

VIALTA INC
Form 10-K
March 31, 2005

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
Form 10-K**

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934.
For the Fiscal Year ended December 31, 2004.**

OR

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

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

94-3337236

*(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 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 the Form 10-K or any amendments to this Form 10-K.

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 126-2) Yes No

The aggregate market value of the voting and non-voting common equity held by non-affiliates of the registrant on June 30, 2004 (based on the average bid and ask price on the OTC Bulletin Board as of such date) was approximately \$17,818,000.

The number of outstanding shares of the registrant's common stock, par value \$0.001 per share, on March 7, 2005 was 83,052,852 shares.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's definitive proxy statement relating to its 2005 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 to which this Report relates, are incorporated by reference into Part III of this Form 10-K Report.

VIALTA, INC.
FORM 10-K
For the Fiscal Year Ended December 31, 2004
INDEX

		Page
<u>PART I</u>		
<u>Item 1.</u>	<u>Business</u>	4
<u>Item 2.</u>	<u>Properties</u>	7
<u>Item 3.</u>	<u>Legal Proceedings</u>	7
<u>Item 4.</u>	<u>Submission of Matters to a Vote of Security Holders</u>	7
<u>PART II</u>		
<u>Item 5.</u>	<u>Market for the Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities</u>	8
<u>Item 6.</u>	<u>Selected Financial Data</u>	9
<u>Item 7.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	10
<u>Item 7A.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	25
<u>Item 8.</u>	<u>Financial Statements and Supplementary Data</u>	26
<u>Item 9.</u>	<u>Changes In and Disagreements with Accountants on Accounting and Financial Disclosure</u>	49
<u>Item 9A.</u>	<u>Controls and Procedures</u>	49
<u>PART III</u>		
<u>Item 10.</u>	<u>Directors and Executive Officers of the Registrant</u>	50
<u>Item 11.</u>	<u>Executive Compensation</u>	50
<u>Item 12.</u>	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	50
<u>Item 13.</u>	<u>Certain Relationships and Related Transactions</u>	50
<u>Item 14.</u>	<u>Principle Accountants Fees and Services</u>	50
<u>PART IV</u>		
<u>Item 15.</u>	<u>Exhibits and Financial Statement Schedules</u>	51
	<u>Signatures</u>	52
	<u>EXHIBIT 23.1</u>	
	<u>EXHIBIT 31.1</u>	
	<u>EXHIBIT 31.2</u>	
	<u>EXHIBIT 32.1</u>	
	<u>EXHIBIT 32.2</u>	

Table of Contents

CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS

This report contains forward-looking statements that involve risks and uncertainties. All statements contained in this report that are not purely historical could be deemed forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. When used in this report, words such as may, might, will, should, expects, plans, anticipates, estimates, predicts, potential, intend, continue, and similar expressions, are intended to identify forward-looking statements. These forward-looking statements might include, without limitation, projections of our future financial performance, our anticipated growth and anticipated trends in our businesses; the features, benefits and advantages of our products; the development of new products, enhancements or technologies; business and sales strategies; developments in our target markets; matters relating to distribution channels, proprietary rights, facilities needs, competition and litigation; future gross margins and operating expense levels; and capital needs. These statements reflect the current views of Vialta or its management with respect to future events and are subject to risks, uncertainties and assumptions. Should one or more of these risks or uncertainties materialize, or should underlying assumptions proved incorrect, our actual results, performance or achievements in fiscal 2005 and beyond could differ materially from those expressed in, or implied by, these forward-looking statements. Factors that could cause or contribute to material differences include, but are not limited to, the merger with Victory Acquisition Corp. not occurring or not closing within the expected timeframe, those discussed below in Item 7 under the heading Other Factors That May Affect Our Business and Future Results: and the risks discussed in our other filings with the Securities and Exchange Commission. We encourage you to read that section carefully. You should not regard the inclusion of forward-looking information as a representation by us or any other person that the future events, plans or expectations contemplated by us will be achieved. Vialta undertakes no obligation to release publicly any updates or revisions to any forward-looking statements to reflect events or circumstances occurring after the date of this report.

Table of Contents

PART I

Item 1: Business

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.

