VIALTA INC
Form 10-Q
November 12, 2004

Table of Contents

**UNITED STATES**
**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

# FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

For the quarterly period ended September 30, 2004.

OR

o **Transitional Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**

For the transition period from: _____ to: _____.

Commission file number 0-32809

**VIALTA, INC.**

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

| Delaware | 94-3337236 |
|---|---|
| (State or Other Jurisdiction of Incorporation or Organization) | (I.R.S. Employer Identification No.) |

48461 Fremont Boulevard
Fremont, California 94538
(Address, including zip code, of Registrant s principal executive offices)

(510) 870-3088
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

The number of outstanding shares of the registrant s common stock, par value $0.001 per share, on November 5, 2004 was 83,014,044 shares.

VIALTA, INC.
FORM 10-Q: QUARTER ENDED SEPTEMBER 30, 2004

TABLE OF CONTENTS


| | Page |
|---|---|
| PART I. FINANCIAL INFORMATION | |
| Item 1. Financial Statements (unaudited): | 3 |
| Condensed Consolidated Balance Sheets September 30, 2004 and December 31, 2003 | 3 |
| Condensed Consolidated Statements of Operations three and nine months ended September 30, 2004 and 2003 | 4 |
| Condensed Consolidated Statements of Cash Flows three and nine months ended September 30, 2004 and 2003 | 5 |
| Notes to Condensed Consolidated Financial Statements | 6 |
| Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations | 11 |
| Item 3. Quantitative and Qualitative Disclosures About Market Risk | 14 |
| Item 4. Controls and Procedures | 14 |
| PART II. OTHER INFORMATION | |
| Item 6. Exhibits and Reports on Form 8-K | 15 |
| SIGNATURES | 16 |
| EXHIBIT INDEX | 17 |
| EXHIBIT 31.1 | |
| EXHIBIT 31.2 | |
| EXHIBIT 32.1 | |
| EXHIBIT 32.2 | |

Table of Contents

**PART I. FINANCIAL INFORMATION**

**ITEM 1: Financial Statements**

**VIALTA, INC.**

**CONDENSED CONSOLIDATED BALANCE SHEETS**
**(in thousands)**
**(unaudited)**

| | September 30, 2004 | December 31, 2003 |
|---|---|---|
| **Assets** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 12,261 | $ 13,756 |
| Restricted cash | 3,049 | 2,226 |
| Short-term investments | 6,213 | 10,552 |
| Accounts receivable, net | 781 | 3,941 |
| Inventories | 6,928 | 5,196 |
| Prepaid expenses and other | 306 | 729 |
| Total current assets | 29,538 | 36,400 |
| Property and equipment, net | 345 | 685 |
| Other assets | 29 | 29 |
| Total assets | $ 29,912 | $ 37,114 |
| **Liabilities and stockholders equity** | | |
| Current liabilities: | | |
| Accounts payable | $ 793 | $ 1,915 |
| Accrued liabilities and other | 2,302 | 3,149 |
| Deferred profit | 1,094 | 3,997 |
| Total current liabilities | 4,189 | 9,061 |
| Stockholders equity: | | |
| Common stock | 95 | 95 |
| Additional paid-in capital | 144,122 | 144,114 |
| Treasury stock | (9,458) | (9,458) |
| Accumulated deficit | (109,020) | (106,709) |
| Accumulated other comprehensive income (loss) | (16) | 11 |

| | | |
|---|---|---|
| Total stockholders equity | 25,723 | 28,053 |
| Total liabilities and stockholders equity | $ 29,912 | $ 37,114 |

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

Table of Contents

**VIALTA, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**
**(in thousands, except per share data)**
**(unaudited)**

