

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

Form 10-K

☒ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the year ended December 31, 2010

OR

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission file number: 001-33435

Cavium Networks, Inc.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

77-0558625
(I.R.S. employer
identification no.)

805 East Middlefield Road
Mountain View, CA 94043
(650) 623-7000

(Address of principal executive offices)

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

<u>Title of Each Class</u>	<u>Name of Each Exchange on Which Registered</u>
Common Stock, \$0.001 par value (Title of Class)	The NASDAQ Stock Market LLC

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

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 such reports), and (2) has been subject to such filing requirements for the past 90 days. YES ☒ NO ☐

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES ☒ NO ☐

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

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

Large accelerated filer	<input checked="" type="checkbox"/>	Accelerated filer	<input type="checkbox"/>
Non-accelerated filer	<input type="checkbox"/> (Do not check if a smaller reporting company)	Smaller reporting company	<input type="checkbox"/>

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES ☐ NO ☒

As of June 30, 2010, the last business day of the registrant's most recently completed second fiscal quarter, the aggregate market value of the voting stock held by non-affiliates was \$1,057,801,529, based on the number of shares held by non-affiliates of the registrant, and based on the reported last sale price of common stock on The NASDAQ Global Market for such date. For purposes of determining whether a stockholder was an affiliate of the registrant at June 30, 2010, the registrant assumed that a stockholder was an affiliate of the registrant at June 30, 2010 if such stockholder beneficially owned 10% or more of the registrant's common stock as represented by the filing of Schedule 13G with the Securities and Exchange Commission and/or was affiliated with an executive officer or director of the registrant at June 30, 2010; provided, however, that organizations whose ownership exceeds 10% of the registrant's outstanding common stock as of June 30, 2010 that represented on such Schedule that they are registered investment advisors or investment companies registered under Section 8 of the Investment Company Act of 1980 were considered to be non-affiliates. This calculation does not reflect a determination that persons are affiliates for any other purposes.

Number of shares of common stock outstanding as of February 24, 2011: 47,057,203

Documents Incorporated by Reference: Portions of the Registrant's definitive Proxy Statement for its 2010 Annual Meeting of Stockholders to be filed with the Securities and Exchange Commission not later than 120 days after the end of the fiscal year covered by this form 10-K are incorporated by reference in Part III of this Form 10-K.

CAVIUM NETWORKS, INC.
YEAR ENDED DECEMBER 31, 2010

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ANNUAL REPORT
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Forward Looking Statements

The information in this Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (“Securities Act”), and Section 21E of the Securities Exchange Act of 1934, as amended (“Exchange Act”), which are subject to the “safe harbor” created by those sections. Such statements are based upon our management’s beliefs and assumptions and on information currently available to our management. Any statements contained herein that are not statements of historical facts may be deemed to be forward-looking statements. For example, words such as “may,” “will,” “should,” “could,” “would,” “estimates,” “predicts,” “potential,” “continue,” “strategy,” “beliefs,” “anticipates,” “plans,” “expects,” “intends” and variations of such words and similar expressions are intended to identify forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance, time frames or achievements to be materially different from any future results, performance, time frames or achievements expressed or implied by the forward-looking statements. These risks, uncertainties and other factors in this Annual Report on Form 10-K are discussed in greater detail under the heading “Risk Factors.” Given these risks, uncertainties and other factors, you should not place undue reliance on these forward-looking statements. These forward-looking statements represent our estimates and assumptions only as of the date of this filing. You should read this Annual Report on Form 10-K completely and with the understanding that our actual future results may be materially different from what we expect. We hereby qualify our forward-looking statements by these cautionary statements. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

PART I

Item 1. *Business*

Overview

We are a provider of highly integrated semiconductor processors that enable intelligent processing for networking, communications, storage, wireless, security, video and connected home and office applications. We refer to our products as enabling intelligent processing because they allow customers to develop networking, wireless, storage and electronic equipment that is application-aware and content-aware and securely processes voice, video and data traffic at high speeds. Our products also include a rich suite of embedded security protocols that enable unified threat management, or UTM, secure connectivity, network perimeter protection, Deep Packet Inspection or DPI, network virtualization, broadband gateways, third generation/fourth generation or 3G/4G wireless infrastructure, storage systems, wireless High-Definition Multimedia Interface or HDMI cable replacement and embedded video applications. Our products are systems on a chip, or SoCs, which incorporate single or multiple processor cores, a highly integrated architecture and customizable software that is based on a broad range of standard operating systems. As a result, our products offer high levels of performance and processing intelligence while reducing product development cycles for our customers and lowering power consumption for end market equipment. We focus our resources on the design, sales and marketing of our products, and outsource the manufacturing of our products.

We generate the majority of our net revenue from sales of our products to providers of networking equipment that sell into the enterprise network, data center, broadband and consumer, access and service provider markets. Our products are used in a broad array of networking equipment, including routers, switches, content-aware switches, UTM and other security appliances, application-aware gateways, voice/video/data, or triple-play, gateways, wireless local area network, or WLAN, and 3G/4G WiMax/Long Term Evolution, or LTE access, aggregation and gateway devices, storage networking equipment, servers and intelligent network interface cards, Internet protocol, or IP surveillance systems, digital video recorders, wireless HDMI cable replacement systems, video conferencing systems and connected home and office equipment such as print servers, wireless routers and

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broadband gateways. The acquisition of MontaVista Software, Inc. (“MontaVista”) in December 2009 complements our broad portfolio of multi-core processors to deliver integrated and optimized hardware and software embedded solutions to the market. Our MontaVista software products generate a majority of revenue from sales of software subscriptions of embedded Linux operating system, related development tools, support and professional services.

Industry Background

Traffic on the Internet, wireless networks and enterprise networks is rapidly increasing due to trends that include greater adoption of multimedia, video, smart-phones, IPTV and rich, interactive Internet applications, voice over IP, or VoIP, video over broadband, file sharing, greater use of web-based cloud services and the proliferation of stored content accessed through networks. Enterprises, service providers and consumers are demanding networking and electronic equipment that can take advantage of these trends, and address the significant market opportunities and life-style changes that these new applications provide. As a result, there is growing pressure on providers of networking equipment, wireless, storage and electronic equipment to rapidly introduce new products with enhanced functionality while reducing their design and manufacturing costs. Providers of networking, wireless, storage and electronic equipment are increasingly seeking advanced processing solutions from third-party vendors to access the best available technology and reduce development costs.

Video on demand, IPTV, peer-to-peer (P2P) video, and Internet video are forecast to account for approximately 90 percent of all consumer IP traffic by 2013 according to Cisco Systems Inc.’s Visual Networking Index forecast. New media rich applications for both consumers and enterprises, like facebook, YouTube, Hulu, MySpace, high definition (“HD”) movie downloads, video conferencing, online gaming, distance learning and telemedicine are the major drivers of this growth. Currently, internet video on the PC is the primary driver of this growth. In the future, Internet delivery of video to the TV and mobile devices followed by cost effective, HD interactive video communications is expected to fuel the future growth of video traffic over the Internet. This growth of video over the network is driving many of our customers in the networking and communications space to acquire video technology, applications and expertise. To address the future needs of our customers we acquired differentiated, low-latency video encoding technology via our purchase of W&W Communications, Inc. (“W&W”) in 2008.

The acquisition of MontaVista complements our broad portfolio of multi-core processors to deliver integrated and optimized embedded solutions to the market. Our MontaVista software products generate a majority of revenue from sales of software subscriptions of embedded Linux operating system, related development tools, support and professional services. In October 2010, we acquired Celestial Systems, an India-based technology and services partner with long term connections and synergies with MontaVista. With the acquisition, we gain critical mass in delivering key technologies and services such as Automotive Infotainment Systems, Digital Media product development and Android commercialization support.

The processing needs of advanced networking systems can be described in the context of the Open System Interconnection, or OSI, Model, which divides network activities, equipment, and protocols into seven layers. According to this model, Layers 1 through 3 are the physical, data link and network layers, respectively, which provide the protocols to ensure the transmission of data between the source and destination regardless of the content and type of data processed. Traditionally, network infrastructure products have focused on Layer 1 through 3 products that route and switch data traffic based solely on the source and destination address contained in the packet header. Processors that provide Layer 1 through 3 solutions are widely available from many vendors. Layers 4 through 7 are the transport, session, presentation and application layers, which provide the protocols to enable the reliable end-to-end communication of application information. Intelligent processing generally takes place in Layers 4 through 7. In order to provide this intelligence, advanced networking systems must include processors that enable extensive inspection of the application and data content, or deep packet inspection, and make intelligent switching and routing decisions based upon that inspection. To address customer demands, providers of networking equipment must offer products that include functionality such as intelligent

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routing or switching of network traffic prioritized by application and data content, and security services. Processors required for Layer 4 through 7 processing are significantly more complex than processors that provide only Layer 1 through 3 solutions.

The processing needs of the digital video market can be categorized into five distinct market segments namely capture, process, transport, receive and display. Our networking products serve in the video traffic transport market with single and multicore processors. The video transport market includes equipment used in cable networks, satellite networks and the Internet such as routers, switches and content load-balancers that support the bandwidth, low-latency and quality of service required for video. Video processing technology is required to play in the capture, process and display segments of the market. The video capture market includes all types of video recording equipment ranging from high-end broadcast quality cameras to IP cameras for video surveillance, video conferencing and personal use camcorders, IP cameras and webcams. The video process market needs high-channel density and translating and transcoding for video infrastructure equipment such as cable head-end video systems, IP Multimedia Subsystem, or IMS, gateways, broadcast systems, multi-channel digital video recorders (DVRs), video conference multi-point control unit and gateways. The video display market includes LCD screens and flat panels, plasma displays and projectors where high quality 1080p HD encode and decode and low latency are required for display and wireless connectivity. This market is served by our video processing products. Networking, wireless, storage and electronic equipment providers address the need for next generation video systems using a variety of approaches. These approaches include internally designed custom semiconductor products, such as application-specific integrated circuits, or ASICs, digital signal processors, or DSPs, field-programmable gate arrays, or FPGAs, or other proprietary chips, multiple chip offerings, general purpose central processing units, or CPUs, from merchant suppliers, software-based solutions or a combination of these approaches. While these approaches have been adequate for the basic Layer 1 through 3 processing, they are less effective as the need for Layer 4 through 7 intelligent processing increases and line rates continue to increase. As a result, providers of networking equipments are increasingly turning to third-party vendors for high performance, power-efficient and cost-effective intelligent processing products.

Products

OCTEON®, *OCTEON Plus®*, *OCTEON II®*, *NITROX®*, *ECONA®* and *Pure Vi™* are trademarks or registered trademarks of Cavium Networks, Inc.

We offer highly integrated semiconductors that provide single or multiple cores of processors, along with intelligent Layer 4 through 7 processing for enterprise network, data center, broadband and consumer, and access and service provider markets. Our products provide scalable, low-power, high performance processors that integrate single or multiple cores, hardware accelerators, memory controllers and input/output interfaces into a single chip and are available across a wide range of price and performance points. All of our products are compatible with standards-based operating systems and general purpose software to enable ease of programming, and are supported by our ecosystem partners. Our MontaVista Software products offer commercial grade embedded Linux operating systems, development tools, support and services. Our software embedded Linux products provide a high quality operating system and productivity tools across a wide range of embedded processors that are sold by us.

Our OCTEON, OCTEON Plus and OCTEON II Multi-core MIPS64 processor families provide integrated Layer 4 through 7 data and security processing (with additional capabilities at Layers 2 and 3) at line speeds from 100Mbps to 40Gbps. OCTEON processors integrate control plane processing, packet processing, security processing and content acceleration, as well as a broad set of input/output interfaces in a single chip. This integration shortens the data paths, eliminates redundant packet processing, simplifies board design and reduces the cost and power consumption compared to alternative products that use multiple chips. Our OCTEON processors have been adopted in a wide variety of original equipment manufacturer, or OEM, networking equipment, including routers, switches, content-aware switches, UTM, and other security appliances, application-aware gateways, voice/video/data, or triple-play, gateways, WLAN and 3G/4G access and aggregation devices, storage networking equipment, servers and intelligent network interface cards.

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The OCTEON Plus and OCTEON II processor families incorporate new interfaces and acceleration features for packet processing, quality of service and content processing for multimedia aware networking and 3G, 4G-LTE, and WiMax wireless applications over the previous generations. The OCTEON Plus and OCTEON II processor families also expanded OCTEON's core target markets in storage, wireless and control plane applications. The OCTEON Plus and OCTEON II processor families also provide hardware acceleration for storage applications such as iSCSI, RAID 6 and data de-duplication and are aimed at iSCSI targets, Fiber Channel to iSCSI bridges and disk arrays.

Our NITROX processor family offers stand-alone security processors and Layer 7 content processors that provide the functionality required for Layer 3 to Layer 7 secure communication in a single chip. These single chip, custom-designed processors provide complete security protocol processing, encryption, authentication algorithms and intelligent deep packet inspection to reduce the load on the system processor and increase total system throughput. The NITROX family consists of products with up to 64 security processors on a chip, providing up to 40Gbps of cryptographic processing up to 200k RSA operations/sec, and are used in a wide variety of OEM networking and data-center equipment, including security appliances, UTM appliances, Layer 4 through 7 load balancers, and other cloud services applications. The NITROX DPI Layer 7 content processor family includes our patented deep packet inspection technology and is used in routers/switches, wireless infrastructure equipment, UTM appliances and Layer 4 -7 load balancers.

Our OCTEON Plus broadband communication processor family consists of single and dual core processors that target wired and wireless broadband gateway applications, with performance requirements ranging from 100Mbps to 1Gbps. The MIPS64-based SoC OCTEON processors integrate single or dual 64-bit CPUs, and provide high performance security processing for applications requiring up to a 1Gbps line rate. These processors are primarily used for broadband routers, WLAN access points and UTM appliances.

The ECONA family of multi-core ARM-based System-on-Chip (SoC) products is targeted at applications that demand highly integrated, cost-effective, energy efficient processing platforms in the broadband-connected, digital home and office markets. The ECONA SoC family integrates multi-core ARM CPUs, comprehensive input/output, or I/O, options and hardware offload blocks for high performance connected gateways and networked storage, security gateways, wireless access, portable media devices and other networked appliances. With integrated power management hardware, the ECONA SoC family is also designed ground-up to meet very stringent power consumption requirements for the Consumer Electronics (CE) devices to enable fan-less operation and compact industrial design. The ECONA SoC family provides best-in-class performance / dollar and performance / watt for the targeted applications.

The PureVu CNW3XXX video processors offer the industry's lowest end-to-end encode-decode latency, high channel density and low power solution for interactive and recording video applications. These processors integrate an H.264 encoder and decoder on a single chip with support for 1080p60 encode/decode, as well as encoding and decoding multiple HD, SD and CIF streams. Through our Super Low Latency (SLL) Technology™ many demanding interactive video applications are possible on CNW3XXX processors. The PureVu CNW3XXX processors are targeted for use in either highly interactive video applications, such as gaming, or in high channel-density video recording applications or in applications that require both low latency and high channel-density; including video conferencing, wireless HDMI adapters, video surveillance DVRs and video servers, gaming, and single or multi-sensor HD and SD IP cameras. The PureVu™ CNW5XXX family combines Cavium's Super-Low-Latency (SLL) H.264 video processor, high performance NITROX security technology, and intelligent networking and packet processing capabilities in a fully integrated SoC that brings our revolutionary netHD™ technology to a variety of video applications, including wireless display, HDMI cable replacement, home media distribution, and video conferencing. The high degree of integration deployed in the CNW5XXX family is intended to provide customers with aggressive system bill-of-materials cost in order to enable mass market adoption in such devices as flat panel TVs, Blu-ray players, notebook PCs and netbooks, gaming consoles, as well as SMB and SOHO video communication systems.

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The MontaVista software products include embedded Linux operating systems, support, development tools and professional services. The MontaVista software product line helps our customers build products around our SoCs in a more time and cost efficient manner. The MontaVista embedded Linux operating system is available in multiple editions based upon the target market. Our MontaVista Linux MVL6 product includes commercial grade Linux operating systems with pre-packaged open source packages and development tools that reduce development time and cost of building products. In addition to our MontaVista software products we also market and sell discrete software stacks designed to help our customers build products with fewer development resources. Furthermore, we offer customized professional services that help our customers build feature rich products using our processor and Linux expertise. In 2010 MontaVista released MontaVista Linux Carrier Grade Edition 6.0 (CGE 6.0) a sixth-generation embedded Linux for the highly demanding network equipment and carrier environments. Key to CGE 6.0 is a multicore resource management architecture that will allow multiple embedded technologies to run side-by-side in a virtualized environment. The MontaVista virtualization platform is based entirely on Linux and includes Linux Containers and KVM virtualization as well as an ultra-fast, RTOS-like Bare Metal Engine (BME) implementation. MontaVista Software continues to implement and support CGE 6.0 across multiple architectures and semiconductor platforms.

Customers

We primarily sell our products to providers of networking, wireless, storage and consumer electronic equipment, either directly or through contract manufacturing organizations and distributors. By providing comprehensive systems-level products along with our ecosystem partners, we provide our customers with products that empower their next-generation networking systems more quickly and at lower cost than other alternatives.

We currently rely, and expect to continue to rely, on a limited number of customers for a significant portion of our revenue. Cisco Systems, Inc. accounted for 22% of net revenue in 2010.

Sales and Marketing

We currently sell our products through our direct sales and applications support organization to providers of networking equipment, original design manufacturers and contract electronics manufacturers, as well as through arrangements with distributors that fulfill third-party orders for our products.

We work directly with our customers' system designers to create demand for our products by providing them with application-specific product information for their system design, engineering and procurement groups. Our technical marketing, sales and field application engineers actively engage potential customers during their design processes to introduce them to our product capabilities and target applications. We design products in an effort to meet the increasingly complex and specific design requirements of our customers. We typically undertake a multi-month sales and development process with our customer system designers and management. If successful, this process culminates in a customer decision to use our product in their system, which we refer to as a design win. Volume production can begin from nine months to three years after the design win depending on the complexity of our customer's product and other factors. Once one of our products is incorporated into a customer's design, it is likely to be used for the life cycle of the customer's product. We believe this to be the case because a redesign would generally be time consuming and expensive.

Manufacturing

We use third-party foundries and assembly and test contractors to manufacture, assemble and test our semiconductor products. This outsourced manufacturing approach allows us to focus our resources on the design, sales and marketing of our products. Our foundries are responsible for procurement of the raw materials used in the production of our products. Our engineers work closely with our foundries and other contractors to increase yields, lower manufacturing costs and improve quality.

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Integrated Circuit Fabrication. Our integrated circuits are fabricated using complementary metal-oxide semiconductor, or CMOS processes, which provide greater flexibility to engage independent foundries to manufacture our integrated circuits. By outsourcing manufacturing, we are able to avoid the cost associated with owning and operating our own manufacturing facility, which would not be feasible for a company at our stage of development. We currently outsource a substantial percentage of our integrated circuit manufacturing to Taiwan Semiconductor Manufacturing Company, or TSMC, with the remaining manufacturing outsourced to United Microelectronics Corporation, or UMC, Fujitsu Microelectronics, or Fujitsu, and Samsung Electronics, or Samsung. We work closely with TSMC, UMC, Fujitsu and Samsung to forecast on a monthly basis our manufacturing capacity requirements. Our integrated circuits are currently fabricated in several advanced, sub-micron manufacturing processes. Because finer manufacturing processes lead to enhanced performance, smaller size and lower power requirements, we continually evaluate the benefits and feasibility of migrating to smaller geometry process technology in order to reduce cost and improve performance.

Assembly and Test. Our products are shipped from our third-party foundries to third-party assembly and test facilities where they are assembled into finished integrated circuit packages and tested. We outsource all product packaging and substantially all testing requirements for these products to several assembly and test subcontractors, including ASE Electronics in Taiwan, Malaysia and Singapore, as well as ISE Labs, Inc. in the United States. Our products are designed to use standard packages and to be tested with widely available test equipment.

Quality Assurance. We have implemented significant quality assurance and test procedures to assure high levels of product quality for our customers. Our designs are subjected to extensive circuit simulation under extreme conditions of temperature, voltage and processing before being committed to manufacture. We have completed and have been awarded ISO 9001 certification and ISO 9001:2000 certification. In addition, all of our independent foundries and assembly and test subcontractors have been awarded ISO 9001 certification.

Research and Development

We believe that our future success depends on our ability to introduce enhancements to our existing products and to develop new products for both existing and new markets. Our research and development efforts are directed largely to the development of additional high-performance multi-core microprocessor semiconductors. We are also focused on incorporating functions currently provided by stand-alone semiconductors into our products. We have assembled a team of highly skilled semiconductor and embedded software design engineers who have strong design expertise in high performance multi-core microprocessor design, along with embedded software, security and networking expertise. Our engineering design teams are located in Mountain View, California, Marlborough, Massachusetts, Beijing, China, Hsin-Chu, Taiwan, Madrid, Spain and Hyderabad, Chennai and Bangalore, India. As of December 31, 2010, we had 367 employees in our research and development group. Our research and development expenses were \$60.6 million, \$42.7 million and \$27.2 million for the years ended December 31, 2010, 2009 and 2008 respectively.

Business Combinations

In the third quarter of 2008, we acquired substantially all of the assets of Star Semiconductor Corporation (“Star”) for a purchase price of \$9.6 million. With the acquisition of Star, we also added the Star ARM-based processors to our portfolio to address connected home and office applications and have since introduced our ECONA line of dual-core ARM processors that address a large variety of connected home and office applications.

In the fourth quarter of 2008, we acquired W&W Communications, Inc. for a total purchase price of \$8.3 million. This acquisition launched us into the video processor market with a broad product line called PureVu. The PureVu family of video processors and modules incorporate proprietary and patent pending video technology that produces perceptual lossless video quality and delivers sub-frame latency with extremely low

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power and cost. These products address the need for video processing in wireless displays, teleconferencing, gaming and other applications.

In the fourth quarter of 2009, we acquired MontaVista for a total purchase price of \$45.2 million. In addition, per the merger agreement, we paid \$6.0 million, consisting of a mix of shares of our common stock and cash to certain individuals in connection with the termination of MontaVista's 2006 Retention Compensation Plan. This acquisition complements our broad portfolio of multi-core processors to deliver integrated and optimized embedded solutions to the market.

In the fourth quarter of 2010, we acquired Celestial Systems Inc. for aggregate cash consideration of \$4.4 million and a possible earn-out of \$1.5 million in cash upon the achievement of certain milestone as set forth in the asset purchase agreement. With the acquisition of Celestial Systems, we gain critical mass in delivering key technologies and services such as Automotive Infotainment Systems, Digital Media product development and Android commercialization and support.

On January 25, 2011, we completed the acquisition of substantially all of the assets of Wavesat Inc., including, but not limited to, certain intellectual property, all of Wavesat's rights to, in and under customer contracts and other material agreements, inventory, equipment, work in progress, fixed assets and goodwill. We paid approximately \$10.0 million in cash, plus the aggregate amount of certain liabilities as specified in the related purchase agreement. Following the closing, we also paid approximately \$1.5 million to Wavesat in connection with a transition services agreement, pursuant to which Wavesat continued to employ certain employees prior to their becoming our employees. This acquisition will add multicore wireless digital system processing to our embedded processor product line.

On January 31, 2011, we entered into an asset purchase agreement with Celestial Semiconductor, Ltd., a Cayman Islands company and no relation to Celestial Systems, Inc. On the terms and subject to the conditions set forth in the asset purchase agreement, we will purchase certain assets of Celestial Semiconductor. Under the terms of the asset purchase agreement, we will pay approximately \$55.0 million in total consideration, consisting of a mix of cash and shares of our common stock. In addition, we may pay additional cash consideration of up to \$10.0 million after the closing per an earn-out provision based upon the sales of Celestial Semiconductor's products following consummation of transactions. With the acquisition of Celestial Semiconductor, we will have a proven processor family targeted for the large and growing market of digital media players.

For a complete discussion on our 2008 to 2010 and subsequent acquisitions, see "Note 5 Business Combinations" in Item 8, of this Annual Report, which is incorporated herein by reference.

Intellectual Property

Our success depends in part upon our ability to protect our core technology and intellectual property. To accomplish this, we rely on a combination of intellectual property rights, including patents, trade secrets, copyrights and trademarks, and contractual protections.

As of December 31, 2010, we had 25 issued and 23 pending patent applications in the United States, and 5 issued and 19 pending foreign patent applications. The issued patents in the United States expire in the years beginning in 2023 through 2025. The issued foreign patents expire in 2022. Our issued patents and pending patent applications relate to security processors, multi-core microprocessor processing and other processing concepts. We focus our patent efforts in the United States, and, when justified by cost and strategic importance, we file corresponding foreign patent applications in strategic jurisdictions such as Japan and Europe. Our patent strategy is designed to provide a balance between the need for coverage in our strategic markets and the need to maintain costs at a reasonable level. We believe our issued patents and patent applications, to the extent the applications are issued, may be used defensively by us in the event of future intellectual property claims.

We may not receive competitive advantages from any rights granted under our patents. We do not know whether any of our patent applications will result in the issuance of any patents or whether the examination process will require us to narrow the scope of our claims. To the extent any of our applications proceed to issuance as a patent, any such future patent may be opposed, contested, circumvented, designed around by a third

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party, or found to be unenforceable or invalidated. In addition, our future patent applications may not be issued with the scope of the claims sought by us, if at all, or the scope of claims we are seeking may not be sufficiently broad to protect our proprietary technologies. Others may develop technologies that are similar or superior to our proprietary technologies, duplicate our proprietary technologies, or design around patents owned or licensed by us. If our products, patents or patent applications are found to conflict with any patent held by third parties, we could be prevented from selling our products, our patents may be declared invalid or our patent applications may not result in issued patents.

In addition to our own intellectual property, we also rely on third-party technologies for the development of our products. We license certain technology from MIPS Technologies, Inc., pursuant to a license agreement entered into in December 2003 wherein we were granted a non-exclusive, worldwide license to MIPS Technologies' microprocessor core technology to develop, implement and use in our products. In September 2010, the Company renewed an agreement with MIPS Technologies which will expire in September 2026. The agreement permits us to continue selling in perpetuity products developed during the term of the agreement containing the licensed technology.

We obtained a registration for our OCTEON and NITROX trademark in the United States. We also have a license from MIPS Technologies, Inc. to use cnMIPS as a trademark.

In addition, we generally control access to and use of our proprietary software and other confidential information through the use of internal and external controls, including contractual protections with employees, contractors, customers and partners. We rely in part on United States and international copyright laws to protect our software. All employees and consultants are required to execute confidentiality agreements in connection with their employment and consulting relationships with us. We also require them to agree to disclose and assign to us all inventions conceived or made in connection with the employment or consulting relationship. We cannot provide any assurance that employees and consultants will abide by the confidentiality or invention assignment terms of their agreements. Despite measures taken to protect our intellectual property, unauthorized parties may copy aspects of our products or obtain and use information that we regard as proprietary.

Despite our efforts to protect our trade secrets and proprietary rights through patents, licenses and confidentiality agreements, unauthorized parties may still copy or otherwise obtain and use our software and technology. In addition, as we expand our international operations, effective patent, copyright, trademark and trade secret protection may not be available or may be limited in foreign countries. If we fail to protect our intellectual property and other proprietary rights, our business could be harmed.

Third parties could claim that our products or technologies infringe their proprietary rights. The semiconductor industry is characterized by the existence of a large number of patents, trademarks and copyrights and by frequent litigation based on allegations of infringement or other violations of intellectual property rights. We expect that the potential for infringement claims against us may further increase as the number of products and competitors in our market increase. Litigation in this industry is often protracted and expensive. Questions of infringement in the semiconductor industry involve highly technical and subjective analyses. In addition, litigation may become necessary in the future to enforce our granted patents and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity, and we may not prevail in any future litigation. The results of any litigation are inherently uncertain. Any successful infringement claim or litigation against us could have a significant adverse impact on our business.

We may be required to seek licenses under patents or intellectual property rights owned by third parties. However, we cannot be certain that third parties will offer licenses to us or that the terms of any licenses offered to us will be acceptable. If we fail to obtain such third-party license for our products, we could incur substantial liabilities or be forced to suspend sales of our products. Any litigation could cause us to incur substantial expenses, reduce our sales, and divert the efforts of our technical and management personnel, whether or not a

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court decided such litigation in our favor. In the event we receive an adverse result in any litigation, we could be required to pay substantial damages, cease sale of products, expend significant resources to develop alternative technology and discontinue the use of processes requiring the relevant technology.

We have not to date been notified of any litigation related to intellectual property.

Competition

We compete with numerous domestic and international semiconductor companies, many of which have greater financial and other resources with which to pursue marketing, technology development, product design, manufacturing, quality, sales and distribution of their products. Our ability to compete effectively depends on defining, designing and regularly introducing new products that anticipate the processing and integration needs of our customers' next-generation products and applications.

In the networking, wireless, storage and connected home and office markets we consider our primary competitors to be other companies that provide embedded processor products to the market, including Broadcom Corporation, Freescale Semiconductor, Inc., Intel Corporation, Marvell Technology Group Ltd., PMC-Sierra, Inc., and NetLogic Microsystems, Inc. Most of these competitors offer products that differ in functionality and processing speeds and address some or all of our four target end markets. In comparison we offer a broad array of highly integrated, intelligent solutions at various performance levels and prices for each of our end markets. Our products generally include a multiple number of processor cores, greater integration of Layer 4 through 7 hardware acceleration and interfaces, and efficient power consumption for networking, communication, security and video applications. In the video capture, process and display market segments we consider our competition to be companies that provide video encode and decode solutions, including Texas Instrument's Digital Signal Processings or TI DSPs and SOCs for H.264 encoding and AMIMON, Inc. for wireless replacement of HDMI cables and wireless video displays.

In the embedded commercial Linux operating system and professional services markets, we consider the primary competitors for our MontaVista software products to be Wind River Systems, Inc., a subsidiary of Intel Corporation and, to a lesser extent, Canonical Programming, Inc. and Mentor Graphics Corporation. As we continue to see success in our professional service business, we anticipate a new set of future competitors in the form of pure software service companies and global systems integrators.

Our competitors include public companies with broader product lines, a large installed base of customers and greater resources compared to us. We expect continued competition from existing suppliers as well as from potential new entrants into our markets. Our ability to compete depends on a number of factors, including our success in identifying new and emerging markets, applications and technologies and developing products for these markets; our products' performance and cost effectiveness relative to that of our competitors'; our success in product functionality and features not previously available in the marketplace; our ability to recruit good talent including software engineers and chip designers; and our ability to protect our intellectual property.

Backlog

Sales of our products are generally made pursuant to purchase orders. We typically include in backlog only those customer orders for which we have accepted purchase orders and which we expect to ship within the next twelve months. Since orders constituting our current backlog are subject to changes in delivery schedules or cancellation with limited or no penalties, we believe that the amount of our backlog is not necessarily an accurate indication of our future revenues.

Geographic Information

For geographic financial information, see "Note 11. Segment and Geographical Information" in Item 8, of this Annual Report, which is incorporated herein by reference.

Employees

As of December 31, 2010, we had 633 regular employees located in the United States, India and other countries in Asia and Europe, which was comprised of: 108 employees in manufacturing and direct service operations, 367 in engineering, research and development, and 158 in sales, marketing and administrative. None of our employees is represented by a labor union and we consider current employee relations to be good.

Executive Officers of the Registrant

The following sets forth certain information regarding our executive officers as of February 24, 2011:

Syed B. Ali	52	President, Chief Executive Officer, Director and Chairman of the Board of Directors
Arthur D. Chadwick	54	Vice President of Finance and Administration, Chief Financial Officer and Secretary
Anil Jain	54	Corporate Vice President, IC Engineering
Rajiv Khemani	43	Chief Operating Officer
Manoj Gujral	48	Vice President and General Manager, Broadband and Consumer Division

Syed B. Ali is one of our founders and has served as our President, Chief Executive Officer and Chairman of the Board of Directors since the inception of the Company in 2000. From 1998 to 2000, Mr. Ali was Vice President of Marketing and Sales at Malleable Technologies, a communication chip company of which he was a founding management team member. Malleable Technologies was acquired by PMC Sierra, a communication IC company in 2000. From 1994 to 1998, Mr. Ali was an Executive Director at Samsung Electronics. Prior to that, he had various positions at Wafer Scale Integration, a division of SGS-Thompson, Tandem Computer, and American Microsystems. He received a BE (Electrical Engineering) from Osmania University, in Hyderabad, India and an MSE from the University of Michigan.

