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

**Form 10-K**

(Mark One)



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

**For the year ended December 31, 2005**

**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: 000-30649**

**CENTILLIUM COMMUNICATIONS, INC.**

*(Exact name of Registrant as Specified in its Charter)*

**Delaware**  
*(State or Other Jurisdiction of  
Incorporation or Organization)*

**94-3263530**  
*(I.R.S. Employer  
Identification Number)*

**215 Fourier Avenue**  
**Fremont, California 94539**  
**(Address of Principal Executive Offices including Zip Code)**  
**(510) 771-3700**  
**(Registrant's Telephone Number, Including Area Code)**

**Securities registered pursuant to Section 12(b) of the Act: None**  
**Securities registered pursuant to Section 12(g) of the Act:**  
**Common Stock**

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Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

☐ YES    ☒ NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

☐ YES    ☒ NO

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 reports), and (2) has been subject to such filing requirements for the past 90 days.

☒ YES    ☐ NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form10-K or any amendment to this Form 10-K.    ☒

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

Large accelerated filer    ☐    Accelerated filer    ☒    Non-accelerated filer    ☐

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

☐ YES    ☒ NO

The aggregate market value of the voting stock held by non-affiliates of the registrant, as of June 30, 2005, the last business day of the registrant's most recently completed second quarter, was approximately \$70,577,000 based upon the closing price for shares of the registrant's common stock as reported by The NASDAQ National Market. Shares of Common Stock held by each executive officer, director and holder of 5% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a conclusive determination for other purposes.

On March 3, 2006, approximately 40,305,403 shares of the registrant's common stock, \$0.001 par value, were outstanding.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

Part III incorporates certain information by reference from the registrant's definitive proxy statement for the 2006 Annual Meeting of Stockholders, to be filed before May 1, 2006.

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**CENTILLIUM COMMUNICATIONS, INC.**

**FORM 10-K  
ANNUAL REPORT**

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## CAUTIONARY STATEMENT

*This report contains forward-looking statements which include, but are not limited to, statements concerning projected revenues, expenses, gross profit and income, the need for additional capital, our target markets, our ability to design, develop and supply competitive products, market acceptance of our products, our ability to achieve further product integration, the status of evolving technologies and their growth potential, and our production capacity. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs, and certain assumptions made by us. Words such as "anticipates," "expects," "intends," "plans," "believes," "seeks," "estimates," "may," "will" and variations of these words or similar expressions are intended to identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. These statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors. The section entitled "Risk Factors" set forth in Part I, Item 1A, of this report, and similar discussions in our other SEC filings, discuss some of the important risk factors that may affect our business, results of operations and financial condition. You should carefully consider those risks, in addition to the other information in this report and in our other filings with the SEC, before deciding to invest in our company or to maintain or increase your investment. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.*

## PART I

### ITEM 1. BUSINESS

#### COMPANY OVERVIEW

Centillium Communications, Inc. (Centillium or the Company) designs, develops and supplies highly-integrated programmable system-on-a-chip (SoC) solutions that enable high-speed broadband access, which is the delivery of high capacity bandwidth to consumers and enterprises for networking of data, voice and video signals. Our SoC products incorporate digital and mixed-signal semiconductors and related software. We serve the Digital Subscriber Line (DSL), Voice over Internet Protocol (VoIP) and Fiber-To-The-Premises (FTTP), which is also known as optical networking, markets. Our customers are systems vendors and original equipment manufacturers who sell DSL and optical network equipment, for deployment in central offices and customer premises, and VoIP equipment, for use in carrier-class and enterprise-class gateways and consumer telephony applications.

Centillium was incorporated in California in February 1997 and was reincorporated in Delaware in December 1999. Our principal executive offices are located at 215 Fourier Avenue, Fremont, CA 94539, and our telephone number at that location is (510) 771-3700. Our Internet address is [www.centillium.com](http://www.centillium.com). We make available free of charge on or through our Internet website our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC. Our common stock trades on the Nasdaq National Market under the symbol "CTLM."

#### INDUSTRY ENVIRONMENT

Over the past two decades, communications technology has evolved from simple analog voice signals transmitted over networks of copper telephone lines to complex analog and digital voice and data signals transmitted over networks of media, such as copper wires, fiber optic strands and wireless transmission over radio frequencies. This evolution has been driven by substantial increases in the number of users and new bandwidth-intensive computing and communications applications, such as web-based commerce, streaming audio and video, IPTV and online gaming. In addition, information is increasingly available via wired and wireless networks through a variety of access devices, including personal computers and handheld computing devices such as personal digital assistants, portable digital audio players, digital cameras and cellular phones. These applications and devices are continuing to require higher and more cost-efficient data transfer rates throughout the network communications infrastructures that serve them.

This evolution has inspired equipment manufacturers and service providers to develop and expand existing broadband communications markets and has created the need for new generations of integrated circuits. Broadband transmission of digital information over existing infrastructure requires highly-integrated mixed-signal semiconductor products to perform critical systems functions such as complex signal processing and converting digital data to and from analog signals. Broadband communications equipment requires substantially higher levels of system performance, in terms of both speed and precision, which typically cannot be adequately addressed by traditional semiconductor products developed for low-speed transmission applications. Moreover, products that are based on multiple discrete analog and digital chipsets generally cannot achieve the cost-effectiveness, performance and reliability requirements demanded by today's broadband marketplace. These requirements are best addressed by new generations of highly-integrated mixed-signal and digital devices that combine complex system functions within high performance circuitry and can be manufactured in high volumes using cost-effective process technologies.

## **TARGET MARKETS AND CENTILLIUM PRODUCTS**

Centillium designs, develops and supplies a portfolio of SoC products for broadband access infrastructure and a number of the key applications enabling broadband services. Currently, our target markets include DSL semiconductor products for use in the service provider's central office and for use in a DSL subscriber's home or business, VoIP products for use in carrier-class and enterprise-class voice gateways and switches and for use in the consumer telephony market and optical access products initially targeting the emerging FTTP market. The following provides a brief description of each of our target markets and the semiconductor solutions we provide in each of these markets.

### **Digital Subscriber Line (DSL)**

Digital subscriber line technologies, commonly known as DSL, represent a family of broadband technologies that use a greater range of frequencies over existing copper telephone lines than traditional telephone services which in turn allows greater bandwidth to send and receive information. DSL speeds range from 128 Kbps up to 50 Mbps depending on the distance between the central office and subscriber. These data rates enable DSL service providers to offer a wide range of new bundled broadband services.

Our DSL products are based on a type of DSL technology known as asymmetrical DSL or ADSL. ADSL technology provides substantially faster transmission of data from the network to the end-user than from the end-user to the network. This tradeoff works to the consumer's advantage in that most users typically download more data from the network than they send to the network. Each of our DSL products generally consists of two semiconductor devices — a mixed-signal device and a digital device. The mixed-signal chip translates signals between analog and digital formats, and our digital chip incorporates our proprietary software programmable digital signal processor.

#### ***DSL Central Office (CO) Infrastructure Products***

Centillium's Maximus<sup>TM</sup> family of DSL central office infrastructure products is used in various types of communications equipment that aggregate and process data traffic from a substantial number of individual telephone lines for transmission through a data network. Our Maximus products are based on our eXtremeDSL<sup>MAX</sup> technology, which supports data rates up to 50 Mbps downstream and 5 Mbps upstream and extends the reach of ADSL service up to 24,000 feet. In addition, it supports the range of data rates required by ADSL2/2+ Annex A, B, C, L and J. Our high performance, tightly-integrated infrastructure chipsets offer high port density coupled with low power consumption. High port density means that a service provider can serve more customers with fewer pieces of equipment, while a low power chipset leads to lower energy and operational costs for the service provider. These features effectively lower costs for service providers.

### ***DSL Customer Premises Equipment (CPE) Products***

Centillium's Palladia™ family of products is used in various types of customer premises equipment that process data signals between a regular telephone line and a computer. It enables end-users to simultaneously connect to the Internet at very high data rates while talking on the telephone or sending a fax. Our Palladia products, as with our Maximus products, are based on our eXtremeDSL<sup>MAX</sup> technology. Our high performance DSL CPE chipsets enable CPE equipment manufacturers to produce devices with high data throughput. In addition, the integration of various features, small form factor and low power consumption of our Palladia chipsets result in lower production and ownership costs.

### **Voice over Internet Protocol (VoIP)**

The increased demand from service providers and enterprises to deliver voice and data communications over a single integrated network has accelerated the trend towards the use of VoIP technology. This technology provides the most bandwidth-efficient method of transmitting voice information in discrete packets over the traditional circuit-based infrastructure of the public switched telephone network. The convergence of voice and data traffic over internet networks delivered from a single multi-service network offers a major benefit through this simplified network solution.

Currently, most telephony service providers maintain two separate networks — one for legacy voice traffic and a second for data traffic. VoIP technology compresses voice signals into discrete packets of data, thereby enabling the voice signals to be transmitted over lower-cost networks originally designed for data-only transmission. VoIP technology is used in numerous new types of communications equipment, such as next generation carrier- and enterprise-class gateways, soft switches, digital loop carriers, IP DSL access multiplexers, media terminal adapters, and home gateways for use by consumers and small businesses. These VoIP technology-based devices enable more efficient and cost-effective voice transmissions than their legacy circuit-switched equipment counterparts. In addition to significant cost savings, VoIP also enables advanced services that traditional telephony could not support. VoIP technology enables and enhances features such as unified messaging and managed services that provide additional value to consumers and businesses and allow service providers to enhance revenue opportunities.

### ***VoIP Products***

Centillium leverages its expertise in mixed-signal system-on-chip technology and software applications to deliver VoIP products for carrier-class and enterprise-class gateways and consumer telephony. Designing VoIP processors for next-generation voice, media and wireless gateways along with carrier-grade VoIP products for the rapidly growing CPE market, our Entropia™ and Atlanta™ product families provide system designers with broad flexibility while delivering a strong combination of performance and features.

Entropia III, our flagship VoIP product, is an advanced VoIP system-on-chip processor that can process up to 1,008 voice channels for voice and media gateways, wireless infrastructure gateways, Class 4 and 5 switch replacements, digital loop carriers, voice-enabled IP routers and IP private branch exchange (PBX) systems. Entropia II LP is our VoIP product that processes up to 336 or 96 voice channels per chip. Entropia II LP is marketed for use in central office and enterprise voice equipment that require mid-level channel densities and central office equipment that process both DSL and VoIP signals. Entropia II LP is marketed for use in central office access gateways and enterprise voice equipment that requires lower channel densities.

Centillium's Voice Services Platform™ (VSP) is a combination of silicon and software building blocks that can be used for the development of consumer VoIP telephony applications. Our VSP provides original equipment manufacturers with toll-quality voice, fax and routing functionality, including advanced calling features such as global phone number portability, virtual phone numbers, conferencing, superior echo cancellation and a host of other new features not available with traditional phone service.

Our Atlanta product family is a voice processing system-on-chip for customer premises equipment that supports toll-quality telephone voice, fax and routing functionality over any broadband access network. System designs based on the Atlanta product family can connect directly to a broadband modem or be added as part of a small office-home office network. The Atlanta A70™ product is the family's entry level SoC while the A80™ SoC adds in the

capability to interface with any WiFi or high-speed adapter. The A90™ SoC is optimized for the Small Office and Home Office (SOHO) market with four voice channels and the highest-performing routing engine available at 100 Mbit/second. At the top of the Atlanta family, the A100™ SoC adds powerful, enterprise-level security and encryption of all data and voice.

### **Fiber-To-The-Premises (FTTP)**

FTTP technologies, as with DSL, provide high speed network access for both residential and business end users. FTTP offers speeds of service up to 1 Gbps without the limitations of distance or the symmetry/asymmetry profiles typical in DSL. In addition, FTTP also has the potential to virtually eliminate the cost of an entire class of equipment in the provider's network: the outside plant electronics. This optical broadband infrastructure enables FTTP service providers to offer a wider range of next generation bundled services to potentially enhance their revenue streams.

Our FTTP products are based on a type of optical technology known as Passive Optical Networking (PON). In this market space, we have introduced Ethernet-based PON (EPON) products. Each of our FTTP products consists of one or two semiconductor devices either working independently or jointly — a mixed-signal device known as a protocol chipset and an analog device known as a transceiver. The mixed-signal chip translates signals between analog and digital formats, and our analog chip incorporates innovative technologies to bring photonic signals into the protocol device.

#### ***FTTP products***

In 2004, we announced four new products for the FTTP market: central office (CO) transceivers, CO protocol processors, customer premises equipment (CPE) transceivers and CPE protocol processors. Transceivers are used to convert light signals contained in individual strands of optical fiber into electrical signals suitable for higher level data processing. Protocol processors pick up the data stream from a transceiver and manage the bi-directional flow of information for delivery to an end user. End users may then use these streams of data to access the Internet over high speed circuits or connect voice devices (VoIP or traditional analog telephones), as well as receive video broadcasts. Our CO products are characterized by high performance, high density and low power consumption, while our CPE products showcase advanced integration of functions targeting cost and ease of design.

### **TECHNOLOGY**

Our primary competitive advantage is technology expertise in key areas including our system-level knowledge, programmable digital signal processor, signal processing algorithms, digital chip design capability, mixed-signal chip design capability and system-level software. Together, these capabilities have enabled us to provide system-level communications products allowing OEM's to have:

- Short time to market through flexibility due to programmability;
- Better performance due to higher data throughput;
- Low power consumption; and
- Best board density due to reduced bill of material and smaller package size.

*Software programmable digital signal processor.* A cornerstone of our technology is our internally-developed software programmable digital signal processor. A digital signal processor, as it relates to communications applications, encodes digital data for transmission over bandwidth-limited media, such as copper telephone lines, and recovers the encoded data at the receiving end. Our software programmable digital signal processor is optimized for communications applications and provides high processing bandwidth with low power requirements. This digital signal processor can be programmed for several different applications, such as DSL and VoIP networking. This software programmable digital signal processor technology gives us the advantage of field programmability of devices. Field programmability means that service providers can remotely upgrade their equipment to address new standards or enable improved features, thereby extending the life cycles of their equipment while incurring lower costs.

*Signal processing algorithms.* A key component of our continued success is the expertise that we have developed in communications algorithms. Communications algorithms are the processes and techniques used to transform a digital data stream into a specially conditioned analog signal suitable for transmission across copper telephone wires. We possess a thorough understanding of, and practical experience in, the process of transmitting and receiving a digital data stream in analog form. We also have significant experience developing algorithms to enable voice compression, echo cancellation and telephony signal processing. This expertise allows us to design highly efficient algorithms that in turn enable us to create products with high performance, re-programmability and low power consumption.

*Digital chip design.* We are experts in the area of highly complex, high-speed digital chip development. We design both the logic and the physical layout for our products. This design expertise has enabled us to develop tightly integrated digital chips that have small form factors with low power consumption.

*Mixed-signal chip design.* A mixed-signal chip translates signals between analog and digital formats. Our team of analog engineers has substantial experience in signal conversion techniques and analog circuit design, and we believe our mixed-signal DSL chip contains among the highest level of integration in the industry. Our expertise also expands into mixed signal Optical PON chips.

*System software.* We have expertise in developing software that addresses the needs of network equipment manufacturers and service providers. Our knowledge of network operation and architectures allows us to write software that ensures that our products are interoperable with communications equipment vendors' products. In addition, our understanding of various operating systems and personal computer environments allows us to create software that provides for simple installation and operation.

## CUSTOMERS AND STRATEGIC RELATIONSHIPS

We sell our products to leading manufacturers of broadband communications equipment in our target markets. Because we leverage our technologies across different markets, certain of our integrated circuits may be incorporated into equipment used in different markets.

A small number of customers have historically accounted for a substantial portion of our revenue. In 2005, 2004 and 2003, NEC Corporation (NEC) accounted for 26%, 42% and 49% and Sumitomo Electric Industries, Ltd (Sumitomo) accounted for 35%, 35% and 31% of net revenues, respectively. Lucent Technologies accounted for 13% of net revenues in 2005. No other customer accounted for 10% or more of net revenues in any year during this three-year period. Furthermore, our revenues since inception have been concentrated in Japan.

The following is a summary of net revenues by major geographic area as a percentage of total revenues:

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Japan .....	64%	78%	79%
United States .....	19	13	12
Other .....	17	9	9
Total .....	<u>100%</u>	<u>100%</u>	<u>100%</u>

The loss of a key customer could materially and adversely affect our business, financial condition and results of operations. We expect that our key customers will continue to account for a substantial portion of our net revenues in 2006 and in the foreseeable future. These customers and their respective contributions to our net revenue have varied and will likely continue to vary from period to period. We typically sell products pursuant to purchase orders that customers can generally cancel or defer on short notice and we do not have agreements with any of our key customers that contain long-term commitments to purchase specified volumes of our products.



## **SALES AND MARKETING**

Our sales and marketing strategy is to achieve design wins with technology leaders in each of our targeted broadband communications markets by, among other things, providing superior design-in engineering support. We believe that providing comprehensive design-in service and support is critical to shortening our customers' design cycles and maintaining a competitive position in our targeted markets. We market and sell our products through our direct sales force and through independent sales representatives.

We manage a number of marketing programs designed to communicate our capabilities and benefits to broadband access equipment manufacturers. Our web site is an important marketing tool where a wide range of information is available, including product information, white papers, application notes, press releases and contributed articles. In addition, we participate in industry trade shows, technical conferences and technology seminars, conduct press tours and publish technical articles in industry journals.

## **BACKLOG**

In many cases we manufacture our products in advance of receiving firm product orders from our customers, based upon our forecasts of worldwide customer demand. Our sales are made primarily pursuant to standard purchase orders for delivery of products. Due to industry practice, which allows customers to cancel or change orders prior to shipment, we believe that backlog is not a reliable indicator of future revenue levels.

## **RESEARCH AND DEVELOPMENT**

We have assembled a core team of experienced engineers and technologists, many of whom are leaders in their particular field or discipline. As of December 31, 2005, we employed 202 engineers in research and development. These employees are involved in advancing our core technologies, as well as applying these core technologies to product development activities in our target markets.

We believe that the achievement of higher levels of integration, functionality and performance and the introduction of new products in our target markets are essential to our growth. Our principal design centers are located in Fremont, California, India and France.

Research and development expense in 2005, 2004 and 2003 was approximately \$29.6 million, \$53.7 million and \$46.2 million, respectively.

## **OPERATIONS AND MANUFACTURING**

We outsource the fabrication, assembly and testing of our semiconductor devices. This fabless model allows us to focus our resources on the design, development and marketing of our products. We manage the production of our devices through our operations and manufacturing group, which consists of technology engineering, test engineering, logistics, quality assurance and reliability.

### ***Wafer Fabrication***

We do not own or operate a wafer fabrication facility. Most of our silicon wafers are produced by Taiwan Semiconductor Manufacturing Company, Semiconductor Manufacturing International Corporation and IBM. The inability of any one of our independent foundry subcontractors to provide the necessary capacity or output for our products could result in significant production delays and could materially and adversely affect our business, financial condition and results of operations. While we currently believe we have adequate capacity to support our current sales levels, we continue to work with our existing foundries to assure production capacity, while maintaining the option of qualifying new foundries to provide additional production capacity if needed. It is possible that adequate foundry capacity may not be available on acceptable terms, if at all. In the event a foundry experiences financial difficulties, or if a foundry suffers any damage or destruction to its facilities, or in the event of any other disruption of foundry capacity, or if there is insufficient capacity to meet our demand, we may not be able to qualify alternative manufacturing sources for existing or new products in a timely manner.

### ***Assembly and Test***

Completed silicon wafers are probed and the individual die are assembled, packaged and tested by one of our subcontractors: Amkor Technology, Inc., STATS ChipPAC Ltd., and United Test and Assembly Center Limited. While we have not experienced any material disruption in supply from assembly and testing subcontractors to date, we could experience assembly and testing problems in the future. The availability of assembly and testing services from these subcontractors could be materially and adversely affected in the event a subcontractor experiences financial difficulties, if a subcontractor suffers any damage or destruction to its respective facilities, or in the event of any other disruption of assembly and testing capacity, or if there is insufficient capacity to meet our demand.