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|---|---|---|---|
| | **2004** | **2003** | **2004** | **2003** |
| Net revenue | $ 1,365 | $ 1,284 | $ 9,121 | $ 7,647 |
| Cost of goods sold | 3,718 | 517 | 6,111 | 1,950 |
| Gross profit (loss) | (2,353) | 767 | 3,010 | 5,697 |
| Operating expenses: | | | | |
| Engineering and development | 321 | 480 | 923 | 2,069 |
| Sales and marketing | 284 | 547 | 1,400 | 1,630 |
| General and administrative | 845 | 1,091 | 3,538 | 4,795 |
| Total operating expenses | 1,450 | 2,118 | 5,861 | 8,494 |
| Operating loss | (3,803) | (1,351) | (2,851) | (2,797) |
| Interest income and other, net | 171 | 168 | 540 | 534 |
| Net loss | $ (3,632) | $ (1,183) | $ (2,311) | $ (2,263) |
| Net loss per share: | | | | |
| Basic and diluted | $ (0.04) | $ (0.01) | $ (0.03) | $ (0.03) |
| Weighted average common shares outstanding: | | | | |
| Basic and diluted | 82,985 | 82,227 | 82,899 | 82,205 |

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

Table of Contents

**VIALTA, INC.**

**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(in thousands)**
**(unaudited)**

| | Nine months ended September 30, | |
|---|---|---|
| | **2004** | **2003** |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | $ (2,311) | $ (2,263) |
| Adjustments to reconcile net income to net cash used in operating activities: | | |
| Depreciation | 346 | 1,288 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable, net | 3160 | 96 |
| Inventories | (1,732) | (2,063) |
| Prepaid expenses and other | 423 | (981) |
| Restricted cash deposit | (823) | |
| Deferred profit | (2,903) | (1,191) |
| Accounts payable and accrued liabilities and other | (1,969) | (539) |
| Net cash used in operating activities | (5,809) | (5,653) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Purchases of short-term investments | (4,300) | (16,492) |
| Proceeds from sales of short-term investments | 8,612 | 15,766 |
| Acquisitions of property and equipment | (6) | (166) |
| Net cash provided by (used in) investing activities: | 4,306 | (892) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Issuance of shares of common stock | 8 | 7 |
| Repurchases of shares of common stock | | (295) |
| Net cash provided by (used in) financing activities: | 8 | (288) |
| Net decrease in cash and cash equivalents | (1,495) | (6,833) |
| Cash and cash equivalents, beginning of the period | 13,756 | 21,863 |

| | | |
|---|---|---|
| Cash and cash equivalents, end of the period | $12,261 | $ 15,030 |

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

Table of Contents

**VIALTA, INC.**

**NOTES TO THE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**
**(unaudited)**

## NOTE 1. THE COMPANY

We develop, design and market consumer electronics products designed to maximize the advantages of digital technology in a convenient and easy-to-use manner. Our primary products are the Beamer personal videophone line and the VistaFrame digital picture frame. Our Beamer videophone products add color video to phone calls, enabling users to see the person they are calling. Since both parties to a video call must have a Beamer videophone product (or compatible videophone), our videophone products are primarily sold in pairs. Our Beamer videophone products work with any home phone over any standard (analog) home phone line, at no additional cost to a regular phone call. Our Beamer videophone products include models that are standalone (such as our first videophone product known as Beamer) or connect through most televisions (the Beamer TV), and may include the ability to send and receive digital pictures (the Beamer FX). Beamer videophone products are carried by such retailers as Best Buy, Fry s Electronics, The Good Guys, The Sharper Image and Cinmar (The Frontgate Catalog), among others.

Our VistaFrame product is a digital picture frame that allows users to display photographs directly from a digital camera memory card or from VistaFrame s internal memory. VistaFrame is compatible with most standard card formats and does not require a camera or computer connection, special wiring or web based services to display digital photographs. With VistaFrame, consumers can view digital pictures individually or in a custom slideshow format with the user selecting the pictures, the display sequence, display interval and the transition effect. VistaFrame is currently available through retailers such as The Sharper Image, The Good Guys and Cinmar, among others.