Arthur D. Chadwick has served as our Vice President of Finance and Administration, Chief Financial Officer and Secretary since December 2004. Prior to joining us, from 1989 to 2004, Mr. Chadwick served as the Senior Vice President of Finance and Administration and Chief Financial Officer at Pinnacle Systems, a provider of digital video processing solutions. From 1979 through 1989, Mr. Chadwick served in various financial and management roles at American Microsystems, Austrian Microsystems, Gould Semiconductor and AMI-Philippines. Mr. Chadwick received a BS degree in Mathematics and an MBA in Finance, both from the University of Michigan.

Anil K. Jain has served as our Corporate Vice President of IC Engineering since January 2001, and is a founding management team member. Prior to joining us, from 1998 to 2000 he was at Compaq Computer, a computer manufacturer. From 1980 to 1998, Mr. Jain served at Digital Equipment Corporation, or DEC, as Senior Consulting Engineer when DEC was acquired by Compaq Computer. He received a BS degree in Electrical Engineering from Punjab Engineering College in Chandigarh India, and an MSEE from the University of Cincinnati.

Rajiv Khemani has served as our Chief Operating Officer effective January 2011. He previously served as our Vice President and General Manager of Networking and Communications Division since February 2009 and has served as our Vice President of Marketing and Sales since January 2007 and has served as our Vice President of Marketing since June 2003. Prior to joining us, from 1998 to May 2003, he worked for Intel Corporation, a microprocessor IC company. From 2002 to 2003, he served as General Manager of Intel's high-end network processor business unit. From 1999 to 2002, he served as Director of Marketing in Intel's network processor division. He joined Intel through Intel's acquisition of Netboost, a network processor startup. Prior to Netboost, Mr. Khemani held engineering, marketing and management positions at Network Appliance and Sun Microsystems. He received a bachelor degree in Computer Engineering from the Indian Institute of Technology,

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New Delhi, an MS in Computer Science from New York University and an MBA from Stanford University Graduate School of Business.

Manoj Gujral has served as our Vice President and General Manager of our Broadband and Consumer Division since May 2010. He brings over 23 years of deep expertise in developing and bringing to market solutions for consumer electronics, personal computers, servers, and mobile devices. Prior to joining us, Manoj served as General Manager of the Desktop Business at Nvidia Corp responsible for GPU and chipset products across all original equipment manufacturer (OEM) customers. Earlier in his tenure at Nvidia, he led the Notebook chipset business from early days through strong revenue momentum in the market place. From 2003-2005, he served as Managing Director of the Specialty Memory business unit at Cypress Semiconductor responsible for system interconnect products for wireless and handset markets. Prior to Cypress, Manoj also worked in various management roles at Raza Foundries, ShareWave and Unisys. Manoj received his MSEE from Oregon State University, MBA from San Jose State University and completed the Executive Leadership Program at Stanford University Graduate School of Business. He has 8 patents issued in the area of computer architecture.

Corporate Information

We were incorporated in California in November 2000 and reincorporated in Delaware in February 2007. Our principal offices are located at 805 East Middlefield Road, Mountain View, California 94043, and our telephone number is (650) 623-7000. Our Web site address is www.caviumnetworks.com. Information found on, or accessible through, our Web site is not a part of, and is not incorporated into, this Annual Report on Form 10-K. Unless the context requires otherwise, references in this Annual Report on Form 10-K to “the company,” “we,” “us” and “our” refer to Cavium Networks, Inc. and its wholly-owned subsidiaries on a consolidated basis.

Available Information

We file electronically with the United States Securities and Exchange Commission, or SEC, our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934. We make available on our website at <http://www.caviumnetworks.com>, free of charge, copies of these reports as soon as reasonably practicable after filing these reports with, or furnishing them to, the SEC.

Item 1A. Risk Factors

The following risks and uncertainties may have a material adverse effect on our business, financial condition or results of operations. Investors should carefully consider the risks described below before making an investment decision. The risks described below are not the only ones we face. Additional risks not presently known to us or that we currently believe are immaterial may also significantly impair our business operations. Our business could be harmed by any of these risks. The trading price of our common stock could decline due to any of these risks, and investors may lose all or part of their investment.

Risks Related to Our Business and Industry

We have a limited history of profitability, and we may not achieve or sustain profitability in the future, on a quarterly or annual basis.

We were established in 2000. Our first quarter of profitability since then was the quarter ended September 30, 2007 and we remained profitable until the quarter ended December 31, 2008. We incurred a net loss of \$21.4 million for the year ended December 31, 2009 and became profitable from the quarter ended June 30, 2010. For the year ended December 31, 2010, we recognized net income of \$37.1 million. As of December 31, 2010, our accumulated deficit was \$41.5 million. We expect to make significant expenditures related to the development of our products and expansion of our business, including research and development

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and sales and administrative expenses. As a public company, we also incur significant legal, accounting and other expenses. Additionally, we may encounter unforeseen difficulties, complications, product delays and other unknown factors that require additional expenditures. As a result of these increased expenditures, we may have to generate and sustain substantially increased revenue to achieve profitability. Our revenue growth trends in prior periods may not be sustainable. Accordingly, we may not be able to achieve or maintain profitability and we may continue to incur losses in the future.

We face intense competition and expect competition to increase in the future, which could reduce our revenue and customer base.

The market for our products is highly competitive and we expect competition to intensify in the future. This competition could make it more difficult for us to sell our products, and result in increased pricing pressure, reduced profit margins, increased sales and marketing expenses and failure to increase, or the loss of, market share or expected market share, any of which would likely seriously harm our business, operating results and financial condition. For instance, semiconductor products have a history of declining prices as the cost of production is reduced. However, if market prices decrease faster than product costs, gross and operating margins can be adversely affected. Currently, we face competition from a number of established companies, including Broadcom Corporation, Freescale Semiconductor, Inc., Intel Corporation, Marvell Technology Group Ltd., PMC-Sierra, Inc., and NetLogic Microsystems, Inc. In addition, in the video capture, process and display market segments we consider our competition to be companies that provide video encode and decode solutions, including Texas Instruments' digital signal processors and SOC's for H.264 encoding and Amimon for wireless replacement of HDMI cables and wireless video displays.

A few of our current competitors operate their own fabrication facilities and have, and some of our potential competitors could have, longer operating histories, greater name recognition, larger customer bases and significantly greater financial, technical, sales, marketing and other resources than we have. Potential customers may prefer to purchase from their existing suppliers rather than a new supplier regardless of product performance or features.

We expect increased competition from other established and emerging companies both domestically and internationally. Our current and potential competitors may also establish cooperative relationships among themselves or with third parties. If so, new competitors or alliances that include our competitors may emerge that could acquire significant market share. We expect these trends to continue as companies attempt to strengthen or maintain their market positions in an evolving industry. In the future, further development by our competitors could cause our products to become obsolete. We expect continued competition from incumbents as well as from new entrants into the markets we serve. Our ability to compete depends on a number of factors, including:

- our success in identifying new and emerging markets, applications and technologies;
- our products' performance and cost effectiveness relative to that of our competitors' products;
- our ability to deliver products in large volume on a timely basis at a competitive price;
- our success in utilizing new and proprietary technologies to offer products and features previously not available in the marketplace;
- our ability to recruit design and application engineers and sales and marketing personnel; and
- our ability to protect our intellectual property.

In addition, we cannot assure you that existing customers or potential customers will not develop their own products, purchase competitive products or acquire companies that use alternative methods to enable networking, communication or security applications to facilitate network-aware processing in their systems. Any of these competitive threats, alone or in combination with others, could seriously harm our business, operating results and financial condition.

Our customers may cancel their orders, change production quantities or delay production, and if we fail to forecast demand for our products accurately, we may incur product shortages, delays in product shipments or excess or insufficient product inventory.

We generally do not obtain firm, long-term purchase commitments from our customers. Because production lead times often exceed the amount of time required to fulfill orders, we often must build in advance of orders, relying on an imperfect demand forecast to project volumes and product mix. Our demand forecast accuracy can be adversely affected by a number of factors, including inaccurate forecasting by our customers, changes in market conditions, adverse changes in our product order mix and demand for our customers' products. Even after an order is received, our customers may cancel these orders or request a decrease in production quantities. Any such cancellation or decrease subjects us to a number of risks, most notably that our projected sales will not materialize on schedule or at all, leading to unanticipated revenue shortfalls and excess or obsolete inventory which we may be unable to sell to other customers. Alternatively, if we are unable to project customer requirements accurately, we may not build enough products, which could lead to delays in product shipments and lost sales opportunities in the near term, as well as force our customers to identify alternative sources, which could affect our ongoing relationships with these customers. We have in the past had customers dramatically increase their requested production quantities with little or no advance notice. If we do not timely fulfill customer demands, our customers may cancel their orders. Either underestimating or overestimating demand would lead to insufficient, excess or obsolete inventory, which could harm our operating results, cash flow and financial condition, as well as our relationships with our customers.

Adverse changes in general economic or political conditions in any of the major countries in which we do business could adversely affect our operating results.

As our business has grown to both customers located in the United States as well as customers located outside of the United States, we have become increasingly subject to the risks arising from adverse changes in both the domestic and global economic and political conditions. For example, the direction and relative strength of the U.S. and international economies remains uncertain due to softness in the housing markets, difficulties in the financial services sector and credit markets and continuing geopolitical uncertainties. If economic growth in the United States and other countries' economies continues to slow, the demand for our customer's products could decline, which would then decrease demand for our products. Furthermore, if economic conditions in the countries into which our customers sell their products continue to deteriorate, some of our customers may decide to postpone or delay certain development programs, which would then delay their need to purchase our products. This could result in a reduction in sales of our products or in a reduction in the growth of our product sales. Any of these events would likely harm investors view of our business, and our results of operations and financial condition.

We receive a substantial portion of our revenues from a limited number of customers, and the loss of, or a significant reduction in, orders from one or a few of our major customers would adversely affect our operations and financial condition.

We receive a substantial portion of our revenues from a limited number of customers. We received an aggregate of approximately 41%, 52% and 57% of our net revenues from our top five customers for the years ended December 31, 2010, 2009 and 2008, respectively. We anticipate that we will continue to be dependent on a limited number of customers for a significant portion of our revenues in the immediate future and in some cases the portion of our revenues attributable to certain customers may increase in the future. However, we may not be able to maintain or increase sales to certain of our top customers for a variety of reasons, including the following:

- our agreements with our customers do not require them to purchase a minimum quantity of our products;
- some of our customers can stop incorporating our products into their own products with limited notice to us and suffer little or no penalty; and

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- many of our customers have pre-existing or concurrent relationships with our current or potential competitors that may affect the customers' decisions to purchase our products.

In the past, we have relied in significant part on our strategic relationships with customers that are technology leaders in our target markets. We intend to continue expanding such relationships and forming new strategic relationships but we cannot assure you that we will be able to do so. These relationships often require us to develop new products that may involve significant technological challenges. Our customers frequently place considerable pressure on us to meet their tight development schedules. Accordingly, we may have to devote a substantial amount of our resources to our strategic relationships, which could detract from or delay our completion of other important development projects. Delays in development could impair our relationships with our other strategic customers and negatively impact sales of the products under development. Moreover, it is possible that our customers may develop their own product or adopt a competitor's solution for products that they currently buy from us. If that happens, our sales would decline and our business, financial condition and results of operations could be materially and adversely affected.

In addition, our relationships with some customers may also deter other potential customers who compete with these customers from buying our products. To attract new customers or retain existing customers, we may offer certain customers favorable prices on our products. In that event, our average selling prices and gross margins would decline. The loss of a key customer, a reduction in sales to any key customer or our inability to attract new significant customers could seriously impact our revenue and materially and adversely affect our results of operations.

We expect our operating results to fluctuate.

We expect our revenues and expense levels to vary in the future, making it difficult to predict our future operating results. In particular, we experience variability in demand for our products as our customers manage their product introduction dates and their inventories. Given the current global economic uncertainty, the demand for our products may be more varied and difficult to ascertain in a timely and efficient manner.

Additional factors that could cause our results to fluctuate include, among other things:

- our ability to retain, recruit and hire key executives, technical personnel and other employees in the positions and numbers, and with the experience and capabilities that we need;
- fluctuations in demand, sales cycles, product mix and prices for our products;
- the timing of our product introductions, and the variability in lead time between the time when a customer begins to design in one of our products and the time when the customer's end system goes into production and they begin purchasing our products;
- the forecasting, scheduling, rescheduling or cancellation of orders by our customers;
- our ability to successfully define, design and release new products in a timely manner that meet our customers' needs;
- changes in manufacturing costs, including wafer, test and assembly costs, mask costs, manufacturing yields and product quality and reliability;
- the timing and availability of adequate manufacturing capacity from our manufacturing suppliers;
- the timing of announcements by our competitors or us;
- future accounting pronouncements and changes in accounting policies;
- volatility in our stock price, which may lead to higher stock compensation expenses;
- general economic and political conditions in the countries where we operate or our products are sold or used; costs associated with litigation, especially related to intellectual property; and
- productivity and growth of our sales and marketing force.

Unfavorable changes in any of the above factors, most of which are beyond our control, could significantly harm our business and results of operations.

We may not sustain our growth rate, and we may not be able to manage any future growth effectively.

We have experienced significant growth in a short period of time. Our net revenues increased from approximately \$7.4 million in 2004 to approximately \$19.4 million in 2005, \$34.2 million in 2006, \$54.2 million in 2007, \$86.6 million in 2008, \$101.2 million in 2009 and \$206.5 million in 2010. We may not achieve similar growth rates in future periods. You should not rely on our operating results for any prior quarterly or annual periods as an indication of our future operating performance. If we are unable to maintain adequate revenue growth, our financial results could suffer and our stock price could decline.

To manage our growth successfully and to continue handling the responsibilities of being a public company, we believe we must effectively, among other things:

- recruit, hire, train and manage additional qualified engineers for our research and development activities, especially in the positions of design engineering, product and test engineering, and applications engineering;
- enhance our information technology support for enterprise resource planning and design engineering by adapting and expanding our systems and tool capabilities, and properly training new hires as to their use;
- expand our administrative, financial and operational systems, procedures and controls; and
- add additional sales personnel and expand sales offices.

If we are unable to manage our growth effectively, we may not be able to take advantage of market opportunities or develop new products and we may fail to satisfy customer requirements, maintain product quality, execute our business plan or respond to competitive pressures.

The average selling prices of products in our markets have historically decreased over time and will likely do so in the future, which could harm our revenues and gross profits.

Average selling prices of semiconductor products in the markets we serve have historically decreased over time. Our gross profits and financial results will suffer if we are unable to offset any reductions in our average selling prices by reducing our costs, developing new or enhanced products on a timely basis with higher selling prices or gross profits, or increasing our sales volumes. Additionally, because we do not operate our own manufacturing, assembly or testing facilities, we may not be able to reduce our costs as rapidly as companies that operate their own facilities, and our costs may even increase, which could also reduce our margins.

We may be unsuccessful in developing and selling new products or in penetrating new markets.

We operate in a dynamic environment characterized by rapidly changing technologies and industry standards and technological obsolescence. Our competitiveness and future success depend on our ability to design, develop, manufacture, assemble, test, market and support new products and enhancements on a timely and cost effective basis. A fundamental shift in technologies in any of our product markets could harm our competitive position within these markets. Our failure to anticipate these shifts, to develop new technologies or to react to changes in existing technologies could materially delay our development of new products, which could result in product obsolescence, decreased revenues and a loss of design wins to our competitors. The success of a new product depends on accurate forecasts of long-term market demand and future technological developments, as well as on a variety of specific implementation factors, including:

- timely and efficient completion of process design and transfer to manufacturing, assembly and test processes;

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- the quality, performance and reliability of the product; and
- effective marketing, sales and service.

If we fail to introduce new products that meet the demand of our customers or penetrate new markets that we target our resources on, our revenues will likely decrease over time and our financial condition could suffer. Additionally, if we concentrate resources on a new market that does not prove profitable or sustainable, our financial condition could decline.

Fluctuations in the mix of products sold may adversely affect our financial results.

Because of the wide price differences among our processors, the mix and types of performance capabilities of processors sold affect the average selling price of our products and have a substantial impact on our revenue. Generally, sales of higher performance products have higher gross margins than sales of lower performance products. We currently offer both higher and lower performance products in our NITROX, OCTEON, ECONA ARM and PureVu Video product families. During 2008 and in the first two quarters of 2009, we experienced a sales mix shift towards increased sales of lower performance, lower margin products, which negatively affected our overall gross margins. In the third and fourth quarters of 2009 compared to the first two quarters of 2009, the product mix moved towards higher performance and higher margin products and had been about the same level throughout 2010. If the sales mix shifts back to lower performance, lower margin products, our overall gross margins will be negatively affected. Fluctuations in the mix and types of our products may also affect the extent to which we are able to recover our fixed costs and investments that are associated with a particular product, and as a result can negatively impact our financial results.

The semiconductor and communications industries have historically experienced significant fluctuations with prolonged downturns, which could impact our operating results, financial condition and cash flows

The semiconductor industry has historically exhibited cyclical behavior, which at various times has included significant downturns in customer demand, including in late 2008 through 2009. Because a significant portion of our expenses is fixed in the near term or is incurred in advance of anticipated sales, we may not be able to decrease our expenses rapidly enough to offset any unanticipated shortfall in revenues. If this situation were to occur, it could adversely affect our operating results, cash flow and financial condition. Furthermore, the semiconductor industry has periodically experienced periods of increased demand and production constraints. If this happens in the future, we may not be able to produce sufficient quantities of our products to meet the increased demand. We may also have difficulty in obtaining sufficient wafer, assembly and test resources from our subcontract manufacturers. Any factor adversely affecting the semiconductor industry in general, or the particular segments of the industry that our products target, may adversely affect our ability to generate revenue and could negatively impact our operating results.

The communications industry has, in the past, experienced pronounced downturns, and these cycles may continue in the future. To respond to a downturn, many networking equipment providers may slow their research and development activities, cancel or delay new product development, reduce their inventories and take a cautious approach to acquiring our products, which would have a significant negative impact on our business. If this situation were to occur, it could adversely affect our operating results, cash flow and financial condition. In the future, any of these trends may also cause our operating results to fluctuate significantly from year to year, which may increase the volatility of the price of our stock.

Our products must meet exact specifications, and defects and failures may occur, which may cause customers to return or stop buying our products.

Our customers generally establish demanding specifications for quality, performance and reliability that our products must meet. However, our products are highly complex and may contain defects and failures when they

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are first introduced or as new versions are released. If defects and failures occur in our products during the design phase or after, we could experience lost revenues, increased costs, including warranty expense and costs associated with customer support, delays in or cancellations or rescheduling of orders or shipments, product returns or discounts, diversion of management resources or damage to our reputation and brand equity, and in some cases consequential damages, any of which would harm our operating results. In addition, delays in our ability to fill product orders as a result of quality control issues may negatively impact our relationship with our customers. We cannot assure you that we will have sufficient resources, including any available insurance, to satisfy any asserted claims.

We may have difficulty selling our products if our customers do not design our products into their systems, and the nature of the design process requires us to incur expenses prior to recognizing revenues associated with those expenses which may adversely affect our financial results.

One of our primary focuses is on winning competitive bid selection processes, known as “design wins,” to develop products for use in our customers’ products. We devote significant time and resources in working with our customers’ system designers to understand their future needs and to provide products that we believe will meet those needs and these bid selection processes can be lengthy. If a customer’s system designer initially chooses a competitor’s product, it becomes significantly more difficult for us to sell our products for use in that system because changing suppliers can involve significant cost, time, effort and risk for our customers. Thus, our failure to win a competitive bid can result in our foregoing revenues from a given customer’s product line for the life of that product. In addition, design opportunities may be infrequent or may be delayed. Our ability to compete in the future will depend, in large part, on our ability to design products to ensure compliance with our customers’ and potential customers’ specifications. We expect to invest significant time and resources and to incur significant expenses to design our products to ensure compliance with relevant specifications.

We often incur significant expenditures in the development of a new product without any assurance that our customers’ system designers will select our product for use in their applications. We often are required to anticipate which product designs will generate demand in advance of our customers expressly indicating a need for that particular design. Even if our customers’ system designers select our products, a substantial period of time will elapse before we generate revenues related to the significant expenses we have incurred.

The reasons for this delay generally include the following elements of our product sales and development cycle timeline and related influences:

- our customers usually require a comprehensive technical evaluation of our products before they incorporate them into their designs;
- it can take from nine months to three years from the time our products are selected to commence commercial shipments; and our customers may experience changed market conditions or product development issues. The resources devoted to product development and sales and marketing may not generate material revenue for us, and from time to time, we may need to write off excess and obsolete inventory if we have produced product in anticipation of expected demand. We may spend resources on the development of products that our customers may not adopt. If we incur significant expenses and investments in inventory in the future that we are not able to recover, and we are not able to compensate for those expenses, our operating results could be adversely affected. In addition, if we sell our products at reduced prices in anticipation of cost reductions but still hold higher cost products in inventory, our operating results would be harmed.

Additionally, even if system designers use our products in their systems, we cannot assure you that these systems will be commercially successful or that we will receive significant revenue from the sales of processors for those systems. As a result, we may be unable to accurately forecast the volume and timing of our orders and revenues associated with any new product introductions.

If customers do not believe our products solve a critical need, our revenues will decline.

Our products are used in networking and security equipment including routers, switches, UTM appliances, intelligent switches, application-aware gateways, triple-play gateways, WLAN and 3G access and aggregation devices, storage networking equipment, servers, intelligent network interface cards, IP surveillance systems, wireless HDMI cable replacement systems, video conferencing systems and connected home and office equipment.

In order to meet our growth and strategic objectives, providers of networking equipment must continue to incorporate our products into their systems and the demands for their systems must grow as well. Our future depends in large part on factors outside our control, and the sale of next-generation networks may not meet our revenue growth and strategic objectives.

Because a significant portion of our software and licenses revenues is derived from subscription-based software licenses, we are dependent upon the ability of our customers to develop and penetrate new markets successfully, and to develop new products for existing markets.

Our subscription-based license revenues depend both upon our ability to successfully negotiate such license agreements with our customers and, in turn, upon our customers' successful commercialization of their underlying products. As our open source business grows, we may not be able to rely on receiving per unit fees from our customers. For our open source business, we may instead need to rely on other fees to compensate for the subscription-based license fees that we have traditionally received for our proprietary products. Also, we derive significant revenues from customers that develop products in highly competitive and technologically complex markets such as the internet infrastructure, server and storage, digital consumer, aerospace and defense, industrial control, medical equipment, gaming, office automation and automotive markets. If these customers sell fewer products or otherwise face significant economic difficulties, particularly in the current global economic recession, our revenues may decline.

In the event we terminate one of our distributor arrangements, it could lead to a loss of revenues and possible product returns.

A portion of our sales is made through third-party distribution agreements. Termination of a distributor relationship, either by us or by the distributor, could result in a temporary or permanent loss of revenues, until a replacement distributor can be established to service the affected end-user customers. We may not be successful in finding suitable alternative distributors on satisfactory terms or at all and this could adversely affect our ability to sell in certain locations or to certain end-user customers. Additionally, if we terminate our relationship with a distributor, we may be obligated to repurchase unsold products. We record a reserve for estimated returns and price credits. If actual returns and credits exceed our estimates, our operating results could be harmed. Our arrangements with our distributors typically also include price protection provisions if we reduce our list prices.

We rely on our ecosystem partners to enhance our product offerings and our inability to continue to develop or maintain such relationships in the future would harm our ability to remain competitive.

We have developed relationships with third parties, which we refer to as ecosystem partners, which provide operating systems, tool support, reference designs and other services designed for specific uses with our SoCs. We believe that these relationships enhance our customers' ability to get their products to market quickly. If we are unable to continue to develop or maintain these relationships, we might not be able to enhance our customers' ability to commercialize their products in a timely fashion and our ability to remain competitive would be harmed.

The loss of any of our key personnel could seriously harm our business, and our failure to attract or retain specialized technical, management or sales and marketing talent could impair our ability to grow our business.

We believe our future success will depend in large part upon our ability to attract, retain and motivate highly skilled managerial, engineering, sales and marketing personnel. The loss of any key employees or the inability to attract, retain or motivate qualified personnel, including engineers and sales and marketing personnel, could delay the development and introduction of and harm our ability to sell our products. We believe that our future success is highly dependent on the contributions of Syed Ali, our co-founder, President and Chief Executive Officer, and others. None of our employees have fixed-term employment contracts; they are all at-will employees. The loss of the services of Mr. Ali, other executive officers or certain other key personnel could materially and adversely affect our business, financial condition and results of operations. For instance, if any of these individuals were to leave our company unexpectedly, we could face substantial difficulty in hiring qualified successors and could experience a loss in productivity during the search for and while any such successor is integrated into our business and operations.

There is currently a shortage of qualified technical personnel with significant experience in the design, development, manufacturing, marketing and sales of integrated circuits. In particular, there is a shortage of engineers who are familiar with the intricacies of the design and manufacture of multi-core networking processors, and competition for these engineers is intense. Our key technical personnel represent a significant asset and serve as the source of our technological and product innovations. We may not be successful in attracting, retaining and motivating sufficient numbers of technical personnel to support our anticipated growth.

To date, we have relied primarily on our direct marketing and sales force to drive new customer design wins and to sell our products. Because we are looking to expand our customer base and grow our sales to existing customers, we will need to hire additional qualified sales personnel in the near term and beyond if we are to achieve revenue growth. The competition for qualified marketing and sales personnel in our industry, and particularly in Silicon Valley, is very intense. If we are unable to hire, train, deploy and manage qualified sales personnel in a timely manner, our ability to grow our business will be impaired. In addition, if we are unable to retain our existing sales personnel, our ability to maintain or grow our current level of revenues will be adversely affected. Further, if we are unable to integrate and retain personnel acquired through our various acquisitions, we may not be able to fully capitalize on such acquisitions.

In addition, we rely on stock-based awards as one means for recruiting, motivating and retaining highly skilled talent. If the value of such stock awards does not appreciate as measured by the performance of the price of our common stock or if our share-based compensation otherwise ceases to be viewed as a valuable benefit, our ability to attract, retain, and motivate employees could be weakened, which could harm our results of operations. The decline in the trading price of our common stock would result in the exercise price of a portion of our outstanding options to exceed the current trading price of our common stock, reducing the effectiveness of these stock-based awards. Consequently, we may not continue to successfully attract and retain key personnel which would harm our business.

We have a limited operating history, and we may have difficulty accurately predicting our future revenues for the purpose of appropriately budgeting and adjusting our expenses.

We were established in 2000. Since we have had only eight quarters of operating profitability, we do not have an extended history from which to predict and manage profitability. Our limited operating experience, a dynamic and rapidly evolving market in which we sell our products, our dependence on a limited number of customers, as well as numerous other factors beyond our control, including general market conditions, impede our ability to forecast quarterly and annual revenues accurately. As a result, we could experience budgeting and cash flow management problems, unexpected fluctuations in our results of operations and other difficulties, any of which could make it difficult for us to attain and maintain profitability and could increase the volatility of the market price of our common stock.

Some of our operations and a significant portion of our customers and contract manufacturers are located outside of the United States, which subjects us to additional risks, including increased complexity and costs of managing international operations and geopolitical instability.

We have international sales offices and research and development facilities and we conduct, and expect to continue to conduct, a significant amount of our business with companies that are located outside the United States, particularly in Asia and Europe. Even customers of ours that are based in the United States often use contract manufacturers based in Asia to manufacture their systems, and it is the contract manufacturers that purchase products directly from us. As a result of our international focus, we face numerous challenges, including:

- increased complexity and costs of managing international operations;
- longer and more difficult collection of receivables;
- difficulties in enforcing contracts generally;
- geopolitical and economic instability and military conflicts;
- limited protection of our intellectual property and other assets;
- compliance with local laws and regulations and unanticipated changes in local laws and regulations, including tax laws and regulations;
- trade and foreign exchange restrictions and higher tariffs;
- travel restrictions;
- timing and availability of import and export licenses and other governmental approvals, permits and licenses, including export classification requirements;
- foreign currency exchange fluctuations relating to our international operating activities;
- transportation delays and limited local infrastructure and disruptions, such as large scale outages or interruptions of service from utilities or telecommunications providers;
- difficulties in staffing international operations;
- heightened risk of terrorism;
- local business and cultural factors that differ from our normal standards and practices;
- differing employment practices and labor issues;
- regional health issues and natural disasters; and
- work stoppages.

We outsource our wafer fabrication, assembly, testing, warehousing and shipping operations to third parties, and rely on these parties to produce and deliver our products according to requested demands in specification, quantity, cost and time.

We rely on third parties for substantially all of our manufacturing operations, including wafer fabrication, assembly, testing, warehousing and shipping. We depend on these parties to supply us with material of a requested quantity in a timely manner that meets our standards for yield, cost and manufacturing quality. We do not have any long-term supply agreements with our manufacturing suppliers. Any problems with our manufacturing supply chain could adversely impact our ability to ship our products to our customers on time and in the quantity required, which in turn could cause an unanticipated decline in our sales and possibly damage our customer relationships.

The fabrication of integrated circuits is a complex and technically demanding process. Our foundries could, from time to time, experience manufacturing defects and reduced manufacturing yields. Changes in manufacturing processes or the inadvertent use of defective or contaminated materials by our foundries could

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result in lower than anticipated manufacturing yields or unacceptable performance. Many of these problems are difficult to detect at an early stage of the manufacturing process and may be time consuming and expensive to correct. Poor yields from our foundries, or defects, integration issues or other performance problems in our products could cause us significant customer relations and business reputation problems, harm our financial results and result in financial or other damages to our customers. Our customers could also seek damages from us for their losses. A product liability claim brought against us, even if unsuccessful, would likely be time consuming and costly to defend.

Our products are manufactured at a limited number of locations. If we experience manufacturing problems at a particular location, we would be required to transfer manufacturing to a backup location or supplier. Converting or transferring manufacturing from a primary location or supplier to a backup fabrication facility could be expensive and could take one to two quarters. During such a transition, we would be required to meet customer demand from our then-existing inventory, as well as any partially finished goods that can be modified to the required product specifications. We do not seek to maintain sufficient inventory to address a lengthy transition period because we believe it is uneconomical to keep more than minimal inventory on hand. As a result, we may not be able to meet customer needs during such a transition, which could delay shipments, cause a production delay or stoppage for our customers, result in a decline in our sales and damage our customer relationships. In addition, we have no long-term supply contracts with the foundries that we work with. Availability of foundry capacity has in the recent past been reduced due to strong demand. The ability of each foundry to provide us with semiconductor devices is limited by its available capacity and existing obligations. Foundry capacity may not be available when we need it or at reasonable prices which could cause us to be unable to meet customer needs, delay shipments, because a production delay or stoppage for our customers, result in a decline in our sales and harm our financial results.

In addition, a significant portion of our sales are to customers that practice just-in-time order management from their suppliers, which gives us a very limited amount of time in which to process and complete these orders. As a result, delays in our production or shipping by the parties to whom we outsource these functions could reduce our sales, damage our customer relationships and damage our reputation in the marketplace, any of which could harm our business, results of operations and financial condition.

Any increase in the manufacturing cost of our products could reduce our gross margins and operating profit.

The semiconductor business exhibits ongoing competitive pricing pressure from customers and competitors. Accordingly, any increase in the cost of our products, whether by adverse purchase price variances or adverse manufacturing cost variances, will reduce our gross margins and operating profit. We do not have any long-term supply agreements with our manufacturing suppliers and we typically negotiate pricing on a purchase order by purchase order basis. Consequently, we may not be able to obtain price reductions or anticipate or prevent future price increases from our suppliers.