### ***Quality Assurance***

Manufacturers of broadband communications equipment demand high quality and reliable semiconductors for incorporation into their products. We focus on product reliability from the initial stage of the design cycle through each specific design process, including layout and production test design. In addition, we subject our designs to in-depth circuit simulation at temperature, voltage and processing extremes before initiating the manufacturing process.

We prequalify our foundry and assembly and testing subcontractors. This prequalification process consists of a series of industry standard environmental product stress tests, as well as an audit and analysis of the subcontractor's quality system and manufacturing capability. We also participate in quality and reliability monitoring through each stage of the production cycle by reviewing electrical and parametric data from our wafer foundry and assembly and testing subcontractors. We monitor wafer foundry production to ensure consistent overall quality, reliability and yield levels.

## **COMPETITION**

Although we produce system-level products, we primarily compete with vendors of semiconductor devices for our target broadband communications market. We believe that the principal factors of competition for semiconductor vendors in these markets are product capabilities, level of integration, rate of data throughput, performance and reliability, power consumption, price, time-to-market, system cost, intellectual property rights, customer support and reputation. We believe we compete favorably with respect to most of these factors.

There are a number of domestic and international suppliers of semiconductors in the markets that we compete in. Many of our competitors operate their own fabrication facilities and have longer operating histories and presence in key markets, greater name recognition, access to larger customer bases and significantly greater financial, sales and marketing, manufacturing, distribution, technical and other resources. As a result, our competitors may be able to adapt more quickly to new or emerging technologies and changes in customer requirements or devote greater resources to the promotion and sale of their products. Current and potential competitors have established or may establish financial or strategic relationships among themselves or with existing or potential customers, resellers or other third parties. Accordingly, it is possible that new competitors or alliances among competitors could emerge and rapidly acquire significant market share. In addition, our competitors may in the future develop technologies that more effectively address our markets at a lower cost. We cannot assure you that we will be able to compete successfully against current or potential competitors, or that competition will not have a material adverse effect on our business, financial condition and results of operations.

## **INTELLECTUAL PROPERTY**

We rely on a combination of copyright, patent, trademark, trade secret and other intellectual property law, nondisclosure agreements and other protective measures to protect our proprietary rights. We also utilize unpatented proprietary know-how and trade secrets and employ various methods to protect such intellectual property.

Although we employ a variety of intellectual property in the development and manufacturing of our products, we believe that none of that intellectual property is individually critical to our current operations. However, taken as a whole, we believe our intellectual property rights are significant and that the loss of all or a substantial portion of such rights could have a material adverse effect on our results of operations. We cannot be assured that our

intellectual property protection measures will be sufficient to prevent misappropriation of our technology. In addition, the laws of many foreign countries do not protect our intellectual properties to the same extent as the laws of the United States. From time to time, third parties have or may assert infringement claims against us or against our customers in connection with their use of our products as is the case in the on-going Fujitsu suit in Japan. In addition, we may desire or be required to renew or to obtain licenses from others in order to further develop and market commercially viable products effectively. We cannot assure you that any necessary licenses will be available on reasonable terms.

## **EMPLOYEES**

As of December 31, 2005, we had a total of 286 employees, of whom 202 were engineers. None of our employees are represented by a labor union. However, certain of our foreign employees are subject to collective bargaining agreements mandated by local country law. We do not anticipate that the results of future negotiations under these collective bargaining agreements will have a material adverse financial impact on our business. We have not experienced any work stoppages. Our future performance depends in significant part upon the continued service of our key personnel, none of whom is bound by an employment agreement requiring service for any definite period of time. Our future success also depends on our continued ability to attract, integrate, retain and motivate highly qualified sales, technical and managerial personnel. Competition for such qualified personnel is intense and there is no assurance that we will continue to be successful in the future.

## **ITEM 1A. RISK FACTORS**

Before deciding to purchase, hold or sell our common stock, you should carefully consider the risks described below, in addition to the other cautionary statements and risks described elsewhere and the other information contained in this Report and in our other filings with the SEC, including subsequent reports on Forms 10-Q and 8-K. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we currently deem immaterial may also affect our business. If any of these known or unknown risks or uncertainties actually occurs, our business, financial condition and results of operations could be seriously be harmed.

### ***Risks Related to Our Business***

#### **We have a history of losses and may experience losses in the future.**

We have not reported an operating profit for any year since our inception and have experienced a net loss of \$11.3 million, \$43.1 million and \$13.4 million in 2005, 2004 and 2003, respectively. With the adoption of SFAS 123R, we will not be profitable in the foreseeable future and it will have a material adverse impact on our operating results.

Our success may depend in large part upon the adoption and utilization of our products and technology, as well as our ability to effectively maintain existing relationships and develop new relationships with customers and strategic partners. If we do not succeed in doing so, we may not achieve or maintain profitability on a timely basis or at all. In particular, we intend to expend significant financial and management resources on product development, sales and marketing, strategic relationships, technology and operating infrastructure. This includes our focus on development of new optical network products and improvements to our DSL products. As a result, we may incur additional losses and continued negative cash flow from operations for the foreseeable future and may not achieve or maintain profitability.

**Because of our lack of diversity in geographic sources of revenues, the slowdown in deployment of DSL in Japan and other factors have affected and may continue to adversely affect our business and operating results.**

Historically, our revenues have been largely dependent on the growth of new DSL subscribers in Japan. Sales to customers in Japan accounted for 64%, 78% and 79% of net revenues in 2005, 2004 and 2003, respectively.

Therefore, the slowdown in deployment of DSL in Japan has adversely affected our operating results. Revenues from Japan decreased from \$55.8 million in 2004 to \$49.0 million in 2005. The continuing low number of net new DSL subscribers in Japan will likely continue to negatively affect our future revenues.

Because a substantial portion of our revenues have been derived from sales into Japan, our revenues have been heavily dependent on developments in the Japanese market. Our sales in Japan have been historically denominated in U.S. dollars and major fluctuations in currency exchange rates could materially affect our Japanese customers' demand, thereby forcing them to reduce their orders, which could adversely affect our operating results. While part of our strategy is to diversify the geographic sources of our revenues, failure to further penetrate markets outside of Japan could harm our business and results of operations and subject us to increased currency risk.

**We derive a substantial majority of our revenues from DSL products, and our failure to diversify our sources of our revenues could harm our business and operating results.**

Historically, our revenues have been derived primarily from the sale of our DSL products. 79%, 94% and 98% of our net revenues were from sales of our DSL products for 2005, 2004 and 2003, respectively. If we are unsuccessful in generating meaningful sales of our VoIP and FFTP products, we may not be able to achieve or sustain profitability.

**We depend on a few customers, and if we lose any of them, our sales and operations will suffer.**

We sell our products primarily to network equipment manufacturers. NEC Corporation (NEC) accounted for 26%, 42% and 49% and Sumitomo Electric Industries, Ltd. (Sumitomo) accounted for 35%, 35% and 31% of net revenues in 2005, 2004 and 2003, respectively. Lucent Technologies accounted for 13% of net revenues in 2005. No other customer accounted for 10% or more of net revenues in any year during this three-year period. We do not have contractual volume commitments with these customers; instead we sell our products to them on an order-by-order basis. Our ability to maintain relationships with these large customers is essential to our ability to meet financial metrics. However, this dependence means that we are especially susceptible to factors that affect their purchasing decisions that are, in many instances, outside of our direct control. These factors include, among other things:

- the fact that many of our customers have pre-existing or concurrent relationships with our competitors that may affect the customers' decision to purchase our products;
- the success of our largest OEM customers; and
- the continued demand for our customers' systems products.

As a result, we may not be able to maintain or increase sales to certain of our large customers for various reasons. Our concentration of business and on-going relationships with our major customers may also deter other potential customers who compete with these existing customers from buying our products. We expect to be dependent upon a relatively small number of large customers in future periods, although the specific customers may vary from period to period. If we are not successful in maintaining relationships with key customers and winning new customers, our business and results of operations will suffer.

**We anticipate lower margins as products mature and as we experience aggressive competition, which could adversely affect our profitability.**

We expect the average selling prices of our products to decline as they mature. Historically, competition in the semiconductor industry has driven down the average selling prices of products. If we price our products too high, our customers may use a competitor's product or an in-house solution. To maintain profit margins, we must reduce our costs sufficiently to offset declines in average selling prices, or successfully sell proportionately more new products with higher average selling prices. Yield or other production problems, or shortages of supply may preclude us from lowering or maintaining current product costs.

We have also experienced more aggressive price competition from competitors in market segments in which we are attempting to expand our business. These circumstances may make some of our products less competitive and we may be forced to decrease our prices significantly to win a design. We may lose design opportunities or may experience overall declines in gross margins as a result of increased price competition.

**Our markets are highly competitive and many of our competitors are established and have greater resources than we have.**

The market for communications semiconductor and software solutions is intensely competitive. Given our stage of development, there is a substantial risk that we will not have the financial resources, technical expertise or marketing and support capabilities to compete successfully. In addition, a number of other semiconductor companies have entered or may enter the market segments adjacent to or addressed by our products. These competitors may have longer operating histories, greater name recognition, larger installed customer bases and significantly greater financial, technical and marketing resources than we have. We may also face competition from customers' or prospective customers' own internal development efforts. Any of these competitors may be able to introduce new technologies, respond more quickly to changing customer requirements or devote greater resources to the development, promotion and sale of their products than we can.

**Third-party claims regarding intellectual property matters could cause us to stop selling our products, pay monetary damages or obtain licenses on adverse terms.**

There is a significant risk that third parties, including current and potential competitors, will claim that our products, or our customers' products, infringe on their intellectual property rights. From time to time, third parties have asserted, and may in the future assert, patent, copyright, trademark or other intellectual property rights to technologies that are important to our business and have demanded or in the future may demand that we license their patents and technology. Any such litigation, whether or not determined in our favor or settled by us, would be costly and divert the attention of our management and technical personnel. Inquiries with respect to the coverage of our intellectual property could develop into litigation. In such a litigation, a court could issue a preliminary injunction that would require us to withdraw or recall certain products. Moreover, we cannot assure you that we would prevail in litigation given the complex technical issues and inherent uncertainties in intellectual property litigation. In the event of an adverse ruling for an intellectual property infringement claim, we could be required to obtain a license or pay substantial damages (including treble damages) or have the sale of our products stopped by a permanent injunction. Such a license may not be available on reasonable terms, or at all. In addition, if a customer of our products cannot acquire a required license on commercially reasonable terms, that customer may choose not to use our products.

We also have obligations to indemnify our customers under some circumstances for infringement of third-party intellectual property rights. We have also received requests from certain customers to include increasingly broad indemnification provisions in our agreements with them. These indemnification provisions may, in some circumstances, result in liability for combinations of components or system level designs and consequential damages and/or lost profits and the costs to us could be substantial and our business could be harmed. Even if claims against us are not valid or successfully asserted, these claims could result in significant costs and a diversion of the attention of management and other key employees to defend. If any intellectual property claims from third parties against one of our customers whom we have indemnified is held to be valid, the costs to us could be substantial and our business could be harmed.

In August 2004, Fujitsu Limited filed a suit against Centillium and Centillium Japan K.K. ("Centillium Japan") in the Tokyo District Court alleging that Centillium and Centillium Japan infringe one Japanese patent jointly owned by Fujitsu and Ricoh Co., Ltd. The complaint seeks significant monetary damages against Centillium and Centillium Japan. The suit is in process and we do not believe it is feasible to predict or determine the outcome or resolution of this litigation with any certainty at this point. We believe we have meritorious defenses and we are continuing to defend ourselves against these claims vigorously. We have already incurred and are likely to continue to incur substantial expenses in our defense against these claims. In the event of a determination adverse to us, we may incur substantial liability and this could have a material adverse effect on our financial position, results of operations or cash flows.

**We operate in the highly cyclical semiconductor industry, which is subject to significant downturns.**

The semiconductor industry is highly cyclical and is characterized by constant and rapid technological change, rapid product obsolescence and price erosion, evolving technical standards, short product life cycles and wide fluctuations in product supply and demand. From time to time these and other factors, together with changes in general economic conditions, cause significant upturns and downturns in the industry, and in our business in particular. Periods of industry downturns have been characterized by diminished product demand, production overcapacity, high inventory levels and accelerated erosion of average selling prices. The semiconductor industry also periodically experiences increased demand and production capacity constraints, which may affect our ability to ship product compared to our competitors and result in deteriorating market share. These factors have caused substantial fluctuations in our revenues and results of operations. We have experienced these cyclical fluctuations in our businesses in the past and we may experience cyclical fluctuations in the future.

**If we are unable to develop and introduce new products successfully and in a cost-effective and timely manner or to achieve market acceptance of our new products, our operating results would be adversely affected.**

Our future success is dependent upon our ability to develop new semiconductor products for existing and new markets, introduce these products in a cost-effective and timely manner and have these products selected by leading equipment manufacturers for design into their own new products. The development of new silicon products is highly complex, and from time to time we have experienced delays in completing the development and introduction of new products and lower than anticipated manufacturing yields in the early production of such products. Our ability to develop and deliver new products successfully will depend on various factors, including our ability to:

- timely and accurately predict market requirements and evolving industry standards;
- successfully define new products;
- timely and accurately identify opportunities in new markets;
- timely complete and introduce new product designs;
- scale our operations in response to changes in demand for our products and services;
- license any desired third party technology or intellectual property rights;
- timely qualify and obtain industry interoperability certification of our products and the products of our customers into which our products will be incorporated;
- obtain sufficient foundry capacity and packaging materials;
- achieve high manufacturing yields;
- shift our products to smaller geometry process technologies to achieve lower cost and higher levels of design integration; and
- gain market acceptance of our products and our customers' products.

If we are not able to develop and introduce new products successfully and in a cost-effective and timely manner, we may need to explore purchasing new products and if unsuccessful, we may be unable to attract new customers or to retain our existing customers as these customers may choose or transition to other companies that can meet their product development needs, which would materially and adversely affect our results of operations. For example, one such FTTP customer in Japan has delayed orders due to its customers' requirements until as late as the fourth quarter of 2006.

**We depend on sole or limited source suppliers for the manufacture of our products.**

As a fabless semiconductor that neither owns nor operates a fabrication or manufacturing facility, we are heavily dependent on certain suppliers. We obtain certain parts, components and packaging used in the delivery of our products from sole or limited sources of supply. For example, we obtain certain semiconductor wafers on a sole source basis from Taiwan Semiconductor Manufacturing Co., Ltd and Semiconductor Manufacturing International Corporation. Developing and maintaining these strategic relationships with our vendors is critical for us to be successful. Any of our sole or limited source suppliers may:

- experience delays in meeting our customer demand on a timely basis, or at all;
- enter into exclusive arrangements with our competitors;
- stop selling their products or components to us at commercially reasonable prices;
- refuse to sell their products or components to us at any price; or
- be subject to production disruptions caused by power outages, earthquakes and financial difficulties.

Developing and maintaining these strategic relationships with our vendors is critical for us to be successful, but our business is susceptible to disruption, and our results of operations can be adversely affected, by any inability to do so. In periods of high demand in the semiconductor market, we may experience delays in meeting our capacity demand for components and as a result may be unable to deliver products to our customers on a timely basis. In addition, we could experience similar delays due to technical and quality control problems at our suppliers' facilities. If any of these events occur, or if our suppliers' facilities suffer any damage or disruption, we may not be able to meet our customer demand on a timely basis, or at all, and may need to successfully qualify an alternative supplier in a timely manner in order to not disrupt our business. We typically require a significant period of time to qualify a new supplier or process before we can begin shipping products. If we cannot accomplish this qualification in a timely manner, we would experience a significant interruption in supply of the affected products. If we are unable to secure sufficient capacity at our suppliers' existing facilities, or in the event of a closure or significant delay at any of these facilities, our relationships with our customers would be harmed and our market share and operating results would suffer as a result.

**Sales of our products depend on the widespread adoption of broadband access services, especially DSL, VoIP and FTTP. If the demand for broadband access service does not increase, we may not be able to generate substantial sales.**

Sales of our products depend on the increased use and widespread adoption of broadband access services, and DSL services in particular, and the ability of telecommunications service providers to market and sell broadband access services. Our business would be harmed, and our results of operations and financial condition would be adversely affected, if the use of broadband access services does not increase as anticipated. Certain critical factors will likely continue to affect the development of the broadband access service market. These factors include:

- inconsistent quality and reliability of service;
- lack of availability of cost-effective, high-speed service;
- lack of interoperability among multiple vendors' network equipment;
- congestion in service providers' networks;
- inadequate security; and
- slow deployment of new broadband services over DSL lines.

**Rapid changes in the market for broadband access chip sets may render our chip sets obsolete or unmarketable.**

The market for chip sets for our products is characterized by:

- intense competition;
- rapid technological change;
- frequent new product introductions by our competitors;
- changes in customer demands; and
- evolving industry standards.

Any of these factors could make our products obsolete or unmarketable. In addition, the life cycles of some of our products may depend upon the life cycles of the end products into which our products will be designed. Products with short life cycles require us to closely manage production and inventory levels. Unanticipated changes in the estimated total demand for our products and/or the estimated life cycles of the end products into which our products are designed may result in obsolete or excess inventories, which in turn may adversely affect our operating results. To compete, we must innovate and introduce new products. If we fail to successfully introduce new products on a timely and cost-effective basis that meet customer requirements and are compatible with evolving industry standards, then our business, financial condition and results of operations will be seriously harmed.

**Because the sales cycle for our products typically lasts up to one year or longer, and may be subject to delays, it is difficult to forecast sales for any given period.**

The sales cycle of our products is lengthy and typically involves a detailed initial technical evaluation of our products by our prospective customers, followed by the design, construction and testing of prototypes incorporating our products. Only after these steps are complete will we receive a purchase order from a customer for volume shipments. This process generally takes from 9 to 12 months, and may last longer. Additionally, this cycle may be as long as 18 to 24 months for our VoIP products. Given this lengthy sales cycle, it is difficult to accurately predict when sales to a particular customer will occur. In addition, we may experience unexpected delays in orders from customers, which may prevent us from realizing forecasted sales for a particular period and in turn adversely impact our stock price. Our products are typically sold to equipment manufacturers, who incorporate our products in the products that they in turn sell to consumers or to network service providers. As a result, any delay by our customers, or by our customers' customers, in the manufacture or distribution of their products will result in a delay in obtaining orders for our products, which could cause our business and results to suffer.

**Because other broadband technologies may compete effectively with DSL services or other services addressed by our products, a slowdown in deployment of DSL services, the lack of significant growth in non-DSL markets that we are targeting and our lack of success in penetrating such markets would adversely affect our business and operating results.**

Our revenues are heavily dependent on the increase in demand for DSL services. DSL services are competing with a variety of different broadband data transmission technologies, including cable modems, satellite and other wireless technologies. While part of our strategy is to diversify our product markets beyond DSL into such areas as FTTP and VoIP, if any technology that is competing with the technologies that we offer is more reliable, faster and/or less expensive or has any other advantages over the technologies for which we have products, then the demand for our products may decrease. The lack of significant growth in those markets we are targeting in general and the lack of success of our products in particular would also adversely affect our business and results of operations.

**Because our products are components of other equipment, if broadband equipment manufacturers do not incorporate our products in their equipment, or if the equipment incorporating our products are not successful, we may not be able to generate sales of our products in volume quantities.**



Our products are not sold directly to the end-user; they are components of other products. As a result, we rely upon equipment manufacturers to design our products into their equipment. We further rely on the manufacturing and deployment of the equipment to be successful. Our customers are typically not obligated to purchase our products and can choose at any time to stop using our products if their own products are not commercially successful or for any other reason. If equipment that incorporates our products is not accepted in the marketplace, we may not achieve sales of our products in volume quantities, which would have a negative impact on our results of operations.

