. dollars, thus limiting our exposure to foreign currency exchange risk. We currently do not enter into forward exchange contracts to hedge exposures denominated in foreign currencies and do not use derivative financial instruments for trading or speculative purposes. The effect of an immediate 10% change in foreign currency exchange rates should not have a material effect on our future operating results or cash flows; however, a long term change in foreign currency rates would likely result in increased wafer, packaging, assembly or testing costs.

Part II. Other Information

Item 1. Legal Proceedings

On April 24, 2001, we filed suit in the U.S. District Court for the Eastern District of Virginia against Genesis Microchip Corp. and Genesis Microchip, Inc. (collectively, Genesis) for infringement of our U.S. patent number 5,905,769 (USDC E.D. Virginia Civil Action No.: CA-01-266-R) (the Federal Suit). On April 24, 2001, we also filed a complaint against Genesis with the International Trade Commission of the United States government (ITC) for unlawful trade practices related to the importation of articles infringing our patent (the ITC investigation). The actions seek injunctions to halt the importation, sale, manufacture and use of Genesis DVI receiver chips that infringe our patent, and monetary damages. We voluntarily moved to dismiss the ITC investigation, with notice that we would proceed directly in the Federal Suit. Our motion to dismiss was granted on February 7, 2002. We filed an amended complaint for the Federal Suit as of February 28, 2002. In April 2002, Genesis answered and made counterclaims against us for non-infringement, license, patent invalidity, fraud, antitrust, unfair competition and patent misuse. Also in April 2002, we filed a motion to dismiss several of the counterclaims, and filed an answer that denied the remaining counterclaims. In addition, we filed a motion to bifurcate trial of the counterclaims to the extent the court does not dismiss them. In the opinion of management, the counterclaims are without merit. We intend to vigorously prosecute the case and to defend ourselves against the counterclaims. We expect that jury selection for trial will begin in January 2003.

Silicon Image, certain officers and directors, and Silicon Image's underwriters have been named as defendants in a securities class action lawsuit captioned *Gonzales v. Silicon Image, et al.*, No. 01 CV 10903 (SDNY 2001) pending in Federal District Court for the Southern District of New York. The lawsuit alleges that all Defendants were part of a scheme to manipulate the price of Silicon Image's stock in the aftermarket following Silicon Image's initial public offering. Response to the complaint and discovery in this action on behalf of the Company and individual defendants has been stayed by order of the court. The lawsuit is proceeding as part of a coordinated action of over 300 such cases brought by plaintiffs in the Southern District of New York. At this time, Silicon Image cannot opine as to the outcome of this lawsuit; however, Silicon Image intends to defend itself vigorously.

In addition, we are involved in a number of judicial and administrative proceedings incidental to our business. We intend to prosecute or defend, as appropriate, such lawsuits vigorously, and although adverse decisions or settlements may occur in one or more of such cases, the

final resolution of these lawsuits, individually or in the aggregate, is not expected to have a material adverse effect on our results of operations or financial position.

Item 2. Changes in Securities and Use of Proceeds

In connection with our acquisition of Zillion Technologies, LLC, we are obligated under an exchange agreement to periodically issue to the two founders of Zillion shares of our common stock as consideration for their membership interests in Zillion which we acquired and services provided pursuant to their employment agreements with us. The Zillion founders were granted registration rights with respect to the shares to be issued under this exchange agreement. These issuances of shares were made in reliance on an exemption from registration under Section 4(2) of the Securities Act. On March 31, 2002, we issued 18,750 shares of our common stock to the Zillion founders pursuant to the exchange agreement. The issuances of shares were made without general solicitation or advertising and were only made to two individuals.

Item 3. Defaults Upon Senior Securities

Not applicable.

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

Not applicable.

Item 5. Other Information

Not applicable.

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

10.43 Lease Agreement dated April 20, 2000 between LBA-VF III, LLC and CMD Technology.

(b) Reports on Form 8-K

On February 11, 2002, we filed a current report on Form 8-K to report under Item 5, our January 24, 2002 earnings release for the quarter and year ended December 31, 2001.

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Signatures

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

Dated: July 12, 2002

Silicon Image, Inc.

/s/ ROBERT G. GARGUS

Robert G. Gargus
Vice President Finance and Administration and Chief Financial Officer
(Principal Financial and Accounting Officer)

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Signatures

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