Some of our competitors may be better financed than we are, may have long-term agreements with our main foundries and may induce our foundries to reallocate capacity to those customers. This reallocation could impair our ability to secure the supply of components that we need. Although we use several independent foundries to manufacture substantially all of our semiconductor products, most of our components are not manufactured at more than one foundry at any given time, and our products typically are designed to be manufactured in a specific process at only one of these foundries. Accordingly, if one of our foundries is unable to provide us with components as needed, we could experience significant delays in securing sufficient supplies of those components. We cannot assure you that any of our existing or new foundries will be able to produce integrated circuits with acceptable manufacturing yields, or that our foundries will be able to deliver enough semiconductor devices to us on a timely basis, or at reasonable prices. These and other related factors could impair our ability to meet our customers' needs and have a material and adverse effect on our operating results.

In order to secure sufficient foundry capacity when demand is high and mitigate the risks described in the foregoing paragraph, we may enter into various arrangements with suppliers that could be costly and harm our operating results, such as nonrefundable deposits with or loans to foundries in exchange for capacity commitments and contracts that commit us to purchase specified quantities of integrated circuits over extended periods. We may not be able to make any such arrangement in a timely fashion or at all, and any arrangements may be costly, reduce our financial flexibility, and not be on terms favorable to us. Moreover, if we are able to secure foundry capacity, we may be obligated to use all of that capacity or incur penalties. These penalties may be expensive and could harm our financial results.

If we fail to maintain an effective system of internal controls, we may not be able to accurately report our financial results or prevent fraud.

Effective internal controls are necessary for us to provide reliable financial reports and effectively prevent fraud. Any inability to provide reliable financial reports or prevent fraud could harm our business. The Sarbanes-Oxley Act of 2002 requires management and our independent registered public accounting firm to evaluate and assess the effectiveness of our internal control over financial reporting. These Sarbanes-Oxley Act requirements may be modified, supplemented or amended from time to time. Implementing these changes may take a significant amount of time and may require specific compliance training of our personnel. In the future, we may discover areas of our internal controls that need improvement. If our independent registered public accounting firm or we discover a material weakness, the disclosure of that fact, even if quickly remedied, could reduce the market's confidence in our financial statements and harm our stock price. We may not be able to effectively and timely implement necessary control changes and employee training to ensure continued compliance with the Sarbanes-Oxley Act and other regulatory and reporting requirements. Our rapid growth in recent years and our possible future expansion through acquisitions, present challenges to maintain the internal control and disclosure control standards applicable to public companies. If we fail to maintain effective internal controls, we could be subject to regulatory scrutiny and sanctions and investors could lose confidence in the accuracy and completeness of our financial reports.

Our acquisition strategy may result in unanticipated accounting charges or otherwise adversely affect our results of operations, and result in difficulties in assimilating and integrating the operations, personnel, technologies and products of acquired companies or businesses, or be dilutive to existing shareholders.

In May 2008, we acquired certain assets of Parallogic Corporation, in August 2008 we acquired substantially all of the assets of Star Semiconductor Corporation, in December 2008, we acquired W&W Communications, Inc., in December 2009 we acquired MontaVista Software, Inc., and in October 2010, we acquired substantially all of the assets of Celestial Systems. In January 2011, we acquired Wavesat, Inc. and we expect that we will in the future continue to acquire companies or assets of companies that we believe to be complementary to our business, including for the purpose of expanding our new product design capacity, introducing new design, market or application skills or enhancing and expanding our existing product lines. In connection with any such future acquisitions, we may need to use a significant portion of our available cash, issue additional equity securities that would dilute current stockholders' percentage ownership and incur substantial debt or contingent liabilities. Such actions could adversely impact our operating results and the market price of our common stock. In addition, difficulties may occur in assimilating and integrating the operations, personnel, technologies, and products of acquired companies or businesses. In addition, key personnel of an acquired company may decide not to work for us. Moreover, to the extent we acquire a company with existing products; those products may have lower gross margins than our customary products, which could adversely affect our gross margin and operating results. If an acquired company also has inventory that we assume, we will be required to write up the carrying value of that inventory to fair value. When that inventory is sold, the gross margins for those products are reduced and our gross margins for that period are negatively affected. Furthermore, the purchase price of any acquired businesses may exceed the current fair values of the net tangible assets of such acquired businesses. As a result, we would be required to record material amounts of goodwill, and acquired in-process research and development charges and other intangible assets, which could

result in significant impairment and acquired in-process research and development charges and amortization expense in future periods. These charges, in addition to the results of operations of such acquired businesses and potential restructuring costs associated with an acquisition, could have a material adverse effect on our business, financial condition and results of operations. We cannot forecast the number, timing or size of future acquisitions, or the effect that any such acquisitions might have on our operating or financial results.

We rely on third-party technologies for the development of our products and our inability to use such technologies in the future would harm our ability to remain competitive.

We rely on third parties for technologies that are integrated into our products, such as wafer fabrication and assembly and test technologies used by our contract manufacturers, as well as licensed MIPS and ARM architecture technologies. If we are unable to continue to use or license these technologies on reasonable terms, or if these technologies fail to operate properly, we may not be able to secure alternatives in a timely manner and our ability to remain competitive would be harmed. In addition, if we are unable to successfully license technology from third parties to develop future products, we may not be able to develop such products in a timely manner or at all.

Our failure to protect our intellectual property rights adequately could impair our ability to compete effectively or to defend ourselves from litigation, which could harm our business, financial condition and results of operations.

We rely primarily on patent, copyright, trademark and trade secret laws, as well as confidentiality and nondisclosure agreements and other methods, to protect our proprietary technologies and know-how. We have been issued 25 patents in the United States and 5 patents in foreign countries and have an additional 23 patent applications pending in the United States and 19 patent applications pending in foreign countries. Even if the pending patent applications are granted, the rights granted to us may not be meaningful or provide us with any commercial advantage. For example, these patents could be opposed, contested, circumvented or designed around by our competitors or be declared invalid or unenforceable in judicial or administrative proceedings. The failure of our patents to adequately protect our technology might make it easier for our competitors to offer similar products or technologies. Our foreign patent protection is generally not as comprehensive as our U.S. patent protection and may not protect our intellectual property in some countries where our products are sold or may be sold in the future. Many U.S.-based companies have encountered substantial intellectual property infringement in foreign countries, including countries where we sell products. Even if foreign patents are granted, effective enforcement in foreign countries may not be available.

Monitoring unauthorized use of our intellectual property is difficult and costly. Although we are not aware of any unauthorized use of our intellectual property in the past, it is possible that unauthorized use of our intellectual property may have occurred or may occur without our knowledge. We cannot assure you that the steps we have taken will prevent unauthorized use of our intellectual property.

Our failure to effectively protect our intellectual property could reduce the value of our technology in licensing arrangements or in cross-licensing negotiations, and could harm our business, results of operations and financial condition. We may in the future need to initiate infringement claims or litigation. Litigation, whether we are a plaintiff or a defendant, can be expensive, time consuming and may divert the efforts of our technical staff and managerial personnel, which could harm our business, whether or not such litigation results in a determination favorable to us.

Our open source business could be seriously harmed by the outcome of lawsuits challenging the use and distribution of Linux-based software products.

We rely on Linux system software as the basis of our software products. Several lawsuits have been filed challenging the right to use and/or distribute Linux system software and software applications based on

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Linux. Although we are not a party to or directly involved in any of the lawsuits relating to Linux, we expect that further lawsuits could be filed against Linux in the future which would challenge the use and distribution of our Linux-based software products. It is impossible to estimate or anticipate all of the financial or other impacts the results of these litigation matters could have on our business. Success by a plaintiff in one or more of these lawsuits could have a material adverse effect on our open source business.

Legal uncertainty surrounding the use and distribution of open source software may cause the market for Linux-based products to disappear, fail to further develop or fail to develop at a rate sufficient to sustain our business.

The majority of our open source software products are licensed from third parties under the GNU General Public License (the “GPL”), and similar open source licenses. There remains some significant confusion among our customers about the scope of their obligations and rights with respect to using and distributing Linux-based products. One element of this confusion is whether the GPL and other open source licenses require customers to (i) make all of the source code for their products available to the public, and/or (ii) license all of the code underlying such products under an open source license. There is little or no legal precedent for interpreting the terms of the GPL and similar open source licenses, including the determination of which types of programs or products would be considered derived works and thus potentially subject to the terms of such open source licenses. If this confusion remains, increases or is prolonged by litigation, the market for Linux-based products may disappear, fail to further develop or fail to develop at a rate sufficient to sustain our open source business.

Our open source business depends on Linux developers to continue to improve Linux and Linux-based applications that are incorporated into our open source products.

Our ability to release major upgrades of MontaVista Linux is largely dependent upon the release of new versions of the Linux kernel. The Linux kernel is the heart of the Linux system software. Linus Torvalds and a small group of engineers are primarily responsible for the development, evolution and maintenance of the Linux kernel. In addition, other individuals and small groups of developers are largely responsible for Linux programs tailored to specific tasks or computer architectures. If Mr. Torvalds or other key developers fail to further develop the Linux kernel or other programs on which we rely, we will have to either develop them ourselves or rely on another party for development. This development effort could be costly and time consuming, and could delay or entirely prevent our open source product release and upgrade schedule.

We may be unsuccessful in marketing our open source products because we encounter widespread negative perceptions about Linux and open source software in general.

Some people still falsely believe that anyone who writes a software program that runs on Linux will necessarily have to publicly disclose the source code for that software. If a potential customer believes their source code will need to be made public if they use our open source product, they may be less likely to purchase our open source product. We devote substantial time and attention helping potential customers understand the legal implications of using our open source products, including that fact that in most instances, applications developed to run on Linux may be distributed under a proprietary license. In many cases, we are required to address these issues at different levels across an organization (such as at the engineering, managerial and executive levels), which can be very time consuming. We are sometimes unsuccessful at convincing a potential customer that using Linux-based system software will not have negative consequences for that customer. Furthermore, many potential customers believe that they should not be required to pay for our open source products, since our open-source products are based on open source (also sometimes called “free”) software. They believe that open source products are all publicly available at no charge. There is also the misconception that distributors of Linux software cannot offer warranties or indemnifications with respect to Linux software. Each of these customer fears or misperceptions could cause us to lose potential orders or cause our customers to delay purchase decisions, which could significantly lengthen our sales cycle. These misperceptions could cause the market for Linux-based products to disappear, fail to further develop, or fail to develop at a rate sufficient to sustain our open source business.

Our open source software may contain errors or defects that could delay introduction of new products, result in costly remedial expenditures or cause disputes with customers.

Most of the open source software that we sell and distribute is developed by third parties with whom we have no business relationship, including thousands of individual software programmers. In order to successfully release our open source products, we must assemble and test software developed by thousands of disparate sources. Despite our efforts, errors have been and may continue to be found in our open source products. If errors are discovered, we may not be able to successfully correct them in a timely manner or at all. Errors and failures in our open source products could result in a loss of, or delay in, market acceptance of our open-source products and could damage our reputation and our ability to convince commercial users of the benefits of Linux-based systems software and other open source software products. In addition, we may need to make significant expenditures of capital resources in order to reduce errors and failures.

We face intense competition related to our open source products, and expect competition to increase in the future, which could reduce our open source-related revenue and customer base.

The market for Linux-based systems software is highly competitive, and we expect competition to intensify in the future. We consider the primary competitors for our MontaVista software products to be Wind River Systems, Inc., a subsidiary of Intel Corporation and, to a lesser extent, Canonical Programming, inc. and Mentor Graphics Corporation. In addition, potential customers for our open source products may believe that they can build their own open source product cheaper or more efficiently than purchasing our products.

In addition to competitors in the business of distributing a commercial Linux-based operating system, we face competition from certain hardware companies who offer Linux-based operating systems and related software components at little or no charge. We also face competition from Linux-based software distributions provided by new and emerging consortiums and software stacks such as Meego, Linaro, Moblin and Android. And because, apart from such hardware vendors and consortiums, there is a large Linux code base generally available at no charge, certain customers or potential customers have made, and will continue to make, efforts to develop their own Linux-based operating system without purchasing or otherwise obtaining it from a third-party vendor. To the extent that the quality and availability of non-commercial Linux-based operating system software continues to improve, it could have a material adverse effect on our ability to sell open source software.

Assertions by third parties of infringement by us of their intellectual property rights could result in significant costs and cause our operating results to suffer.

The semiconductor industry is characterized by vigorous protection and pursuit of intellectual property rights and positions, which has resulted in protracted and expensive litigation for many companies. We expect that in the future we may receive communications from various industry participants alleging our infringement of their patents, trade secrets or other intellectual property rights. Any lawsuits resulting from such allegations could subject us to significant liability for damages and invalidate our proprietary rights. Any potential intellectual property litigation also could force us to do one or more of the following:

- stop selling products or using technology that contain the allegedly infringing intellectual property;
- lose the opportunity to license our technology to others or to collect royalty payments based upon successful protection and assertion of our intellectual property against others; incur significant legal expenses;
- pay substantial damages to the party whose intellectual property rights we may be found to be infringing;
- redesign those products that contain the allegedly infringing intellectual property; or
- attempt to obtain a license to the relevant intellectual property from third parties, which may not be available on reasonable terms or at all.

Any significant impairment of our intellectual property rights from any litigation we face could harm our business and our ability to compete.

Our customers could also become the target of litigation relating to the patent and other intellectual property rights of others. This could trigger technical support and indemnification obligations in some of our licenses or customer agreements. These obligations could result in substantial expenses, including the payment by us of costs and damages relating to claims of intellectual property infringement. In addition to the time and expense required for us to provide support or indemnification to our customers, any such litigation could disrupt the businesses of our customers, which in turn could hurt our relationships with our customers and cause the sale of our products to decrease. We cannot assure you that claims for indemnification will not be made or that if made, such claims would not have a material adverse effect on our business, operating results or financial conditions.

Our third-party contractors are concentrated primarily in Asia, an area subject to earthquake and other risks. Any disruption to the operations of these contractors could cause significant delays in the production or shipment of our products.

Substantially all of our products are manufactured by third-party contractors located in Taiwan and to a lesser extent manufactured by third party contractors located in Japan, Malaysia and Korea. The risk of an earthquake in any of those countries or elsewhere in Asia is significant due to the proximity of major earthquake fault lines to the facilities of our foundries and assembly and test subcontractors. For example, several major earthquakes have occurred in Taiwan and Japan since our incorporation in 2000. Although our third-party contractors did not suffer any significant damage as a result of these most recent earthquakes, the occurrence of additional earthquakes or other natural disasters could result in the disruption of our foundry or assembly and test capacity. Any disruption resulting from such events could cause significant delays in the production or shipment of our products until we are able to shift our manufacturing, assembling or testing from the affected contractor to another third-party vendor. We may not be able to obtain alternate capacity on favorable terms, if at all.

We may experience difficulties in transitioning to new wafer fabrication process technologies or in achieving higher levels of design integration, which 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 semiconductor products to increasingly smaller line width geometries. This transition requires us to modify our designs to work with the manufacturing processes of our foundries. We periodically evaluate the benefits, on a product-by-product basis, of migrating to new process technologies to reduce cost and improve performance. We may face difficulties, delays and expenses as we continue to transition our products to new processes. We are dependent on our relationships with our foundry contractors to transition to new processes successfully. We cannot assure you that the foundries that we use will be able to effectively manage the transition or that we will be able to maintain our existing foundry relationships or develop new ones. If any of our foundry contractors or we experience significant delays in this transition or fail to efficiently implement this transition, we could experience reduced manufacturing yields, delays in product deliveries and increased expenses, all of which could harm our relationships with our customers and our results of operations. As new 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.

Our investment portfolio may become impaired by further deterioration of the capital markets.

Our cash equivalents at December 31, 2010 consisted primarily of an investment in a money market fund, which is invested primarily in United States treasury securities, bonds of government agencies, and corporate bonds. We follow an established investment policy and set of guidelines to monitor, manage and limit our exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits our exposure to any one issuer, as well as our maximum exposure to various asset classes.

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As a result of current adverse financial market conditions, investments in some financial instruments, such as structured investment vehicles, sub-prime mortgage-backed securities and collateralized debt obligations, may pose risks arising from liquidity and credit concerns. As of December 31, 2010, we had no direct holdings in these categories of investments and our indirect exposure to these financial instruments through our holdings in money market instruments was immaterial. As of December 31, 2010, we had no impairment charge associated with our cash equivalents relating to such adverse financial market conditions. Although we believe our current investment portfolio has very little risk of impairment, we cannot predict future market conditions or market liquidity and can provide no assurance that our investment portfolio will remain unimpaired.

We may need to raise additional capital, which might not be available or which, if available, may be on terms that are not favorable to use.

We believe our existing cash and cash equivalent balances and cash expected to be generated from our operations will be sufficient to meet our working capital, capital expenditures and other needs for at least the next 12 months. In the future, we may need to raise additional funds, and we cannot be certain that we will be able to obtain additional financing on favorable terms, if at all. If we issue equity securities to raise additional funds, the ownership percentage of our stockholders would be reduced, and the new equity securities may have rights, preferences or privileges senior to those of existing holders of our common stock. If we borrow money, we may incur significant interest charges, which could harm our profitability. Holders of debt would also have rights, preferences or privileges senior to those of existing holders of our common stock. If we cannot raise needed funds on acceptable terms, 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 harm our business, operating results and financial condition.

We may incur impairments to goodwill or long-lived assets.

We review our long-lived assets, including goodwill and other intangible assets, for impairment annually in the fourth quarter or whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable.

Significant negative industry or economic trends, including a significant decline in the market price of our common stock, reduced estimates of future cash flows for our reporting units or disruptions to our business could lead to an impairment charge of our long-lived assets, including goodwill and other intangible assets.

Our valuation methodology for assessing impairment requires management to make judgments and assumptions based on historical experience and to rely heavily on projections of future operating performance. We operate in highly competitive environments and projections of future operating results and cash flows may vary significantly from results. Additionally, if our analysis results in impairment to our goodwill, we may be required to record a charge to earnings in our financial statements during a period in which such impairment is determined to exist, which may negatively impact our results of operations.

The complexity of accounting regulations and related interpretations and policies, particularly those related to revenue recognition, could materially affect our financial results for a given period.

Although we use standardized agreements designed to meet current revenue recognition criteria under generally accepted accounting principles, we must often negotiate and revise terms and conditions of these standardized agreements, particularly in multi-element license and services transactions. As we increase our transactions to more complex multi-element transactions, negotiation of mutually acceptable terms and conditions may require us to defer recognition of revenue on such licenses. We believe that we are in compliance with the guidance as provided under multiple element arrangements; however, bigger and more complex, multi-element transactions may require additional accounting analysis to account for them accurately. Errors in such analysis in any period could lead to unanticipated changes in our revenue accounting practices and may affect the

timing of revenue recognition, which could adversely affect our financial results. If we later discover that we have interpreted and applied revenue recognition rules differently than prescribed by generally accepted accounting principles in the U.S., we could be required to devote significant management resources, and incur the expense associated with an audit, restatement or other examination of our financial statements.

Our future effective tax rates could be affected by the allocation of our income among different geographic regions, which could affect our future operating results, financial condition and cash flows.

As a global Company, we are subject to taxation in the United States and various other countries and states. Significant judgment is required to determine and estimate worldwide tax liabilities. We may further expand our international operations and staff to better support our international markets. As a result, we anticipate that our consolidated pre-tax income will be subject to foreign tax at relatively lower tax rates when compared to the United States federal statutory tax rate and, as a consequence, our effective income tax rate is expected to be lower than the United States federal statutory rate. Our future effective income tax rates could be adversely affected if tax authorities challenge our international tax structure or if the relative mix of United States and international income changes for any reason, or US tax laws were to change in the future. Accordingly, there can be no assurance that our income tax rate will be less than the United States federal statutory rate.

Any significant change in our future effective tax rates could adversely impact our consolidated financial position, results of operations and cash flows. Our future effective tax rates may be adversely affected by a number of factors including:

- changes in tax laws in the countries in which we operate or the interpretation of such laws;
- increase in expenses not deductible for tax purposes, including write-offs of acquired in-process research and development and impairment of goodwill in connection with the acquisitions;
- changes in share based compensation expense
- changes in generally accepted accounting principles; and
- our ability to use tax attributes such as research and development tax credits and net operating losses of acquired companies to the fullest extent.

Changes in valuation allowance of deferred tax assets may affect our future operating results

We record a valuation allowance to reduce our net deferred tax assets to the amount that we believe is more likely than not to be realized. In assessing the need for a valuation allowance, we consider historical levels of income, expectations and risks associated with estimates of future taxable income and ongoing prudent and practical tax planning strategies. On a periodic basis we evaluate our deferred tax asset balance for realizability. To the extent we believe it is more likely than not that some portion of our deferred tax assets will not be realized, we will increase the valuation allowance against the deferred tax assets. Realization of our deferred tax assets is dependent primarily upon future taxable income in related tax jurisdictions.

As of December 31, 2010, we assessed that it is more-likely-than-not that we will realize our federal deferred tax assets based on positive evidence of our history of profits and projections of future income. Accordingly, we only applied a valuation allowance on the state deferred tax assets. In the event future income by jurisdiction is less than what is currently projected, we may be required to record a valuation allowance to these deferred tax assets in jurisdictions where realization of such assets are no longer more-likely-than-not. This would have adverse impact in our operating results (see Note 9, "Income Taxes", of the Notes to Consolidated Financial Statements).

Risks Related to our Common Stock

The market price of our common stock may be volatile, which could cause the value of your investment to decline.

The trading prices of the securities of technology companies have been highly volatile. Further, our common stock has a limited trading history. Since our initial public offering in May 2007 through December 31, 2010, our stock price has fluctuated from a low of \$7.61 to a high of \$39.56. We cannot predict the extent to which the trading market will continue to develop or how liquid the market may become. The trading price of our common stock is therefore likely to be highly volatile and could be subject to wide fluctuations in price in response to various factors, some of which are beyond our control. These factors include:

- quarterly variations in our results of operations or those of our competitors;
- general economic conditions and slow or negative growth of related markets;
- announcements by us or our competitors of design wins, acquisitions, new products, significant contracts, commercial relationships or capital commitments;
- our ability to develop and market new and enhanced products on a timely basis;
- commencement of, or our involvement in, litigation;
- disruption to our operations;
- the emergence of new sales channels in which we are unable to compete effectively;
- any major change in our board of directors or management;
- changes in financial estimates including our ability to meet our future revenue and operating profit or loss projections;
- changes in governmental regulations; and
- changes in earnings estimates or recommendations by securities analysts.

Furthermore, the stock market in general, and the market for semiconductor and other technology companies in particular, have experienced price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of those companies. These broad market and industry factors may seriously harm the market price of our common stock, regardless of our actual operating performance. These trading price fluctuations may also make it more difficult for us to use our common stock as a means to make acquisitions or to use options to purchase our common stock to attract and retain employees. In addition, in the past, following periods of volatility in the overall market and the market price of a company's securities, securities class action litigation has often been instituted against these companies. This litigation, if instituted against us, could result in substantial costs and a diversion of our management's attention and resources.

Future sales of our common stock in the public market could cause our stock price to fall.

Sales of a substantial number of shares of our common stock in the public market, or the perception that these sales might occur, could depress the market price of our common stock and could impair our ability to raise capital through the sale of additional equity securities. As of December 31, 2010, we had 46,338,336 shares of common stock outstanding, all of which shares were eligible for sale in the public market, subject in some cases to the volume limitations and manner of sale requirements under Rule 144.

In addition, we have filed registration statements on Form S-8 under the Securities Act of 1933, as amended, to register the shares of our common stock reserved for issuance under our stock option plans, and intend to file additional registration statements on Form S-8 to register the shares automatically added each year to the share reserves under these plans.

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Pursuant to the terms of a Registration Rights Agreement dated December 14, 2009 we entered into with the selling stockholders, we have filed a registration statement under the Securities Act, registering the resale of the 1,467,612 shares of common stock we issued to the selling stockholders pursuant to that certain Agreement and Plan of Merger and Reorganization, dated November 6, 2009, among Cavium Networks, MV Acquisition Corporation, a Delaware corporation and wholly owned subsidiary of Cavium Networks, Mantra, LLC, a Delaware limited liability company and wholly owned subsidiary of Cavium Networks, MontaVista Software, Inc., a Delaware corporation and with respect to sections 9 and 10.1 of the Merger Agreement, Thomas Kelly as the MontaVista stockholders' agent.

Delaware law and our amended and restated certificate of incorporation and bylaws contain provisions that could delay or discourage takeover attempts that stockholders may consider favorable.

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

- the division of our board of directors into three classes;
- the right of the board of directors to elect a director to fill a vacancy created by the expansion of the board of directors or due to the resignation or departure of an existing board member;
- the prohibition of cumulative voting in the election of directors, which would otherwise allow less than a majority of stockholders to elect director candidates;
- the requirement for the advance notice of nominations for election to the board of directors or for proposing matters that can be acted upon at a stockholders' meeting;
- the ability of our board of directors to alter our bylaws without obtaining stockholder approval;
- the ability of the board of directors to issue, without stockholder approval, up to 10,000,000 shares of preferred stock with terms set by the board of directors, which rights could be senior to those of our common stock;
- the elimination of the rights of stockholders to call a special meeting of stockholders and to take action by written consent in lieu of a meeting;
- the required approval of at least 66 2/3% of the shares entitled to vote at an election of directors to adopt, amend or repeal our bylaws or repeal the provisions of our amended and restated certificate of incorporation regarding the election and removal of directors and the inability of stockholders to take action by written consent in lieu of a meeting; and
- the required approval of at least a majority of the shares entitled to vote at an election of directors to remove directors without cause.

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

Item 1B. *Unresolved Staff Comments*

Not applicable.

Item 2. Properties

Our principal executive office is located in a leased facility in Mountain View, California, consisting of approximately 32,500 square feet of office space under lease that expires at the end of August 2011. This facility accommodates our principal software engineering, sales, marketing, operations and finance and administrative activities.

Our semiconductor product segment occupies a shared portion of the leased facility in Mountain View, California. In connection with our acquisition of W&W, we assumed W&W's lease of office space in Sunnyvale, California consisting of approximately 10,600 square feet that expired in January 2011. We also occupy space in Marlborough, Massachusetts, consisting of approximately 74,700 square feet of office space under a lease that expires at the end of April 2013, which accommodates our product design team. Internationally, we also lease offices in Hyderabad, Chennai and Bangalore, India, consisting of approximately 38,200 square feet that expires at the end of October 2012 and May 2013, which accommodates our product design team. In addition, we lease office spaces that are not considered principal offices in Beijing, China, Hsin-Chu, Taiwan and Madrid, Spain which accommodates our product design teams.

Our software and services segment occupies mainly the assumed MontaVista's leased office space in Sunnyvale, California consisting of approximately 82,000 square feet that expires in January 2013.

We do not own any real property. We believe that our leased facilities are adequate to meet our current needs and that additional facilities are available for lease to meet future needs.

Item 3. Legal Proceedings

From time to time, we may become involved in legal proceedings arising in the ordinary course of our business. As of the date of this Annual Report on Form 10-K, we are not currently a party to any legal proceedings the outcome of which, if determined adversely to us, would individually or in the aggregate have a material adverse effect on our business, operating results, financial condition or cash flows.

Item 4. Reserved

Part II

Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities*

Market Information for Common Stock

Our common stock has been quoted on The NASDAQ Global Market under the symbol "CAVM" since our initial public offering on May 2, 2007. Prior to that time, there was no public market for our common stock. As of February 24, 2011, there were approximately 92 holders of record of our common stock.

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The following table sets forth for the indicated periods the high and low sales prices of our common stock as reported by The NASDAQ Global Market.

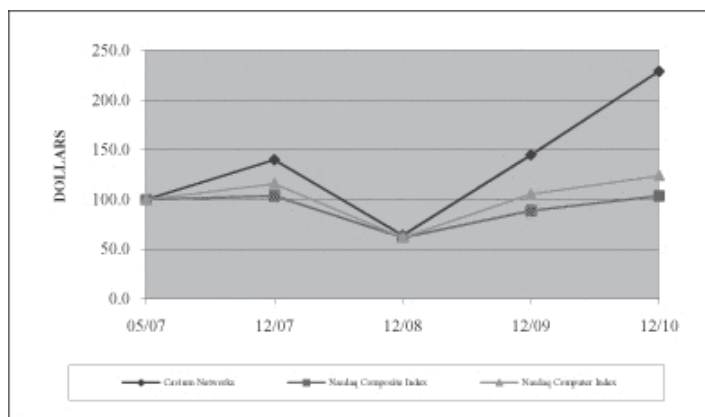
	High	Low
First Quarter of 2010	\$ 25.74	\$21.59
Second Quarter of 2010	\$ 29.02	\$ 24.62
Third Quarter of 2010	\$ 31.11	\$22.66
Fourth Quarter of 2010	\$39.56	\$ 28.17
First Quarter of 2009	\$ 12.44	\$ 7.61
Second Quarter of 2009	\$ 17.53	\$ 11.40
Third Quarter of 2009	\$ 22.03	\$ 16.13
Fourth Quarter of 2009	\$ 24.41	\$ 18.52

Dividend Policy

We have never paid any cash dividends on our common stock. Our board of directors currently intends to retain any future earnings to support operations and to finance the growth and development of our business and does not intend to pay cash dividends on our common stock for the foreseeable future. Any future determination related to our dividend policy will be made at the discretion of our board.

Stock Performance Graph(1)

The graph set forth below shows a comparison of the cumulative total stockholder return on our common stock between May 2, 2007 (the date of our initial public offering) and December 31, 2010, with the cumulative total return of (i) the NASDAQ Computer Index and (ii) the NASDAQ Composite Index, over the same period. This graph assumes the investment of \$100,000 on May 2, 2007 in our common stock, the NASDAQ Computer Index and the NASDAQ Composite Index, and assumes the reinvestment of dividends, if any. The graph assumes the value of our common stock on May 2, 2007 was the closing sales price of \$16.45 per share. The stockholder return shown in the graph below is not necessarily indicative of, nor is it intended to forecast, the potential future performance of our common stock, and we do not make or endorse any predictions as to future stockholder returns. Information used in the graph was obtained from Yahoo, Inc., a source believed to be reliable, but we are not responsible for any errors or omissions in such information.



	5/2/2007	12/31/2007	12/31/2008	12/31/2009	12/31/2010
Cavium Networks	100.0	139.9	63.9	144.9	229.1
Nasdaq Composite Index	100.0	103.7	61.7	88.7	103.7
Nasdaq Computer Index	100.0	115.8	61.8	105.5	123.9

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- (1) This Section is not “soliciting material,” is not deemed “filed” with the SEC and is not to be incorporated by reference in any filing of the Company under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934 Act, as amended, whether made before or after the date hereof and irrespective of any general incorporation language in any such filing.

Recent Sales of Unregistered Securities*(a) Sale of Unregistered Securities*

None.

(b) Use of Proceeds from Public Offering of Common Stock

Our initial public offering of common stock was effected through a Registration Statement on Form S-1 (File No. 333-140660), that was declared effective by the SEC on May 1, 2007. We registered 7,762,500 shares of our common stock with a proposed maximum aggregate offering price of \$104.8 million, all of which we sold. The offering was completed after the sale of all 7,762,500 shares. Morgan Stanley & Co. Incorporated and Lehman Brothers Inc. were the joint book-running managing underwriters of our initial public offering and Thomas Weisel Partners LLC, Needham & Company, LLC and JMP Securities LLC acted as co-managers. As of December 31, 2010, \$45.6 million of the approximately \$94.7 million in net proceeds received by us in the offering, after deducting approximately \$7.3 million in underwriting discounts, commissions, and \$2.8 million in other offering costs, were invested in various interest-bearing instruments, and \$49.1 million of the net proceeds had been used for acquisitions, general corporate purposes, including the repayment of the outstanding balances under the term loan with Silicon Valley Bank, and general and administrative and manufacturing expenses. None of the expenses or payments was paid, directly or indirectly, to directors, officers or persons owning 10% or more of our common stock, or to our affiliates other than payments in the ordinary course of business to officers for salaries and to non-employee directors as compensation for board or board committee service.