**We are subject to order and shipment uncertainties, and any significant order cancellations or deferrals could adversely affect our business.**

We typically sell products pursuant to purchase orders that customers can generally cancel or defer on short notice without incurring a significant penalty. Any significant cancellations or deferrals in the future could materially and adversely affect our business, financial condition and results of operations. In addition, cancellations or deferrals of product orders, the return of previously sold products or the overproduction of products due to the failure of anticipated orders to materialize could cause us to hold excess or obsolete inventory, which could reduce our profit margins, increase product obsolescence and restrict our ability to fund our operations. Furthermore, we generally recognize revenues upon shipment of products to a customer. If a customer refuses to accept shipped products, we could incur significant charges against our revenues.

**We derive a substantial amount of our revenues from international sources, and difficulties associated with international operations could harm our business.**

A substantial portion of our revenues has been derived from customers located outside of the United States. In 2005, 2004 and 2003, 74%, 86% and 87%, respectively, of our net revenues were to customers located in Asia. We may be unable to successfully overcome the difficulties associated with international operations. These difficulties include:

- political, social and economic instability;
- exposure to different legal standards, particularly with respect to intellectual property;
- natural disasters and public health emergencies;
- nationalization of business and blocking of cash flows;
- trade and travel restrictions;
- the imposition of governmental controls and restrictions;
- burdens of complying with a variety of foreign laws;
- import and export license requirements and restrictions of the United States and each other country in which we operate;
- unexpected changes in regulatory requirements;
- foreign technical standards;
- changes in taxation and tariffs;
- difficulties in staffing and managing international operations;
- foreign currency exchange rates;

- difficulties in collecting receivables from foreign entities or delayed revenue recognition; and
- potentially adverse tax consequences.

Any of the factors described above may have a material adverse effect on our ability to increase or maintain our foreign sales.

Because sales of our products are denominated exclusively in United States dollars, increases in the value of the United States dollar could increase the price of our products so that they become relatively more expensive to customers in the local currency of a particular country, leading to a reduction in sales and profitability in that country.

**We are exposed to increased costs and risks associated with complying with increasing and new regulation of corporate governance and disclosure standards.**

We are spending an increased amount of management time and internal and external resources to comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ Stock Market rules. In particular, our management, including our CEO and CFO, does not expect that our internal controls over financial reporting will prevent all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, involving Centillum have been, or will be, detected. These inherent limitations include the realities that judgments in decision making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and we cannot assure you that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

Although our management has determined, and our independent registered public accounting firm has attested, that our internal control over financial reporting was effective as of December 31, 2005, we cannot assure you that we or our independent registered public accounting firm will not identify a material weakness in our internal controls in the future. A material weakness in our internal controls over financial reporting would require management and our independent registered public accounting firm to evaluate our internal controls as ineffective. If our internal controls over financial reporting are not considered adequate, we may experience a loss of public confidence, which could have an adverse effect on our business and our stock price.

**Because manufacturers of communications equipment may be reluctant to change their sources of components, if we do not achieve design wins with such manufacturers, we may be unable to secure sales from these customers in the future.**

Once a manufacturer of communications equipment has designed a supplier's semiconductor into its products, the manufacturer may be reluctant to change its source of semiconductors due to the significant costs associated with qualifying a new supplier. Accordingly, our failure to achieve design wins with equipment manufacturers, who have chosen a competitor's semiconductors could create barriers to future sales opportunities with these manufacturers.

**We may need to raise additional capital which might not be available or which, if available, could be on terms adverse to our common stockholders.**

We expect that our current cash and cash equivalents and investment securities balances will be adequate to meet our working capital and capital expenditure needs for at least twelve months. After that, we may need to raise additional funds, and we cannot be certain that additional financing will be available in amounts or on terms

acceptable to us, if at all. We may also require additional capital for the acquisition of businesses, products and technologies that are complementary to ours. Further, if we issue equity securities, the ownership percentage of our stockholders would be reduced, and the new equity securities may have rights, preferences or privileges senior to those existing holders of our common stock. If we are unable to obtain this additional financing, we may not be able to develop or enhance our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could seriously harm our business, operating results and financial condition.

**A general economic slowdown and a slowdown in spending in the telecommunications industry have affected and may continue to negatively affect our business and operating results.**

There have been announcements throughout the worldwide telecommunications industry of current and planned reductions in component inventory levels and equipment production volumes, and of delays in the build-out of new infrastructure. Any of these trends, if continued, could result in lower than expected demand for our products, which could have a material adverse effect on our revenues and results of operations generally, and could cause the market price of our common stock to decline. Specifically, we have experienced:

- reduced demand for our products;
- increased price competition for our products;
- increased risk of excess and obsolete inventories; and
- higher research and development and general and administrative costs, as a percentage of revenues.

Recent geopolitical and social turmoil in many parts of the world, including actual incidents and potential future acts of terrorism and war, may continue to put pressure on global economic conditions. These geopolitical and social conditions, together with the resulting economic uncertainties, make it extremely difficult for us, our customers and our vendors to accurately forecast and plan future business activities. This reduced predictability challenges our ability to operate profitably or to increase revenues. In particular, it is difficult to develop and implement strategies to create sustainable business models and efficient operations, and to effectively manage outsourced relationships for services such as contract manufacturing and information technology. If the current uncertain economic conditions continue or deteriorate, there could be additional material adverse impact on our financial position, revenues, results of operations, or cash flow.

**Changes in the accounting treatment of stock options will adversely affect our results of operations.**

In December 2004, the FASB issued SFAS 123R which requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in Centillum's consolidated statements of operations. The accounting provisions of SFAS 123R were to take effect for reporting periods beginning after June 15, 2005. In April 2005, the SEC announced the adoption of a new rule that amends the compliance dates for SFAS 123R. The SEC's new rule allows companies to implement SFAS 123R at the beginning of their next fiscal year, instead of the next reporting period, that begins after June 15, 2005. Centillum is therefore required to adopt SFAS 123R in the first quarter of 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition. Although Centillum has not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, it believes the adoption will have a material adverse impact on operating results.

**Our customers may demand preferential terms or lengthen our sales cycle, which would adversely affect our results of operations.**

Our customers are in most cases larger than us and are able to exert a high degree of influence over us. These customers may have sufficient bargaining power to demand low prices and other terms and conditions that may materially adversely affect our business, financial condition and results of operations. In addition, prior to selling our products to such customers, we must typically undergo lengthy product approval processes, often taking up to one

year. Accordingly, we are continually submitting successive versions of our products as well as new products to our customers for approval. The length of the approval process can vary and is affected by a number of factors, including customer priorities, customer budgets and regulatory issues affecting telecommunication service providers. Delays in the product approval process could materially adversely affect our business, financial condition and results of operations. While we have been successful in the past in obtaining product approvals from our customers, such approvals and the ensuing sales of such products may not continue to occur. Delays can also be caused by late deliveries by other vendors, changes in implementation priorities and slower than anticipated growth in demand for the services that our products support. A delay in, or cancellation of, the sale of our products could adversely affect our results from operations or cause them to significantly vary from quarter to quarter.

**We may be unable to attract, retain and motivate qualified personnel, which could seriously harm our business.**

Our future success depends on our ability to attract, retain and motivate qualified personnel, including executive officers and other key management and technical personnel. As the source of our technological and product innovations, our key technical personnel represent a significant asset. The competition for such personnel can be intense in the semiconductor industry. We do not have employment agreements with these executives, or any other key employees, that govern the length of their service. We have had, and may continue to have, particular difficulty attracting and retaining key personnel during periods of poor operating performance. The loss of the services of certain key senior management or technical personnel, or our inability to attract, retain and motivate qualified personnel, could materially and adversely affect our business, financial condition and results of operations.

**Future consolidation in the telecommunications equipment industry may increase competition that could harm our business.**

The markets in which we compete are characterized by increasing consolidation both within the telecommunications equipment sector and by companies combining or acquiring data communications assets and assets for delivering voice-related services. We cannot predict with certainty how industry consolidation will affect our competitors. We may not be able to compete successfully in an increasingly consolidated industry. Increased competition and consolidation in our industry may require that we reduce the prices of our products or result in a loss of market share, which could materially adversely affect our business, financial condition and results of operations. Additionally, because we are now, and may in the future be, dependent on certain strategic relationships with third parties in our industry, any additional consolidation involving these parties could reduce the demand for our products and otherwise harm our business prospects.

**If we deliver products with defects, our credibility will be harmed, and the sales and market acceptance of our products will decrease.**

Our products are complex and have contained errors, defects and bugs when introduced and revised. In the future we may experience further errors, defects and bugs. If we deliver products with errors, defects or bugs or products that have reliability, quality or compatibility problems, our credibility and the market acceptance and sales of our products could be harmed, which could adversely affect our ability to retain existing customers or attract new customers. Further, if our products contain errors, defects and bugs, then we may be required to expend significant capital and resources to alleviate such problems and may have our sales to customers interrupted or delayed. If any of these problems are not found until we have commenced commercial production, we may be required to incur additional development costs and product repair or replacement costs. Defects could also lead to potential liability as a result of product liability lawsuits against us or against our customers. We have agreed to indemnify some of our customers in some circumstances against liability from defects in our products. A successful product liability claim could seriously harm our business, financial condition and results of operations, and may divert our technical and other resources from other development efforts.

**We may experience difficulties in transitioning to smaller geometry process technologies or in achieving higher levels of design integration and that may result in reduced manufacturing yields, delays in product deliveries and increased expenses.**

In order to remain competitive, we expect to continue to transition our products to increasingly smaller line

width geometries. This transition will require us to modify the manufacturing processes for our products and redesign some products. We periodically evaluate the benefits, on a product-by-product basis, of migrating to smaller geometry process technologies to reduce our costs, and we have designed some of our products to be manufactured in .35 micron, .25 micron, .18 micron and .13 micron geometry processes.

In the past, we have experienced some difficulties in shifting to smaller geometry process technologies or new manufacturing processes, which resulted in reduced manufacturing yields, delays in product deliveries and increased expenses. We may face similar difficulties, delays and expenses as we continue to transition our products to smaller geometry processes. We are dependent on our relationships with our foundries to transition to smaller geometry processes successfully. We cannot assure you that our foundries will be able to effectively manage the transition or that we will be able to maintain our foundry relationships. If our foundries or we experience significant delays in this transition or fail to efficiently implement this transition, our business, financial condition and results of operations could be materially and adversely affected. As smaller geometry processes become more prevalent, we expect to continue to integrate greater levels of functionality, as well as customer and third party intellectual property, into our products. However, we may not be able to achieve higher levels of design integration or deliver new integrated products on a timely basis, or at all.

**Our future success will depend in part on our ability to protect our proprietary rights and the technologies used in our principal products, and if we do not enforce and protect our intellectual property, our business will be harmed.**

We rely on a combination of patent, copyright and trademark laws, trade secrets, confidentiality agreements and other contractual provisions to protect our proprietary rights. However, these measures afford only limited protection. Our failure to adequately protect our proprietary rights may adversely affect us. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use trade secrets or other information that we regard as proprietary.

The laws of some foreign countries do not protect our proprietary rights to the same extent as do the laws of the United States, and many U.S. companies have encountered substantial infringement problems in these countries. There is a risk that our efforts to protect proprietary rights may not be adequate. For example, our competitors may independently develop similar technology, duplicate our products or design around our patents or our other intellectual property rights. If we fail to adequately protect our intellectual property or if the laws of a foreign jurisdiction do not effectively permit such protection, it would be easier for our competitors to sell competing products.

### ***Risks Related to Our Common Stock***

**Our stock price may continue to be volatile.**

The market price of our common stock has been volatile. Since January 1, 2002 our common stock has traded at prices as low as \$1.08 and as high as \$14.58 per share. The price of our common stock will likely continue to fluctuate significantly in response to the following factors, some of which are beyond our control:

- variations in our quarterly operating results;
- changes in financial estimates of our revenues and operating results by securities analysts;
- changes in market valuations of integrated circuit companies;
- announcements by us, our competitors or others in related market segments of significant contracts, acquisitions, strategic partnerships, joint ventures or capital commitments;
- loss or decrease in sales to a major customer or failure to complete significant transactions;
- loss or reduction in manufacturing capacity from one or more of our key suppliers;
- additions or departures of key personnel;

- future sales of our common stock;
- inconsistent or low levels of trading volume of our common stock;
- commencement of or involvement in litigation;
- announcements by us or our competitors of key design wins and product introductions;
- a decrease in the average selling price of our products;
- ability to achieve cost reductions; and
- fluctuations in the timing and amount of customer requests for product shipments.

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

In the past, securities class action litigation often has been brought against a company following periods of volatility in the market price of its securities. Companies such as ours in the semiconductor industry and other technology industries are particularly vulnerable to this kind of litigation due to the high volatility of their stock prices. While we are not aware of any such contemplated class action litigation against us, we may in the future be the target of securities litigation. Any securities litigation could result in substantial costs and could divert the attention and resources of our management.

**If securities or industry analysts do not publish research or reports about our business or if they issue an adverse opinion regarding our stock, our stock price and trading volume could decline.**

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

**ITEM 1B. *UNRESOLVED STAFF COMMENTS***

Not applicable.

**ITEM 2. *PROPERTIES***

We lease two buildings in Fremont, California with approximately 104,000 square feet of space under a lease which expires in February 2011. One building which we occupy is approximately 52,000 square feet and houses our corporate headquarters, administration, sales and marketing, research and development, and operations departments. A second building, which we vacated and for which we recorded \$2.2 million in charges for surplus space in 2005, is approximately 52,000 square feet and is available for sublease. Internationally, we lease space in India and France for engineering design centers, and in Japan, China, Taiwan, France and South Korea for sales offices. We believe that our current facilities are adequate for our needs.

### **ITEM 3. *LEGAL PROCEEDINGS***

Centillium enters into standard indemnification agreements in the ordinary course of business. Pursuant to these agreements, Centillium indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally our business partners or customers, in connection with certain patent, copyright or other intellectual property infringement claims by any third parties with respect to our products. The term of these indemnification agreements is generally perpetual but is typically subject to an overall cap on liability. Centillium has not incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements and we have no liabilities recorded for these agreements as of December 31, 2005.

In August 2004, Fujitsu Limited filed a suit against Centillium and Centillium Japan K.K. (“Centillium Japan”) in the Tokyo District Court alleging that Centillium and Centillium Japan infringe one Japanese patent jointly owned by Fujitsu and Ricoh Co. Ltd. The complaint seeks significant monetary damages against Centillium and Centillium Japan. The suit is in process and we do not believe it is feasible to predict or determine the outcome or resolution of this litigation with any certainty at this point. We believe we have meritorious defenses and we are continuing to defend ourselves against these claims vigorously. We have already incurred and are likely to continue to incur substantial expenses in our defense against these claims. In the event of a determination adverse to us, we may incur substantial liability and this could have a material adverse effect on our financial position, results of operations or cash flows.

Centillium is involved in other litigation and responding to claims arising in the ordinary course of business. Centillium intends to defend itself vigorously in these other matters. Centillium’s management believes that it is unlikely that the outcome of these other matters will have a material adverse effect on the Centillium’s financial statements, although there can be no assurance in this regard. In addition, Centillium is responding to other claims arising in the ordinary course of business. In certain cases, management has accrued estimates of the amounts it expects to pay upon resolution of such matters and such amounts are included in accrued liabilities. Should Centillium not be able to secure the terms it expects, these estimates may change and will be recognized in the period in which they are identified. Although the ultimate outcome of such inquiries is not presently determinable, management believes that the resolution of these matters will not have a material adverse effect on Centillium’s financial position or results of operations.

### **ITEM 4. *SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS***

No matters were submitted to a vote of the security holders during the quarter ended December 31, 2005.

## PART II

### ITEM 5. *MARKET FOR THE REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES*

#### Price Range of Common Stock

Our common stock has traded on The NASDAQ National Market under the symbol "CTLTM" since our initial public offering in May 2000. The following table sets forth, for the periods indicated, the high and low bid prices for the common stock on The NASDAQ National Market:

<b>2005 Quarters Ended:</b>	<b>High</b>	<b>Low</b>
First Quarter .....	\$ 2.82	\$ 1.83
Second Quarter .....	\$ 2.57	\$ 1.90
Third Quarter .....	\$ 4.20	\$ 2.14
Fourth Quarter .....	\$ 4.70	\$ 2.94
<b>2004 Quarters Ended:</b>		
First Quarter .....	\$ 7.60	\$ 4.15
Second Quarter .....	\$ 5.07	\$ 2.98
Third Quarter .....	\$ 3.82	\$ 2.35
Fourth Quarter .....	\$ 2.92	\$ 2.05

On March 3, 2006, there were approximately 129 record holders of Centillum's Common Stock, and the last reported sale price of our common stock was \$3.37. There were approximately 5,181 beneficial stockholders as of March 3, 2006.

#### Dividend Policy

We have never declared or paid cash dividends on shares of our capital stock. We currently intend to retain all of our earnings, if any, for use in our business and in acquisitions of other businesses, products or technologies and do not anticipate paying any cash dividends in the foreseeable future.



## ITEM 6. *SELECTED CONSOLIDATED FINANCIAL DATA*

The following selected consolidated financial data below is not necessarily indicative of results of future operations and should be read in conjunction with the consolidated financial statements and related notes thereto and “Management’s Discussion and Analysis of Financial Condition and Results of Operations” appearing elsewhere in this Annual Report on Form 10-K.

	Years Ended December 31,				
	<u>2005 (1)</u>	<u>2004</u>	<u>2003</u>	<u>2002 (2)</u>	<u>2001 (3)</u>
	(In thousands, except per share data)				
<b>Consolidated Statement of Operations Data:</b>					
Net revenues .....	\$ 76,127	\$ 71,151	\$124,976	\$104,972	\$159,507
Gross profit .....	\$ 40,972	\$ 33,472	\$ 53,823	\$ 45,472	\$ 79,726
Operating loss .....	\$(12,810)	\$(43,977)	\$(14,298)	\$(35,630)	\$(21,847)
Net loss .....	\$(11,285)	\$(43,062)	\$(13,359)	\$(33,301)	\$(19,693)
Basic and diluted net loss per share .....	\$ (0.29)	\$ (1.13)	\$ (0.37)	\$ (0.96)	\$ (0.59)
Shares used to compute basic and diluted net loss per share .....	39,312	38,210	36,433	34,641	33,495
<b>Consolidated Balance Sheet Data:</b>					
Cash, cash equivalents, and short-term investments .....	\$ 61,340	\$ 62,191	\$ 89,626	\$102,002	\$110,853
Working capital .....	\$ 44,539	\$ 49,115	\$ 88,284	\$ 83,795	\$103,663
Total assets .....	\$ 78,347	\$ 81,945	\$125,624	\$122,439	\$144,208
Capital lease obligation, less current portion .	\$ -	\$ -	\$ -	\$ 525	\$ -
Total stockholders' equity .....	\$ 46,612	\$ 55,332	\$ 96,037	\$ 93,823	\$121,158

- (1) Results of operations for 2005 include \$2.2 million in charges for surplus space at our Fremont, California location.
- (2) Results of operations for 2002 include a \$5.8 million charge for impairment of goodwill.
- (3) Results of operations for 2001 include a \$7.4 million charge for in-process research and development.

## ITEM 7. *MANAGEMENT’S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS*

### *Forward-Looking Statements*

You should read the following discussion and analysis in conjunction with our consolidated financial statements and the related notes thereto contained elsewhere in this report. The information in this report is not a complete description of our business or the risks associated with an investment in our common stock. We urge you to carefully review and consider the various disclosures made by us in this report and in our other reports filed with the SEC.

All statements included or incorporated by reference in this report, other than statements or characterizations of historical fact, are “forward-looking statements” that are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are generally preceded by words that imply a future state such as “expected” or “anticipated” or imply that a particular future event or events will occur such as “will.” Investors are cautioned that all forward-looking statements involve risks and uncertainties and that actual results could be materially different from those expressed in any forward-looking statement. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

The section entitled “Risk Factors” and similar discussions in our other reports filed with the SEC discuss some of the important risk factors that may affect our business, results of operations and financial condition. Copies of our reports filed with the SEC are available from us without charge and on the SEC’s website at [www.sec.gov](http://www.sec.gov). You should carefully consider those risks, in addition to the other information in this report and in our other filings with the SEC, before deciding to invest in Centillium or to maintain or increase your investment.