Since our inception, we have incurred substantial losses and negative cash flows from operations. We expect operating losses and negative cash flows from operations to continue for the foreseeable future and anticipate that losses may increase from current levels because of additional costs and expenses related to sales and marketing activities, expansion of operations, expansion of product offerings and development of relationships with other businesses. We believe that we have sufficient cash and cash equivalents, restricted cash and investments to fund our existing operations through September 30, 2005. However, in the longer term, failure to generate sufficient revenues, raise additional capital or reduce spending could have a material adverse effect on our ability to continue to operate our business. In June 2004, we announced that we had retained an investment banking firm to advise us on a range of strategic alternatives, including a possible sale of the company. Our board of directors has appointed a special committee of independent directors to work with the investment banking firm and evaluate any strategic alternatives which may be presented for consideration.

## NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Basis of presentation

The accompanying unaudited condensed consolidated financial statements have been prepared by us pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles in the United States of America have been condensed or omitted pursuant to such rules and regulations. In the opinion of management, the accompanying unaudited condensed interim financial statements contain all adjustments, all of which are normal and recurring in nature, necessary to fairly present our financial position, operating results and cash flows. These unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto for the year ended December 31, 2003, included in our Annual

Report on Form 10-K filed on March 26, 2004. The results of operations for the three and nine months ended September 30, 2004 are not necessarily indicative of the results that may be expected for any other period or for the fiscal year ending December 31, 2004.

**Principles of consolidation**

The consolidated financial statements include the accounts of Vialta, Inc. and our subsidiaries. All material intercompany accounts and transactions have been eliminated in consolidation.

**Cash equivalents, restricted cash and investments**

We consider all highly liquid investments with an initial maturity of 90 days or less to be cash equivalents. Cash equivalents

Table of Contents

primarily represent money market funds, recorded at cost, which approximate their fair value.

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

Investments with maturity dates of 90 days or more are classified as short-term investments since we have the ability to redeem them within the year.

**Revenue recognition**

Products sold to retailers and distributors are subject to rights of return. We defer recognition of revenue on products sold to retailers and distributors until the retailers and distributors sell the products to their customers. Revenue is also deferred for the initial thirty-day period during which our direct customers, retailers and distributors have the unconditional right to return products.

We generally recognize revenue on products sold to end customers upon shipment provided that we have no post-sale obligations, we can reliably estimate and accrue warranty costs and sales returns, the price is fixed or determinable and collection of the resulting receivable is reasonably assured. For sales to international distributors and strategic partners we generally recognize revenue based on the above criteria and upon receipt of payment in full. For sales to end customers that do not meet the above criteria, revenue is deferred until such criteria are met.

**Allowances for sales returns**

Allowances are provided for estimated returns. Provision for return allowances are recorded at the time when revenue is recognized based on historical returns, current economic trends and changes in customer demand. Such allowances are adjusted periodically to reflect actual experience and anticipated returns.

**Warranty**

We provide a limited warranty on our products for periods ranging from 90 days to 12 months from the date of sale to the end customers. We estimate warranty costs based on historical experience and accrue for estimated costs as a charge to cost of sales when revenue is recognized. The following table shows the details of the product warranty accrual, as required by FASB Interpretation No. 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others, for the nine months ended September 30, 2004 (in thousands):

| | September 30, 2004 |
|---|---|
| Beginning balance | $ 768 |
| Accruals for warranties issued during the period | 133 |
| Settlements made during the period | (202) |

| | |
|---|---|
| Ending balance | $ 699 |

**Comprehensive income**

Comprehensive income is defined to include all changes in equity during a period from non-owner sources. For the three and nine months ended September 30, 2004 and September 30, 2003, comprehensive income approximated the net income reported.

**Stock-based compensation**

We account for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board Opinion No. 25, or APB No. 25, Accounting for Stock Issued to Employees. Under APB No. 25, compensation cost is measured as the excess, if any, of the quoted market price of its stock at the date of grant over the exercise price of the option granted. Compensation

Table of Contents

cost for stock options, if any, is recognized ratably over the vesting period. We provide additional pro forma disclosures as required under SFAS No. 123, Accounting for Stock-Based Compensation and SFAS No. 148, Accounting for Stock-Based Compensation, Transition and Disclosure.

The following table illustrates the effect on our net loss and net loss per share if we had recorded compensation costs based on the estimated grant date fair value as defined by SFAS No. 123 for all granted stock-based awards (in thousands, except per share amounts).