(c) Purchases of Equity Securities by the Issuer and Affiliated Purchasers

The following table provides information regarding repurchases of common stock during the three months ended December 31, 2010:

<u>Period</u>	<u>Total Number of Shares Purchased (1)</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs</u>
October 1, 2010 — October 31, 2010	—	—	Not applicable	Not applicable
November 1, 2010 — November 30, 2010	—	—	Not applicable	Not applicable
December 1, 2010 — December 31, 2010	334	\$ 3.04	Not applicable	Not applicable
	<u>334</u>	<u>\$ 3.04</u>		

- (1) Represents shares of our common stock repurchased by us from employees upon termination of service pursuant to the terms and conditions of our 2001 Stock Incentive Plan, which permits us to elect to purchase such shares at the original issuance price.

Item 6. Selected Financial Data

The following selected consolidated financial data should be read in conjunction with our audited consolidated financial statements and related notes thereto and with “Management’s Discussion and Analysis of Financial Condition and Results of Operations” section and other financial information included elsewhere in this Annual Report on Form 10-K. The consolidated statements of operations data for each of the years ended December 31, 2010, 2009 and 2008, and the summary consolidated balance sheet data as of December 31, 2010 and 2009, are derived from our audited consolidated financial statements included elsewhere in this Annual Report on Form 10-K. The consolidated statements of operations data for the years ended December 31, 2007 and 2006, and the summary consolidated balance sheet data as of December 31, 2008, 2007 and 2006, are derived from audited consolidated financial statements which are not included in this Annual Report on Form 10-K. Our historical results are not necessarily indicative of the results to be expected in any future period.

	Year Ended December 31,				
	2010	2009	2008	2007	2006
	(in thousands, except per share data)				
Consolidated Statements of Operations Data:					
Net revenue	\$ 206,500	\$ 101,214	\$ 86,609	\$ 54,203	\$ 34,205
Cost of revenue ⁽¹⁾⁽²⁾	79,487	51,112	35,639	19,898	13,092
Gross profit	127,013	50,102	50,970	34,305	21,113
Operating expenses:					
Research and development ⁽²⁾	60,602	42,682	27,180	19,548	18,651
Sales, general and administrative ⁽²⁾	55,303	28,651	22,111	14,688	10,058
In-process research and development	—	—	1,319	—	—
Total operating expenses	115,905	71,333	50,610	34,236	28,709
Income (loss) from operations	11,108	(21,231)	360	69	(7,596)
Other income (expense), net:					
Interest expense	(405)	(244)	(499)	(622)	(707)
Warrant revaluation expense	—	—	—	(573)	(467)
Interest income and other	(1,004)	330	2,576	3,458	345
Total other income (expense), net	(1,409)	86	2,077	2,263	(829)
Income (loss) before income tax expense	9,699	(21,145)	2,437	2,332	(8,425)
Income tax (benefit) expense	(27,425)	249	930	142	560
Net income (loss)	\$ 37,124	\$ (21,394)	\$ 1,507	\$ 2,190	\$ (8,985)
Net income (loss) per common share, basic	\$ 0.83	\$ (0.52)	\$ 0.04	\$ 0.08	\$ (1.11)
Shares used in computing basic net income (loss) per common share	44,740	41,435	40,385	29,006	8,066
Net income (loss) per common share, diluted	\$ 0.77	\$ (0.52)	\$ 0.04	\$ 0.07	\$ (1.11)
Shares used in computing diluted net income (loss) per common share	48,235	41,435	42,566	32,432	8,066

(1) Includes amortization of intangibles from acquisitions of \$4,456, \$5,381, \$1,737, \$860 and \$1,116, in the years ended December 31, 2010, 2009, 2008, 2007 and 2006, respectively.

(2) Includes stock-based compensation expense as follows:

	Year Ended December 31,				
	2010	2009	2008	2007	2006
	(in thousands)				
Cost of revenue	\$ 1,271	\$ 373	\$ 179	\$ 43	\$ 9
Research and development	9,929	5,574	2,684	805	396
Sales, general and administrative	10,269	5,780	3,194	1,021	340
Total stock-based compensation expense	\$21,469	\$11,727	\$6,057	\$1,869	\$745

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	Year Ended December 31,				
	2010	2009	2008 (in thousands)	2007	2006
Consolidated Balance Sheet Data:					
Cash and cash equivalents	\$ 90,673	\$ 58,918	\$ 77,027	\$ 98,462	\$ 10,154
Working capital	117,872 ⁽¹⁾	65,897	90,335	105,048	11,689
Total assets	291,620 ⁽¹⁾	199,795	151,164	134,610	29,962
Preferred stock warrant liability	—	—	—	—	701
Capital lease and technology license obligations	11,044	9,012	4,735	8,530	7,580
Other non-current liabilities	8,309 ⁽¹⁾	2,569	1,162	—	39
Convertible preferred stock	—	—	—	—	72,437
Common stock and additional paid-in capital	276,103	234,990	185,784	175,580	3,740
Total stockholders' equity (deficit)	234,610	156,373	128,561	116,850	(57,180)

- (1) Subsequent to our fourth quarter and year-end earnings release included in our Current Report on 8-K dated January 31, 2011, we performed further analysis in the course of finalizing the consolidated financial statements included in the Form 10-K for the year ended December 31, 2010, and concluded that it was appropriate to reclassify certain deferred tax assets and liabilities from long-term to current. These reclassifications do not indicate a change in our previously reported operating performance.

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

The following discussion should be read in conjunction with the Consolidated Financial Statements and the related notes that appear elsewhere in the document.

The information in this Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended ("Securities Act"), and Section 21E of the Securities Exchange Act of 1934, as amended ("Exchange Act"), which are subject to the "safe harbor" created by those sections. Forward-looking statements are based on our management's beliefs and assumptions and on information currently available to our management. In some cases, you can identify forward-looking statements by terms such as "may," "will," "should," "could," "would," "estimate," "project," "predict," "potential," "continue," "strategy," "believe," "anticipate," "plan," "expect," "intend" and similar expression intended to identify forward-looking statements. These statements involve known and unknown risks, uncertainties and other factors, which may cause our actual results, performance, time frames or achievements to be materially different from any future results, performance, time frames or achievements expressed or implied by the forward-looking statements. We discuss many of these risks, uncertainties and other factors in this Annual Report on Form 10-K in greater detail under the heading "Risk Factors." Given these risks, uncertainties and other factors, you should not place undue reliance on these forward-looking statements. Also, these forward-looking statements represent our estimates and assumptions only as of the date of this filing. You should read this Annual Report on Form 10-K completely and with the understanding that our actual future results may be materially different from what we expect. We hereby qualify our forward-looking statements by these cautionary statements. Except as required by law, we assume no obligation to update these forward-looking statements publicly, or to update the reasons actual results could differ materially from those anticipated in these forward-looking statements, even if new information becomes available in the future.

OCTEON®, OCTEON Plus®, OCTEON II®, NITROX®, ECONA® and Pure Vi™ are trademarks or registered trademarks of Cavium Networks, Inc.

Overview

We are a provider of highly integrated semiconductor processors that enable intelligent processing for networking, communications, storage, wireless, security, video and connected home and office applications. We refer to our products as enabling intelligent processing because they allow customers to develop networking, wireless, storage and electronic equipment that is application-aware and content-aware and securely processes voice, video and data traffic at high speeds. Our products also include a rich suite of embedded security protocols that enable unified threat management, or UTM, secure connectivity, network perimeter protection, Deep Packet Inspection or DPI, network virtualization, broadband gateways, 3G/4G wireless infrastructure, storage systems, wireless HDMI cable replacement and embedded video applications. Our products are systems on a chip, or SoCs, which incorporate single or multiple processor cores, a highly integrated architecture and customizable software that is based on a broad range of standard operating systems. As a result, our products offer high levels of performance and processing intelligence while reducing product development cycles for our customers and lowering power consumption for end market equipment. We focus our resources on the design, sales and marketing of our products, and outsource the manufacturing of our products.

From our incorporation in 2000 through 2003, we were primarily engaged in the design and development of our first processor family, NITROX, which we began shipping commercially in 2003. In 2004, we introduced and commenced commercial shipments of NITROX Soho. In 2006, we commenced our first commercial shipments of our OCTEON family of multi-core MIPS64® processors. We introduced a number of new products within all three of these product families in 2006. In 2007 we introduced our new line of OCTEON based storage services processors designed to address the specific needs in the storage market, as well as other new products in the OCTEON and NITROX families. In 2008, we expanded our OCTEON and NITROX product families with new products including wireless services processors to address the needs for wireless infrastructure equipment. In 2009, we announced the next generation OCTEON II Internet Application Processor (“IAP”) family multi-core MIPS64® processors, with one to 32 cores to address next generation networking applications support converged voice, video, data mobile traffic and services. In addition, in 2009, we expanded our NITROX product family offering to include the NITROX DPI processor, which facilitates several significant enhancements and increased performance.

In the third quarter of 2008, we acquired substantially all of the assets of Star for a purchase price of approximately \$9.6 million. With the acquisition of Star, we also added the Star ARM-based processors to our portfolio to address connected home and office applications and have since introduced our ECONA line of dual-core ARM processors for that address a large variety of connected home and office applications.

In the fourth quarter of 2008, we acquired W&W for a total purchase price of \$8.3 million. This acquisition launched us into the video processor market with a broad product line called PureVu. The PureVu family of video processors and modules incorporate proprietary and patent pending video technology that produces perceptual lossless video quality and delivers sub-frame latency with extremely low power and cost. These products address the need for video processing in wireless displays, teleconferencing, gaming and other applications.

In the fourth quarter of 2009, we acquired MontaVista for a total purchase price of \$45.2 million. In addition, per the merger agreement, we paid \$6.0 million, consisting of a mix of shares of our common stock and cash to certain individuals in connection with the termination of MontaVista’s 2006 Retention Compensation Plan. This acquisition complements our broad portfolio of multi-core processors to deliver integrated and optimized embedded solutions to the market.

In the fourth quarter of 2010, we acquired Celestial Systems, Inc. for aggregate cash consideration of \$4.4 million and a possible earn-out of \$1.5 million in cash upon the achievement of certain milestone as set forth in the asset purchase agreement. With the acquisition of Celestial Systems, we gain critical mass in delivering key technologies and services such as Automotive Infotainment Systems, Digital Media product development and Android commercialization and support.

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On January 25, 2011, we completed the acquisition of substantially all of the assets of Wavesat Inc., including, but not limited to, certain intellectual property, all of Wavesat's rights to, in and under customer contracts and other material agreements, inventory, equipment, work in progress, fixed assets, certain accounts receivable and goodwill. We paid approximately \$10.0 million in cash, plus the aggregate amount of certain liabilities, which were specified in the related purchase agreement. Following the closing, we also paid approximately 1.5 million to Wavesat in connection with a transition services agreement, pursuant to which Wavesat continued to employ certain employees prior to their becoming our employees. This acquisition will add multicore wireless digital system processing to our embedded processor product line.

On January 31, 2011, we entered into an asset purchase agreement with Celestial Semiconductor, Ltd., a Cayman Islands company. On the terms and subject to the conditions set forth in the asset purchase agreement, we will purchase certain assets of Celestial Semiconductor. Under the terms of the asset purchase agreement, we will pay approximately \$55.0 million in total consideration, consisting of a mix of cash and shares of our common stock. In addition, the Company may pay additional cash consideration of up to \$10.0 million after the closing per an earn-out provision based upon the sales of Celestial Semiconductor's products following consummation of the transaction. With the acquisition of Celestial Semiconductor, Inc., we will have a proven processor family targeted for the large and growing market of digital media players.

For a complete discussion on our 2008 to 2010 and subsequent acquisitions, see "Note 5 Business Combinations" in Item 8, of this Annual Report, which is incorporated herein by reference.

Since inception, we have invested heavily in new product development and our net revenue has grown from \$19.4 million in 2005 to \$34.2 million in 2006, \$54.2 million in 2007, \$86.6 million in 2008, \$101.2 million in 2009 and \$206.5 million in 2010 driven primarily by demand in the enterprise network and data center markets, and more recently in 2009 the revenue growth was mainly due to increased demand in the broadband and consumer markets. We expect sales of our products for use in the enterprise network and data center markets to continue to represent a significant portion of our revenue in the foreseeable future, however, we do expect growth in the broadband and consumer as well as the access and service provider markets.

We primarily sell our products to OEMs, either directly or through their contract manufacturers. Contract manufacturers purchase our products only when an OEM incorporates our product into the OEM's product, not as commercial off-the-shelf products. Our customers' products are complex and require significant time to define, design and ramp to volume production. Accordingly, our sales cycle is long. This cycle begins with our technical marketing, sales and field application engineers engaging with our customers' system designers and management, which is typically a multi-month process. If we are successful, a customer will decide to incorporate our product in its product, which we refer to as a design win. Because the sales cycles for our products are long, we incur expenses to develop and sell our products, regardless of whether we achieve the design win and well in advance of generating revenue, if any, from those expenditures. We do not have long-term purchase commitments from any of our customers, as sales of our products are generally made under individual purchase orders. However, once one of our products is incorporated into a customer's design, it is likely to remain designed in for the life cycle of the product. We believe this to be the case because a redesign would generally be time consuming and expensive. We have experienced revenue growth due to an increase in the number of our products, an expansion of our customer base, an increase in the number of average design wins within any one customer and an increase in the average revenue per design win.

Key Business Metrics

Design Wins. We closely monitor design wins by customer and end market on a periodic basis. We consider design wins to be a key ingredient in our future success, although the revenue generated by each design can vary significantly. Our long-term sales expectations are based on internal forecasts from specific customer design wins based upon the expected time to market for end customer products deploying our products and associated revenue potential.

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Pricing and Margins. Pricing and margins depend on the features of the products we provide to our customers. In general, products with more complex configurations and higher performance tend to be priced higher and have higher gross margins. These configurations tend to be used in high performance applications that are focused on the enterprise network, data center, and access and service provider markets. We tend to experience price decreases over the life cycle of our products, which can vary by market and application. In general, we experience less pricing volatility with customers that sell to the enterprise and data center markets.

Sales Volume. A typical design win can generate a wide range of sales volumes for our products, depending on the end market demand for our customers' products. This can depend on several factors, including the reputation, market penetration, the size of the end market that the product addresses, and the marketing and sales effectiveness of our customer. In general, our customers with greater market penetration and better branding tend to develop products that generate larger volumes over the product life cycle. In addition, some markets generate large volumes if the end market product is adopted by the mass market.

Customer Product Life Cycle. We typically commence commercial shipments from nine months to three years following the design win. Once our product is in production, revenue from a particular customer may continue for several years. We estimate our customers' product life cycles based on the customer, type of product and end market. In general, products that go into the enterprise network and data center take longer to reach volume production but tend to have longer lives. Products for other markets, such as broadband and consumer, tend to ramp relatively quickly, but generally have shorter life cycles. We estimate these life cycles based on our management's experience with providers of networking equipment and the semiconductor market as a whole.

Critical Accounting Policies and Estimates

Our management's discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in accordance with United States generally accepted accounting principles, or GAAP. These accounting principles require us to make certain estimates and judgments that can affect the reported amounts of assets and liabilities as of the dates of the consolidated financial statements, the disclosure of contingencies as of the dates of the consolidated financial statements, and the reported amounts of revenue and expenses during the periods presented. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. If actual results or events differ materially from those contemplated by us in making these estimates, our reported financial condition and results of operations for future periods could be materially affected. See "Risk Factors" for certain matters that may affect our future financial condition or results of operations.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if the changes in estimate that are reasonably likely to occur could materially impact the financial statements. Our management has discussed the development, selection and disclosure of these estimates with the Audit Committee of our Board of Directors. See Note 1 to our audited consolidated financial statements for a more comprehensive discussion of our significant accounting policies. We believe the following critical accounting policies reflect significant judgments and estimates used in the preparation of our consolidated financial statements:

- revenue recognition;
- stock-based compensation;
- inventory valuation;
- accounting for income taxes;
- mask costs;

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- business combinations; and
- goodwill and purchased intangible assets.

Revenue Recognition

We derive our revenue primarily from sales of semiconductor products and sales of software licenses and services. We recognize revenue when all of the following criteria have been met: (i) persuasive evidence of a binding arrangement exists, (ii) delivery has occurred, (iii) the price is deemed fixed and free of contingencies and significant uncertainties, and (iv) collection is probable. Our price is considered fixed or determinable at the execution of an agreement, based on specific products and quantities to be delivered at specified prices, which is often memorialized with a customer purchase order. Our agreements with non-distributor customers do not include rights of return or acceptance provisions. We assess the ability to collect from our customers based on a number of factors, including credit worthiness and any past transaction history of the customers.

Shipping charges billed to customers are included in product revenue and the related shipping costs are included in cost of revenue. We generally recognize revenue at the time of shipment to our customers. Revenue from the sales of semiconductor products consists of sales of our products for a new design are usually made directly to networking OEMs as they design and develop their products. Once their design enters production, they often outsource their manufacturing contract manufacturers to purchase our products directly from us or from our distributors.

Revenue is recognized upon shipment for sales to distributors with limited rights of returns and price protection if we conclude we can reasonably estimate the credits for returns and price adjustments issuable. We record an estimated allowance, at the time of shipment, based on the historical patterns of returns and pricing credits of sales recognized upon shipment.

Revenue and costs relating to sales to distributors are deferred if we grant more than limited rights of returns and price credits or if it cannot reasonably estimate the level of returns and credits issuable. We have a distribution agreement with Avnet, Inc. to distribute our products primarily in the United States. Given the terms of the distribution agreement, for sales to Avnet, revenue and costs are deferred until products are sold by Avnet to its end customers.

We also derive revenue from licensing software and providing software maintenance and support. Software arrangements typically include: (i) an end-user license fee paid in exchange for the use of our products for a specified period of time, generally 12 months (time-based license); and (ii) a support arrangement that provides for technical support and unspecified product updates and upgrades on a when and if available basis over the period of the related license.

Revenue from software and service arrangements is recorded when all of the following criteria are met.

Persuasive evidence of an arrangement exists — We require either a written contract signed by both the customer and us, or a shrink-wrap or click-through contract whereby the customer agrees to our standard license terms, together with a non-cancellable purchase order, or a purchase order from these customers that have previously negotiated an end-user license arrangement or volume purchase arrangement.

Delivery has occurred — We deliver software to our customers electronically and considers delivery to have occurred once the access codes are provided that allow the customer to take immediate possession of the software.

The fee is fixed or determinable — Our determination that an arrangement fee is fixed or determinable depends principally on the arrangement's payment terms.

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Collectibility is probable — We assess the collectibility of an arrangement on a case-by-case basis, based on the financial condition of the customer as well as any established payment history.

We allocate revenue between elements in a multiple-element revenue arrangement based on vendor specific objective evidence of fair value (“VSOE”) for each undelivered element. VSOE is based on the price charged when an element is sold separately. We enter into multiple-element arrangements that generally include time-based licenses and support that are typically not sold separately. Revenue from such arrangements is deferred and recognized ratably over the term that support is offered, which is typically 12 months.

The software arrangement may also include professional services, and such services may be purchased separately. Professional services engagements are billed on either a fixed-fee or time-and-materials basis. For fixed-fee arrangements, professional services revenue is recognized under the proportional performance method, with the associated costs included in cost of revenue. We estimate the proportional performance of the arrangements based on an analysis of progress toward completion. We periodically evaluate the actual status of each project to ensure that the estimates to complete each contract remain accurate, and a loss is recognized when the total estimated project cost exceeds project revenue. If the amount billed exceeds the amount of revenue recognized, the excess amount is recorded as deferred revenue. Revenue recognized in any period is dependent on progress toward completion of projects in progress. To the extent we are unable to estimate the proportional performance then the revenue is recognized on a completed performance basis. Revenue for time-and-materials engagements is recognized as the effort is incurred.

In addition, we also enter into multiple element arrangements, which consist of the combination of licensed software, support and professional services. Professional services in such arrangements do not involve significant customization, modification or development of software licensed under the time based licenses and are not essential to the functionality of such software. Provided that the total arrangement consideration is fixed and determinable at the inception of the arrangement, we allocate the total arrangement consideration to professional services and time based licenses bundled with support based on VSOE for professional services and VSOE for time based licenses bundled with support. Each unit of accounting is then accounted for under the applicable revenue recognition guidance. For arrangements with services that are essential to the functionality of the software, the license and related service revenues are recognized using proportional performance method.

If we are unable to establish VSOE for each undelivered element of the arrangement, revenue for the entire arrangement is deferred until the time that we are able to establish VSOE for the undelivered elements or there is only one remaining undelivered element. When the revenue is deferred, the direct costs incurred in relation to the professional services arrangement are deferred and is recorded as deferred costs in prepaid expenses and other current assets.

Stock-Based Compensation

We apply the fair value recognition provisions of stock-based compensation, and accordingly, use the prospective transition method, which requires us to determine fair value only for awards granted, modified, repurchased or cancelled after the adoption date. The share-based compensation expense is measured at the grant date based on the fair value of the award and is recognized as compensation expense net of an estimated forfeiture rate over the vesting period. We use the Black-Scholes option-pricing model to determine the fair value of stock options, which require various subjective assumptions, including expected volatility, expected term and the risk-free interest rates. We estimate the expected volatility based on the historical stock price volatility of comparable companies over the estimated expected term of our share-based awards. We use the simplified method as permitted under the provisions of stock-based compensation to determine the expected term of our share-based awards. We calculate the expected forfeiture rate based on average historical trends. The assumptions used in calculating the fair value of share-based payment awards represent management’s best estimates and judgment. If factors change and we use different assumptions, our stock-based compensation

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expense could be materially different in the future. If our actual forfeiture rate is materially different from our estimate, the stock-based compensation expense could be significantly different from what we have recorded in the current period.

Inventory Valuation

We write down inventory based on aging and forecasted demand. These factors are impacted by market and economic conditions, technology changes, new product introductions and changes in strategic direction and require management to make estimates that may include uncertain elements. If actual market conditions or demand for our products are less favorable than those projected, additional inventory write-downs may be required, which would negatively affect gross margins in the period when such write-downs are recorded.

Accounting for Income Taxes

We account for income taxes under the asset and liability approach. This process involves estimating our actual current tax exposure, including assessing the risks associated with tax audits, and assessing temporary differences resulting from different treatment of items for tax and accounting purposes. These differences result in deferred tax assets and liabilities. We must then assess the likelihood that our deferred tax assets will be recovered from future taxable income and, to the extent we believe that recovery is not likely, we must establish a valuation allowance. Significant judgment is required in determining the valuation allowance recorded against our deferred tax assets. In assessing the valuation allowance, we consider all available evidence including past operating results and estimates of future taxable income. Our net deferred tax assets relate predominantly to our United States federal tax jurisdiction. If our assumptions and consequently our estimates change in the future, the valuation allowances we have established may be increased or decreased, resulting in a respective increase or decrease in income tax expense.

We believe that our reserve for uncertain tax positions, including related interest, is adequate. The amounts ultimately paid upon resolution of audits could be materially different from the amounts previously included in our income tax expense and therefore could have a material impact on our tax provision, net income and cash flows. In the event that actual results differ from these estimates or we adjust these estimates in future periods, we may need to record additional income tax expense or establish an additional valuation allowance, which could materially impact our financial position and results of operations.

Mask Costs

We incur costs for the fabrication of masks used by our contract manufacturers to manufacture wafers that incorporate our products. We capitalize the costs of fabrication masks that are reasonably expected to be used during production manufacturing. Such amounts are included within property and equipment and are generally depreciated over a period of 12 months. If we do not reasonably expect to use the fabrication mask during production manufacturing, the related mask costs are expensed to research and development in the period in which the costs are incurred.

Business Combinations

We account for business combinations using the purchase method of accounting. We determine the recognition of intangible assets based on the following criteria: (i) the intangible asset arises from contractual or other rights; or (ii) the intangible is separable or divisible from the acquired entity and capable of being sold, transferred, licensed, returned or exchanged. In accordance with the guidance provided under business combinations, we allocate the purchase price of business combinations to the tangible assets, liabilities and intangible assets acquired, including in-process research and development ("IPR&D"), based on their estimated fair values. The excess purchase price over those fair values is recorded as goodwill. Management makes valuation assumptions that require significant estimates, especially with respect to intangible assets. Critical

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estimates in valuing certain intangible assets include, but are not limited to future expected cash flows from customer contracts, customer lists, and distribution agreements and acquired developed technologies, expected costs to develop IPR&D into commercially viable products, estimated cash flows from projects when completed and discount rates. We estimate fair value based upon assumptions we believe to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates. Other estimates associated with the accounting for acquisitions may change as additional information becomes available regarding the assets acquired and liabilities assumed.

Effective January 1, 2009, we adopted the updated authoritative guidance on business combinations which establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. It also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and the financial effects of the business combination. The updated standards also provides guidance for recognizing changes in an acquirer's existing income tax valuation allowances and tax uncertainty accruals that result from a business combination transaction as adjustments to income tax expense. Similarly, under the updated guidance, we expensed related transaction costs of \$2.1 million and \$958,000 in 2010 and 2009 associated with the acquisitions, which would have been capitalized under the prior accounting standards. The updated guidance also addresses application issues regarding the initial recognition and measurement, subsequent measurement and accounting of disclosures of assets and liabilities arising from contingencies in business combination. In circumstances where the acquisition date fair value for a contingency cannot be determined during the measurement period and it is concluded that is probable that an asset or liability exists as of the acquisition date and the amount cannot be reasonably estimated, a contingency is recognized as of the acquisition date based on the estimated amount. The adoption of this updated guidance had a material impact in our 2010 and 2009 consolidated financial statements and believed that it will have material impact on our future consolidated financial statements.

Goodwill and Purchased Intangible Assets

Goodwill is measured as the excess of the cost of an acquisition over the sum of the amounts assigned to tangible and identifiable intangible assets and liabilities assumed. We review goodwill and finite-lived purchased intangible assets for impairment whenever there is evidence that recent events or changes in circumstances have made recovery of an asset's carrying value were not recoverable. We also assess potential impairment of our goodwill on an annual basis, regardless if there is evidence of impairment. Applying the provisions of "Intangibles-Goodwill and Other", we perform goodwill impairment test at the reporting unit level. If the fair value of each of the reporting units exceeds the carrying value of the reporting unit, goodwill is not impaired. In addition to the goodwill impairment, we also perform impairment review of finite-lived intangibles for the carrying value and the remaining useful lives of the assets. If the carrying value or the remaining useful life of the intangible assets is not recoverable, we record a charge equal to the difference between carrying and fair value. Significant management judgment is required in the grouping of long-lived assets and forecasts of future operating results that are used in the evaluation of carrying value of goodwill and finite-lived intangible assets. If our actual results, or the plans and estimates used in future impairment analyses, are lower than the original estimates used to assess the recoverability of these assets, we could incur additional impairment charges.

Results of Operations

Net Revenue. Our net revenue consists primarily of sales of our semiconductor products to providers of networking equipment and their contract manufacturers and distributors. Initial sales of our products for a new design are usually made directly to providers of networking equipment as they design and develop their product. Once their design enters production, they often outsource their manufacturing to contract manufacturers that purchase our products directly from us or from our distributors. We price our products based on market and competitive conditions and periodically reduce the price of our products, as market and competitive conditions

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change, and as manufacturing costs are reduced. We do not experience different margins on direct sales to providers of networking equipment and indirect sales through contract manufacturers because in all cases we negotiate product pricing directly with the providers of networking equipment. To date, most of our sales are denominated in U.S. dollars.

Our end customers representing greater than 10% of consolidated net revenue for each of the years ended were:

	Year Ended December 31,		
	2010	2009	2008
Percentage of total net revenue			
Cisco	22%	24%	29%
Actiontec	*	10%	*
F5 Networks	*	*	11%
Sumitomo	*	*	11%

* Represents less than 10% of consolidated net revenue

Revenue and costs relating to sales to distributors are deferred if we grant more than limited rights of returns and price credits or if we cannot reasonably estimate the level of returns and credits issuable. During the quarter ended June 30, 2007, we signed a distribution agreement with Avnet to distribute our products primarily in the United States. Given the terms of the distribution agreement, for sales to Avnet, revenue and costs are deferred until products are sold by Avnet to their end customers. For the years ended December 31, 2010, 2009 and 2008, 6.4%, 5.5% and 3.6% of our net revenues were from products sold by Avnet, respectively. Revenue recognition depends on notification from Avnet that product has been sold to Avnet's end customers.

Our distributors, other than Avnet, Inc. are used primarily to support international sale logistics in Asia, including importation and credit management. Total net revenue through distributors was \$66.7 million, \$38.6 million and \$29.4 million for the years ended December 31, 2010, 2009 and 2008, respectively, which accounted for 32.3%, 38.2% and 33.9% of net revenue for the years ended December 31, 2010, 2009 and 2008, respectively. The inventory at these distributors at end of the period may fluctuate from time to time mainly due to the OEM production ramps or new customer demands. While we have purchase agreements with our distributors, the distributors do not have long-term contracts with any of the equipment providers. Our distributor agreements limit the distributor's ability to return product up to a portion of purchases in the preceding quarter. Given our experience, along with our distributors' limited contractual return rights, we believe we can reasonably estimate expected returns from our distributors. Accordingly, we recognize sales through distributors at the time of shipment, reduced by our estimate of expected returns.

The following table is based on the geographic location of the original equipment manufacturers or the distributors who purchased our products. For sales to our distributors, their geographic location may be different from the geographic locations of the ultimate end customers. Sales by geography for the periods indicated were:

	Year Ended December 31,		
	2010	2009 (in thousands)	2008
United States	\$ 70,247	\$ 40,623	\$ 44,787
China	58,017	24,189	9,849
Taiwan	28,393	15,224	11,533
Japan	19,273	10,802	11,559
Malaysia	12,696	5,088	6,639
Other countries	17,874	5,288	2,242
Total	<u>206,500</u>	<u>\$101,214</u>	<u>\$ 86,609</u>

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Cost of Revenue and Gross Margin. We outsource wafer fabrication, assembly and test functions of our products. A significant portion of our cost of revenue consists of payments for the purchase of wafers and for assembly and test services, amortization of acquired intangibles and amortization related to capitalized mask costs. To a lesser extent, cost of revenue includes expenses relating to our internal operations that manage our contractors, stock-based compensation, the cost of shipping and logistics, royalties, inventory valuation expenses for excess and obsolete inventories, warranty costs and changes in product cost due to changes in sort, assembly and test yields. In general, our cost of revenue associated with a particular product declines over time as a result of yield improvements, primarily associated with design and test enhancements.

We use third-party foundries and assembly and test contractors, which are primarily located in Asia, to manufacture, assemble and test our semiconductor products. We purchase processed wafers on a per wafer basis from our fabrication suppliers, which are currently TSMC, UMC, Fujitsu and Samsung. We also outsource the sort, assembly, final testing and other processing of our product to third-party contractors, primarily ASE and ISE. We negotiate wafer fabrication on a purchase order basis and do not have long-term agreements with any of our third-party contractors. A significant disruption in the operations of one or more of these contractors would impact the production of our products which could have a material adverse effect on our business, financial condition and results of operations.

Cost of revenue also includes amortized costs of certain identifiable intangible assets from our business acquisitions to the extent those identifiable intangible assets are directly associated to cost of revenue. Following table summarizes the capitalized identifiable intangible assets acquired from acquisition and the related estimated useful lives used for amortization:

<u>Acquired From</u>	<u>Acquired Date</u>	<u>Amount (in thousands)</u>	<u>Method of Amortization</u>	<u>Estimated Useful Life</u>
Paralogic	May 20, 2008	\$ 450	Straight-line	1 - 5 Years
Star	August 1, 2008	5,295	Straight-line	>1 - 7 Years
W&W	December 23, 2008	10,114	Straight-line	>1 - 6 Years
MontaVista	December 14, 2009	14,909	Straight-line	5 - 7 Years
Celestial Systems	October 5, 2010	2,410	Straight-line	5 Years

The total intangible assets amortization expense from the above acquisitions included in cost of revenue was \$4.5 million, \$5.4 million and \$1.7 million for the years ended December 31, 2010, 2009 and 2008, respectively. In addition, in the year ended December 31, 2009, we incurred \$315,000 expense related to the fair value adjustment of W&W inventory and in the year ended December 31, 2008, we incurred \$470,000 expense related to the fair value adjustment of Star and W&W inventory.