### ***Overview***

Centillium designs, develops and supplies highly-integrated programmable system-on-a-chip (SOC) solutions that enable high-speed broadband access, which is the delivery of high-capacity bandwidth to consumers and enterprises for networking of data, voice and video signals. Our SOC products incorporate digital and mixed-signal semiconductors and related software. We serve the Digital Subscriber Line (DSL), Voice over Internet Protocol (VoIP) and Fiber-To-The-Premises (FTTP), which is also known as optical networking, markets. Our customers are systems vendors and original equipment manufacturers who sell DSL and optical network equipment for deployment in central offices and customer premises, and VoIP equipment, for use in carrier-class and enterprise-class gateways and consumer telephony.

We currently sell through our direct sales force and through independent sales representatives in the Asia-Pacific region, Europe, and North America.

Since inception, our net revenues have been derived primarily from the sale of our DSL products to two customers in Japan. These two customers are NEC Corporation (NEC) and Sumitomo Electric Industries, Ltd. (Sumitomo). In 2004 compared to 2003, the ADSL new subscriber market in Japan shrank dramatically, which adversely impacted our financial performance. In 2005 compared to 2004, the ADSL new subscriber market shrank further. As the DSL market continues to approach maturity, we expect that the new subscriber rate in 2006 will remain at or be lower than the rate experienced in 2005.

We have not reported an operating profit for any year since inception and have experienced net losses of approximately \$11.3 million, \$43.1 million and \$13.4 million for 2005, 2004 and 2003, respectively. We expect to continue to incur operating losses and negative cash flows in the near term.

We must achieve substantial revenue growth and continue to reduce expenses to improve our financial position. Our ability to achieve the necessary revenue growth will depend on how successful we are in diversifying our DSL business to markets outside of Japan and diversifying our business by targeting opportunities in the FTTP and VoIP markets. During the third quarter of 2005, we announced our entry into the VDSL market with eXtremeVDSL2™, a highly optimized and flexible solution that will complement our FTTP initiative and extend our DSL product portfolio. In the second quarter of 2005, we announced an expansion to the Palladia™ 400 product family, which delivers the industry’s first integrated VoIP solution for the ADSL market. In 2004, we introduced Atlanta 100, which provides a secure high performance router solution for the CPE market with superior VoIP capability, and our Voice Services Platform (VSP), which is designed as the consumer electronics industry’s turnkey platform for the development and deployment of carrier-grade VoIP products.

We announced in 2004 a line of optical access products for the developing FTTP market. Our FTTP revenues were \$3.8 million and \$877,000 in 2005 and 2004, respectively. Growth, if any, in our FTTP revenues in 2006 and beyond is dependent on qualification of our FTTP products and the purchase of significant quantities of these products by our customers. One such customer in Japan, which we had expected to account for a significant percentage of this growth, has postponed purchases because our product did not meet a previously waived requirement. Moreover, for this customer, our product must now meet additional requirements and we are in the process of redesigning this product. This is expected to significantly slow our anticipated growth in optical revenues in 2006. We will also incur further costs to implement these customer requirements. Even if we are successful, we expect the delay to defer revenue to as late as the fourth quarter of 2006 and possibly beyond. However, there can be no assurance that our product will meet customer requirements now or in the future and that even if they do meet these requirements, that our customers will purchase our product.

In addition to our expanded product lines, we have also increased our sales and marketing presence outside of Japan. We reduced our operating expenses, primarily in the research and development area. The investments we made in our design center in India and in attracting talented engineers resulted in our ability to reduce expenses by conducting more of our research and development in India, where costs are substantially lower than in the United States.

In 2005, we recorded total charges of about \$2.2 million for surplus space in a building at our Fremont, California location, which we abandoned. In addition, we recorded a \$1.0 million charge for licensed software tools, which were written off as these tools are not expected to have future alternative uses. During the fourth quarter of 2004, we restructured our organization by implementing a workforce reduction and terminating a \$1.4 million license for certain software design tools. We also cancelled certain development programs to better focus on higher growth opportunities. The total expense related to the reduction in force was \$1.3 million, of which \$1.0 million related to research and development personnel. These initiatives coupled with a 7% increase in 2005 revenues, an increase in the 2005 gross margin, as well as further expense reductions resulted in a significant decrease in our net loss for 2005. Our net loss decreased by approximately \$31.8 million, or 74%, to a net loss of \$11.3 million for 2005 as compared to \$43.1 million for 2004.

Our planned actions for 2006 are based on certain assumptions concerning the adoption of broadband technologies, the rate of DSL subscriber growth, the successful deployment of our FTTP products in Japan and the cost and expense structure of our business. These assumptions could prove to be inaccurate. If current economic conditions deteriorate to an unexpected degree, or if our planned actions are not successful in achieving our goals, there could be additional adverse impacts on our revenues, profitability, financial position, or cash flows. In that case, we might need to modify our strategic focus and restructure our business to realign our resources and achieve additional cost and expense savings.

*Net Revenues:* In 2005, 2004 and 2003, DSL revenues accounted for 79%, 94% and 98% of our net revenues, respectively. In 2005, 2004 and 2003, NEC accounted for 26%, 42% and 49% and Sumitomo accounted for 35%, 35% and 31% of net revenues, respectively. Lucent Technologies accounted for 13% of net revenues in 2005. No other customer accounted for 10% or more of net revenues in any year during this three-year period.

We believe revenues from our DSL products will continue to decrease as a percentage of net revenues due to the anticipated growth in revenues from VoIP and FTTP products. We believe that our three largest customers will continue to account for a substantial portion of our net revenues in 2006.

Our sales have historically been denominated in U.S. dollars, and major fluctuations in currency and exchange rates could materially impact our customers' demand and pricing overall.

The cycle for test, evaluation and adoption of our products by customers can range from three to more than six months, with an additional three to more than nine months before a customer commences volume production of equipment incorporating our products. Additionally, this cycle may be as long as 18 to 24 months for our VoIP products. Due to this lengthy sales cycle, we may experience significant delays from the time we incur expenses for research and development, marketing and selling, and investment in inventory, to the time we generate corresponding revenues, if any. We anticipate that the rate of orders may vary significantly from quarter to quarter. If anticipated shipments in any quarter do not occur when expected, expenses and inventory levels could be disproportionately high or low, and our results of operations for that quarter, and potentially for future quarters, would be materially and adversely affected.

Competition and technological change in the rapidly evolving DSL market has and may continue to influence our quarterly and annual net revenues and results of operations. Average selling prices of our products tend to be higher at the time of introduction and decline over time due to competitive pressures. We expect this pattern to continue with existing and future products. Our average selling prices are also impacted by our customer concentration and product mix.

*Cost of Revenues:* We are a fabless semiconductor company and we outsource the wafer fabrication, assembly and testing of our products. Our cost of revenues primarily consists of purchased finished wafers, assembly and test

services, royalties, overhead associated with procurement and production engineering, provisions for excess and obsolete inventories, and product warranty costs.

*Research and Development Expenses:* Research and development expenses consist primarily of employee compensation and related personnel expenses, fees paid to consultants, non-recurring engineering, prototype costs, evaluation and testing of pre-production parts and engineering design tools. We expense our research and development costs as they are incurred. Several components of our research and development effort require significant expenditures, the timing of which can cause significant quarterly variability in our expenses.

*Selling, General and Administrative Expenses:* Selling, general and administrative (SG&A) expenses include employee compensation and related personnel expenses in sales and marketing, product marketing, applications engineering, and corporate functions including accounting, finance, legal, human resources and information systems.

*Stock-based Compensation:* Deferred compensation represents the difference between the grant price and the fair market value for financial statement reporting purposes of our common stock option and restricted stock grants. As required by APB 25, we have recorded an adjustment to stock-based compensation expense related to employees who forfeited options for which compensation expense had been recognized using the graded vesting method, but which are unvested on the date their employment terminated. Amortization of deferred compensation using the straight-line vesting method was \$36,000 in 2005 compared to \$289,000 in 2004. The pro forma disclosures previously permitted under SFAS 123 will no longer be an alternative to financial statement recognition beginning in the first quarter of 2006. Although Centillium has not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, it believes the adoption of SFAS 123R will have a material adverse impact on operating results.

*Interest Income and Other, Net:* Interest income consists of interest earned on cash and cash equivalent balances and short-term investments.

*Provision for Income Taxes:* The provision for income tax expense was \$149,000 in 2005, \$155,000 in 2004 and \$133,000 in 2003. The provisions for income taxes relate to current taxes payable for income generated by the Company's subsidiaries located in foreign jurisdictions.

As of December 31, 2005, we have \$132.9 million and \$35.6 million of net operating loss carryforwards for U.S. federal and state purposes, respectively. We also have research and development tax credit carryforwards for U.S. federal and state purposes of approximately \$5.1 million and \$5.7 million, respectively. The federal net operating losses and federal tax credit carryforwards will expire at various dates beginning in 2018, if not utilized. The California net operating losses will expire at various dates beginning in 2006.

Utilization of net operating loss and credit carry-forwards may be subject to a substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code of 1986, as amended, and similar state provisions. The annual limitation may result in the expiration of net operating losses and tax credit carry-forwards before full utilization.

Financial Accounting Standards Board Statement No. 109, "Accounting for Income Taxes," provides for the recognition of deferred tax assets if realization of such assets is more likely than not. Based upon the weight of available evidence, which includes our historical operating performance and our reported cumulative net losses to date, we have provided a full valuation allowance against our deferred tax assets because we do not believe it is more likely than not that these deferred tax assets will be realized.

### ***Critical Accounting Policies***

*General:* Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with U.S. generally accepted accounting principles. The preparation of these financial statements requires that we make assumptions, estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures of contingent assets and liabilities reported in the consolidated financial statements and accompanying notes. On an ongoing basis, we evaluate our estimates based on historical experience and on various other assumptions that we

believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. Actual results may differ from these estimates under different assumptions or conditions.

We believe that, of the significant accounting policies used in the preparation of our consolidated financial statements (see Note 1 of Notes to Consolidated Financial Statements), the following are critical accounting policies, which may involve a higher degree of judgment and complexity.

*Revenue Recognition:* Revenues related to product sales are generally recognized when the products have been shipped and risk of loss has passed to the customer, collection of the resulting receivable is reasonably assured, persuasive evidence of an arrangement exists, and the price is fixed or determinable. If sales arrangements contain customer-specific acceptance requirements, revenue is deferred and is recognized upon receipt of customer acceptance.

*Sales Returns and Allowances:* We establish, upon shipment of our products, a provision for estimated returns. Under certain circumstances, we allow our customers to return products and a provision is made for such returns. Our estimate of product returns is based on contractual terms or sales agreements, historical experience and expectation of future conditions. Additional provisions and allowances may be required, resulting in decreased net revenue and gross profit, should we experience increased product returns.

*Allowance for Doubtful Accounts:* We perform ongoing credit evaluations of our customers and adjust credit limits, as determined by our review of current credit information. We record allowances for doubtful accounts for estimated losses based upon specifically identified amounts that we believe to be uncollectible. We record additional allowances based on certain percentages of our aged receivables, which are determined based on historical experience and our assessment of the general financial condition of our customer base. If our actual collections experience changes, revisions to our allowances may be required. We have a limited number of customers with individually large amounts due at any given balance sheet date. Any unanticipated change in one of those customers' creditworthiness or other matters affecting the collectibility of amounts due from such customers could have a material effect on our results of operations in the period in which such changes or events occur.

*Inventories:* Inventories are stated at the lower of standard cost, which approximates actual cost, or net realizable value. Cost is based on a first-in, first-out basis. We perform detailed reviews of the net realizable value of inventories, both on hand as well as for inventories we are committed to purchase with consideration given to deterioration, obsolescence, and other factors. We typically use a six- or nine-month rolling forecast based on the type of products, anticipated product orders, product order history, forecasts and backlog. We compare our current or committed inventory levels to these forecasts on a regular basis and any adverse changes to our future product demand may result in increased writedowns, resulting in decreased gross profit. In the event we experience unanticipated demand and are able to sell previously written down inventories, gross profit will increase.

*Warranty:* A limited warranty is provided on our products generally for a period of one year and allowances for estimated warranty costs are recorded during the period of sale. While we engage in product quality programs and processes, including monitoring and evaluating the quality of our suppliers, our warranty obligation is affected by product failure rates, the cost of replacing chipsets, rework costs and freight incurred in replacing a chipset after failure. We monitor product returns for warranty and maintain a reserve for the related warranty expenses based on historical experience of similar products. The determination of such allowances requires us to make estimates of product return rates and expected costs to repair or replace the products under warranty. If actual return rates and/or repair and replacement costs differ significantly from our estimates, adjustments to recognize additional cost of sales may be required.

*Litigation and Contingencies:* From time to time, we receive various inquiries or claims in connection with patent and other intellectual property rights. In certain cases, we have accrued estimates of the amounts we expect to pay upon resolution of such matters. Should we not be able to secure the terms we expect or should the terms become more favorable than the terms we expect, these estimates may change and may result in increased accruals, resulting in decreased profit or decreased accruals, resulting in increased profit, respectively.

The above items are not a comprehensive list of all of our accounting policies. In many cases, the accounting treatment of a particular transaction is specifically dictated by GAAP with no need for our management's judgment in their application. There are also areas in which our management's judgment in selecting any available alternative would not produce a materially different result. See our consolidated financial statements and related notes thereto included elsewhere in this Annual Report on Form 10-K that contain accounting policies and other disclosures required by GAAP.

## Results of Operations

The following table sets forth, for the periods presented, certain data from our consolidated statements of operations expressed as a percentage of total revenues:

	Years Ended December 31,		
	2005	2004	2003
Net revenues .....	100%	100%	100%
Cost of revenues .....	46	53	57
Gross profit .....	54	47	43
Operating expenses:			
Research and development .....	39	76	37
Selling, general and administrative .....	32	33	18
Amortization of acquisition-related intangibles .....	-	-	*
Total operating expenses .....	71	109	55
Operating loss .....	(17)	(62)	(12)
Interest income, net .....	2	1	1
Loss before provision for income taxes .....	(15)	(61)	(11)
Provision for income taxes .....	*	*	*
Net loss .....	<u>(15)%</u>	<u>(61)%</u>	<u>(11)%</u>

\* Less than 1%

## Years ended December 31, 2005 and 2004

*Net Revenues:* The following table presents net revenues, cost of revenues and gross profit (in thousands except for percentages):

	Year Ended December 31, 2005		Year Ended December 31, 2004		Increase/ (Decrease)	% Change
	Amount	% of Net Revenues	Amount	% of Net Revenues		
Net revenues .....	\$ 76,127	100%	\$ 71,151	100%	\$ 4,976	7 %
Cost of revenues .....	35,155	46%	37,679	53%	(2,524)	(7)%
Gross Profit .....	<u>\$ 40,972</u>	<u>54%</u>	<u>\$ 33,472</u>	<u>47%</u>	<u>\$ 7,500</u>	22 %

Our revenues are generated principally by sales of our DSL, VoIP and FTTP products. The following table presents net revenues for each of our major product lines (in thousands except for percentages);

<b>Products</b>	<b>Year Ended December 31, 2005</b>		<b>Year Ended December 31, 2004</b>		<b>Increase/ (Decrease)</b>	<b>% Change</b>
	<b>Amount</b>	<b>% of Net Revenues</b>	<b>Amount</b>	<b>% of Net Revenues</b>		
DSL .....	\$ 60,313	79%	\$ 66,757	94%	\$ (6,444)	(10)%
VoIP .....	12,034	16%	3,507	5%	8,527	243 %
FTTP .....	3,780	5%	887	1%	2,893	326 %
Net revenues .....	<u>\$ 76,127</u>	<u>100%</u>	<u>\$ 71,151</u>	<u>100%</u>	<u>\$ 4,976</u>	<u>7 %</u>

Net revenues in 2005 were \$76.1 million, compared with \$71.2 million in 2004, an increase of \$4.9 million, or 7%. Revenues from our DSL products accounted for \$60.3 million, or 79%, of net revenues in 2005, as compared to \$66.8 million or 94%, of net revenues in 2004. The decline in DSL revenues was primarily due to a significant decrease in the number of new DSL subscribers in Japan as compared to 2004, and to a lesser extent, by a decrease in the average selling price of our DSL products. Average selling prices of products are expected to decline as they mature. Historically, competition in the semiconductor industry has driven down the average selling prices of products. Revenues from Japan comprised 64% and 78% of our net revenues in 2005 and 2004, respectively. Japan's DSL market has been an important part of our business, and new DSL subscribers in Japan has been a significant driver of consumption for Centillum's DSL products. Therefore, the continuing decreasing number of new DSL subscribers in Japan will likely continue to impact our future revenues. Revenues from Japan, which have been largely attributable to our DSL products, have decreased by \$6.8 million to \$49.0 million in 2005 as compared to \$55.8 million in 2004.

Revenues from VoIP products accounted for \$12.0 million of revenues in 2005 as compared to \$3.5 million in 2004, or 16% and 5% of net revenues, respectively. We expect our VoIP revenues to continue to grow in absolute dollars and as a percentage of revenues in 2006. Revenues from our FTTP products accounted for \$3.8 million of revenues in 2005 as compared to \$887,000 in 2004, or 5% and 1% of net revenues, respectively. We expect our FTTP revenues to continue to grow in 2006, but this growth is highly dependent on qualification of our FTTP products and the purchase of significant quantities of these products by our customers. One such customer in Japan has postponed purchases because our product did not meet a previously waived requirement. This is expected to significantly slow our anticipated growth in optical revenues in 2006 and we expect the delay to defer revenue to as late as the fourth quarter of 2006 and possibly beyond.

The following customers, the first two of whom are located in Japan, accounted for more than 10% of net revenues:

	<b>Years Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
NEC .....	26%	42%
Sumitomo .....	35%	35%
Lucent .....	13%	*

\* Less than 10%

*Gross Profit:* Gross profit represents net revenues less the cost of revenues. Gross profit increased by \$7.5 million, to \$41.0 million in 2005 from \$33.5 million in 2004. The increase was primarily due to significant increases in VoIP and FTTP revenues as the impact of the decrease in DSL revenues on gross profit was largely offset by



lower wafer, assembly and test costs, as well as improved yields and a favorable product mix. Gross profit margin increased to 54% in 2005 from 47% in 2004 primarily due to the lower costs, improved yields and product mix, which more than offset the decline in the average selling price. Our future gross profit margins may be affected by competitive pricing strategies, fluctuations in unit volume and manufacturing costs, and changes in product and customer mix among other factors.

*Research and Development Expenses:* Research and development expenses decreased by 45% to \$29.6 million in 2005 from \$53.7 million in 2004. The \$24.1 million decrease resulted primarily from \$10.7 million in decreased employee compensation and related personnel expenses, \$4.1 million in engineering design tools expense which includes a \$1.0 million charge for licensed software tools, which were written off as these tools are not expected to have future alternative uses, \$4.0 million in engineering evaluation board and pre-production testing expenses, \$3.4 million in consulting expense, \$1.2 million in facilities and \$0.7 million in travel expense. The decreased expenses in employee compensation and related personnel expenses was primarily attributable to significantly lower headcount in the United States due to both the reduction in force implemented in the fourth quarter of 2004 and to additional decreases in headcount in 2005. However, we expect research and development expenses in 2006 to be slightly higher than in 2005 as we anticipate a higher level of program development. However, there can be no assurance that our research and development expenses will not increase further in the future.

*Selling, General and Administrative Expenses:* Selling, general and administrative expenses in 2005 increased by 2% to \$24.2 million from \$23.7 million in 2004. The \$0.5 million increase resulted primarily from the \$2.2 million charge for surplus space in our Fremont, California location which we abandoned and to a \$0.9 million increase in sales commissions, partially offset by decreases in expenses of \$1.1 million in marketing, \$0.4 million in public company compliance, \$0.4 million in travel, \$0.3 million in depreciation and amortization, \$0.2 million in business insurance and \$0.2 million in legal expenses. We expect that selling, general and administrative expenses in 2006 will decrease in absolute dollars and as a percentage of revenues. However, there can be no assurance that our sales and marketing expense will not increase in the future or that we will develop a cost structure, which will lead to profitability under current and expected revenue levels.

