

STMICROELECTRONICS NV  
Form 6-K  
May 04, 2005

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

**FORM 6-K**

**REPORT OF FOREIGN PRIVATE ISSUER  
PURSUANT TO RULE 13a-16 or 15d-16 OF  
THE SECURITIES EXCHANGE ACT OF 1934**

**Report on Form 6-K dated May 4, 2005**

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**STMicroelectronics N.V.**

(Name of Registrant)

39, Chemin du Champ-des-Filles  
1228 Plan-les-Ouates, Geneva, Switzerland  
(Address of Principal Executive Offices)

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Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F:

Form 20-F

Form 40-F

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7):

Yes

No

Indicate by check mark whether the registrant by furnishing the information contained in this form is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934:

Yes

No

If  Yes is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82- \_\_\_\_\_

Enclosure: STMicroelectronics N.V.'s First Quarter 2005:

Operating and Financial Review and Prospects;

Unaudited Interim Consolidated Statements of Income, Balance Sheets, Statements of Cash Flow, and Statements of Changes in Shareholders' Equity and related Notes for the three months ended April 2, 2005; and

Certifications pursuant to Sections 302 (Exhibits 12.1 and 12.2) and 906 (Exhibit 13.1) of the Sarbanes-Oxley Act of 2002, submitted to the Commission on a voluntary basis.

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## OPERATING AND FINANCIAL REVIEW AND PROSPECTS

### Overview

*The following discussion should be read in conjunction with our Unaudited Interim Consolidated Statements of Income, Balance Sheets, Statements of Cash Flow and Statements of Changes in Shareholders' Equity for the three months ended April 2, 2005 and Notes thereto included elsewhere in this Form 6-K. The following discussion contains statements of future expectations and other forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, or Section 21E of the Securities Exchange Act of 1934, each as amended, particularly in the sections Critical Accounting Policies Using Significant Estimates, Business Outlook and Liquidity and Capital Resources Financial Outlook. Our actual results may differ significantly from those projected in the forward-looking statements. For a discussion of factors that might cause future actual results to differ materially from our recent results or those projected in the forward-looking statements in addition to the factors set forth below, see Cautionary Note Regarding Forward-Looking Statements and Item 3. Key Information Risk Factors included in our annual report on Form 20-F for the year ended December 31, 2004 as filed with the U.S. Securities and Exchange Commission (the Commission or the SEC) on March 23, 2005 (the Form 20-F), as they may be updated in our SEC submissions from time to time. We assume no obligation to update the forward-looking statements or such risk factors.*

### Critical Accounting Policies Using Significant Estimates

The preparation of our Consolidated Financial Statements in accordance with accounting principles generally accepted in the United States of America ( U.S. GAAP ), requires us to make estimates and assumptions that have a significant impact on the results we report in our consolidated financial statements, which we discuss under the section Results of Operations. Some of our accounting policies require us to make difficult and subjective judgments that can affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of net revenue and expenses during the reporting period. The primary areas that require significant estimates and judgments by management include, but are not limited to, sales returns and allowances; reserves for price protection to certain distributor customers; allowances for doubtful accounts; inventory reserves and normal manufacturing capacity thresholds to determine costs to be capitalized in inventory; accruals for warranty costs; litigation and claims; valuation of acquired intangibles; goodwill; investments and tangible assets as well as the impairment of their related carrying values; restructuring charges; other non-recurring special charges; assumptions used in calculating pension obligations and pro forma share-based compensation; assessment of hedge effectiveness of derivative instruments; deferred income tax assets, including required valuation allowances and liabilities; as well as provisions for specifically identified income tax exposures. We base our estimates and assumptions on historical experience and on various other factors such as market trends and business plans 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. While we regularly evaluate our estimates and assumptions, our actual results may differ materially and adversely from our estimates. To the extent there are material differences between the actual results and these estimates, our future results of operations could be significantly affected.

We believe the following critical accounting policies require us to make significant judgments and estimates in the preparation of our consolidated financial statements:

**Revenue recognition.** Our policy is to recognize revenues from sales of products to our customers when all of the following conditions have been met: (a) persuasive evidence of an arrangement exists; (b) delivery has occurred; (c) the selling price is fixed or determinable; and (d) collectibility is reasonably assured. This usually occurs at the time of shipment. We determine the amount of reported revenues based on certain judgments or estimates, and this amount of reported revenue may vary if we elect to make different judgments or estimates.

Consistent with standard business practice in the semiconductor industry, price protection is granted to distribution customers on their existing inventory of our products to compensate them for declines in market prices. The ultimate decision to authorize a distributor refund remains fully within our control. We accrue a provision for price protection based on a rolling historical price trend computed on a monthly basis as a percentage of gross distributor sales. This historical price trend represents differences in recent months between the invoiced price and the final price to the distributor, adjusted if required, to accommodate a significant move in the current market price. The short outstanding inventory time period, visibility into the standard inventory product pricing (as opposed to certain customized products) and long distributor pricing history have enabled us to reliably estimate price protection provisions at period-end. We record the accrued amounts as a deduction of revenue at the time of the sale. If market conditions differ from our assumptions, this could have an impact on future periods; in particular, if market conditions were to deteriorate, net revenues could be reduced due to higher product returns and price reductions at the time these adjustments occur.



Our customers occasionally return our products for technical reasons. Our standard terms and conditions of sale provide that if we determine that products are non-conforming, we will repair or replace the non-conforming products, or issue a credit or rebate of the purchase price. Quality returns are not related to any technological obsolescence issues and are identified shortly after sale in customer quality control testing. Quality returns are always associated with end-user customers, not with distribution channels. We provide for such returns when they are considered as probable and can be reasonably estimated. We record the accrued amounts as a reduction of revenue.

We do not have insurance against product claims and we record a provision for warranty costs as a charge against cost of sales based on historical trends of warranty costs incurred as a percentage of sales which we have determined to be a reasonable estimate of the probable losses to be incurred for warranty claims in a period. Any potential warranty claims are subject to our determination that we are at fault and liable for damages, and such claims usually must be submitted within a short period following the date of sale. This warranty is given in lieu of all other warranties, conditions or terms expressed or implied by statute or common law. We limit our liability to the price allocable to the products which gives rise to the claims.

We maintain an allowance for doubtful accounts for potential estimated losses resulting from our customers' inability to make required payments. We base our estimates on historical collection trends. We recorded a provision of 1.0% of total receivables in the first quarter of 2005. In addition, we are required to evaluate our customers' credit ratings from time to time and take an additional provision for any specific account that we estimate as doubtful. Although we have determined that our most significant customers are creditworthy, if the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payments, additional allowances could be required.

**Goodwill and purchased intangible assets.** The purchase method of accounting for acquisitions requires extensive use of estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired, including in-process research and development, which is expensed immediately. Goodwill and intangible assets deemed to have indefinite lives are not amortized but are instead subject to annual impairment tests. The amounts and useful lives assigned to other intangible assets impact future amortization. If the assumptions and estimates used to allocate the purchase price are not correct or if business conditions change, purchase price adjustments or future asset impairment charges could be required. At April 2, 2005, the value of goodwill amounted to \$228 million.

**Impairment of goodwill.** Goodwill acquired in business combinations is not amortized and is instead subject to an impairment test to be performed on an annual basis, or more frequently if indicators of impairment exist, in order to assess the recoverability of its carrying value. Goodwill subject to potential impairment is tested at a level of reporting referred to as a reporting unit. We define our reporting units one level below the three semiconductor product groups described in the *Business Overview* included in this Form 6-K. This impairment test determines whether the fair value of each reporting unit for which goodwill is allocated is lower than the total carrying amount of relevant net assets allocated to such reporting unit, including its allocated goodwill. If lower, the implied fair value of the reporting unit goodwill is then compared to the carrying value of the goodwill and an impairment charge is recognized for any excess. In determining the fair value of a reporting unit, we usually estimate the expected discounted future cash flows associated with the reporting unit. Significant management judgments and estimates are used in forecasting the future discounted cash flows including: the applicable industry's sales volume forecast and selling price evolution, the reporting unit's market penetration, the market acceptance of certain new technologies and relevant costs structure. Our evaluations are based on financial plans updated with the latest available projections of the semiconductor market evolution, our sales expectations and our costs evaluation and are consistent with the plans and estimates that we use to manage our business. It is possible, however, that the plans and estimates used may be incorrect, and future adverse changes in market conditions or operating results of acquired businesses not in line with our estimates may require impairment of certain goodwill. For example, in the first quarter of 2005, following the decision taken in January 2005 to discontinue the Customer Premises Equipment (CPE) product lines, we recorded an impairment charge of \$39 million on goodwill.

**Intangible assets subject to amortization.** Intangible assets subject to amortization include the cost of technologies and licenses purchased from third parties, internally developed software which is capitalized and purchased software. Intangible assets subject to amortization are reflected net of any impairment losses. These are amortized over a period ranging from three to seven years. The carrying value of intangible assets subject to amortization is evaluated whenever changes in circumstances indicate that the carrying amount may not be recoverable. In determining recoverability, we initially assess whether the carrying value exceeds the undiscounted cash flows associated with the intangible assets. If exceeded, we then evaluate whether an impairment charge is required by determining if the asset's carrying value also exceeds its fair value. An impairment loss is recognized for the excess of the carrying amount over the fair value. We normally estimate the fair value based on the projected discounted future cash flows associated with the intangible assets. Significant management judgments and estimates are required and used in the forecasts of future operating results that are used in the discounted cash flow method of valuation, including: the applicable industry's sales volume forecast and selling price evolution, our market penetration, the market acceptance of certain new technologies and costs evaluation. Our evaluations are based on financial plans updated with the latest available projections of the semiconductor market evolution and our sales expectations and are consistent with the plans and estimates that we use to manage our business. It is possible, however, that the plans and estimates used may be incorrect and that future adverse changes in market conditions or operating results of businesses acquired may not be in line with our estimates and may therefore require impairment of certain intangible assets. For example in the first quarter of 2005, we recorded an impairment of \$24 million of intangible assets mainly related to the decision taken in January 2005 to discontinue the Customer Premises Equipment ( CPE ) product lines. At April 2, 2005, the value of intangible assets subject to amortization amounted to \$250 million.

**Property, plant and equipment.** Our business requires substantial investments in technologically advanced manufacturing facilities, which may become significantly underutilized or obsolete as a result of rapid changes in demand and ongoing technological evolution. We estimate the useful life of our manufacturing equipment, which is the largest component of our long-lived assets, to be six years. This estimate is based on our experience with using equipment over time. Depreciation expense is a major element of our manufacturing cost structure. We begin to depreciate new equipment when it is put into use.

We evaluate each period whether there is reason to suspect that tangible assets or groups of assets might not be recoverable. Several impairment indicators exist for making this assessment, such as: significant changes in the technological, market, economic or legal environment in which we operate or in the market to which the asset is dedicated; available evidence of obsolescence of the asset; strategic management decisions impacting production or indication that its economic performance is, or will be, worse than expected. In determining the recoverability of assets to be held and used, we initially assess whether the carrying value exceeds the undiscounted cash flows associated with the tangible assets or group of assets. If exceeded, we then evaluate whether an impairment charge is required by determining if the asset's carrying value also exceeds its fair value. We normally estimate this fair value based on independent market appraisals or the sum of discounted future cash flows, using market assumptions such as the utilization of our fabrication facilities and the ability to upgrade such facilities, change in the selling price and the adoption of new technologies. We also evaluate the continued validity of an asset's useful life when impairment indicators are identified. Assets classified as held for disposal are reflected at the lower of their carrying amount or fair value less selling costs and are not depreciated during the selling period. Selling costs include incremental direct costs to transact the sale that we would not have incurred except for the decision to sell.

Our evaluations are based on financial plans updated with the latest projections of the semiconductor market and of our sales expectations, from which we derive the future production needs and loading of our manufacturing facilities, and which are consistent with the plans and estimates that we use to manage our business. These plans are highly variable due to the high volatility of the semiconductor business and therefore are subject to continuous modifications. If the future evolution differs from the basis of our plans, both in terms of market evolution and production allocation to our manufacturing plants, this could require a further review of the carrying amount of our tangible assets resulting in a potential impairment loss. Factors we consider important which could trigger an impairment review include: significant negative industry trends, significant underutilization of the assets, and significant changes in how we use the assets in our plants. Since a significant portion of our tangible assets are carried by our European affiliates and their cost of operations are mainly denominated in euros, while revenues primarily are denominated in U.S. dollars, the exchange rate dynamic may trigger impairment charges.

**Inventory.** Inventory is stated at the lower of cost or net realizable value. Cost is computed by adjusting standard cost to approximate actual manufacturing costs on a quarterly basis; the cost is therefore dependent on our manufacturing performance. In the case of underutilization of our manufacturing facilities, we estimate the costs associated with the excess capacity; these costs are not included in the valuation of inventories but charged directly to cost of sales.

The valuation of inventory requires us to estimate obsolete or excess inventory as well as inventory that is not of saleable quality. Provisions for obsolescence are estimated for excess uncommitted inventories based on the previous quarter sales, order backlog and production plans. To the extent that future negative market conditions generate order backlog cancellations and declining sales, or if future conditions are less favorable than the projected revenue assumptions, we could be required to record additional inventory provisions, which would have a negative impact on our gross margin.

**Restructuring charges.** We have undertaken, and we may continue to undertake, significant restructuring initiatives, which have required us, or may require us in the future, to develop formalized plans for the exiting or disposing of certain activities. We recognize the fair value of a liability for costs associated with an exit or disposal activity when a probable liability exists and it can be reasonably estimated. We record estimated charges for non voluntary termination benefit arrangements such as severance and outplacement costs meeting the criteria for a liability as described above. Given the significance of and the timing of the execution of such activities, the process is complex and involves periodic reviews of estimates made at the time the original decisions were taken. As we operate in a highly cyclical industry, we continue to evaluate business conditions. If broader or new initiatives, which could include production curtailment or closure of other manufacturing facilities were to be taken, we may be required to incur additional charges as well as to change estimates of amounts previously recorded. The potential impact of these charges could be material and have a material adverse effect on our results of operations or financial condition. In the first quarter of 2005, the amount of restructuring charges and other related closure costs amounted to \$15 million before taxes, out of which \$7 million related to our formerly announced October 2003 plan and \$8 million related to our new 2005 restructuring initiatives.

**Income taxes.** We are required to make estimates and judgments in determining income tax expense for financial statement purposes. These estimates and judgments also occur in the calculation of certain tax assets and liabilities and provisions.

We are required to assess the likelihood to recover our deferred tax assets. If recovery is not likely, we are required to increase our provision for taxes by recording a valuation allowance against the deferred tax assets that we estimate will not ultimately be recoverable. As of April 2, 2005, we believed that all of the deferred tax assets, net of valuation allowances, as recorded on our balance sheet, would ultimately be recovered. However, should there be a change in our ability to recover our deferred tax assets or in our estimates of the valuation allowance, or in the tax rates applicable in the various jurisdictions, this could have an impact on our future tax provision in the periods in which these changes could occur.

In addition, the calculation of our tax liabilities involves dealing with uncertainties in the application of complex tax regulations. We recognize liabilities for anticipated tax audit issues based on our estimate that probable additional taxes will be due. We reverse the liability and recognize a tax benefit during the period if we ultimately determine that the liability is no longer necessary. For example, during the first quarter of 2005, we reversed some provisions for approximately \$20 million pursuant to an agreement concluded with U.S. tax authorities. We record an additional charge in our provision for taxes in the period in which we determine that the recorded tax liability is less than what we expect the ultimate assessment to be.

**Patent and other intellectual property litigation or claims.** As is the case with many companies in the semiconductor industry, we have from time to time received, and may in the future receive, communications alleging possible infringement of patents and other intellectual property rights of others. Furthermore, we may become involved in costly litigation brought against us regarding patents, mask works, copyrights, trademarks or trade secrets. In the event that the outcome of any litigation would be unfavorable to us, we may be required to take a license to the underlying intellectual property right upon economically unfavorable terms and conditions, and possibly pay damages for prior use, and/or face an injunction, all of which singly or in the aggregate could have a material adverse effect on our results of operations and ability to compete. We constantly monitor, with the support of our outside attorneys when deemed necessary or advisable, the chances of any such intellectual property claims being successfully asserted. We record a provision when we estimate that the claim could successfully be asserted in a court of law, when the loss is considered probable and in the absence of a valid offset or counterclaim. See "Item 3. Key Information Risk Factors We depend on patents to protect our rights to our technology" included in our Form 20-F, as may be updated from time to time in our public filings.