We also incur costs for the fabrication of masks used by our contract manufacturers to manufacture wafers that incorporate our products. During the years ended December 31, 2010, 2009 and 2008, we capitalized \$3.1 million, \$680,000 and \$4.2 million of mask costs, respectively. As our product processes continue to mature and as we develop more history and experience, we expect to capitalize most or all of our mask costs in the future. We amortize the cost of fabrication masks that we reasonably expect to use for production manufacturing generally over a 12-month period. Total amortized expenses for the masks included in cost of revenue were \$1.4 million, \$2.1 million and \$3.5 million for the years ended December 31, 2010, 2009 and 2008, respectively. The unamortized balance of capitalized mask costs at December 31, 2010 and December 31, 2009 was \$2.4 million and \$510,000, respectively.

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Our revenue, cost of revenue, gross profit and gross margin for the years ended December 31, 2010, 2009 and 2008 were:

	For the Year Ended December 31,		
	2010	2009 (in thousands)	2008
Net revenue	\$206,500	\$101,214	\$86,609
Cost of revenue	79,487	51,112	35,639
Gross Profit	<u>\$ 127,013</u>	<u>\$ 50,102</u>	<u>\$ 50,970</u>
Gross Margin	61.5%	49.5%	58.9%

Our gross margin has been and will continue to be affected by a variety of factors, including the product mix, average sales prices of our products, the amortization expense associated with the acquired intangible assets, the timing of cost reductions for fabricated wafers and assembly and test service costs, inventory valuation charges, the cost of fabrication masks that are capitalized and amortized, and the timing and changes in sort, assembly and test yields. Overall gross margin is impacted by the mix between higher performance, higher margin products and services and lower performance, lower margin products and services. In addition, we typically experience lower yields and higher associated costs on new products, which improve as production volumes increase.

Research and Development Expenses. Research and development expenses primarily include personnel costs, engineering design development software and hardware tools, allocated facilities expenses and depreciation of equipment used in research and development and stock-based compensation.

We expect research and development expenses to continue to increase in total dollars. Additionally, as a percentage of revenue, these costs fluctuate from one period to another. Total research and development expenses for the years ended December 31, 2010, 2009 and 2008 were:

	For the Year Ended December 31,		
	2010	2009 (in thousands)	2008
Research and development expenses	\$60,602	\$42,682	\$27,180
Percent of total net revenue	29.3%	42.2%	31.4%

Sales, General and Administrative Expenses. Sales, general and administrative expenses primarily include personnel costs, accounting and legal fees, information systems, sales commissions, trade shows, marketing programs, depreciation, allocated facilities expenses and stock-based compensation. We expect sales, general and administrative expenses to increase in absolute dollars. Total sales, general and administrative costs for the years ended December 31, 2010, 2009 and 2008 were:

	For the Year Ended December 31,		
	2010	2009 (in thousands)	2008
Sales, general and administrative	\$55,303	\$28,651	\$22,111
Percent of total net revenue	26.8%	28.3%	25.5%

Other Income (Expense), Net. Other income (expense), net primarily includes interest income on cash and cash equivalents, foreign currency gains and losses, financing expenses and interest expense associated with the installment payment of capital leases. Total other income (expense) net for the years ended December 31, 2010, 2009 and 2008 was:

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	For the Year Ended December 31,		
	2010	2009 (in thousands)	2008
Interest income and other, net	\$ (1,004)	\$ 330	\$ 2,576
Interest expense	(405)	(244)	(499)
Total other (expense) income, net	<u>\$ (1,409)</u>	<u>\$ 86</u>	<u>\$ 2,077</u>

Provision for Income Taxes. The following table presents the provision for income taxes and the effective tax rates for the three years ended December 31, 2010, 2009 and 2008 were:

	For the Year Ended December 31,		
	2010	2009 (in thousands)	2008
Income (loss) before income taxes	\$ 9,699	\$ (21,145)	\$ 2,437
Income tax (benefit) expense	(27,425)	249	930
Effective tax rate	-282.8%	-1.2%	38.2%

We recorded income tax benefit of \$27.4 million for the year ended December 31, 2010, and income tax expense of \$249,000 and \$930,000 for the years ended December 31, 2009 and 2008, respectively. The income tax benefit for the year ended December 31, 2010 primarily consists of \$1.5 million of current federal, state and foreign income tax expense, offset by \$28.9 million of tax benefit due to the release of the valuation allowance for federal deferred tax assets. The provision for the year ended December 31, 2009 primarily consists of \$297,000 of international and \$130,000 of state taxes which are offset by prior year federal tax adjustments of \$177,000. The provision for the years ended December 31, 2008 was primarily due to the federal alternative minimum tax on profits in the United States adjusted by certain non-deductible items, international taxes and state income taxes.

Fiscal 2010 Compared to Fiscal 2009

Net Revenue. Our net revenue in 2010 increased by \$105.3 million or 104% compared to 2009. The increase in net revenue in 2010 was mainly attributable to an increase in sales to our enterprise, data center and service provider market by \$72.8 million as a result of continued strong unit shipment growth driven largely by sales of wireless infrastructure equipment to our major customers. Revenue in our broadband and consumer market also increased by \$6.9 million due to the increase in demand for our products. In addition, revenue in our software and services market increased by \$25.6 million which was mainly driven by increased subscription and service contracts with our existing and new customers as a result of our acquisition of MontaVista at the end of 2009.

In 2010, we derived 32.3% of our revenue from distributors compared to 38.2% in 2009.

Cost of Revenue and Gross Margin. Cost of revenue increased in 2010 by \$28.4 million or 56% compared to 2009 primarily due to the increase in net revenue. Gross margin increased by 12.0 percentage points in 2010 compared to 2009 primarily due to decreased product cost associated with fabricated wafers and assembly and test costs. In addition, to a lesser extent, gross margin improvement was a result of a favorable product sales mix, with increased sales of higher margin products and services.

Research and Development Expenses. Research and development expenses increased by \$17.9 million, or 42% in 2010 compared to 2009. The increase was primarily due to higher salaries and benefit expenses of \$6.9 million and stock-based compensation expenses and related taxes of \$5.1 million as a result of an increase in headcount. Research and development headcount increased to 367 at end of 2010 from 304 at the end of 2009. In addition, outsourced engineering services increased by \$1.8 million, depreciation and amortization expense increased by \$1.6 million and other miscellaneous research and development expenses increased by \$2.5 million.

The increase was mainly attributable to our increased research and development efforts to support our new product developments.

Sales, General and Administrative Expenses. Sales, general and administrative expenses increased by \$26.7 million, or 93% in 2010 compared to 2009. The increase was primarily attributable to higher salaries and employee benefits of \$12.3 million and stock based compensation and related taxes of \$4.9 million mainly due to an increase in headcount and to the lesser extent due to retention bonuses as a result of business acquisitions. Sales, general and administrative headcount increased to 158 at end of 2010 from 145 at end of 2009. The 2009 headcount includes 58 employees from MontaVista which were employed in December 2009 upon the completion of the acquisition. In addition, commission and bonuses increased by \$3.0 million due to the increase in revenue resulting in higher sales commissions and business acquisition retention bonuses. Outside services which includes legal and audit fees increased by \$2.1 million generally as a result of business acquisitions. The remaining increase was mainly due to our overall business growth and development.

Income Tax (Benefit) Expense. Income tax changed from expense of \$249,000 in 2009 to a benefit of \$27.4 million in 2010. The tax benefit in 2010 was due to release of valuation allowance for federal deferred tax asset of \$28.9 million offset by the income tax provision of \$1.5 million for foreign and state income taxes. The release of valuation allowance is due to the Company's history of earnings and expectation of future taxable income for U.S. federal income tax purposes.

Other Income (Expense), Net. Other income (expense), net, decreased by \$1.5 million in 2010 compared to 2009. The total decrease consists of the decrease in interest income and other, net of \$1.3 million and an increase in total interest expense of \$161,000. The decrease in interest income and other, net was primarily due to the provision for a note receivable of \$1.0 million that was deemed uncollectible in 2010, and to a lesser extent due to lower interest income resulting from lower short-term U.S. interest rates. The increase in interest expense was primarily due to a higher interest expense associated with the installment payment of capitalized leases.

Fiscal 2009 Compared to Fiscal 2008

Net Revenue. Our net revenue in 2009 increased by \$14.6 million or 16.9% compared to 2008. The increase in net revenue in 2009 was mainly attributable to an increase in sales of \$14.8 million in broadband and consumer markets due to increase in demand for our products from our existing and new customers combined with revenue generated from our acquisitions completed in 2008. In addition, approximately \$935,000 of the increase was contributed from our acquisition completed in December 2009. The increase was partially offset by a sales decline of approximately \$253,000 in the data center and access and service provider and enterprise network markets, as a result of the overall 2009 global economic downturn.

In 2009, we derived 38.2% of our revenue from distributors compared to 33.9% in 2008.

Cost of Revenue and Gross Margin. Gross margin decreased by 9.4 percentage points in 2009 compared to 2008. The decline in gross margin in 2009 compared to 2008 was primarily due to a sales mix shift in the first half of 2009 towards increased sales of lower performance, lower margin products particularly in the broadband and consumer markets. In addition, to a lesser extent, the gross margin decline was due to higher amortization costs of acquired intangible assets resulting from the acquisitions completed in 2008 and 2009.

Research and Development Expenses. Research and development expenses increased by \$15.5 million or 57% in 2009 compared to 2008. The increase was primarily the result of higher salaries and benefit expenses of \$9.1 million and stock-based compensation expenses of \$2.9 million due to increased headcount. In addition, professional services and other miscellaneous expenses accounted for \$3.1 million and design tools accounted for \$436,000 of the increase in 2009. Research and development headcount increased to 304 at the end of 2009 from 238 at the end of 2008.

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Sales, General and Administrative Expenses. Sales, general and administrative expenses increased \$6.5 million or 30% in 2009 compared to 2008. The increase was primarily due to higher stock-based compensation expense and salaries, benefits and commissions accounted of approximately \$4.4 million as a result of increased headcount. In addition, accounting and legal fees and other services primarily related to the acquisition completed in 2009 accounted for approximately \$958,000 of the increase, and depreciation and other expenses accounted for the remaining \$1.1 million. Sales, general and administrative headcount increased to 145 at the end of 2009 from 91 at the end of 2008.

Income Tax Expense. Income tax expense decreased by \$680,000 in 2009 compared to 2008. The decrease was primarily due to prior year federal tax adjustments recorded in the 2009 tax provision. These adjustments were offset in part by higher international taxes and state income taxes in 2009 compared to 2008.

Other Income (Expense), Net. Other income (expense), net, decreased by \$2.0 million in 2009 compared to 2008. The decrease was mainly due to a decrease in interest income resulting from lower interest rates in 2009 compared to 2008.

Quarterly Results of Operations

The following table sets forth our unaudited consolidated statements of operations data for each of the eight quarters in the period ended December 31, 2010. The quarterly data have been prepared on the same basis as the audited consolidated financial statements. You should read this information together with our consolidated financial statements and related notes included elsewhere in this Annual Report. We anticipate that the rate of new sales orders may vary significantly from quarter to quarter. Consequently, if anticipated sales and shipments in any quarter do not occur when expected, expenses and inventory levels could be disproportionately high, and our operating results for that quarter and future quarters may be adversely affected. In addition, because of the rapidly evolving nature of our business, we believe that period-to-period comparisons of revenue and operating results, including gross margin and operating expenses as a percentage of total revenue should not be relied upon as indications of future performance. Although we have experienced significant percentage growth in revenue, we do not believe that our historical growth rates are necessarily indicative of future growth. Net income (loss) per common share, basic and diluted, for the four quarters of each fiscal year may not sum to the total for the fiscal year because of the different number of shares outstanding during each period.

	Quarter Ended							
	2010				2009			
	Dec. 31	Sep. 30	Jun. 30	Mar. 31	Dec. 31	Sep. 30	Jun. 30	Mar. 31
	(in thousands, except per share data)							
Net revenue	\$ 59,803	\$ 55,207	\$ 49,853	\$ 41,637	\$ 32,134	\$ 25,894	\$ 22,804	\$ 20,382
Cost of revenue	22,315	20,811	19,519	16,842	15,592	12,567	12,139	10,814
Gross profit	37,488	34,396	30,334	24,795	16,542	13,327	10,665	9,568
Operating expenses:								
Research and development	15,914	15,807	14,894	13,987	11,788	10,629	10,274	9,991
Sales, general and administrative	14,751	12,981	13,536	14,035	9,341	6,647	6,526	6,137
Total operating expenses	30,665	28,788	28,430	28,022	21,129	17,276	16,800	16,128
Income (loss) from operations	6,823	5,608	1,904	(3,227)	(4,587)	(3,949)	(6,135)	(6,560)
Other income (expense), net:								
Interest expense	(83)	(93)	(105)	(124)	(44)	(54)	(67)	(79)
Interest income and other	111	94	(1,097)	(112)	102	4	90	134
Total other income (expense), net	28	1	(1,202)	(236)	58	(50)	23	55
Income (loss) before income tax expense	6,851	5,609	702	(3,463)	(4,529)	(3,999)	(6,112)	(6,505)
Income tax (benefit) expense	(27,770) ⁽¹⁾	643	55	(353)	(2)	167	56	28
Net income (loss)	\$ 34,621	\$ 4,966	\$ 647	\$ (3,110)	\$ (4,527)	\$ (4,166)	\$ (6,168)	\$ (6,533)
Net income (loss) per common share, basic	\$ 0.76	\$ 0.11	\$ 0.01	\$ (0.07)	\$ (0.11)	\$ (0.10)	\$ (0.15)	\$ (0.16)
Net income (loss) per common share, diluted	\$ 0.70	\$ 0.10	\$ 0.01	\$ (0.07)	\$ (0.11)	\$ (0.10)	\$ (0.15)	\$ (0.16)

- (1) Income tax benefit of \$27.8 million for the quarter ended December 31, 2010 includes a one-time income tax benefit from the release of valuation allowance primarily from federal deferred tax assets of \$28.9 million.

Liquidity and Capital Resources

In May 2007, we received net proceeds of approximately \$94.7 million (after underwriters' discounts of \$7.3 million and additional offering related costs of approximately \$2.8 million). Our other primary sources of cash historically have been cash generated from operations and cash received from the exercise of employee stock options. As of December 31, 2010, we had cash and cash equivalents of \$90.7 million and net accounts receivable of \$29.9 million.

Following is a summary of our working capital and cash and cash equivalents as of December 31, 2010 and 2009:

	As of December 31,	
	2010	2009
	(in thousands)	
Working capital	\$ 117,872	\$65,897
Cash and cash equivalents	\$ 90,673	\$ 58,918

Following is a summary of our cash flows from operating activities, investing activities and financing activities for the years ended December 31, 2010, 2009 and 2008:

	For the Year Ended December 31,		
	2010	2009	2008
		(in thousands)	
Net cash provided by (used in) operating activities	\$ 32,906	\$ (375)	\$ 10,627
Net cash used in investing activities	\$ (14,721)	\$ (17,047)	\$ (29,120)
Net cash provided by (used in) financing activities	\$ 13,570	\$ (687)	\$ (2,942)

Cash Flows from Operating Activities

Net cash flows from operating activities were \$32.9 million in 2010 compared to \$375,000 cash used in operating activities in 2009. The increase in our cash flows from operations was primarily due to cash inflow from net income of \$37.1 million in 2010 compared to a cash outflow from net loss of \$21.4 million in 2009. Non-cash expenses decreased by \$17.7 million in 2010 compared to 2009, which is mainly attributable to an increase in net deferred tax assets of \$28.7 million, partially offset by higher stock-based compensation of \$9.7 million, provision for note receivable of \$1.0 million and higher depreciation and amortization expense of \$313,000. The increase in cash flows from operations as a result of the increase in net income and non-cash expenses in 2010 as compared to 2009 was partially offset by the decrease in the changes in assets and liabilities of \$7.6 million. The decrease in the changes in assets and liabilities was mainly due to an increase in inventory as a result of higher inventory build-up in anticipation for higher shipments and an increase in accounts receivable due to higher revenue. The increase was partially offset by higher accounts payable, accrued expense and other liabilities as a result of the expansion of our operations.

Net cash flows from operating activities decreased by \$11.0 million in 2009 compared to 2008. The decrease was primarily due to a net loss of \$21.4 million in 2009 compared to net income of \$1.5 million in 2008, which was offset in part by non-cash expenses that were \$7.2 million higher in 2009 compared to 2008. The increase in non-cash expenses was mainly attributable to the higher stock-based compensation expense due to increased headcount as a result of our acquisitions completed in 2008 and 2009 and higher amortization expenses resulting from the intangibles acquired in connection with such acquisitions. In addition, changes in assets and liabilities, net increased by \$4.7 million in 2009 compared to 2008.

Cash Flows from Investing Activities

Net cash used in investing activities decreased by \$2.3 million in 2010 compared to 2009. The decrease was mainly due to lower acquisition related cash payments in 2010 compared to 2009 of approximately \$5.8 million. The decrease was partially offset by higher purchases of property and equipment of \$3.4 million in 2010 compared to 2009.

Net cash used in investing activities decreased by \$12.1 million in 2009 compared to 2008. The decrease was mainly due to lower cash payments in 2009 compared to the cash payments in 2008 for the acquisitions completed in 2009 and 2008. In addition, lower cash used for purchases of property and equipment in 2009 compared to 2008 contributed to the overall decrease.

Cash Flows from Financing Activities

Net cash provided by financing activities was \$13.6 million in 2010 compared to net cash used in financing activities of \$687,000 in 2009. The increase in cash provided by financing activities was mainly due to higher cash proceeds from stock option exercises of \$17.3 million, partially offset by higher principal payments of capital lease and technology license obligations of \$3.1 million.

Net cash used in financing activities decreased by \$2.3 million in 2009 compared to 2008. The decrease was mainly due to higher cash proceeds from stock option exercises combined with lower cash used for principal payments of capital lease and technology license obligations in 2009 compared to 2008.

Cash equivalents consist primarily of an investment in a money market fund. We believe that our \$90.7 million of cash and cash equivalents at December 31, 2010 and expected cash flow from operations, if any, will be sufficient to fund our projected operating requirements for at least twelve months. Our future capital requirements will depend on many factors, including our rate of revenue growth, the expansion of our engineering, sales and marketing activities, the timing and extent of our expansion into new territories, the timing of introductions of new products and enhancements to existing products and the continuing market acceptance of our products. Although we currently are not a party to any agreement with respect to potential material investments in, or acquisitions of, complementary businesses, services or technologies, other than disclosed in Note 5, we may enter into these types of arrangements in the future, which could also require us to seek additional equity or debt financing. Additional funds may not be available on terms favorable to us or at all.

Indemnities

In the ordinary course of business, we have entered into agreements with customers that include indemnity provisions. Based on historical experience and information known as of December 31, 2010, we believe our exposure related to the above indemnities at December 31, 2010 is not material. We also enter into indemnification agreements with our officers and directors and our certificate of incorporation and bylaws include similar indemnification obligations to our officers and directors. It is not possible to determine the amount of our liability related to these indemnification agreements and obligations to our officers and directors due to the limited history of prior indemnification claims and the unique facts and circumstances involved in each particular agreement.

Off-Balance Sheet Arrangements

During the periods presented, we did not have, nor do we currently have, any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

Contractual Obligations

The following is a summary of our contractual obligations as of December 31, 2010:

	Payments Due By Period				Total
	Less Than 1 Year	1 to 2 Years	3 to 5 Years (in thousands)	More Than 5 Years	
Operating lease obligations	\$ 3,094	\$ 2,606	\$ 50	\$ —	\$ 5,750
Capital lease obligations	8,320	3,021	—	—	11,341
Purchase obligations	600	900	—	—	1,500
Total	<u>\$12,014</u>	<u>\$6,527</u>	<u>\$ 50</u>	<u>\$ —</u>	<u>\$18,591</u>

As of December 31, 2010, we had \$1.3 million of total gross unrecognized tax benefits and related interest. The timing of any payments which could result from these unrecognized tax benefits will depend upon a number of factors. Accordingly, the timing of payment cannot be estimated. We do not expect a significant tax payment related to these obligations to occur within the next 12 months.

As of December 31, 2010, we have funding commitments in relation to the asset purchase agreements entered in January 2011 for the acquisition of Wavesat and Celestial Semiconductor. The total purchase price consideration for the Wavesat acquisition amounted to \$10.0 million which was paid in January 2011. In addition, following the closing of Wavesat acquisition, we also paid \$1.5 million to Wavesat in connection with a transition services agreement, pursuant to which Wavesat continued to employ certain employees prior to their becoming our employees. For Celestial Semiconductor acquisition, we will pay approximately \$55.0 million in total consideration, consisting of a mix of cash and shares of our common stock. In addition, we may pay additional cash consideration up to \$10.0 million after the closing per an earn-out provision based upon the sales of Celestial Semiconductor's products following the consummation of the transaction.

Recent Accounting Pronouncements

See "Recent Accounting Pronouncements" in "Note 1 Organization and Significant Accounting Policies" in Item 8, of this Annual Report, which is incorporated herein by reference.

Item 7A. Quantitative and Qualitative Disclosure About Market Risk

Foreign Currency Risk

Most of our sales are denominated in United States dollars. We therefore have minimal foreign currency risk associated with sale of products. Our international sales and marketing and research and development operations incur expenses that are denominated in foreign currencies. These expenses could be materially affected by currency fluctuations; however, we do not consider this currency risk to be material as the related costs do not constitute a significant portion of our total spending. We outsource our wafer fabrication, assembly, testing, warehousing and shipping operations; however all expenses related thereto are denominated in United States dollars.

Interest Rate Risk

We had cash and cash equivalents of \$90.7 million at December 31, 2010, which was held for working capital purposes. We do not enter into investments for trading or speculative purposes. We do not believe that we have any material exposure to changes in the fair value of these investments as a result of changes in interest rates due to their short term nature. Declines in interest rates, however, will reduce future investment income.

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Item 8. *Financial Statements and Supplementary Data*

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

The following financial statements are filed as part of this Annual Report

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and
Stockholders of Cavium Networks, Inc.

In our opinion, the consolidated financial statements listed in the index appearing under Item 15(a)(1) present fairly, in all material respects, the financial position of Cavium Networks, Inc. and its subsidiaries at December 31, 2010 and December 31, 2009, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2010 in conformity with accounting principles generally accepted in the United States of America. In addition, in our opinion, the financial statement schedule listed in the index appearing under Item 15(a)(2) presents fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2010, based on criteria established in *Internal Control — Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for these financial statements and financial statement schedule, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in Management's Report on Internal Control over Financial Reporting under Item 9A. Our responsibility is to express opinions on these financial statements, on the financial statement schedule, and on the Company's internal control over financial reporting based on our integrated audits (which were integrated audits in 2010 and 2009). We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

As discussed in Note 1 to the consolidated financial statements, the Company changed the manner in which it accounts for business combinations in 2009.

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 (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (ii) 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 (iii) 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.

/s/ PricewaterhouseCoopers LLP
San Jose, California
February 28, 2011

CAVIUM NETWORKS, INC.
CONSOLIDATED BALANCE SHEETS
(In thousands, except share and per share data)

	As of December 31,	
	2010	2009
Assets		
Current assets:		
Cash and cash equivalents	\$ 90,673	\$ 58,918
Accounts receivable, net of allowances of \$579 and \$367, respectively	29,912	21,958
Inventories	31,556	17,965
Prepaid expenses and other current assets	2,423	2,152
Deferred income taxes	9,053	16
Total current assets	163,617	101,009
Property and equipment, net	14,162	14,972
Intangible assets, net	29,226	25,388
Goodwill	57,230	56,607
Deferred income taxes	26,020	228
Other assets	1,365	1,591
Total assets	<u>\$291,620</u>	<u>\$199,795</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 14,160	\$ 10,784
Accrued expenses and other current liabilities	8,136	8,444
Deferred revenue	15,361	12,613
Capital lease and technology license obligations, current portion	8,088	3,271
Total current liabilities	45,745	35,112
Capital lease and technology license obligations, net of current portion	2,956	5,741
Deferred tax liability	5,917	—
Other non-current liabilities	2,392	2,569
Total liabilities	<u>57,010</u>	<u>43,422</u>
Commitments and contingencies (Note 12)		
Stockholders' equity		
Preferred stock, par value \$0.001:		
10,000,000 shares authorized, no shares issued and outstanding as of December 31, 2010 and 2009	—	—
Common stock, par value \$0.001:		
200,000,000 shares authorized; 46,338,336 and 43,507,161 shares issued and outstanding; as of December 31, 2010 and 2009, respectively	46	44
Additional paid-in capital	276,057	234,946
Accumulated deficit	(41,493)	(78,617)
Total stockholders' equity	234,610	156,373
Total liabilities and stockholders' equity	<u>\$291,620</u>	<u>\$199,795</u>

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

CAVIUM NETWORKS, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(In thousands, except per share data)

	Year ended December 31,		
	2010	2009	2008
Net revenue	\$ 206,500	\$ 101,214	\$ 86,609
Cost of revenue	79,487	51,112	35,639
Gross profit	127,013	50,102	50,970
Operating expenses:			
Research and development	60,602	42,682	27,180
Sales, general and administrative	55,303	28,651	22,111
In-process research and development	—	—	1,319
Total operating expenses	115,905	71,333	50,610
Income (loss) from operations	11,108	(21,231)	360
Other income (expense), net:			
Interest expense	(405)	(244)	(499)
Interest income and other	(1,004)	330	2,576
Total other income (expense), net	(1,409)	86	2,077
Income (loss) before income tax expense	9,699	(21,145)	2,437
Income tax (benefit) expense	(27,425)	249	930
Net income (loss)	\$ 37,124	\$ (21,394)	\$ 1,507
Net income (loss) per common share, basic	\$ 0.83	\$ (0.52)	\$ 0.04
Shares used in computing basic net income (loss) per common share	44,740	41,435	40,385
Net income (loss) per common share, diluted	\$ 0.77	\$ (0.52)	\$ 0.04
Shares used in computing diluted net income (loss) per common share	48,235	41,435	42,566

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

CAVIUM NETWORKS, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN
STOCKHOLDERS' EQUITY (DEFICIT)
(In thousands, except share data)

	<u>Common Stock</u>		<u>Additional Paid-in Capital</u>	<u>Deficit</u>	<u>Total Stockholders' Equity/(Deficit)</u>
	<u>Shares</u>	<u>Amount</u>	(in thousands, except per share data)		
Balance at December 31, 2007	40,307,361	\$ 40	\$ 175,540	\$ (58,730)	\$ 116,850
Common stock issued in connection with exercises of stock options	516,759	1	857		858
Common stock issued in connection with vesting of restricted stock units	25,125				—
Vesting of early-exercised stock options			70		70
Repurchase of shares of unvested common stock	(4,480)		(4)		(4)
Stock-based compensation			6,182		6,182
Issuance of common stock in connection with business acquisition	338,245		3,098		3,098
Net income				1,507	1,507
Balance at December 31, 2008	41,183,010	41	185,743	(57,223)	128,561
Common stock issued in connection with exercises of stock options	523,932	1	2,438		2,439
Common stock issued in connection with vesting of restricted stock units	175,902				—
Repurchase of shares of unvested common stock	(2,502)		(15)		(15)
Stock-based compensation			11,768		11,768
Issuance of common stock in connection with business acquisition	1,592,193	2	34,294		34,296
Issuance of common stock for settlement of liabilities	34,626		718		718
Net loss				(21,394)	(21,394)
Balance at December 31, 2009	43,507,161	44	234,946	(78,617)	156,373
Common stock issued in connection with exercises of stock options	2,407,792	2	19,744		19,746
Common stock issued in connection with vesting of restricted stock units	424,551				—
Repurchase of shares of unvested common stock	(1,168)		(4)		(4)
Stock-based compensation			21,371		21,371
Net income				37,124	37,124
Balance at December 31, 2010	46,338,336	\$ 46	\$ 276,057	\$ (41,493)	\$ 234,610

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

CAVIUM NETWORKS, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)

	Year Ended December 31,		
	2010	2009	2008
Cash flows from operating activities:			
Net income (loss)	\$ 37,124	\$ (21,394)	\$ 1,507
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Stock-based compensation expense	21,469	11,727	6,057
Depreciation and amortization	15,115	14,802	11,978
Provision for a note receivable	1,000	—	—
In-process research and development	—	—	1,319
Deferred income taxes	(28,912)	(244)	—
Other	—	39	—
Changes in assets and liabilities, net of effects of acquisitions:			
Accounts receivable, net	(7,750)	(6,726)	(3,901)
Inventories	(13,688)	(651)	(6,063)
Prepaid expenses and other current assets	(721)	266	(66)
Other assets	189	(421)	(275)
Accounts payable	3,875	(457)	1,360
Deferred revenue	3,258	3,743	35
Accrued expenses and other current and non-current liabilities	1,947	(1,059)	(1,324)
Net cash provided by (used in) operating activities	32,906	(375)	10,627
Cash flows from investing activities:			
Purchases of property and equipment	(6,847)	(3,431)	(8,965)
Note receivable	(550)	(450)	—
Acquisition of businesses, net of cash acquired	(6,667)	(12,487)	(19,824)
Purchases of intangible assets	(657)	(679)	(331)
Net cash used in investing activities	(14,721)	(17,047)	(29,120)
Cash flows from financing activities:			
Proceeds from issuance of common stock upon exercise of options	19,744	2,439	858
Principal payment of capital lease and technology license obligations	(6,170)	(3,111)	(3,796)
Repurchases of shares of unvested common stock	(4)	(15)	(4)
Net cash provided by (used in) financing activities	13,570	(687)	(2,942)
Net increase (decrease) in cash and cash equivalents	31,755	(18,109)	(21,435)
Cash and cash equivalents, beginning of period	58,918	77,027	98,462
Cash and cash equivalents, end of period	\$ 90,673	\$ 58,918	\$ 77,027
Supplemental disclosure of cash flow information:			
Cash paid for interest	\$ 406	\$ 243	\$ 499
Cash paid for taxes	424	372	909
Supplemental disclosure of non-cash investing and financing activities:			
Issuance of common stock in connection with the acquisition	\$ —	\$ 34,296	\$ 3,098
Issuance of common stock for settlement of liabilities	—	718	—
Accrual for acquisition related costs	27	2,268	4,709
Purchases from capital lease and technology license	8,450	9,036	723
Vesting of early exercised options	—	—	70

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

CAVIUM NETWORKS, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Organization and Significant Accounting Policies

Organization

Cavium Networks, Inc., (the “Company”), was incorporated in the state of California on November 21, 2000 and was reincorporated in the state of Delaware effective February 6, 2007. The Company designs, develops and markets semiconductor processors for intelligent and secure networks.

During the year ended December 31, 2008, the Company completed purchases of Parallogic Corporation (“Parallogic”), Star Semiconductor Corporation (“Star”) and W&W Communications, Inc. (“W&W”). During the year ended December 31, 2009, the Company completed the purchase of MontaVista Software, Inc. (“MontaVista”). In October 2010, the Company completed the purchase of Celestial Systems, Inc. (“Celestial Systems”). For a complete discussion on the 2008, 2009 and 2010 acquisitions, see “Note 5 Business Combinations.”

Basis of Consolidation

The consolidated financial statements include the accounts of Cavium Networks, Inc. and its wholly owned subsidiaries. All significant intercompany transactions and balances have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in its consolidated financial statements and accompanying notes. Management bases its estimates on historical experience and on various other assumptions it believes to be reasonable under the circumstances, the results of which form the basis of making judgments about the carrying values of assets and liabilities. Actual results could differ from those estimates.