*Stock-based Compensation Expense:* Stock-based compensation expense was \$36,000 in 2005 compared to \$289,000 in 2004. In April 2005, our Board of Directors determined to supplement the equity-based compensation of the Board by making an annual grant to each non-employee director of 5,000 shares of restricted common stock of the Company, with such shares vesting 100% on the first anniversary of the date of the grant resulting in a compensation expense of \$36,000 for the year ended December 31, 2005.

The 2004 expense was attributable to the amortization of deferred compensation expense recorded in 2000, net of forfeitures, using the graded vesting method, which resulted in accelerated amortization of deferred compensation expense in the earlier years of the awards' vesting period. As required by APB 25, we have recorded an adjustment to stock-based compensation expense related to employees who forfeited options for which compensation expense had been recognized using the graded vesting method, but which are unvested on the date their employment terminated.

*Interest Income and Other, Net:* Interest income and other, net was \$1.7 million in 2005 compared to \$1.1 million in 2004. The overall rise in interest rates throughout 2005 resulted in an increased interest income that more than offset the decrease in funds available for investment.

*Provision for Income Taxes:* The provision for income tax expense was \$149,000 in 2005 and \$155,000 in 2004. The provision for income taxes relates to current taxes payable for income generated by the Company's subsidiaries located in foreign jurisdictions.

As of December 31, 2005, we have \$132.9 million and \$35.6 million of net operating loss carryforwards for federal and state purposes, respectively. We also have research and development tax credit carryforwards for federal and state purposes of approximately \$5.1 million and \$5.7 million, respectively. The federal net operating losses and federal tax credit carryforwards will expire at various dates beginning in 2018, if not utilized. The California net operating losses will expire at various dates beginning in 2006.

**Years ended December 31, 2004 and 2003**

*Net Revenues:* The following table presents net revenues, cost of revenues and gross profit (in thousands except for percentages):

	Year Ended		Year Ended			
	December 31, 2004		December 31, 2003			
		% of Net		% of Net	Increase/	%
	Amount	Revenues	Amount	Revenues	(Decrease)	Change
Net revenues .....	\$ 71,151	100%	\$ 124,976	100%	\$ (53,825)	(43)%
Cost of revenues .....	37,679	53%	71,153	57%	(33,474)	(47)%
Gross Profit .....	\$ 33,472	47%	\$ 53,823	43%	\$ (20,351)	(38)%

Our revenues are generated principally by sales of our DSL, VoIP and FTTP products. The following table presents net revenues for each of our major product lines (in thousands except for percentages):

	Year Ended		Year Ended			
	December 31, 2004		December 31, 2003			
		% of Net		% of Net	Increase/	%
Products	Amount	Revenues	Amount	Revenues	(Decrease)	Change
DSL .....	\$ 66,757	94%	\$ 122,101	98%	\$ (55,344)	(45)%
VoIP .....	3,507	5%	2,470	2%	1,037	42 %
FTTP .....	887	1%	405	0%	482	119 %
Net revenues .....	\$ 71,151	100%	\$ 124,976	100%	\$ (53,825)	(43)%

Net revenues in 2004 were \$71.2 million, compared with \$125.0 million in 2003, a decrease of \$53.8 million, or 43%. Revenues from our DSL products accounted for \$66.8 million, or 94%, of net revenues in 2004, as compared to \$122.1 million, or 98%, of net revenues in 2003. The decline in DSL revenues was primarily due to a significant decrease in the number of new DSL subscribers in Japan as compared to 2003, and to a much lesser extent, by a decrease in the average selling price. Revenues from Japan comprised 78% and 79% of our net revenues in 2004 and 2003, respectively. Revenues from VoIP products accounted for \$3.5 million of revenues in 2004 as compared to \$2.5 million in 2003, or 5% and 2% of net revenues, respectively.

The following customers, the both of whom are located in Japan, accounted for more than 10% of net revenues:

	<b>Years Ended December 31,</b>	
	<b>2004</b>	<b>2003</b>
NEC .....	42%	49%
Sumitomo .....	35%	31%

*Gross Profit:* Gross profit decreased by \$20.4 million to \$33.5 million in 2004 from \$53.8 million in 2003. The decrease was primarily due to substantially lower unit volume. The gross profit margin increased to 47% in 2004 from 43% in 2003 primarily due to lower manufacturing costs which more than offset the decline in the average selling price.

*Research and Development Expenses:* Research and development expenses increased by 16% to \$53.7 million in 2004 from \$46.2 million in 2003. The \$7.5 million increase resulted primarily from the increase in expenditures for new engineering development programs including \$2.0 million in employee compensation, \$1.5 million in consulting expense, \$1.3 million in software development tools expense, \$1.1 million of engineering evaluation boards expense, and \$0.7 million in travel expense, partially offset by a decrease in stock-based compensation of \$0.8 million. In the fourth quarter of 2004 we re-focused our engineering efforts by implementing a reduction in force resulting in a \$1.0 million charge. In addition, we recorded a \$1.4 million charge due to the early termination of a certain licensed software development tool.

*Selling, General and Administrative Expenses:* Selling, general and administrative expenses in 2004 increased by 8% to 23.7 million from \$21.9 million in 2003. The increase was largely due to a \$1.8 million increase in compensation and travel expenses resulting from the substantial increase in our sales and marketing headcount, a \$0.8 million increase in costs associated with complying with new corporate governance and public disclosure standards, partially offset by a \$0.4 million decrease in stock-based compensation and a \$0.3 million decrease in business insurance.

*Stock-based Compensation Expense:* Stock-based compensation expense was \$289,000 in 2004 compared to \$1.4 million in 2003. The \$1.1 million decrease was primarily related to the use of the graded vesting method, which resulted in accelerated amortization of deferred compensation expense in the earlier years of the awards' vesting period. As required by APB 25, we have recorded an adjustment to stock-based compensation expense related to employees who forfeited options for which compensation expense had been recognized using the graded vesting method, but which are unvested on the date their employment terminated. As of December 31, 2004, deferred compensation had been fully amortized.

*Interest Income and Other, Net:* Interest income and other, net was \$1.1 million in both 2004 and 2003 as the impact of higher interest rates in 2004 offset the decrease in funds available for investment.

*Provision for Income Taxes:* The provision for income tax expense was \$155,000 in 2004 and \$133,000 in 2003. The provisions for income taxes relate to current taxes payable for income generated by Centillum's subsidiaries located in foreign jurisdictions.

## **Liquidity and Capital Resources**

Since our inception, we have financed our operations primarily through operating activities and the sale of equity securities. At December 31, 2005, we had \$61.3 million in cash, cash equivalents and short-term investments as compared to \$62.2 million at December 31, 2004.

Operating activities during 2005 used \$2.0 million in cash primarily due to our net loss of \$11.3 million and increases in accounts receivable of \$1.8 million and other current and long-term assets of \$0.9 million. Net cash used in operating activities were partially offset by non-cash expenses of \$3.8 million for depreciation and amortization, and a \$0.6 million loss on retirement of property and equipment, decrease in inventories of \$2.5 million, and increases of \$2.3 million in accrued liabilities, \$1.5 million in other long-term liabilities, \$0.9 million in accrued compensation and related expenses and \$0.4 million in accounts payable. The loss was due to an organizational infrastructure that was larger than the scale of our business. Inventories decreased at December 31, 2005 primarily due to the timing of inventory receipts. The increase in accounts receivable resulted from later shipments in the three months ended December 31, 2005 as compared to the three months ended December 31, 2004. We anticipate that our operating expenses will be lower in 2006.

Net cash provided by investing activities was \$6.9 million in 2005. Net cash provided by investing activities related to sales and maturities of short-term investments of \$91.8 million, partially offset by purchases of short-term investments of \$83.5 million and the purchase of \$1.4 million of property and equipment. Property and equipment purchases relate principally to the purchase of engineering design tools, lab equipment and computer hardware to support our research and development. We expect expenditures for property and equipment to continue at a similar level in the near term to support our current operating and research and development activities.

Net cash provided by financing activities was \$2.5 million in 2005, which consisted of net proceeds from the issuance of common stock under employee stock plans.

Our principal source of liquidity as of December 31, 2005 consisted of \$61.3 million of cash and cash equivalents, and short-term investments. We believe our cash, cash equivalents and investment securities will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next twelve months. The rate at which we will consume cash will be dependent on the cash needs of future operations that will, in turn, be directly affected by various risks and uncertainties, including, but not limited to, the levels of demand for our products and other risks listed in the “Risk Factors” section.

### Contractual Obligations

Significant contractual obligations and commercial commitments are shown in the table below (in thousands):

	Payments Due by Period				
	Total	Less than 1 Year	1-3 Years	3-5 Years	More Than 5 Years
Operating leases .....	\$ 12,725	\$ 3,453	\$ 8,073	\$ 1,199	\$ -
Purchase obligations .....	6,872	6,872	-	-	-
Total .....	<u>\$ 19,597</u>	<u>\$ 10,325</u>	<u>\$ 8,073</u>	<u>\$ 1,199</u>	<u>\$ -</u>

We have taken substantial steps during the second half of 2004 and during 2005 to reduce losses and preserve cash and anticipate operating expenses in 2006 to be less than 2005. Our future capital requirements depend on many factors that affect our research and development, and sales and marketing activities. We believe that existing cash and investment securities and anticipated cash flows from operations will be sufficient to support our current operating plan for 2006. These cash flow and operating results expectations are subject to numerous assumptions, many of which may not actually occur. If some or all of such assumptions do not occur, our results may be substantially lower or different than expected. Such assumptions include, without limitation, assumptions that new product introductions will occur on a timely basis and achieve market acceptance, that our existing and potential customer base will continue to grow and that our industry’s competitive landscape will not change adversely. For more information about the risks relating to our business, please read carefully the Risk Factors set forth below.

We expect to devote capital resources to continue our research and development efforts, to support our sales and marketing, and to fund general corporate activities. From time to time, we receive various inquiries or claims in connection with intellectual property and other rights and may become party to associated claims. In certain cases, management has accrued estimates of the amounts it expects to pay upon resolution of such matters. Depending on the amount and timing of the resolutions of these claims, our future cash flows could be materially adversely affected in a particular period.

If our existing resources and cash generated from operations are insufficient to satisfy our liquidity requirements in the long term, we may seek to raise additional funds through public or private debt or equity financings. The sale of equity or debt securities could result in additional dilution to our stockholders, and we cannot be certain that additional financing will be available in amounts or on terms acceptable to us, if at all. If we are unable to obtain this additional financing, we may be required to reduce the scope of our planned product development and sales and marketing efforts, which could harm our business, financial condition and operating results.

### Off-Balance Sheet Arrangements

As of December 31, 2005, we did not have any significant off-balance-sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K.

### Recent Accounting Pronouncements

In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, “Accounting Changes

and Error Corrections—a Replacement of APB Opinion No. 20 and FASB Statement No. 3” (SFAS 154), which requires retrospective application to prior periods’ financial statements of every voluntary change in accounting principal unless it is impracticable to do so. SFAS 154 is effective for accounting changes and corrections of errors beginning in fiscal 2007. Centillum does not expect the adoption of this standard to have a material effect on Centillum’s financial position or results of operations.

In December 2004, the FASB issued SFAS 123R “Share-Based Payment” which requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in the Company’s consolidated statements of operations. The accounting provisions of SFAS 123R was originally effective for reporting periods beginning after June 15, 2005. On April 14, 2005 the U.S. Securities and Exchange Commission announced a deferral of the effective date of FAS 123R for calendar year companies until the beginning of 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition beginning in the first quarter of 2006. As noted earlier, Centillum has not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, but it believes that the adoption will have a material adverse impact on operating results. See Note 1 of Notes to the Consolidated Financial Statements for information related to the pro forma effect on Centillum’s reported net income and net earnings per share of applying the fair value provisions of the SFAS 123, “Accounting for Stock-Based Compensation,” to stock-based employee compensation.

In March 2005, the SEC released SEC Staff Accounting Bulletin No. 107 (SAB 107). SAB 107 provides the SEC staff position regarding the application of SFAS 123R “Share-Based Payment.” SAB 107 contains interpretive guidance relating to the interaction between SFAS 123R and certain SEC rules and regulations, as well as the SEC staff’s views regarding the valuation of share-based payment arrangements for public companies. SAB 107 also highlights the importance of disclosures made related to the accounting for share-based payment transactions. Centillum is currently evaluating SAB 107 and will be incorporating it as part of its adoption of SFAS 123R in the first quarter of 2006.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29. The guidance in APB Opinion No. 29, Accounting for Nonmonetary Transactions, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have a material impact on the Company’s financial position and results of operations.

In November 2004, the FASB issued Statement No. 151 “Inventory Costs, an amendment of ARB No. 43, Chapter 4,” (SFAS 151), which amends the guidance in ARB No. 43, Chapter 4, “Inventory Pricing” to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and spoilage. This statement now requires that these costs be expensed as current period charges. In addition, this statement requires that the allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. The provisions of this statement are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. We do not believe that our adoption of SFAS 151 on January 1, 2006 will have a material effect on our financial position, results of operations or cash flows.

In various areas, including revenue recognition and stock option accounting, accounting standards and practices continue to evolve. Additionally, the SEC and the FASB’s Emerging Issues Task Force continue to address revenue and stock option related accounting issues. The management of Centillum believes it is in compliance with all of the rules and related guidance as they currently exist. However, any changes to U.S. generally accepted accounting principles in these areas could impact Centillum’s future accounting.

#### **ITEM 7A. *QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK***

The primary objective of our investment activities is to preserve principal while concurrently maximizing the income we receive from our investments without significantly increasing risk. Some of the securities that we may invest in may be subject to market risk. This means that a change in prevailing interest rates may cause the principal amount of the investment to fluctuate. For example, if we hold a security that was issued with a fixed interest rate at the then-prevailing rate and the prevailing interest rate later rises, the current value of the principal amount of our investment will decline. To minimize this risk in the future, we intend to maintain our portfolio of cash equivalents and short-term investments in a variety of securities, including commercial paper, money market funds, government and non-government debt securities, with maturities of less than eighteen months. In general, money market funds are not subject to market risk because the interest paid on such funds fluctuates with the prevailing interest rate. As of December 31, 2005, all of our investments were in money market funds, high quality commercial paper, and government and non-government debt securities. A hypothetical 100 basis point increase in interest rates would result in an approximate \$82,000 decrease in the fair value of our available-for-sale securities as of December 31, 2005. See Note 3 of Notes to the Consolidated Financial Statements.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**CENTILLIUM COMMUNICATIONS, INC.  
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**REPORT OF INDEPENDENT REGISTERED PUBLIC  
ACCOUNTING FIRM**

The Board of Directors and Stockholders  
Centillum Communications, Inc.

We have audited the accompanying consolidated balance sheets of Centillum Communications, Inc. as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005. Our audits also included the financial statement schedule listed in the Index at Item 15(a). These consolidated financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and schedule based on our audits.

We conducted our audits in accordance with the auditing standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Centillum Communications, Inc. at December 31, 2005 and 2004, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 31, 2005, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Centillum Communications, Inc.'s internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 10, 2006 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

San Jose, California  
March 10, 2006



**REPORT OF INDEPENDENT REGISTERED PUBLIC  
ACCOUNTING FIRM**

The Board of Directors and Stockholders  
Centillum Communications, Inc.

We have audited management's assessment, included in the accompanying Management's Report on Internal Control over Financial Reporting appearing under Item 9A, that Centillum Communications, Inc. maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Centillum Communications, Inc.'s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

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

In our opinion, management's assessment that Centillum Communications, Inc. maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, Centillum Communications, Inc. maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Centillum Communications, Inc. as of December 31, 2005 and 2004, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2005 and our report dated March 10, 2006 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

San Jose, California  
March 10, 2006

**CENTILLIUM COMMUNICATIONS, INC.**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
	<b>(in thousands, except per share data)</b>		
Net revenues .....	\$ 76,127	\$ 71,151	\$ 124,976
Cost of revenues .....	<u>35,155</u>	<u>37,679</u>	<u>71,153</u>
Gross profit .....	40,972	33,472	53,823
Operating expenses:			
Research and development .....	29,611	53,743	46,162
Selling, general and administrative .....	24,171	23,706	21,876
Amortization of acquisition-related intangibles .....	-	-	83
Total operating expenses .....	<u>53,782</u>	<u>77,449</u>	<u>68,121</u>
Operating loss .....	(12,810)	(43,977)	(14,298)
Interest income and other, net .....	<u>1,674</u>	<u>1,070</u>	<u>1,072</u>
Loss before provision for income taxes .....	(11,136)	(42,907)	(13,226)
Provision for income taxes .....	<u>149</u>	<u>155</u>	<u>133</u>
Net loss .....	<u>\$ (11,285)</u>	<u>\$ (43,062)</u>	<u>\$ (13,359)</u>
Basic and diluted net loss per share .....	<u>\$ (0.29)</u>	<u>\$ (1.13)</u>	<u>\$ (0.37)</u>
Shares used to compute basic and diluted net loss per share .....	<u>39,312</u>	<u>38,210</u>	<u>36,433</u>

See accompanying notes.

**CENTILLIUM COMMUNICATIONS, INC.**  
**CONSOLIDATED BALANCE SHEETS**

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
	<b>(In thousands, except share and per share data)</b>	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents .....	\$ 39,440	\$ 31,996
Short-term investments .....	21,900	30,195
Accounts receivable (net of allowance for doubtful accounts of \$169 and \$151 at December 31, 2005 and 2004, respectively) .....	7,177	5,348
Inventories .....	3,609	6,100
Other current assets .....	<u>1,780</u>	<u>1,225</u>
Total current assets .....	73,906	74,864
Property and equipment, net .....	3,529	6,528
Other assets .....	<u>912</u>	<u>553</u>
Total assets .....	<u>\$ 78,347</u>	<u>\$ 81,945</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable .....	\$ 5,987	\$ 5,599
Accrued compensation and related expenses .....	4,247	3,364
Accrued liabilities .....	<u>19,133</u>	<u>16,786</u>
Total current liabilities .....	29,367	25,749
Long-term liabilities:		
Other long-term liabilities .....	<u>2,368</u>	<u>864</u>
Total liabilities .....	<u>31,735</u>	<u>26,613</u>
Commitments and contingencies (Note 4)		
Stockholders' equity:		
Common stock; \$0.001 par value:		
Authorized shares: 100,000,000; Issued and outstanding shares: 40,205,940 at December 31, 2005, 38,810,001 at December 31, 2004	40	39
Additional paid-in capital .....	247,081	244,493
Deferred compensation .....	(24)	-
Accumulated deficit .....	(200,440)	(189,155)
Accumulated other comprehensive loss .....	<u>(45)</u>	<u>(45)</u>
Total stockholders' equity .....	<u>46,612</u>	<u>55,332</u>
Total liabilities and stockholders' equity .....	<u>\$ 78,347</u>	<u>\$ 81,945</u>

See accompanying notes.