In December 2004, we settled certain litigations relating to claims of infringements of patents and similar intellectual property rights of others. Payments, which had already been largely accrued for were made in the first quarter of 2005, pursuant to said settlement agreements.

ST is currently a party to legal proceedings with SanDisk Corporation ("SanDisk").

On October 15, 2004, SanDisk filed a complaint against us in the United States International Trade Commission (the "ITC") with respect to certain NAND memory products, alleging patent infringement and seeking an order excluding our products from importation into the United States. On November 15, 2004, the ITC instituted an investigation against us in response to the complaint.

On October 15, 2004, SanDisk also filed a complaint for patent infringement, and declaratory judgment of non-infringement and patent invalidity, against us in the United States District Court for the Northern District of California. The complaint alleges that our products infringe a SanDisk U.S. patent and seeks a declaratory judgment that SanDisk does not infringe several of our U.S. patents. By order dated January 4, 2005, the court stayed SanDisk's patent infringement claim pending an outcome in the ITC action discussed above. On January 20, 2005, the court issued an order granting our motion to dismiss the declaratory judgment causes of action. SanDisk has appealed the order to the United States Court of Appeals for the Federal Circuit.

On February 4, 2005, we filed two complaints for patent infringement against SanDisk in the United States District Court for the Eastern District of Texas. The complaints allege that SanDisk products infringe seven of our U.S. patents. On March 28, 2005, SanDisk filed motions to dismiss, transfer, or sever and stay the cases. On April 22, 2005, SanDisk filed a counterclaim against us alleging that our products practice two SanDisk patents. On April 25 and 27, 2005, the court issued orders denying the motions to dismiss, transfer, or sever and stay the cases.

On March 28, 2005, SanDisk filed a complaint for declaratory judgment of non-infringement and patent invalidity against us in the United States District Court for the Northern District of California. The complaint seeks a declaratory judgment that SanDisk does not infringe several of our U.S. patents. On April 11, 2005,

SanDisk voluntarily dismissed the case.

Based on our current assessment, made with support of our outside attorneys, we do not believe that the SanDisk litigation will result in a probable loss, or will have a material adverse effect on our financial position, cash flow, or results of operations. However, if we are unsuccessful in resolving these proceedings, or if the outcome of any other litigation or claim would be unfavorable to us, we may incur money damages, or an injunction or exclusion order.

**Other claims.** We are subject to the possibility of loss contingencies arising in the ordinary course of business. These include, but are not limited to: warranty costs on our products not covered by insurance, breach of contract claims, tax claims and provisions for specifically identified income tax exposures as well as claims for environmental damages. In determining loss contingencies, we consider the likelihood of a loss of an asset or the incurrence of a liability, as well as our ability to reasonably estimate the amount of such loss or liability. An estimated loss is recorded when it is probable that a liability has been incurred and the amount of the loss can be reasonably estimated. We regularly reevaluate any losses and claims and determine whether they need to be readjusted based on the current information available to us. In the event of litigation that is adversely determined with respect to our interests, or in the event we need to change our evaluation of a potential third-party claim based on new evidence or communications, this could have a material adverse effect on our results of operations or financial condition at the time it were to materialize.

***Fiscal Year***

Our fiscal year starts at January 1, the first quarter of 2005 lasted until Saturday, April 2, 2005. The second quarter of 2005 will end on July 2, 2005, and the third quarter of 2005 will end on October 1, 2005. The fourth quarter of 2005 will end on December 31, 2005.

***Business Overview***

The total available market is defined as the TAM, while the serviceable available market, the SAM, is defined as the market for products produced by us (which consists of the TAM and excludes PC motherboard major devices such as microprocessors (MPU), dynamic random access memories (DRAMs), and optoelectronics devices).



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Effective January 1, 2005, we realigned our product groups to increase market focus and realize the full potential of our products, technologies, sales and marketing channels. Beginning with this first quarter of 2005, we now report our sales and operating income in three segments:

the new Application Specific Products Groups ( ASG ) segment, comprised of three product groups our new Home, Personal and Communication Sector ( HPC ), our new Computer Peripherals Group ( CPG ) and our new Automotive Product Group ( APG ). Our new HPC Sector is comprised of the telecommunications and the audio divisions from the former TPA combined with the consumer group from the former CMG Group. Our new CPG Group covers computer peripherals products, specifically disk drives and printers, and our new APG Group now comprises all of our major complex products related to automotive applications formerly within the automotive group of TPA and in other product groups (notably from the former DSG and the Microcontroller Group);

the Memory Products Group ( MPG ) segment, comprised of our memories and Smart card businesses; and

the new Micro, Linear and Discrete Group ( MLD ) segment, comprised of most of the former DSG plus standard microcontroller and industrial devices (including the programmable systems memories ( PSM ) division from the former MPG).

Based upon preliminary industry estimates, in the first quarter of 2005, semiconductor industry revenue increased year-over-year by approximately 13% for the TAM and by approximately 11% for the SAM. On a sequential basis, in the first quarter of 2005, the TAM registered a slight increase of 0.4% and the SAM registered an increase of approximately 2%.

On a year-over-year basis, our net revenues have improved 2.6% from \$2,029 million in the first quarter of 2004 to \$2,083 million in the first quarter of 2005, however declining 10.5% on a sequential basis from \$2,328 million in the fourth quarter of 2004. Based on preliminary industry estimates, our revenue performances were below the level registered by the TAM and the SAM. Our first quarter 2005 results were within the guidance released to the market announcing a sequential decrease between 4% and 12% in comparison to the fourth quarter of 2004. On a sequential basis, our net revenues were negatively impacted by unfavorable seasonal dynamics resulting in lower sales volumes and continuing pricing pressures across many of our product families. The year-over-year increase of our net revenues was mainly driven by higher sales volume which was significantly offset by an average price decline of about 5%.

Our gross margin for the first quarter of 2005 was 32.9%, decreasing both in comparison to 35.4% gross margin in the first quarter of 2004 and 36.6% in the fourth quarter of 2004. The lower gross margin was mainly generated by the selling price decline, lower utilization rates of certain of our wafer fabs and the weaker U.S. dollar exchange rate against the other major international currencies.

Our selling, general and administrative expenses and research and development expenses were impacted in the first quarter of 2005 by one-time compensation and related charges of about \$20 million related to the retirement of our former CEO and of a limited number of senior executive officers granted by our Supervisory Board. Excluding these one-time compensation charges, the aggregate amount of these expenses was basically flat in dollar value compared to the fourth quarter of 2004; but increased by about 9% compared to the first quarter of 2004 mainly due to higher investment in research and development and the impact of the weakening U.S. dollar exchange rate. Furthermore, our Supervisory Board granted an additional special contribution to a non profitable charitable institution amounting to \$4 million, which is included as charge in Other Income and Expenses, net .

Additionally, in the first quarter of 2005, we registered a benefit in income taxes of \$20 million due to the reverse of certain tax provisions accrued in previous periods.

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Our first quarter 2005 earnings were also penalized by impairment, restructuring charges and other related closure costs for a total amount of \$78 million mainly relating to the announcement to eliminate low-volume, non strategic product families such as the scaling back of Access programs focused on Customer Premises Equipment ( CPE ) and to the previously announced 150mm restructuring plan.

In summary, our profitability during the first quarter 2005 was negatively impacted by the following factors:

the lower volume of sales compared to the fourth quarter of 2004,

the lower gross margin compared both to the fourth quarter 2004 and the first quarter of 2004, which reflected increased price pressure, lower utilization rates and the weaker US dollar,

the one-time compensation and related charges and the one-time special contribution to a non profit charitable institution, and

the impairment, restructuring charges and other closure costs.

However, our profitability was improved by the tax provision reversal of \$20 million.

This resulted in an operating loss in the first quarter of 2005 of \$68 million, compared to the operating income of \$210 million in the fourth quarter 2004 and the operating income of \$80 million in the first quarter of 2004.

In the first quarter of 2005, our capital expenditures were \$564 million compared to \$423 million in the fourth quarter 2004 and \$321 million in the first quarter of 2004, due to the payment of capital expenditures purchased during the last period of 2004. See Liquidity and Capital Resources Liquidity . At April 2, 2005, our net financial position resulted in a net debt position of \$210 million compared to a net debt position of \$8 million at December 31, 2004. Our total financial debt was \$1,897 million, of which \$1,702 million was long-term debt. At April 2, 2005, our cash and marketable securities amounted to \$1,687 million. See Liquidity and Capital Resources Capital Resources in this Form 6-K for a definition and reconciliation of net financial position, which is a non-GAAP financial measure.

We are focusing on improving the competitiveness of our Company. In addition to previously announced initiatives, we are undertaking several new actions designed to streamline our cost structure and strengthen our product portfolio, the two positive drivers of our gross margin. We expect the actions completed to date to progressively provide results which will ultimately yield approximately \$100 million per quarter in manufacturing costs and expense savings in the fourth quarter of 2005 compared to the same period of 2004. We are migrating a portion of memory wafer output to Asia. This coupled with repatriation of wafer supply and assembly services will improve both our fab loading and our manufacturing cost structure. Our procurement cost reduction campaign underway since January has resulted in substantial savings thus far, and this effort continues. Moreover, we continue our expense reduction initiatives, including the consolidation of certain general and administrative functions as well as the closure of several non-manufacturing sites.

From a product perspective, our objective is to accelerate innovation in order to increase our product leadership and importantly to strengthen our gross margin over the medium term. Our progress thus far is encouraging as we have a number of new products entering key markets, including: digital consumer System-on-Chip ( SoC ) in 90 nanometer technology, a first in our industry; system-in-package solutions for both Radio Frequency ( RF ) and energy management in cellular phones, and new SoC solutions in data storage. We also have begun Application-Specific Integrated Circuits ( ASIC ) designs in 65 nanometer platforms for wireless terminal and infrastructure products with several key customers.

With our significant research and development resources and deep talent pool, we believe that our product objectives can be accomplished through better focus and by selectively reallocating research and development resources to higher priority product categories. Therefore, in order to accelerate our research and development programs, we are redeploying approximately 1,000 engineers, representing 10% of our research and development workforce from non-core programs, including Field Programmable Gate Array ( FPGA ) and third-party design services, and from CPE modem and Global System for Mobile ( GSM ) chipset activities.

These are forward-looking statements that are subject to known and unknown risks and uncertainties that could cause actual results to differ materially; in particular, refer to those known risks and uncertainties described in *Cautionary Note on Forward-Looking Statements* herein and *Item 3. Key Information Risk Factors* in our Form 20-F as may be updated from time to time in our SEC filings.

### **Business Outlook**

We are beginning to see signs of improvement in certain segments of the marketplace: the first indications of increased order flow from the distribution market, as well as a pattern of strengthening in wireless. However, we still see strong price pressure in several markets, notably memory. With the present order visibility, we expect sales to grow sequentially in the range of -1% to 7%. For the 2005 second quarter the gross margin is expected to be about 33.5%, plus or minus one percentage point, reflecting both price pressure and progressive cost reduction. This guidance is based on a currency exchange rate of \$1.30 to €1.00.

For the full year 2005, we are confirming that the level of our capital investment will be \$1.5 billion.

These are forward-looking statements that are subject to known and unknown risks and uncertainties that could cause actual results to differ materially; in particular, refer to those known risks and uncertainties described in *Cautionary Note on Forward-Looking Statements* herein and *Item 3. Key Information Risk Factors* in our Form 20-F as may be updated from time to time in our SEC filings.

### **Other Developments in the First Quarter of 2005**

In January 2005, we decided to reduce our Access technology products for CPE modem products. This decision was intended to eliminate certain low-volume, non strategic product families whose return in the current environment did not meet internal targets. This decision resulted in a total impairment charge of approximately \$63 million in the first quarter of 2005 out of which \$61 million related to impairment of intangible assets and goodwill related to the CPE product lines.

On February 28, 2005, we signed an advanced pricing agreement for the period 2001 through 2007 with the United States Internal Revenue Service resulting in a net one-time tax benefit of approximately \$20 million in the first quarter of 2005.

At our annual general meeting of shareholders held on March 18, 2005, our shareholders approved the distribution of a cash dividend of \$0.12 per common share in respect to the 2004 financial year, equivalent to the prior year's cash dividend payment, for a total of approximately \$107 million to be paid in the latter half of May 2005. In addition, the shareholders approved the appointment of our Supervisory Board and Managing Board members, amendments to our articles of association and to our 2001 Employee Stock Option Plan, as well as a new 2005 Supervisory Board member and professional stock-based compensation plan, among other resolutions. Our Supervisory Board is composed of Messrs. Gérald Arbola, Matteo del Fante, Tom de Waard, Didier Lombard, Bruno Steve and Antonino Turicchi, who were each appointed for a three-year term, as well as Messrs. Doug Dunn, Francis Gavois and Robert White, who were each appointed for a one-year term.

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After our annual general meeting of shareholders, the Supervisory Board met and appointed Mr. Gérald Arbola as Chairman of the Supervisory Board and Mr. Bruno Steve as Vice Chairman, each for a three-year term. In addition, the Supervisory Board appointed Mr. Gérald Arbola as Chairman of the Strategic Committee, Mr. Bruno Steve as Vice Chairman, and Messrs. Turicchi, Lombard and White as members.

In the first quarter of 2005, we recorded in our income statement a total charge of \$24 million before tax (\$20 million after tax) for the compensation packages and special bonuses granted to our former CEO and to a limited number of senior executives. This charge included:

- a one-time compensation package and bonus to our former CEO amounting to \$7 million, including \$1 million for social charges as granted by our Supervisory Board;

- a special contribution to a non profit charitable institution amounting to \$4 million as granted by our Supervisory Board;

- an additional pension plan of \$8 million, of which \$3 million was allocated to grant an annuity of \$200 thousand to our former CEO as granted by our Supervisory Board; and

- special compensation packages for two of our former senior executives for a total amount of \$5 million including social charges.

On November 16, 2004, we signed a joint-venture agreement with Hynix Semiconductor Inc. to build a front-end memory-manufacturing facility in Wuxi City, Jiangsu Province, China. The conditions for the creation of the new company were met on April 28, 2005; we expect to make capital investments totaling \$125 million in 2005 and \$125 million in 2006. In addition, we have undertaken to extend \$250 million in long-term financing to the new joint venture guaranteed by subordinated collateral on the joint-venture assets.

### **Results of Operations**

#### **Segment Information**

We operate in two business areas: Semiconductors and Subsystems.

In the Semiconductors business area, we design, develop, manufacture and market a broad range of products, including discrete, memories and standard commodity components, application-specific integrated circuits ( ASICs ), full custom devices and semicustom devices and application-specific standard products ( ASSPs ) for analog, digital, and mixed-signal applications. In addition, we further participate in the manufacturing value chain of Smart card products through our Incard division, which includes the production and sale of both silicon chips and Smart cards. Our principal investment and resource allocation decisions in the Semiconductor business area are for expenditures on research and development and capital investments in front-end and back-end manufacturing facilities.

In the Semiconductors segment, effective January 1, 2005, we realigned our product groups to increase market focus and realize the full potential of our products, technologies, and sales and marketing channels. Beginning with this first quarter of 2005, we now report our sales and operating income in three segments:

- the new Application Specific Products Groups ( ASG ) segment, comprised of three product groups our new Home, Personal and Communication Sector ( HPC ), our new Computer Peripherals Group ( CPG ) and our new Automotive Product Group ( APG ). Our new HPC Sector is comprised of the telecommunications and the audio divisions from the former TPA combined with the consumer group from the former CMG Group. Our new CPG Group covers computer peripherals products, specifically disk drives and printers, and our new APG Group now comprises all of our major complex products related to automotive applications formerly within the automotive group of TPA and in other product groups (notably from the former DSG and the Microcontroller Group);

- the Memory Products Group ( MPG ) segment, comprised of our memories and Smart card businesses; and

- the new Micro, Linear and Discrete Group ( MLD ) segment, comprised of most of the former DSG plus standard microcontroller and industrial devices (including the programmable systems memories ( PSM ) division from the former MPG).