Segment Reporting

Operating segments are based on products and services provided by each segment, internal organization structure, manner in which operations are managed, criteria used by the Chief Operating Decision Maker (“CODM”) to assess the segment performance as well as resource allocation and the availability of discrete financial information. The Company’s primary business has been its semiconductor processor business, which comes from the development and sale of OCTEON, NITROX, ECONA and PureVu products. As such, historically, the Company reported one reporting segment. In the fourth quarter of 2009, the Company completed the acquisition of MontaVista. As a result of the acquisition, the Company’s total software and services now accounts for a more significant portion of its overall business. The financial model, type of products and services, nature of the production process and the sales and distribution process for the Company’s software and services business differs from that of its semiconductor processor business which resulted to change on how the CODM reviews the financial information and manages the business strategy and operations. As such, effective 2010, the Company has determined that it operates in two reportable segments, namely: (1) semiconductor products; and (2) software and services. The Company has updated its fiscal 2009 segment financial information to conform to fiscal 2010 measures used by the CODM.

Summary of Significant Accounting Policies

Cash and Cash Equivalents

The Company considers all highly liquid investments with an original or remaining maturity of 90 days or less at the date of purchase to be cash equivalents. Cash equivalents consist primarily of an investment in a money market fund.

Allowance for Doubtful Accounts

The Company reviews its allowance for doubtful accounts by assessing individual accounts receivable over a specific age and amount. The Company's allowance for doubtful accounts was \$47,000 and \$24,000 as of December 31, 2010 and 2009, respectively.

Inventories

Inventories consist of work-in-process and finished goods. Inventories not related to an acquisition are stated at the lower of cost (determined using the first-in, first-out method), or market value (estimated net realizable value). Inventories from acquisitions are stated at fair value at the date of acquisition. The Company writes down excess and obsolete inventory based on aging and forecasted demand, which includes estimates taking into consideration the Company's outlook on uncertain events such as market and economic conditions, technology changes, new product introductions and changes in strategic direction. Actual demand may differ from forecasted demand and such differences may have a material effect on recorded inventory values. Inventory write-downs are not reversed until the related inventories have been sold or scrapped.

Property and Equipment

Property and equipment are stated at cost and depreciated over their estimated useful lives using the straight-line method. Leasehold improvements are amortized over the shorter of estimated useful lives or unexpired lease term. Additions and improvements that increase the value or extend the life of an asset are capitalized. Upon retirement or sale, the cost of assets disposed of and the related accumulated depreciation are removed from the accounts and any resulting gain or loss is credited or charged to income. Repairs and maintenance costs are expensed as incurred.

	Estimated Useful Lives
Software, computer and other equipment	1 to 5 years
Mask costs and test equipment	1 to 3 years
Furniture, office equipment and leasehold improvements	1 to 5 years

The Company capitalizes the cost of fabrication masks that are reasonably expected to be used during production manufacturing. Such amounts are included within property and equipment and are generally depreciated over a period of twelve months. If the Company does not reasonably expect to use the fabrication mask during production manufacturing, the related mask costs are expensed to research and development expense in the period in which the costs are incurred. The Company has capitalized \$3.1 million, \$680,000 and \$4.2 million of mask costs for the years ended December 31, 2010, 2009 and 2008, respectively. For the years ended December 31, 2010, 2009 and total, total amortization expense from masks were \$1.4 million, \$2.1 million and \$3.5 million, respectively.

Impairment of Long-Lived Assets

The Company reviews long-lived assets, including property and equipment, for impairment whenever events or changes in business circumstances indicate that the carrying amount of the assets may not be fully recoverable. According to the Company's accounting policy, when such indicators are present, if the undiscounted cash flows expected to be generated from operations from those long-lived assets are less than the carrying value of those long-lived assets, the Company compares the fair value of the assets (estimated using discounted future net cash flows to be generated from the lowest common level of operations utilizing the assets) to the carrying value of the long-lived assets to determine any impairment charges. The Company reduces the carrying value of the long-lived assets if the carrying value of the long-lived assets is greater than their fair value. No impairment to the carrying value of long-lived assets was identified by the Company during the years ended December 31, 2010, 2009 and 2008.

Fair Value of Financial Instruments

The carrying amounts of certain of the Company's financial instruments, including cash and cash equivalents, accounts receivable, other assets, accounts payable, accrued expenses and other current liabilities, approximate their fair values due to their short-term nature.

Concentration of Risk

The Company's products are currently manufactured, assembled and tested by third-party contractors in Asia. There are no long-term agreements with any of these contractors. A significant disruption in the operations of one or more of these contractors would impact the production of the Company's products for a substantial period of time, which could have a material adverse effect on the Company's business, financial condition and results of operations.

Financial instruments that potentially subject the Company to a concentration of credit risk consist of cash, cash equivalents and accounts receivable. The Company deposits cash with credit worthy financial institutions. The Company has not experienced any losses on its deposits of cash. Management believes that the financial institutions are reputable and, accordingly, minimal credit risk exists. The Company follows an established investment policy and set of guidelines to monitor, manage and limit the Company's exposure to interest rate and credit risk. The policy sets forth credit quality standards and limits the Company's exposure to any one issuer, as well as the maximum exposure to various asset classes.

A majority of the Company's accounts receivable are derived from customers headquartered in the United States. The Company performs ongoing credit evaluations of its customers' financial condition and, generally, requires no collateral from its customers. The Company provides an allowance for doubtful accounts receivable based upon the expected collectability of accounts receivable.

The end customers representing greater than 10% of consolidated net revenue for each of the years ended were:

	Year Ended December 31,		
	2010	2009	2008
Percentage of total net revenue			
Cisco	22%	24%	29%
Actiontec	*	10%	*
F5 Networks	*	*	11%
Sumitomo	*	*	11%

* Represents less than 10% of the net revenue for the respective period end.

Summarized below are individual customers whose accounts receivable balances were 10% or higher of the consolidated gross receivable:

	As of December 31,	
	2010	2009
Percentage of gross accounts receivable		
Flextronics	14%	14%
Jabil	10%	*

* Represents less than 10% of the gross accounts receivable for the respective period end.

Business Combinations

The Company accounts for business combinations using the purchase method of accounting. The Company determines the recognition of intangible assets based on the following criteria: (i) the intangible asset arises from contractual or other rights; or (ii) the intangible is separable or divisible from the acquired entity and capable of being sold, transferred, licensed, returned or exchanged. In accordance with the guidance provided under business combinations, the Company allocates the purchase price of business combinations to the tangible assets, liabilities and intangible assets acquired, including in-process research and development ("IPR&D"), based on their estimated fair values. The excess purchase price over those fair values is recorded as goodwill. Management makes valuation assumptions that require significant estimates, especially with respect to intangible assets. Critical estimates in valuing certain intangible assets include, but are not limited to future expected cash flows from customer contracts, customer lists, and distribution agreements and acquired developed technologies, expected costs to develop IPR&D into commercially viable products, estimated cash flows from projects when completed and discount rates. The Company estimates fair value based upon assumptions that is believed to be reasonable, but which are inherently uncertain and unpredictable and, as a result, actual results may differ from estimates. Other estimates associated with the accounting for acquisitions may change as additional information becomes available regarding the assets acquired and liabilities assumed.

Effective January 1, 2009, the Company adopted the updated authoritative guidance on business combinations which establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any non-controlling interest in the acquiree. It also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statements to evaluate the nature and the financial effects of the business combination. The updated standards also provides guidance for recognizing changes in an acquirer's existing income tax valuation allowances and tax uncertainty accruals that result from a business combination transaction as adjustments to income tax expense. Similarly, under the updated guidance, the Company expensed related transaction costs of \$2.1 million and \$958,000 in 2010 and 2009 associated with the acquisitions, which would have been capitalized under the prior accounting standards. The updated guidance also addresses application issues regarding the initial recognition and measurement, subsequent measurement and accounting of disclosures of assets and liabilities arising from contingencies in business combination. In circumstances where the acquisition date fair value for a contingency cannot be determined during the measurement period and it is concluded that is probable that an asset or liability exists as of the acquisition date and the amount cannot be reasonably estimated, a contingency is recognized as of the acquisition date based on the estimated amount.

Goodwill and intangible assets

Goodwill is measured as the excess of the cost of an acquisition over the sum of the amounts assigned to tangible and identifiable intangible assets and liabilities assumed. Intangible assets which includes mainly prepaid technology licenses and acquired technologies and customer contracts and relationships, which include technology acquired from other companies either as a result of acquisitions or licensing, are capitalized and amortized on the straight-line method over the estimated useful life of the technologies, which generally range from one to seven years depending on the nature of the intangible assets. Technology licenses payable in installments are capitalized using the present value of the payments.

The Company assesses potential impairment of its goodwill and intangible assets whenever there is evidence that recent events or changes in circumstances have made recovery of an asset's carrying value were not recoverable. The Company also assesses potential impairment of its goodwill on an annual basis at the beginning of the fourth quarter, regardless if there is evidence of impairment. If indicators of impairment were to be present in intangible assets used in operations and future undiscounted cash flows were not expected to be sufficient to

recover the assets' carrying amount, an impairment loss would be recorded in the period identified. The amount of an impairment loss would be recognized as the excess of the asset's carrying value over its fair value. Factors the Company considers important, which may cause impairment include, among others, significant changes in the manner of use of the acquired asset, negative industry or economic trends, and significant underperformance relative to historical or projected operating results. No impairment loss was recorded for the periods presented.

In accordance with the guidance on "Intangible-Goodwill and Other," a two-step impairment test is required to identify potential goodwill impairment and measure the amount of the goodwill impairment loss to be recognized. In the first step, the fair value of each reporting unit is compared to its carrying value to determine if the goodwill is impaired. If the fair value of the reporting unit exceeds the carrying value of the net assets assigned to that unit, then goodwill is not impaired and no further testing is required. If the carrying value of the net assets assigned to the reporting unit were to exceed its fair value, then the second step is performed in order to determine the implied fair value of the reporting unit's goodwill and an impairment loss is recorded for an amount equal to the difference between the implied fair value and the carrying value of the goodwill. The goodwill impairment analysis did not result in an impairment charge for the fiscal years ended 2010 and 2009.

Determining the fair value of a reporting unit and intangible asset is judgmental and involves the use of significant estimates and assumptions. The Company based its fair value estimates on assumptions that are believed to be reasonable but are uncertain and subject to changes in market conditions.

Revenue Recognition

The Company derives its revenue from sales of semiconductor products and sales of software licenses and services. The Company recognizes revenue when all of the following criteria have been met: (i) persuasive evidence of a binding arrangement exists, (ii) delivery has occurred, (iii) the price is deemed fixed or determinable and free of contingencies and significant uncertainties, and (iv) collection is probable. The price is considered fixed or determinable at the execution of an agreement, based on specific products and quantities to be delivered at specified prices, which is often memorialized with a customer purchase order. Agreements with non-distributor customers do not include rights of return or acceptance provisions. The Company assesses the ability to collect from the Company's customers based on a number of factors, including credit worthiness and any past transaction history of the customer.

Shipping charges billed to customers are included in product revenue and the related shipping costs are included in cost of revenue. The Company generally recognizes revenue at the time of shipment to the Company's customers. Revenue from the sales of semiconductor products consists of sales of the Company's products to networking original equipment manufacturers, or OEMs, their contract manufacturers or distributors. Initial sales of the Company's products for a new design are usually made directly to networking OEMs as they design and develop their product. Once their design enters production, they often outsource their manufacturing to contract manufacturers that purchase the Company's products directly from the Company or from the Company's distributors.

Revenue is recognized upon shipment for sales to distributors with limited rights of returns and price protection if the Company concludes it can reasonably estimate the credits for returns and price adjustments issuable. The Company records an estimated allowance, at the time of shipment, based on the Company's historical patterns of returns and pricing credits of sales recognized upon shipment. The credits issued to distributors or other customers were not material in the years ended December 31, 2010, 2009 and 2008. The inventory at these distributors at end of the period may fluctuate from time to time mainly due to the OEM production ramps or new customer demands.

Revenue and costs relating to sales to distributors are deferred if the Company grants more than limited rights of returns and price credits or if it cannot reasonably estimate the level of returns and credits issuable. The Company has a distribution agreement with Avnet, Inc. to distribute the Company's products primarily in the United States.

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Given the terms of the distribution agreement, for sales to Avnet, revenue and costs are deferred until products are sold by Avnet to its end customers. For the years ended December 31, 2010, 2009 and 2008, 6.4%, 5.5% and 3.6%, respectively, of the Company's net revenues were from products sold by Avnet. Revenue recognition depends on notification from the distributor that product has been sold to Avnet's end customers. Avnet reports to the Company, on at least a monthly basis, the product resale price, quantity and end customer shipment information, as well as inventory on hand. Reported distributor inventory on hand is reconciled monthly to the Company's deferred revenue and cost balances. Deferred margin on shipments to Avnet is included in deferred revenue. Accounts receivable from Avnet is recognized and inventory is relieved when title to inventories transfers, which typically takes place at the time of shipment, which is the point in time at which the Company has a legal enforceable right to collection under normal payment terms.

The Company also derives revenue from licensing software and providing software maintenance and support. Software arrangements typically include: (i) an end-user license fee paid in exchange for the use of the Company's products for a specified period of time, generally 12 months (time-based license); and (ii) a support arrangement that provides for technical support and unspecified product updates and upgrades on a when and if available basis over the period of the related license.

Revenue from software and service arrangements is recorded when all of the following criteria are met.

Persuasive evidence of an arrangement exists — The Company requires either a written contract signed by both the customer and the Company, or a shrink-wrap or click-through contract whereby the customer agrees to the Company's standard license terms, together with a non-cancellable purchase order, or a purchase order from these customers that have previously negotiated an end-user license arrangement or volume purchase arrangement.

Delivery has occurred — The Company delivers software to its customers electronically and considers delivery to have occurred once the access codes are provided that allow the customer to take immediate possession of the software.

The fee is fixed or determinable — The Company's determination that an arrangement fee is fixed or determinable depends principally on the arrangement's payment terms.

Collectibility is probable — The Company assesses the collectibility of an arrangement on a case-by-case basis, based on the financial condition of the customer as well as any established payment history.

The Company allocates revenue between elements in a multiple-element revenue arrangement based on vendor specific objective evidence of fair value ("VSOE") for each undelivered element. VSOE is based on the price charged when an element is sold separately. The Company enters into multiple-element arrangements that generally include time-based licenses and support that are typically not sold separately. Revenue from such arrangements is deferred and recognized ratably over the term that support is offered, which is typically 12 months.

The software arrangement may also include professional services, and such services may be purchased separately. Professional services engagements are billed on either a fixed-fee or time-and-materials basis. For fixed-fee arrangements, professional services revenue is recognized under the proportional performance method, with the associated costs included in cost of revenue. The Company estimates the proportional performance of the arrangements based on an analysis of progress toward completion. The Company periodically evaluates the actual status of each project to ensure that the estimates to complete each contract remain accurate, and a loss is recognized when the total estimated project cost exceeds project revenue. If the amount billed exceeds the amount of revenue recognized, the excess amount is recorded as deferred revenue. Revenue recognized in any period is dependent on progress toward completion of projects in progress. To the extent the Company is unable to estimate the proportional performance then the revenue is recognized on a completed performance basis. Revenue for time-and-materials engagements is recognized as the effort is incurred.

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In addition, the Company also enters into multiple element arrangements, which consist of the combination of licensed software, support and professional services. Professional services in such arrangements do not involve significant customization, modification or development of software licensed under the time based licenses and are not essential to the functionality of such software. Provided that the total arrangement consideration is fixed and determinable at the inception of the arrangement, the Company allocates the total arrangement consideration to professional services and time based licenses bundled with support based on VSOE for professional services and VSOE for time based licenses bundled with support. Each unit of accounting is then accounted for under the applicable revenue recognition guidance. For arrangements with services that are essential to the functionality of the software, the license and related service revenues are recognized using proportional performance method.

If the Company is unable to establish VSOE for each undelivered element of the arrangement, revenue for the entire arrangement is deferred until the time the Company is able to establish VSOE for the undelivered elements or there is only one remaining undelivered element. When the revenue is deferred, the direct costs incurred in relation to the professional services arrangement are deferred and is recorded as deferred costs in prepaid expenses and other current assets.

Revenue derived from licensing software and providing software maintenance, support and training for the years ended December 31, 2010, 2009 and 2008 amounted to \$20.2 million, \$2.8 million and \$2.2 million, respectively. Revenue from professional service arrangements for the years ended December 31, 2010, 2009 and 2008 amounted to \$11.0 million, \$2.6 million and \$3.0 million, respectively.

Deferred revenue

The Company records deferred revenue for customer billings and advance payments received from customers before the performance obligations have been completed and/or services have been performed. In addition, the Company also records deferred revenue, net of deferred costs on shipments to Avnet. Total net deferred revenue as of December 31, 2010 and 2009 comprised of the following:

	As of December 31,	
	2010	2009
	(in thousands)	
Services / Support and Maintenance	\$ 5,794	\$ 4,211
Software License / Subscription	6,044	7,711
Distributors	3,523	691
	<u>\$15,361</u>	<u>\$12,613</u>

[Table of Contents](#)**Warranty Accrual**

The Company's products are subject to a one-year warranty period. The Company provides for the estimated future costs of replacement upon shipment of the product as cost of revenue. The warranty accrual is estimated based on historical claims compared to historical revenue. In addition, the Company also provides a one-year warranty period on certain professional services. Such warranty accrual is estimated based on the resource hours needed to cover during the warranty period. The following table presents a reconciliation of the Company's warranty liability, which is included within accrued expenses and other current liabilities in the consolidated balance sheets:

	Year Ended December 31,		
	2010	2009	2008
	(in thousands)		
Beginning balance	\$ 209	\$ 154	\$ 261
Accruals	345	695	144
Settlements and adjustments made	(320)	(640)	(251)
Ending balance	<u>\$ 234</u>	<u>\$ 209</u>	<u>\$ 154</u>

Indemnities

In the ordinary course of business the Company enters into agreements with customers that include indemnity provisions. Based on historical experience and other available information the Company believes its exposure related to the above indemnity provisions were immaterial for each of the periods presented.

Research and Development

Research and development costs are expensed as incurred and primarily include personnel costs, prototype expenses, which include the cost of fabrication mask costs not reasonably expected to be used in production manufacturing, and allocated facilities costs as well as depreciation of equipment used in research and development.

Advertising

The Company expenses advertising costs as incurred. Advertising costs were \$855,000, \$396,000 and \$367,000 for the years ended December 31, 2010, 2009 and 2008 respectively.

Operating Leases

The Company recognizes rent expense on a straight-line basis over the term of the lease. The difference between rent expense and rent paid is recorded as deferred rent in accrued expenses and other current and non-current liabilities components of the consolidated balance sheets.

Income Taxes

The Company provides for deferred income taxes under the asset and liability method. Under this method, deferred tax assets, including those related to tax loss carryforwards and credits, and liabilities are determined based on the differences between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse. A valuation allowance is recorded to reduce deferred tax assets when management cannot conclude that it is more likely than not that the net deferred tax asset will be recovered. The valuation allowance was determined in accordance with the provisions of income taxes which require assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction by jurisdiction basis. The Company has projected that it will earn sufficient future taxable income to justify a release

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of the valuation allowance on its federal and minor portion of its state deferred tax assets. The Company continues to maintain a full valuation allowance against certain state deferred tax assets until sufficient positive evidence exists to support the reversal of this valuation allowance.

Accounting for Stock-Based Compensation

The Company applies the fair value recognition provisions of stock-based compensation, and accordingly, uses the prospective transition method, which requires us to determine fair value only to awards granted, modified, repurchased or cancelled after the adoption date. The Company recognizes this expense on a straight-line basis over the options' vesting periods. The Company estimates the grant date fair value of stock option awards using the Black-Scholes option valuation model.

For the years ended December 31, 2010, 2009 and 2008, the Company recorded stock-based compensation expense of \$21.5 million, \$11.7 million and \$6.1 million, respectively. In future periods, stock-based compensation expense may increase as the Company issues additional stock-based awards to continue to attract and retain key employees. The Company recognizes stock-based compensation expense only for the portion of stock options that are expected to vest, based on the Company's estimated forfeiture rate. If the actual number of future forfeitures differs from that estimated by management, the Company may be required to record adjustments to stock-based compensation expense in future periods.

The Company accounts for stock options issued to nonemployees in accordance with the provisions of the equity-based payments to non-employees. The fair value of the stock options granted to non-employees was estimated using the Black-Scholes option valuation model. This model utilizes the estimated fair value of the Company's common stock, the contractual term of the option, the expected volatility of the price of the Company's common stock, risk-free interest rates and the expected dividend yields of the Company's common stock. Stock-based compensation expense related to non-employees was immaterial.

The following table presents the detail of stock-based compensation expense amounts included in the consolidated statement of operations for each of the last years presented:

	Year Ended December 31,		
	2010	2009 (in thousands)	2008
Cost of revenue	\$ 1,271	\$ 373	\$ 179
Research and development	9,929	5,574	2,684
Sales, general and administrative	10,269	5,780	3,194
	<u>\$21,469</u>	<u>\$ 11,727</u>	<u>\$6,057</u>

The total stock-based compensation cost capitalized as part of inventory as of December 31, 2010 and 2009 \$111,000 and \$209,000, respectively.

Other Comprehensive Income (Loss)

Comprehensive income (loss) includes all changes in equity that are not the result of transactions with stockholders. For the year ended 2010, 2009 or 2008, there are no components of comprehensive income (loss) which are excluded from the net income (loss) and, therefore, no separate statement of comprehensive income (loss) has been presented.

Foreign Currency Translation

The Company uses the United States dollar as the functional currency for most of its subsidiaries. Assets and liabilities denominated in non-U.S. dollars are remeasured into U.S. dollars at end-of-period exchange rates

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for monetary assets and liabilities, and historical exchange rates for nonmonetary assets and liabilities. Net revenue and expenses are remeasured at average exchange rates in effect during each period, except for those revenue, cost of sales and expenses related to the nonmonetary assets and liabilities, which are remeasured at historical exchange rates. The aggregate foreign exchange loss was \$152,000 for the year ended December 31, 2010 and the aggregate foreign exchange gain was \$77,000 and \$118,000 for the year ended December 31, 2009 and 2008, respectively, which was included in interest income and other in the consolidated statements of operations.

Recent Accounting Pronouncements

In April 2010, the FASB issued Update No. 2010-17, or ASU 2010-17, Revenue Recognition — Milestone Method, which updates the guidance currently included under topic 605, Revenue Recognition. ASU 2010-17 provides guidance on defining the milestone and determining when the use of the milestone method of revenue recognition for research or development transactions is appropriate. It provides criteria for evaluating if the milestone is substantive and clarifies that a vendor can recognize consideration that is contingent upon achievement of a milestone as revenue in the period in which the milestone is achieved, if the milestone meets all the criteria to be considered substantive. ASU 2010-17 is effective for milestones achieved in fiscal years, and interim periods within those years, beginning after June 15, 2010 and should be applied prospectively. This standard is applicable to the Company beginning January 1, 2011. The Company is currently evaluating the potential impact, if any, of the new accounting guidance on its consolidated financial statements.

In October 2009, the FASB issued Update No. 2009-13 or ASU 2009-13, which updates the guidance currently included under topic ASC 605-25, Multiple Element Arrangements. ASU 2009-13 relates to the final consensus reached by FASB on a new revenue recognition guidance regarding revenue arrangements with multiple deliverables. The new accounting guidance addresses how to determine whether an arrangement involving multiple deliverables contains more than one unit of accounting, and how the arrangement consideration should be allocated among the separate units of accounting. The new accounting guidance is effective for fiscal years beginning after June 15, 2010 and may be applied retrospectively or prospectively for new or materially modified arrangements. This standard is applicable to the Company beginning January 1, 2011. The Company is currently evaluating the potential impact, if any, of the new accounting guidance on its consolidated financial statements.

2. Net Income (Loss) Per Common Share

The Company calculates basic net income (loss) per common share by dividing net income (loss) by the weighted average number of common shares outstanding during the reporting period (excluding shares subject to repurchase). Diluted net income (loss) per common share is computed by dividing net income (loss) by the weighted-average number of common and potentially dilutive common shares outstanding during the reporting period. Potentially dilutive securities are composed of incremental common shares issuable upon the exercise of stock options and restricted stock units.

The following table sets forth the computation of net income (loss) per share:

	Year Ended December 31,		
	2010	2009	2008
		(in thousands)	
Net income (loss)	\$ 37,124	\$ (21,394)	\$ 1,507
Weighted average common shares outstanding — basic	44,740	41,435	40,385
Dilutive effect of employee stock plans	3,495	—	2,181
Weighted average common shares outstanding — diluted	48,235	41,435	42,566
Basic net income (loss) per share	0.83	(0.52)	0.04
Diluted net income (loss) per share	0.77	(0.52)	0.04

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The following weighted average outstanding options and restricted stock units were excluded from the computation of diluted net income (loss) per common share for the periods presented because including them would have had an anti-dilutive effect:

	Year Ended December 31,		
	2010	2009	2008
		(in thousands)	
Options to purchase common stock	143	7,569	643
Restricted stock units	—	843	—

3. Fair Value

The Company's financial assets and liabilities measured at fair value on a recurring basis include cash equivalents. Fair value is defined as the price that would be received from selling an asset and paid to transfer a liability in an orderly transaction between market participants at the measurement date. A three-tiered fair value hierarchy is established as basis for considering the above assumptions and determining the inputs used in the valuation methodologies in measuring fair values. The three levels of inputs are defined as follows:

Level 1 — Unadjusted quoted market prices for identical assets or liabilities in active markets that the Company has the ability to access.

Level 2 — Quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in inactive markets.

Level 3 — Valuations based on models where significant inputs are not observable. The unobservable inputs reflect the Company's own assumptions about the assumptions that market participants would use.

At December 31, 2010 and 2009, all of the Company's investments were classified as cash equivalents and are comprised of an investment in a money market fund. In accordance with the guidance provided under fair value measurements and disclosures, the Company determined the fair value hierarchy of its money market fund as Level 1, which approximated \$71.1 million and \$49.1 million as of December 31, 2010 and 2009, respectively.

4. Balance Sheet Components

Inventories

Inventories are stated at the lower of cost (determined using the first-in, first-out method), or market value (estimated net realizable value) and are comprised of the following:

	As of December 31,	
	2010	2009
	(in thousands)	
Work-in-process	\$ 24,015	\$ 14,492
Finished goods	7,541	3,473
	<u>\$31,556</u>	<u>\$17,965</u>

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Property and equipment, net, consist of the following:

	As of December 31,	
	2010	2009
	(in thousands)	
Mask costs and test equipment	\$ 16,911	\$ 11,791
Software, computer and other equipment	20,836	19,352
Furniture, office equipment and leasehold improvements	561	466
	38,308	31,609
Less: accumulated depreciation and amortization	(24,146)	(16,637)
	<u>\$ 14,162</u>	<u>\$ 14,972</u>

Depreciation and amortization expense was \$8.4 million, \$7.7 million and \$8.7 million for the years ended December 31, 2010, 2009 and 2008, respectively.

The Company leases certain design tools under time-based capital lease arrangements which are included in property and equipment, and they were \$11.9 million and \$11.2 million at December 31, 2010 and 2009, respectively. Amortization expense related to assets recorded under capital leasing agreements was \$3.8 million, \$3.0 million and \$2.8 million for the years ended December 31, 2010, 2009 and 2008, respectively.

Accrued expenses and other current liabilities consist of the following:

	As of December 31,	
	2010	2009
	(in thousands)	
Accrued compensation and related benefits	\$ 4,214	\$ 3,577
Acquisition related payables	27	2,268
Restructuring related payables	470	623
Customer deposits	652	—
Professional fees	779	688
Income tax payable	1,001	567
Royalty payable	312	285
Accrued warranty	234	209
Other	447	227
	<u>\$8,136</u>	<u>\$ 8,444</u>

Other non-current liabilities consist of the following:

	As of December 31,	
	2010	2009
	(in thousands)	
Accrued rent	\$ 600	\$ 884
Restructuring related payables	470	1,036
Income tax payable	1,322	649
	<u>\$2,392</u>	<u>\$2,569</u>

5. Business Combinations

Parallogic Corporation

On May 20, 2008, the Company acquired certain assets of Parallogic, a privately held company. The aggregate purchase price consisted of cash consideration of \$1.3 million, including direct acquisition costs of \$61,000. The Company paid \$826,000 in cash at the time of close of the acquisition. In 2009, the Company paid two installments of \$220,000 each due to Parallogic's achievement of the milestones as defined in the merger agreement.

The total purchase price was allocated to tangible and identifiable intangible assets based on their estimated fair value as of May 20, 2008. The excess of the purchase price over the tangible and identifiable intangible assets was recorded as goodwill. The purchase price allocation was as follows (in thousands):

	<u>Amount</u> <u>(in thousands)</u>
Net tangible assets	\$ —
Identifiable intangible assets:	
Customer relationships	76
Developed technology	374
Goodwill	816
Total purchase price	<u>\$ 1,266</u>

The fair value assigned to developed technology and customer relationships were based upon future discounted cash flows related to the assets' projected income streams using a discount rate of 20% and 15% respectively. Factors considered in estimating the discounted cash flows to be derived from developed technology and customer relationships include risk related to the characteristics and applications of the technology, existing and future markets and an assessment of the age of the technology within its life span. The Company is amortizing the purchased intangible assets to cost of revenue on a straight-line basis over their estimated useful life of one to five years.

With this acquisition, the Company better positioned itself to deliver professional services for customers to help reduce the time-to-market for design wins and provide high-performance tuning. This acquisition was integrated into the software and services segment.

The results of operations from Parallogic have been included in the Company's consolidated statements of operations only since the date of acquisition. Pro forma results of operations for the acquisition have not been presented as the effect has not been significant.

Star Semiconductor Corporation

On August 1, 2008, the Company acquired substantially all of the intangible assets and inventory and certain other tangible assets of Star, a Taiwan-based design house in Hsinchu that builds highly integrated ARM-based system-on-a-chip, or SOC, processors for the broadband, connected home and small office/home office market segments. The Company paid \$9.6 million in cash, including acquisition related expenses of \$808,000. The results of operations from Star have been included in the Company's consolidated statements of operations only since the date of acquisition.

The acquisition was accounted for using the purchase method of accounting, and, accordingly, the total estimated purchase price was allocated to the tangible and identifiable intangible assets and liabilities assumed

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based on their relative fair values. The excess of the purchase price over the net tangible and identifiable intangible assets was recorded as goodwill. The purchase price was finalized in the third quarter of 2009. The total purchase price was as follows:

	<u>Amount</u> (in thousands)
Cash consideration	\$ 8,790
Acquisition related expenses (1)	808
Total purchase price	\$ 9,598

- (1) Acquisition related expenses include legal and consulting fees and other external costs directly related to the acquisition.

The purchase price allocation was as follows (in thousands):

	<u>Amount</u> (in thousands)
Net tangible assets	\$ 973
Identifiable intangible assets	5,295
Goodwill	3,330
Total purchase price	\$ 9,598

The following table represents details of the purchased intangible assets as part of the acquisition:

Intangible Assets	<u>Estimated Useful Life (in Years)</u>	<u>Amount</u> (in thousands)
Existing technology — product	4.0	\$ 3,849
Core technology — product	4.0	467
Existing technology — licence	0.2	507
Customer contracts and relationships	7.0	307
Tradename	2.0	82
Order backlog	0.2	83
Total		\$ 5,295

The fair value of the existing technology- product, existing technology-license and the customer contracts and relationships was determined based on an income approach using the discounted cash flow method. The discount rate of 18.0% used to value the existing technology — product and discount rate of 20.0% used to value the customer contracts and relationships was estimated using a discount rate based on implied rate of return of the transaction, adjusted for the specific risk profile of each asset. The discount rate of 4.5% used to value the existing technology-license was based on a short-term risk free interest rate. The remaining useful life was estimated based on historical product development cycles, the projected rate of technology attrition, and the patterns of projected economic benefit of the assets.