**CENTILLIUM COMMUNICATIONS, INC.**  
**CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY**

	<u>Common Stock</u>		<u>Additional</u>	<u>Deferred</u>	<u>Accumulated</u>	<u>Accumulated</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Paid-In</u>	<u>Compensation</u>	<u>Deficit</u>	<u>Other Comprehensive</u>	<u>Stockholders'</u>
			<u>Capital</u>			<u>Income (Loss)</u>	<u>Equity</u>
(In thousands, except share data)							
<b>Balance at December 31, 2002</b>	35,245,171	\$ 35	\$ 228,847	\$ (2,333)	\$ (132,734)	\$ 8	\$ 93,823
Exercise of options to purchase common stock for cash .....	2,129,049	3	11,743	-	-	-	11,746
Proceeds from contribution by stockholder .....	-	-	857	-	-	-	857
Issuance of shares under employee stock purchase plan .....	456,865	-	1,516	-	-	-	1,516
Reversal of deferred compensation .....	-	-	(615)	615	-	-	-
Stock-based compensation expense, net .....	-	-	-	1,426	-	-	1,426
Net loss .....	-	-	-	-	(13,359)	-	(13,359)
Unrealized gain on available-for-sale investments .....	-	-	-	-	-	28	28
Total comprehensive loss .....							(13,331)
<b>Balance at December 31, 2003</b>	37,831,085	38	242,348	(292)	(146,093)	36	96,037
Exercise of options to purchase common stock for cash .....	344,709	-	588	-	-	-	588
Issuance of shares under employee stock purchase plan .....	634,207	1	1,560	-	-	-	1,561
Reversal of deferred compensation .....	-	-	(3)	3	-	-	-
Stock-based compensation expense, net .....	-	-	-	289	-	-	289
Net loss .....	-	-	-	-	(43,062)	-	(43,062)
Unrealized gain on available-for-sale investments .....	-	-	-	-	-	(81)	(81)
Total comprehensive loss .....							(43,143)
<b>Balance at December 31, 2004</b>	38,810,001	39	244,493	-	(189,155)	(45)	55,332
Exercise of options to purchase common stock for cash .....	876,059	1	1,634	-	-	-	1,635
Issuance of shares under employee stock purchase plan .....	489,880	-	894	-	-	-	894
Issuance of shares under restricted stock plan .....	30,000	-	60	(60)	-	-	-
Stock-based compensation expense, net .....	-	-	-	36	-	-	36
Net loss .....	-	-	-	-	(11,285)	-	(11,285)
Total comprehensive loss .....							(11,285)
<b>Balance at December 31, 2005</b>	<u>40,205,940</u>	<u>\$ 40</u>	<u>\$ 247,081</u>	<u>\$ (24)</u>	<u>\$ (200,440)</u>	<u>\$ (45)</u>	<u>\$ 46,612</u>

See accompanying notes.

**CENTILLIUM COMMUNICATIONS, INC.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

	Years Ended December 31,		
	2005	2004	2003
	(In thousands)		
OPERATING ACTIVITIES			
Net loss .....	\$ (11,285)	\$ (43,062)	\$ (13,359)
Adjustments to reconcile net loss to net cash used in operating activities:			
Depreciation and amortization expense .....	3,798	4,974	6,350
Stock-based compensation expense .....	36	289	1,426
Loss on retirement of property and equipment .....	568	82	19
Amortization of acquisition related intangibles .....	-	-	83
Changes in operating assets and liabilities:			
Accounts receivable .....	(1,829)	7,128	(9,612)
Inventories .....	2,491	5,808	(7,778)
Other current assets .....	(555)	2,493	(1,096)
Other assets .....	(359)	(42)	(162)
Accounts payable .....	388	(1,835)	(1,051)
Accrued compensation and related expenses .....	883	(1,951)	1,324
Accrued liabilities .....	2,347	618	2,349
Other long-term liabilities .....	1,504	721	(125)
Net cash used in operating activities .....	(2,013)	(24,777)	(21,632)
INVESTING ACTIVITIES			
Purchases of short-term investments .....	(83,503)	(28,696)	(90,131)
Sales and maturities of short-term investments .....	91,798	63,312	33,756
Purchases of property and equipment .....	(1,367)	(4,199)	(3,365)
Net cash provided by (used in) investing activities .....	6,928	30,417	(59,740)
FINANCING ACTIVITIES			
Principal payments on capital lease obligations .....	-	(527)	(1,526)
Proceeds from issuance of common stock .....	2,529	2,149	13,262
Proceeds from contribution by stockholder .....	-	-	857
Net cash provided by financing activities .....	2,529	1,622	12,593
Net increase (decrease) in cash and cash equivalents .....	7,444	7,262	(68,779)
Cash and cash equivalents at beginning of period .....	31,996	24,734	93,513
Cash and cash equivalents at end of period .....	\$ 39,440	\$ 31,996	\$ 24,734
SUPPLEMENTAL DISCLOSURES OF CASH FLOW			
Cash paid for interest .....	\$ 1	\$ 2	\$ 49
Cash paid for income taxes .....	\$ 68	\$ 20	\$ 51
SUPPLEMENTAL DISCLOSURES OF NON-CASH TRANSACTIONS			
Deferred compensation related to stock option grants, net of terminations .....	\$ -	\$ (3)	\$ (615)

See accompanying notes.

## CENTILLIUM COMMUNICATIONS, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### **Note 1. Summary of Significant Accounting Policies**

Centillium Communications, Inc. (Centillium or the Company) was incorporated in California in February 1997 and was reincorporated in Delaware in December 1999. The Company designs, develops and supplies highly-integrated programmable semiconductors that enable broadband communications, which is the high-speed networking of data, voice and video signals. The Company's system-level products incorporate digital and mixed-signal semiconductors and related software. The Company serves the Digital Subscriber Line (DSL), Voice over Internet Protocol (VoIP) and Fiber-To-The-Premises (FTTP), which is also known as optical networking, markets. Its customers are original equipment manufacturers (OEMs) who sell DSL and optical network equipment for deployment in central offices and customer premises and VoIP equipment for use in carrier-class and enterprise-class gateways and consumer telephony.

*Basis of Presentation:* The accompanying consolidated financial statements include those of Centillium and its wholly-owned subsidiaries, after elimination of all intercompany accounts and transactions. Centillium has prepared the accompanying consolidated financial statements in conformity with U.S. generally accepted accounting principles. The financial information reflects all adjustments which are, in the opinion of management, necessary to provide fair consolidated balance sheets, consolidated statements of income and cash flows for the periods presented.

*Use of Estimates:* The preparation of the consolidated financial statements in conformity with U.S. generally accepted accounting principles requires Centillium to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of sales and expenses during the reporting periods. Such management estimates include allowances for doubtful accounts receivable, provisions for inventories to reflect net realizable value, sales returns and allowances, product warranty and other liabilities. Actual results could differ from those estimates.

*Revenue Recognition:* Revenues related to product sales are generally recognized when the products have been shipped and risk of loss has passed to the customer, collection of the resulting receivable is reasonably assured, persuasive evidence of an arrangement exists, and the price is fixed or determinable. If sales arrangements contain customer-specific acceptance requirements, revenue is deferred and is recognized upon receipt of customer acceptance.

*Sales Returns and Allowances:* The Company establishes, upon shipment of its products, a provision for estimated returns. Under certain circumstances, the Company will allow its customers to return products and a provision is made for such returns. The estimate of product returns is based on contractual terms or sales agreements, historical experience and expectation of future conditions. Additional provisions and allowances may be required, resulting in decreased net revenue and gross profit, should the Company experience increased product returns.

*Allowance for Doubtful Accounts:* The Company performs ongoing credit evaluations of its customers and adjusts credit limits, as determined by its review of current credit information. The Company records allowances for doubtful accounts for estimated losses based upon specifically identified amounts that are believed to be uncollectible. The Company records additional allowances based on certain percentages of the aged receivables, which are determined based on historical experience and an assessment of the general financial condition of the customer base. If actual collections experience changes, revisions to the allowances may be required. The Company has a limited number of customers with individually large amounts due at any given balance sheet date. Any unanticipated change in one of those customers' creditworthiness or other matters affecting the collectibility of

amounts due from such customers could have a material effect on the results of operations in the period in which such changes or events occur.

*Warranty:* A limited warranty is provided on the Company's products generally for a period of one year and allowances for estimated warranty costs are recorded during the period of sale. While the Company engages in product quality programs and processes, including monitoring and evaluating the quality of its suppliers, the warranty obligation is affected by product failure rates, the cost of replacing chipsets, rework costs and freight incurred in replacing a chipset after failure. The Company monitors chipset returns for warranty and maintains a reserve for the related warranty expenses based on historical experience of similar products. The determination of such allowances requires the Company to make estimates of product return rates and expected costs to repair or replace the products under warranty. The Company periodically assesses the adequacy of the warranty liability and adjusts such amounts as necessary.

*Concentrations of Credit Risk:* Financial instruments that potentially subject the Company to significant concentration of credit risk consist principally of cash, cash equivalents, short-term investments and accounts receivable. The Company places its cash, cash-equivalents and short-term investments in several high credit-quality financial institutions. The Company is exposed to credit risk in the event of default by these institutions to the extent of the amount recorded on the balance sheet. Accounts receivable are billed in U.S. currency and are derived from revenues earned from customers primarily located in Japan and the United States. The Company performs ongoing credit evaluations of its customers' financial condition and generally does not require collateral. The Company maintains reserves for potential credit losses. Management judgment is used to estimate the required reserves. Actual results could differ from those estimates.

*Customer Concentrations:* At December 31, 2005, three customers accounted for 42%, 28% and 12% of the Company's accounts receivable; at December 31, 2004, three customers accounted for 31%, 20% and 13% of the Company's accounts receivable. NEC Corporation (NEC) accounted for 26%, 42% and 49% and Sumitomo Electric Industries, Ltd. (Sumitomo) accounted for 35%, 35% and 31% of net revenues, respectively, in 2005, 2004, and 2003. Lucent Technologies accounted for 13% of net revenues in 2005. No other customer accounted for 10% or more of net revenues in any year during this three-year period. Any unanticipated change in one of those customers' creditworthiness or other matters affecting the collectibility of amounts due from such customers could have a material adverse effect on the results of operations in the period in which such changes or events occur.

The Company has a limited number of customers with individually large amounts due at any given balance sheet date. Any unanticipated change in any one of those customers' creditworthiness or other matters affecting the collectibility of amounts due from such customers could have a material adverse effect on the results of operations in the period in which such changes or events occur.

*Supplier Concentrations:* The Company depends on a limited number of outside contractors to fabricate, assemble and test its semiconductor devices. The Company generally sources its production through standard purchase orders and has wafer supply and assembly and test agreements with certain outside contractors. While the Company seeks to maintain a sufficient level of supply and endeavors to maintain ongoing communications with suppliers to guard against interruptions or cessation of supply, business and results of operations could be adversely affected by a stoppage or delay of supply, substitution of more expensive or less reliable products or services, receipt of defective semiconductor devices, an increase in the price of products, or inability to obtain reduced pricing from suppliers in response to competitive pressures.

*Cash Equivalents and Short-term Investments:* The Company invests its excess cash in money market funds, obligations of the U.S. government, and debt instruments and considers all highly liquid instruments purchased with an original maturity of three months or less to be cash equivalents. Cash equivalents, which consist primarily of money market funds, are recorded at cost, which approximates fair value.

The Company's investments in marketable equity securities and all debt securities are classified as available-for-sale at the time of purchase and the Company periodically reevaluates such designation. The investments are adjusted for amortization of premiums and discounts to maturity and such amortization is included in interest income, net. At December 31, 2005 and 2004, all of the Company's investments in debt securities were classified as available-for-sale, with changes in market value recorded as unrealized gains and losses in accumulated other

comprehensive income until their disposition. Realized gains and losses and declines in value judged to be other than temporary on available-for-sale securities are included in interest income, net and were insignificant for all periods presented. The cost of securities sold is based on the specific-identification method.

*Inventories:* Inventories are stated at the lower of standard cost, which approximates actual cost, or net realizable value. Cost is based on a first-in, first-out basis. The Company performs detailed reviews of the net realizable value of inventories, both on hand as well as for inventories that it is committed to purchase with consideration given to deterioration, obsolescence, and other factors. The Company typically uses a six- or nine-month rolling forecast based on the type of products, anticipated product orders, product order history, forecasts and backlog. The Company compares its current or committed inventory levels to these forecasts on a regular basis and any adverse changes to the future product demand may result in increased writedowns, resulting in decreased gross profit. In the event the Company experiences unanticipated demand and is able to sell previously written down inventories, gross profit will increase.

*Property and Equipment:* Property and equipment are carried at cost less accumulated depreciation and amortization. Property and equipment, with the exception of leasehold improvements, are depreciated for using the straight-line method over estimated useful lives of three years. Leasehold improvements are amortized using the straight-line method over the shorter of the useful lives of the assets or the terms of the leases.

*Impairment of Long-lived Assets:* The Company reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The Company measures the recoverability of long-lived assets by comparison of the carrying amount to undiscounted future net cash flows. If the Company considers such assets to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the long-lived assets exceeds their fair value, as determined by discounted cash flows.

*Software Development Costs:* Costs incurred in the research and development of the software embedded in the Company's products are expensed as incurred until technological feasibility has been established. The Company believes its current process for developing software is essentially completed concurrently with the establishment of technological feasibility, which is evidenced by the completion of a detail program design or, in its absence, completion of a working model that includes the semiconductor device and embedded software. Capitalized costs are amortized based on current and future revenue for each product with an annual minimum equal to the straight-line amortization over the remaining estimated economic life of the product.

*Advertising Costs:* The Company expenses advertising costs as incurred. These costs were not material and are included in selling, general and administrative expenses.

*Shipping and Handling:* The cost of shipping products to customers is not material, and is included in cost of goods sold.

*Foreign Currency Accounting:* The United States dollar is the functional currency for all foreign operations. The effect on the consolidated statements of operations of transaction and remeasurement gains and losses is insignificant for all years presented and is included in *Interest Income and Other, Net*.

*Fair Value of Financial Instruments:* The Company has evaluated the estimated fair value of financial instruments. The amounts reported for cash and cash equivalents, accounts receivable, short-term borrowings, accounts payable, and accrued expenses approximate the fair value due to their short maturities. Investment securities are reported at their estimated fair value based on quoted market prices. Realized gains and losses from the Company's investments have been insignificant.

*Net Loss Per Share:* Basic and diluted net loss per share have been computed using the weighted average number of shares of common stock outstanding during the period, less shares subject to repurchase. Options and warrants to purchase 9.0 million, 7.9 million and 12.7 million shares of common stock in 2005, 2004 and 2003, respectively, were excluded from the computation of diluted net loss per share as the effect would have been antidilutive. The following table presents the computation of basic and diluted net loss per share (in thousands, except per share amounts):



	Years Ended December 31,		
	2005	2004	2003
Net loss .....	\$ (11,285)	\$ (43,062)	\$ (13,359)
Basic and diluted weighted average shares used to compute basic and diluted net loss per share .....	<u>39,312</u>	<u>38,210</u>	<u>36,433</u>
Basic and diluted net loss per common share .....	<u>\$ (0.29)</u>	<u>\$ (1.13)</u>	<u>\$ (0.37)</u>

*Stock-based Compensation:* The Company has employee stock plans that are described more fully in Note 5. The Company has elected to account for its employee stock plans in accordance with the intrinsic value method under Accounting Principles Board Opinion No. 25, "Accounting For Stock Issued to Employees" (APB Opinion No. 25). The following table illustrates the effect on net loss and loss per share had compensation expense for the Company's stock-based award plans been determined on the fair value at the grant dates for awards under the plan consistent with the method of Statement of Financial Accounting Standards No. 123, "Accounting For Stock Issued to Employees" (FAS 123). For purposes of the following FAS 123 pro forma disclosures, the estimated fair value of the options is amortized to expense over the options' vesting period (in thousands, except per share amounts):

	Years Ended December 31,		
	2005	2004	2003
Net loss as reported .....	\$ (11,285)	\$ (43,062)	\$ (13,359)
Add: Stock-based compensation expense included in reported net loss, net of recovery .....	36	289	1,426
Less: Total stock-based compensation expense under fair value based method for all awards, net of related tax effects .....	<u>(4,601)</u>	<u>(10,220)</u>	<u>(23,303)</u>
Pro forma net loss .....	<u>\$ (15,850)</u>	<u>\$ (52,993)</u>	<u>\$ (35,236)</u>
Basic and diluted net loss per share:			
As reported .....	\$ (0.29)	\$ (1.13)	\$ (0.37)
Pro forma .....	\$ (0.40)	\$ (1.39)	\$ (0.97)

The pro forma stock-based compensation expense of \$4.6 million for the year ended December 31, 2005 includes a credit of \$161,000 for the three months ended June 30, 2005. This credit resulted from a significant decrease in the number of actual options issued in connection with Centillum's November 30, 2004 option exchange program as compared to the estimated amounts used in calculating stock based compensation expense during the fourth quarter of 2004 and the first quarter of 2005. The actual number of options granted at the end of this program was less than the original estimate due to employee terminations during this period.

See Note 5 for a discussion of the assumptions used in the option pricing model and estimated fair value of employee stock options. The amounts in 2003 have been restated to reflect the correction of errors made in volatility and expected life assumptions. The restatement decreased the pro forma net loss by approximately \$2.0 million in 2003 and decreased the pro forma basic and diluted net loss per share by \$0.05 in 2003.

The Company accounts for stock issued to non-employees in accordance with the provisions of FAS 123 and Emerging Issues Task Force Issue No. 96-18, "Accounting for Equity Instruments That are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services." Direct grants of shares of common stock are made to certain advisors and consultants to the Company for past services with no vesting or future performance obligations. The fair value of such grants is immediately charged to expense in accordance with EITF 96-18.

*Recent Accounting Pronouncements:* In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, “Accounting Changes and Error Corrections—a Replacement of APB Opinion No. 20 and FASB Statement No. 3” (SFAS 154), which requires retrospective application to prior periods’ financial statements of every voluntary change in accounting principal unless it is impracticable to do so. SFAS 154 is effective for accounting changes and corrections of errors beginning in fiscal 2007. Centillum does not expect the adoption of this standard to have a material effect on Centillum’s financial position or results of operations.

In December 2004, the FASB issued SFAS 123R “Share-Based Payment” which requires the measurement of all employee share-based payments to employees, including grants of employee stock options, using a fair-value-based method and the recording of such expense in the Company’s consolidated statements of operations. The accounting provisions of SFAS 123R was originally effective for reporting periods beginning after June 15, 2005. On April 14, 2005 the U.S. Securities and Exchange Commission announced a deferral of the effective date of FAS 123R for calendar year companies until the beginning of 2006. The pro forma disclosures previously permitted under SFAS 123 no longer will be an alternative to financial statement recognition beginning in the first quarter of 2006. Although Centillum has not yet determined whether the adoption of SFAS 123R will result in amounts that are similar to the current pro forma disclosures under SFAS 123, it believes the adoption will have a material adverse impact on operating results.

In March 2005, the SEC released SEC Staff Accounting Bulletin No. 107 (SAB 107). SAB 107 provides the SEC staff position regarding the application of SFAS 123R “Share-Based Payment.” SAB 107 contains interpretive guidance relating to the interaction between SFAS 123R and certain SEC rules and regulations, as well as the staff’s views regarding the valuation of share-based payment arrangements for public companies. SAB 107 also highlights the importance of disclosures made related to the accounting for share-based payment transactions. Centillum is currently evaluating SAB 107 and will be incorporating it as part of its adoption of SFAS 123R in the first quarter of 2006.

In December 2004, the FASB issued SFAS No. 153, Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29. The guidance in APB Opinion No. 29, Accounting for Nonmonetary Transactions, is based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of assets exchanged. The guidance in that Opinion, however, included certain exceptions to that principle. This Statement amends Opinion 29 to eliminate the exception for nonmonetary exchanges of similar productive assets that do not have commercial substance. A nonmonetary exchange has commercial substance if the future cash flows of the entity are expected to change significantly as a result of the exchange. SFAS No. 153 is effective for nonmonetary exchanges occurring in fiscal periods beginning after June 15, 2005. The adoption of SFAS No. 153 is not expected to have a material impact on the Company’s financial position and results of operations.