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We have restated our results in prior periods for illustrative comparisons of our performance by product group and by period. The segment information of 2004 has been restated using the same principles as the ones used for the current year. Furthermore, the preparation of segment information in accordance with the new organization of the groups, due to the significant changes in the segment structure, requires management to make significant estimates, assumptions and judgments in determining the operating income of the new groups for the prior year, which can affect the reported amounts for 2004.

In the Subsystems business area, we design, develop, manufacture and market subsystems and modules for the telecommunications, automotive and industrial markets including mobile phone accessories, battery chargers, ISDN power supplies and in-vehicle equipment for electronic toll payment. Based on its immateriality to our business as a whole, the Subsystems segment does not meet the requirements for a reportable segment as defined in Statement of Financial Accounting Standards No. 131, *Disclosures about Segments of an Enterprise and Related Information* (FAS 131).

The following tables present our consolidated net revenues and consolidated operating income by semiconductor product segment. For the computation of the Groups' internal financial measurements, we use certain internal rules of allocation for the costs not directly chargeable to the Groups, including cost of sales, selling, general and administrative expenses and a significant part of research and development expenses. Additionally, in compliance with our internal policies, certain cost items are not charged to the Groups, including impairment, restructuring charges and other related closure costs, start-up costs of new manufacturing facilities, some strategic and special research and development programs or other corporate sponsored initiatives, including certain corporate level operating expenses and certain other miscellaneous charges. Starting in the first quarter 2005, we allocated the starting up costs to expand our marketing and design presence in new developing areas to each Group, and we restated prior year results accordingly.

|  | (unaudited)<br>Three Months Ended |                   |
|--|-----------------------------------|-------------------|
|  | April 2, 2005                     | March 27,<br>2004 |
|  | (in millions)                     |                   |
| <b>Net revenues by product groups:</b> |                                   |                   |
| Application Specific Products          | \$ 1,188                          | \$ 1,161          |
| Micro, Linear and Discrete             | 457                               | 420               |
| Memory Products                        | 421                               | 431               |
| Others <sup>(1)</sup>                  | 17                                | 17                |
| <b>Total consolidated net revenues</b> | <b>\$ 2,083</b>                   | <b>\$ 2,029</b>   |

(1) Includes revenues from sales of subsystems and other products not allocated to product groups.

|   | (unaudited)<br>Three Months Ended |                   |
|---|-----------------------------------|-------------------|
|   | April 2, 2005                     | March 27,<br>2004 |
|   | (in millions)                     |                   |
| <b>Operating income (loss) by product groups:</b> |                                   |                   |
| Application Specific Products                     | \$ 65                             | \$ 118            |
| Micro, Linear and Discrete                        | 71                                | 71                |
| Memory Products                                   | (62)                              | (3)               |
| Total operating income of product groups          | 74                                | 186               |
| Others <sup>(1)</sup>                             | (142)                             | (106)             |
| <b>Total consolidated operating income (loss)</b> | <b>\$ (68)</b>                    | <b>\$ 80</b>      |

(1) Operating income (loss) of Others includes items such as impairment, restructuring charges and other related closure costs, start-up costs, and other unallocated expenses such as: strategic or special research and development programs, certain corporate level operating expenses,

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certain patent claims and litigations, and other costs that are not allocated to the product groups, as well as operating earnings or losses of the Subsystems and Other Products Group. Certain costs, mainly R&D, formerly in the Others category have been allocated to the groups, thus the comparable amounts reported in this category in prior period reports may not be the same, while prior periods are accordingly reclassified in the above table.

(unaudited)  
Three Months Ended

April 2, 2005      March 27,  
2004

(as percentages of net  
revenues)

**Operating income (loss) by product groups:**

|   |               |             |
|---|---------------|-------------|
| Application Specific Products <sup>(1)</sup>                    | 5.5%          | 10.2%       |
| Micro, Linear and Discrete <sup>(1)</sup>                       | 15.5          | 16.9        |
| Memory Products <sup>(1)</sup>                                  | (14.7)        | (0.7)       |
| Others <sup>(2)</sup>   | (6.8)         | (5.2)       |
| <b>Total consolidated operating income (loss)<sup>(3)</sup></b> | <b>(3.2)%</b> | <b>4.0%</b> |

(1) As a percentage of net revenues per product group.

(2) As a percentage of total net revenues. Includes operating income (loss) from sales of subsystems and other income (costs) not allocated to product groups.

(3) As a percentage of total net revenues.

(unaudited)  
Three Months Ended

April 2, 2005      March 27,  
2004

(in millions)

**Reconciliation to consolidated operating income (loss):**

|   |                |              |
|---|----------------|--------------|
| Total operating income (loss) of product groups                   | \$ 74          | \$ 186       |
| Strategic and other research and development programs             | (17)           | (21)         |
| Start-up costs  | (22)           | (23)         |
| Impairment, restructuring charges and other related closure costs | (78)           | (33)         |
| One-time compensation and special contributions <sup>(1)</sup>    | (22)           |              |
| Other non-allocated provisions                                    | (3)            | (29)         |
| Others <sup>(2)</sup>   | (142)          | (106)        |
| <b>Total consolidated operating income (loss)</b>                 | <b>\$ (68)</b> | <b>\$ 80</b> |

The total charge for one-time compensation and special contributions was \$24 million, of which \$22 million not allocated to product groups and (1) \$2 million allocated to product groups.

(2) Includes unallocated expenses such as: strategic and special research and development programs, certain corporate level operating expenses, certain patent claims and litigations, and other costs that are not allocated to the product groups.

**Net revenues by location of order shipment**

The table below sets forth information on our net revenues by location of order shipment:

(unaudited)  
Three Months Ended

April 2, 2005      March 27,  
2004

(in millions)



**Net Revenues by Location of Order Shipment<sup>(1)</sup>**

|                                 |           |              |           |              |
|---------------------------------|-----------|--------------|-----------|--------------|
| Europe <sup>(2)</sup>           | \$        | 679          | \$        | 649          |
| North America                   |           | 284          |           | 302          |
| Asia/Pacific                    |           | 906          |           | 854          |
| Japan                           |           | 74           |           | 87           |
| Emerging Markets <sup>(2)</sup> |           | 140          |           | 137          |
| <b>Total</b>                    | <b>\$</b> | <b>2,083</b> | <b>\$</b> | <b>2,029</b> |

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Net revenues by location of order shipment are classified by location of customer invoiced. For example, products ordered by U.S.-based companies to be invoiced to Asia/Pacific affiliates are classified as Asia/Pacific revenues.

- (1) Since January 1, 2005, the region Europe includes the former East European countries that joined the European Union in 2004. These countries were part of the Emerging Markets perimeter in the previous periods. Net revenues for Europe and Emerging Markets for prior periods were restated according to the new perimeter.
- (2)

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The table below shows our net revenues by location of order shipment and market segment application in percentages of net revenues:

|   | (unaudited)<br>Three Months Ended |                |
|---|-----------------------------------|----------------|
|   | April 2, 2005                     | March 27, 2004 |
| (as percentages of net revenues)                                |                                   |                |
| <b>Net Revenues by Location of Order Shipment<sup>(1)</sup></b> |                                   |                |
| Europe <sup>(2)</sup>   | 32.6%                             | 32.0%          |
| North America   | 13.6                              | 14.9           |
| Asia/Pacific  | 43.5                              | 42.1           |
| Japan   | 3.6                               | 4.3            |
| Emerging Markets <sup>(2)</sup>                                 | 6.7                               | 6.7            |
| <b>Total</b>  | <b>100.0%</b>                     | <b>100.0%</b>  |
| <b>Net Revenues by Market Segment Application:</b>              |                                   |                |
| Automotive  | 16%                               | 15%            |
| Consumer  | 19                                | 20             |
| Computer  | 18                                | 17             |
| Telecom   | 32                                | 32             |
| Industrial and Other  | 15                                | 16             |
| <b>Total</b>  | <b>100.0%</b>                     | <b>100.0%</b>  |

Net revenues by location of order shipment are classified by location of customer invoiced. For example, products ordered by U.S.-based

(1) companies to be invoiced to Asia/Pacific affiliates are classified as Asia/Pacific revenues.

Since January 1, 2005, the region Europe includes the former East European countries that joined the European Union in 2004. These countries were part of the Emerging Markets perimeter in the previous periods. Net revenues for Europe and Emerging Markets for prior

(2) periods were restated according to the new perimeter.

The following table sets forth certain financial data from our consolidated statements of income, expressed in each case as a percentage of net revenues:

|   | (unaudited)<br>Three Months Ended |                |
|---|-----------------------------------|----------------|
|   | April 2, 2005                     | March 27, 2004 |
| (as a percentage of net revenues)                                 |                                   |                |
| Net sales   | 99.9%                             | 100.0%         |
| Other revenues  | 0.1                               |                |
| <b>Net revenues</b>   | <b>100.0</b>                      | <b>100.0</b>   |
| Cost of sales   | (67.1)                            | (64.6)         |
| <b>Gross profit</b>   | <b>32.9</b>                       | <b>35.4</b>    |
| Selling, general and administrative                               | (12.7)                            | (11.3)         |
| Research and development  | (19.4)                            | (17.9)         |
| Other income and expenses, net                                    | (0.3)                             | (0.6)          |
| Impairment, restructuring charges and other related closure costs | (3.7)                             | (1.6)          |
| <b>Operating income (loss)</b>                                    | <b>(3.2)</b>                      | <b>4.0</b>     |
| Interest income (expense), net                                    | 0.3                               | (0.2)          |
| <b>Income (loss) before income taxes and minority interests</b>   | <b>(2.9)</b>                      | <b>3.8</b>     |
| Income tax benefit (expense)                                      | 1.5                               |                |
| <b>Income (loss) before minority interests</b>                    | <b>(1.4)</b>                      | <b>3.8</b>     |
| Minority interests  | (0.1)                             |                |
| <b>Net income (loss)</b>  | <b>(1.5%)</b>                     | <b>3.8%</b>    |



[Back to Contents](#)**First Quarter of 2005 vs. First Quarter of 2004**

Based upon preliminary industry estimates, in the first quarter of 2005, semiconductor industry revenue increased year-over-year by approximately 13% for the TAM and by approximately 11% for the SAM. On a sequential basis compared to the fourth quarter of 2004, revenues in the first quarter of 2005 increased approximately 0.4% for the TAM and 2% for the SAM.

*Net Revenues*

|                | Quarter ended    |                 |                   | % Variation |                |
|----------------|------------------|-----------------|-------------------|-------------|----------------|
|                | April 2,<br>2005 | Dec 31,<br>2004 | March 27,<br>2004 | Sequential  | Year-over-year |
|                | (in millions)    |                 |                   |             |                |
| Net sales      | \$ 2,081         | \$ 2,326        | \$ 2,028          | (10.6%)     | 2.6%           |
| Other revenues | 2                | 2               | 1                 | 26.7%       | 137.5%         |
| Net revenues   | \$ 2,083         | \$ 2,328        | \$ 2,029          | (10.5%)     | 2.6%           |

On a year-over-year basis, our first quarter 2005 revenues increased 2.6% compared to the first quarter of 2004. This was mainly due to the higher sales volume that more than compensated the negative impact of the decline in selling prices. Major increases in net revenues were registered in MLD and ASG while MPG net revenues were decreasing. On a sequential basis, our first quarter of 2005 recorded a 10.5% decrease resulting from a significant drop in volume, a further decline in selling prices and a less favorable product mix. During the first quarter of 2005, due to ongoing price pressure in the semiconductor market, our net revenues were negatively impacted and our average selling prices decreased by approximately 3% sequentially and by approximately 5% compared to the first quarter of 2004.

With respect to our product segments, in the first quarter of 2005, net revenues for ASG increased 2.3% over the first quarter of 2004 due to higher sales volume mainly in Automotive, Data storage, Imaging and Cellular phones, and a more favorable product mix mainly in Automotive, and Imaging products for cellular phones. The volume increase and a more favorable product mix were partially offset by a decline in average selling prices. First quarter 2005 net revenues for MLD increased 8.9% compared to the first quarter of 2004 mainly due to the volume increase mainly registered in Microcontrollers, Power Mos and discrete products and more favorable product mix. MPG net revenues in the first quarter of 2005 decreased by 2.4% in comparison to the first quarter of 2004, which is the result of a strong decline in selling prices, which was partially offset by the sales volume increase.

In the first quarter 2005, net revenues for ASG decreased 10.6% sequentially, mainly due to lower sales volume and average selling price decline in most of the product groups, while data storage net revenues increased by approximately 12%. Net revenues for MLD decreased 7.6% sequentially, mainly due to lower sales volume in most of the product groups. MPG net revenues decreased 13.3% in the first quarter of 2005 compared to the fourth quarter of 2004 mainly due to lower sales volume and the decline in selling prices.

During the first quarter of 2005, net revenues by segment market application were mainly increasing compared to the first quarter of 2004, in Automotive by approximately 13%, Computer by 5% and Telecom by 2%, while Consumer and Industrial and Other decreased by 3% and 1% respectively.

By location of order shipment, major increases in net revenues in the first quarter of 2005 versus the first quarter of 2004 were registered in the Asia Pacific, Europe and Emerging Markets regions, which revenues increased by approximately 6%, 5% and 2%, respectively, while North America and Japan revenues were decreasing by 6% and 15%, respectively.

In the first quarter of 2005, we had several large customers, with the largest one, the Nokia group of companies, accounting for approximately 20% of our net revenues, basically equivalent to the 21% it accounted for during the fourth quarter of 2004, and higher than the 15% it accounted for during the first quarter of 2004. Our top ten original equipment manufacturer customers accounted for approximately 48% of our net revenues in the first quarter of 2005 compared to approximately 48% of our net revenues in the fourth quarter of 2004 and approximately 43% of our net revenues in the first quarter of 2004.



[Back to Contents](#)*Gross profit*

|  | Quarter ended |              |                | % Variation |                |
|--|---------------|--------------|----------------|-------------|----------------|
|  | April 2, 2005 | Dec 31, 2004 | March 27, 2004 | Sequential  | Year-over-year |
|  | (in millions) |              |                |             |                |
| Cost of sales                                  | \$ (1,398)    | \$ (1,476)   | \$ (1,311)     | (5.3%)      | (6.6%)         |
| Gross profit                                   | \$ 685        | \$ 852       | \$ 718         | (19.7%)     | (4.7%)         |
| Gross margin (as a percentage of net revenues) | 32.9%         | 36.6%        | 35.4%          |             |                |

Gross margin in the first quarter of 2005 decreased to 32.9% compared to 36.6% in the fourth quarter of 2004 and 35.4% in the first quarter of 2004. The first quarter of 2005 gross margin was negatively impacted in comparison with the first quarter of 2004 by the continuing pricing pressure and the negative impact of the U.S. dollar weakening, which exceeded the benefits of improved manufacturing efficiencies and higher sales volume. On a sequential basis, our gross margin deteriorated due to the decline in selling prices, and lower volume and related reduced capacity utilization in some fabs. In addition, the further weakening of the U.S. dollar compared to the other major currencies negatively impacted our gross margin in the first quarter by approximately 100 basis points compared to the fourth quarter of 2004.

*Selling, general and administrative expenses*

|  | Quarter ended |              |                | % Variation |                |
|--|---------------|--------------|----------------|-------------|----------------|
|  | April 2, 2005 | Dec 31, 2004 | March 27, 2004 | Sequential  | Year-over-year |
|  | (in millions) |              |                |             |                |
| Selling, general and administrative expenses | \$ (265)      | \$ (245)     | \$ (230)       | (8.0%)      | (14.9%)        |
| As a percentage of net revenues              | (12.7%)       | (10.5%)      | (11.3%)        |             |                |

Our selling, general and administrative expenses increased 14.9% in the first quarter of 2005 compared to the first quarter of 2004. This increase was mainly associated with the provision amounting to \$15 million in one-time compensation charges to be paid to the former CEO and three other senior executives as decided by our Supervisory Board, higher spending in marketing activities associated with our program to broaden our customer base and the negative impact of the U.S. dollar decline. On a sequential basis, we registered an increase of 8.0% mainly due to the one-time compensation charges of \$15 million as well as the negative impact of the U.S. dollar decline. Excluding this specific item, selling, general and administrative expenses would have amounted to \$250 million, corresponding to a 2% increase compared to the fourth quarter of 2004.