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| Net loss, as reported | $(3,632) | $(1,183) | $(2,311) | $(2,263) |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (141) | (286) | (554) | (1,024) |
| Pro forma net loss | $(3,773) | $(1,469) | $(2,865) | $(3,287) |
| Pro forma net loss per share: | | | | |
| Basic and diluted | $ (0.05) | $ (0.02) | $ (0.03) | $ (0.04) |

**NOTE 3. RELATED PARTY TRANSACTIONS**

The following is a summary of major transactions between us and ESS Technology, Inc., which was our parent company prior to August 2001, for the periods presented (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2004 | 2003 | 2004 | 2003 |
| Net payables at beginning of period | $(223) | $(477) | $ (281) | $ (33) |
| Charges by Vialta to ESS | | | 55 | 2 |
| Charges by ESS to Vialta: | | | | |
| Purchase of products | (93) | (176) | (815) | (195) |
| Building lease | (130) | (127) | (377) | (1,054) |
| Other | (2) | (12) | (12) | (65) |
| Cash receipts from ESS | (37) | | (55) | (2) |
| Cash payments made to ESS | 304 | 580 | 1,304 | 1,135 |

| | | | | |
|---|---|---|---|---|
| Net payables at end of period | $(181) | $(212) | $ (181) | $ (212) |

**NOTE 4. INVENTORIES**

The following table summarizes the activity in inventories and reserves for the nine months ended September 30, 2004 (in thousands):

| | Gross | Reserve | Net |
|---|---|---|---|
| **As of December 31, 2003** | $ 9,332 | $(4,136) | $ 5,196 |
| Purchase of inventories | 10,214 | | 10,214 |
| Additional reserves | | (3,390) | (3,390) |
| Shipments | (6,963) | 1,895 | (5,068) |
| Use or Disposal of inventories | (115) | 91 | (24) |
| **As of September 30, 2004** | $12,468 | $(5,540) | $ 6,928 |
| Raw Material | $ 5,838 | $(1,615) | $ 4,223 |
| Finished Goods | 6,630 | (3,925) | 2,705 |
| | $12,468 | $(5,540) | $ 6,928 |

Included in cost of goods sold for the three months ended September 30, 2004 was $3.4 million in additional reserves for raw

Table of Contents

material and finished goods inventory related to our products. During the three months ended September 30, 2004 cost of goods sold was higher than what would have been recognized had these additional reserves not been recorded. In addition, because a portion of our inventory costs for our Beamer videophone products were reserved in prior periods, the cost of goods sold for the nine months ended September 30, 2004 was lower than what would have been recorded had inventory costs not been previously reserved.

**NOTE 5. BALANCE SHEET COMPONENTS (in thousands)**

| | September 30, 2004 | December 31, 2003 |
|---|---|---|
| **Short-term investments** | | |
| US Government debt securities | $ 4,400 | $ 3,480 |
| Corporate debt securities | 1,813 | 7,072 |
| | $ 6,213 | $ 10,552 |
| **Accounts receivable, net** | | |
| Accounts receivable | $ 852 | $ 4,004 |
| Less: Allowance for doubtful accounts | (71) | (63) |
| | $ 781 | $ 3,941 |
| **Prepaid expenses and other** | | |
| Prepaid insurance | $ 284 | $ 308 |
| Other receivables from supplier | | 296 |
| Other current assets | 22 | 125 |
| | $ 306 | $ 729 |
| **Property and equipment, net** | | |
| Machinery and equipment | $ 1,037 | $ 5,918 |
| Furniture and fixtures | 551 | 561 |
| Software and web site development cost | 259 | 5,323 |
| | 1,847 | 11,802 |
| Less: Accumulated depreciation | (1,502) | (11,117) |

| | | |
|---|---|---|
| | $ 345 | $ 685 |
| **Accrued liabilities and other** | | |
| Accrued compensation costs | $ 911 | $ 1,241 |
| Customer deposits | 6 | 764 |
| Product return/warranty liability | 699 | 484 |
| Accrued charges, related party | 181 | 281 |
| Other current liabililties | 505 | 379 |
| | $ 2,302 | $ 3,149 |
| **Deferred profit** | | |
| Deferred revenue | $ 1,706 | $ 5,198 |
| Deferred costs | (612) | (1,201) |
| Deferred profit | $ 1,094 | $ 3,997 |