## **Note 2. Balance Sheet Information**

Inventories (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
Work-in-process .....	\$ 1,371	\$ 3,694
Finished goods .....	2,238	2,406
	<u>\$ 3,609</u>	<u>\$ 6,100</u>

Property and equipment, net (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
Equipment and software .....	\$ 28,742	\$ 27,922
Furniture and fixtures .....	1,107	1,131
Leasehold improvements .....	1,439	1,400
	31,288	30,453
Accumulated depreciation and amortization .....	(27,759)	(23,925)
Property and equipment, net .....	<u>\$ 3,529</u>	<u>\$ 6,528</u>

Accrued liabilities (in thousands):

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
Accrued royalties .....	\$ 16,323	\$ 13,773
Accrued other liabilities .....	2,810	3,013
	<u>\$ 19,133</u>	<u>\$ 16,786</u>

Warranty reserve (in thousands):

	<b>Balance at Beginning of Period</b>	<b>Product Warranty Accruals</b>	<b>Warranty Costs Incurred</b>	<b>Balance at End of Period</b>
Year ended December 31, 2005 .....	<u>\$ 164</u>	<u>\$ 32</u>	<u>\$ (84)</u>	<u>\$ 112</u>
Year ended December 31, 2004 .....	<u>\$ 460</u>	<u>\$ (197)</u>	<u>\$ (99)</u>	<u>\$ 164</u>
Year ended December 31, 2003 .....	<u>\$ 608</u>	<u>\$ 343</u>	<u>\$ (491)</u>	<u>\$ 460</u>

### Note 3. Cash Equivalents and Short-term Investments

Cash equivalents and short-term investments (in thousands):

	<b>December 31, 2005</b>		
	<b>Amortized Cost</b>	<b>Gross Unrealized Gains/ (Losses)</b>	<b>Estimated Fair Value</b>
<b>Cash Equivalents</b>			
Money Market Funds .....	\$ 29,620	\$ -	\$ 29,620
<b>Short-term Investments</b>			
Obligations of the U.S. government and affiliated agencies .....	21,945	(45)	21,900
Total	<u>\$ 51,565</u>	<u>\$ (45)</u>	<u>\$ 51,520</u>

	<b>December 31, 2004</b>		
<b>Cash Equivalents</b>			
Money Market Funds .....	\$ 28,798	\$ -	\$ 28,798
<b>Short-term Investments</b>			
Obligations of the U.S. government and affiliated			
agencies .....	19,030	(45)	18,985
Auction rate securities .....	11,210	-	11,210
	<u>30,240</u>	<u>(45)</u>	<u>30,195</u>
Total	<u>\$ 59,038</u>	<u>\$ (45)</u>	<u>\$ 58,993</u>

The estimated fair value of short-term investments is based on quoted market prices. The contractual maturity of all short-term investments was less than twelve months as of December 31, 2005.

#### **Note 4. Commitments and Contingencies**

The Company leases its facilities under operating leases expiring through 2011. In 2004, the Company capitalized \$731,000 of lease incentives received upon the move to new office premises at Fremont, California, which is being amortized over the lease period. Rental expense was approximately \$3.7 million, which includes \$2.2 million in surplus space charges, \$2.2 million and \$2.4 million in 2005, 2004 and 2003, respectively. Additionally, the Company leases certain software under operating leases expiring through December 2010.

Future minimum lease payments under the Company's operating leases at December 31, 2005 are as follows (in thousands):

	<b>Operating Leases</b>
2006 .....	\$ 3,453
2007 .....	3,615
2008 .....	2,316
2009 .....	2,142
2010 .....	1,027
Thereafter .....	172
Total minimum payments .....	<u>\$ 12,725</u>

In 2005, the Company recorded \$2.2 million in charges for surplus space in its Fremont, California location, which it abandoned. The operating lease for this location expires in February 2011. Centillum has no future requirement for the surplus space as a result of the decrease in personnel in Fremont. This charge has been included primarily within selling, general and administrative expense in the statement of operations.

Changes to the surplus space liability as of December 31, 2005 are as below (in thousands):

<b>Surplus space charges:</b>	<b><u>Amount</u></b>
Surplus space charges recorded in the year ended December 31, 2005 .....	\$ 2,186
Leasehold improvements abandoned .....	(386)
Facility costs incurred and offset against liability .....	(223)
Ending surplus space liability balance at December 31, 2005 .....	<u>\$ 1,577</u>

The Company does not own or operate a fabrication facility and foundries located in Asia currently supply substantially all of its wafer requirements. The Company's purchase obligations to these foundries are based on non-cancelable purchase orders. As of December 31, 2005, the Company's non-cancelable purchase obligations for wafers, all expected to be delivered within the next six months, is \$6.9 million.

Centillum enters into standard indemnification agreements in the ordinary course of business. Pursuant to these agreements, Centillum indemnifies, holds harmless, and agrees to reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally its business partners or customers, in connection with certain patent, copyright or other intellectual property infringement claims by any third parties with respect to its products. The term of these indemnification agreements is generally perpetual but is typically subject to an overall cap on liability. Centillum has not incurred significant costs to defend lawsuits or settle claims related to these indemnification agreements and it has no liabilities recorded for these agreements as of December 31, 2005.

The semiconductor and telecommunications industries are characterized by substantial litigation regarding patent and other intellectual property rights. In August 2004, Fujitsu Limited filed a suit against Centillum Communications, Inc. and Centillum Japan K.K. ("Centillum Japan") in the Tokyo District Court alleging that Centillum and Centillum Japan infringe one Japanese patent jointly owned by Fujitsu and Ricoh Co. Ltd. The complaint seeks monetary damages against Centillum and Centillum Japan. The suit is in process and we do not believe it is feasible to predict or determine the outcome or resolution of this litigation with any certainty at this point. The Company believes it has meritorious defenses and is continuing to defend itself against these claims vigorously. The Company has incurred and is likely to continue to incur substantial expenses in its defense against these claims. In the event of a determination adverse to the Company, it may incur substantial liability and this could have a material adverse effect on its financial position, results of operations or cash flows.

The Company is involved in other litigation and responding to claims arising in the ordinary course of business. The Company intends to defend itself vigorously in these other matters. The Company's management believes that it is unlikely that the outcome of these other matters will have a material adverse effect on the Company's financial statements, although there can be no assurance in this regard.

In addition, Centillum is responding to other claims arising in the ordinary course of business. In certain cases, management has accrued estimates of the amounts it expects to pay upon resolution of such matters and such amounts are included in accrued liabilities. Should Centillum not be able to secure the terms it expects, these estimates may change and will be recognized in the period in which they are identified. Although the ultimate outcome of such inquiries is not presently determinable, management believes that the resolution of these matters will not have a material adverse effect on Centillum's financial position or results of operations.

## **Note 5. Stockholders' Equity**

*Preferred Stock:* The Board of Directors has the authority, without any further vote or action by the stockholders, to provide for the issuance of 9,500,000 shares of preferred stock from time to time in one or more series with such designation, rights, preferences and limitations as the Board of Directors may determine, including the consideration received therefore, the number of shares comprising each series, dividend rates, redemption provisions, liquidation preferences, redemption fund provisions, conversion rights, and voting rights, all without the approval of the holders of common stock.

*Stockholder Rights Plan:* In December 2002, the Company's Board of Directors approved the adoption of a stockholder rights plan and reserved 500,000 shares of preferred stock for issuance under the plan. The plan is designed to assure that Centillum stockholders receive fair value in the event of a future unsolicited business combination or similar transaction involving Centillum in a manner or on terms not approved by the Centillum Board of Directors.

Under the plan, Centillum issued a dividend of one right for each outstanding share of common stock of the Company held by stockholders of record as of the close of business on January 9, 2003. Each right will initially entitle stockholders to purchase a fractional share of the Company's preferred stock for \$25.00. However, the rights will become exercisable only after the occurrence of certain specified events, including the acquisition of 15% or more of Centillum's outstanding common stock by an unsolicited third party acquirer. Upon the occurrence of any such event, under the terms specified in the plan, each right entitles the holder, other than the unsolicited third party acquirer, to purchase a certain number of shares of common stock of the Company, at a fifty percent discount to the then-current market price. The rights expire on January 9, 2013, under the terms of the plan. Centillum's Board of Directors may redeem outstanding rights at a price of \$0.001 per right, with certain exceptions. The terms of the rights and the rights plan may be amended by Centillum's Board of Directors at any time without the approval of the rights holders as set forth in the rights plan.

*Common Stock Reserved:*

Common stock reserved is as follows:

	<b>December 31,</b>	
	<b>2005</b>	<b>2004</b>
Common stock options .....	20,026,475	18,633,934
Employee stock purchase plan .....	37,090	138,870
Common stock warrants .....	-	9,450
	<u>20,063,565</u>	<u>18,782,254</u>

*Deferred Stock-based Compensation:* Deferred compensation represents the difference between the grant price and the fair value of the Company's common stock options granted. As of December 31, 2004, deferred compensation had been fully amortized. Stock-based compensation expense was computed using the graded vesting method, in accordance with FAS Interpretation No. 28 over the vesting period of each respective option, which was generally four years. This resulted in the acceleration of amortization expense, in which approximately 59%, 25%, 12% and 4% of deferred compensation was expensed in years one, two, three and four, respectively. As required by APB 25, an adjustment was recorded to amortization of deferred compensation when employees forfeited options for which compensation expense was recognized using the graded vesting method, but which were unvested on the date their employment terminated. In 2005, 2004 and 2003, the Company recorded adjustments to deferred compensation of \$0, \$3,000 and \$615,000 related to the cancellation of certain option grants.

In April 2005, Centillum's Board of Directors determined to supplement the equity-based compensation to the Board by making an annual grant to each non-employee director of 5,000 shares of restricted common stock of the Company, with such shares vesting 100% on the first anniversary of the date of the grant resulting in a compensation expense of \$36,000 for the year ended December 31, 2005.

Stock based compensation expense, net of adjustments, is included in the associated expense categories as follows (in thousands):

	Years Ended December 31,		
	2005	2004	2003
Cost of revenues .....	\$ -	\$ 7	\$ 39
Research and development .....	-	218	907
Selling, general and administrative .....	36	64	480
	<u>\$ 36</u>	<u>\$ 289</u>	<u>\$ 1,426</u>

*Proceeds from Stockholder:* During the quarter ended June 30, 2003, a stockholder sold shares of Centillum stock in a transaction deemed to be a short-swing sale. Under Section 16(b) of the Securities Exchange Act of 1934, the shareholder was required to disgorge to the Company the profit realized from the stock sale in the amount of approximately \$857,000. The Company accounted for the transaction as a contribution from a stockholder and reflected the proceeds as an increase to additional paid in capital in its financial statements. Proceeds from this sale did not effect the Company's consolidated statement of operations.

*Stock Options:* In March 1997, the Board of Directors approved a stock option plan that authorized the granting of options to purchase shares of the Company's common stock. The plan is administered by the Board of Directors and provides for incentive stock options or nonqualified stock options to be issued to employees, directors, and consultants of the Company. Prices for incentive stock options may not be less than the fair value of the common stock at the date of grant. Prices for nonqualified stock options may not be less than 85% of the fair value of the common stock at the date of grant. Options generally vest over a four-year period. Unexercised options expire ten years after the date of grant. The plan also provides for automatic annual increases on the first day of each of the Company's years equal to 6% of the Company's outstanding common stock on the date of the annual increase.

In February 2001, the Company adopted a nonstatutory stock option plan that authorized the granting of nonstatutory stock options ("options") to purchase shares of the Company's common stock. Such shares may be authorized, but unissued, or reacquired common stock. The plan is administered by the Board of Directors or any of its Committees and provides for options to be issued to employees and consultants of the Company only and not to officers and directors, except in connection with an officer's initial service to the Company. Options generally vest over a period of four years from the date of grant and prices for such options are determined by the plan administrator, with the prices generally being not less than the fair value of the common stock at the date of grant. Upon termination of the option holder's employment, any unvested stock issued shall revert back to the plan.

In December 2001 and November 2004, the Company offered a voluntary stock option exchange program to its employees and certain officers. Under the December 2001 program, participants exchanged stock options with exercise prices which were equal to or greater than \$10.00 per share for new options which were granted in June 2002, six months and one day from the date options were tendered in December 2001. In December 2001, 5.2 million stock options were tendered and cancelled. In June 2002, the Company issued options for 5.1 million shares of common stock at an exercise price of \$6.62 per share, which was equal to 100 percent of the market price of Centillum's common stock on the grant date. The terms and conditions of the replacement options, including the vesting schedules, were substantially the same as the terms and conditions of the options cancelled.

Under the November 2004 program, participants exchanged stock options with exercise prices which were equal to or greater than \$4.00 per share for which options were granted in June 2002, six months and one day from the date options were tendered in November 2004. In December 2004, 3.7 million stock options were tendered and cancelled. In June 2005, the Company issued options for 2.1 million shares of common stock at an exercise price of \$2.17 per share, which was equal to 100 percent of the market price of Centillum's common stock on the grant date. The terms and conditions of the replacement options, including the vesting schedules, were substantially the same as the terms and conditions of the options cancelled.

The following is a summary of additional information with respect to the stock option plans:

	<b>Options Outstanding</b>		
	<b>Available for Grant</b>	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>
Balance at December 31, 2002 .....	3,440,878	13,282,740	\$ 7.71
Options authorized .....	2,114,710	-	-
Options granted .....	(3,044,911)	3,044,911	6.30
Options exercised .....	-	(2,137,258)	5.50
Options available due to repurchase of unvested shares .....	7,896	-	-
Options cancelled .....	<u>1,542,025</u>	<u>(1,542,025)</u>	8.86
Balance at December 31, 2003 .....	4,060,598	12,648,368	7.60
Options authorized .....	2,269,865	-	-
Options granted .....	(2,659,900)	2,659,900	3.75
Options exercised .....	-	(344,897)	1.71
Options cancelled .....	<u>7,070,895</u>	<u>(7,070,895)</u>	7.97
Balance at December 31, 2004 .....	10,741,458	7,892,476	6.23
Options authorized .....	2,268,600	-	-
Options granted .....	(4,610,808)	4,610,808	2.40
Options exercised .....	-	(876,059)	1.87
Options cancelled .....	<u>2,617,204</u>	<u>(2,617,204)</u>	6.61
Balance at December 31, 2005 .....	<u>11,016,454</u>	<u>9,010,021</u>	\$ 4.59

In addition, the following table summarizes information about stock options that were outstanding and exercisable at December 31, 2005:

<b>Range of Exercise Prices</b>	<b>Options Outstanding</b>			<b>Options Exercisable</b>		
	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life (years)</b>	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Life (years)</b>
\$ 0.40-\$ 2.10 .....	726,413	\$ 1.63	7.60	325,037	\$ 1.30	6.04
\$ 2.17-\$ 2.17 .....	1,371,472	2.17	6.92	1,023,255	2.17	6.60
\$ 2.22-\$ 2.56 .....	1,294,000	2.46	8.58	310,077	2.48	7.61
\$ 2.59-\$ 2.59 .....	45,283	2.59	6.95	34,043	2.59	6.95
\$ 2.61-\$ 2.61 .....	1,134,380	2.61	9.57	-	-	-
\$ 2.67-\$ 3.91 .....	1,212,484	3.40	8.64	419,608	3.47	8.12
\$ 3.91-\$ 5.00 .....	1,129,137	4.83	6.32	805,827	4.87	5.56
\$ 5.15-\$ 37.15 .....	<u>2,096,852</u>	10.18	6.00	<u>1,962,973</u>	10.45	5.91
	<u>9,010,021</u>	\$ 4.59	7.49	<u>4,880,820</u>	\$ 6.02	6.31

At December 31, 2004 and 2003, options for 4,355,523 and 5,286,711 shares, respectively, were exercisable at a weighted average price of \$7.99 and \$9.09 per share, respectively.



*Employee Stock Purchase Plan:* To provide employees with an opportunity to purchase common stock of the Company through payroll deductions, the Company established the 2000 Employee Stock Purchase Plan and initially reserved 500,000 shares of common stock for issuance to participants. In addition, the plan provides for automatic annual increases on the first day of each of the Company's years equal to the lesser of 400,000 shares or 1% of the Company's outstanding common stock on the date of the annual increase, or a lesser number of shares determined by the Board of Directors. Under the plan, the Company's employees, subject to certain restrictions, may purchase shares of common stock at the lesser of 85 percent of the fair market value at either the beginning or end of each six-month offering period. Under the plan, the Company sold 489,880, 634,207 and 456,865 shares of common stock during years 2005, 2004 and 2003, respectively.

*SFAS 123 Assumptions and Fair Value:* The Company has elected to follow APB Opinion No. 25 and related interpretations in accounting for its employee stock options because, as discussed below, the alternative fair value accounting provided for under FAS 123 requires use of option valuation models that were not developed for use in valuing employee stock options. Under APB Opinion No. 25, when the exercise price of the Company's employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized. The fair value of options granted in 2005, 2004 and 2003 reported in Note 1 was estimated at the date of grant.

The option valuation models used to estimate the fair value of options under FAS 123 were developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions, including the expected life of the option. Because the Company's employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options. Pro forma information regarding net loss is required by FAS 123, which requires that the information be determined as if the Company has accounted for its employee stock-based awards under the fair value method of FAS 123. The fair value of the options granted in all periods were estimated using the Black-Scholes method, with the following weighted average assumptions:

	<b>Stock Option Plan</b>			<b>Employee Stock Purchase Plan</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>	<b>2005</b>	<b>2004</b>	<b>2003</b>
Expected life .....	2.3 years	2.9 years	2.9 years	6.0 months	6.0 months	6.0 months
Volatility .....	86%	109%	130%	59%	70%	107%
Risk-free interest rate ...	3.75%	2.73%	3.12%	3.06%	1.86%	1.61%
Dividend rate .....	-	-	-	-	-	-

The options' weighted average grant date fair value, which is the value assigned to the options under FAS 123, was approximately \$1.17, \$2.42 and \$4.56 in 2005, 2004 and 2003, respectively. The weighted-average fair value of purchase rights granted under the Employee Stock Purchase Plan in 2005, 2004 and 2003 were \$0.94, \$1.30, and \$2.14 per share, respectively.

## **Note 6. Income Taxes**

The provision for income taxes (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Current:			
Federal .....	\$ -	\$ -	\$ -
State .....	4	6	5
Foreign .....	145	149	128
	<u>\$ 149</u>	<u>\$ 155</u>	<u>\$ 133</u>

The difference between the provision (benefit) for income taxes and the amount computed by applying the federal statutory income tax rate of 34% to loss before taxes is explained as follows (in thousands):

	<b>Years Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
Tax provision (benefit) at federal statutory rate .....	\$ (3,787)	\$ (14,588)	\$ (4,497)
Loss for which no tax benefit is currently recognizable ...	3,796	14,417	3,957
Deferred compensation .....	12	98	485
Other .....	128	228	188
Total tax provision (benefit) .....	<u>\$ 149</u>	<u>\$ 155</u>	<u>\$ 133</u>

As of December 31, 2005, the Company had \$132.9 million and \$35.6 million of net operating loss carryforwards for U.S. federal and state purposes, respectively. The Company also has research and development tax credit carryforwards for U.S. federal and state purposes of approximately \$5.1 million and \$5.7 million, respectively. The federal net operating losses and federal tax credit carryforwards will expire at various dates beginning in 2018, if not utilized. The California net operating losses will expire at various dates beginning in 2006, if not utilized.

Utilization of the net operating loss and credits carryforwards may be subject to a substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code of 1986, as amended, and similar state provisions. The annual limitation may result in the expiration of net operating losses and tax credit carryforwards before full utilization.

Deferred taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred taxes consist of the following (in thousands):

	<b>Years Ended December 31,</b>	
	<b>2005</b>	<b>2004</b>
Deferred tax assets:		
Net operating loss carryforwards .....	\$ 47,354	\$ 43,116
Research and development credit carryforwards .....	8,908	7,872
Reserves and accruals not currently deductible .....	9,999	10,171
Capitalized research and development expenses .....	958	1,188
Total deferred tax assets .....	67,219	62,347
Valuation allowance .....	(67,219)	(62,347)
Net deferred tax assets .....	<u>\$ -</u>	<u>\$ -</u>

Financial Accounting Standards Board Statement No. 109, "Accounting for Income Taxes" provides for the recognition of deferred tax assets if realization of such assets is more likely than not. Based upon the weight of available evidence, which includes the Company's historical operating performance and the reported cumulative net losses to date, the Company has provided a full valuation allowance against its deferred tax assets.