On March 29, 2005, we announced a definitive agreement to merge with Victory Acquisition Corp., a newly formed entity established by Fred S.L. Chan, Chairman of the Company, and certain of his family members. Victory will acquire the approximately 60% of our stock not owned by it for \$0.36 per share in cash. The merger is expected to be completed in the second quarter of 2005 and is subject to Vialta shareholder and customary approvals.

We were incorporated in April 1999 as a wholly owned subsidiary of ESS Technology, Inc. (ESS). In August 2001, we were spun off from ESS Technology, Inc. and operate as a stand-alone entity.

See Item 8 Financial Statements and Supplementary Data for additional financial information regarding our business.

Products

We have developed and introduced two distinct product lines: Beamer videophones and VistaFrame, both designed to offer greater convenience and ease-of-use to consumers.

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™). All of our Beamer videophone products are compatible with any home phone over any standard (analog) home phone line and do not require any additional equipment (other than a compatible television, in the case of Beamer TV) or wiring. In addition, our Beamer videophone products provide the consumer with three viewing options (the calling party, the receiving party, or picture-in-picture) and the ability to adjust the level of movement fluidity in relation to detail. Our videophone products also have a snapshot feature that temporarily pauses any new video transmission, resulting in a higher resolution image on the LCD or television screen, depending on the model. A video start feature gives users full control over initiating the video transmission to another user, for complete video privacy whenever desired. Beamer won a 2003 Best of Innovations award in the telephone category from the Consumer Electronics Association based on criteria consisting of value to users, aesthetics, innovativeness, and contributions to quality of life. Beamer also won a 2003 Good Buy award from *Good Housekeeping* magazine based on criteria including ingenuity, value and exceptional performance. In addition, Beamer TV won a 2004 Best of Innovations Honoree Award from the Consumer Electronics Association.

During 2004, we announced that we had developed a broadband version of our Beamer videophone and that field-testing and public availability of a broadband Beamer videophone would occur before the end of 2004. We have delayed field-tests of our broadband videophone products while we continue to refine and test prototypes of these products. We currently expect to field-test our broadband videophone products with a few select broadband service providers in the second half of 2005. We expect commercial introduction of broadband versions of our Beamer videophone products to occur in 2006.

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

Table of Contents

in a custom slideshow format with the user selecting the pictures, the display sequence, display interval and the transition effect.

Sales and Marketing

We began nationwide retail distribution of our first Beamer videophone during the third quarter of 2002. Beamer TV, Beamer FX and VistaFrame began nationwide retail distribution in the third quarter of 2003. Our Beamer videophone products are currently carried by retailers such as Best Buy, Fry's Electronics, The Good Guys, The Discovery Channel, Cinmar (The Frontgate Catalog) and The Sharper Image, among others. VistaFrame is currently carried by retailers such as The Sharper Image, The Discovery Channel, Cinmar and The Good Guys. Sales to The Sharper Image represented 23% and sales to CEC represented 12% of our total revenue in 2004. We market our Beamer videophone products and VistaFrame to retailers and distributors in the U.S. market through a combination of our direct sales force and independent sales representatives. All of our products may also be purchased directly by consumers from our on-line web store. In 2004 our retail and marketing initiatives included targeted print advertising such as in product circulars and catalogs, special promotions and price rebates. In 2004 we continued to expand our distribution for our Beamer videophone products and VistaFrame in the international consumer market through distributors and strategic partners in such countries as China, Taiwan, Korea, Greece, Mexico, The Netherlands, Switzerland, Turkey, The United Kingdom, France, India, Indonesia, Portugal, South Africa, Spain and Belgium.

To continue to build consumer demand and acceptance for our products, we expect to continue to provide for retail and consumer initiatives, including direct mail, e-marketing campaigns, special promotions and other initiatives. Whenever possible, we will combine branding with product promotion opportunities. In addition, we will continue to place an emphasis on generating favorable press from industry analysts, trade reporters and the general consumer media.

Product Development

Our product development efforts focus on bringing innovative digital consumer electronics products to the retail marketplace. Because much of the core development related to our Beamer videophone products and VistaFrame has already been completed, our engineers are engaged in the development of new products and other improvements and modifications to our existing products. We are currently continuing the development of our Beamer videophone products for broadband. We currently expect to field-test our broadband videophone products with a few select broadband service providers in the second half of 2005 and we expect commercial introduction of broadband versions of our Beamer videophone products to occur in 2006.