The fair value of core technology and trade name was determined using a variation of income approach known as the profit allocation method. The estimated savings in profit were determined using a 3.0% profit allocation rate and a discount rate of 18.0%. The estimated useful life was determined based on the future economic benefit expected to be received from the assets.

The fair value of order backlog was determined using a cost approach where the fair value was based on estimated sales and marketing expenses expected to be incurred to regenerate the order backlog. The estimated useful life was determined based on the future economic benefit expected to be received from the asset.

The acquisition provided the Company with a highly experienced stand-alone SOC processor team based in Taiwan. This acquisition was integrated into the semiconductor products segment.

W&W Communications, Inc.

On December 23, 2008, the Company completed the acquisition of W&W Communications, Inc. ("W&W"). Total merger consideration was \$8.3 million, which consisted of cash consideration of \$3.9 million, 338,245 unregistered common shares of the Company valued at \$3.1 million and direct acquisition costs of approximately \$1.3 million. Additionally, in order to effect the acquisition of W&W, the Company assumed and immediately paid-off W&W's notes payable of \$8.9 million. As the notes payable were immediately paid-off, the \$8.9 million has been presented as a cash outflow and included in "Acquisition of businesses, net of cash acquired" within the cash flows used in investing activities section of the consolidated statement of cash flows for the year ended December 31, 2008. In connection with the acquisition, the Company recorded \$880,000 of restructuring costs related to the contractual operating lease obligations of a W&W facility in accordance with the guidance provided under business combinations. The costs associated with the obligation were recognized as a liability assumed in the purchase business combination and included in the purchase price allocation. The results of operations from W&W have been included in the Company's consolidated statements of operations only since the date of acquisition.

The acquisition was accounted for using the purchase method of accounting, and accordingly, the total estimated purchase price was allocated to the tangible and identifiable intangible assets and liabilities assumed based on their relative fair values. The excess of the purchase price over the net tangible and identifiable intangible assets was recorded as goodwill. The purchase price allocation was finalized in the fourth quarter of 2009. The total purchase price was as follows:

	<u>Amount</u> (in thousands)
Cash consideration (1)	\$ 3,891
Value of common stock issued	3,098
Acquisition related expenses (2)	1,262
Total purchase price	<u>\$ 8,251</u>

- (1) Of the total cash consideration of \$3.9 million, \$0.1 million was paid in fiscal 2008 and \$3.8 million was paid in fiscal 2009.
- (2) Acquisition related expenses of \$1.3 million include legal and consulting fees and other external costs directly related to the acquisition, of which \$0.5 million was paid in fiscal 2008 and the remaining \$0.8 million was paid in fiscal 2009.

The purchase price allocation was as follows (in thousands):

	<u>Amount</u> (in thousands)
Cash and cash equivalents	\$ 283
Inventories	829
Other assets	224
Goodwill	8,887
In-process research and development	1,319
Other intangibles	10,114
Accounts payable	(1,357)
Accrued expenses	(2,438)
Accrued restructuring	(750)
Notes payable	(8,860)
Total purchase price	<u>\$ 8,251</u>

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The fair value of intangible assets of \$10.1 million has been allocated to the following identifiable intangible asset categories:

Intangible Assets	Estimated Useful Life (in Years)	Amount (in thousands)
Existing technology	1.0-5.0	\$ 7,768
Core technology	5.0	1,306
Customer contracts and relationships	6.0	583
Order backlog	0.6	457
Total		<u>\$ 10,114</u>

Of the \$11.4 million of acquired intangible assets, \$1.3 million was assigned to in-process research and development or IPR&D and expensed immediately as it related to a project which had not reached technological feasibility at the time of acquisition, and had no future alternative use. The fair value of the IPR&D was determined based on an income approach using the discounted cash flow method. A discount rate of 24% used to value the project was based on the implied rate of return of the transaction, adjusted to reflect additional risks inherent in the acquired project. The Company expects to benefit from the IPR&D project beginning in 2010.

The fair value of the existing technology and customer contracts and relationships was determined based on an income approach using the discounted cash flow method. A discount rate of 18% was used to value the existing technology and a discount rate of 20% was used to value the customer contracts and relationships and was estimated using a discount rate based on implied rate of return of the transaction, adjusted for the specific risk profile of each asset. The remaining useful life of existing technology was estimated based on historical product development cycles, the projected rate of technology attrition, and the patterns of project economic benefit of the assets. The remaining useful life of customer contracts and relationships was estimated based on customer attrition, new customer acquisition and future economic benefit of the asset.

The fair value of core technology was determined using a variation of income approach known as the profit allocation method. The estimated savings in profit were determined using a 5% profit allocation rate and a discount rate of 20%. The estimated useful life was determined based on the future economic benefit expected to be received from the asset.

The fair value of order backlog was determined using a cost approach where the fair value was based on estimated sales and marketing expenses expected that would have to be incurred to regenerate the order backlog. The estimated useful life was determined based on the future economic benefit expected to be received from the asset.

The acquisition allowed the Company to strategically acquire W&W's developed technology and its design team for the emerging consumer market for high definition encoding semiconductors. This acquisition was integrated into the semiconductor product segment.

MontaVista Software, Inc.

On December 14, 2009, the Company completed the acquisition of MontaVista. Pursuant to the merger agreement, the Company paid \$10.9 million in cash and issued 1,592,193 common shares of the Company valued at \$34.3 million based on the Company's December 14, 2009 closing stock price per share. Included in the purchase price was \$1.1 million in cash and 160,000 shares of the Company's common stock that were placed in escrow for a limited period after closing in order to indemnify the Company for certain matters, including breaches of representations and warranties and covenants made by MontaVista in the merger agreement. In addition per the merger agreement, the Company paid \$6.0 million, consisting of a mix of shares of the Company's common stock and cash to certain individuals in connection with the termination of MontaVista's 2006 Retention Compensation Plan.

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The Company accounted for this business combination by applying the acquisition method, and accordingly, the estimated purchase price was allocated to the tangible assets and identifiable intangible assets acquired and liabilities assumed based on their relative fair values. The excess of the purchase price over the net tangible and identifiable intangible assets and liabilities assumed was recorded as goodwill. The purchase price allocation was finalized in the fourth quarter of 2010. The total purchase price was as follows:

	<u>Amount</u> (in thousands)
Cash consideration (1)	\$ 10,948
Value of common stock issued	34,296
Total purchase price	<u>\$ 45,244</u>

- (1) Of the total cash consideration of \$10.9 million, \$8.6 million and \$2.3 million were paid in 2009 and 2010, respectively.

The purchase price allocation was as follows:

	<u>Amount</u> (in thousands)
Cash and cash equivalents	\$ 1,207
Accounts receivable	1,388
Prepaid expenses and other current assets	1,262
Property and equipment	729
Goodwill	42,228
Indentifiable intangibles	14,909
Accounts payable and accrued liabilities	(9,819)
Deferred revenue	(6,660)
Total purchase price	<u>\$ 45,244</u>

The following table represents details of the purchased intangible assets as part of the acquisition:

Intangible Assets	<u>Estimated Useful Life (in Years)</u>	<u>Amount</u> (in thousands)
Existing technology	5.0	\$ 1,295
Subscriber base	7.0	10,485
Customer contracts and relationships	6.0	2,215
Tradename/Trademarks	5.0	914
Total		<u>\$ 14,909</u>

The fair value of the subscriber base as well as the customer contracts and related relationships were determined based on an income approach using the discounted cash flow method. A discount rate of 12.0% was used to value the subscriber base as well as the customer contracts and related relationships. In each case, the discount rate was estimated using a discount rate based on the implied rate of return of the transaction, adjusted for the specific risk profile of each asset. The remaining useful life of the subscriber base as well as the customer contracts and related relationships were estimated based on projected customer attrition and new customer acquisition, and the pattern of projected economic benefit of the asset.

The fair values of the existing technology and the trade name / trademarks were determined using a variation of the income approach known as the profit allocation method. To estimate the fair value of the existing technology an estimated savings in profit was determined using a 3.0% profit allocation rate and a 12.0% discount rate. The remaining useful life for the existing technology was based on historical product development cycles, the projected rate of technology attrition, and the pattern of projected economic benefit of the asset. To

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estimate the fair value of the trade name / trademarks an estimated savings in profit was determined using a 1.0% profit allocation rate and a 14.0% discount rate. The remaining useful life for the trade name / trademarks was determined based on the future economic benefit expected to be received from the asset. In each case, the discount rate was estimated using a discount rate based on the implied rate of return of the transaction, adjusted for the specific risk profile of each asset.

Of the total purchase price, \$42.2 million has been allocated to goodwill. Goodwill represents the excess of the purchase price over the fair value of the underlying net tangible and identifiable intangible assets acquired and liabilities assumed and goodwill is not deductible for tax purposes. The acquisition of MontaVista is intended to complement the Company's broad portfolio of multi-core processors to deliver integrated and optimized embedded solutions to the market and thus integrated into the software and services segment. These new opportunities, among other factors were the reasons for the establishment of the purchase price, resulting in the recognition of a significant amount of goodwill. Goodwill amounts are not amortized, but rather are tested for impairment at least annually. In the event that the Company determines that the value of goodwill has become impaired, the Company will record a charge for the amount of impairment during the fiscal quarter in which such determination is made.

Celestial Systems, Inc.

On October 5, 2010, the Company completed the acquisition of Celestial Systems Inc. ("Celestial Systems") pursuant to the parallel asset purchase agreement entered between Celestial Systems and the Company. The Company agreed to acquire the intellectual properties, customer contracts and relationships and certain equipment for aggregate cash consideration of \$4.4 million and a possible earn-out of approximately \$1.5 million in cash upon the achievement of certain milestone as set forth in the asset purchase agreement.

The Company accounted for this business combination by applying the acquisition method, and accordingly, the estimated purchase price was allocated to the tangible assets and identifiable intangible assets acquired and liabilities assumed based on their relative fair values. The excess of the purchase price over the net tangible and identifiable intangible assets and liabilities assumed was recorded as goodwill. The total purchase price includes the cash consideration of \$4.4 million which was paid out at the closing date of acquisition. The earn-out of \$1.5 million which represents additional bonus to a Celestial Systems' executive employed by the Company will be recognized as compensation expense ratably over one year from acquisition date. The Company expects that it is probable based on service period that the full earn-out payment will be incurred and expects to payout the full amount in the fourth quarter of 2011. As of December 31, 2010, the Company recorded \$375,000 of the total earn-out cash payment liability within accrued expense and other current liabilities.

The preliminary purchase price allocation was as follows:

	<u>Amount</u> <u>(in thousands)</u>
Net tangible assets	\$ 47
Identifiable intangible assets	2,410
Goodwill	1,969
Total purchase price	<u>\$ 4,426</u>

The following table represents details of the purchased intangible assets as part of the acquisition:

<u>Intangible Assets</u>	<u>Estimated Useful Life (in Years)</u>	<u>Amount</u> <u>(in thousands)</u>
Existing technology	5.0	\$ 1,200
Customer contracts and relationships	5.0	1,210
Total		<u>\$ 2,410</u>

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The fair value of the existing technology and customer contracts and relationships was determined based on the income approach using the discounted cash flow method. A discount rate of 18% was used to value for both the existing technology and the customer contracts and relationships and was estimated using a discount rate based on implied rate of return of the transaction, adjusted for the specific risk profile for each asset. The remaining useful life of existing technology was estimated based on historical product development cycles, the projected rate of technology attrition, and the patterns of project benefit of the asset. The remaining useful life of customer contacts and relationships was estimated based on customer attrition, new customer acquisition and future economic benefit of the asset.

With this acquisition, the Company gains critical mass in delivering key technologies and services such as automotive infotainment systems, digital media product development and android commercialization and support. This acquisition is related to our software and services segment.

The results of operations from Celestial Systems have been included in the Company's consolidated statements of operations only since the date of acquisition. Pro forma results of operations for the acquisition have not been presented as the effect has not been significant.

Pro forma financial information

The unaudited financial information in the table below summarizes the combined results of operations of the Company, Star, W&W and MontaVista, on a pro forma basis, as though the companies had been combined as of the beginning of each of the periods presented. The pro forma financial information is presented for informational purposes only and is not indicative of the results of operations that would have been achieved if the acquisitions had taken place at the beginning of each of the periods presented. The pro forma financial information for all periods presented includes the purchase accounting adjustments on historical Star and W&W inventory, adjustments to depreciation on acquired property and equipment, amortization charges from acquired intangible assets and related tax effects.

The unaudited pro forma financial information for the year ended December 31, 2009 combines the historical results of the Company and MontaVista subsequent to December 14, 2009 (the acquisition date), and the historical results for MontaVista from January 1, 2009 to December 14, 2009. In 2009, \$935,000 of revenue resulted from MontaVista subsequent to the acquisition date. The unaudited financial information for the year ended December 31, 2008 combines the results for the Company for the year ended December 31, 2008, which include the results of Start subsequent to August 1, 2008 (acquisition date) and W&W subsequent to December 23, 2008 (the acquisition date), and the historical results for the Star for the seven months ended July 31, 2008, W&W from January 1, 2008 to December 23, 2008 and MontaVista for the year ended December 31, 2008. The following table summarizes the unaudited pro forma financial information (in thousands, except per share amounts):

	Year Ended December 31,	
	2009	2008
Net revenue	\$ 128,442	\$ 124,862
Net loss	\$(36,998)	\$ (20,720)
Net loss per common share, basic and diluted	\$ (0.86)	\$ (0.49)

Subsequent Acquisitions

On January 25, 2011, the Company completed the acquisition of substantially all of the assets of Wavesat Inc. ("Wavesat"), including, but not limited to, certain intellectual property, all of Wavesat's rights to, in and under customer contracts and other material agreements, inventory, equipment, work in progress, fixed assets and goodwill. The Company paid \$10.0 million in cash, plus the aggregate amount of certain liabilities, which were

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specified in the related purchase agreement. Of the \$10.0 million purchase price, \$1.0 million was deposited in escrow for a limited period after closing in order to secure Wavesat's indemnification obligations under the purchase agreement, including for breaches of representations and warranties and covenants made by Wavesat as defined in the related purchase agreement. Following the closing, the Company has also paid approximately \$1.5 million to Wavesat in connection with a transition services agreement, pursuant to which Wavesat continued to employ certain employees prior to their becoming employees of the Company. This acquisition will add multicore wireless digital system processing to the Company's embedded processor product line.

On January 31, 2011, the Company entered into an asset purchase agreement with Celestial Semiconductor, Ltd. ("Celestial Semiconductor"), a Cayman Islands company. On the terms and subject to the conditions set forth in the asset purchase, the Company will purchase certain assets of Celestial Semiconductor. Under the terms of the asset purchase agreement, the Company will pay approximately \$55.0 million in total consideration, consisting of a mix of cash and shares of the Company's common stock. A portion of the cash consideration will be deposited in escrow for a one year period after closing in order to secure Celestial Semiconductor's indemnification obligations under the asset purchase agreement, including breaches of representations and warranties and covenants made by Celestial Semiconductor in the asset purchase agreement. In addition, the Company may pay additional cash consideration of up to \$10.0 million after the closing per an earn-out provision based upon the sales of Celestial Semiconductor's products following consummation of the transaction. With the acquisition of Celestial Semiconductor, Inc., the Company will have a proven processor family targeted for the large and growing market of digital media players.

The Company is currently evaluating the purchase price allocations following the consummation of these transactions. The preliminary purchase price allocation and unaudited pro forma combined financial information is not disclosed in this annual report given the short period of time between the filing date of this report and the acquisition date of Wavesat and the acquisition closing of Celestial Semiconductor.

6. Goodwill and Intangible Assets, Net

Goodwill

The following table presents the changes in the carrying amount of goodwill:

	As of December 31, 2010			As of December 31, 2009		
	Semiconductor Products	Software and Services	Total	Semiconductor Products	Software and Services	Total
	(in thousands)					
Balance at beginning of the period	\$ 12,217	\$ 44,390	\$56,607	\$ 12,109	\$ 816	\$12,925
Additions	—	1,969	1,969	—	43,574	43,574
Adjustments	—	(1,346)	(1,346)	108	—	108
Balance at end of the period	<u>\$ 12,217</u>	<u>\$ 45,013</u>	<u>\$ 57,230</u>	<u>\$ 12,217</u>	<u>\$ 44,390</u>	<u>\$56,607</u>

The addition of \$2.0 million in 2010 relates to the acquisition of Celestial Systems and the \$43.6 million in 2009 relates to the acquisition of MontaVista. The adjustment in goodwill of \$1.4 million in 2010 was mainly related to purchase price allocation adjustments for the fair value of tangible assets and liabilities acquired from the MontaVista and the adjustments of \$108,000 in 2009 was related to prior acquisitions completed in 2008 (see Note 5).

The Company performed an annual impairment assessment of the carrying value of the goodwill recorded in connection with the various acquisitions as required by the related accounting standards. The Company compared the estimated fair value against the carrying value of the goodwill at the reporting unit level and determined that

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the goodwill is not impaired. Based on the Company's assessment, the total fair value of the reporting units was approximately seven (7) times higher compared to its carrying value at December 31, 2010. The fair value of each reporting units were determined based on the weighted fair value identified using market and income valuation approach. Determining the fair value of each reporting units is judgmental in nature and requires the use of significant estimates and assumptions, including revenue growth rates and operating margin, discount rates and future market conditions, among others.

Intangible assets, net consisted of the following:

	As of December 31,	
	2010	2009
	(in thousands)	
Existing and core technology — product	\$ 28,950	\$ 27,750
Technology license	18,340	10,196
Customer contracts and relationships	4,391	3,181
Trade name	996	996
Order backlog	540	540
	<u>53,217</u>	<u>42,663</u>
Less: accumulated amortization		
Existing and core technology — product	(12,251)	(8,027)
Technology license	(10,082)	(8,389)
Customer contracts and relationships	(846)	(253)
Trade name	(272)	(66)
Order backlog	(540)	(540)
	<u>\$ 29,226</u>	<u>\$ 25,388</u>

Amortization expenses were \$6.7 million, \$7.1 million and \$3.3 million for the years ended December 31, 2010, 2009 and 2008, respectively. The amortization expense for the year ended December 31, 2009 includes \$1.3 million related to the reduction of the estimated remaining useful life of one of the intangible assets acquired from the acquisition of W&W.

As of December 31, 2010, the weighted-average remaining estimated lives for intangible assets are approximately 3.1 years for existing and core technology-product and 2.5 years for technology license. The weighted average remaining estimated life of intangible assets in total is approximately 2.9 years. Future amortization expenses as of December 31, 2010 are estimated to be \$6.4 million for 2011, \$5.6 million for 2012, \$4.7 million for 2013, \$3.4 million for 2013, \$2.7 million for 2014 and \$6.5 million thereafter.

7. Restructuring Accrual

In connection with the acquisition of W&W, the Company recorded restructuring liabilities of \$880,000 and was reduced by \$190,000 during the third quarter of 2009 as a result of the completion of a sub-lease agreement. This restructuring related liability is related to an operating lease commitment for one W&W facility, which the Company no longer occupies. The W&W obligation was settled at the end of January 2011 with payment of \$36,000. The sublease expired in 2010.

In connection with the acquisition of MontaVista in 2009, the Company assumed a restructuring related liability of \$1.3 million. The liability is related to the operating lease facility for the portion that MontaVista no longer occupies. The Company expects the MontaVista obligation to be settled by the end of January 2013 with payments of \$434,000 each in 2011 and 2012, respectively, and \$36,000 in 2013. Of the \$904,000 net balance as of December 31, 2010, \$434,000 was recorded as restructuring related payables in accrued expenses and other current liabilities and the remaining \$470,000 was recorded in other non-current liabilities.

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In connection with a workforce reduction action in the three months ended June 30, 2009, the Company incurred \$316,000 in expenses primarily related to severance and related costs. These charges were recorded as operating expenses and the Company fully paid the amount by the end of June, 2009.

A summary of the accrued restructuring liabilities, net of related activities during the years ended December 31, 2010 and 2009 is as follows:

	As of December 31, 2010			As of December 31, 2009		
	(in thousands)					
	Severance and other benefits	Excess facility related costs	Total	Severance and other benefits	Excess facility related costs	Total
Accrued restructuring — beginning of the year	\$ —	\$ 1,659	\$1,659	\$ —	\$ 853	\$ 853
Additions	—	—	—	316	1,364	1,680
Cash payments and other non-cash adjustments	—	(719)	(719)	(316)	(558)	(874)
Accrued restructuring — end of the year	—	940	940	—	1,659	1,659
Less: current portion	—	470	470	—	623	623
Long-term portion	\$ —	\$ 470	\$ 470	\$ —	\$ 1,036	\$ 1,036

8. Stockholders' Equity

Common and Preferred Stock

As of December 31, 2010, the Company is authorized to issue 200,000,000 shares of \$0.001 par value common stock and 10,000,000 shares of \$0.001 par value preferred stock. The Company has the authority to issue preferred stock in one or more series and to fix the rights, preferences, privileges and restrictions thereof, including dividend rights, dividend rates, conversion rights, voting rights, terms of redemption and liquidation preferences. As of December 31, 2010 and 2009, no shares of preferred stock were outstanding.

2007 Stock Incentive Plan

Upon completion of its IPO in May 2007, the Company adopted the 2007 Stock Incentive Plan, the 2007 Plan, which reserved 5,000,000 shares of the Company's common stock. The number of shares of the common stock reserved for issuance will be increased annually on January 1st each year for 10 years commencing from January 1, 2008 through January 1, 2017, by the lesser of (i) 5% of the total number of shares of the common stock outstanding on the applicable January 1st date or (ii) 5,000,000 shares. The board of directors may also act, prior to the first day of any fiscal year, to increase the number of shares as the board of directors shall determine, which number shall be less than each of (i) and (ii). The maximum number of shares that may be issued pursuant to the exercise of incentive stock options under the 2007 Plan is equal to 10,000,000 shares. As of December 31, 2010, there were 3,602,360 shares reserved for issuance under the 2007 Plan. The 2007 Plan provides for the grant of incentive stock options, non-statutory stock options, restricted stock awards, restricted stock unit awards, stock appreciation rights, performance stock awards, and other forms of equity compensation (collectively, "stock awards"), and performance cash awards, all of which may be granted to employees (including officers), directors, and consultants or affiliates. Awards granted under the 2007 Plan vest at the rate specified by the plan administrator, typically with 1/8th of the shares vesting six months after the date of grant and 1/48th of the shares vesting monthly thereafter over the next three and one half years. The term of awards expires seven to ten years from the date of grant. As of December 31, 2010, 8,443,341 shares have been granted under the 2007 Plan.

2001 Stock Incentive Plan

As of December 31, 2010, the Company's 2001 Stock Incentive Plan, the 2001 Plan, reserved 459,503 shares of the Company's common stock for issuance to employees, officers, consultants and advisors of

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the Company. Options granted under the 2001 Plan were either incentive stock options or non-statutory stock options as determined by the Company's board of directors. Options granted under the 2001 Plan vest at the rate specified by the plan administrator, typically with 1/8th of the shares vesting six months after the date of grant and 1/48th of the shares vesting monthly thereafter over the next three and one half years to four and one half years. The term of option expires ten years from the date of grant. No shares were granted under the 2001 Plan in 2010.

Under the Company's 2001 Plan, certain employees have the right to early-exercise unvested stock options, subject to rights held by the Company to repurchase unvested shares in the event of voluntary or involuntary termination. For options granted prior to March 2005, the Company has the right to repurchase any such shares at the shares' original purchase price. For options granted after March 2005, the Company has the right to repurchase such shares at the lower of market value or the original purchase price.

Detail related to activity of all unvested shares of common stock is as follows:

	Number of Unvested Shares Outstanding	Weighted-Average Exercise/Purchase Price
Balance as of December 31, 2007	436,662	\$ 2.45
Issued	—	—
Vested	(286,303)	1.94
Repurchased	(4,795)	0.84
Balance as of December 31, 2008	145,564	\$ 3.50
Issued	—	—
Vested	(101,391)	3.00
Repurchased	(2,502)	5.99
Balance as of December 31, 2009	41,671	\$ 4.59
Issued	—	—
Vested	(36,528)	4.62
Repurchased	(1,168)	3.04
Balance as of December 31, 2010	3,975	4.76

Detail related to stock option activity is as follows:

	Number of Shares Outstanding	Weighted Average Exercise Price
Balance as of December 31, 2007	3,920,001	\$ 3.86
Options granted	2,124,475	16.32
Options exercised	(516,759)	1.58
Options cancelled and forfeited	(130,263)	12.15
Balance as of December 31, 2008	5,397,454	\$ 8.78
Options granted	3,032,486	11.39
Options exercised	(523,932)	4.65
Options cancelled and forfeited	(336,911)	14.93
Balance as of December 31, 2009	7,569,097	\$ 9.84
Options granted	768,226	25.52
Options exercised	(2,407,792)	8.20
Options cancelled and forfeited	(315,967)	15.97
Balance as of December 31, 2010	5,613,564	\$ 12.34

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The aggregate intrinsic value for options exercised during the year ended December 31, 2010 and 2009 were \$71.7 million and \$9.9 million, respectively, representing the difference between the closing price of the Company's common stock at the date of exercise and the exercise price paid.

The following table summarizes information about stock options outstanding as of December 31, 2010:

Exercise Prices	Outstanding Options			Exercisable Options		Aggregate Intrinsic Value
	Number of Shares	Weighted Average Remaining Contractual Term	Weighted Average Exercise Price	Number of shares	Weighted Average Exercise Price	
\$0.03 - \$1.50	440,447	4.50	\$ 0.97	440,447	\$ 0.97	
3.04 - 3.04	794,418	5.22	3.04	754,162	3.04	
3.74 - 8.52	562,322	5.38	7.94	358,256	7.71	
10.32 - 10.32	1,407,959	5.10	10.32	459,414	10.32	
12.56 - 14.42	145,393	4.88	13.80	60,438	13.84	
14.80 - 14.80	893,157	4.21	14.80	510,350	14.80	
16.32 - 24.16	907,922	5.60	21.60	218,450	21.02	
24.99 - 29.92	347,803	6.23	26.24	117,994	26.54	
30.12 - 30.12	94,476	6.82	30.12	—	—	
31.54 - 31.54	19,667	6.79	31.54	14,540	31.54	
0.03 - 31.54	5,613,564	5.14	\$ 12.34	2,934,051	\$ 9.13	\$ 142,255,497
Exercisable	2,934,051	4.99	\$ 9.13			\$ 83,763,789
Vested and expected to vest	5,519,827	5.13	\$ 12.23			\$ 140,488,659

The aggregate intrinsic value for options outstanding at December 31, 2010 was \$142.3 million representing the difference between the weighted average exercise price and \$37.68, the closing price of the Company's common stock at December 31, 2010, as reported on The NASDAQ Global Market, for all in the money options outstanding.

The fair value of each employee option grants for the years ended December 31, 2010, 2009 and 2008 was estimated on the date of grant using the Black-Scholes option-pricing model with the following assumptions.

	For the Year Ended December 31,		
	2010	2009	2008
Risk-free interest rate	1.03% - 2.09%	1.52% - 2.19%	1.31% - 3.32%
Expected life	4 - 5 years	4 - 5 years	4 - 5 years
Dividend yield	0%	0%	0%
Volatility	55% - 57%	58% - 64%	55% - 63%

The Company determined that it was not practical to calculate the historical volatility of its share price since the Company's securities were not publicly traded prior to May 2007 and before which there was no readily determinable market value for its stock. Further, the Company is a high-growth technology company whose future operating results are not comparable to its prior operating results. Therefore, the Company estimated its expected volatility based on reported market value data for a group of publicly traded companies, which it selected from certain market indices, that the Company believed was relatively comparable after consideration of their size, stage of life cycle, profitability, growth, and risk and return on investment. The expected term represents the period that stock-based awards are expected to be outstanding, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior as influenced by changes to the terms of our stock-based awards. The Company uses the simplified method to determine the expected term as permitted by the provisions of stock-based compensation.

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The estimated weighted-average grant date fair value of options granted during the twelve months ended December 31, 2010, 2009 and 2008 were \$12.20, \$5.77 and \$7.87, respectively. There were \$19.2 million of unrecognized compensation cost, net of estimated forfeitures as of December 31, 2010. The unrecognized compensation cost at December 31, 2010 is expected to be recognized over a weighted average period of 2.21 years.

Restricted Stock Unit Awards

The company began issuing restricted stock units, or RSUs, in the fourth quarter of 2007. Shares are issued on the date the restricted stock units vest, and the fair value of the underlying stock on the dates of grant is recognized as stock-based compensation over a three or four-year vesting period. A summary of the activity of restricted stock for the related periods are presented below:

	Number of Shares	Weighted- Average Grant Date Fair Value Per Share
Balance as of December 31, 2007	12,000	\$ 31.54
Granted	300,820	16.82
Issued and released	(25,125)	20.07
Cancelled and forfeited	(6,762)	16.54
Balance as of December 31, 2008	280,933	\$ 17.16
Granted	768,893	16.48
Issued and released	(175,902)	13.10
Cancelled and forfeited	(31,388)	14.25
Balance as of December 31, 2009	842,536	\$ 17.49
Granted	1,250,741	25.66
Issued and released	(424,551)	20.64
Cancelled and forfeited	(76,687)	23.01
Balance as of December 31, 2010	1,592,039	\$ 22.80
Expected to vest as of December 31, 2010	1,496,889	\$ 22.80

The total intrinsic value of the RSUs issued as of December 31, 2010 was \$56.4 million, representing the closing price of the Company's stock on December 31, 2010, multiplied by the number of non-vested RSUs expected to vest as of December 31, 2010.

For RSUs, stock-based compensation is calculated based on the market price of the Company's common stock on the date of the grant, multiplied by the number of RSUs granted. The grant date fair value of RSUs, less estimated forfeitures, is recognized on a straight-line basis, over the vesting period.

As of December 31, 2010, the total unrecognized compensation cost, net of estimated forfeitures related to restricted stock units granted under the Company's 2007 Equity Incentive Plan amounted to \$31.0 million. The unrecognized compensation cost at December 31, 2010 is expected to be recognized over a weighted average period of 2.92 years.

9. Income Taxes

The Company recorded income tax benefit of \$27.4 million for the year ended December 31, 2010 and income tax expense of \$249,000 and \$930,000 for the years ended December 31, 2009 and 2008, respectively. The tax benefit for the year ended December 31, 2010 primarily consists of a \$28.9 million tax benefit due to the release of valuation allowance for federal income tax assets, partially offset by tax provision of \$1.5 million. The provision for the year ended December 31, 2010 consists of \$636,000 of federal tax expense primarily relating to

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an adjustment to unrecognized tax benefit reserves for transfer pricing, \$21,000 of various state taxes and \$829,000 of international taxes resulting from the statutory foreign tax rates applied against the profit of the foreign subsidiaries. The provision for the year ended December 31, 2009 primarily consists of international and state taxes which are offset by prior year federal tax adjustments. The provision for the year ended December 31, 2008 was primarily due to the federal alternative minimum tax on profits in the Company's United States profits adjusted by certain non-deductible items, international taxes and state income taxes.