The valuation allowance increased by approximately \$4.9 million, \$18.3 million and \$9.2 million in 2005, 2004 and 2003, respectively. The valuation allowance at December 31, 2005 and 2004 includes approximately \$10.3 million and \$9.7 million, respectively, related to stock option deductions, the benefit of which will be recorded in paid-in capital when realized.

## Note 7. Business Segment Information

Centillum operates in one operating segment, broadband communications. Centillum's foreign operations consist primarily of design centers in India and France, and sales and marketing offices in several locations around the world. Long-lived assets outside the United States are not significant. Geographic sales information is based on the location of the end customer. Net revenues by major geographic area consists of (in thousands):

	Years Ended December 31,		
	2005	2004	2003
Japan .....	\$ 48,983	\$ 55,812	\$ 99,137
United States .....	14,246	9,426	14,470
Other Asia-Pacific .....	7,483	5,344	9,806
Other .....	5,415	569	1,563
	<u>\$ 76,127</u>	<u>\$ 71,151</u>	<u>\$ 124,976</u>

The following customers, the first two of whom are located in Japan, account for 10% or more of net revenues:

	Years Ended December 31,		
	2005	2004	2003
NEC .....	26%	42%	49%
Sumitomo .....	35%	35%	31%
Lucent .....	13%	*	*

\* Less than 10%

## Note 8. 401(k) Profit Sharing Plan And Trust

The Company has adopted a 401(k) Profit Sharing Plan and Trust that allows eligible employees to make contributions subject to certain limitations. The Company may make discretionary contributions based on profitability as determined by the Board of Directors. No contributions were made by the Company to the plan in 2005, 2004 and 2003.

## Note 9. Related Party Transactions

One of Centillum's directors, elected in the first quarter of 2004, is a director of Cadence Design Systems, Inc. (Cadence), a company from which Centillum licenses software tools. In December 2005, Centillum entered into an arrangement to license certain software tools from Cadence under an operating lease that requires quarterly payments through the fourth quarter of 2008. During 2003, the Company entered into an agreement to license certain software tools from Cadence under an operating lease that required quarterly payments through the third quarter of 2005. This agreement was amended in December 2004 resulting in a \$1.4 million charge for termination of certain licensed software tools that had no future use. The Company expanded its access to these software tools in 2006 due to increased program development levels from the substantially reduced levels in 2005. Amounts paid to Cadence were \$1.1 million and \$1.6 million for the years ended December 31, 2005 and 2004, respectively. As of December 31, 2005, the Company had no liability to Cadence. As of December 31, 2004, the Company had recorded a liability of \$1.1 million due to Cadence.

This director is also a director of Semiconductor Manufacturing International Corporation (SMIC), a company from which Centillum purchases foundry services and products. Purchases from SMIC were \$7.9 million, \$9.3 million and \$486,000 in 2005, 2004 and 2003, respectively. As of December 31, 2005, the Company had recorded a liability of \$821,000 due to SMIC. As of December 31, 2004, the Company had no liability to SMIC. As of December 31, 2003, the Company had recorded a liability of \$213,000 due to SMIC.

**Note 10. Supplementary Data: Quarterly Results of Operations (unaudited)**

Summarized quarterly financial information (in thousands, except per share data):

	<b>Dec 31, 2005</b>	<b>Sep 30, 2005</b>	<b>Jun 30, 2005</b>	<b>Mar 31, 2005</b>
<b>Consolidated Statement of Operations Data:</b>				
Net revenues .....	\$ 20,291	\$ 19,993	\$ 18,647	\$ 17,196
Cost of revenues .....	\$ 8,168	\$ 8,690	\$ 9,564	\$ 8,733
Gross profit .....	\$ 12,123	\$ 11,303	\$ 9,083	\$ 8,463
Operating loss .....	\$ (911)	\$ (1,231)	\$ (4,056)	\$ (6,612)
Net loss .....	\$ (394)	\$ (822)	\$ (3,716)	\$ (6,353)
Basic and diluted net loss per share .....	\$ (0.01)	\$ (0.02)	\$ (0.10)	\$ (0.16)
Shares used to compute basic and diluted net loss per share .....	39,312	39,427	39,042	38,845
	<b>Dec 31, 2004</b>	<b>Sep 30, 2004</b>	<b>Jun 30, 2004</b>	<b>Mar 31, 2004</b>
<b>Consolidated Statement of Operations Data:</b>				
Net revenues .....	\$ 16,412	\$ 20,368	\$ 18,532	\$ 15,839
Cost of revenues .....	\$ 8,500	\$ 10,281	\$ 10,114	\$ 8,784
Gross profit .....	\$ 7,912	\$ 10,087	\$ 8,418	\$ 7,055
Operating loss .....	\$ (11,983)	\$ (7,795)	\$ (11,259)	\$ (12,940)
Net loss .....	\$ (11,750)	\$ (7,613)	\$ (11,010)	\$ (12,689)
Basic and diluted net loss per share .....	\$ (0.30)	\$ (0.20)	\$ (0.29)	\$ (0.33)
Shares used to compute basic and diluted net loss per share .....	38,543	38,340	38,066	37,891

**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

**Controls and Procedures**

*Evaluation of disclosure controls and procedures.* Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(c) and 15(d)-15(e) under the Exchange Act) as of the end of the period covered by this Annual Report on Form 10-K. Based on this evaluation, our Chief Executive Officer and our management, including our Chief Financial Officer has concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

*Changes in internal control over financial reporting.* There was no change in our internal control over financial reporting that occurred during the period covered by this Annual Report on Form 10-K that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Management's Report on Internal Control over Financial Reporting**

Our management is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934, as amended). Our management assessed the effectiveness of our internal control over financial reporting as of December 31, 2005. In making this assessment, our management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control-Integrated Framework. Our management has concluded that, as of December 31, 2005, our internal control over financial reporting is effective based on these criteria. Our independent registered public accounting firm, Ernst & Young LLP, has issued an audit report on our assessment of our internal control over financial reporting, which is included elsewhere herein.

**ITEM 9B. OTHER INFORMATION**

The following disclosures would have otherwise been filed on Form 8-K under the caption "Item 1.01. Entry into a Material Definitive Agreement." On March 10, 2006, the Board of Directors of Centillum approved bonuses for the executive officers of Centillum. A summary of the bonuses is filed as Exhibit 10.49.

### **PART III**

#### **ITEM 10. *DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT***

The information required by this item is incorporated by reference from the information under the captions “Information Concerning Solicitation and Voting,” “Election for Directors” and “Section 16(a) Beneficial Ownership Reporting Compliance” contained in our definitive proxy statement, which we refer to herein as the Proxy Statement, to be filed before May 1, 2006 in connection with solicitation of proxies for our 2006 Annual Meeting of Stockholders.

#### **ITEM 11. *EXECUTIVE COMPENSATION***

The information required by this item is incorporated by reference from the information under the captions “Executive Compensation” and “Compensation of Directors” contained in the Proxy Statement.

#### **ITEM 12. *SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS***

The information required by this item is incorporated by reference from the information under the caption “Security Ownership of Certain Beneficial Owners and Management” and “Securities Authorized for Issuance Under Equity Compensation Plans” contained in the Proxy Statement.

#### **ITEM 13. *CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS***

The information required by this item is incorporated by reference from the information under the captions “Certain Transactions” contained in the Proxy Statement.

#### **ITEM 14. *PRINCIPAL ACCOUNTING FEES AND SERVICES***

The information required by this item is incorporated by reference from the information under the caption “Audit and Related Fees” contained in the Proxy Statement.

## PART IV

### ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

#### (a) (1) Financial Statements

The Financial Statements required by this item are listed on the Index to Consolidated Financial Statements in Part II, Item 8 of this report.

#### (a) (2) Financial Statements Schedules

The following financial statement schedule of Centillum Communications, Inc. for the years ended December 31, 2005, 2004 and 2003 should be read in conjunction with the Consolidated Financial Statements of Centillum Communications, Inc.

#### Schedule II — Consolidated Valuation and Qualifying Accounts

Allowance for Doubtful Accounts (in thousands):

	<b>Balance at Beginning of Period</b>	<b>Charged to Costs and Expense</b>	<b>Deduction Write-Offs</b>	<b>Balance at End of Period</b>
Year ended December 31, 2003 .....	<u>\$ 160</u>	<u>\$ -</u>	<u>\$ (51)</u>	<u>\$ 109</u>
Year ended December 31, 2004 .....	<u>\$ 109</u>	<u>\$ 42</u>	<u>\$ -</u>	<u>\$ 151</u>
Year ended December 31, 2005 .....	<u>\$ 151</u>	<u>\$ 18</u>	<u>\$ -</u>	<u>\$ 169</u>

All other schedules have been omitted because they are not applicable or are not required or the information required to be set forth therein is included in the Consolidated Financial Statements or Notes thereto.

*(a) (3) Exhibits*

<b><u>Exhibit Number</u></b>	<b><u>Description</u></b>
3.1(1)	Certificate of Incorporation of the Registrant
3.2(4)	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of the Registrant
4.1(1)	Specimen certificate of common stock
4.2(1)	Bylaws of the Registrant
4.3(5)	Preferred Stock Rights Agreement, dated as of December 30, 2002, between the Registrant and Mellon Investor Services LLC
10.1(1)	Form of Indemnification Agreement between the Registrant and each of its directors and officers
10.2(2)	1997 Stock Plan
10.3(2)	2000 Employee Stock Purchase Plan
10.21(1)	Foundry Agreement, dated March 7, 2000, between Registrant and United Microelectronics Corporation
10.22(1)	Assembly and Test Services Agreement, dated February 28, 2000, between Registrant and ST Assembly and Test Services, Ltd.
10.23(2)	2001 Nonstatutory Stock Option Plan
10.26(3)	Change of Control Severance Agreement between the Registrant and Faraj Aalaei dated December 14, 2000
10.28(3)	Change of Control Severance Agreement between the Registrant and Kamran Elahian dated December 14, 2000
10.31(6)	Amendment No. 1 to Change of Control Severance Agreement between the Registrant and Faraj Aalaei dated November 19, 2002
10.33(6)	Change of Control Severance Agreement between the Registrant and William Mackenzie dated January 14, 2003
10.35(7)	Offer letter between the Registrant and Tony Shakib dated March 24, 2003
10.36(7)	Change of Control Severance Agreement between the Registrant and Tony Shakib dated March 31, 2003
10.37(8)	Lease, dated December 23, 2003, between the Registrant and Bedford Property Investors, Inc.
10.38(9)	Offer letter between the Registrant and J. Scott Kamsler dated July 13, 2004
10.39(9)	Change of Control Severance Agreement between the Registrant and J. Scott Kamsler dated July 23, 2004
10.40(10)	Offer letter between the Registrant and Wayne Gartin dated September 16, 2004
10.42(12)	Change of Control Severance Agreement between the Registrant and Armando Pereira dated March 10, 2005
10.43(13)	Offer Letter between the Registrant and Jitesh Vadhia dated March 25, 2005
10.44(14)	Employment Transition and Separation Agreement between the Registrant and Amando Pereira effective April 21, 2005
10.46(16)	Form of Stock Purchase Right and Restricted Stock Agreement for certain non-employee directors



<u>Exhibit Number</u>	<u>Description</u>
10.47(17)	Executive Officer Annual Compensation for Selected Executives
10.48(18)	Change of Control Severance Agreement between the Registrant and Jitesh Vadhia dated February 16, 2006
10.49	2005 Executive Bonus Summary
14.1(8)	Ethics Policy
21.1(3)	Subsidiaries of the Registrant
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer Pursuant to Exchange Act Rules 13a-14 and 15d-14
31.2	Certification of Chief Financial Officer Pursuant to Exchange Act Rules 13a-14 and 15d-14
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
<hr/>	
(1)	Incorporated by reference to the Exhibits filed with the Registration Statement of Form S-1 (No. 333-30772), declared effective by the Commission on May 23, 2000.
(2)	Incorporated by reference to the Exhibits filed with the Registration Statement of Form S-8 (No. 333-56610), filed with the Commission on March 6, 2001.
(3)	Incorporated by reference to the Exhibits filed with the Registrant's Annual Report on Form 10-K for the year ended December 31, 2000 filed with the Commission on March 19, 2001.
(4)	Incorporated by reference to the Exhibits filed with the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001 filed with the Commission on March 27, 2002.
(5)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on December 31, 2002.
(6)	Incorporated by reference to the Exhibits filed with the Registrant's Annual Report on Form 10-K for the year ended December 31, 2002 filed with the Commission on February 18, 2003.
(7)	Incorporated by reference to the Exhibits filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2003 filed with the Commission on May 7, 2003.
(8)	Incorporated by reference to the Exhibits filed with the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003 filed with the Commission on March 5, 2004.
(9)	Incorporated by reference to the Exhibits filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 filed with the Commission on August 5, 2004.
(10)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on September 30, 2004.
(11)	Incorporated by reference to the Exhibits filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 filed with the Commission on November 5, 2004.
(12)	Incorporated by reference to the Exhibits filed with the Registrant's Annual Report on Form 10-K for the year ended December 31, 2004 filed with the Commission on March 11, 2005.
(13)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on April 19, 2005.
(14)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on May 11, 2005.

<u>Exhibit Number</u>	<u>Description</u>
(15)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on May 16, 2005.
(16)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on June 9, 2005.
(17)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on July 27, 2005.
(18)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on February 16, 2006.

*(b) Exhibits*

The Company hereby files as part of this Form 10-K the Exhibits listed in Item 15 (a)(3) above.

*(c) Financial Statement Schedules*

The financial statement schedule is included in item 15(a)(2) above

## SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this Annual Report on Form 10-K to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Fremont, State of California, on March 13, 2006.

CENTILLIUM COMMUNICATIONS , INC.

By: /s/ FARAJ AALAEI  
**Faraj Aalaei**  
**Chief Executive Officer**

Pursuant to the requirements of the Securities Exchange Act of 1934, this Annual Report on Form 10-K has been signed below by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ KAMRAN ELAHIAN</u> <b>Kamran Elahian</b>	Chairman of the Board	March 13, 2006
<u>/s/ FARAJ AALAEI</u> <b>Faraj Aalaei</b>	Chief Executive Officer and Director (Principal Executive Officer)	March 13, 2006
<u>/s/ J. SCOTT KAMSLER</u> <b>J. Scott Kamsler</b>	Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 13, 2006
<u>/s/ JERE DRUMMOND</u> <b>Jere Drummond</b>	Director	March 13, 2006
<u>/s/ ROBERT C. HAWK</u> <b>Robert C. Hawk</b>	Director	March 13, 2006
<u>/s/ SAM SRINIVASAN</u> <b>Sam Srinivasan</b>	Director	March 13, 2006
<u>/s/ LIP-BU TAN</u> <b>Lip-Bu Tan</b>	Director	March 13, 2006

## Exhibit Index

<u>Exhibit Number</u>	<u>Description</u>
3.1(1)	Certificate of Incorporation of the Registrant
3.2(4)	Certificate of Designation of Rights, Preferences and Privileges of Series A Participating Preferred Stock of the Registrant
4.1(1)	Specimen certificate of common stock
4.2(1)	Bylaws of the Registrant
4.3(5)	Preferred Stock Rights Agreement, dated as of December 30, 2002, between the Registrant and Mellon Investor Services LLC
10.1(1)	Form of Indemnification Agreement between the Registrant and each of its directors and officers
10.2(2)	1997 Stock Plan
10.3(2)	2000 Employee Stock Purchase Plan
10.21(1)	Foundry Agreement, dated March 7, 2000, between Registrant and United Microelectronics Corporation
10.22(1)	Assembly and Test Services Agreement, dated February 28, 2000, between Registrant and ST Assembly and Test Services, Ltd.
10.23(2)	2001 Nonstatutory Stock Option Plan
10.26(3)	Change of Control Severance Agreement between the Registrant and Faraj Aalaei dated December 14, 2000
10.28(3)	Change of Control Severance Agreement between the Registrant and Kamran Elahian dated December 14, 2000
10.31(6)	Amendment No. 1 to Change of Control Severance Agreement between the Registrant and Faraj Aalaei dated November 19, 2002
10.33(6)	Change of Control Severance Agreement between the Registrant and William Mackenzie dated January 14, 2003
10.35(7)	Offer letter between the Registrant and Tony Shakib dated March 24, 2003
10.36(7)	Change of Control Severance Agreement between the Registrant and Tony Shakib dated March 31, 2003
10.37(8)	Lease, dated December 23, 2003, between the Registrant and Bedford Property Investors, Inc.
10.38(9)	Offer letter between the Registrant and J. Scott Kamsler dated July 13, 2004
10.39(9)	Change of Control Severance Agreement between the Registrant and J. Scott Kamsler dated July 23, 2004
10.40(10)	Offer letter between the Registrant and Wayne Gartin dated September 16, 2004
10.41(11)	Change of Control Severance Agreement between the Registrant and Wayne Gartin dated September 29, 2004
10.42(12)	Change of Control Severance Agreement between the Registrant and Armando Pereira dated March 10, 2005
10.43(13)	Offer Letter between the Registrant and Jitesh Vadhia dated March 25, 2005

<u>Exhibit Number</u>	<u>Description</u>
10.44(14)	Employment Transition and Separation Agreement between the Registrant and Amando Pereira effective April 21, 2005
10.45(15)	Employment Transition and Separation Agreement between the Registrant and Tony Shakib effective April 21, 2005
10.46(16)	Form of Stock Purchase Right and Restricted Stock Agreement for certain non-employee directors
10.47(17)	Executive Officer Annual Compensation for Selected Executives
10.48(18)	Change of Control Severance Agreement between the Registrant and Jitesh Vadhia dated February 16, 2006
10.49	2005 Executive Bonus Summary
14.1(8)	Ethics Policy
21.1(3)	Subsidiaries of the Registrant
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer Pursuant to Exchange Act Rules 13a-14 and 15d-14
31.2	Certification of Chief Financial Officer Pursuant to Exchange Act Rules 13a-14 and 15d-14
32.1	Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
32.2	Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
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(1)	Incorporated by reference to the Exhibits filed with the Registration Statement of Form S-1 (No. 333-30772), declared effective by the Commission on May 23, 2000.
(2)	Incorporated by reference to the Exhibits filed with the Registration Statement of Form S-8 (No. 333-56610), filed with the Commission on March 6, 2001.
(3)	Incorporated by reference to the Exhibits filed with the Registrant's Annual Report on Form 10-K for the year ended December 31, 2000 filed with the Commission on March 19, 2001.
(4)	Incorporated by reference to the Exhibits filed with the Registrant's Annual Report on Form 10-K for the year ended December 31, 2001 filed with the Commission on March 27, 2002.
(5)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on December 31, 2002.
(6)	Incorporated by reference to the Exhibits filed with the Registrant's Annual Report on Form 10-K for the year ended December 31, 2002 filed with the Commission on February 18, 2003.
(7)	Incorporated by reference to the Exhibits filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 2003 filed with the Commission on May 7, 2003.
(8)	Incorporated by reference to the Exhibits filed with the Registrant's Annual Report on Form 10-K for the year ended December 31, 2003 filed with the Commission on March 5, 2004.
(9)	Incorporated by reference to the Exhibits filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended June 30, 2004 filed with the Commission on August 5, 2004.
(10)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on September 30, 2004.
(11)	Incorporated by reference to the Exhibits filed with the Registrant's Quarterly Report on Form 10-Q for the quarter ended September 30, 2004 filed with the Commission on November 5, 2004.
(12)	Incorporated by reference to the Exhibits filed with the Registrant's Annual Report on Form 10-K for

<b><u>Exhibit Number</u></b>	<b><u>Description</u></b>
	the year ended December 31, 2004 filed with the Commission on March 11, 2005.
(13)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on April 19, 2005.
(14)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on May 11, 2005.
(15)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on May 16, 2005.
(16)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on June 9, 2005.
(17)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on July 27, 2005.
(18)	Incorporated by reference to the Exhibits filed with the Registrant's Current Report on Form 8-K filed with the Commission on February 16, 2006.