Table of Contents

**NOTE 6. COMPUTATION OF NET INCOME PER SHARE**

Basic and diluted net loss per share is computed by dividing the net loss by the weighted average number of shares of common stock outstanding for the periods (in thousands, except per share amounts).

| | For the three months ended September 30, | | For the nine months ended September 30, | |
|---|---|---|---|---|
| | **2004** | **2003** | **2004** | **2003** |
| Net loss | $ (3,632) | $ (1,183) | $ (2,311) | $ (2,263) |
| Basic and diluted weighted average common shares outstanding | 82,985 | 82,227 | 82,899 | 82,205 |
| Net and diluted net loss per share | $ (0.04) | $ (0.01) | $ (0.03) | $ (0.03) |

Common stock equivalents of 11,700,000 at September 30, 2004 and 12,628,000 shares at September 30, 2003 have been excluded from the net and diluted net loss per share calculation above because to include them would be anti-dilutive for the periods indicated.

Table of Contents

**ITEM 2: Management s Discussion and Analysis of Financial Condition and Results of Operations**

*The following discussion includes forward-looking statements with respect to our future financial performance. Actual results may differ materially from those currently anticipated depending on a variety of factors, including those described below under the sub-heading Other Factors That May Affect Our Business and Future Results and the risks discussed in our most recent filing with the Securities and Exchange Commission. The following discussion should be read in conjunction with the unaudited Condensed Consolidated Financial Statements and notes thereto that appear elsewhere in this report. References herein to we, our, us, and similar words or phrases are references collectively to Vialta, Inc. and its subsidiaries.*

**Overview**

We develop, design and market consumer electronics products designed to maximize the advantages of digital technology in a convenient and easy-to-use manner. Our primary products are the Beamer personal videophone line and the VistaFrame digital picture frame. Our Beamer videophone products add color video to phone calls, enabling users to see the person they are calling. Since both parties to a video call must have a Beamer videophone product (or compatible videophone), our products are primarily sold in pairs. Our Beamer videophones work with any home phone over any standard (analog) home phone line, at no additional cost to a regular phone call. Our videophone products include models that are standalone (such as our first videophone product known as Beamer) or connect through most televisions (the Beamer TV), and may include the ability to send and receive digital pictures (the Beamer FX). You can find our Beamer videophone products carried by such retailers as Best Buy, Fry s Electronics, The Good Guys, The Sharper Image and Cinmar (The Frontgate Catalog), among others.

Our VistaFrame product is a digital picture frame that allows users to display photographs directly from a digital camera memory card or from VistaFrame s internal memory. VistaFrame is compatible with most standard card formats and does not require a camera or computer connection, special wiring or web based services. With VistaFrame consumers can view digital pictures individually or in a custom slideshow format with the user selecting the pictures, the display sequence, display interval and the transition effect. VistaFrame is currently available through retailers such as The Sharper Image, The Good Guys and Cinmar, among others.

Since our inception, we have financed our operations primarily from funds raised in private offerings of convertible preferred stock and common stock. For the three months ended September 30, 2004 and September 30, 2003 we had net losses of $3.6 million and $1.2 million, respectively. For the nine months ended September 30, 2004 and September 30, 2003 we had net losses of $2.3 million and $2.3 million, respectively. We expect to incur losses at least for fiscal 2004. As of September 30, 2004, we had an accumulated deficit of $109.0 million.

**Results of Operations**

**For the three months ended September 30, 2004 compared with three months ended September 30, 2003**

*Net revenue.* Net revenue was $1.4 million for the three months ended September 30, 2004 compared to $1.3 million for the three months ended September 30, 2003. The increase was the result of $848,000 in net revenue from our new products, (Beamer TV, Beamer FX and VistaFrame). The increase in net revenue from new products in the three months ended September 30, 2004 was partially offset by a decrease of $754,000 in net revenue from sales of our original product, Beamer.