The domestic and foreign components of income (loss) before income tax expense were as follows:

	Year Ended December 31,		
	2010	2009	2008
		(in thousands)	
Domestic	\$ (8,456)	\$ (8,978)	\$ 14,131
Foreign	18,156	(12,165)	(11,694)
	<u>\$ 9,700</u>	<u>\$ (21,143)</u>	<u>\$ 2,437</u>

Income tax expense consists of the following:

	Year Ended December 31,		
	2010	2009	2008
		(in thousands)	
Current tax provision			
Domestic	\$ 658	\$ (47)	\$ 865
Foreign	829	296	65
	<u>\$ 1,487</u>	<u>\$ 249</u>	<u>\$ 930</u>
Deferred tax provision (benefit)			
Domestic	\$ (28,846)	\$ —	\$ —
Foreign	(66)	—	—
	<u>\$ (28,912)</u>	<u>\$ —</u>	<u>\$ —</u>
Total tax expense	<u>\$ (27,425)</u>	<u>\$ 249</u>	<u>\$ 930</u>

The Company's effective tax rate differs from the United States federal statutory rate as follows:

	Year Ended December 31,		
	2010	2009	2008
Income tax at statutory rate	35.0%	34.0%	34.0%
Non-deductible stock compensation costs	9.6	(2.2)	10.4
Other	1.8	(0.4)	3.4
Foreign net operating losses not benefited	0.2	(21.7)	166.0
State taxes, net of federal benefit	0.1	(0.4)	1.6
Non-deductible in-process research and development	—	—	18.4
Alternative minimum tax	—	—	33.0
Research and development credits	(16.3)	—	—
Foreign tax rate differences	(43.3)	—	—
Change in valuation allowance	(269.9)	(10.5)	(228.6)
Total	<u>(282.80)%</u>	<u>(1.20)%</u>	<u>38.20%</u>

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The tax effects of the temporary differences that give rise to deferred tax assets and liabilities are as follows:

	As of December 31,	
	2010	2009
	(in thousands)	
Deferred tax assets:		
Tax credits	\$ 14,172	\$ 14,020
Net operating loss carryforwards	18,750	22,428
Capitalized research and development	16	36
Depreciation and amortization	3,758	3,179
Stock compensation	5,722	4,789
Other	4,488	2,867
Gross deferred tax assets	46,906	47,319
Less: valuation allowance	(11,833)	(39,601)
Net deferred tax assets	35,073	7,718
Deferred tax liabilities:		
Other	(5,917)	(7,474)
Net deferred tax assets	\$29,156	\$ 244

As of December 31, 2010, the Company had total net operating loss carryforwards for federal and state income tax purposes of \$144.0 million and \$147.2 million respectively. If not utilized, these net federal and state operating loss carryforwards will expire beginning in 2020 and 2014, respectively. The federal net operating loss carryforwards of \$144.0 million are comprised of stock option deductions of \$65.0 million, which will be credited to equity when realized. The state net operating loss carryforwards of \$147.2 million are comprised of stock option deductions of \$76.0 million, which will be credited to equity when realized.

The Company is tracking the portion of its deferred tax assets attributable to stock option benefits in a separate memo account pursuant to the accounting guidance for stock-based compensation. Therefore, these amounts are no longer included in the Company's gross or net deferred tax assets. Pursuant to the guidance under stock-based compensation, the stock option benefits of approximately \$25.2 million will only be recorded to equity when they reduce cash taxes payable.

The Company also had federal and other state research and development tax credit carryforwards of approximately \$11.1 million and \$5.8 million, respectively. The federal and other state tax credit carryforwards will expire commencing 2020 and 2016, respectively, except for the California research tax credits which carry forward indefinitely. The Company also has various miscellaneous federal, state and foreign tax credits of approximately \$1.0 million. The Company currently maintains a full valuation allowance on its deferred tax assets in California and Massachusetts.

The Company's net deferred tax assets relate predominantly to its United States tax jurisdiction. The valuation allowance is determined in accordance with the provisions of income taxes which require an assessment of both positive and negative evidence when determining whether it is more likely than not that deferred tax assets are recoverable; such assessment is required on a jurisdiction by jurisdiction basis. Due to projected future income, there is no valuation allowance placed on the federal deferred tax assets. A valuation allowance of \$12.0 million was placed on the Company's state deferred tax assets.

The Company has reviewed whether the utilization of its net operating losses and research credits are subject to a substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code and similar state provisions. Utilization of these carryforwards are restricted and results in some amount of these carryforwards expiring prior to benefiting the Company.

Undistributed earnings of our foreign subsidiary of approximately \$0.3 million at December 31, 2010 and 2009, are considered to be indefinitely reinvested and, accordingly, no provisions for federal and state income

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taxes have been provided thereon. Upon distribution of those earnings in the form of dividends or otherwise, the Company would be subject to both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes payable to various foreign countries.

The following table summarizes the activity related to the unrecognized tax benefits:

	Year Ended December 31,		
	2010	2009	2008
		(in thousands)	
Balance at beginning of the year	\$ 4,849	\$ 4,033	\$ 3,574
Gross increases related to prior years tax positions	6,943	117	147
Gross increases related to current years tax positions	1,157	699	312
Balance at the end of the year	<u>\$ 12,949</u>	<u>\$ 4,849</u>	<u>\$ 4,033</u>

Included in the unrecognized tax benefits at December 31, 2010 is \$12.9 million tax benefits that, if recognized, would reduce the Company's annual effective tax rate. The Company's practice is to recognize interest and/or penalties related to income tax matters in income tax expense. The Company also accrued potential penalties and interest of \$29,000 and \$19,000 related to these unrecognized tax benefits in 2009 and 2008, respectively and none in 2010. The Company does not expect its unrecognized tax benefits to change significantly over the next 12 months.

The Company in the future may expand its international operations and staff to better support its expansion into international markets. The Company's foreign subsidiaries have acquired certain rights to sell the existing intellectual property and intellectual property that will be developed or licensed in the future. The existing rights were transferred for an initial payment. As a result of these changes and an expanding customer base in Asia, the Company expects that an increasing percentage of its consolidated pre-tax income will be derived from, and reinvested in, its Asian operations. The Company anticipates that this pre-tax income will be subject to foreign tax at relatively lower tax rates when compared to the United States federal statutory tax rate and as a consequence, the Company's effective income tax rate is expected to be lower than the United States federal statutory rate.

The Company's major tax jurisdictions are the United States federal government, the state of California and Singapore. The Company files income tax returns in the United States federal jurisdiction, the state of California and various state and foreign tax jurisdictions in which it has a subsidiary or branch operation. The United States federal corporation income tax returns beginning with the 2000 tax year remain subject to examination by the Internal Revenue Service, or IRS. The California corporation income tax returns beginning with the 2000 tax year remain subject to examination by the California Franchise Tax Board. There are no on-going tax audits in the major tax jurisdictions.

10. Retirement Plan

The Company has established a defined contribution savings plan under Section 401(k) of the Internal Revenue Code. This plan covers substantially all employees who meet minimum age and service requirements and allows participants to defer a portion of their annual compensation on a pre-tax basis. The Company matches 50% of the employees' contribution up to \$2,000 per employee. Company contributions to the plan may be made at the discretion of the board of directors. The Company matching contribution was deferred effective January 2009 and was reinstated beginning January 2010. For the years ended December 31, 2010, 2009 and 2008, the Company's defined contribution expense was \$517,000, \$37,000 and \$266,000, respectively.

11. Segment and Geographical Information

Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision-maker, or CODM in deciding how to allocate

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resources and in assessing performance. The Company's primary business has been its semiconductor processor business, which comes from the development and sale of its OCTEON, NITROX, ECONA and PureVu products. Historically, financial information was presented on a consolidated basis to the Company's for the purpose of evaluating financial performance and allocating resources accompanied by information about revenue by customer and geography region. As such historically the Company reported one reportable segment.

In the fourth quarter of 2009, the Company completed the acquisition of MontaVista. As a result of the acquisition, the Company's total software and services now accounts for a more significant portion of its overall business. The financial model, type of products and services, nature of the production process and sales and distribution process for the Company's software and services business differs from that of its semiconductor processor business. In addition, the external reports that the Company uses to communicate its financial information to investors have now evolved to treat its software and services business separately. Furthermore, the CODM reviews financial information separately for the Company's software and services business for purpose of evaluating financial performance and allocating resources. As such, in accordance with segment reporting guidance, effective 2010, the Company has determined that it operates in two reportable segments, namely: (1) semiconductor products; and (2) software and services. The Company has updated its fiscal 2009 segment financial information to conform to fiscal 2010 measures used by the CODM.

The two reportable segments are based upon the Company's internal organizational structure, the manner in which the operations are managed, the criteria used by the CODM to evaluate segment performance and the availability of separate financial information. The accounting policies for the segment reporting are the same as for the Company as a whole. The financial information used by the Company's CODM to evaluate segments results are net revenue and income (loss) from segment operations.

Segment financial information for the Company's reportable segments was as follows:

	For the Year Ended December 31,		
	2010	2009	2008
	(in thousands)		
Net revenue:			
Semiconductor products	\$ 175,157	\$ 95,425	\$ 81,059
Software and services	31,343	5,789	5,550
Total consolidated net revenue	<u>\$ 206,500</u>	<u>\$ 101,214</u>	<u>\$ 86,609</u>
Segment income:			
Semiconductor products	\$ 48,947	\$ 4,266	\$ 12,151
Software and services	5,562	3,930	5,130
Total segment income from operations	<u>\$ 54,509</u>	<u>\$ 8,196</u>	<u>\$ 17,281</u>

The following is a reconciliation of the total segment income from operations to the amounts reported on the condensed consolidated financial statements:

	For the Year Ended December 31,		
	2010	2009	2008
	(in thousands)		
Segment income from reportable segments	\$ 54,509	\$ 8,196	\$ 17,281
Unallocated stock compensation and related taxes	(22,962)	(11,997)	(6,381)
Amortization of acquired intangible assets	(5,022)	(5,535)	(2,430)
Acquisition related expenses	(6,661)	(5,698)	(1,789)
Unallocated corporate, general and administrative expenses	(8,756)	(6,197)	(6,321)
Total consolidated income (loss) from operations	11,108	(21,231)	360
Other (expense) income, net	(1,409)	86	2,077
Total consolidated income(loss) before income taxes	<u>\$ 9,699</u>	<u>\$ (21,145)</u>	<u>\$ 2,437</u>

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The following table is based on the geographic location of the original equipment manufacturers or the distributors who purchased the Company's products. For sales to the distributors, their geographic location may be different from the geographic locations of the ultimate end customers. Sales by geography for the periods indicated were as follows:

	For the Year Ended December 31,		
	2010	2009 (in thousands)	2008
United States	\$ 70,247	\$ 40,623	\$ 44,787
China	58,017	24,189	9,849
Taiwan	28,393	15,224	11,533
Japan	19,273	10,802	11,559
Malaysia	12,696	5,088	6,639
Other countries	17,874	5,288	2,242
Total	\$206,500	\$101,214	\$ 86,609

The following table set forth long lived assets, which consist primarily of property and equipment by geographic regions based on the location of the asset:

	As of December 31,	
	2010	2009 (in thousands)
United States	\$ 13,690	\$ 14,492
All other countries	472	480
Total	\$ 14,162	\$ 14,972

12. Commitments and Contingencies

The Company is not currently a party to any legal proceedings that management believes would have a material adverse effect on the consolidated financial position, results of operations or cash flows of the Company.

The Company leases its facilities under non-cancelable operating leases, which contain renewal options and escalation clauses, and expire through July 2014. The Company also acquires certain assets under capital leases.

Minimum commitments under non-cancelable capital and operating lease agreements, excluding those leases included in the accrued restructuring liability (See Note 7) as of December 31, 2010 were as follows:

	Capital lease and technology license obligations	Operating leases (in thousands)	Total
2011	\$ 8,320	\$ 3,094	\$ 11,414
2012	3,021	2,009	5,030
2013	—	597	597
2014	—	50	50
	\$ 11,341	\$ 5,750	\$17,091
Less: Interest component	(297)		
Present value of minimum lease payment	11,044		
Less: current portion	(8,088)		
Long-term portion of obligations	\$ 2,956		

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As of December 31, 2010, the Company has funding commitments in relation to the asset purchase agreements entered in January 2011 for the acquisition of Wavesat and Celestial Semiconductor. The total purchase price consideration for the Wavesat acquisition amounted to approximately \$10.0 million which was paid in January 2011. Following the closing, the Company has also paid approximately \$1.5 million to Wavesat in connection with a transition services agreement, pursuant to which Wavesat continued to employ certain employees prior to their becoming employees of the Company. For Celestial Semiconductor acquisition, the Company will pay approximately \$55.0 million in total consideration, consisting of a mix of cash and shares of our common stock. In addition, the Company may pay additional cash consideration up to \$10.0 million per the earn-out provision after the closing based upon the sales of Celestial Semiconductor's products following the consummation of the transaction.

Rent expense incurred under operating leases was \$3.2 million, \$2.2 million and \$1.6 million for the years ended December 31, 2010, 2009 and 2008, respectively.

The capital lease and technology license obligations include future cash payments payable primarily for license agreements with outside vendors. The significant obligations which have outstanding payments as of December 31, 2010 relates to a license agreement, which was entered into in October 2009 for certain design tools totaling \$9.5 million, with 12 installment payments. The term of the license will expire in October 2012. The present value of the installment payments has been capitalized and is amortized over three years, and included within capital lease and technology license obligations on consolidated balance sheets. As of December 31, 2010, \$3.9 million of the total \$9.5 million due under the license agreement was paid. Further, the Company entered into a licensing agreement in April 2010 for certain design tools totaling \$950,000, which has been capitalized and is amortized over three years, and included within capital lease and technology license obligations on the consolidated balance sheet. As of December 31, 2010, \$100,000 of the total \$950,000 due under the license agreement was paid.

On September 29, 2010, the Company renewed an agreement with MIPS to use certain licensed technology. Pursuant to the agreement, which will expire in September 2026, the Company can use the licensed technology in exchange for license fees and royalties on the Company's products that incorporate the licensed technology. The full license fees have been capitalized as intangible assets, which will be amortized over the license term.

Schedule II — Valuation and Qualifying Accounts and Reserves

Description	Balance at Beginning of Period	Additions	Deduction	Balance at End of Period
	(In thousands)			
Year ended December 31, 2010				
Allowance for doubtful accounts	\$ 24	\$ 68	\$ (45)	\$ 47
Allowance for customer returns	343	1,765	(1,576)	532
Income tax valuation allowance	39,601	—	(27,768)	11,833
Year ended December 31, 2009				
Allowance for doubtful accounts	\$ 34	\$ —	\$ (10)	\$ 24
Allowance for customer returns	169	1,291	(1,117)	343
Income tax valuation allowance	14,430	25,171	—	39,601
Year ended December 31, 2008				
Allowance for doubtful accounts	\$ 38	\$ —	\$ (4)	\$ 34
Allowance for customer returns	139	695(1)	(665)(1)	169
Income tax valuation allowance	13,136	1,294	—	14,430

(1) Certain reclassifications have been made to 2008 amounts to conform to 2009 presentation.

All other schedules are omitted because they are inapplicable or the requested information is shown in the consolidated financial statements of the registrant or related notes thereto.

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

Not applicable.

Item 9A. Controls and Procedures

MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

Cavium Networks, Inc.'s management is responsible for establishing and maintaining adequate internal control over financial reporting for Cavium (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act of 1934, as amended). Cavium'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 U.S. generally accepted accounting principles. Cavium's internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of Cavium; (ii) 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 Cavium are being made only in accordance with authorizations of management and directors of Cavium; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of Cavium'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. Our management does not expect that our disclosure controls or our internal control over financial reporting will prevent or detect 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. 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. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, have been detected. These inherent

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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 there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

Cavium's management assessed the effectiveness of Cavium's internal control over financial reporting as of December 31, 2010, utilizing the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in Internal Control-Integrated Framework. Based on the assessment by Cavium's management, we determined that Cavium's internal control over financial reporting was effective as of December 31, 2010. Management reviewed the results of their assessment with our Audit Committee. The effectiveness of the Company's internal control over financial reporting as of December 31, 2010 has been audited by PricewaterhouseCoopers LLP, an independent registered public accounting firm, as stated in their report which appears herein.

Changes in Internal Control Over Financial Reporting

In December 2009, we completed the acquisition of MontaVista. During the year ended December 31, 2010, we completed the incorporation of processes which were previously operated separately by MontaVista in our systems control environment. There were no other significant changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act of 1934, as amended) during the year ended December 31, 2010 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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(e) and 15d-15(e) of the Exchange Act of 1934, as amended) 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 Chief Financial Officer have 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 Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to management as appropriate to allow for timely decisions regarding required disclosure.

Item 9B. *Other Information*

None.

PART III

Certain information required by Part III is omitted from this Annual Report on Form 10-K since we intend to file our definitive proxy statement for our 2011 annual meeting of stockholders, pursuant to Regulation 14A of the Securities Exchange Act, not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, and certain information to be included in the proxy statement is incorporated herein by reference.

Item 10. *Directors, Executive Officers and Corporate Governance*

The information required by this item with respect to directors and executive officers may be found under the caption “Executive Officers of the Registrant” in Part I, Item 1 of this Annual Report on Form 10-K, and in the section entitled “Proposal 1 — Election of Directors” appearing in the Proxy Statement. Such information is incorporated herein by reference.

The information required by this Item with respect to our audit committee and audit committee financial expert may be found in the section entitled “Proposal 1 — Election of Directors — Audit Committee” appearing in the Proxy Statement. Such information is incorporated herein by reference.

The information required by this Item with respect to compliance with Section 16(a) of the Securities Exchange Act of 1934 and our code of ethics may be found in the sections entitled “Section 16(a) Beneficial Ownership Reporting Compliance” and “Proposal 1 — Election of Directors — Code of Ethics,” respectively, appearing in the Proxy Statement. Such information is incorporated herein by reference.

We have adopted the Cavium Networks, Inc. Code of Business Conduct and Ethics that applies to all officers, directors and employees. The Code of Business Conduct and Ethics is available on our website at <http://investor.caviumnetworks.com>. If we make any substantive amendments to the Code of Business Conduct and Ethics or grant any waivers from a provision of the Code to any executive officer or director, we will promptly disclose the nature of the amendment or waiver on our website.

Item 11. *Executive Compensation.*

The information required by this item is included in our proxy statement for our 2011 annual meeting of stockholders under the sections entitled “Executive Compensation,” “Compensation Committee Interlocks and Insider Participation” and “Compensation Committee Report” and is incorporated herein by reference.

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

The information required by this item relating to security ownership of certain beneficial owners and management is included in our proxy statement for our 2011 annual meeting of stockholders under the section entitled “Security Ownership of Certain Beneficial Owners and Management” and is incorporated herein by reference.

The information required by this item with respect to securities authorized for issuance under our equity compensation plans is incorporated herein by reference to the information from the proxy statement for our 2010 annual meeting of stockholders under the section entitled “Equity Compensation Plan Information” and is incorporated herein by reference.

Item 13. *Certain Relationships and Related Transactions, and Director Independence.*

The information required by this item is included in our proxy statement for our 2010 annual meeting of stockholders under the sections entitled “Transactions with Related Persons” and “Information Regarding the Board of Directors and Corporate Governance” and is incorporated herein by reference.

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Item 14. *Principal Accounting Fees and Services.*

The information required by this item is incorporated herein by reference to the information included in our proxy statement for our 2010 annual meeting of stockholders under the section entitled “Proposal 2 — Ratification of Selection of Auditors.”

PART IV

Item 15. *Exhibits, Financial Statement Schedules*

Index to Consolidated Financial Statements

a. The following documents are filed as part of this report:

- | | | |
|----|--|----|
| 1. | Financial Statements: | 55 |
| | See Index to Financial Statements in Item 8 of this Annual Report on Form 10-K, which is incorporated herein by reference. | |
| 2. | Financial Statement Schedule: | 92 |
| | Schedule II — Valuation and Qualifying Accounts and Reserve | |
| 3. | Exhibits: | 97 |
| | The exhibits listed in the accompanying index to exhibits are filed or incorporated by reference as a part of this Annual Report on Form 10-K. | |

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on February 28, 2011.

Cavium Networks, Inc.

By /s/ Syed Ali
Syed Ali
President and Chief Executive Officer

By /s/ Arthur Chadwick
Arthur Chadwick
Chief Financial Officer, Vice President of Finance
and Administration and Secretary

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

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Syed Ali</u> Syed Ali	President, Chief Executive Officer and Director (Principal Executive Officer)	February 28, 2011
<u>/s/ Arthur Chadwick</u> Arthur Chadwick	Chief Financial Officer, Vice President of Finance and Administration and Secretary (Principal Financial and Accounting Officer)	February 28, 2011
<u>/s/ Kris Chellam</u> Kris Chellam	Director	February 28, 2011
<u>/s/ Sanjay Mehrotra</u> Sanjay Mehrotra	Director	February 28, 2011
<u>/s/ Anthony Pantuso</u> Anthony Pantuso	Director	February 28, 2011
<u>/s/ C.N. Reddy</u> C.N. Reddy	Director	February 28, 2011
<u>/s/ Anthony Thornley</u> Anthony Thornley	Director	February 28, 2011

EXHIBIT INDEX

Exhibit Number	Description	Incorporated by Reference			
		Schedule/ Form	File Number	Exhibit	Filing Date
2.1	Asset Purchase Agreement, dated January 25, 2011, between the Registrant and Wavesat, Inc.	8-K	001-33435	2.1	1/31/2011
2.2	Asset Purchase Agreement, dated January 31, 2011, between the Registrant and Celestial Semiconductor Ltd.	8-K/A	001-33435	2.2	2/3/2011
2.3	Asset Purchase Agreement by and between the Registrant, Cavium International, Cavium (Taiwan) Ltd., and Star Semiconductor Corporation, dated July 15, 2008	8-K	001-33435	10.1	7/16/2008
2.4	Agreement and Plan of Merger and Reorganization by and between the Registrant, WWC Acquisition Corporation, WWC I, LLC, and W&W Communications, Inc., dated November 6, 2009	8-K	001-33435	10.26	11/10/2008
2.5	Agreement and Plan Merger and Reorganization by and between the Registrant, MV Acquisition Corporation, Manta, LLC ., and MontaVista Software, Inc., dated November 6, 2009	8-K	001-33435	2.1	11/10/2009
2.6	Amendment No. 1 to Agreement and Plan Merger and Reorganization by and between the Registrant, MV Acquisition Corporation, Manta, LLC ., and MontaVista Software, Inc., dated November 6, 2009	8-K	001-33435	10.1	12/18/2009
3.1	Amended and Restated Certificate of Incorporation of the Registrant	10-K	001-33435	3.1	3/2/2009
3.2	Amended and Restated Bylaws of the Registrant	S-1/A	333-140660	3.5	4/13/2007
4.1	Reference is made to exhibits 3.1 and 3.2				
4.2	Form of the Registrant's Common Stock Certificate	S-1/A	333-140660	4.2	4/24/2007
4.3	Third Amended and Restated Investors' Rights Agreement, dated December 8, 2004, as amended on October 25, 2005 and August 9, 2006, by and among the Registrant and certain of its security holders	S-1	333-140660	4.3	2/13/2007
4.4	Registration Rights Agreement by and between the Registrant and certain stockholders of MontaVista Software, Inc., dated December 14, 2009.	8-K	001-33435	4.1	12/18/2009
10.1	Form of Indemnity Agreement entered into between the Registrant and its directors and officers	S-1	333-140660	10.1	2/13/2007
10.2 †	2001 Stock Incentive Plan and forms of agreements thereunder	S-1	333-140660	10.2	2/13/2007
10.3 †	2007 Equity Incentive Plan	10-K	001-33435	3.1	3/2/2009
10.4 †	Form of Option Agreement under 2007 Equity Incentive Plan	10-Q	001-33435	10.24	5/2/2008

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Exhibit Number	Description	Incorporated by Reference			
		Schedule/ Form	File Number	Exhibit	Filing Date
10.5 †	Form of Option Grant Notice and Form of Exercise Notice under 2007 Equity Incentive Plan	S-1	333-140660	10.4	2/13/2007
10.6 †	Form of Restricted Stock Unit Award under 2007 Equity Incentive Plan	10-Q	333-33435	10.25	8/8/2008
10.7 †	Restricted Stock Unit Retention Plan	10-K	001-33435	10.7	3/2/2009
10.8 †	Executive Employment Agreement, dated January 2, 2001, between the Registrant and Syed Ali	S-1	333-140660	10.5	2/13/2007
10.9 †	Amendment to Executive Employment Agreement, dated December 24, 2008, between the Registrant and Syed Ali	10-K	001-33435	10.9	3/2/2009
10.10 †	Employment Offer Letter, dated December 27, 2004, between the Registrant and Arthur Chadwick	S-1	333-140660	10.6	2/13/2007
10.11 †	Employment Offer Letter, dated January 22, 2001, between the Registrant and Anil K. Jain	S-1	333-140660	10.7	2/13/2007
10.12 †	Amendment to Offer Letter, dated December 24, 2008, between the Registrant and Anil Jain	10-K	001-33435	10.12	3/2/2009
10.13 †	Employment Offer Letter, dated May 6, 2003, between the Registrant and Rajiv Khemani	S-1	333-140660	10.8	2/13/2007
10.14 †	Employment Offer Letter, dated May 1, 2008, between the Registrant and Sandeep Vij	10-Q	001-33435	10.23	5/2/2008
10.15 †	Amendment to Offer Letter, dated December 23, 2008, between the Registrant and Sandeep Vij	10-K	001-33435	10.15	3/2/2009
10.16 †	Letter Agreement, dated November 4, 2005, between the Registrant and Kris Chellam	S-1	333-140660	10.9	2/13/2007
10.17 †	Letter Agreement, dated September 1, 2006, between the Registrant and Anthony Thornley	S-1	333-140660	10.10	2/13/2007
10.18 †	Letter Agreement, dated July 15, 2009, between the Registrant and Sanjay Mehrotra	8-K	001-33435	10.1	7/24/2009
10.19 †	2010 Executive Officer Salaries	8-K	001-33435		10/23/2009
10.20	Lease Agreement, dated April 15, 2005, between the Registrant and MB Technology Park, LLC	S-1	333-140660	10.11	2/13/2007
10.21	First Amendment to Lease Agreement, dated March 6 2008, between the Registrant and MB Technology Park, LLC	10-K	001-33435	10.12	3/10/2008
#10.22	Master Technology License Agreement, dated December 30, 2003, between the Registrant and MIPS Technologies, Inc.	S-1/A	333-140660	10.21	4/6/2007
#10.23	MIPS Core Technology Schedule, dated as of September 29, 2010, by and among the Registrant and MIPS Technologies, Inc.	10-Q	001-33435	10.1	10/29/2010

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Exhibit Number	Description	Incorporated by Reference			
		Schedule/ Form	File Number	Exhibit	Filing Date
10.26	Agreement and Plan of Merger and Reorganization by and between the Registrant, MV Acquisition Corporation, Mantra, LLC, and MontaVista Software, Inc., dated November 6, 2009.	8-K	001-33435	2.1	11/10/2009
10.27	Amendment No. 1 to Agreement and Plan of Merger and Reorganization by and between the Registrant, MV Acquisition Corporation, Mantra, LLC, and MontaVista Software, Inc., dated December 14, 2009.	8-K	001-33435	10.1	12/18/2009
10.28 †	Employment Offer Letter, dated March 22, 2010, between the Registrant and Manoj Gujral	10-Q	001-33435	10.1	07/30/2010
21.1 *	Subsidiaries of the Registrant				
23.1 *	Consent of PricewaterhouseCoopers LLP, independent registered public accounting firm				
31.1 *	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Syed B. Ali, President and Chief Executive Officer				
31.2 *	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 of Arthur D. Chadwick, Chief Financial Officer				
32.1 *	Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 of Syed B. Ali, President and Chief Executive Officer and Arthur D. Chadwick, Chief Financial Officer				
101.INS **	XBRL Instance Document				
101.SCH **	XBRL Taxonomy Extension Schema Document				
101.CAL **	XBRL Taxonomy Extension Calculation Linkbase Document				
101.DEF **	XBRL Taxonomy Extension Definition Linkbase Document				
101.LAB **	XBRL Taxonomy Extension Labels Linkbase Document				
101.PRE **	XBRL Taxonomy Extension Presentation Linkbase Document				
*	Filed herewith				
**	Pursuant to applicable securities laws and regulations, the Registrant is deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and is not subject to liability under any anti-fraud provision of the federal securities laws as long as the Registrant has made a good faith attempt to comply with the submission requirements and promptly amends the interactive data files after becoming aware that the interactive data files fails to comply with the submission requirements.				

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In accordance with the Rule 406T of the Regulation S-T, the information in these exhibits is furnished and deemed not filed or a part of a registration statement or prospectus for purposes of Section 11 and 12 of the Securities Act of 1933, is deemed not filed for purposes of Section 18 of the Exchange Act of 1934, and otherwise is not subject to liability under these sections and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, except as expressly set forth by specific reference in such filing.

Confidential treatment has been requested with respect to certain portions of this exhibit. Omitted portions have been filed separately with the Securities and Exchange Commission.

† Management contract or compensatory plan or arrangement.

List of subsidiaries of the Registrant

Subsidiary	Jurisdiction
Cavium Networks International, Inc.	Delaware
Cavium International	Cayman
Cavium Networks International	Cayman
Cavium Networks (India) Private Limited	India
Cavium Networks Asia	Cayman
Cavium Networks U.K. Limited	England
Cavium LLC	California
Cavium Networks Korea LLC	Korea
Cavium (Taiwan) Ltd.	Taiwan
Cavium Semiconductor Technology (Shanghai) Co., Ltd.	China
Cavium Networks Singapore Pte. Ltd.	Singapore
WWC I, LLC	Delaware
Beijing WWCOMS Info Technology Ltd.	China
MontaVista Software Japan, Inc.	Japan
MontaVista Korea	Korea
MontaVista Software SAS	France
MontaVista Software GmbH	Germany
MontaVista Software AB	Sweden
MontaVista Software GmbH	Switzerland
MontaVista MontaVista Software Limited	United Kingdom
MontaVista Software LLC	Delaware
MontaVista Software Canada, Inc.	Canada
DSP Research, Inc.	California

Consent of Independent Auditors

We consent to the incorporation by reference in the Registration Statements (Form S-8 No. 333-166651, Form S-8 No.333-159031, Form S-8 No. 333-149932, Form S-8 No. 333-143094 and Form S-3 No. 333-164282) of Cavium Networks, Inc. of our report dated February 28, 2011, relating to the financial statements, financial statement schedule and the effectiveness of internal control over financial reporting, which appears in this Form 10-K.

/s/ PricewaterhouseCoopers LLP

San Jose, California

February 28, 2011

CERTIFICATION

I, Syed B. Ali, certify that:

1. I have reviewed this annual report on Form 10-K of Cavium Networks, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during registrant's most recent fiscal quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 28, 2011

/s/ Syed B. Ali

Syed B. Ali
President, Chief Executive Officer and Director
(Principal Executive Officer)

CERTIFICATION

I, Arthur D. Chadwick, certify that:

1. I have reviewed this annual report on Form 10-K of Cavium Networks, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - (b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, 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;
 - (c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during registrant's most recent fiscal quarter (the registrant's fourth quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: February 28, 2011

/s/ Arthur D. Chadwick

Arthur D. Chadwick
Chief Financial Officer, Vice President of Finance and Administration and Secretary
(Principal Financial Officer)

CERTIFICATION

Pursuant to the requirement set forth in Rule 13a-14(b) of the Securities Exchange Act of 1934, as amended (the “Exchange Act”), and Section 1350 of Chapter 63 of Title 18 of the United States Code (18 U.S.C. §1350), Syed B. Ali, Chief Executive Officer of Cavium Networks, Inc. (the “Company”), and Arthur D. Chadwick, Chief Financial Officer of the Company, each hereby certifies that, to the best of his knowledge:

1. The Company’s Annual Report on Form 10-K for the period ended December 31, 2010, to which this Certification is attached as Exhibit 32.1 (the “Annual Report”) fully complies with the requirements of Section 13(a) or Section 15(d) of the Exchange Act, and
2. The information contained in the Annual Report fairly presents, in all material respects, the financial condition of the Company at the end of the period covered by the Annual Report and results of operations of the Company for the period covered by the Annual Report.

In Witness Whereof, the undersigned have set their hands hereto as of the 28th day of February, 2011.

/s/ Syed B. Ali

Syed B. Ali
President, Chief Executive Officer and Director
(Principal Executive Officer)

/s/ Arthur D. Chadwick

Arthur D. Chadwick
Chief Financial Officer, Vice President of Finance and Administration and Secretary
(Principal Financial Officer)

This certification accompanies the Form 10-K to which it relates, is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Cavium Networks, Inc. under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended (whether made before or after the date of the Form 10-K), irrespective of any general incorporation language contained in such filing.