Intellectual Property

We rely on a combination of patent, trademark and copyright law, trade secret protection and confidentiality or license agreements with our employees, customers, partners and others to protect proprietary rights. We have filed two patent applications, one to cover proprietary functions and digital encoder and decoder solutions for ViDVD, a product we discontinued in 2002 and another to cover audio compression technology. In addition, we have filed similar applications in Taiwan and under the Patent Cooperation Treaty. To date, none of the patents have been issued.

We have filed trademark applications in the U.S., Brazil, Canada, China, the European Union, Hong Kong, Japan, Singapore and Taiwan. The marks for which we have filed applications include, among others, the Vialta logo, Beamer, Phone Video Station, PVS and Viewphone.

In connection with our spin-off by ESS, we entered into a master technology ownership and license agreement with ESS, pursuant to which we and ESS acknowledged the specific technology and trademarks related to our business that are owned by us.

At the time of our formation, we entered into several intellectual property agreements with ESS. We purchased from ESS all of ESS' proprietary rights and benefits conferred under U.S. laws with respect to its videophone business. The master technology ownership and license agreement supercedes prior intellectual

Table of Contents

property and research and development agreements between ESS and us. In addition, we entered into a purchase agreement under which ESS agreed to provide us with semiconductor products. Financial information regarding our related party transactions with ESS are set forth in Note 9 of the Notes to Consolidated Financial Statements in Item 8 of this report.

Manufacturing

We have developed all of our products internally and outsource manufacturing. Our Beamer videophone products and VistaFrame are currently manufactured by two contract manufacturers located in China. We believe these manufacturers will provide us with sufficient manufacturing capacity to meet our current product demand. Our quality assurance engineers are located in China to oversee our contract manufacturers. We outsource import and export logistics, including clearance of Chinese and U.S. customs and ocean freight. We currently handle warehousing and all shipments to retail distribution centers, individual retailers and individual customers purchasing our products online.

Seasonality

Our operating results are subject to seasonality and to quarterly and annual fluctuations. Domestic consumer electronic product sales have traditionally been much higher during the holiday shopping season than during other times of the year. Our domestic sales this past year reflected this anticipated seasonality.

Competition

Our Beamer videophone products compete directly with several other companies in the videophone market that offer products delivering similar features. We believe none of these companies has secured nationwide retail distribution relationships. The majority of our competitors' videophone products are primarily available through specialized retailers and websites. Furthermore, the majority of other videophone models have been integrated with handsets and have a significantly higher per unit retail price than our Beamer videophone products. We believe the key competitive factors for videophone products are price, cost to use, quality of the video (especially moving images), retail distribution, brand awareness and ease of installation and use. We believe that among manufacturers of videophones that use analog phone lines, we compete favorably on the basis of price, video quality, product availability and ease of installation and use. In addition, we face competition from other video communication products utilizing Internet and broadband connections and digital camera cellular telephones. Internet and broadband products, which frequently are priced less than our Beamer videophone products, utilize a personal computer or television, currently require subscription to an ISP and may require additional subscription services. These products may also be interoperable with users of competitive products, provide multiple transmission and storage options, and act as a digital camera. Digital camera cellular telephones only offer still picture transmission or reception and require a digital cellular connection. Many of the current and prospective competitors in this market are larger, better known and have greater resources and experience than us.

VistaFrame competes directly with several other companies in the digital picture frame market that offer products that are similar to VistaFrame. The majority of these products are primarily available through specialized or regional retailers and websites. In addition other digital picture frame products either have limited digital camera memory card compatibility or require a phone line connection and a fee-based subscription service in order to download pictures into the frame.

Financial Information about Segments and Geographic Areas

We operate as one business segment in two geographic areas—domestic and international. Financial information about our business and geographic areas is set forth in Note 14 of the Notes to Consolidated Financial Statements in Item 8 of this report.

Table of Contents

Employees

As of February 28, 2005, we had 38 employees, including 11 in research and development, 6 in marketing, sales and support, 12 in manufacturing and operations and 9 in finance and administration.