*Cost of goods sold*. Cost of goods sold was $3.7 million for the three months ended September 30, 2004 compared to $517,000 for the three months ended September 30, 2003. This increase is primarily due to additional inventory reserves of $3.4 million on raw material and finished goods inventory which was recorded during the current quarter

and costs associated with our newer products (Beamer TV, Beamer FX and VistaFrame). During the three months ended September 30, 2004 cost of goods sold was higher than what would have been recognized had these additional reserves not been recorded.

*Gross profit (loss).* Gross loss was $2.4 million for the three months ended September 30, 2004 compared to gross profit of $767,000 for the three months ended September 30, 2003. These amounts reflect inventory reserves recorded in the current and previous periods.

*Engineering and development.* Engineering and development expenses were $321,000 for the three months ended September 30,

Table of Contents

2004, compared to $480,000 for the three months ended September 30, 2003. The decrease was primarily due to reductions in engineering and development personnel. We do not expect engineering and development expenses to increase significantly in future periods.

*Sales and marketing.* Sales and marketing expenses were $284,000 for the three months ended September 30, 2004, compared to $547,000 for the three months ended September 30, 2003. The decrease was primarily due to reductions in sales and marketing personnel. We expect sales and marketing spending to moderately increase in the fourth quarter to support retail and consumer marketing initiatives during the holiday season. We do not currently have the resources to support a significant and sustained national advertising and consumer awareness program which may be necessary to maintain or significantly increase sales.

*General and administrative.* General and administrative expenses were $845,000 for the three months ended September 30, 2004 compared to $1.1 million for the three months ended September 30, 2003. The decrease was primarily due to a reduction in general and administrative personnel, a decrease in legal expenses and a decrease in insurance premiums.

*Interest income and other, net.* Interest income and other, net, was $171,000 for the three months ended September 30, 2004, compared to $168,000 for the three months ended September 30, 2003.

**For the nine months ended September 30, 2004 compared with nine months ended September 30, 2003**

*Net revenue.* Net revenue was $9.1 million for the nine months ended September 30, 2004 compared to $7.6 million for the nine months ended September 30, 2003. The increase in net revenue was the result of an increase in the number of retailers and distributors which carry our products combined with an increase in the number of products offered, partially offset by a decrease in sales from our original Beamer product. Net revenue for the nine months ended September 30, 2004 included $3.9 million in revenue from new products, such as Beamer TV and VistaFrame and $5.2 million in revenue from sales of Beamer.

*Cost of goods sold*. Cost of goods sold was $6.1 million for the nine months ended September 30, 2004 compared to $2.0 million for the nine months ended September 30, 2003. This increase is primarily due to additional inventory reserves of $3.4 million on raw material and finished goods inventory which was recorded during the current quarter and to costs associated with our newer products (Beamer TV, Beamer FX and VistaFrame). In addition, because a portion of our inventory costs for our Beamer videophone products were reserved in prior periods, the cost of goods sold for the nine months ended September 30, 2004 and September 30, 2003 was lower than what would have been recorded had inventory costs not been previously reserved.

*Gross profit*. Gross profit was $3.0 million for the nine months ended September 30, 2004 compared to $5.7 million for the nine months ended September 30, 2003. These amounts reflect inventory reserves recorded in the current and previous periods.

*Engineering and development.* Engineering and development expenses were $923,000 for the nine months ended September 30, 2004, compared to $2.1 million for the nine months ended September 30, 2003. The decrease was primarily due to reductions in engineering and development personnel. We do not expect engineering and development expenses to increase significantly in future periods.

*Sales and marketing.* Sales and marketing expenses were $1.4 million for each of the nine months ended September 30, 2004, compared to $1.6 million for the nine months ended September 30, 2003. We expect sales and marketing spending to increase moderately in the fourth quarter to support retail and consumer marketing initiatives during the holiday season. We do not currently have the resources to support a significant and sustained national

advertising and consumer awareness program which may be necessary to maintain or significantly increase sales.