*Research and development expenses*

|                                   | Quarter ended |              |                | % Variation |                |
|-----------------------------------|---------------|--------------|----------------|-------------|----------------|
|                                   | April 2, 2005 | Dec 31, 2004 | March 27, 2004 | Sequential  | Year-over-year |
|                                   | (in millions) |              |                |             |                |
| Research and development expenses | \$ (404)      | \$ (402)     | \$ (363)       | (0.4%)      | (11.3%)        |
| As a percentage of net revenues   | (19.4%)       | (17.3%)      | (17.9%)        |             |                |

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In the first quarter of 2005, research and development expenses increased 11.3% compared to the first quarter of 2004, due to higher levels of investment in research and development activities and due to the impact of the U.S. dollar decline. In addition, in the first quarter of 2005, research and development expenses included a \$5 million one-time termination charge to be paid to two former executives. On a sequential basis, our research and development expenses remained basically flat.

On a year-over-year basis, as a percentage of net revenues, research and development expenses grew at a higher rate than our net revenues, increasing from 17.9% in the first quarter of 2004 up to 19.4% in the first quarter of 2005. Research and development expenses represented 17.3% as a percentage of our fourth quarter of 2004 sales.

[Back to Contents](#)*Other income and expenses, net*

|                                       | Quarter ended |              |                |
|---------------------------------------|---------------|--------------|----------------|
|                                       | April 2, 2005 | Dec 31, 2004 | March 27, 2004 |
|                                       | (in millions) |              |                |
| Research and development funding      | \$ 14         | \$ 47        | \$ 16          |
| Start-up costs                        | (22)          | (18)         | (23)           |
| Exchange gain (loss) net              | 14            | 14           | 1              |
| Patent claim costs                    | (5)           | (16)         | (6)            |
| Gain on sale of non-current assets    |               |              | 4              |
| Other, net                            | (7)           | (4)          | (4)            |
| <b>Other income and expenses, net</b> | <b>\$ (6)</b> | <b>\$ 23</b> | <b>\$ (12)</b> |
| As a percentage of net revenues       | (0.3%)        | 1.0%         | (0.6%)         |

Other income and expenses, net resulted in an expense of \$6 million in the first quarter of 2005, compared to expense of \$12 million in the first quarter of 2004. On a year-over-year basis, the most important variation was the result of an exchange gain of \$14 million related to realized and unrealized exchange gains and losses related to transactions denominated in foreign currencies, not designated as cash flow hedge. Startup costs in the first quarter of 2005 were related to our 150-mm fab expansion in Singapore and the conversion to 200-mm fab in Agrate (Italy). Patent claim costs included costs associated with several ongoing litigations and claims. Patent claim costs are categorized either as patent litigation costs or pre-litigation costs, amounting to \$3 million and \$2 million, respectively. The \$7 million of miscellaneous charges of the first quarter of 2005 included \$4 million one-time contribution to a non profitable charitable institution as decided by our Supervisory Board. In the fourth quarter of 2004, Other income and expenses, net resulted in an income of \$23 million due to the higher level of research and development funding.

*Impairment, restructuring charges and other related closure costs*

|   | Quarter ended |              |                |
|---|---------------|--------------|----------------|
|   | April 2, 2005 | Dec 31, 2004 | March 27, 2004 |
|   | (in millions) |              |                |
| Impairment, restructuring charges and other related closure costs | \$ (78)       | \$ (18)      | \$ (33)        |
| As a percentage of net revenues                                   | (3.7%)        | (0.8%)       | (1.6%)         |

In the first quarter of 2005, we recorded impairment, restructuring charges and other related closure costs of \$78 million. This expense was mainly composed of:

the reduction of Access technology products for Customer Premises Equipment (CPE), as announced in January 2005, that generated an impairment charge of \$61 million on goodwill and other intangible assets as well as \$5 million charge for workforce termination benefits pursuant to the exit plan committed in one of our European subsidiaries;

the closure of certain sites in Germany and in the USA, which resulted in a restructuring expense and other related closure costs of approximately \$3 million corresponding to unused lease and employee termination costs; and

the continuation of our restructuring plan, mainly related to 150-mm fabs, announced in October 2003 that generated restructuring charges of approximately \$7 million. Through the period ended April 2, 2005, we have incurred \$288 million in connection with our restructuring plan announced in October 2003 of the total expected approximate \$350 million in pre-tax charges. We expect to incur the balance in the coming quarters.

See Note 7 to our Unaudited Interim Consolidated Financial Statements.





[Back to Contents](#)*Operating income (loss)*

|                                 | Quarter ended |              |                |
|---------------------------------|---------------|--------------|----------------|
|                                 | April 2, 2005 | Dec 31, 2004 | March 27, 2004 |
|                                 | (in millions) |              |                |
| Operating income (loss)         | \$ (68)       | \$ 210       | \$ 80          |
| As a percentage of net revenues | (3.2%)        | 9.0%         | 4.0%           |

Our operating result translated from an operating income of \$80 million in the first quarter of 2004 to an operating loss of \$68 million in the first quarter of 2005, due to several factors that negatively impacted our profitability although our net revenues have increased. These factors mainly included:

seasonal volume decline in revenues;

the negative impact of the ongoing pricing pressure on our net revenues;

the negative impact of the U.S. dollar decline; and

the increase in our total operating expenses from \$638 million in the first quarter of 2004 to \$753 million in the first quarter of 2005 in relation to the impairment of CPE and one-time compensation and related charges.

These negative factors were partially compensated by improved efficiencies in our manufacturing activities and higher volume of sales.

In the first quarter of 2005, MLD registered an operating income of \$71 million, equivalent to the first quarter of 2004, as improved sales volume offset the negative impacts of ongoing pricing pressure and increased operating expenses. ASG operating income decreased to \$65 million, significantly decreasing compared to \$118 million in the first quarter of 2004 due to pricing pressure and increased operating expenses. In the first quarter of 2005, MPG registered an operating loss of \$62 million, compared to an operating loss of \$3 million in the first quarter of 2004, due to the negative price impact and lower sales. All the groups were negatively impacted by the decline in the value of the U.S. dollar.

*Interest income (expense), net*

|                                | Quarter ended |              |                |
|--------------------------------|---------------|--------------|----------------|
|                                | April 2, 2005 | Dec 31, 2004 | March 27, 2004 |
|                                | (in millions) |              |                |
| Interest income (expense), net | \$ 7          | \$ 5         | \$ (4)         |

The interest income, net, of \$7 million of the first quarter of 2005 is in line with the interest income, net, of \$5 million recorded in the fourth quarter of 2004 and represents an improvement compared to the first quarter 2004, reflecting the decrease in interest expense due to our repurchases of our 2010 Bonds and our early redemption of the 2009 LYONs.

*Income tax benefit (expense)*

|  | Quarter ended |              |                |
|--|---------------|--------------|----------------|
|  | April 2, 2005 | Dec 31, 2004 | March 27, 2004 |
|  | (in millions) |              |                |

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|                              |    |    |    |      |    |   |
|------------------------------|----|----|----|------|----|---|
| Income tax benefit (expense) | \$ | 31 | \$ | (26) | \$ | 1 |
|------------------------------|----|----|----|------|----|---|

During the first quarter of 2005, we incurred an income tax benefit of \$31 million, which included a \$20 million reversal of certain tax provisions following the conclusion of an advanced pricing agreement for the period 2001 through 2007 with the United States Internal Revenue Service. Excluding these amounts, our effective tax rate would have been 16.4%, which is equivalent to the estimate of the 2005 tax charges in each of our jurisdictions. The effective tax rate for the first quarter of 2005 was computed on the basis of actual tax charges in each jurisdiction. Our tax rate is variable and depends on changes in the level of operating profits within various local jurisdictions and on changes in the applicable taxation rates of these jurisdictions, as well as changes in estimated tax provisions due to new events. We currently enjoy certain tax benefits in some countries; as such benefits may not be available in the future due to changes in the local jurisdictions, our effective tax rate could be different in future quarters and may increase in the coming years.

[Back to Contents](#)*Net income (loss)*

|                                 | Quarter ended |              |                |
|---------------------------------|---------------|--------------|----------------|
|                                 | April 2, 2005 | Dec 31, 2004 | March 27, 2004 |
|                                 | (in millions) |              |                |
| Net income (loss)               | \$ (31)       | \$ 187       | \$ 77          |
| As a percentage of net revenues | (1.5%)        | 8.0%         | 3.8%           |

For the first quarter of 2005, we reported a net loss of \$31 million, compared to net income of \$77 million in the first quarter of 2004 and net income of \$187 million in the fourth quarter of 2004. Basic and diluted earnings per share for the first quarter of 2005 were \$0.03 loss, deteriorating from basic and diluted earnings of \$0.09 and \$0.08 per share, respectively, for the first quarter of 2004 and compared to basic and diluted earnings per share of \$0.21 and \$0.20, respectively, for the fourth quarter of 2004. The first quarter of 2005 earnings per share included net cost equivalent to \$0.07 per diluted share associated with the impairment and one-time compensation charges, and with the tax benefit generated by our reverse of certain income tax provisions.

**Related-Party Transactions**

On February 27, 2005, the board of directors of France Telecom appointed Didier Lombard, member of our Supervisory Board, as its Chairman and CEO. France Telecom and its subsidiaries are our suppliers and we will disclose the relevant transactions in our annual report.

At a meeting on April 26, 2005, the Managing Board informed the Supervisory Board about the renewal of a contract for the provision of various telecom-related services with EQUANT, a subsidiary of France Telecom. The Supervisory Board noted the Management Board's assessment of the positive commercial benefits of such contract. Additionally, the Supervisory Board noted that the contract was concluded at normal and competitive conditions and was based on a long-standing proven business relationship between EQUANT and us, which was established before EQUANT became a controlled subsidiary of France Telecom.

**Impact of Changes in Exchange Rates**

Our results of operations and financial condition can be significantly affected by material changes in exchange rates between the U.S. dollar and other currencies where we maintain our operations, particularly the euro, the Japanese yen and other Asian currencies.

As a market rule, the reference currency for the semiconductor industry is the U.S. dollar, and product prices are mainly denominated in U.S. dollars. However, revenues for certain of our products (primarily dedicated products sold in Europe and Japan) that are quoted in currencies other than the U.S. dollar are directly affected by fluctuations in the value of the U.S. dollar. Revenues for all other products, which are either quoted in U.S. dollars and billed in U.S. dollars or translated into local currencies for payment, tend not to be affected significantly by fluctuations in exchange rates, except to the extent that there is a lag between changes in currency rates and adjustments in the local currency equivalent price paid for such products. As a result of the currency variations, the appreciation of the euro compared to the U.S. dollar increases in the short term our level of revenues when reported in U.S. dollars.

Certain significant costs incurred by us, such as manufacturing, labor costs and depreciation charges, selling, general and administrative expenses, and research and development expenses, are incurred in the currency of the jurisdictions in which our operations are located, and most of our operations are located in the euro zone or other currency areas. Currency exchange rate fluctuations affect our results of operations because our reporting currency is the U.S. dollar, while we receive a limited part of our revenues, and more importantly, incur the majority of our costs, in currencies other than the U.S. dollar. In the first quarter of 2005, the average rate of U.S. dollar during the period declined in value, particularly against the euro, causing us to report higher expenses and negatively impacting both our gross margin and operating income. Our Consolidated Statement of Income for the first quarter of 2005 includes income and expense items translated at the average exchange rate for the period. The average rate of the euro to the U.S. dollar was €1.00 for \$1.31 in the first quarter of 2005, and it was €1.00 for \$1.27 in the fourth quarter of 2004 and €1.00 for \$1.26 in the first quarter of 2004. The further weakening of the U.S. dollar compared to the other major currencies negatively impacted our gross margin in the first quarter of 2005 by approximately 100 basis points compared to the fourth quarter

of 2004. A continuation in the decline of the U.S. dollar compared to the other major currencies, which affect our operations, would negatively impact our expenses, margins and profitability.

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Our principal strategy to reduce the risks associated with exchange rate fluctuations has been to balance as much as possible the proportion of sales to our customers denominated in U.S. dollars with the amount of raw materials, purchases and services from our suppliers denominated in U.S. dollars, thereby reducing the potential exchange rate impact of certain variable costs relative to revenues. In order to further reduce the exposure to U.S. dollar exchange rate fluctuations, we have hedged certain line items on our income statement, in particular with respect to a portion of cost of goods sold, most of the research and development expenses and certain selling and general and administrative expenses, located in the euro zone. As of April 2, 2005 these hedging contracts represent a deferred loss of \$32 million after tax, registered in other comprehensive income in shareholders' equity, compared to deferred profit of \$59 million after tax as at December 31, 2004. However, there is no guarantee that we will be capable of reaching a complete balance, and, consequently, our result of operations could be impacted by significant fluctuations in exchange rates. In addition, in order to avoid potential exchange rate risks on our commercial transactions, from time to time, we may purchase or sell forward foreign currency exchange contracts and currency options to cover foreign currency exposure in payables or receivables at our affiliates. Our management strategies to reduce exchange rate risks have served to mitigate, but not eliminate, the positive or negative impact of exchange rate fluctuations. No assurance may be given that our hedging activities will sufficiently protect us against declines in the value of the dollar, and if the value of the dollar increases, we will record losses in connection with the loss in value of the remaining forward hedging contracts at the time.

Assets and liabilities of subsidiaries are, for consolidation purposes, translated into U.S. dollars at the period-end exchange rate. Income and expenses are translated at the average exchange rate for the period. The balance sheet impact of such translation adjustments has been, and may be expected to be, significant from period to period since a large part of our assets and liabilities are accounted for in euro as their functional currency. Adjustments resulting from the translation are recorded directly in shareholders' equity, and are shown as accumulated other comprehensive income (loss) in the consolidated statements of changes in shareholders' equity. At April 2, 2005, our outstanding indebtedness was denominated principally in U.S. dollars and, to a limited extent, in euros and in Singapore dollars.

For a more detailed discussion, see Item 3. Key Information Risk Factors Our financial results can be adversely affected by fluctuations in exchange rates, principally in the value of the U.S. dollar as set forth in our Form 20-F.

### **Liquidity and Capital Resources**

Treasury activities are regulated by our policies, which define procedures, objectives and controls. The policies focus on the management of our financial risk in terms of exposure to currency rates and interest rates. Most treasury activities are centralized, with any local treasury activities subject to oversight from our head treasury office. The majority of our cash and cash equivalents are held in U.S. dollars and are placed with financial institutions rated A or higher. Marginal amounts are held in other currencies. See Item 11. Quantitative and Qualitative Disclosures about Market Risk in our Form 20-F. At April 2, 2005, there had been no material changes in foreign currency operations and hedging transactions exposures from those disclosed in our Form 20-F.

At April 2, 2005, cash and cash equivalents totaled \$1,162 million, compared to \$1,950 million at December 31, 2004. Our available cash decreased in the first quarter of 2005 due to the \$525 investment in marketable securities and the negative net operating cash flow of the period. In the first quarter of 2005, we invested \$525 million in credit-linked deposits issued by several primary banks in order to maximize the return on available cash. These credit-linked deposits are reinvested by the banks in underlying instruments (reference debt) that have been issued by different financial institutions with a minimum rating of A- and include a derivative instrument related to the underlying credit default swap of the credit-linked deposit. We determined that this derivative element had no material impact on our interim Consolidated Financial Statements as of April 2, 2005. Interest on these instruments is paid quarterly and the interest rate is fixed every three months based on the LIBOR rate of the U.S. dollar plus a spread. Interest is payable through the final maturity of these instruments scheduled to occur by December 31, 2005, unless suspended by credit default of the reference debt. Additionally, the carrying value of the instruments depends on the non-default of the reference debt. The principal will be repaid at final maturity unless a default occurs, in which case repayment of principal would be reduced based on the decline in value of the defaulted debt.

[Back to Contents](#)**Liquidity**

We maintain a significant cash position and a low debt to equity ratio which provide us with adequate financial flexibility. As in the past, our cash management policy is to finance our investment needs mainly with net cash generated from operating activities. Net cash from operating activities was \$359 million in the first quarter of 2005, while net cash used in investing activities was \$1,100 million, of which \$525 million related to investments in short-term marketable securities.

*Net cash from operating activities.* The major source of cash during the first quarter of 2005 and in prior periods was cash provided by operating activities. Our net cash from operating activities totaled \$359 million in the first quarter of 2005, decreasing from \$552 million in the first quarter of 2004, due to the lower profitability level and the negative changes in assets and liabilities.

Changes in our operating assets and liabilities resulted in net cash used of \$157 million in the first quarter of 2005, compared to net cash generated of \$26 million in the first quarter of 2004. In the first quarter of 2005, the increase in our trade accounts receivable used net cash of \$24 million, while it used \$125 million of net cash in the first quarter of 2004. Inventory used net cash for \$65 million in the first quarter of 2005, while in the first quarter of 2004 inventory generated net cash of \$44 million. Finally, our trade payables used net cash of \$57 million in the first quarter of 2005, while they generated net cash of \$169 million in the first quarter of 2004.

*Net cash used in investing activities.* Net cash used in investing activities was \$1,100 million in the first quarter of 2005, compared to \$1,367 million in the first quarter of 2004. Payments for purchases of tangible assets were the main utilization of cash amounting to \$564 million for the first quarter of 2005, a significant increase over the \$321 million in the first quarter of 2004. Purchases of marketable securities in the first quarter of 2005 amounted to \$525 million compared to \$1,030 in the first quarter of 2004.

*Net operating cash flow.* We define net operating cash flow as net cash from operating activities minus net cash used in investing activities, excluding payment for purchases of and proceeds from the sale of marketable securities. We believe net operating cash flow provides useful information for investors because it measures our capacity to generate cash from our operating activities to sustain our investments for our operating activities. Net operating cash flow is not a U.S. GAAP measure and does not represent total cash flow since it does not include the cash flows generated by or used in financing activities. In addition, our definition of net operating cash flow may differ from definitions used by other companies. Net operating cash flow is determined as follows from our Unaudited Interim Consolidated Statements of Cash Flow:

|   | <b>Three Months Ended</b> |                       |
|---|---------------------------|-----------------------|
|   | <b>April 2, 2005</b>      | <b>March 27, 2004</b> |
|   | <b>(in millions)</b>      |                       |
| Net cash from operating activities            | \$ 359                    | \$ 552                |
| Net cash used in investing activities         | (1,100)                   | (1,367)               |
| Payment for purchase of marketable securities | 525                       | 1,030                 |
| Net operating cash flow                       | <b>\$ (216)</b>           | <b>\$ 215</b>         |

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We generated negative net operating cash flow of \$216 million in the first quarter of 2005, compared to positive net operating cash flow of \$215 million in the first quarter of 2004. This resulted mainly from the payment of purchases of tangible assets related to the capital investments undertaken in the fourth quarter of 2004 and to the decrease of profitability to a net loss of \$31 million.

*Net cash used in financing activities.* Net cash used in financing activities was \$38 million in the first quarter of 2005 compared to \$77 million used in the first quarter of 2004. The major item of cash used in financing activities in the first quarter of 2005 was the repayment of long-term debt for \$20 million.

**Capital Resources***Net financial position*

We define our net financial position as the difference between our total cash position (cash, cash equivalents and marketable securities) net of total financial debt (bank overdrafts, current portion of long-term debt and long-term debt). Net financial position is not a U.S. GAAP measure. We believe our net financial position provides useful information for investors because it gives evidence of our global position either in terms of net indebtedness or net cash by measuring our capital resources based on cash, cash equivalents and marketable securities and the total level of our financial indebtedness. The net financial position is determined as follows from our Unaudited Interim Consolidated Balance Sheet as at April 2, 2005:

|                                   | As at           |                |
|-----------------------------------|-----------------|----------------|
|                                   | April 2, 2005   | March 27, 2004 |
|                                   | (in millions)   |                |
| Cash and cash equivalents         | \$ 1,162        | \$ 2,103       |
| Marketable securities             | 525             | 1,030          |
| <b>Total cash position</b>        | <b>1,687</b>    | <b>3,133</b>   |
| Bank overdrafts                   | (37)            | (4)            |
| Current portion of long-term debt | (158)           | (443)          |
| Long-term debt                    | (1,702)         | (2,555)        |
| <b>Total financial debt</b>       | <b>(1,897)</b>  | <b>(3,002)</b> |
| <b>Net financial position</b>     | <b>\$ (210)</b> | <b>\$ 131</b>  |

The net financial position (cash, cash equivalents and marketable securities net of total financial debt) as of April 2, 2005 was a net debt in the amount of \$210 million, representing deterioration from the net cash position of \$131 million as of March 27, 2004.

At April 2, 2005, the aggregate amount of our long-term debt was \$1,702 million, including \$1,379 million of our negative yield zero coupon senior convertible bonds due 2013 ( 2013 Bonds ). Additionally, the aggregate amount of our available short-term credit facilities was approximately \$1,891 million, under which \$37 million was used at April 2, 2005. Our long-term financing instruments contain standard covenants, but do not impose minimum financial ratios or similar obligations on us.

As of April 2, 2005, we have the following credit ratings on our 2013 Bonds:

|   | Moody's<br>Investors<br>Service | Standard &<br>Poor's |
|---|---------------------------------|----------------------|
| Zero Coupon Senior Convertible Bonds due 2013 | A3                              | A                    |

In the event of a downgrade of these ratings, we believe we would continue to have access to sufficient capital resources.





**Contractual Obligations, Commitments and Contingencies**

Our contractual obligations, commercial commitments and contingencies as of April 2, 2005, and for each of the five years to come and thereafter, were as follows:

|   | Payments due by period<br>(unaudited) |                 |               |               |              |              |              |                 |
|---|---------------------------------------|-----------------|---------------|---------------|--------------|--------------|--------------|-----------------|
|   | Total                                 | 2005            | 2006          | 2007          | 2008         | 2009         | 2010         | Thereafter      |
| Capital leases <sup>(2)</sup>   | \$ 33                                 | \$ 4            | \$ 6          | \$ 6          | \$ 6         | \$ 5         | \$ 5         | \$ 1            |
| Operating leases <sup>(1)</sup>   | 281                                   | 39              | 38            | 31            | 27           | 23           | 19           | 104             |
| Purchase obligations <sup>(1)</sup>                                     | 967                                   | 922             | 42            | 3             |              |              |              |                 |
| of which:   |                                       |                 |               |               |              |              |              |                 |
| Equipment purchase  | 675                                   | 668             | 7             |               |              |              |              |                 |
| Foundry purchase  | 179                                   | 179             |               |               |              |              |              |                 |
| Software, technology licenses and design                                | 113                                   | 75              | 35            | 3             |              |              |              |                 |
| Joint Venture Agreement with Hynix Semiconductor Inc. <sup>(1)(4)</sup> | 250                                   | 125             | 125           |               |              |              |              |                 |
| Other Obligations <sup>(1)</sup>  | 172                                   | 62              | 56            | 45            | 3            | 2            | 1            | 3               |
| Long-term debt obligations <sup>(2)(3)</sup>                            | 1,702                                 |                 | 122           | 85            | 27           | 27           | 25           | 1,416           |
| Pension obligations <sup>(2)</sup>                                      | 265                                   | 33              | 21            | 18            | 20           | 21           | 17           | 135             |
| Other non-current liabilities <sup>(2)</sup>                            | 22                                    | 1               | 7             | 3             | 3            | 3            | 3            | 2               |
| <b>Total</b>  | <b>\$ 3,692</b>                       | <b>\$ 1,186</b> | <b>\$ 417</b> | <b>\$ 191</b> | <b>\$ 86</b> | <b>\$ 81</b> | <b>\$ 70</b> | <b>\$ 1,661</b> |

(1) Items not reflected on the Unaudited Interim Consolidated Balance Sheet at April 2, 2005.

(2) Items reflected on the Unaudited Interim Consolidated Balance Sheet at April 2, 2005.

See Note 12 to the Unaudited Interim Consolidated Financial Statements at April 2, 2005 for additional information related to long-term debt and redeemable convertible securities, in particular, in respect to the noteholders' option to put our convertible bonds for earlier redemption in

(3) August 2006.

These amounts correspond to our capital commitments to the joint venture, but not the additional \$250 million in loans that we have committed to provide.

Operating leases are mainly related to building leases. The amount disclosed is composed of minimum payments for future leases from 2005 to 2010 and thereafter. We lease land, buildings, plants and equipment under operating leases that expire at various dates under non-cancelable lease agreements.

Purchase obligations are primarily comprised of purchase commitments for equipment, for outsourced foundry wafers and for software licenses.

We signed a joint-venture agreement with Hynix Semiconductor Inc. on November 16, 2004 to build a front-end memory-manufacturing facility in Wuxi City, Jiangsu Province, China. As the business license for the joint venture was obtained in April 2005, we expect to fulfill our financial obligations later in 2005. In addition, we are committed to grant long-term financing for \$250 million to the new joint venture guaranteed by subordinated collateral on the joint venture's assets.

Long-term debt obligations mainly consist of bank loans and convertible debt issued by us that is totally or partially redeemable for cash at the option of the holder. They include maximum future amounts that may be redeemable for cash at the option of the holder, at fixed prices. At the holder's option, any outstanding 2013 Bond may be redeemed for cash on August 5, 2006, 2008 or 2010 for a total aggregate amount payable by us of \$1,379 million on August 5, 2006, \$1,365 million on August 5, 2008 or \$1,352 million on August 5, 2010. The conversion ratio is \$985.09 per \$1,000 principal amount of 2013 Bonds at August 5, 2006, \$975.28 at August 5, 2008 and \$965.56 at August 5, 2010, subject to adjustments in certain circumstances.

Pension obligations consist of our best estimates of the amounts that will be payable by us for the retirement plans based on the assumption that our employees will work for us until they reach the age of retirement. The final actual amount to be paid and related timings of such payments may vary significantly due to early retirements or terminations. This amount does not include the additional pension plan of \$8 million granted by our Supervisory Board to the CEO and to a limited number of senior executives, which was recorded as current liabilities, as we are willing to transfer this obligation to an insurance company.



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Other non-current liabilities include future unused leases and miscellaneous contractual obligations.

Other obligations primarily relate to contractual firm commitments with respect to cooperation agreements.

Other than those described above, there are no material off-balance sheet obligations, contractual obligations or other commitments.

### **Financial Outlook**

We currently expect that capital spending for 2005 will be approximately \$1.5 billion, significantly below the \$2.05 billion spent in 2004. We have the flexibility to modulate our investments up or down in response to changes in market conditions, and we are ready to accelerate or slow down investments in leading-edge technologies if market trends require. At April 2, 2005, we had a total of \$675 million in outstanding commitments for equipment purchases for 2005 and 2006.

The most significant of our 2005 capital expenditure projects are expected to be (i) the capacity expansion of our 200-mm and 150-mm front-end facilities in Singapore; (ii) the completion of building and facilities for our 300-mm front-end plant in Catania (Italy); (iii) the conversion to 200-mm of our front-end facility in Agrate, Italy; (iv) the expansion of our 200-mm front-end facility in Phoenix, Arizona; (v) the expansion of the 300-mm front-end joint project with Philips Semiconductors International B.V. and Freescale Semiconductor, Inc. in Crolles (France); and (vi) the capacity expansion of our back-end plants in Muar (Malaysia), Toa Payoh (Singapore) and Malta. We will continue to monitor our level of capital spending, however, taking into consideration factors such as trends in the semiconductor industry, capacity utilization and announced additions. We expect to have significant capital requirements in the coming years and intend to continue to devote a substantial portion of our net revenues to research and development. We plan to fund our capital requirements from cash provided by operations, available funds and available support from third parties (including state support), and may have recourse to borrowings under available credit lines and, to the extent necessary or attractive based on market conditions prevailing at the time, the issuing of debt or additional equity securities. A substantial deterioration of our economic results and consequently of our profitability could generate a deterioration of the cash generated by our operating activities. Therefore, there can be no assurance that, in future periods, we will generate the same level of cash as in the previous years to fund our capital expenditures for expansion plans, our working capital requirements, research and development and industrialization costs.

The holders of our 2013 Bonds may require us to redeem them on August 5, 2006 at a price of \$985.09 per one thousand dollar face value. The conversion ratio is \$985.09 per \$1,000 principal amount of 2013 Bonds at August 5, 2006, \$975.28 at August 5, 2008 and \$965.56 at August 5, 2010, subject to adjustments in certain circumstances. The total redeemable amount will be equivalent to \$1,379 million on August 5, 2006. There can be no assurance that additional financing will be available as necessary, or that any such financing, if available, will be on terms acceptable to us. However, we believe that cash generated from operations, existing funds, available support from third parties, and additional borrowings will be sufficient to meet our anticipated needs for liquidity through at least 2005.

### Impact of Recently Issued U.S. Accounting Standards

In November 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 151, *Inventory Costs, an amendment of ARB No. 43, Chapter 4* ( FAS 151 ). The Standard requires abnormal amounts of idle capacity and spoilage costs to be excluded from the cost of inventory and expensed when incurred. The provisions of FAS 151 are applicable prospectively to inventory costs incurred during fiscal years beginning after June 15, 2005. As costs associated with underutilization of manufacturing facilities have historically been charged directly to cost of sales, we believe that FAS 151 will have no material effect on our financial position or results of operations.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 153, *Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29* ( FAS 153 ). This Statement amends Opinion 29 to eliminate the exception to the basis measurement principle (fair value) for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of transactions that do not have commercial substance, that is, transactions that are not expected to result in significant changes in the cash flows of the reporting entity. The Statement is effective prospectively for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005, with early application permitted. We have not had any nonmonetary exchanges of assets since FAS 153 was published and believe that FAS 153 will have no material effect on our financial position or results of operations.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* ( FAS 123R ). This Statement revises FASB Statement No. 123, *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. FAS 123R requires a public entity to measure the cost of share-based service awards based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award or the requisite service period, usually the vesting period. The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models adjusted for the unique characteristics of those instruments. FAS 123R also requires more extensive disclosures than the previous standards relating to the nature of share-based payment transactions, compensation cost and cash flow effects. On April 14, 2005, the U.S. Securities and Exchange Commission amended the effective date of FAS 123R; the Statement now applies to all awards granted and to all unvested awards modified, repurchased, or cancelled during the first annual reporting period beginning after June 15, 2005. FAS 123R provides a choice of transition methods including the modified prospective application method, which allows discretionary restatement of interim periods during the calendar year of adoption, or the modified retrospective application method, which allows the restatement of the prior years presented. Each method requires the cumulative effect of initially applying FAS 123R to be recognized in the period of adoption. We will adopt FAS 123R in the first quarter of 2006 using the modified prospective application method. As a significant number of option grants are above current market prices, we believe that our existing equity-based compensation strategy is minimally effective in motivating and retaining key employees. Therefore, we are currently reviewing our share-based remunerations programs. In conjunction with this review, we intend to accelerate the vesting period of outstanding stock options, following authorization from our shareholders at our annual general meeting held on March 18, 2005. In addition, we are evaluating to base our share-based remuneration programs on nonvested shares. We will disclose the cumulative impact on our consolidated accumulated result from adopting FAS 123R when such review is finalized. The impact on our financial position and results of operations are illustrated in the information presented in note 15 to our Unaudited Interim Consolidated Financial Statements Fair value of stock-based compensation .

### Backlog and Customers

We began the second quarter of 2005 with a backlog 11% higher than we had entering the second quarter of 2004. In the first quarter of 2005, we had several large customers, with the Nokia Group of companies being the largest and accounting for approximately 20% of our revenues. Total original equipment manufacturers ( OEMs ) accounted for approximately 82% of our net revenues, of which the top ten OEM customers accounted for approximately 48%. Distributors accounted for approximately 18% of our net revenues. We have no assurance that the Nokia Group of companies, or any other large customer, will continue to generate revenues for us at the same levels. If we were to lose one or more of our key customers, or if they were to significantly reduce their bookings, or fail to meet their payment obligations, our operating results and financial condition could be adversely affected.

**Changes to Our Share Capital, Stock Option Grants and Other Matters**

The following table sets forth changes to our share capital as of April 2, 2005:

| Year              | Transaction         | Number of shares | Nominal value (euro) | Cumulative amount of capital (euro) | Cumulative number of shares | Nominal value of increase/reduction in capital | Amount of issue premium (euro) | Cumulative issue premium (euro) |
|-------------------|---------------------|------------------|----------------------|-------------------------------------|-----------------------------|--|--------------------------------|---------------------------------|
| (in millions)     |                     |                  |                      |                                     |                             |  |                                |                                 |
| December 31, 2005 | LYONs conversion    | 1,761            | 1.04                 | 941,521,357                         | 905,308,997                 | 1,831  | 46,225                         | 1,708,949,494                   |
| April 2, 2005     | Exercise of options | 63,270           | 1.04                 | 941,587,158                         | 905,372,267                 | 65,801   | 571,525                        | 1,709,521,019                   |
| April 2, 2005     | Conversion of bonds | 59               | 1.04                 | 941,587,219                         | 905,372,326                 | 61   | 1,448                          | 1,709,522,467                   |

The following table summarizes the amount of stock options authorized to be granted exercised, cancelled and outstanding as of April 2, 2005:

|   | Employees  |            | Supervisory Board |         |         | Total      |
|---|------------|------------|-------------------|---------|---------|------------|
|   | 1995 Plan  | 2001 Plan  | 1996              | 1999    | 2002    |            |
| Remaining amount authorized to be granted | 0          | 15,216,052 | 0                 | 0       | 0       | 15,216,052 |
| Amount exercised                          | 9,788,894  | 9,650      | 280,000           | 18,000  | 0       | 10,096,544 |
| Amount cancelled                          | 2,353,770  | 2,940,585  | 72,000            | 63,000  | 24,000  | 5,453,355  |
| Amount outstanding                        | 19,419,277 | 44,783,948 | 48,500            | 342,000 | 372,000 | 64,965,725 |

The Supervisory Board granted 29,200 options at an exercise price of \$16.73 on January 31, 2005 and 13,000 options at an exercise price of \$17.31 on March 17, 2005.

During our Annual General Meeting of Shareholders held on March 18, 2005, the amendment of our existing 2001 Employee Stock Option Plan proposed by our Supervisory Board was approved. Our Supervisory Board decided to authorize to accelerate vesting of outstanding stock options in connection with the overall change of our stock-based compensation policy. In addition to that, nonvested stock awards will be introduced with our next 2005 allocation. The maximum number of nonvested shares will be four million shares and will fall within the outstanding amount of options to be granted under our existing 2001 Stock Option Plan.

**Disclosure Controls and Procedures**

Our chief executive officer and chief financial officer, after evaluating the effectiveness of our disclosure controls and procedures (as defined in Exchange Act Rule 13a-14(c)) as of the end of the period covered by this report, have concluded that, as of such date, our disclosure controls and procedures were effective to ensure that material information relating to our company was made known to them by others within our company, particularly during the period when this Form 6-K was being prepared.

There were no significant changes in our internal controls over financial reporting or in other factors that could significantly affect these controls during the period covered by this report, nor were there any significant deficiencies or material weaknesses in our internal controls requiring corrective actions in addition to those taken from time to time.

## Other Reviews

We have sent this report to our Audit Committee, which had an opportunity to raise questions with our management and independent auditors before we submitted it to the Securities and Exchange Commission.

## Cautionary Note Regarding Forward-Looking Statements

Some of the statements contained in Overview Business Outlook and in Liquidity and Capital Resources Financial Outlook and elsewhere in this Form 6-K, that are not historical facts, are statements of future expectations and other forward-looking statements (within the meaning of Section 27A of the Securities Act of 1933 or Section 21E of the Securities Exchange Act of 1934, each as amended) that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those in such statements due to, among other factors:

future developments of the world semiconductor market, in particular the future demand for semiconductor products in the key application markets and from key customers served by our products;

pricing pressures, losses or curtailments of purchases from key customers as well as inventory adjustments from distributors;

changes in the exchange rates between the US Dollar and the Euro, compared to the current exchange rate of \$1.30=1 Euro, and between the US Dollar and the currencies of the other major countries in which we have our operating infrastructure;

our ability to develop new products in time to meet market demand for volume supplies;

our ability to complete, successfully and in a timely manner, our various announced initiatives to improve the efficiency of our research and development programs, our manufacturing and the reduction of our procurement costs;

the anticipated benefits of research & development alliances and cooperative activities;

the ramp- up of volume production in new manufacturing technologies at our fabs;

the ability of our suppliers to meet our demands for products and to offer competitive pricing;

changes in the economic, social, or political environment, as well as natural events such as severe weather, health risks or earthquakes in the countries in which we and our key customers operate;

our ability to obtain required licenses on third party intellectual property; and

make consistent changes in our taxation rate, tax provisions and deferred taxes.

Such forward-looking statements are subject to various risks and uncertainties, which may cause actual results and performance of our business to differ materially and adversely from the forward-looking statements. Certain such forward-looking statements can be identified by the use of forward-looking terminology such as believe, may, will, should, would be or anticipated, similar expressions or the negative thereof or other variations thereof or comparable terminology, or by discussions of strategy, plans or intentions. Some of these risk factors are set forth and are discussed in more detail in Item 3. Key Information Risk Factors in our Form 20-F. Should one or more of these risks or uncertainties materialize, or should underlying assumptions prove incorrect, actual results may vary materially from those described in this Form 6-K as anticipated, believed or expected. We do not intend, and do not assume any obligation, to update any industry information or forward-looking statements set forth in this Form 6-K to reflect subsequent events or circumstances.

Unfavorable changes in the above or other factors listed under Risk Factors from time to time in our Securities and Exchange Commission (SEC) filings, could have a material adverse effect on our business and/or financial condition.

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**STMicroelectronics N.V.**  
**CONSOLIDATED STATEMENTS OF INCOME**

|   | Three months ended<br>(unaudited) |                   |
|---|-----------------------------------|-------------------|
|   | April 2,<br>2005                  | March 27,<br>2004 |
| <b>In millions of U.S. dollars except per share amounts</b>       |                                   |                   |
| Net sales   | 2,081                             | 2,028             |
| Other revenues  | 2                                 | 1                 |
| <b>Net revenues</b>   | <b>2,083</b>                      | <b>2,029</b>      |
| Cost of sales   | (1,398)                           | (1,311)           |
| <b>Gross profit</b>   | <b>685</b>                        | <b>718</b>        |
| Selling, general and administrative                               | (265)                             | (230)             |
| Research and development  | (404)                             | (363)             |
| Other income and expenses, net                                    | (6)                               | (12)              |
| Impairment, restructuring charges and other related closure costs | (78)                              | (33)              |
| <b>Operating income (loss)</b>                                    | <b>(68)</b>                       | <b>80</b>         |
| Interest income (expense), net                                    | 7                                 | (4)               |
| <b>Income (loss) before income taxes and minority interests</b>   | <b>(61)</b>                       | <b>76</b>         |
| Income tax benefit  | 31                                | 1                 |
| <b>Income (loss) before minority interests</b>                    | <b>(30)</b>                       | <b>77</b>         |
| Minority interests  | (1)                               | 0                 |
| <b>Net income (loss)</b>  | <b>(31)</b>                       | <b>77</b>         |
| <b>Earnings (loss) per share (Basic)</b>                          | <b>(0.03)</b>                     | <b>0.09</b>       |
| <b>Earnings (loss) per share (Diluted)</b>                        | <b>(0.03)</b>                     | <b>0.08</b>       |

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

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**STMicroelectronics N.V.**  
**CONSOLIDATED BALANCE SHEETS**

| In millions of U.S. dollars                 | As at         |               |
|---|---------------|---------------|
|   | April 2,      | December 31,  |
|   | 2005          | 2004          |
|   | (unaudited)   | (audited)     |
| <b>Assets</b>                               |               |               |
| <b>Current assets :</b>                     |               |               |
| Cash and cash equivalents                   | 1,162         | 1,950         |
| Marketable securities                       | 525           | 0             |
| Trade accounts receivable, net              | 1,414         | 1,408         |
| Inventories, net                            | 1,369         | 1,344         |
| Deferred tax assets                         | 141           | 140           |
| Other receivables and assets                | 740           | 785           |
| <b>Total current assets</b>                 | <b>5,351</b>  | <b>5,627</b>  |
| Goodwill                                    | 228           | 264           |
| Other intangible assets, net                | 250           | 291           |
| Property, plant and equipment, net          | 7,039         | 7,442         |
| Long-term deferred tax assets               | 59            | 59            |
| Investments and other non-current assets    | 119           | 117           |
| <b>Total assets</b>                         | <b>13,046</b> | <b>13,800</b> |
| <b>Liabilities and shareholders' equity</b> |               |               |
| <b>Current liabilities:</b>                 |               |               |
| Bank overdrafts                             | 37            | 58            |
| Current portion of long-term debt           | 158           | 133           |
| Trade accounts payable                      | 1,027         | 1,352         |
| Other payables and accrued liabilities      | 852           | 776           |
| Deferred tax liabilities                    | 7             | 17            |
| Accrued income tax                          | 157           | 176           |
| <b>Total current liabilities</b>            | <b>2,238</b>  | <b>2,512</b>  |

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|  |               |               |
|--|---------------|---------------|
| Long-term debt   | 1,702         | 1,767         |
| Reserve for pension and termination indemnities  | 265           | 285           |
| Long-term deferred tax liabilities   | 50            | 63            |
| Other non-current liabilities  | 22            | 15            |
|  | <u>2,039</u>  | <u>2,130</u>  |
| <b>Total liabilities</b>   | <b>4,277</b>  | <b>4,642</b>  |
| Commitment and contingencies   |               |               |
| <b>Minority interests</b>  | <b>49</b>     | <b>48</b>     |
| Common stock (preferred stock: 540,000,000 shares authorized, not issued; common stock: Euro 1.04 nominal value, 1,200,000,000 shares authorized, 905,372,326 shares issued, 891,972,326 shares outstanding) | 1,150         | 1,150         |
| Capital surplus  | 1,925         | 1,924         |
| Accumulated result   | 5,237         | 5,268         |
| Accumulated other comprehensive income   | 756           | 1,116         |
| Treasury stock   | (348)         | (348)         |
|  | <u>8,720</u>  | <u>9,110</u>  |
| <b>Shareholders' equity</b>  | <b>8,720</b>  | <b>9,110</b>  |
| <b>Total liabilities and shareholders' equity</b>  | <b>13,046</b> | <b>13,800</b> |

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

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**STMicroelectronics N.V.**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

| In millions of U.S. dollars   | Three Months Ended<br>(unaudited) |                   |
|---|-----------------------------------|-------------------|
|   | April 2,<br>2005                  | March 27,<br>2004 |
| <b>Cash flows from operating activities:</b>  |                                   |                   |
| Net income (loss)   | (31)                              | 77                |
| Items to reconcile net income and cash flows from operating activities:                 |                                   |                   |
| Depreciation and amortization   | 506                               | 421               |
| Amortization of discount on convertible debt  | 1                                 | 11                |
| Other non-cash items  | 2                                 | (3)               |
| Minority interest in net income of subsidiaries   | 1                                 |                   |
| Deferred income tax   | (23)                              | (3)               |
| Impairment, restructuring charges and other related closure costs, net of cash payments | 60                                | 23                |
| Changes in assets and liabilities:  |                                   |                   |
| Trade receivables, net  | (24)                              | (125)             |
| Inventories, net  | (65)                              | 44                |
| Trade payables  | (57)                              | 169               |
| Other assets and liabilities, net   | (11)                              | (62)              |
| <b>Net cash from operating activities</b>   | <b>359</b>                        | <b>552</b>        |
| <b>Cash flows from investing activities:</b>  |                                   |                   |
| Payment for purchases of tangible assets  | (564)                             | (321)             |
| Payment for purchases of marketable securities  | (525)                             | (1,030)           |
| Investment in intangible and financial assets   | (11)                              | (13)              |
| Payment for acquisitions, net of cash received  |                                   | (3)               |
| <b>Net cash used in investing activities</b>  | <b>(1,100)</b>                    | <b>(1,367)</b>    |
| <b>Cash flows from financing activities:</b>  |                                   |                   |
| Repayment of long-term debt   | (20)                              | (50)              |
| Decrease in short-term facilities   | (19)                              | (41)              |
| Capital increase  | 1                                 | 14                |
| <b>Net cash used in financing activities</b>  | <b>(38)</b>                       | <b>(77)</b>       |
| Effect of changes in exchange rates   | (9)                               | (3)               |

|   |              |              |
|---|--------------|--------------|
| <b>Net cash decrease</b>                                    | <b>(788)</b> | <b>(895)</b> |
|   | <hr/>        | <hr/>        |
| <b>Cash and cash equivalents at beginning of the period</b> | <b>1,950</b> | <b>2,998</b> |
|   | <hr/>        | <hr/>        |
| <b>Cash and cash equivalents at end of the period</b>       | <b>1,162</b> | <b>2,103</b> |
|   | <hr/>        | <hr/>        |

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

[Back to Contents](#)**STMicroelectronics N.V.****CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

In millions of U.S. dollars, except per share amounts

|  | Common<br>Stock | Capital<br>Surplus | Treasury<br>Stock | Accumulated<br>Result | Accumulated<br>Other<br>Comprehensive<br>income (loss) | Shareholders'<br>Equity |
|--|-----------------|--------------------|-------------------|-----------------------|--|-------------------------|
| <b>Balance as of December 31, 2003 (audited)</b> | 1,146           | 1,905              | (348)             | 4,774                 | 623  | 8,100                   |
| Capital increase                                 | 4               | 19                 |                   |                       |  | 23                      |
| Comprehensive income:                            |                 |                    |                   |                       |  |                         |
| Net Income                                       |                 |                    |                   | 601                   |  | 601                     |
| Other comprehensive income, net of tax           |                 |                    |                   |                       | 493  | 493                     |
| Comprehensive income                             |                 |                    |                   |                       |  | 1,094                   |
| Dividends, \$0.12 per share                      |                 |                    |                   | (107)                 |  | (107)                   |
| <b>Balance as of December 31, 2004 (audited)</b> | 1,150           | 1,924              | (348)             | 5,268                 | 1,116  | 9,110                   |
| Capital increase                                 |                 | 1                  |                   |                       |  | 1                       |
| Comprehensive income (loss):                     |                 |                    |                   |                       |  |                         |
| Net loss   |                 |                    |                   | (31)                  |  | (31)                    |
| Other comprehensive loss, net of tax             |                 |                    |                   |                       | (360)  | (360)                   |
| Comprehensive income (loss)                      |                 |                    |                   |                       |  | (391)                   |
| <b>Balance as of April 2, 2005 (unaudited)</b>   | 1,150           | 1,925              | (348)             | 5,237                 | 756  | 8,720                   |

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

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**STMicroelectronics N.V.**

**Notes to Interim Consolidated Financial Statements (unaudited)**

**1. The Company**

STMicroelectronics N.V. (the Company) is registered in The Netherlands with its statutory domicile in Amsterdam. The Company was formed in 1987 with the original name of SGS-THOMSON Microelectronics by the combination of the semiconductor business of SGS Microelettronica (then owned by Società Finanziaria Telefonica (S.T.E.T.), an Italian corporation) and the non-military business of Thomson Semiconducteurs (then owned by Thomson-CSF, a French corporation) whereby each company contributed their respective semiconductor businesses in exchange for a 50% interest in the Company.

The Company is a global independent semiconductor company that designs, develops, manufactures and markets a broad range of semiconductor integrated circuits ( ICs ) and discrete devices. The Company offers a diversified product portfolio and develops products for a wide range of market applications, including automotive products, computer peripherals, telecommunications systems, consumer products, industrial automation and control systems. Within its diversified portfolio, the Company has focused on developing products that leverage its technological strengths in creating customized, system-level solutions with high-growth digital and mixed-signal content.

**2. Fiscal year**

The Company's fiscal year ends on December 31. Interim periods are established for accounting purposes on a thirteen-week basis. In 2005, the Company's first quarter ended on April 2, its second quarter will end on July 2, its third quarter on October 1 and its fourth quarter will end on December 31.

**3. Basis of Presentation**

The accompanying Unaudited Interim Consolidated Financial Statements of the Company have been prepared in conformity with accounting principles generally accepted in the United States of America ( U.S. GAAP ), consistent in all material respects with those applied for the year ended December 31, 2004. The interim financial information is unaudited but reflects all normal adjustments which are, in the opinion of management, necessary to provide a fair statement of results for the periods presented. The results of operations for the interim period are not necessarily indicative of the results to be expected for the entire year.

All balances and values in the current and prior periods are in millions of dollars, except share and per-share amounts.

The accompanying Unaudited Interim Consolidated Financial Statements do not include certain footnotes and financial presentation normally required on an annual basis under U.S. GAAP. Therefore, these interim financial statements should be read in conjunction with the Consolidated Financial Statements in the Company's Annual Report on Form 20-F for the year ended December 31, 2004.

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#### 4. Use of Estimates

The preparation of financial statements in accordance with U.S. GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of net revenue and expenses during the reporting period. The primary areas that require significant estimates and judgments by management include, but are not limited to, sales returns and allowances, allowances for doubtful accounts, inventory reserves and normal manufacturing capacity thresholds to determine costs capitalized in inventory, accruals for warranty costs, litigation and claims, valuation of acquired intangibles, goodwill, investments and tangible assets as well as the impairment of their related carrying values, restructuring charges, other non-recurring special charges, assumptions used in calculating pension obligations and pro forma share-based compensation, assessment of hedge effectiveness of derivative instruments, deferred income tax assets including required valuation allowances and liabilities as well as provisions for specifically identified income tax exposures. The Company bases the estimates and assumptions on historical experience and on various other factors such as market trends and business plans that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities. The actual results experienced by the Company could differ materially and adversely from management's estimates. To the extent there are material differences between the estimates and the actual results, future results of operations could be significantly affected.

#### 5. Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 151, *Inventory Costs, an amendment of ARB No. 43, Chapter 4* ( FAS 151 ). The Standard requires abnormal amounts of idle capacity and spoilage costs to be excluded from the cost of inventory and expensed when incurred. The provisions of FAS 151 are applicable prospectively to inventory costs incurred during fiscal years beginning after June 15, 2005. As costs associated with underutilization of manufacturing facilities have historically been charged directly to cost of sales, the Company believes that FAS 151 will have no material effect on its financial position or results of operations.

In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 153, *Exchanges of Nonmonetary Assets, an amendment of APB Opinion No. 29* ( FAS 153 ). This Statement amends Opinion 29 to eliminate the exception to the basis measurement principle (fair value) for nonmonetary exchanges of similar productive assets and replaces it with a general exception for exchanges of transactions that do not have commercial substance, that is, transactions that are not expected to result in significant changes in the cash flows of the reporting entity. The Statement is effective prospectively for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005, with early application permitted. The Company has not had any nonmonetary exchanges of assets since FAS 153 was published and believes that FAS 153 will have no material effect on its financial position or results of operations.



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In December 2004, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* ( FAS 123R ). This Statement revises FASB Statement No. 123, *Accounting for Stock-Based Compensation* and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. FAS 123R requires a public entity to measure the cost of share-based service awards based on the grant-date fair value of the award. That cost will be recognized over the period during which an employee is required to provide service in exchange for the award or the requisite service period, usually the vesting period. The grant-date fair value of employee share options and similar instruments will be estimated using option-pricing models adjusted for the unique characteristics of those instruments. FAS 123R also requires more extensive disclosures than the previous standards relating to the nature of share-based payment transactions, compensation cost and cash flow effects. On April 14, 2005, the U.S. Securities and Exchange Commission amended the effective date of FAS 123R; the Statement now applies to all awards granted and to all unvested awards modified, repurchased, or cancelled during the first annual reporting period beginning after June 15, 2005. FAS 123R provides a choice of transition methods including the modified prospective application method, which allows discretionary restatement of interim periods during the calendar year of adoption, or the modified retrospective application method, which allows the restatement of the prior years presented. Each method requires the cumulative effect of initially applying FAS 123R to be recognized in the period of adoption. The Company will adopt FAS 123R in the first quarter of 2006 using the modified prospective application method. As a significant number of option grants are above current market prices, the Company believes their existing equity-based compensation strategy is minimally effective in motivating and retaining key employees. Therefore, the Company is currently reviewing its share-based remunerations programs. In conjunction with this review, the Company intends to accelerate the vesting period of outstanding stock options, following authorization from the Company's shareholders at the annual general meeting held on March 18, 2005. In addition, the Company is evaluating to base its share-based remuneration programs on nonvested shares. The Company will disclose the cumulative impact on its consolidated accumulated result from adopting FAS 123R when such review is finalized. The impact on the Company's financial position and results of operations are further illustrated in the information presented in note 15 Fair value of stock-based compensation.

[Back to Contents](#)**6. Other Income and Expenses, Net**

Other income and expenses, net consisted of the following:

|                                    | (unaudited)        |                   |
|------------------------------------|--------------------|-------------------|
|                                    | Three months ended |                   |
|                                    | April 2,<br>2005   | March 27,<br>2004 |
| <b>In millions of U.S dollars</b>  |                    |                   |
| Research and development funding   | 14                 | 16                |
| Start-up costs                     | (22)               | (23)              |
| Exchange gain, net                 | 14                 | 1                 |
| Patent claim costs                 | (5)                | (6)               |
| Gain on sale of non-current assets |                    | 4                 |
| Other, net                         | (7)                | (4)               |
| <b>Total</b>                       | <b>(6)</b>         | <b>(12)</b>       |

Start-up costs represent costs incurred in the start-up and testing of the Company's new manufacturing facilities, before reaching the earlier of a minimum level of production or 6-months after the fabrication line's quality qualification. For the first quarter of 2005, start-up costs mainly related to the 200mm fab in Agrate (Italy) and the 150mm fab in Ang Mo Kio (Singapore). For the same period of 2004, start-up costs mainly related to the 300mm pilot line in Crolles (France), the launch of the 150mm fab in Ang Mo Kio (Singapore), the upgrading of the 200mm fab in Agrate (Italy) and the build-up of the 300mm fab in Catania (Italy).

Fundings received by the Company are mainly from governmental agencies and income is recorded as recognized when all contractually required conditions are fulfilled. The Company's primary sources for government funding are French, Italian and other European Union ( EU ) governmental entities. Such funding is generally provided to encourage research and development activities, industrialization and the economic development of underdeveloped regions. Certain specific contracts contain obligations to maintain a minimum level of employment and investment during a certain amount of time. There could be penalties if these objectives are not fulfilled. Other contracts contain penalties for late deliveries or for breach of contract, which may result in repayment obligations.

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Patent claim costs correspond to patent litigation costs, which include legal and attorney fees and payment of claims, and patent pre-litigation costs, which are composed of consultancy fees and legal fees. Patent litigation costs are costs incurred in respect of pending litigation. Patent pre-litigation costs are costs incurred to prepare for licensing discussions with third parties with a view to concluding an agreement. Litigation may occur if such discussions are unsuccessful. In the first quarter of 2005, patent litigation costs and patent pre-litigation costs amounted to \$3 million and \$2 million respectively. In the first quarter of 2004, patent litigation costs amounted to \$5 million and patent pre-litigation costs amounted to \$1 million.

Exchange gain, net includes the realized and unrealized exchange gains and losses related to transactions denominated in foreign currencies. It includes all transactions to cover exchange risk not designated as cash flow hedge.

## 7. Impairment, Restructuring Charges and Other Related Closure Costs

During the third quarter of 2003, the Company commenced a plan to restructure its 150mm fab operations and part of its back-end operations in order to improve cost competitiveness. The 150mm restructuring plan focuses on cost reduction by migrating a large part of European and U.S. 150mm production to Singapore and by upgrading production to a finer geometry 200mm wafer fabs. The plan includes the discontinuation of the production of Rennes (France), which was completed during 2004, the closure as soon as operationally feasible of the 150mm wafer pilot line in Castelletto (Italy) and the downsizing by approximately one-half of the 150mm wafer fab in Carrollton, Texas. Furthermore, the 150mm wafer fab production in Agrate (Italy) and Rousset (France) will be gradually phased-out in favor of 200mm wafer ramp-ups at existing facilities in these locations, which will be expanded or upgraded to accommodate additional finer geometry wafer capacity. Impairment, restructuring charges and other related closure costs incurred in the first quarter of 2005 and the same period of 2004 are summarized as follows:

| Three months ended<br>April 2, 2005 | Impairment  | Restructuring<br>charges | Other related<br>closure costs | Total impairment,<br>restructuring charges and<br>other related closure<br>costs |
|-------------------------------------|-------------|--------------------------|--------------------------------|--|
| 150mm fab operations                |             | (2)                      | (4)                            | (6)  |
| Back-end operations                 |             |                          |                                |  |
| Intangible assets and investments   | (63)        |                          |                                | (63)   |
| Other                               |             | (8)                      | (1)                            | (9)  |
| <b>Total</b>                        | <b>(63)</b> | <b>(10)</b>              | <b>(5)</b>                     | <b>(78)</b>  |

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| Three months ended<br>March 27, 2004 | Impairment | Restructuring<br>charges | Other related<br>closure costs | Total impairment,<br>restructuring charges and<br>other related closure<br>costs |
|--------------------------------------|------------|--------------------------|--------------------------------|--|
| 150mm fab operations                 |            | (25)                     | (6)                            | (31)   |
| Back-end operations                  |            |                          | (1)                            | (1)  |
| Intangible assets and investments    |            |                          |                                |  |
| Other                                |            | (1)                      |                                | (1)  |
| Total                                |            | (26)                     | (7)                            | (33)   |

#### Impairment charges

In January 2005, the Company decided to reduce its Access technology products for Customer Premises Equipment ( CPE ) modem products. This decision was intended to eliminate certain low volume, non-strategic product families whose returns in the current environment did not meet internal targets. The Company reports CPE business as part of the Access reporting unit. Following the decision to discontinue a portion of this reporting unit, the Company, in compliance with FAS 142 *Goodwill and Other Intangible Assets*, reassessed the allocation of goodwill to businesses composing the Access reporting unit according to the relative fair values as determined based on market comparables of these businesses in the total reporting unit. The reassessment gave an allocation of \$39 million of goodwill allocated to the CPE business unit in addition to \$22 million of intangible assets without alternative use following the discontinuation of CPE product lines, which resulted in a total impairment charge of \$61 million in the first quarter of 2005.

Moreover, impairment charges of \$2 million for technologies and other intangible assets were incurred pursuant to the decision of the Company to close a research and development design center in Karlsruhe (Germany) and the discontinuation of a development project in Singapore.

No impairment charge was recorded during the same period of 2004.

#### Restructuring charges and other related closure costs

Provisions for restructuring charges and other related closure costs as at April 2, 2005 are summarized as follows:

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|  | 150mm fab<br>operations |                                | Back-end<br>operations | Other    | Total<br>restructuring<br>&<br>other related<br>closure costs |
|--|-------------------------|--------------------------------|------------------------|----------|---|
|  | Restructuring           | Other related<br>closure costs | Total                  |          |   |
| <b>Provision as at December 31, 2004</b> | <b>36</b>               | <b>1</b>                       | <b>37</b>              | <b>3</b> | <b>40</b>   |
| Charges incurred in 2005                 | 2                       | 4                              | 6                      | 9        | 15  |
| Amounts paid                             | (10)                    | (5)                            | (15)                   | (3)      | (18)  |
| Currency translation effect              | (2)                     |                                | (2)                    |          | (2)   |
| <b>Provision as at April 2, 2005</b>     | <b>26</b>               | <b>0</b>                       | <b>26</b>              | <b>9</b> | <b>35</b>   |

150mm fab operations:

Restructuring charges incurred in the first quarter of 2005 primarily related to \$2 million in termination benefits for the sites of Agrate (Italy) and Rousset (France) and \$4 million of other charges associated with the closure and transfers of production for the site in Rennes (France) for \$3 million and Carrollton (USA) for \$1 million.

During the first quarter of 2004, the Company recorded restructuring charges of \$31 million for its 150mm fab operations, relating mainly to the discontinuation of Rennes, for which the exit plan was communicated to employees in March 2004. At communication date, the Company recorded \$25 million corresponding to involuntary termination benefits and certain period charges related to the transfer of employees to other sites of the Company during the first quarter of 2004. In addition, the Company registered \$6 million of other related closure costs, mainly related to the closure of Rennes and other similar costs in the United States and Europe.

Back-end operations:

During the first quarter of 2005, minor charges for transfer costs and involuntary termination payments were incurred in back-end sites in Singapore and Morocco. During the same period of 2004, transfer costs amounting to \$1 million were registered in Morocco.

Other:

Pursuant to the decision of reducing its Access technology products for Customer Premises Equipment ( CPE ) modem products, the Company committed to an exit plan in Zaventem (Belgium) and accrued for \$5 million of obligatory workforce termination benefits in the first quarter of 2005.

Moreover, in order to optimize its research and development sites, the Company decided to cease its activities in two locations, Karlsruhe (Germany) and Malvern (USA). The Company incurred in the first quarter of 2005 \$3 million restructuring charges corresponding to unused lease and employee involuntary termination costs relating to the closure of these two sites.

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In the first quarter of 2005 and 2004, charges totaling \$1 million were paid by the Company for voluntary termination benefits in France.

In the first quarter of 2005, total cash outlays amounted to \$18 million.

Of the total plan of impairment and restructuring costs for the front-end and back-end reorganization, \$288 million has been incurred as of April 2, 2005 (\$7 million in 2005, \$76 million in 2004 and \$205 million in 2003), out of the total expected approximate \$350 million pre-tax charges. The restructuring plan and related manufacturing initiatives are expected to be largely completed by mid-2006. In addition to this plan, the reorganization and restructuring actions taken in the first quarter of 2005 generated impairment and restructuring charges that amounted to \$71 million. The total actual costs that the Company will incur may differ from these estimates based on the timing required to complete the restructuring plan, the number of people involved, the final agreed termination benefits and the costs associated with the transfer of equipment, products and processes.

### 8. Interest income (expense), net

Interest income (expense), net consisted of the following:

|                            | (unaudited)        |                   |
|----------------------------|--------------------|-------------------|
|                            | Three months ended |                   |
| In millions of U.S dollars | April 2,<br>2005   | March 27,<br>2004 |
| Income                     | 12                 | 11                |
| Expense                    | (5)                | (15)              |
| <b>Total</b>               | <b>7</b>           | <b>(4)</b>        |

Interest expense also included charges related to the amortization of issuance costs incurred by the Company for the outstanding convertible bonds.

### 9. Marketable securities

In the first quarter of 2005, the Company invested \$525 million of existing cash in credit-linked deposits issued by several primary banks in order to maximize the return on available cash. These credit-linked deposits are reinvested by the banks in underlying debt instruments (reference debt) that have been issued by different banks with a minimum rating of A- and include a derivative instrument related to the underlying credit default swap of the credit-linked deposits. The Company has determined that this derivative element does not have a material impact on the interim consolidated financial statements as of April 2, 2005. Interest on these instruments is paid quarterly and the interest rate is fixed every three months based on the LIBOR rate of the U.S. dollar plus a spread. Interest is payable through the final maturity of these instruments scheduled to occur before the 2005 year-end, unless suspended by credit default of the reference debt. Additionally, the carrying value of the instruments depends on the non-default of the reference debt. The principal will be repaid at final maturity unless a default occurs, in which case repayment of principal would be reduced based on the decline in value of the defaulted debt.

[Back to Contents](#)**10. Inventories, net**

Inventories are stated at the lower of cost or net realizable value. Cost is computed by adjusting standard cost to approximate actual manufacturing costs on a quarterly basis; the cost is therefore dependent on the Company manufacturing performance. In the case of underutilization of its manufacturing facilities, the costs associated with the excess capacity are not included in the valuation of inventories but charged directly to cost of sales.

Provisions for obsolescence are estimated for uncommitted inventories based on the previous quarter sales, orders backlog and production plans.

Inventories, net of reserve consisted of the following:

| In millions of U.S. dollars | (Unaudited)         | (Audited)               |
|-----------------------------|---------------------|-------------------------|
|                             | As at April 2, 2005 | As at December 31, 2004 |
| Raw materials               | 70                  | 70                      |
| Work-in-process             | 896                 | 874                     |
| Finished products           | 403                 | 400                     |
| <b>Total</b>                | <b>1,369</b>        | <b>1,344</b>            |

**11. Investments and other non-current assets**

Investments and other non-current assets consisted of the following:

| In millions of U.S. dollars                           | (Unaudited)         | (Audited)               |
|---|---------------------|-------------------------|
|   | As at April 2, 2005 | As at December 31, 2004 |
| Equity-method investments                             | 6                   | 6                       |
| Cost Investments                                      | 35                  | 34                      |
| Deposits and long-term receivables related to funding | 72                  | 69                      |
| Debt issuance costs, net                              | 6                   | 8                       |
| <b>Total</b>  | <b>119</b>          | <b>117</b>              |

*SuperH Joint Venture*

In 2001, the Company and Renesas Technology Corp. (previously known as Hitachi, Ltd.) formed a joint venture to develop and license RISC microprocessors. The joint venture, SuperH Inc., was initially capitalized with the Company's contribution of \$15 million of cash plus internally developed technologies with an agreed intrinsic value of \$14 million for a 44% interest. Renesas Technology Corp. contributed \$37 million of cash for a 56% interest. The Company accounts for its share in the SuperH, Inc. joint venture under the equity method based on the actual results of the joint venture. During 2002 and 2003, the Company made additional capital contributions on which accumulated losses have exceeded the Company's total investment, which is shown at a zero carrying value at April 2, 2005.





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In 2004, the shareholders agreed to restructure the joint venture by transferring the intellectual properties to each shareholder and continuing any further development individually. In March 2005, the Board of Directors decided to close the joint venture. The Company estimates that no future losses will result from this liquidation in excess of the existing provisions.

*UPEK Inc.*

In the first quarter of 2004, the Company and Sofinnova Capital IV FCPR formed a new company, UPEK Inc., as a venture capitalist-funded spin-off of the Company's TouchChip business. UPEK, Inc. was initially capitalized with the Company's transfer of the business, personnel and technology assets related to the fingerprint biometrics business, formerly known as the TouchChip Business Unit, for a 48% interest. Sofinnova Capital IV FCPR contributed \$11 million of cash for a 52% interest. The shareholder agreement requires Sofinnova Capital IV FCPR to additionally contribute \$9 million within approximately 12 months from the first quarter of 2004. During the first quarter of 2005, such contribution was made by Sofinnova Capital IV FCPR, reducing the Company's ownership to 33%.

The Company is accounting for its share in UPEK, Inc. under the equity method.

*DNP Photomask Europe S.p.A.*

The Company entered into a joint venture agreement in 2002 with Dai Nippon Printing Co, Ltd for the development and production of photomask in which the Company holds a 19% interest. The joint venture, DNP Photomask Europe S.p.A, was initially capitalized with the Company's contribution of €2 million of cash. Dai Nippon Printing Co, Ltd contributed €8 million of cash for an 81% interest. In the event of the liquidation of the joint venture, the Company is required to repurchase the land at cost, and the facility at 10% of its net book value, if no suitable buyer is identified. No provision for this obligation has been registered so far. At April 2, 2005, the Company's total contribution to the joint venture is \$10 million. The Company continues to maintain its 19% ownership of the joint venture, and accounts for this investment under the cost method.

The Company has identified the joint venture relationship as a Variable Interest Entity (VIE), but has determined that it is not the primary beneficiary of the VIE. The Company estimates that no future loss exposure will result from the joint venture.

[Back to Contents](#)**12. Long-term Debt**

Long-term debt consisted of the following:

| In millions of U.S dollars  | <u>(Unaudited)</u>             | <u>(Audited)</u>                   |
|---|--------------------------------|------------------------------------|
|   | <u>As at April 2,<br/>2005</u> | <u>As at December 31,<br/>2004</u> |
| <b>Bank loans:</b>  |                                |                                    |
| 2.52% (weighted average) due 2007, fixed interest rate                    | 151                            | 153                                |
| 2.46% (weighted average) due 2006, floating interest rate at Libor + 0.30 | 81                             | 105                                |
| 3.80% (weighted average) due 2007, floating interest rate                 | 42                             | 44                                 |
| <b>Funding program loans:</b>   |                                |                                    |
| 1.09% (weighted average), due 2009, fixed interest rate                   | 97                             | 102                                |
| 0.83% (weighted average), due 2017, fixed interest rate                   | 52                             | 55                                 |
| 3.43% (weighted average), due 2012, fixed interest rate                   | 14                             | 14                                 |
| 5.35% (weighted average), due 2006, fixed interest rate                   | 12                             | 13                                 |
| <b>Capital leases:</b>  |                                |                                    |
| 4.79% due 2011, fixed interest rate                                       | 32                             | 35                                 |
| <b>Convertible debt:</b>  |                                |                                    |
| -0.50% convertible bonds due 2013   | 1,379                          | 1,379                              |
| <b>Total long-term debt</b>   | <b>1,860</b>                   | <b>1,900</b>                       |
| Less current portion  | 158                            | 133                                |
| <b>Total long-term debt, less current portion</b>                         | <b>1,702</b>                   | <b>1,767</b>                       |

**13. Earnings (Loss) per Share**

Basic net earnings (loss) per share is computed based on net income (loss) available to common shareholders using the weighted-average number of common shares outstanding during the reported period; the number of outstanding shares does not include treasury shares. Diluted earnings (loss) per share is computed using the weighted-average number of common shares and dilutive potential common shares outstanding during the period, such as stock issuable pursuant to the exercise of stock options outstanding and the conversion of convertible debt.

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(In millions of U.S. dollars, except per share amounts):

|  | (unaudited)        |                   |
|--|--------------------|-------------------|
|  | Three Months Ended |                   |
|  | April 2,<br>2005   | March 27,<br>2004 |
| <b>Basic Earnings (Loss) per Share:</b>                        |                    |                   |
| Net income (loss)  | (31)               | 77                |
| Weighted average shares outstanding                            | 891,928,298        | 890,211,387       |
| <b>Earnings (Loss) per Share (basic)</b>                       | <b>(0.03)</b>      | <b>0.09</b>       |
| <br>   |                    |                   |
| Diluted Earnings (Loss) per Share:                             |                    |                   |
| Net income (loss)  | (31)               | 77                |
| Interest expense on convertible debt, net of tax               |                    | 1                 |
| Net income (loss), adjusted                                    | (31)               | 78                |
| <br>   |                    |                   |
| Weighted average shares outstanding                            | 891,928,298        | 890,211,387       |
| Dilutive effect of stock options                               |                    | 6,563,534         |
| Dilutive effect of convertible debt                            |                    | 41,880,160        |
| Number of shares used in calculating Earnings (Loss) per Share | 891,928,298        | 938,655,081       |
| <br>   |                    |                   |
| <b>Earnings (Loss) per Share (diluted)</b>                     | <b>(0.03)</b>      | <b>0.08</b>       |

As of April 2, 2005, common shares issued were 905,372,326 shares of which 13,400,000 shares were owned by the Company as treasury stock.

As of April 2, 2005, there were outstanding stock options exercisable into the equivalent of 64,965,725 common shares and convertible debt exercisable into the equivalent of 41,880,114 common shares.

#### 14. Retirement plans

The Company and its subsidiaries have a number of defined benefit pension plans covering employees in various countries. The plans provide for pension benefits, the amounts of which are calculated based on factors such as years of service and employee compensation levels. Eligibility is generally determined in accordance with local statutory requirements.

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The components of the net periodic benefit cost include the following:

| In millions of US dollars           | (unaudited)<br>Three Months Ended |                   |
|-------------------------------------|-----------------------------------|-------------------|
|                                     | April 2, 2005                     | March<br>27, 2004 |
| Service cost                        | 1                                 | 4                 |
| Interest cost                       | 4                                 | 3                 |
| Expected return on plan assets      | (3)                               | (2)               |
| Amortization of net (gain) and loss | 1                                 | 1                 |
| <b>Net periodic benefit cost</b>    | <b>3</b>                          | <b>6</b>          |

Employer contributions expected to be paid in 2005 are consistent with the amounts disclosed in the consolidated financial statements for the year ended December 31, 2004.

#### 15. Fair value of stock-based compensation

At April 2, 2005, the Company has five stock-based employee and Supervisory Board compensation plans as well as an employee share purchase plan which are described in detail in Note 17 of the consolidated financial statements located at Item 18 of the Form 20-F. The Company applies the intrinsic-value-based method prescribed by Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* (APB 25), and related Interpretations, in accounting for stock-based awards to employees. No stock-based employee compensation cost is reflected in net income, as all options under those plans were granted at an exercise price equal to the market value of the underlying common stock on the date of grant. Pro forma information regarding net income and earnings per share is required by Statement of Financial Accounting Standards Board No. 123 *Accounting for Stock-Based Compensation* (FAS 123) as if the Company had accounted for its stock-based awards to employees under the fair value method prescribed by FAS 123, which results in a charge for total stock-based employee expense, net of related tax effects.

The fair value of the Company's stock-based awards to employees was estimated using a Black-Scholes option-pricing model. Forfeitures of options are reflected in the pro forma charge as they occur. For those stock option plans with graded vesting periods, the Company has determined the historical exercise activity for such plans actually reflects that employees exercise the option after the close of the graded vesting period. Therefore, the Company recognizes the estimated pro forma charge for plans with graded vesting periods on a straight-line basis.

The fair value was estimated using the following weighted-average assumptions:

|                         | Three months<br>ended April 2,<br>2005 | Three months<br>ended March 27,<br>2004 |
|-------------------------|--|---|
| Expected life (years)   | 6                                      | 6                                       |
| Volatility              | 52.9%                                  | 57.5%                                   |
| Risk-free interest rate | 3.84%                                  | 3.4%                                    |
| Dividend yield          | 0.69%                                  | 0.45%                                   |



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The weighted average fair value of options granted in the first quarter of 2005 and the same period of 2004 was \$8.60 and \$14.72, respectively.

The following table illustrates the effect on net income (loss) and earnings (loss) per share if the Company had applied the fair value recognition provisions of FAS 123 to employee stock-based compensation, which consists of applying the amortization of the fair-value of stock-based compensation over the vesting period.

|   | (unaudited)   |  |
|---|---|--|
|   | <b>Three<br/>months<br/>ended<br/>April 2, 2005</b> | Three months<br>ended<br>March 27,<br>2004 |
|   | <u>                    </u>                         | <u>                    </u>                |
| Net income (loss), as reported  | (31)  | 77   |
| Deduct:   | (36)  | (41)                                       |
| Total stock-based employee compensation expense<br>determined under FAS 123, net of related tax effects |   |  |
| Net income (loss), pro forma  | <u>(67)</u>   | <u>36</u>                                  |
| Earnings (loss) per share:  |   |  |
| Basic, as reported  | (0.03)  | 0.09                                       |
| Basic, pro forma  | (0.07)  | 0.04                                       |
| Diluted, as reported  | (0.03)  | 0.08                                       |
| Diluted, pro forma  | <u>(0.07)</u>                                       | <u>0.04</u>                                |

In connection with an overall change of the Company's stock-based compensation policy, the Company intends to accelerate the vesting period of the outstanding unvested stock options.

## 16. Dividends

At the Annual General Meeting of Shareholders on March 18, 2005, shareholders approved the distribution of \$0.12 per share in cash dividends. The dividend amount of approximately \$107 million will be paid in the second quarter of 2005.

At the Annual General Meeting of Shareholders on April 23, 2004, shareholders approved the distribution of \$0.12 per share in cash dividends. The dividend amount of \$107 million was paid in the second quarter of 2004.

## 17. Treasury Stock

In 2002, the Company repurchased 13,400,000 own shares, for a total amount of \$348 million, which were reflected at cost as a reduction of the shareholders' equity. The repurchased shares have been designated to be used for the Company's employee stock option plan.

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As of April 2, 2005, none of the common shares repurchased had been transferred to employees under the employee stock option plan.

### **18. Contingencies**

The Company is subject to the possibility of loss contingencies arising in the ordinary course of business. These include but are not limited to: warranty cost on the products of the Company not covered by insurance, breach of contract claims, claims for unauthorized use of third party intellectual property, tax claims and provisions for specifically identified income tax exposures as well as claims for environmental damages. In determining loss contingencies, the Company considers the likelihood of a loss of an asset or the incurrence of a liability as well as the ability to reasonably estimate the amount of such loss or liability. An estimated loss is recorded when it is probable that a liability has been incurred and when the amount of the loss can be reasonably estimated. The Company regularly reevaluates claims to determine whether provisions need to be readjusted based on the most current information available to the Company. Adverse changes in evaluations which result in adverse determinations with respect to the interests of the Company could have a material negative effect on the Company's results of operations, cash flows or its financial position for the period in which they occur.

### **19. Claims and Legal proceedings**

The Company has received and may in the future receive communications alleging possible infringements, in particular in the case of patents and similar intellectual property rights of others. Furthermore, the Company may become involved in costly litigation brought against the Company regarding patents, mask works, copyrights, trademarks or trade secrets. In the event that the outcome of any litigation would be unfavorable to the Company, the Company may be required to license the underlying intellectual property right at economically unfavorable terms and conditions, and possibly pay damages for prior use and/or face an injunction, all of which individually or in the aggregate could have a material adverse effect on the Company's results of operations, cash flows or financial position and ability to compete.

The Company is involved in various lawsuits, claims, investigations and proceedings incidental to the normal conduct of its operations, other than external patent utilization. These matters mainly include the risks associated with claims from customers or other parties and tax disputes. The Company has accrued for these loss contingencies when the loss is probable and can be estimated. The Company regularly evaluates claims and legal proceedings together with their related probable losses to determine whether they need to be adjusted based on the current information available to the Company. Legal costs associated with claims are expensed as incurred. In the event of litigation which is adversely determined with respect to the Company's interests, or in the event the Company needs to change its evaluation of a potential third-party claim, based on new evidence or communications, a material adverse effect could impact its operations or financial condition at the time it were to materialize.

During 2004, the Company has settled certain disputes with respect to claims and litigation relating to possible infringements of patents and similar intellectual property rights of others. An accrual of \$10 million had been established at December 31, 2003 for such claims, which was paid in the first quarter of 2005 in accordance with the final settlements. No additional accrual has been recorded in 2005 since no other risks were estimated to result in a probable loss.

The Company is currently a party to legal proceedings with SanDisk Corporation ("SanDisk"). Based on management's current assumptions made with support of the company's outside attorneys, the Company does not believe that the SanDisk litigation will result in a probable loss.

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**SIGNATURES**

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

**STMicroelectronics N.V.**

Date: May 4, 2005

By: /s/ Carlo Bozotti

Name: **Carlo Bozotti**  
Title: **President and Chief Executive Officer and Sole Member of our Managing Board**

Enclosure: STMicroelectronics N.V. s First Quarter 2005:

Operating and Financial Review and Prospects;  
Unaudited Interim Consolidated Statements of Income, Balance Sheets, Statements of Cash Flow, and Statements of Changes in Shareholders' Equity and related Notes for the three months ended April 2, 2005; and  
Certifications pursuant to Sections 302 (Exhibits 12.1 and 12.2) and 906 (Exhibit 13.1) of the Sarbanes-Oxley Act of 2002, submitted to the Commission on a voluntary basis.

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