Item 2: *Properties*

As of February 28, 2005, our corporate headquarters occupies approximately 31,000 square feet of a building located in Fremont, California, under a lease from ESS that expires in July 2005. We also lease office space for a development center in Hong Kong. We believe that our existing facilities are adequate for our current needs. We believe that, if necessary, we will be able to renew our lease prior to its expiration in July 2005 or we will be able to find adequate office space elsewhere in the area at comparable rates.

Item 3: *Legal Proceedings*

We are not a party to any litigation at the present time.

Item 4: *Submission of Matters to a Vote of Security Holders*

There were no matters submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2004.

Table of Contents**PART II****Item 5: Market for the Registrant's Common Equity, Related Shareholder Matters and Issuer Purchases of Equity Securities**

Our common stock has been quoted on the OTC Bulletin Board under the symbol VLTA since August 21, 2001. The following table sets forth the high and low bid prices for the common stock as reported by the OTC Bulletin Board during the periods indicated. Such prices reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not necessarily represent actual transactions.

	High	Low
Fiscal 2002:		
First Quarter ended March 31, 2002	\$ 1.50	\$ 1.01
Second Quarter ended June 30, 2002	\$ 1.07	\$ 0.45
Third Quarter ended September 30, 2002	\$ 1.18	\$ 0.59
Fourth Quarter ended December 31, 2002	\$ 0.72	\$ 0.26
Fiscal 2003:		
First Quarter ended March 31, 2003	\$ 0.45	\$ 0.30
Second Quarter ended June 30, 2003	\$ 0.51	\$ 0.28
Third Quarter ended September 30, 2003	\$ 0.49	\$ 0.33
Fourth Quarter ended December 31, 2003	\$ 0.81	\$ 0.35
Fiscal 2004:		
First Quarter ended March 31, 2004	\$ 0.70	\$ 0.32
Second Quarter ended June 30, 2004	\$ 0.39	\$ 0.32
Third Quarter ended September 30, 2004	\$ 0.35	\$ 0.23
Fourth Quarter ended December 31, 2004	\$ 0.25	\$ 0.16

As of March 7, 2005, there were approximately 329 record holders of our common stock.

We have never declared or paid any cash dividends on our common stock. We currently anticipate that we will retain any earnings for use in our business, and we do not anticipate paying any cash dividends in the foreseeable future.

Table of Contents**Item 6: Selected Consolidated Financial Data**

You should read the selected consolidated financial data set forth below in conjunction with Management's Discussion and Analysis of Financial Condition and Results of Operations and our consolidated financial statements and related notes included elsewhere in this report. The selected consolidated statement of operations data set forth below is derived from our audited consolidated financial statements. The information below is not necessarily indicative of the results of operations to be expected for any future period.

Years Ended December 31,

2004 2003 2002 2001 2000

(In thousands, except per share amounts)

Consolidated Statement of Operations Data:

Revenue, net	\$ 12,747	\$ 10,331	\$	\$	\$
Cost of good sold	8,022	2,941			
Gross profit	4,725	7,390			
Operating expenses:					
Product costs			10,421		
Engineering and development	1,247	2,557	13,264	25,250	19,558
Sales and marketing	2,011	4,427	3,100	3,738	2,927
General and administrative	4,573	5,753	5,643	9,301	6,699
Amortization and impairment of content licenses			11,395		
Total operating expenses	7,831	12,737	43,823	38,289	29,184
Operating loss	(3,106)	(5,347)	(43,823)	(38,289)	(29,184)
Interest income, net	717	733	1,244	3,606	7,688
Gain on investment		571			
Other income (expense)				(1,266)	(1,682)
Loss before income tax benefit	(2,389)	(4,043)	(42,579)	(35,949)	(23,178)
Income tax benefit					260
Net loss	\$ (2,389)	\$ (4,043)	\$ (42,579)	\$ (35,949)	\$ (22,918)
Net loss per share:					
Basic and diluted	\$ (0.03)	\$ (0.05)	\$ (0.51)	\$ (0.83)	\$ (3.68)
Weighted average common shares outstanding:					
Basic and diluted	82,930	82,285	83,578	43,248	6,222

December 31,

	2004	2003	2002	2001	2000
	(In thousands)				
Consolidated Balance Sheet Data:					
Cash and cash equivalents and short-term investments	\$ 18,402	\$ 24,308	\$ 32,701	\$ 67,428	\$ 136,490
Restricted cash	3,057	2,226			
Working capital	22,261	25,365	30,201	66,830	109,870
Total assets	29,402	37,114	40,327	83,866	153,691
Total current liabilities	3,753	9,061	7,949	3,587	33,594
Redeemable convertible preferred stock					142,600
Total stockholders' equity (deficit)	25,649	28,053	32,378	80,279	(22,503)

Table of Contents**Item 7: 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, Cautionary Statement Regarding Forward-Looking Statements as well as 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. This following discussion should be read in conjunction with the Selected Consolidated Financial Data and the Consolidated Financial Statements and notes thereto that appear elsewhere in this report.

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 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™). Our Beamer videophone products are currently carried by retailers such as Best Buy, Fry's Electronics, The Good Guys, The Discovery Channel, Cinmar (The Frontgate Catalog) and The Sharper Image, 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 carried by retailers such as The Sharper Image, The Discovery Channel, Cinmar and The Good Guys.

Since our inception, we have financed our operations primarily from funds raised in private offerings of convertible preferred stock and common stock and through vendor credit. For the years ended December 31, 2004, 2003, and 2002 we had net losses of \$2.4 million, \$4.0 million and \$42.6 million, respectively, and expect to incur losses in 2005. As of December 31, 2004, we had an accumulated deficit of \$109.1 million.

On March 29, 2005, we announced a definitive agreement to merge with Victory Acquisition Corp., a newly formed entity established by Fred S.L. Chan, Chairman of the Company, and certain of his family members. Victory will acquire the approximately 60% of our stock not owned by it for \$0.36 per share in cash. The merger is expected to be completed in the second quarter of 2005 and is subject to Vialta shareholder and customary approvals.

Results of Operations***For the year ended December 31, 2004 compared with the year ended December 31, 2003***

Net revenue. Net revenue was \$12.7 million for the year ended December 31, 2004 compared to \$10.3 million for the year ended December 31, 2003. The revenue growth was substantially driven by an increase in units sales volume. Net revenue included \$9.3 million in domestic sales for 2004 compared to \$7.1 million for 2003 and \$3.4 million in international sales for 2004 compared to \$3.2 million for 2003. Net revenue from sales of our Beamer videophone products accounted for 73% of total net revenue. The increase in net revenue reflected the recognition in 2004 of \$5.2 million of revenue deferred at December 31, 2003, compared to \$3.2 million of revenue that was deferred at December 31, 2002 and that was recognized in fiscal 2003. At December 31, 2004 the Company had \$3.1 million in deferred revenue. For the fiscal year 2004, The Sharper Image and CEC accounted for approximately 23% and 12%, respectively, of our net revenue. For the

Table of Contents

fiscal year 2003, Best Buy and CEC accounted for approximately 18% and 16%, respectively, of our net revenue.

Cost of goods sold. Cost of goods sold was \$8.0 million for the year ended December 31, 2004 compared to \$2.9 million for the year ended December 31, 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 third quarter of 2004. In addition, during the second half of 2004 product costs were recorded at full cost as compared to the first half of 2004 and fiscal 2003 where 56% and 83%, respectively, of our inventory costs for our Beamer videophone products were expensed in prior periods. At September 30, 2002, we had no historical experience selling Beamer (our first videophone Product) and there was significant uncertainty regarding our ability to recover costs incurred in building inventories related to Beamer. As a result, we expensed Beamer inventory costs as incurred through the third quarter of 2002. Following the nationwide commercial launch of Beamer, we began to capitalize the additional value of Beamer inventory costs in the fourth quarter of 2002. Because a significant portion of our inventory for raw materials and finished goods for our Beamer videophone products was expensed in prior periods, cost of goods sold for the years ended December 31, 2004 and 2003 was lower than what would otherwise have been recorded.

Gross profit. Gross profit was \$4.7 million for the year ended December 31, 2004 compared to \$7.4 million for the year ended December 31, 2003. If we had not previously expensed inventory costs, our gross profit would have been approximately \$2.0 million for the year ended December 31, 2004.

Engineering and development. Engineering and development expenses were \$1.2 million for the year ended December 31, 2004, compared to \$2.6 million for the year ended December 31, 2003. The decrease was primarily due to reductions in engineering and development personnel and a decrease in depreciation expense due to equipment being fully depreciated. We expect engineering and development expenses to remain constant in future periods.

Sales and marketing. Sales and marketing expenses were \$2.0 million for the year ended December 31, 2004, compared to \$4.4 million for the year ended December 31, 2003. The decrease is primarily due to a decrease of \$2.1 million in television advertising and promotional campaigns that occurred in the fourth quarter of 2003. There were no comparable television advertising expenses for the year ended December 31, 2004 and promotion campaign expenses were lower in the fourth quarter of 2004 compared to the fourth quarter of 2003. We do not expect an increase in sales and marketing expenses in future periods, and we currently do not 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 \$4.6 million for the year ended December 31, 2004, compared to \$5.8 million for the year ended December 31, 2003. The decrease was primarily due to a reduction in general and administrative personnel, and decreases in legal expense, insurance and office rent. We expect general and administrative expenses to remain constant in future periods.

Interest income and other, net. Interest income and other, net, was \$717,000 for the year ended December 31, 2004, compared to \$733,000 for the year ended December 31, 2003.

Gain on Investment. During the fourth quarter of 2003, we recorded a gain on investments of \$571,000. The gain on investments was attributable to a cash dividend paid to us on preferred shares we previously acquired in an unrelated company. Our original investment in this company had been written down to zero in a prior period. There is no comparable gain for the year ended December 31, 2004.

For the year ended December 31, 2003 compared with the year ended December 31, 2002

Net revenue. Net revenue was \$10.3 million for the year ended December 31, 2003. There was no revenue for the year ended December 31, 2002. Included in net revenue for 2003 was approximately \$7.1 million in domestic sales and approximately \$3.2 million from international sales. In addition to revenue generated from our first videophone product, Beamer, we also recorded domestic net revenue during the fourth quarter of 2003 from sales activity related to our new products BeamerTV, BeamerFX (which was introduced in the fourth quarter of 2003 on a very limited basis) and VistaFrame. Net revenue from sales of our Beamer

Table of Contents

videophone products accounted for 97% of total net revenue for the year ended December 31, 2003. During the first quarter of 2003, we began to recognize revenue on sales of Beamer, net of estimated warranty claims and estimated returns. We began nationwide distribution of Beamer during the third quarter of 2002 and more significant shipments during the fourth quarter of 2002. For most of these shipments, the standard warranty and return period had not been completed as of December 31, 2002. Due to a limited history of warranty and sales returns for Beamer, we did not recognize revenue for sales through December 31, 2002. As a result, revenue for the year ended December 31, 2003, includes the recognition of deferred revenue of approximately \$3.2 million related to shipments of Beamer, which were made during the third and fourth quarters of 2002.

Cost of goods sold. Cost of goods sold was \$2.9 million for the year ended December 31, 2003. There was no similar expense for the year ended December 31, 2002. Because a significant portion of our inventory for raw materials and finished goods for our Beamer videophone products was expensed in prior periods, cost of goods sold for the year ended December 31, 2003 was lower than what would otherwise have been recorded. If we had not previously expensed inventory costs, our cost of goods sold would have been \$7.8 million for the year ended December 31, 2003.

Gross profit. Gross profit was \$7.4 million for the year ended December 31, 2003. If we had not previously expensed inventory costs, our gross profit would have been approximately \$2.5 million for the year ended December 31, 2003.

Product Costs. Product costs were \$10.4 million for the year ended December 31, 2002. Product costs represent inventory expenditures for raw materials and finished goods related to our Beamer videophone products. At September 30, 2002, we had no historical experience selling Beamer (our first videophone product) and there was significant uncertainty regarding our ability to recover costs incurred in building inventories related to Beamer. As a result, we expensed Beamer inventory costs as incurred through the third quarter of 2002. Following the nationwide commercial launch of Beamer, we began to capitalize the additional value of Beamer inventory costs in the fourth quarter of 2002.

Engineering and development. Engineering and development expenses were \$2.6 million for the year ended December 31, 2003, compared to \$13.3 million for the year ended December 31, 2002. The decrease was primarily due to reductions in engineering and development personnel and other development expenditures as we shifted our focus to sales and marketing efforts from core development activities. Included in engineering and development expenses for the year ended December 31, 2002 were development expenses related to ViDVD and ViMagazine as well as expenses related to our Internet Service Provider, known as ViZip. Since all development activities related to ViDVD, ViMagazine and ViZip were discontinued during 2002, there were no comparable expenses for the year ended December 31, 2003.

Sales and Marketing. Sales and marketing expenses were \$4.4 million for the year ended December 31, 2003, compared to \$3.1 million for the year ended December 31, 2002. The increase in sales and marketing expenses is primarily due to \$2.1 million in television commercials that aired in certain markets (Los Angeles and San Francisco) and in-store demonstration programs (in selected stores and regions), which occurred, in the fourth quarter of 2003. This increase was partially offset by an overall decrease in sales and marketing expenses for the year ended December 31, 2003 when compared to the prior fiscal year.

General and Administrative. General and administrative expenses were \$5.8 million for the year ended December 31, 2003, compared to \$5.6 million for the year ended December 31, 2002.

Amortization and Impairment of Content Licenses. Amortization and impairment of content licenses for ViMagazine was \$11.4 million in the year ended December 31, 2002. During January 2002, we licensed feature film content from Artisan Entertainment for \$10.0 million to use as part of our ViMagazine. Starting in the first quarter of 2002, we began to expense our content licenses, based on the greater of the royalty amounts due or amortization on a straight-line basis over an estimated life of three years. During the fourth quarter of 2002, we concluded that the content licenses had suffered a permanent decline in value, as a result of our decision not to market ViMagazine, and the remaining unamortized balance of \$8.3 million was written down to zero. The \$10.0 million license fee to Artisan Entertainment included a \$5.0 million note that matures in April 2005 and would convert to a license fee if certain events occurred. We continue to receive current

Table of Contents

interest payments on the note and, since conversion is unlikely, we may receive the principal at maturity. If we were to be paid at maturity we would recognize a gain at that time. There is no comparable expense for the year ended December 31, 2003.

Interest Income, Net. Interest income was \$733,000 for the year ended December 31, 2003, compared to \$1.2 million for the year ended December 31, 2002. The decrease in interest income was primarily due to lower cash balances and lower yields on available-for-sale securities during the year ended December 31, 2003 as compared to the year ended December 31, 2002.

Gain on Investment. During the fourth quarter of 2003 we recorded a gain on investments of \$571,000. The gain on investments was attributable to a cash dividend paid to us on preferred shares we previously acquired in an unrelated company. Our original investment in this company had been written down to zero in a prior period.

Off-Balance Sheet Arrangements

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 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 December 31, 2004 are as follows: \$351,000 and \$141,000 for the years 2005 and 2006 respectively.

Apart from operating leases disclosed above, we do not have any off-balance sheet arrangements.

Liquidity and Capital Resources

As of December 31, 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 \$5.9 million for the year ended December 31, 2004 compared to \$7.9 million for the year ended December 31, 2003, representing a decrease of approximately \$2.0 million. The decrease in cash used in operating activities was primarily due to a significant reduction in our operating expenses, combined with cash received from sales of our products. In addition, our cash flow from operations for the year ended December 31, 2004 benefited from a decrease in inventory.

Net cash provided by investing activities for the year ended December 31, 2004 was \$3.8 million compared to \$2.4 million of cash used in investing activities for the year ended December 31, 2003 representing an increase of approximately \$6.2 million. The increase in net cash provided by investing activities for the year ended December 31, 2004 compared to net cash used in investing activities for the year ended December 31, 2003 was primarily due to a reduction in purchases and sales of short-term investments.

Net cash provided by financing activities was insignificant for the year ended December 31, 2004 compared to \$285,000 net cash used in financing activities for the year ended December 31, 2003, which was primarily related to repurchases of our common stock.

Capital expenditures for the 12-month period ending December 31, 2005 are anticipated to be approximately \$100,000, primarily to acquire capital equipment.

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 year ended December 31, 2004. As of December 31, 2004, approximately 8,036,000 shares remain authorized for repurchase.

Table of Contents

We believe that our existing cash and cash equivalents and investments will be sufficient to fund our operations through December 31, 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, 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