*General and administrative.* General and administrative expenses were $3.5 million for the nine months ended September 30, 2004, compared to $4.8 million for the nine months ended September 30, 2003. The decrease was primarily due to a reduction in general and administrative personnel, a decrease in legal expenses, a decrease in insurance premiums and a decrease in rent expense. In July 2003, we amended the lease agreement for our headquarters with ESS. The terms of the amendment included a reduction in the monthly rent to then current market rates. We do not expect general and administrative expenses to increase significantly in future periods.

Table of Contents

*Interest income and other, net.* Interest income and other, net, was $540,000 for the nine months ended September 30, 2004, compared to $534,000 for the nine months ended September 30, 2003.

**Liquidity and Capital Resources**

As of September 30, 2004, we had $21.5 million in cash and cash equivalents, restricted cash and short-term investments compared to $26.5 million as of December 31, 2003, representing a decrease of $5.0 million.

Our principal sources of liquidity are cash and cash equivalents and investments. Net cash used in operating activities was $5.8 million for the nine months ended September 30, 2004 compared to $5.7 million for the nine months ended September 30, 2003, representing an increase of approximately $100,000.

Net cash provided by investing activities for the nine months ended September 30, 2004 was $4.3 million. Net cash provided by investing activities was primarily related to proceeds from the sale of short-term investments. Net cash used in investing activities was $892,000 million for the nine months ended September 30, 2003. Net cash used in investing activities was primarily related to purchases of short-term investments.

Net cash provided by financing activities for the nine months ended September 30, 2004 was $8,000 compared to $288,000 of net cash used in financing activities for the nine months ended September 30, 2003. Net cash used in financing activities for the nine months ended September 30, 2003 was primarily related to repurchases of our common stock.

Capital expenditures for the three-month period ending December 31, 2004 are expected to be less than $25,000, primarily to acquire capital equipment. We may utilize cash to acquire or invest in complementary businesses or products or to obtain the right to use complementary technologies. Any such acquisition or investment may significantly increase our planned requirements for capital. From time to time, in the ordinary course of our business, we may evaluate potential acquisitions of investments in such businesses, products or technologies owned by third parties.

In September 2001, the Board of Directors authorized the repurchase of up to 10,000,000 shares of our common stock in open market or private transactions over a twelve-month period. In June 2002, the Board of Directors authorized the existing stock repurchase program be extended to include the repurchase of up to an additional 10,000,000 shares of common stock. Through December 31, 2003, we repurchased approximately 11,964,000 shares of common stock at an aggregate cost of $9.4 million. There were no common stock repurchases during the nine months ended September 30, 2004. As of September 30, 2004, approximately 8,036,000 shares remain authorized for repurchase.

In January 2000, we entered into a three-year non-cancelable lease agreement for our headquarters with ESS. In July 2003, we amended the lease. The terms of the amendment include a 60% reduction in the amount of square footage leased, a reduction in the monthly rent to then current market rates and an extension of the term from December 31, 2003 to June 30, 2005. Under the terms of this and other leases, with various expiration dates through 2006, our future minimum rental payments as of September 30, 2004 are as follows: $138,000, $351,000 and $141,000 for the three months ending December 31, 2004 and for the years ending December 31, 2005, and 2006 respectively.

We believe that our existing cash and cash equivalents and investments will be sufficient to fund our operations through September 30, 2005. However, to continue our operations beyond that date, or if our current level of operations change, or to achieve our longer-term goals of introducing additional products to consumers and to support and sustain a significant national consumer marketing campaign, we believe we will need to raise additional capital,

which may not be available on acceptable terms, if at all. We have historically used vendor credit as well as private offerings of convertible preferred stock and common stock to fund operations and provide for capital requirements. However, the price per share of any future equity-related financing will be determined at the time the offering is made and cannot be anticipated at this time. If additional funds are raised through the issuance of equity securities, the percentage ownership of current stockholders is likely to or will be reduced and such equity securities may have rights, preferences or privileges better than those of current stockholders. We cannot assure you that any additional financing will be available or that, if available, it will be sufficient or it can be obtained on terms favorable to us or our stockholders. If adequate funds are not available if and when needed, we would be required to delay, limit or eliminate some or all of our proposed operations. In June 2004, we announced that we had retained an investment banking firm to advise us on a range of strategic alternatives, including a possible sale of the company. Our board of directors has appointed a special committee of independent directors to work with the investment banking firm and evaluate any strategic alternatives which may be presented for consideration.

Table of Contents

**Critical Accounting Policies**

Our critical accounting policies were disclosed in Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, of our Annual Report on Form 10-K for the year ended December 31, 2003. On an ongoing basis, we re-evaluate our judgments and estimates including those related to valuation of inventories, valuation of long-lived assets and certain risks and concentrations. We base our estimates and judgments on our historical experience, knowledge of current conditions and our beliefs of what could occur in the future considering available information. Actual results may differ from these estimates under different assumptions or conditions. We apply our estimates and judgments consistently for all periods presented.

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

Factors that could impact our future business, consolidated financial position, results of operations or cash flows and cause future results to differ from our expectations include the following: the ability to achieve revenues and profitability; the ability to raise additional capital; competition; pricing pressures; the dependence on a limited number of products and the need to develop new products and features; the success of our existing products and other consumer products we may develop; component supply shortages; potential conflicts with ESS Technology, Inc., our former parent; the success of current distribution and retail relationships and the ability to enter into additional distribution agreements; risks associated with the expansion of our business, including increased costs and the strain on management and other resources; the risk of product defects, system failures or interruptions; general economic, political and regulatory changes including in Asia; claims by third parties of intellectual property infringement; dependence on key management personnel and the need to attract and retain additional qualified personnel; risks associated with possible business acquisitions; regulatory changes that affect consumer electronics, telecommunications, copyrights or the internet; quarterly fluctuations in operating results; risks of class action lawsuits based on fluctuations in our stock price; seasonal trends; and risks identified in the our Annual Report on Form 10-K for the fiscal year ended December 31, 2003 and other filings with the Securities and Exchange Commission.

**ITEM 3: Quantitative and Qualitative Disclosure About Market Risk**

**Interest Rate Risks**. We invest in short-term investments. Consequently, we are exposed to fluctuations in interest rates on these investments. Increases or decreases in interest rates generally translate into decreases and increases in the fair value of these investments. In addition, the credit worthiness of the issuer, relative values of alternative investments, the liquidity of the instrument, and other general market conditions may affect the fair values of interest rate sensitive investments. In order to reduce the risk from fluctuations in rates, we invest in highly liquid governmental notes and bonds with contractual maturities of less than two years. All of the investments have been classified as available for sale, and at September 30, 2004, are recorded at market values.

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

**ITEM 4: Controls and Procedures**

Our Chief Executive Officer and Chief Financial Officer (our principal executive officer and principal financial officer, respectively) have concluded, based on their evaluation as of the end of the period covered by this quarterly report, that our disclosure controls and procedures are effective to ensure that material information required to be disclosed by us in reports filed or submitted by us under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time period specified in the SEC s rules and forms, and includes controls and procedures designed to ensure that material information required to be disclosed by us in such reports is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

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

Table of Contents

## PART II. OTHER INFORMATION

### ITEM 6: Exhibits and Reports on Form 8-K

(a) Exhibits. We incorporate by reference all exhibits filed in connection with our annual report on Form 10-K for the year ended December 31, 2003.

31.1 Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

31.2 Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

32.1 Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

32.2 Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K. No reports were filed on Form 8-K for the quarter ended September 30, 2004.

Table of Contents

**SIGNATURES**

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

VIALTA, INC. (Registrant)

Date: November 12, 2004

By: /s/ Didier Pietri
Didier Pietri
Chief Executive Officer

By: /s/ William M. Scharninghausen
William M. Scharninghausen
Chief Financial Officer

Table of Contents

## EXHIBIT INDEX

| Exhibit Number | Description |
|---|---|
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 |
| 32.1 | Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |
| 32.2 | Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |