TERAYON COMMUNICATION SYSTEMS
Form 10-Q
August 09, 2005

Table of Contents

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q
þ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED June 30, 2005
OR
o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM _________TO _________.
Commission File Number: 000-24647
TERAYON COMMUNICATION SYSTEMS, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	77-0328533
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(IRS EMPLOYER IDENTIFICATION NO.)

4988 GREAT AMERICA PARKWAY
SANTA CLARA, CALIFORNIA 95054
(408) 235-5500
(ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF THE REGISTRANT S PRINCIPAL EXECUTIVE OFFICES)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes þ No o
Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes þ No o
APPLICABLE ONLY TO CORPORATE ISSUERS:
As of July 29, 2005 registrant had outstanding 77,273,819 shares of Common Stock.

INDEX
TERAYON COMMUNICATION SYSTEMS, INC.

Page No.

PART I FINANCIAL INFORMATION

PART II OTHER INFORMATION

Table of Contents

SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 which are subject to the safe harbor created by those sections. These forward-looking statements include, but are not limited to: statements related to industry trends and future growth in the markets for cable modem systems; our strategies for reducing the cost of our products; our product development efforts; our future research and development; the timing of our introduction of new products; the timing and extent of deployment of our products by our customers; the future sales of our products; and our future revenues and profitability. We usually use words such as may, will, should, expect, plan, anticipate, estimate, predict, future, intend, or certain or the negative of these terms or similar expressions to identify forward-looking statements. Discussions containing such forward-looking statements may be found throughout the document. These forward-looking statements involve certain risks and uncertainties that could cause actual results to differ materially from those in such forward-looking statements. We disclaim any obligation to update these forward-looking statements as a result of subsequent events. The business risks discussed in Part 1, Item 2 of this Report on Form 10-Q, among other things, should be considered in evaluating our prospects and future financial performance.

Table of Contents

PART I. FINANCIAL INFORMATION
ITEM 1. FINANCIAL STATEMENTS

TERAYON COMMUNICATION SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	June 30, 2005 (unaudited)	December 31, 2004
ASSETS		
Current assets:		
Cash and cash equivalents	$ 38,605	$ 43,218
Short-term investments	66,383	54,517
Accounts receivable, net	17,645	16,554
Accounts receivable from related parties	2,312	3,106
Other current receivables	1,758	1,044
Inventory	12,759	17,144
Other current assets	2,100	2,042
Total current assets	141,562	137,625
Property and equipment, net	4,538	5,760
Restricted cash	8,763	8,827
Other assets	633	1,522
Total assets	$ 155,496	$ 153,734
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 4,572	$ 7,845
Accrued payroll and related expenses	3,147	3,936
Deferred revenues	5,427	2,579
Deferred gain on sale of semiconductor assets	8,578	
Accrued warranty expenses	2,722	3,870
Current portion of accrued restructuring and executive severance	1,991	3,902
Accrued vendor cancellation charges	374	521
Accrued other liabilities	3,609	4,562
Interest payable	1,356	1,356
Total current liabilities	31,776	28,571
Other long-term obligations	1,720	2,077
Long term portion of accrued restructuring and executive severance	1,721	1,664
Convertible subordinated notes	65,081	65,081
Commitments and contingencies		
Stockholders equity:		
Common stock	77	76

Additional paid in capital	1,085,820	1,083,711
Accumulated deficit	(1,027,203)	(1,024,091)
Treasury stock, at cost	(773)	(773)
Accumulated other comprehensive loss	(2,723)	(2,582)
Total stockholders equity	55,198	56,341
Total liabilities and stockholders equity	$ 155,496	$ 153,734

See accompanying notes.

3

Table of Contents

TERAYON COMMUNICATION SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three months ended June 30,		Six months ended June 30,	
	2005	**2004**	**2005**	**2004**
Revenues	$24,692	$40,138	$42,228	$ 80,560
Related party revenues	4,841	2,644	13,668	3,389
Total revenues	29,533	42,782	55,896	83,949
Cost of revenues	14,024	27,046	25,379	55,605
Cost of related party revenues	2,677	614	4,364	825
Total cost of revenues	16,701	27,660	29,743	56,430
Gross profit	12,832	15,122	26,153	27,519
Operating expenses:				
Research and development	4,427	8,516	10,371	17,984
Sales and marketing	5,611	5,411	11,285	12,632
General and administrative	2,878	2,953	5,673	5,388
Restructuring charges, executive severance and asset write-offs	282	3,579	1,564	6,946
Total operating expenses	13,198	20,459	28,893	42,950
Loss from operations	(366)	(5,337)	(2,740)	(15,431)
Interest income	672	460	1,240	912
Interest expense	(814)	(826)	(1,627)	(1,643)
Other income (expense), net	(50)	921	15	1,200
Loss before income tax benefit (provision)	558	(4,782)	(3,112)	(14,962)
Income tax benefit (provision)	50	(79)		(146)
Net loss	$ (508)	$ (4,861)	$ (3,112)	$(15,108)
Net loss per share, basic and diluted	$ (0.01)	$ (0.06)	$ (0.04)	$ (0.20)
Shares used in per share calculation, basic and diluted	77,057	75,551	76,898	75,534

See accompanying notes.

Table of Contents

TERAYON COMMUNICATION SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(in thousands)
(unaudited)

	Six Months Ended June 30, 2005	Six Months Ended June 30, 2004
Operating activities:		
Net loss	$ (3,112)	$ (15,108)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	1,708	3,319
Reduction of accounts receivable allowance	(675)	
Amortization of deferred compensation		17
Inventory reserves	858	969
Impairment and write-off of fixed assets	330	130
Net changes in operating assets and liabilities:		
Accounts receivable	(416)	2,420
Accounts receivable from related parties	794	(505)
Inventory	3,527	(6,008)
Other assets	181	2,813
Accounts payable	(3,273)	(9,569)
Accrued payroll and related expenses	(789)	(1,618)
Deferred revenues	2,848	1,668
Accrued warranty expenses	(1,148)	(1,318)
Accrued restructuring and executive severance	(1,853)	4,570
Accrued vendor cancellation charges	(147)	(2,156)
Other accrued liabilities	(1,311)	(806)
Net cash used in operating activities	(2,478)	(21,182)
Investing activities:		
Purchases of short-term investments	(48,938)	(78,000)
Proceeds from sales and maturities of short-term investments	36,941	117,429
Proceeds from sale of semiconductor assets, net	8,578	
Purchases of property and equipment	(816)	(1,623)
Net cash provided by (used in) investing activities	(4,235)	37,806
Financing activities:		
Principal payments on capital leases		(178)
Proceeds from issuance of common stock	2,109	781
Net cash provided by financing activities	2,109	603
Effect of foreign currency exchange rate changes	(9)	368

Net increase (decrease) in cash and cash equivalents	(4,613)	17,595
Cash and cash equivalents at beginning of period	43,218	30,188
Cash and cash equivalents at end of period	$ 38,605	$ 47,783

See accompanying notes.

Table of Contents

TERAYON COMMUNICATION SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited)

1. Organization

Description of Business

Terayon Communication Systems, Inc. (Company) was incorporated under the laws of the State of California on January 20, 1993. In June 1998, the Company reincorporated in the State of Delaware.

The Company develops, markets and sells equipment to broadband service providers who use the Company s products to deliver broadband voice, digital video solutions (DVS) and data services to residential and business subscribers.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the condensed consolidated financial statements at June 30, 2005 and for the three and six months ended June 30, 2005 and 2004 have been included.

Results for the three and six months ended June 30, 2005 are not necessarily indicative of results for the entire fiscal year or future periods. These financial statements should be read in conjunction with the consolidated financial statements and the accompanying notes included in the Company s Form 10-K dated March 15, 2005, as filed with the U.S. Securities and Exchange Commission. The accompanying condensed consolidated balance sheet at December 31, 2004 is derived from audited consolidated financial statements at that date.

Reclassifications

Certain amounts such as cost of related party revenues in the 2004 financial statements have been reclassified to conform to the 2005 presentation.

Basis of Consolidation

The condensed consolidated financial statements include the accounts of the Company and its wholly owned subsidiaries. All intercompany balances and transactions have been eliminated.

Use of Estimates

The preparation of the condensed consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. Estimates are based on historical experience, input from sources outside of the Company, and other relevant facts and circumstances. Areas that are particularly significant include the Company s valuation of its accounts receivable and inventory, the assessment of recoverability and the measurement of impairment of fixed assets, and the recognition of restructuring liabilities.

Net Loss Per Share

The numerator and denominator of basic and diluted net loss per share is provided as follows (in thousands, except per share amounts):

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
Net loss	$ (508)	$ (4,861)	$ (3,112)	$(15,108)
Shares used in computing basic and diluted net loss per share	77,057	75,551	76,898	75,534

Basic and diluted net loss per share	$ (0.01)	$ (0.06)	$ (0.04)	$ (0.20)

Options to purchase 13,844,360 and 15,836,009 shares of common stock were outstanding at June 30, 2005 and June 30, 2004, respectively, but were not included in the computation of diluted net loss per share since the effect would have been anti-dilutive.

Table of Contents

Stock-based Compensation

The Company accounts for stock-based compensation for its employees using the intrinsic value method presented in Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, (APB 25), and includes the disclosure-only provisions as required under Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation (SFAS 123). The Company provides additional pro forma disclosures as required under SFAS 123 and SFAS 148, Accounting for Stock-Based Compensation, Transition and Disclosure .

For purposes of pro forma disclosures, the estimated fair value of the options granted and employee stock purchase plan shares to be issued is amortized to expense over their respective vesting periods. Had compensation cost for the Company s stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS 123, the Company s net loss and net loss per share would have been increased to the pro forma amounts indicated below (in thousands, except per share data):

		Three months ended June 30,		Six months ended June 30,	
		2005	2004	2005	2004
Net loss, as reported		$ (508)	$ (4,861)	$ (3,112)	$ (15,108)
Add:	Stock-based compensation under APB 25		17		17
Deduct:	Stock option compensation expense determined under fair value-based method	(1,051)	(3,703)	(2,367)	(8,213)
	Employee stock purchase plan compensation expense determined under fair value-based method		(357)		(713)
Pro forma net loss		$ (1,559)	$ (8,904)	$ (5,479)	$ (24,017)
Net loss per share, basic and diluted, as reported		$ (0.01)	$ (0.06)	$ (0.04)	$ (0.20)
Pro forma net loss per share, basic and diluted		$ (0.02)	$ (0.12)	$ (0.07)	$ (0.32)
Shares used in computing net loss per share , as reported, and pro forma net loss per share, as reported, basic and diluted		77,057	75,551	76,898	75,534

Inventory

Inventory is stated at the lower of cost (first-in, first-out) or market. The components of inventory are as follows (in thousands):

	June 30, 2005	December 31, 2004
Raw materials	$ 473	$ 1,880
Work-in-process	23	1,501
Finished goods	12,263	13,763
Inventory	$ 12,759	$ 17,144

Purchase Obligations

The Company has purchase obligations to certain of its suppliers that support the Company s ability to manufacture its products. The obligations consist of purchase orders placed with vendors for goods and services and require the Company to purchase minimum quantities of the suppliers products at a specified price. As of June 30, 2005, $21.8 million of purchase obligations were outstanding. The Company accrued for vendor cancellation charges in an amount, which represented management s estimate of the Company s exposure to vendors for its inventory commitments that will not be consumed in the ordinary course of business. At June 30, 2005, accrued vendor cancellation charges were $0.4 million and the remaining $21.4 million was attributable to open purchase orders that are expected to be utilized in the normal course of business. The remaining obligations are expected to become payable at various times throughout 2005.

Changes in Accounting Estimates

For the three and six months ended June 30, 2005, the Company s gross margins were benefited by the reversal of approximately $0.2 million and $0.4 million, respectively of accrued vendor cancellation charges, which were previously recorded as cost of goods sold. Additionally, for the three and six months ended June 30, 2004, the Company reversed approximately $0.8 million and $2.1 million, respectively, of accrued vendor cancellation charges, which were previously recorded as cost of goods sold. The Company reversed these charges as it was able to negotiate downward certain vendor cancellation to more favorable terms. During the three and six months ended June 30, 2005, the Company s gross margins were benefited by the sale of previously reserved inventory of approximately $1.9 million and $2.6 million, respectively, of inventory provisions, which were previously recorded as cost of goods sold. Additionally, during the three and six months ended June 30, 2004, the Company reversed approximately $0.3 million and $0.8 million, respectively, of inventory provisions, which were previously recorded as cost of goods sold. The Company reversed these provisions as it was able to sell inventory originally considered to be excess or obsolete.

In the first quarter of 2005, the Company reversed approximately $0.6 million of accounts receivable allowances as the Company was able to collect accounts which had previously been specifically reserved.

Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss presented in the accompanying condensed consolidated balance sheets consists of net unrealized gains or losses on short-term investments and accumulated net foreign currency translation gains or losses.

The following are the components of comprehensive loss (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2005	2004	2005	2004
Net loss	$(508)	$(4,861)	$(3,112)	$(15,108)
Cumulative translation adjustments	22	444	(9)	368
Change in unrealized gain (loss) on available-for-sale investments	174	(537)	(131)	(534)
Total comprehensive loss	$(312)	$(4,954)	$(3,252)	$(15,274)

Table of Contents

Impact of Recently Issued Accounting Standards

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123 (revised 2004), (SFAS 123(R)), Share-Based Payment, which replaces SFAS 123, Accounting for Stock-Based Compensation, and supersedes APB 25, Accounting for Stock Issued to Employees. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. SFAS 123(R) eliminates the alternative to use APB 25 s intrinsic value method of accounting that was provided in SFAS 123 as originally issued. The Company s effective date for implementation of SFAS 123(R) is January 1, 2006. The Company has not yet determined which phase-in method it will adopt. In the first quarter of 2005, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107, which provided further clarification on the implementation of SFAS 123(R).

As permitted by SFAS 123, the Company currently accounts for share-based payments to employees using APB 25 s intrinsic value method and, as such, generally recognizes no compensation expense for employee stock options. Accordingly, the adoption of SFAS 123(R) s fair value method will likely have a material impact on the Company s results of operations, although it will have no impact on its overall financial position. See *Stock Based Compensation*, above for information related to the pro forma effects on the Company s reported net loss and net loss per common share of applying the fair value recognition provisions of the previous SFAS 123 to stock-based employee compensation.

In November 2004, the FASB issued SFAS 151, Inventory Costs, which revised Accounting Research Bulletin No. 43 (ARB 43), relating to inventory costs. This revision is to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). SFAS 151 requires that these items be recognized as a current period charge regardless of whether they meet the criterion specified in ARB 43. In addition, SFAS 151 requires the allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS 151 is not expected to have a material impact on the Company s financial statements.

3. Contingencies

Beginning in April 2000, several plaintiffs filed class action lawsuits in federal court against the Company and certain of the Company s officers and directors. Later that year, the cases were consolidated in the United States District Court, Northern District of California as In re Terayon Communication Systems, Inc. Securities Litigation. The Court then appointed lead plaintiffs who filed an amended complaint. In 2001, the Court granted in part and denied in part defendants motion to dismiss, and plaintiffs filed a new complaint. In 2002, the Court denied defendants motion to dismiss that complaint, which, like the earlier complaints, alleges that the defendants violated the federal securities laws by issuing materially false and misleading statements and failing to disclose material information regarding the Company s technology. On February 24, 2003, the Court certified a plaintiff class consisting of those who purchased or otherwise acquired the Company s securities between November 15, 1999 and April 11, 2000.

On September 8, 2003, the Court heard defendants motion to disqualify two of the lead plaintiffs and to modify the definition of the plaintiff class. On September 10, 2003, the Court issued an order vacating the hearing date for the parties summary judgment motions, and, on September 22, 2003, the Court issued another order staying all discovery until further notice and vacating the trial date, which had been November 4, 2003.

On February 23, 2004, the Court issued an order disqualifying two of the lead plaintiffs. The order also states that plaintiffs counsel must provide certain information to the Court about counsel s relationship with the disqualified lead plaintiffs, and it provides that defendants may serve certain additional discovery. On March 24, 2004, plaintiffs submitted certain documents to the Court in response to its order, and, on April 16, 2004, the Company responded to this submission. The Company has also initiated discovery pursuant to the Court s February 23, 2004 order. Were an unfavorable ruling to occur in this legal matter, there exists the possibility of a material adverse impact on the Company s results of operations for the period in which the ruling occurs.

On October 16, 2000, a lawsuit was filed against the Company and the individual defendants (Zaki Rakib, Selim Rakib and Raymond Fritz) in the California Superior Court, San Luis Obispo County. This lawsuit is titled Bertram v. Terayon Communications Systems, Inc. The factual allegations in the Bertram complaint were similar to those in the federal class action, but the Bertram complaint sought remedies under state law. Defendants removed the Bertram case to the United States District Court, Central District of California, which dismissed the complaint and transferred the case to the United States District Court, Northern District of California. That Court eventually issued an order dismissing the case. Plaintiffs have appealed this order, and their appeal was heard on April 16, 2004. On June 9, 2004, the United States Court of Appeals for the Ninth Circuit affirmed the order dismissing the Bertram case.

The Court of Appeals opinion affirming dismissal of the Bertram case does not end the class action. The Company believes that the allegations in the class action are without merit, and intends to contest this matter vigorously. This matter, however, could prove costly and time consuming to defend, and there can be no assurances about the eventual outcome.

In 2002, two shareholders filed derivative cases purportedly on behalf of the Company against certain of its current and former directors, officers, and investors. (The defendants differed somewhat in the two cases.) Since the cases were filed, the investor defendants have been dismissed without prejudice, and the lawsuits have been consolidated as Campbell v. Rakib in the California Superior Court, Santa Clara County. The Company is a nominal defendant in these lawsuits, which allege claims relating to essentially the same purportedly misleading statements that are at issue in the pending securities class action. In the securities class action, the Company disputes making any misleading statements. The derivative complaints also allege claims relating to stock sales by certain of the director and officer defendants.

The Company believes that there are many defects in the derivative complaints. However, were an unfavorable ruling to occur in this legal matter, there exists the possibility of a material adverse impact on the Company s results of operations for the period in which the ruling occurs.

In January 2005, Adelphia Corporation (Adelphia) sued the Company in the District Court of the City and County of Denver, Colorado. Adelphia s complaint alleges, among other things, breach of contract and misrepresentation in connection with the Company s sale of CMTS products to Adelphia and the Company s announcement to cease future investment in the CMTS market. Adelphia seeks damages in excess of $25.0 million and declaratory relief. The Company moved to dismiss the complaint seeking an order blocking the case from going forward at a preliminary stage. The court denied the Company s motion to dismiss the complaint, thereby permitting the case and discovery to go forward. The Company filed its response to Adelphia s complaint and discovery has begun. The case is currently set for trial to commence on May 15, 2006. As the Company believes that Adelphia s allegations are without merit, it intends to contest this matter vigorously. This matter, however, could prove costly and time consuming to defend, and there can be no assurances about the eventual outcome. Were an unfavorable ruling to occur in this legal matter, there exists the possibility of a material adverse impact on the Company s results of operations for the period in which the ruling occurs.

The Company has received letters claiming that its technology infringes the intellectual property rights of others. The Company has consulted with its patent counsel and is in the process of reviewing the allegations made by such third parties. If these allegations were submitted to a court, the court could find that the Company s products infringe third party intellectual property rights. If the Company is found to have infringed third party rights, the Company could be subject to substantial damages and/or an injunction preventing the Company from conducting its business. In addition, other third parties may assert infringement claims against the Company in the future. A claim of infringement, whether meritorious or

10

not, could be time-consuming, result in costly litigation, divert the Company s management s resources cause product shipment delays or require the Company to enter into royalty or licensing arrangements. These royalty or licensing arrangements may not be available on terms acceptable to the Company, if at all.

Furthermore, the Company has in the past agreed to, and may from time to time in the future agree to, indemnify a customer of its technology or products for claims against the customer by a third party based on claims that its technology or products infringe intellectual property rights of that third party. These types of claims, meritorious or not, can result in costly and time-consuming litigation; divert management s attention and other resources; require the Company to enter into royalty arrangements; subject the Company to damages or injunctions restricting the sale of its products; require the Company to indemnify its customers for the use of the allegedly infringing products; require the Company to refund payment of allegedly infringing products to its customers or to forgo future payments; require the Company to redesign certain of its products; or damage its reputation, any one of which could materially and adversely affect the Company s business, results of operations and financial condition.

The Company may, in the future, take legal action to enforce its patents and other intellectual property rights, to protect its trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could negatively affect the Company s business, operating results, financial position and liquidity.

The Company is currently a party to various other legal proceedings, in addition to those noted above, and may become involved from time to time in other legal proceedings in the future. While the Company currently believes that the ultimate outcome of these proceedings, individually and in the aggregate, will not have a material adverse effect on its financial position or overall results of operations, litigation is subject to inherent uncertainties. Were an unfavorable ruling to occur in any of the Company s legal proceedings, there exists the possibility of a material adverse impact on the Company s financial condition and results of operations for the period in which the ruling occurs. The estimate of the potential impact on the Company s financial position and overall results of operations for any of the above legal proceedings could change in the future.

4. Operating Segment Information

The Company operates as one business segment.

	Three months ended June 30,		Six months ended June 30,	
(in thousands)	2005	2004	2005	2004
Revenues by product:				
Digital Video Solutions (DVS)	$17,339	$ 7,508	$30,385	$13,579
Home Access Solutions (HAS)	10,590	24,983	22,160	48,597
Cable Modem Termination Systems (CMTS)	1,506	10,291	3,157	21,588
Other	98		194	185
Total revenues	$29,533	$42,782	$55,896	$83,949
Revenues by geographic areas:				
United States	$20,223	$21,226	$35,490	$43,058
Americas, excluding United States	431	224	568	1,838
Europe, Middle East and Africa, (EMEA), excluding Israel	2,288	7,041	6,474	14,965
Israel	2,797	5,931	3,984	9,215
Asia, excluding Japan	3,400	5,037	8,965	9,132
Japan	394	3,294	394	5,688
Other		29	21	53
Total	$29,533	$42,782	$55,896	$83,949

	June 30, 2005	December 31, 2004
Long-lived assets:		
United States	$ 4,079	$ 4,423
Americas, excluding United States		402
EMEA, excluding Israel	96	131
Israel	273	687
Asia	90	117
Total long-lived assets	4,538	5,760
Total current assets	141,562	137,625
Other assets	9,396	10,349
Total assets	$155,496	$153,734

Two customers, Comcast Corporation (Comcast) and Harmonic, Inc. (Harmonic), accounted for 10% or more of total revenues (24% and 16%) for the three months ended June 30, 2005. Two customers, Harmonic and Comcast, accounted for 10% or more of total revenues (24% and 17%) for the six months ended June 30, 2005. Two customers, Adelphia Communications Corporation (Adelphia) and Telenet, accounted for 10% or more of total revenues (25% and 12%) for the three months ended June 30, 2004. Two customers, Adelphia and Telenet, accounted for 10% or more of total revenues (23% and 10%) for the six months ended June 30, 2004. One of these customers is Harmonic which is a related party (see Note 6). For the three and six months ended June 30, 2005, Harmonic accounted for 16% and 24% respectively of the Company s total revenues. For the three and six months ended June 30, 2004, Harmonic accounted for 6% and 4% respectively of the Company s total revenues.

At June 30, 2005, Comcast, Harmonic, Adelphia, and Telenet accounted for $4.3 million, $2.3 million, $1.5 million, and $0.1 million, respectively of the accounts receivable. At June 30, 2004, Comcast, Harmonic, Adelphia, and Telenet accounted for $0.9 million, $1.1 million, $5.3 million, and $4.7 million, respectively of the accounts receivable.

5. Restructuring Charges and Asset Write-offs

Restructuring

The Company accrues for termination costs in accordance with SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities,* and SFAS 112, "*Employers Accounting for Post Employment Benefits* . Liabilities are initially measured at their fair value on the date in which they are incurred based on plans approved by the Company s Board of Directors. Accrued employee termination costs principally consist of three components: 1) a lump-sum severance payment based upon the years of service; 2) COBRA insurance based on years of service; and 3) an estimate of costs for outplacement services provided to the affected employees. Most employees are terminated on the date of notification so there is no additional service period required to be included in the determination of accrued termination costs. Where services are required for a period over 60 days, the Company ratably amortizes termination costs over the required service period.

2004 Restructurings

During the first quarter of 2004, the Company initiated a Board of Director s approved restructuring plan to bring operating expenses in line with revenue levels. The Company incurred restructuring charges in the amount of $3.3 million of which $1.0 million related to employee termination costs, $0.9 million related to termination costs for an aircraft lease, and $1.4 million related to costs for excess leased facilities in the first quarter of 2004. The Company incurred additional restructuring charges in the amount of $1.1 million in the second quarter of 2004 related to additional costs for excess leased facilities resulting in a second restructuring plan. In the fourth quarter of 2004, to further conform the Company s expenses to its revenue and to cease investment in the CMTS product line, the

Company s Board of Directors approved a third restructuring plan that resulted in a charge in the amount of $1.3 million related to employee terminations.

Each quarter, the Company re-evaluates the 2004 restructuring charges for the employee severance, excess leased facilities and the aircraft lease. Based on market conditions, new assumptions provided by its real-estate broker, and the terms of an aircraft sublease agreement, which the Company entered into in the third quarter of 2004, the Company revalues the restructuring liability. During the first six months of 2005, the Company re-evaluated the 2004 restructuring liability estimates. Based on new

12

Table of Contents

assumptions provided by its real-estate broker, the Company increased the 2004 restructuring accrual by $0.9 million in the first six months of 2005. Additionally, the Company increased its estimated 2004 restructuring liability for employee severance in the first six months of 2005 by $1.0 million.

As of June 30, 2005, $3.2 million of 2004 restructuring charges remained accrued. In the six months ended June 30, 2005, the Company had paid $1.1 million in employee termination costs, $0.1 million of costs related to the aircraft lease, and $0.7 million of costs related to excess leased facilities.

The Company anticipates the remaining restructuring accrual related to the aircraft lease to be substantially utilized for servicing operating lease payments, through January 2007. The remaining restructuring accrual related to excess leased facilities is expected to be utilized for servicing operating lease payments or negotiating a buyout of operating lease commitments through October 2009.

The accrual for the aircraft lease approximates the difference between the Company s current costs for the aircraft lease and the estimated income derived from the sublease of the aircraft.

The amount of net charges accrued under the 2004 restructuring plans assumes that the Company will successfully sublease excess leased facilities. The accrual for the excess leased facilities includes the estimated income derived from subleasing, which is based on information from the Company s real-estate brokers, who provide estimates based on assumptions relevant to the real estate market conditions. Even though it is the Company s intent to sublease its interests in the excess facility at the earliest possible time, the Company cannot determine with certainty a fixed date by which such events will occur, if at all. In light of this uncertainty, the Company will continue to periodically re-evaluate and adjust the accrual, as necessary.

This table summarizes the accrued restructuring balances related to the 2004 restructurings as of June 30, 2005 (in thousands):

	Involuntary Employee Terminations	Aircraft Lease Termination	Excess Leased Facilities and Cancelled Contracts,	Total
Balance at December 31, 2004	$ 592	$ 692	$ 1,998	$ 3,282
Cash payments	(1,121)	(125)	(679)	(1,925)
Charges	965			965
Changes in estimate			907	907
Balance at June 30, 2005	$ 436	$ 567	$ 2,226	$ 3,229

2002 Restructuring

During 2002, a restructuring plan (2002 Plan) was approved by the Board of Directors and the Company incurred restructuring charges in the amount of $3.6 million, of which none remained accrued at June 30, 2005, for excess leased facilities in Israel. During 2004, improving real estate market conditions in Israel gave rise to the Company s improved tenant sublease assumptions and, as a result, the Company revalued the accrual for excess leased facilities in Israel and decreased the accrual by $0.1 million. Additionally, the Company reclassified $1.1 million between the 2002 Plan and 2001 Plan in the fourth quarter of 2004.

This table summarizes the accrued restructuring balances related to the 2002 Plan as of June 30, 2005 (in thousands):

Table of Contents

	Involuntary Employee Terminations	Excess Leased Facilities and Cancelled Contracts	Total
Balance at December 31, 2004	$	$ 15	$ 15
Changes in estimate		(15)	(15)
Balance at June 30, 2005	$	$	$

2001 Restructuring

During 2001, the Board of Directors approved a restructuring plan (2001 Plan) and the Company incurred restructuring charges in the amount of $12.7 million, of which $0.5 million remained accrued at June 30, 2005, primarily for excess leased facilities in Israel. During 2004, improving real estate market conditions in Israel gave rise to the Company s improved tenant sublease assumptions thereby resulting in a change in estimate of $1.4 million. Additionally, a reclassification between the 2002 Plan and 2001 Plan increased the 2001 Plan by $1.1 million in the fourth quarter of 2004. The Company currently anticipates the remaining restructuring accrual relating to excess leased facilities will be utilized for servicing operating lease payments through 2005.

During the first half of 2005, the Company re-evaluated the 2001 restructuring accrual estimates for the excess facilities in Israel. Based on actual sublease income and new assumptions provided by its real-estate broker, the Company decreased the restructuring charge by $0.4 million for the six months ended June 30, 2005.

This table summarizes the accrued restructuring balances related to the 2001 Plan as of June 30, 2005 (in thousands):

	Involuntary Employee Terminations	Excess Leased Facilities and Cancelled Contracts	Total
Balance at December 31, 2004	$ 50	$ 1,788	$ 1,838
Cash payments	(50)	(957)	(1,007)
Changes in estimate		(361)	(361)
Balance at June 30, 2005	$	$ (470)	$ (470)

Executive Severance

In 2003 and 2004, the Company entered into employment agreements with four executive officers who subsequently resigned from the Company. The Company recorded a severance provision of $1.7 million related to termination costs for these officers in the six months ended June 30, 2004. Most of the severance costs related to these officers were paid in 2004. Approximately $13,000 of employee benefits for the executive officers remained accrued at June 30, 2005, which is expected to be paid through 2005.

Asset Write-offs

The Company wrote off $0.1 million and $0.1 million in the six months ended June 30, 2005 and June 30, 2004, respectively, of fixed assets related to restructuring activities, which were determined to have no remaining useful life.

Table of Contents

6. Related Party Transactions

Lewis Solomon, a member of the Company s Board of Directors is also a member of the Board of Directors of Harmonic, Inc. (Harmonic). Harmonic is an authorized, non-exclusive reseller of certain of the Company s video products. For the six months ended June 30, 2005 and June 30, 2004, related party revenue from Harmonic was $13.7 million and $3.4 million, respectively.

Cost of related party revenues in the Company s consolidated statements of operations consists of direct and indirect costs. Accounts receivable from Harmonic totaled approximately $2.3 million at June 30, 2005. Harmonic is not a supplier to the Company.

7. Product Warranties

The Company provides for estimated product warranty expenses when it sells the related products. The Company has comprehensive processes that it uses to estimate accruals for warranty exposure. The processes include specific evaluation by product type, estimated failure rates and costs to repair or replace. Although the Company believes it has the continued ability to reasonably estimate warranty expenses, unforeseeable changes in factors used to estimate the accrual for warranty could occur. These unforeseeable changes could cause a material change in the Company s warranty accrual estimate. Such a change would be recorded in the period in which the change was identified.

An analysis of changes in the liability for product warranties for the six months ended June 30, 2005 and 2004, is as follows (in thousands):

	Balance at beginning of period	Additions charged to expenses	Expiration of accrued warranty	Charges for warranty services provided	Balance at end of period
Six months ended June 30, 2004					
Accrued warranty expenses	$5,509	1,922	(1,300)	(1,940)	$4,191
Six months ended June 30, 2005					
Accrued warranty expenses	$3,870	830	(475)	(1,503)	$2,722

8. Sale of Certain Assets

ATI

On February 7, 2005, the Company entered into an agreement with ATI Technologies, Inc (ATI) to sell certain cable modem semiconductor assets to ATI for a total purchase price of up to $13.8 million if the Company achieves all the milestones specified in the agreement. Under the terms of the agreement, ATI acquired the Company s cable modem silicon intellectual property and related software, assumed a lease and hired approximately twenty-five employees from the Company s design team. Upon closing on March 9, 2005, the Company received $8.6 million in cash, which was comprised of a $6.95 million initial payment and $1.65 million of the $1.9 million for having met the first milestone. In May 2005, the Company received an additional $2.5 million upon completion of two additional milestones. As of June 30, 2005, the Company had deferred the net gain of $8.6 million, which represented the cash receipt of $11.1 million, less transaction related costs of $2.5 million. The balance of up to $2.7 million of the purchase price will be paid to the Company in the event the Company meets the two remaining milestones over the subsequent 15 months following the closing, and upon the release of the escrow. The agreement also sets forth representations and warranties made by the Company that may cause it to incur liabilities and penalties arising out of its failure to meet certain conditions and milestones. The maximum liability for the Company is the greater of $11.5 million or the total amount of the purchase price paid by ATI plus $1.5 million. The gain on the sale of the assets, if any, will be recognized upon completion of all milestones or when the contingencies related to the sale are resolved.

Israel Subsidiaries

On April 2, 2004, the Company sold all of its ownership in Radwiz, Ltd., Ultracom Communications Holdings Ltd. and Combox Ltd. to a third party for a cash payment of $150,000. In connection with this disposition, the acquirer received obsolete inventories with no book value, $0.2 million of selected net assets, and assumed $1.35 million of net liabilities related to these subsidiaries. The Company recorded a net gain of $1.3 million on this transaction in the second quarter of 2004, which is included as an element of other income (expense) in the accompanying condensed consolidated statement of operations.

Table of Contents

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis should be read in conjunction with our condensed consolidated financial statements and notes thereto.

Overview

We sell our digital video solution (DVS) products to cable operators, satellite providers and television broadcasters. Additionally, we sell our home access solution (HAS) products, including cable modems, embedded multimedia terminal adapters (eMTA), home networking devices, and to a lesser extent cable modem termination system (CMTS) product line to cable operators.

On February 7, 2005, we entered into an agreement with ATI Technologies, Inc (ATI) to sell certain cable modem semiconductor assets to ATI for a total purchase price of up to $13.8 million if we achieve all the milestones specified in the agreement. Under the terms of the agreement, ATI acquired our cable modem silicon intellectual property and related software, assumed a lease and hired approximately twenty-five employees from our design team. Upon closing on March 9, 2005, we received $8.6 million in cash, which was comprised of a $6.95 million initial payment and $1.65 million of the $1.9 million for having met the first milestone. In May 2005, we received an additional $2.5 million upon completion of two additional milestones. As of June 30, 2005, we had deferred the net gain of $8.6 million, which represented the cash receipt of $11.1 million, less transaction related costs of $2.5 million. The balance of up to $2.7 million of the purchase price will be paid to us in the event we meet the two remaining milestones over the subsequent 15 months following the closing, and upon the release of the escrow. The agreement also sets forth representations and warranties made by us that may cause us to incur liabilities and penalties arising out of our failure to meet certain conditions and milestones. The maximum liability for us is the greater of $11.5 million or the total amount of the purchase price paid by ATI plus $1.5 million. The gain on the sale of the assets, if any, will be recognized upon completion of all milestones or when the contingencies related to the sale are resolved.

We have not been profitable since our inception. We had a net loss of $0.5 million or $0.01 per share for the quarter ended June 30, 2005. Our ability to grow our business and attain profitability is dependent on our ability to effectively compete in the marketplace with our current products and services, develop and introduce new products and services, contain operating expenses and improve our gross margins, as well as continued investment in equipment by the broadband provider industry.

At June 30, 2005, we had approximately $105.0 million in unrestricted cash, cash equivalents and short-term investments as compared to approximately $97.7 million at December 31, 2004. This increase in the first six months of 2005 primarily resulted from the ATI transaction, offset by the use of cash for operating activities.

A more detailed description of the risks to our business can be found in the section captioned Risk Factors in this quarterly report.

Critical Accounting Policies

There have been no material changes to any of our critical accounting policies and estimates as disclosed in our report on Form 10-K for the year ended December 31, 2004.

Table of Contents

Results of Operations
Three and Six months ended June 30, 2005 and June 30, 2004
Revenues

(in thousands)	For the three months ended June 30, 2005	2004	For the six months ended June 30, 2005	2004	% Change for the three months ended June 30, 2005/2004	% Change for the six months ended June 30, 2005/2004
Revenues	$29,533	$42,782	$55,896	$83,949	(31%)	(33%)

Our revenues decreased 31% for the quarter ended June 30, 2005 compared to the quarter ended June 30, 2004 and decreased 33% for the six months ended June 30, 2005 compared to the six months ended June 30, 2004. While sales of our DVS products increased, the overall decrease was primarily due to decreased sales of our HAS and CMTS products. We expect overall revenues to remain flat or increase slightly on a sequential basis in 2005.

Revenues by Groups of Similar Products

(in thousands)	For the three months ended June 30, 2005	2004	For the six months ended June 30, 2005	2004	% Change for the three months ended June 30, 2005/2004	% Change for the six months ended June 30, 2005/2004
Revenues by product:						
DVS	$17,339	$ 7,508	$30,385	$13,579	131%	124%
HAS	10,590	24,983	22,160	48,597	(58%)	(54%)
CMTS	1,506	10,291	3,157	21,588	(85%)	(85%)
Other	98		194	185	100%	5%
Total revenues	$29,533	$42,782	$55,896	$83,949	(31%)	(33%)

Revenues from DVS products increased in 2005 compared to 2004, due to significant shipments of the CP 7600G edge decoder, primarily in the second quarter of 2005, as well as continued sales of our DM 6400 CherryPickers. We are encouraged by the prospects for the DVS business to grow and believe that we will continue to see increased demand of DVS products resulting from more high definition television (HDTV) programming and other digital video services, including digital ad insertion.

HAS revenues decreased in 2005 compared to 2004, primarily due to an overall decrease in modem sales. The number of modems sold decreased from 0.5 million in the second quarter of 2004 to 0.2 million in the same period in 2005. The intensely competitive nature of the market for broadband products has resulted in significant price erosion of Average Selling Prices (ASP). While we continue to see a decrease in ASPs in the second quarter of 2005, the overall ASP of all modems we sold in the second quarter of 2005 increased due to increased sales of our higher priced eMTA modems. We expect HAS revenues to remain relatively flat or increase slightly in the remainder of 2005.

CMTS revenues continued to decline in 2005 compared to 2004, due to our decision to cease investment in the CMTS product line as announced in the third quarter of 2004. We expect CMTS revenues to continue to decrease in 2005.

Table of Contents

Revenues by Geographic Region

(in thousands)	For the three months ended June 30, 2005	For the three months ended June 30, 2004	For the six months ended June 30, 2005	For the six months ended June 30, 2004	% Change for the three months ended June 30, 2005/2004	% Change for the six months ended June 30, 2005/2004
Revenues by geographic areas:						
United States	$20,223	$21,226	$35,490	$43,058	(5%)	(18%)
Americas, excluding United States	431	224	568	1,838	92%	(69%)
Europe, Middle East and Africa, (EMEA), excluding Israel	2,288	7,041	6,474	14,965	(68%)	(57%)
Israel	2,797	5,931	3,984	9,215	(53%)	(57%)
Asia excluding Japan	3,400	5,037	8,965	9,132	(32%)	(2%)
Japan	394	3,294	394	5,688	(88%)	(93%)
Other		29	21	53	(100%)	(60%)
Total	$29,533	$42,782	$55,896	$83,949	(31%)	(33%)

Revenues in the United States decreased in the three and six months ended June 30, 2005 compared to the same periods in 2004, primarily due to decreased sales of CMTSs and HAS products to United States Major Systems Operators (MSOs). Revenues in EMEA, Israel, and Asia also decreased in the same period due to decreased sales of our CMTS and HAS products. During the second quarter of 2005, we continued to emphasize sales to our United States, Israel, and Asian customers while placing a lower emphasis on other locations such as Canada, South America and Japan. In the remainder of 2005, we expect revenues to remain flat or slightly increase in the United States and EMEA markets. Two customers, Comcast Corporation (Comcast) and Harmonic, Inc. (Harmonic), accounted for 10% or more of total revenues (24% and 16%) for the three months ended June 30, 2005. Two customers, Harmonic and Comcast, accounted for 10% or more of total revenues (24% and 17%) for the six months ended June 30, 2005. Two customers, Adelphia Communications Corporation (Adelphia) and Telenet, accounted for 10% or more of total revenues (25% and 12%) for the three months ended June 30, 2004. Two customers, Adelphia and Telenet, accounted for 10% or more of total revenues (23% and 10%) for the six months ended June 30, 2004. At June 30, 2005, Comcast, Harmonic, Adelphia, and Telenet accounted for $4.3 million, $2.3 million, $1.5 million, and $0.1 million, respectively of the accounts receivable. At June 30, 2004, Comcast, Harmonic, Adelphia, and Telenet accounted for $0.9 million, $1.1 million, $5.3 million, and $4.7 million, respectively of the accounts receivable.

Related Party Revenues

	For the three months ended June 30,	For the six months ended June 30,	% Change for the three months ended June 30,	% Change for the six months ended June 30,

(in thousands)	2005	2004	2005	2004	2005/2004	2005/2004
Related party revenues	$4,841	$2,644	$13,668	$3,389	83%	303%

Related party revenues increased in 2005 compared to 2004. Lewis Solomon, a member of our board of directors, is a member of the board of directors of Harmonic. All related party revenues are attributable to Harmonic and are included in related party revenues in 2005 and 2004. The increase in related party revenues was primarily due to an increase of sales of our DVS products to Harmonic in 2005 as compared to 2004. Harmonic is not a supplier to us.

Cost of Goods Sold and Gross Profit

	For the three months ended June 30,		For the six months ended June 30,		% Change for the three months ended June 30,	% Change for the six months ended June 30,
(in thousands)	2005	2004	2005	2004	2005/2004	2005/2004
Cost of revenues	$14,024	$27,046	$25,379	$55,605	(48%)	(54%)
Cost of related party revenues	2,677	614	4,364	825	336%	429%
Total cost of goods sold	$16,701	$27,660	$29,743	$56,430	(40%)	(47%)
Gross profit	$12,832	$15,122	$26,153	$27,519	(15%)	(5%)

18

Table of Contents

Cost of goods sold consists of direct product costs as well as the cost of our manufacturing operations. The cost of manufacturing includes contract manufacturing, test and quality assurance for products, warranty costs and associated costs of personnel and equipment. In the three and six months ended June 30, 2005, cost of goods sold was approximately 57% and 53% of revenues, respectively, compared to 65% and 67% of revenues, respectively, in the same periods in 2004. For the three and six months ended June 30, 2005, our gross margins were benefited by the reversal of approximately $0.2 million and $0.4 million, respectively of accrued vendor cancellation charges, which were previously recorded as cost of goods sold. Additionally, for the three and six months ended June 30, 2004, we reversed approximately $0.8 million and $2.1 million, respectively, of accrued vendor cancellation charges, which were previously recorded as cost of goods sold. During the three and six months ended June 30, 2005, our gross margins were benefited primarily by reversal of inventory provisions, which were previously recorded as cost of goods sold, upon the sale of previously reserved CMTS inventory of approximately $1.9 million and $2.6 million. We reversed these provisions as we were able to sell inventory originally considered to be excess or obsolete. Additionally, during the three and six months ended June 30, 2004, we reversed approximately $0.3 million and $0.8 million, respectively, of inventory provisions, which were previously recorded as cost of goods sold. We reversed these provisions as we were able to sell inventory originally considered to be excess or obsolete.

In 2005, related party cost of revenues increased compared to 2004 due to increased sales of our DVS products to Harmonic in 2005 as compared to sales in 2004.

Our gross profit decreased in the three and six months ended June 30, 2005 compared to the same period in 2004. The decrease in our gross profit was primarily related to a decrease in revenues from our HAS and CMTS products.

During 2005, we will continue to focus on improving sales of higher margin products and reducing product manufacturing costs. We are now partnering with contract manufacturers in Asia and the U.S. for our HAS and DVS products, which may provide us with more competitive component pricing, economies of scale, and improved manufacturing capabilities. We may be able to increase our margins by obtaining a product mix that is expected to shift to higher margin DVS products. Additionally, We expect HAS product mix to shift to higher margin priced eMTA products. However, there are no assurances that we will succeed in selling a greater percentage of higher margin products or reducing our product manufacturing costs.

Operating Expenses

(in thousands)	For the three months ended June 30, 2005	For the three months ended June 30, 2004	For the six months ended June 30, 2005	For the six months ended June 30, 2004	% Change for the three months ended June 30, 2005/2004	% Change for the six months ended June 30, 2005/2004
Research and development	$4,427	$8,516	$10,371	$17,984	(48%)	(42%)
Sales and marketing	$5,611	$5,411	$11,285	$12,632	4%	(11%)
General and administrative	$2,878	$2,953	$ 5,673	$ 5,388	(3%)	5%

Research and Development. Research and development expenses consist primarily of personnel costs, internally designed prototype material expenditures, and expenditures for outside engineering consultants, and testing equipment and supplies required to develop and enhance our products. Research and development expenses decreased 48% to $4.4 million or 15% of sales in the second quarter of 2005 from $8.5 million or 20% of sales in the same period in 2004. The $4.1 million decrease in research and development expenses was attributable to $2.5 million of reductions in employee related expenses primarily related to our decision to cease investment in the CMTS product line as announced in the third quarter of 2004, $0.6 million decrease in allocations of facility and overhead related support costs, and $1.1 reduction of other expenses, partially offset by an increase of $0.1 million of outside engineering

19

consultants. Research and development expenses decreased 42% to $10.4 million or 19% of sales in the six months ended June 30, 2005 from $18.0 million or 21% of sales in the same period in 2004. The $7.6 million decrease in research and development expenses was attributable to $4.5 million of reductions in employee related expenses primarily related to our decision to cease investment in the CMTS product line as announced in the third quarter of 2004, $1.8 million decrease in allocations of facility and overhead related support costs, and $1.7 reduction of other expenses, partially offset by an increase of $0.4 million of outside engineering consultants. We believe it is critical for the Company to continue to make significant investments in research and development to create innovative technologies and products that meet the current and future requirements of our customers. Accordingly, we intend to continue our investment in research and development in 2005 primarily in our DVS products.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries and commissions for sales personnel, and marketing and support personnel, and costs related to marketing communications, consulting and travel. Sales and marketing expenses increased by $0.2 million to $5.6 million or 19% of sales in the second quarter of 2005 from $5.4 million or 13% of sales in the same period in 2004. The $0.2 million increase in sales and marketing expenses was primarily due $0.4 million of increased cost for trade shows, $0.2 million of increased spending for outside consultants, and $0.3 million of overall sales and marketing costs, partially offset by $0.7 million in decreased employee expenses due to decreased headcount. Sales and marketing expenses decreased by $1.3 million to $11.3 million or 20% of sales in the six months ended June 30, 2005 from $12.6 million or 15% of sales in the same period in 2004. The $1.3 million decrease in sales and marketing expenses was primarily due to $1.1 million in decreased employee expenses due to decreased headcount and $0.8 million of decreased corporate aircraft expenses, offset by $0.6 million of overall sales and marketing cost increases. We currently expect sales and marketing expenses to be relatively flat to slightly lower in 2005 when compared to 2004.

General and Administrative. General and administrative expenses consist primarily of salary and benefits for administrative officers and support personnel, travel expenses and legal, and accounting and consulting fees. General and administrative expenses decreased by $0.1 million to $2.9 million or 10% of sales in the quarter ended June 30, 2005 from $3.0 million or 7% of sales in the same period in 2004. The $0.1 million decrease was primarily due to $0.2 million in reduced employee expenses and $0.4 million in decreased facilities costs, offset by $0.5 million increase in allocations of facility and overhead related support costs. General and administrative expenses increased by $0.3 million to $5.7 million or 10% of sales in the six months ended June 30, 2005 from $5.4 million or 6% of sales in the same period in 2004. The $0.3 million increase was primarily due to $0.3 million of increased spending for outside consultants and a $2.2 million increase in allocations of facility and overhead related support costs, partially offset by a $0.6 million reduction in our allowance for doubtful accounts credited to general and administrative expense, $0.5 million in reduced employee expenses due to lower headcount, and $1.1 million of overall general and administrative cost decreases. We currently expect general and administrative expenses to be relatively flat in 2005 when compared to 2004.

Restructuring Charges and Asset Write-offs

	For the three months ended June 30,		For the six months ended June 30,	
(in thousands)	2005	2004	2005	2004
Executive severance charges	$	$1,682	$	$1,682
Restructuring charges, net	282	1,897	1,479	5,158
Long-lived assets written-off			85	106
Restructuring costs and asset write-offs	$282	$3,579	$1,564	$6,946

Restructuring Costs During the first quarter of 2004, we initiated a Board of Directors approved restructuring plan to bring operating expenses in line with revenue levels. We incurred restructuring charges in the amount of $3.3 million of which $1.0 million related to employee termination costs, $0.9 million related to termination costs for an aircraft lease, and $1.4 million related to costs for excess leased facilities in the first quarter of 2004. We incurred additional restructuring charges in the amount of

20

Table of Contents

$1.1 million in the second quarter of 2004 related to additional costs for excess leased facilities resulting in a second restructuring plan. In the fourth quarter of 2004, to further conform our expenses to our revenue and to cease investment in the CMTS product line, our Board of Directors approved a third restructuring plan that resulted in a charge in the amount of $1.3 million related to employee terminations. The remaining restructuring accrual related to the aircraft lease is expected to be substantially utilized for servicing operating lease payments through January 2007, and the remaining restructuring accrual related to excess leased facilities, is expected to be utilized for servicing operating lease payments or negotiating a buyout of operating lease commitments, through October 2009.

The reserve for the aircraft lease and excess leased facilities was based on information provided by our brokers that estimated, based on assumptions relevant to the aircraft and real estate market conditions as of the date of our restructuring plan, the time it would be likely to take until the aircraft and excess leased facilities would be fully sub-leased. Even though it is our intent to sublease, assign or sell our interests in the excess facilities at the earliest possible time, we cannot determine with certainty a fixed date by which such events will occur. In light of this uncertainty, we will periodically re-evaluate and adjust the reserve, as necessary.

In the third quarter of 2002, we initiated a restructuring program. As part of this program, we restructured our worldwide operations including a worldwide reduction in workforce and the consolidation of excess leased facilities. We incurred restructuring charges of $3.6 million related to the 2002 restructuring. Of the total restructuring charge, $2.3 million was related to employee termination costs. The remaining $1.3 million related primarily to costs for excess leased facilities. At June 30, 2005, no 2002 restructuring charges remained accrued.

In 2001 we incurred restructuring charges of $12.7 million. Of the total restructuring charges recorded, $3.2 million related to employee termination costs covering 293 technical, production, and administrative employees. The remaining $9.5 million of restructuring charges related primarily to costs for excess leased facilities. As of June 30, 2005, restructuring charges of $0.5 million remained accrued. We anticipate utilizing the remaining restructuring accrual, which relates to servicing operating lease payments of operating lease commitments, through 2005.

Executive Severance In 2003 and 2004, we entered into employment agreements with four executive officers who subsequently resigned. Most of the severance costs related to these officers were paid in 2004. Approximately $13,000 of employee benefits for the executive officers remain accrued, which are expected to be paid through 2005.

Asset Write-offs We wrote off $0.1 million and $0.1 million in the six months ended June 30, 2005 and June 30, 2004, respectively, of fixed assets related to restructuring activities, which were determined to have no remaining useful life.

Non-operating Expenses

(in thousands)	For the three months ended June 30, 2005	2004	For the six months ended June 30, 2005	2004	% Change for the three months ended June 30, 2005/2004	% Change for the six months ended June 30, 2005/2004
Interest income	$ 672	$ 460	$ 1,240	$ 912	46%	36%
Interest expense	$(814)	$(826)	$(1,627)	$(1,643)	(1%)	(1%)
Other income expense	$ (50)	$ 921	$ 15	$ 1,200	(106%)	(99%)

Interest Income. Interest income increased in the three and six months ended June 30, 2005 compared to the same periods in 2004. The increase in interest income was primarily due to slightly higher interest rates.

Interest Expense. Interest expense, which related primarily to interest on our Convertible Subordinated Notes (Notes) due in 2007, remained relatively flat in the three and six months ended June 30, 2005 compared to the same periods in 2004.

Other Income. Other income is generally comprised of realization of foreign currency gains and losses, realized gains or losses on investments, and non-operational gains and losses. In the second quarter of 2004, we sold all of our ownership in Radwiz, Ltd., Ultracom Communication Holdings Ltd. and Combox Ltd. to a third party for a cash payment of $150,000. In connection with this disposition, the acquirer received obsolete inventories with no book value, $0.2 million of selected net assets, and $1.35 million of net liabilities related to these subsidiaries. We recorded other income of $1.3 million on this transaction in the second quarter of 2004.

Income Taxes

	For the three months ended June 30,		For the six months ended June 30,	
(in thousands)	2005	2004	2005	2004
Income tax expense	$ 50	$ (79)		$ (146)

We have generated losses since our inception. Tax expense for the three and six months ended June 30, 2005 and 2004 primarily relates to foreign taxes. In the second quarter of 2005, we reversed approximately $50,000 of foreign income tax expense, which had previously been recorded in the first quarter of 2005, due to a revaluation of estimated tax expense in the second quarter of 2005 recorded in a prior period that is no longer required by the foreign jurisdiction.

Litigation

See Part II, Item 1 Legal Proceedings.

Off-Balance Sheet Financings and Liabilities

Other than lease commitments and unconditional purchase obligations incurred in the normal course of business, we do not have any off-balance sheet financing arrangements or liabilities, guarantee contracts, retained or contingent interests in transferred assets or any obligation arising out of a material variable interest in an unconsolidated entity. We do not have any majority-owned subsidiaries that are not included in the consolidated financial statements.

Liquidity and Capital Resources

At June 30, 2005, we had approximately $38.6 million in unrestricted cash and cash equivalents and $66.4 million in short-term investments.

In July 2000, we issued $500.0 million of Notes, resulting in net proceeds to us of approximately $484.4 million. The Notes are a general unsecured obligation and are subordinated in right of payment to all of our existing and future senior indebtedness and to all of the liabilities of our subsidiaries. The Notes are convertible into shares of our common stock at a conversion price of $84.01 per share at any time on or after October 24, 2000 through maturity, unless previously redeemed or repurchased. Interest is payable semi-annually. Debt issuance costs related to the Notes were approximately $15.6 million. The Notes mature in August 2007.

Table of Contents

Through June 30, 2005, we had repurchased approximately $434.9 million of the Notes for $171.0 million in cash and $17.9 million in stock, resulting in a gain on early retirement of debt of approximately $234.4 million net of related unamortized issuance costs of $11.6 million in prior periods. No Notes were repurchased in 2003, 2004, or 2005.

Cash used in operating activities for the six months ended June 30, 2005 was $2.5 million compared to $21.2 million in the same period in 2004. In 2005, significant uses of cash from operating activities included a $3.1 million loss and a $3.3 million reduction of accounts payable partially offset by $3.5 million net decrease in gross inventory. Inventory levels decreased at June 30, 2005 when compared to December 31, 2004. In the six months ended June 30, 2004, significant uses of cash from operating activities included a $15.1 million loss, $9.6 million decrease in accounts payable, and $6.0 million for purchases of inventory.

Cash used in investing activities for the six months ended June 30, 2005 was $4.2 million compared to cash provided by investing activities of $37.8 million in the same period in 2004. Investing activities consisted primarily of net purchases and sales of short-term investments. Net cash used in investment activities during 2005 also included proceeds from the sale of our semiconductor assets to ATI described below.

On February 7, 2005, we entered into an agreement with ATI Technologies, Inc (ATI) to sell certain cable modem semiconductor assets to ATI for a total purchase price of up to $13.8 million if we achieve all the milestones specified in the agreement. Under the terms of the agreement, ATI acquired our cable modem silicon intellectual property and related software, assumed a lease and hired approximately twenty-five employees from our design team. Upon closing on March 9, 2005, we received $8.6 million in cash, which was comprised of a $6.95 million initial payment, and $1.65 million of the $1.9 million for having met the first milestone. In May 2005, we received an additional $2.5 million upon completion of two additional milestones. As of June 30, 2005, we had deferred the net gain of $8.6 million, which represented the cash receipt of $11.1 million, less transaction related costs of $2.5 million. The balance of up to $2.7 million of the purchase price will be paid to us in the event we meet the two remaining milestones over the subsequent 15 months following the closing, and upon the release of the escrow. The agreement also sets forth representations and warranties made by us that may cause us to incur liabilities and penalties arising out of our failure to meet certain conditions and milestones. The maximum liability for us is the greater of $11.5 million or the total amount of the purchase price paid by ATI plus $1.5 million. The gain on the sale of the assets, if any, will be recognized upon completion of all milestones or when the contingencies related to the sale are resolved.

Cash provided by financing activities was $2.1 million in 2005 primarily due to proceeds from the exercise of stock options. Cash provided by financing activities was $0.6 million in 2004 primarily due to proceeds from the exercise of stock options and the sale of shares of common stock through our Employee Stock Purchase Plan in 2004.

We currently believe that our current unrestricted cash, cash equivalents, and short term investment balances will be sufficient to satisfy our cash requirements for at least the next 12 months. In order to achieve profitability in the future, we will need to increase revenues, primarily through sales of more profitable products, and decrease costs. These statements are forward-looking in nature and involve risks and uncertainties. Actual results may vary as a result of a number of factors, including those discussed under the risk factor Our Operating Results May Fluctuate below and elsewhere. We may need to raise additional funds in order to support more rapid expansion, develop new or enhanced services, respond to competitive pressures, acquire complementary businesses or technologies or respond to unanticipated cash requirements. We may seek to raise additional funds through private or public sales of securities, strategic relationships, bank debt, and financing under leasing arrangements or otherwise. If additional funds are raised through the issuance of equity securities, the percentage ownership of our current stockholders will be reduced, stockholders may experience additional dilution or such equity securities may have rights, preferences or privileges senior to those of the holders of our common stock. We cannot assure you that additional financing will be available on acceptable terms, if at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to continue operations, develop our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could have a material adverse effect on our business, financial condition and operating results.

Contractual Obligations

The following summarizes our contractual obligations at June 30, 2005, and the effect such obligations are expected to have on our liquidity and cash flows in future periods (in millions):

		Payments Due by Period			
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Unconditional Purchase Obligations	$ 21.8	$21.8	$	$	$
Long Term Debt	65.1		65.1		
Operating Lease Obligations	14.3	3.8	6.3	4.1	0.1
Aircraft Lease Obligations	2.3	1.5	0.8		
Total Contractual Commitments	$103.5	$27.1	$72.2	$4.1	$0.1

We have unconditional purchase obligations to certain of our suppliers that support our ability to manufacture our products. The obligations require us to purchase minimum quantities of the suppliers products at a specified price. As of June 30, 2005, we had approximately $21.8 million of purchase obligations, of which $0.4 million is included in the Condensed Consolidated Balance Sheet as accrued vendor cancellation charges, and the remaining $21.4 is attributable to open purchase orders. The remaining obligations are expected to become payable at various times through 2005.

Other commercial commitments, primarily required to support operating leases, are as follows (in millions):

		Amount of Commitment Expiration Per Period			
	Total Amounts Committed	Less than 1 year	1-3 years	4-5 years	Over 5 years
Deposits	$7.5	$	$7.5	$	$
Standby Letters of Credit	1.2	0.9		0.3	
Total Commercial Commitments	$8.7	$0.9	$7.5	$0.3	$

In 2002, we entered into an operating lease arrangement to lease a corporate aircraft. This lease arrangement was secured by a $9.0 million letter of credit. The letter of credit was reduced to $7.5 million in February 2003. During 2004 the $7.5 million letter of credit was converted to a cash deposit. This lease commitment is included in the table above. In March 2004, in connection with our worldwide restructuring, we notified the lessor of our intentions to locate a purchaser for our remaining obligations under this lease. In August 2004, we entered into an agreement with a third party to sublease the corporate aircraft through December 31, 2006.

Impact of Recently Issued Accounting Standards

On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS 123 (revised 2004), (SFAS 123(R)), Share-Based Payment, which replaces SFAS 123, Accounting for Stock-Based Compensation, and supersedes APB 25, Accounting for Stock Issued to Employees. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. SFAS 123(R) eliminates the alternative to use APB 25 s intrinsic value method of accounting that was provided in SFAS

Table of Contents

123 as originally issued. After a phase-in period for SFAS 123(R), pro forma disclosure will no longer be allowed. The SEC announced in the second quarter of 2005 that it would extend this phase-in period and, therefore, our effective date for implementation of SFAS 123(R) is January 1, 2006. We have not yet determined which phase-in method it will adopt. In the first quarter of 2005 the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin No. 107, which provided further clarification on the implementation of SFAS 123(R).

As permitted by SFAS 123, we currently account for share-based payments to employees using APB 25 s intrinsic value method and, as such, generally recognize no compensation expense for employee stock options. Accordingly, the adoption of SFAS 123(R) s fair value method will likely have a material impact on our results of operations, although it will have no impact on our overall financial position. See *Stock Based Compensation*, above for information related to the pro forma effects on our reported net loss and net loss per common share of applying the fair value recognition provisions of the previous SFAS 123 to stock-based employee compensation.

In November 2004, the FASB issued SFAS 151, Inventory Costs, which revised Accounting Research Bulletin No. 43 (ARB 43), relating to inventory costs. This revision is to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs and wasted material (spoilage). SFAS 151 requires that these items be recognized as a current period charge regardless of whether they meet the criterion specified in ARB 43. In addition, SFAS 151 requires the allocation of fixed production overheads to the costs of conversion be based on normal capacity of the production facilities. SFAS 151 is effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS 151 is not expected to have a material impact on our financial statements.

RISK FACTORS

You should carefully consider the risks described below before making an investment decision. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations. If any of the following risks actually occur, our business could be harmed. In such case, the trading price of our common stock could decline, and you may lose all or part of your investment.

Risks Related to Our Business

We have a history of losses and may continue to incur losses in the future

It is difficult to predict our future operating results. We began shipping products commercially in June 1997, and we have been shipping products in volume since the first quarter of 1998. As of June 30, 2005, we had an accumulated deficit of approximately $1.0 billion. We believe that we will continue to experience challenges in selling our products at a profit and may continue to operate with net losses for the foreseeable future. In the past few years, we experienced a decrease in revenues compared to 2001 and 2000, in large part, due to the erosion of average selling prices (ASPs) of our products due to our transition from a proprietary platform to the Data Over Cable System Interface (DOCSIS) standards platform and a drop in sales volume of cable modem termination systems (CMTS). Additionally, we are experiencing a decline in revenues from 2004 to 2005 primarily because of our decision to cease investment in our CMTS product line, which has resulted in a significant decline in sales, and a decline in the sale of our HAS products. Our revenue decreased for the six months ended June 30, 2005 to $55.9 million from $83.9 million in the same period in 2004, and to $29.5 million from $42.8 million for the three months ended June 30, 2005 and 2004, respectively. We incurred losses of $0.5 million and $3.1 million in the three and six months ended June 30, 2005. As a result of our losses, we have had to use available cash and cash equivalents to supplement the operation of our business. Additionally, we generally have been unable to significantly reduce our short-term expenses in order to compensate for unexpected decreases in anticipated revenues or delays in generating anticipated revenues. For example, we have fixed commitments with some of our suppliers that require us to purchase minimum quantities of their products at a specified price irrespective of whether we can subsequently use such quantities in our products. Further, we have experienced and will likely continue to experience declining ASPs of our products. In addition, we have significant operating lease commitments for facilities and equipment that generally cannot be cancelled in the short-term without substantial penalties, if at all.

Table of Contents

We may continue to experience fluctuations in our operating results and face unpredictability in our future revenues

Our quarterly revenues have fluctuated and are likely to continue to fluctuate significantly in the future due to a number of factors, many of which we cannot control. Factors that affect our revenues include, among others, the following:

- variations in the timing of orders and shipments of our products;
- variations in the size of the orders by our customers and pricing concessions on volume sales;
- competitive market conditions;
- unpredictable sales cycles;
- new product introductions by competitors or by us;
- delays in our introduction of new products;
- delays in our introduction of added features to our products;
- delays in the commercialization of products that are competitive in the marketplace;
- delays in our receipt of and cancellation of orders forecasted by customers;
- variations in capital spending budgets of cable operators and other broadband service providers;
- international conflicts, including the continuing conflict in Iraq, and acts of terrorism and the impact of adverse economic, market and political conditions worldwide; and
- ability of our products to be qualified or certified as meeting industry standards.

Our quarterly results are affected by the gross margin we achieve for the quarter relative to our gross revenues. A variety of factors influence our gross margin for a particular quarter, including, among others, the following:

- the sales mix of our products;
- the volume of products manufactured;
- the type of distribution channel through which we sell our products;
- the ASPs of our products;
- our ability to manage excess and obsolete inventory;
- delays in reducing the cost of our products;
- the costs of manufacturing our products; and
- the effectiveness of our cost reduction measures.

Table of Contents

We often recognize a substantial portion of our revenues in the last month of the quarter. We establish our expenditure levels for product development and other operating expenses based on projected sales levels, and expenses are relatively fixed, particularly in the short term. For example, a significant percentage of these operating expenses are fixed due to operating leases for our facilities and equipment. Also, we have fixed commitments with some of our suppliers that require us to purchase minimum quantities of their products at a specified price. Because in the past, we have been unable to use all of the products that we purchased from our suppliers, we have taken vendor cancellation charges as a result of these fixed commitments, and we may have to take additional charges in the future if we are unable to use all of the products that we purchase from our suppliers. As of June 30, 2005, $21.8 million of purchase obligations were outstanding. The obligations are generally expected to become payable at various times throughout 2005. Accordingly, variations in timing of sales can cause significant fluctuations in operating results. In addition, because a significant portion of our business is derived from orders placed by a limited number of large customers, the timing of such orders can also cause significant fluctuations in our operating results. Our expenses for any given quarter are typically based on expected sales and if sales are below expectations; our operating results may be adversely impacted by our inability to adjust spending to compensate for the shortfall. Moreover, our research and development expenses fluctuate in response to new product development, and changing industry requirements and customer demands.

Additionally, the unit ASPs of our HAS products declined considerably in 2004, 2003, and 2002, and to a lesser extent, in 2005. We anticipate that unit ASPs of our HAS products will continue to decline in the future. This has caused and will continue to cause a decrease in our gross margins if we are unable to offset the decline in ASPs of our HAS products with cost reduction measures. In addition, the gross margins we realize from the sale of our products are affected by the mix of product sales between higher margin, lower volume digital video solutions (DVS) products and applications and lower margin, higher volume HAS products. We are attempting to increase our gross margin by increasing the sale of our DVS products, cost-reducing the HAS products, and ceasing investment in our CMTS product line. However, there are no assurances that we will succeed. For 2005, we expect that sales of our low-margin HAS products will continue to make up a significant portion of our revenues. If we do not continue to generate a greater percentage of total revenues from our DVS product revenues, we will not succeed in greatly improving our gross margin.

We are dependent on a small number of customers and resellers and our business could be harmed by the loss of any of these customers or reductions in their purchasing volumes

Our customers have undergone and continue to undergo significant consolidation in both North America and internationally, as a limited number of cable operators control an increasing number of systems. For example, the top nine cable operators in the United States operate systems that service approximately 90% of homes that receive cable services in the United States. As a result of the consolidation among cable operators, our revenue has been and will continue to be dependent on sales to the few leading cable operators worldwide. Two customers, Comcast Corporation (Comcast) and Harmonic, Inc. (Harmonic), accounted for 10% or more of total revenues (24% and 16%) for the three months ended June 30, 2005. Two customers, Harmonic and Comcast, accounted for 10% or more of total revenues (24% and 17%) for the six months ended June 30, 2005. Two customers, Adelphia Communications Corporation (Adelphia) and Telenet, accounted for 10% or more of total revenues (25% and 12%) for the three months ended June 30, 2004. Two customers, Adelphia and Telenet, accounted for 10% or more of total revenues (23% and 10%) for the six months ended June 30, 2004. At June 30, 2005, Comcast, Harmonic, Adelphia, and Telenet accounted for \$4.3 million, \$2.3 million, \$1.5 million, and \$0.1 million, respectively of the accounts receivable. At June 30, 2004, Comcast, Harmonic, Adelphia, and Telenet accounted for \$0.9 million, \$1.1 million, \$5.3 million, and \$4.7 million, respectively of the accounts receivable. Adelphia is not expected to be a customer in 2005 due to our decision to cease investment in our CMTS product line, which may continue to have a material adverse effect on our business or results of operations in 2005. As is common in our industry, we typically do not enter into contracts with our customers in which they commit to purchase products from us. Typically, our sales are made on a purchase order or system contract basis, and none of our customers has entered into a long-term agreement requiring it to purchase our products. Moreover, we do not typically require our customers to purchase a minimum quantity of our products, and our customers can generally cancel or significantly reduce their orders on short notice without significant penalties. The loss of any of our customers can have a material adverse effect on our results of operations. Further, any reduction in orders from a given customer also may have a material adverse affect on our results of operations.

Significant sales of our DVS products are made to a small number of resellers, who often incorporate our DVS products and applications in systems that are sold to an end-user customer, which is typically a cable operator, satellite provider or broadcast operator. If one or more of these resellers develop their own products or elect to purchase similar products from another vendor, our revenue and results of operations may suffer.

Also, we may not succeed in attracting new customers as many of our potential customers have pre-existing relationships with our current or potential competitors and the continued consolidation of the cable industry reduces the number of potential customers. To attract new customers, we may be faced with intense price competition, which may affect our gross margins.

We may also lose existing customers or experience declining business in our DVS and HAS products from our existing customers because of our decision to cease investment in our CMTS product line. For example, Adelphia, one of our largest CMTS customers, indicated that it will no longer purchase HAS or DVS products from us. The loss of Adelphia and the loss of any additional CMTS customers that decrease or cease their purchases of DVS and HAS products could continue to materially adversely affect our business and results of operations.

Recent changes in senior management and the reductions in workforce associated with our restructuring efforts could disrupt the operation of our business, distract our management from focusing on revenue- generating efforts, result in the erosion of employee morale, and impair our ability to respond rapidly to growth opportunities in the future

We have experienced a number of recent changes in senior management and other key personnel. Our Chief Executive Officer, President and Chief Technology Officer, Chief Operating Officer, Chief Financial Officer and General Counsel all resigned within the latter half of 2004. Our new Chief Executive Officer was appointed in September 2004 and our new Chief Financial Officer was appointed in late November 2004. We also have recently experienced increased turnover in our video engineering group and finance organization. The recruitment and retention of a new senior management staff and turnover in key personnel has created and could continue to create a number of transitional challenges for us. These transitional issues have caused, and may cause, disruptions to our business. We cannot be assured that a smooth transition of our senior management staff has occurred, or that we have taken the necessary steps to

effect an orderly continuation of our operations during the transitional period. Further, the process of locating personnel with the combination of skills and attributes required to carry out our goals and integrating such personnel once they are recruited is often lengthy. We cannot be assured that the integration of our new senior management staff will occur in a timely manner, or that such integration will not present additional transitional challenges for us or adversely affect the operation of our business.

Moreover, we have implemented a number of restructuring plans since 2001, including the most recent restructuring activities in 2004 that resulted in personnel reduction of 40%. The employee reductions and changes in connection with our restructuring activities, as well as future changes in senior management and key personnel, could result in an erosion of morale, and affect the focus and productivity of our remaining employees, including those directly responsible for revenue generation and the management and administration of our finances, which in turn may adversely affect our revenue in the future or cause other administrative deficiencies. Additionally, employees directly affected by the reductions may seek future employment with our business partners, customers or competitors. Although all employees are required to sign a proprietary information agreement with us at the time of hire, there can be no assurances that the confidential nature of our proprietary information will be maintained in the course of such future employment. Additionally, we may face wrongful termination, discrimination, or other claims from employees affected by the reduction related to their employment and termination. We could incur substantial costs in defending ourselves or our employees against such claims, regardless of the merits of such actions. Furthermore, such matters could divert the attention of our employees, including management, away from our operations, harm productivity, harm our reputation and increase our expenses. We cannot assure you that our restructuring efforts will be successful, and we may need to take additional restructuring efforts, including additional personnel reduction, in the future.

We are dependent on key personnel

Due to the specialized nature of our business, we are highly dependent on the continued service of, and on our ability to attract and retain qualified senior management, engineering, sales and marketing personnel and employees with significant experience and expertise in video, data networking and radio frequency design. The competition for some of these personnel is intense, particularly for engineers with Moving Picture Experts Group (MPEG) experience. We may incur additional expenses to attract and retain key personnel. There can be no assurances that the additional expenses we may incur, or our efforts to recruit such individuals, will be successful, and if they are not, our business may experience significant disruption or adverse effects. In addition, if we are unable to hire qualified personnel as needed in a timely manner, we may be unable to adequately manage and grow our business.

We do not have key person insurance coverage for the loss of any of our employees. Any officer or employee can terminate his or her relationship with us at any time. Our employees generally are not bound by non-competition agreements.

There are many risks associated with our participation in industry standards

In connection with the development of the DOCSIS 2.0 specification by CableLabs, a cable industry consortium that establishes cable technology standards and administers compliance testing, we entered into an agreement with CableLabs whereby we licensed to CableLabs on a royalty-free basis any of our intellectual property rights, including rights to our proprietary S-CDMA technology, to the extent that such rights may be asserted against a party desiring to design, manufacture or sell DOCSIS based products, including DOCSIS 2.0 based products. This license agreement grants to CableLabs the right to sublicense our intellectual property, including our intellectual property rights in our S-CDMA patents, to manufacturers that compete with us in the marketplace for DOCSIS based products. As a result of this license to CableLabs, our competitors that produce DOCSIS-based products have access to our technology without having to pay us any royalties or other compensation for the use of our technology. As a result of our contribution of technology to the DOCSIS intellectual property pool, we may have foregone significant revenue from the potential licensing of our proprietary technology, and we may be unable to recoup the investment in the research and development of intellectual property contributed to the DOCSIS technology pool.

Table of Contents

Additionally, the agreement that we signed with CableLabs to participate in the DOCSIS intellectual property pool may make it difficult for us to enforce our intellectual property rights against other companies. Certain cable equipment vendors manufacture and sell DOCSIS based and DOCSIS certified and qualified products without sublicensing from CableLabs the technology in the CableLabs intellectual property pool. Due to the interests of cable operators in having as many equipment vendors as possible, we may feel constrained by competitive pressures from pursuing the enforcement of our intellectual property rights against our competitors that have not entered into sublicenses with CableLabs. Moreover, if we seek to enforce our intellectual property rights against other equipment manufacturers that access technology from the CableLabs intellectual property pool, our license to the technology in the pool may be jeopardized. Certain contributors of technology to the CableLabs intellectual property pool are our competitors and may elect to revoke our license to their technology if we attempt to enforce our intellectual property rights against them.

We may have lost any competitive advantage that our proprietary S-CDMA technology may have provided us in the marketplace by licensing it to CableLabs and we may lose any competitive advantage that any other proprietary technology that is licensed to CableLabs. Additionally, we may face increased competition because our competitors have the ability to incorporate our technology into their products. We believe that this increased competition could come from existing competitors or from new competitors who enter the market and that such competition is likely to result in lower product ASPs, which could harm our revenues and gross margins. Additionally, because our competitors will be able to incorporate our technology into their products, our current customers may choose alternate suppliers or choose to purchase DOCSIS-compliant products from multiple suppliers. We may be unable to effectively compete with the other vendors if we cannot produce DOCSIS compliant cable products more quickly or at lower cost than our competitors.

DOCSIS specifications have not yet been accepted in Asia, although an increasing number of Asian cable operators are requiring product to be DOCSIS qualified or certified. A related specification for cable products, called the Euro-DOCSIS specification, has been formalized by TComLabs, a cable technology consortium of European cable operators, and European and some Asian cable operators have embraced it. We have contributed certain of our technologies, including our proprietary S-CDMA technology, to the Euro-DOCSIS specification. We may develop and sell products that comply with the Euro-DOCSIS specification, and we may be unsuccessful in these efforts. Even if we are successful in our efforts, we may face some of the same risks associated with our contribution of intellectual property to the CableLabs DOCSIS intellectual property pool.

We need to certify and qualify our new and existing products to meet industry specifications in order to remain competitive

Major cable operators worldwide have endorsed the DOCSIS, Euro-DOCSIS and PacketCable specifications and rarely purchase data and voice equipment that is not certified or qualified as compliant with these specifications. Although there are currently no specifications for DVS products, if such specifications are adopted, then we will not only need to certify our video products with such specifications, but we may experience more intense price competition for our DVS products and erosion in ASPs. In addition, we currently need to certify our HAS products. Traditionally, cable operators have chosen to purchase only products meeting industry specifications because the specifications enable interoperability among products from multiple vendors, which leads to increased competition among equipment manufacturers and consequently lowers product ASPs. As a result, our future success depends on our ability to compete effectively in this marketplace by developing, marketing and selling products that are certified and qualified to industry standards in a timely and cost effective manner.

The DOCSIS and PacketCable specifications are promulgated by CableLabs. Currently these specifications have been widely adopted by cable operators in North America and by some cable operators in Asia, Latin America and Europe. The Euro-DOCSIS specifications have been developed by TComLabs specifically to meet the requirements of European operators, and have found some acceptance in China as well. There is no guarantee that our products will continue to be DOCSIS, EuroDOCSIS or PacketCable certified or qualified, or will be certified for any new standards that may emerge. If we are unable to certify or qualify our products as compliant with DOCSIS, EuroDOCSIS or PacketCable or other applicable standards in a timely manner, we may be unable to sell our products and may lose some or all of any advantage we might otherwise have had, and our future operating results may be adversely affected.

Although we sell certified and qualified data and voice products, there have been and may continue to be instances where our existing customers and potential new customers elect to purchase products from one or more of our competitors rather than from us. In response, we have reduced our prices and continue to experience customer demand to further reduce our prices in order to promote sales of our current products. This has had and may continue to have an adverse impact on our revenues, operating results and gross margin.

Developing products to meet these various industry specifications has several risks. The first is the cost and effort to engineer standards-based products and to then prepare them for compliance testing. Not only do we have to certify or qualify new products, but any of our currently certified or qualified products must be re-certified or re-qualified should they be changed in any way. Second, there is no guarantee that these products will be certified or qualified as meeting these specifications in a timely fashion, if ever. Because most cable operators purchase only those products that have been certified or qualified as meeting these specifications, it is highly unlikely that we will be able to sell our products until they achieve certification or qualification, which can be a lengthy process. As a result, we may incur significant research and development expenses to develop new products that may not receive certification or qualification and we cannot recoup the costs of these research and development expenses by marketing uncertified or unqualified products. Moreover, a consequence of cable operators only purchasing products certified or qualified as meeting industry specifications is the increased competition between equipment vendors, which has resulted in a steady and ongoing decline in equipment prices as vendors compete for cable operators business. Third, there is no guarantee that we will be able to support all future cable industry specifications, which will likely have an adverse impact on our future revenues.

Our video products and applications must achieve widespread market acceptance to advance the growth of our digital video solutions business

Our success depends upon the widespread acceptance of our video products and applications by broadband providers. Traditionally, we have had success selling our DVS products to cable operators and satellite providers; however, there is no guarantee that this success will continue as the products and applications evolve and as new competitors enter the market. In 2004, we introduced a new DVS product which is geared towards television broadcasters. Currently, we have had one large deployment of this product and have had limited sales of this product through resale channels. We are currently developing technology for the deployment of video for the telecom carriers; however, there is no guarantee that we will continue to pursue that development, that our product will work or that our product will find widespread acceptance among the telecom carriers.

The emerging market trend to standardize the digital video technology may challenge our ability to continue to grow our digital video business

Comcast Corporation, Time-Warner, Inc. and Cox Communications, Inc., the three largest cable operators in the United States, started their Next-Generation Network Architecture (NGNA) initiative in 2003 to develop a common approach to transform their cable systems into all-digital networks. This initiative could potentially impact video technology, including our video technology and products. As a group, the operators can work more effectively with equipment vendors in defining the products and product capabilities required for the migration. In 2004, the participating operators commissioned CableLabs to manage the NGNA initiative and to develop a set of standards to which equipment vendors can build their products. The NGNA initiative is so far following the model successfully proven with the earlier DOCSIS initiative, which enabled the development of interoperable cable modems, CMTSs and other associated equipment that allowed United States operators to rollout broadband cable modem service much faster, more broadly and with greater success than telecom carriers could offer their competing DSL service. As it has with data services, CableLabs may request companies to contribute their video

Table of Contents

technologies to a DOCSIS-like technology pool on a royalty-free basis. If we contribute any of our video technology to a DOCSIS-like technology pool, our video technology is subject to the same risks as those associated with the standards-based technology for our data services, which are discussed above.

Subject to the success of the initiative, cable operators may want to purchase only video products that have been certified or qualified by CableLabs, in which case we will not be able to sell our video products until they achieve certification or qualification, which, based on our experience with our data services, can be a lengthy process. As a result, we may incur significant research and development expenses to develop new video products that may not receive certification or qualification and we may not be able to recoup the costs of these research and development expenses by marketing uncertified or unqualified products. Moreover, there is no guarantee that we will be able to support all future specifications relating to video products, which would likely have an adverse impact on our future revenues. Furthermore, a consequence of cable operators purchasing only certified or qualified products, based on our experience with the data services, is the increased competition between equipment vendors, which would result in a steady and ongoing decline in equipment prices as vendors compete for cable operators business. Consequently, our future success may depend on our ability to compete effectively in the video marketplace by developing, marketing and selling products that are certified and qualified to industry standards in a timely fashion and in a cost effective manner.

We depend on broadband providers capital spending for a substantial portion of our revenue and any decrease or delay in capital spending would negatively impact our operating results and financial condition

Historically, almost all of our sales had been derived from sales to broadband providers and, more specifically, cable operators, and we expect these sales to constitute a significant portion of net sales for the foreseeable future. Demand for our products will depend on the magnitude and timing of capital spending by broadband providers. These capital spending patterns depend on a variety of factors including:

- the availability of financing;
- annual budget cycles, as well as the typical reduction in upgrade projects during the winter months;
- the status of federal, local and foreign government regulation and deregulation of the telecommunications industry;
- overall demand for broadband services and the acceptance of new data, video and voice services;
- evolving industry standards and network architectures;
- competitive pressures (including the availability of alternative data transmission and access technologies);
- discretionary consumer spending patterns; and
- general economic conditions.

Table of Contents

Average selling prices of broadband equipment may continue to decline, decreasing our gross margins

The broadband equipment market has been characterized by erosion of product ASPs, particularly for HAS products, which declined considerably in 2004, 2003, and 2002, and to a lesser extent in 2005. This erosion may continue. The ASPs for our products are likely to continue to decline due to competitive pricing pressures, promotional programs and customers possessing strong negotiating positions which require price reductions as a condition of purchase. In addition, we believe that the widespread adoption of industry specifications, such as the DOCSIS and EuroDOCSIS specifications, is further eroding ASPs as cable modems and other similar HAS products become commodity products. If a specification is adopted for video technology, our DVS products may experience the same ASP erosion. Decreasing ASPs could result in decreased revenues even if the number of units sold increases. Decreasing ASPs may also require us to sell our products at much lower gross margin than in the past, and in fact, we may sell products at a loss. The primary reason that our gross profits have generally declined in recent years is the decline in product ASPs. As a result, we may experience substantial period-to-period fluctuations in future revenue, gross margin and operating results due to ASP erosion. Therefore, we must continue to develop and introduce on a timely basis and a cost- effective manner new products or next-generation products with enhanced functionalities that can be sold at higher gross margins. If we fail to do so our revenues and gross margins may decline further.

In addition, the gross margins we realize from the sale of our products are affected by the mix of product sales between higher margin, lower volume digital video solutions (DVS) products, and applications and lower margin, higher volume HAS products. We are attempting to increase our gross margin by increasing the sale of our DVS products, reducing the manufacturing costs associated with the HAS products, and ceasing investment in our CMTS product line. However, there are no assurances that we will succeed. For 2005, we expect that sales of our low-margin HAS products will continue to represent a significant portion of our revenues. If we do not generate a greater percentage of total revenues from our DVS product revenues, we will not succeed in greatly improving our gross margin.

We must achieve cost reductions or increase revenues to attain profitability

In prior years, we experienced revenue declines, which were, in large part, due to declining product ASPs due to our transition from a proprietary platform to the DOCSIS standards platform. In order to achieve profitability, we must significantly increase our revenues, reduce the cost of our products, and maintain or reduce our operating expenses.

Although we have implemented expense reduction and restructuring plans in the past, including the latest restructurings in the fourth quarter of 2004, that have focused on cost reductions and operating efficiencies, we still operate at a loss. A large portion of our expenses, including rent, and operating lease expenditures, is fixed and difficult to reduce or change. Accordingly, if our revenue does not meet our expectations, we may not be able to adjust our expenses quickly enough to compensate for the shortfall in revenue, which, in turn, could materially and adversely impact our business, financial condition and results of operations.

As product ASPs decline, we need to reduce the cost of our products through design and engineering changes. We may not be successful in redesigning our products, and, even if we are successful, our efforts may be delayed or our redesigned products may contain significant errors and product defects. In addition, any redesign may not result in sufficient cost reductions to allow us to reduce significantly the prices of our products or improve our gross margins. Reductions in our product costs may require us to use lower-priced components that are highly integrated in future products and may require us to enter into high volume or long-term purchase or manufacturing agreements. Volume purchase or manufacturing agreements may not be available on acceptable terms, if at all, and we could incur significant expenses without related revenues if we cannot use the products or services offered by such agreements. We have incurred significant vendor cancellation charges related to volume purchase and manufacturing agreements in the past and may incur such charges in the future.

Table of Contents

We may not be able to raise additional funds to continue operating our business

Our main source of liquidity continues to be our unrestricted cash and cash equivalents on hand. As a result of our history of operating losses, we expect to continue to use our unrestricted cash to fund operating losses in the future. Our unrestricted cash, cash equivalents and short-term investments increased to $105.0 million at June 30, 2005, from $97.7 million at December 31, 2004. If our operating losses are more severe than expected or continue longer than expected, we may find it necessary to seek other sources of financing to support our capital needs and provide available funds for working capital. Furthermore, as of June 30, 2005, we had $65.1 million of notes outstanding that mature in August 2007 and may need to seek additional financing to repay the notes at maturity.

There may be few sources of financing available to us. Commercial bank financing may not be available to us on acceptable terms. Accordingly, any plan to raise additional capital, if available to us, would likely involve an equity-based or equity-linked financing, such as the issuance of convertible debt, common stock or preferred stock, which would be dilutive to our stockholders. On October 7, 2003, we filed a registration statement on Form S-3 with the SEC. This shelf registration statement will allow us to issue various types of securities, including common stock, preferred stock, debt securities and warrants to purchase common stock, from time to time up to an aggregate of $125.0 million, subject to market conditions and our capital needs. However, we may not be able to sell securities on terms acceptable to us. If we are unable to procure additional working capital, as necessary, we may be unable to continue operations.

We may dispose of or discontinue existing product lines, which may adversely impact our future results

On an ongoing basis, we evaluate our various product offerings in order to determine whether any should be discontinued or, to the extent possible, divested. Moreover, the worldwide downturn in the telecommunications industry led us to reassess our business strategy, which in turn caused us to discontinue investment in certain product lines. We have ceased investment in the telecom and satellite businesses and largely sold or discontinued the various businesses we acquired in 1999 and 2000. In October 2004, we also announced our decision to cease investment in the CMTS product line. In March 2005, we sold to ATI Technologies Inc. certain of our cable modem semiconductor assets.

We cannot guarantee that we have correctly forecasted, or will correctly forecast in the future, the right product lines to dispose or discontinue or that our decision to dispose of or discontinue various investments and product lines is prudent if market conditions change. In addition, there are no assurances that the discontinuance of various product lines will reduce our operating expenses or will not cause us to incur material charges associated with such decision. Furthermore, the discontinuance of existing product lines entails various risks, including the risks that we will not be able to find a buyer for a product line or the purchase price obtained will not be equal to the book value of the assets for the product line. Other risks include managing the expectations of, and maintaining good relations with, our customers who previously purchased products from our disposed or discontinued product lines, which could prevent us from selling other products to them in the future. We may also incur other liabilities and costs associated with our disposal or discontinuance of product lines.

We may be unable to provide adequate customer support

Our ability to achieve our planned sales growth and retain current and future customers will depend in part upon the quality of our customer support operations. Our customers generally require significant support and training with respect to our products, particularly in the initial deployment and implementation stages. Spikes in demand of our support services may cause us to be unable to serve our customers adequately. We may not have sufficient personnel to provide the levels of support that our customers may require during initial product deployment or on an ongoing basis especially during peak periods. Our inability to provide sufficient support to our customers could delay or prevent the successful deployment of our products. In addition, our failure to provide adequate support could harm our reputation and relationships with our customers and could prevent us from selling products to existing customers or gaining new customers.

Furthermore, we may experience transitional issues relating to customer support in connection with our decision to dispose of or discontinue various investments and product lines. We may incur liability associated with customers dissatisfaction with the level of customer support maintained for discontinued product lines.

We may have financial exposure to litigation

We and/or our directors and officers are defendants in a number of lawsuits, including securities litigation lawsuits and the lawsuit with Adelphia discussed above (See Part II Item 1 Legal Proceedings for more information regarding our litigation). As a result, we may have financial exposure to litigation as a defendant and because we are obligated to indemnify our officers and members of our board of directors for certain actions taken by our officers and directors on our behalf.

In order to limit financial exposure arising from litigation and/or our obligation to indemnify our officers and directors, we have historically purchased directors and officers insurance (D&O Insurance). There can be no assurance that D&O Insurance will be available to us in the future or, if D&O Insurance is available, that it will not be prohibitively expensive. Additionally, some insurance underwriters who offered D&O Insurance in the past have been placed into liquidation or may be, at some future point, placed into liquidation.

If there is no insurance coverage for the litigation or, even if there is insurance coverage, if a carrier is subsequently liquidated or placed into liquidation, we will be responsible for the attorney fees and costs resulting from the litigation. The incurrence of significant fees and expenses in connection with the litigation could have a material adverse effect on our results of operations.

The sales cycle for certain of our products is lengthy, which makes forecasting of our customer orders and revenues difficult

The sales cycle for certain of our products is lengthy, often lasting nine months to more than a year. Our customers generally conduct significant technical evaluations, including customer trials, of our products as well as competing products prior to making a purchasing decision. In addition, purchasing decisions may also be delayed because of a customer s internal budget approval processes. Because of the lengthy sales cycle and the size of customer orders, if orders forecasted for a specific customer for a particular period do not occur in that period, our revenues and operating results for that particular quarter could suffer. Moreover, a portion of our expenses related to an anticipated order is fixed and difficult to reduce or change, which may further impact our revenues and operating results for a particular period.

We need to develop additional distribution channels to market and sell our products

The vast majority of our data and voice product sales have traditionally been to large cable operators. Our DVS products have been traditionally sold to large cable operators and satellite operators with recent, limited sales to television broadcasters. Although we intend to establish strategic relationships with leading distributors worldwide to new customers, we may not succeed in establishing these relationships. Even if we do establish these relationships, the distributors may not succeed in marketing our products to their customers. Some of our competitors have established long-standing relationships with these cable operators that may limit our and our distributors ability to sell our products to those customers. Even if we were to sell our products to those customers, it would likely not be based on long-term commitments, and those customers would be able to terminate their relationships with us at any time without significant penalties.

We may fail to accurately forecast customer demand for our products

The nature of the broadband industry makes it difficult for us to accurately forecast demand for our products. Our inability to forecast accurately the actual demand for our products may result in too much or too little supply of products or an over/under capacity of manufacturing or testing resources at any given point in time. The existence of any one or more of these situations could have a negative impact on our business, operating results or financial condition. We have incurred significant vendor cancellation charges related to volume purchase and manufacturing agreements in the past and may incur such charges in the future. We had purchase obligations of approximately $21.8 million as of June 30, 2005, primarily to purchase minimum quantities of materials and components used to manufacture our products. We may be obligated to fulfill these purchase obligations even if demand for our products is lower than we anticipate.

We may not be able to manage expenses and inventory risks associated with meeting the demand of our customers

From time to time, we receive indications from our customers as to their future plans and requirements to ensure that we will be prepared to meet their demand for our products. If actual orders differ materially from these indications, our ability to manage inventory and expenses may be affected. In addition, if we fail to meet customers supply expectations, we may lose business from such customers. If we enter into purchase commitments to acquire materials, or expend resources to manufacture products and such products are not purchased by our customers, our business and operating results could suffer.

We are dependent on key third-party suppliers and any failure by them to deliver components could limit our ability to satisfy customer demand

We manufacture all of our products using components or subassemblies procured from third-party suppliers, including semiconductors. Some of these components are available from a sole source and others are available from limited sources. A majority of our sales are from products containing one or more components that are available only from sole source suppliers. For example, our video equipment is single sourced from a manufacturer in San Jose, California. Our modems are sourced from a manufacturer in China. Additionally, some of our components are custom parts that are produced to our specifications, and it may be difficult to move the manufacturing of such components from one vendor to another vendor.

Any interruption in the operations of our vendors of sole source or custom product parts could adversely affect our ability to meet our scheduled product deliveries to customers. If we are unable to obtain a sufficient supply of components, including semiconductors, from our current sources, we could experience difficulties in obtaining alternative sources or in altering product designs to use alternative components. Resulting delays or reductions in product shipments could damage customer relationships and expose us to potential damages that may arise from our inability to supply our customers with products. Further, a significant increase in the price of one or more of these components, such as our semiconductor components, could harm our gross margin or operating results. Additionally, we attempt to limit this risk by maintaining safety stocks of these components, subassemblies and modules. As a result of this investment in inventories, we have in the past and in the future may be subject to risk of excess and obsolete inventories, which could harm our business. In this regard, our gross margins and operating results could be adversely affected by excess and obsolete inventory.

We may be unable to migrate to new semiconductor process technologies successfully or on a timely basis

Our future success will depend in part upon our ability to develop products that utilize new semiconductor process technologies. These technologies change rapidly and require us to spend significant amounts on research and development. We continuously evaluate the benefits of redesigning our integrated circuits using smaller geometry process technologies to improve performance and reduce costs. The transition of our products to integrated circuits with increasingly smaller geometries will be important to our competitive position. Other companies have experienced difficulty in migrating to new semiconductor processes and, consequently, have suffered reduced yields, delays in product deliveries and increased expense levels. Moreover, we depend on our relationship with our third-party manufacturers to migrate to smaller geometry processes successfully.

Table of Contents

Our ability to directly control product delivery schedules and product quality is dependent on third-party contract manufacturers

Most of our products are assembled and tested by contract manufacturers using testing equipment that we provide. As a result of our dependence on these contract manufacturers for the assembly and testing of our products, we do not directly control product delivery schedules or product quality. Any product shortages or quality assurance problems could increase the costs of manufacturing, assembling or testing our products. In addition, as manufacturing volume increases, we will need to procure and assemble additional testing equipment and provide it to our contract manufacturers. The production and assembly of testing equipment typically requires significant lead times. We could experience significant delays in the shipment of our products if we are unable to provide this testing equipment to our contract manufacturers in a timely manner.

We are dependent upon international sales and there are many risks associated with international operations

We expect sales to customers outside of the United States to continue to represent a significant percentage of our revenues for the foreseeable future. For the six months ended June 30, 2005 and the twelve months ended December 31, 2004, 2003 and 2002, approximately 37%, 45%, 44% and 68%, respectively, of our net revenues were from customers outside of the U.S. International sales are subject to a number of risks, including the following:

- changes in foreign government regulations and communications standards;
- import and export license requirements, tariffs and taxes;
- trade barriers and trade disputes;
- difficulty in protecting intellectual property;
- difficulty in collecting accounts receivable;
- currency fluctuations;
- the burden of complying with a wide variety of foreign laws, treaties and technical standards;
- difficulty in staffing and managing foreign operations; and
- political and economic instability.

If our customers are affected by currency devaluations or general economic downturns their ability to purchase our products could be reduced significantly. Payment cycles for international customers typically are longer than those for customers in North America.

Our international operations are subject to certain risks common to foreign operations in general, such as governmental regulations and import restrictions. In addition, there are social, political, labor and economic conditions in specific countries or regions as well as difficulties in staffing and managing foreign operations, and potential adverse foreign tax consequences, among other factors that could also have an impact on our business and results of operations outside of the United States.

Furthermore, foreign countries may decide to prohibit, terminate or delay the construction of new broadband infrastructures for a variety of reasons. These reasons include environmental issues, economic downturns and availability of favorable pricing for other communications services or the availability and cost of related equipment. Any such action by foreign countries would reduce the market for our products.

Like other companies operating or selling internationally, we are subject to the Foreign Corrupt Practices Act (FCPA) and other laws which prohibit improper payments or offers of payments to foreign governments and their officials and political parties by U.S. and other business entities for the purpose of obtaining or retaining business. We make sales in countries known to experience corruption. Our sales

activities in such countries create the risk of an unauthorized payments or offers of payments by one of our employees, consultants, sales agents or distributors which could be in violation of various laws including the FCPA, even though such parties are not always subject to our control. We have attempted to implement safeguards to prevent losses from such practices and to discourage such practices by our employees, consultants, sales agents and distributors. However, our safeguards may prove to be less than effective and our employees, consultants, sales agents or distributors may engage in conduct for which we might be held responsible. Violations of the FCPA may result in severe criminal or civil sanctions, and we may be subject to other liabilities, which could negatively affect our business, financial condition and results of operations.

The deployment process for our equipment may be lengthy and may delay the receipt of new orders and cause fluctuations in our revenues

The timing of deployment of our equipment can be subject to a number of other risks, including the availability of skilled engineering and technical personnel, the availability of other equipment such as fiber optic cable, and the need for local zoning and licensing approvals. We believe that changes in our customers deployment plans have delayed, and may in the future delay the receipt of new orders. Since the majority of our sales have been to relatively few customers, a delay in equipment deployment with any one customer has in the past had, and could in the future, have a material adverse effect on our sales for a particular quarter.

Our industry is highly competitive with many larger and more established competitors

The market for our products is extremely competitive and is characterized by rapid technological change. Our direct competitors include Ambit Microsystems Corporation, Cisco Systems, BigBand Networks, Motorola, Scientific-Atlanta and RGB Networks. Additionally, we face competition from early stage companies with access to significant financial backing that improve existing technologies or develop new technologies. The principal competitive factors in our market include the following:

- product performance, features and reliability;
- price;
- size and stability of operations;
- breadth of product line;
- sales and distribution capabilities;
- technical support and service;
- relationships with providers of service providers; and
- compliance with industry standards.

Some of these factors are outside of our control. Conditions in the market could change rapidly and significantly as a result of technological advancements. The development and market acceptance of alternative technologies could decrease the demand for our products or render them obsolete. Our competitors may introduce products that are less costly, provide superior performance or achieve greater market acceptance than our products.

Many of our current and potential competitors have greater financial, technical, marketing, distribution, customer support and other resources, as well as better name recognition and access to customers than we do. The widespread adoption of DOCSIS and other industry standards has and is likely to continue to cause increased price competition. We believe that the adoption of these standards have resulted in and are likely to continue to result in lower ASPs for our products. Any increased price competition or reduction in sales of our products, particularly our higher margin head-end products, has resulted and will continue to result in decreased revenue and downward pressure on our gross margin. These competitive pressures have and are likely to continue to have an adverse impact on our business.

Our business is subject to the risks of warranty returns, product liability and product defects

Products like ours are very complex and can frequently contain undetected errors or failures, especially when first introduced or when new versions are released. Despite testing, errors may occur. Product errors could affect the performance or interoperability of our products, delay the development or release of new products or new versions of products, adversely affect our reputation and our customers willingness to buy products from us and adversely affect market acceptance or perception of our products. Any such errors or delays in releasing new products or new versions of products or allegations of unsatisfactory performance could cause us to lose revenue or market share, increase our service costs, cause us to incur substantial costs in redesigning the products, subject us to liability for damages and divert our resources from other tasks, any one of which could materially and adversely affect our business, results of operations and financial condition. Although we have limitation of liability provisions in our standard terms and conditions of sale, they may not be effective as a result of federal, state or local laws or ordinances or unfavorable judicial decisions in the United States or other countries. The sale and support of our products also entails the risk of product liability claims. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not adequately cover any claim asserted against us. In addition, even claims that ultimately are unsuccessful could result in our expenditure of funds in litigation and divert management s time and other resources.

We may be unable to adequately protect or enforce our intellectual property rights

We rely on a combination of patent, trade secret, copyright and trademark laws and contractual restrictions to establish and protect proprietary rights in our products. Even though we seek to establish and protect proprietary rights in our products, there are risks. There are no assurances that any patent, trademark, copyright or other intellectual property rights owned by us will not be invalidated, circumvented or challenged, that such intellectual property rights will provide competitive advantages to us or that any of our pending or future patent applications will be issued with the scope of the claims sought by us, if at all. There are no assurances that others will not develop technologies that are similar or superior to our technology, duplicate our technology or design around the patents that we own. In addition, effective patent, copyright and trade secret protection may be unavailable or limited in certain foreign countries in which we do business or may do business in the future.

Our pending patent applications may not be granted. Even if they are granted, the claims covered by any patent may be reduced from those included in our applications. Any patent might be subject to challenge in court and, whether or not challenged, might not be broad enough to prevent third parties from developing equivalent technologies or products without a license from us.

We believe that the future success of our business will depend on our ability to translate the technological expertise and innovation of our employees into new and enhanced products. We have entered into confidentiality and invention assignment agreements with our employees, and we enter into non-disclosure agreements with many of our suppliers, distributors and appropriate customers so as to limit access to and disclosure of our proprietary information. These contractual arrangements, as well as statutory protections, may not prove sufficient to prevent misappropriation of our trade secrets or technology or deter independent third-party development of similar technologies. In addition, the laws of some foreign countries may not protect our intellectual property rights to the same extent as do the laws of the United States. We may, in the future, take legal action to enforce our patents and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could negatively affect our business, operating results, financial position and liquidity.

Table of Contents

CableLabs DOCSIS 2.0 specification includes two advanced physical layer technologies, S-CDMA and A-TDMA. In connection with the development of the DOCSIS 2.0 specification by CableLabs, we entered into an agreement with CableLabs, on a royalty-free basis, whereby we licensed to CableLabs many of our intellectual property rights to the extent that such rights may be asserted against a party desiring to design, manufacture or sell DOCSIS-based products, including DOCSIS 2.0-based products. This license agreement grants to CableLabs the right to sublicense our intellectual property, including our intellectual property rights in our S-CDMA patents, to manufacturers that compete with us in the marketplace for DOCSIS based products.

We pursue the registration of our trademarks in the United States and have applications pending to register several of our trademarks throughout the world. However, the laws of certain foreign countries might not protect our products or intellectual property rights to the same extent as the laws of the United States. Effective trademark, copyright, trade secret and patent protection may not be available in every country in which our products may be manufactured, marketed or sold.

Third party claims of infringement or other claims against us could adversely affect our ability to market our products, require us to redesign our products or seek licenses from third parties, and seriously harm our operating results and disrupt our business

As is typical in our industry, we have been and may from time to time be notified of claims asserting that we are infringing intellectual property rights owned by third parties. We also have in the past agreed to, and may from time to time in the future agree to, indemnify customers of our technology or products for claims against such customers by a third party based on claims that our technology or products infringe patents of that third party. We further believe that companies may be increasingly subject to infringement claims as distressed companies and individuals attempt to generate cash by enforcing their patent portfolio against a wide range of products. These types of claims, meritorious or not, can result in costly and time-consuming litigation; divert management s attention and other resources; require us to enter into royalty arrangements; subject us to damages or injunctions restricting the sale of our products, require us to indemnify our customers for the use of the allegedly infringing products; require us to refund payment of allegedly infringing products to our customers or to forgo future payments; require us to redesign certain of our products; or damage our reputation. Our failure to obtain a license for key intellectual property rights from a third party for technology used by us could cause us to incur substantial liabilities and to suspend the manufacturing of products utilizing the technology. Alternatively, we could be required to expend significant resources to develop non-infringing technology with no assurances that we would be successful in such endeavors. The occurrence of any of the above events could materially and adversely affect our business, results of operations and financial condition.

Our indebtedness could adversely affect our financial condition and we may incur substantially more debt

As of June 30, 2005, we had approximately $68.5 million of long-term obligations of which $65.1 million is long-term debt associated with our Notes. This level of indebtedness may adversely affect our stockholders by:

- making it more difficult for us to satisfy our obligations with respect to our indebtedness;
- increasing our vulnerability to general adverse economic and industry conditions;
- limiting our ability to obtain additional financing;
- requiring the dedication of a substantial portion of our cash flow from operations to the payment of principal of, and interest on, our indebtedness, thereby reducing the availability of our cash flow to fund our growth strategy, working capital, capital expenditures and other general corporate purposes;
- limiting our flexibility in planning for, or reacting to, changes in our business and the industry; and
- placing us at a competitive disadvantage relative to our competitors with less debt.

We may incur substantial additional debt in the future. If new debt is added to our current levels, the related risks described above could intensify.

Table of Contents

We need to develop and introduce new and enhanced products in a timely manner to remain competitive

The markets in which we operate are characterized by rapidly changing technologies, evolving industry standards, frequent new product introductions and relatively short product life. The pursuit of necessary technological advances and the development of new products require substantial time and expense. For example, we acquired ten businesses during the period between 1999 and 2000. Due to various economic conditions, none of the products from our acquired businesses, other than the CherryPicker products, have achieved the level of market acceptance that was forecasted at the time of their acquisitions. Additionally, certain product groups have not achieved the level of technological development needed to be marketable or to expand the market. As a result, we recorded an aggregate of approximately $576.8 million related to impairment charges and write-down of in- process research and development related to the acquired technologies, both of which negatively impacted our operating results in 2001 and 2002.

To compete successfully in the markets in which we operate, we must design, develop, manufacture and sell new or enhanced products that provide increasingly higher levels of performance and reliability. However, we may not be able to successfully develop or introduce these products, if our products are not:

- cost effective;
- brought to market in a timely manner;
- in accordance with evolving industry standards and architecture; or
- fail to achieve market acceptance.

There is no assurance that the technologies we are currently developing or intend to develop will achieve feasibility or that even if we are successful, the developed product will be accepted by the market. We may not be able to recover the costs of existing and future product developments and our failure to do so may materially and adversely impact our business, financial condition and results of operations.

We are exposed to the credit risk of our customers and to credit exposures in weakened markets, which could result in material losses

Most of our sales are on an open credit basis, with payment terms of 30 to 60 days typically in the United States, and because of local customs or conditions, longer in some markets outside the United States. Beyond our open credit arrangements, we have also experienced a request for customer financing and facilitation of leasing arrangements, which we have not provided to date and do not expect to provide in the future. We expect demand for enhanced open credit terms, for example, longer payment terms, customer financing and leasing arrangements to continue and believe that such arrangements are a competitive factor in obtaining business. Our decision not to provide these types of financing arrangements may adversely affect our ability to sell products, and therefore, our revenue, operations and business.

Because of the current condition in the global economy, our exposure to credit risks relating to sales on an open-credit basis has increased. Although we monitor and attempt to mitigate the associated risk, there can be no assurance that our efforts will be effective in reducing credit risk. Additionally, there have been significant insolvencies and bankruptcies among our customers, which have and may continue to cause us to incur economic and financial losses. There can be no assurance that additional losses would not be incurred and that such losses would not be material. Although these losses have generally not been material to date, future losses, if incurred, could harm our business and have a material adverse effect on our operating results and financial condition.

We have and we may seek to expand our business through acquisitions which could disrupt our business operations and harm our operating results

In order to expand our business, we may make strategic acquisitions of other companies or certain assets. We plan to continue to evaluate opportunities for strategic acquisitions from time to time, and may make an acquisition at some future point. However, the current volatility in the stock market and the current price of our common stock may adversely affect our ability to make such acquisitions. Any acquisition that we make involves substantial risks, including the following:

- difficulties in integrating the operations, technologies, products and personnel of an acquired company;
- diversion of management s attention from normal daily operations of the business;
- potential difficulties in completing projects associated with in-process research and development;
- difficulties in entering markets in which we have no or limited direct prior experience and where competitors in such markets have stronger market positions;
- initial dependence on unfamiliar supply chains or relatively small supply partners;
- insufficient revenues to offset increased expenses associated with acquisitions; and
- the potential loss of key employees of the acquired companies.

Acquisitions may also cause us to:

- issue common stock that would dilute our current stockholders percentage ownership;
- assume liabilities;
- record goodwill and non-amortizable intangible assets that will be subject to impairment testing and potential periodic impairment charges;
- incur amortization expenses related to certain intangible assets;
- incur large and immediate write-offs; or
- become subject to litigation.

For example, we made ten acquisitions during the period between 1999 and 2000. Due to various economic conditions, none of the products from our acquired businesses have achieved the level of market acceptance that was forecasted at the time of their acquisitions. As a result, we recorded an aggregate of approximately $576.8 million related to impairment charges and write-down of in-process research and development related to the acquired technologies, both of which negatively impacted our operating results in 2001 and 2002.

Mergers and acquisitions of high-technology companies are inherently risky, and no assurance can be given that our future acquisitions will be successful and will not materially adversely affect our business, operating results or financial condition. Failure to manage and successfully integrate acquisitions we make could harm our business and operating results in a material way. Even when an acquired company has already developed and marketed products, there can be no assurance that product enhancements will be made in a timely fashion or that all pre-acquisition due diligence will have identified all possible issues that might arise with respect to such products.

Table of Contents

Our products are subject to safety approvals and certifications

In the United States, our products are required to meet certain safety requirements. For example, we are required to have our products certified by Underwriters Laboratory in order to meet federal requirements relating to electrical appliances to be used inside the home. Outside the United States, our products are subject to the regulatory requirements of each country in which the products are manufactured or sold. These requirements are likely to vary widely. We may be unable to obtain on a timely basis or at all the regulatory approvals that may be required for the manufacture, marketing and sale of our products.

Compliance with current and future environmental regulations may be costly which could impact our future earnings.

We may be subject to environmental and other regulations due to our production and marketing of products in certain states and countries. In addition, we could face significant costs and liabilities in connection with product take-back legislation, which enables customers to return a product at the end of its useful life and charges us with financial and other responsibility for environmentally safe collection, recycling, treatment and disposal. We also face increasing complexity in our product design and procurement operations as we adjust to new and upcoming requirements relating to the materials composition of our products, including the restrictions on lead and certain other substances in electronics that will apply to specified electronics products put on the market in the European Union as of July 1, 2006 (Restriction of Hazardous Substances in Electrical and Electronic Equipment Directive (EU RoHS)). The European Union has also finalized the Waste Electrical and Electronic Equipment Directive, which makes producers of electrical goods financially responsible for specified collection, recycling, treatment and disposal of past and future covered products. The deadline for enacting and implementing this directive by individual European Union governments was August 13, 2004 (such legislation, together with the directive, the WEEE Legislation), although extensions were granted in some countries. Producers are to be financially responsible under the WEEE Legislation beginning in August 2005. Other countries, such as the United States, China and Japan, have enacted or may enact laws or regulations similar to the EU RoHS or WEEE legislation. Other environmental regulations may require us to reengineer our products to utilize components which are more environmentally compatible. Such reengineering and component substitution may result in additional costs to us. Although we currently do not anticipate any material adverse effects based on the nature of our operations and the effect of such laws, there is no assurance that such existing laws or future laws will not have a material adverse effect on us.

Various export licensing requirements could materially and adversely affect our business or require us to significantly modify our current business practices

Various government export regulations may apply to the encryption or other features of our products. We may have to make certain filings with the government in order to obtain permission to export certain of our products. In the past, we may have inadvertently failed to file certain export applications and notices, and we may have to make certain filings and request permission to continue exportation of any affected products without interruption while these applications are pending. If we do have to make such filings, there are no assurances that we will obtain permission to continue exporting the affected products or that we will obtain any required export approvals now or in the future. If we do not receive the required export approvals, we may be unable to ship those products to certain customers located outside of the United States. In addition, we may be subject to fines or other penalties due to the failure to file certain export applications and notices.

Compliance with changing laws and regulations relating to corporate governance and public disclosure has resulted, and will continue to result, in the incurrence of additional expenses associated with being a public company

New and changing laws and regulations, including the Sarbanes-Oxley Act of 2002, new SEC regulations and NASDAQ National Market Rules, impose stricter corporate governance requirements, greater disclosure obligations, and greater focus on disclosure and internal controls. These new laws and regulations have had the effect of increasing the complexity and cost of our Company s corporate governance compliance, diverting the time and attention of our management from revenue-generating activities to compliance activities, and increasing the risk of personal liability for our board members and executive officers involved in our Company s corporate governance process. Our efforts to comply with evolving laws and regulations have resulted, and will continue to result, in increased general and administrative expenses, and increased professional and independent auditor fees. In addition, it has become more difficult and expensive for us to obtain director and officer liability insurance.

In order to meet the new corporate governance and financial disclosure obligations, we have been taking, and will continue to take, steps to improve our controls and procedures, including disclosure and internal controls, and related corporate governance policies and procedures to address compliance issues and correct any deficiencies that we may discover. For example, pursuant to the requirements of Section 404 of Sarbanes-Oxley, we undertook a comprehensive and costly evaluation of our internal controls and disclosure controls and procedures. Based on this evaluation, our management determined that our internal controls over financial reporting and our disclosure controls and procedures as of December 31, 2004 were ineffective. Furthermore, we have determined that our disclosure controls and procedures as of March 31, 2005 continued to be ineffective. In response to these deficiencies, our management has commenced the necessary processes and procedures to remediate the deficiencies in our disclosure and internal control by establishing, implementing and testing additional controls. As of June 30, 2005, we have determined that our disclosure controls and products are effective and that our material weaknesses have been remediated. However, our efforts to correct the deficiencies in our disclosure and internal controls have required, and will continue to require, the commitment of significant financial and managerial resources. In addition, we anticipate the costs associated with the testing and evaluation of our internal controls will be significant and material in fiscal year 2005 and may continue to be material in future fiscal years as these controls are maintained and continually evaluated and tested.

Furthermore, changes in our operations and the growth of our business may require us to modify and expand our disclosure controls and procedures, internal controls and related corporate governance policies. In addition, the new and changed laws and regulations are subject to varying interpretations in many cases due to their lack of specificity, and as a result, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. If our efforts to comply with new or changed laws and regulations differ from the conduct intended by regulatory or governing bodies due to ambiguities or varying interpretations of the law, we could be subject to regulatory sanctions, our reputation may be harmed and our stock price may be adversely affected.

Newly adopted accounting regulations that require companies to expense stock options will result in a decrease in our earnings and our stock price may decline.

The Financial Accounting Standards Board recently adopted the previously proposed regulations that will eliminate the ability to account for share-based compensation transactions using the intrinsic method that we currently use and generally would require that such transactions be accounted for using a fair-value-based method and recognized as an expense in our consolidated statement of operations. We will be required to expense stock options effective in periods after January 1, 2006. Currently, we generally only disclose such expenses on a pro forma basis in the notes to our consolidated financial statements in accordance with accounting principles generally accepted in the United States. The adoption of this new accounting regulation will have a significant impact on our results of operations and our stock price could decline accordingly.

Exchange rate fluctuations could cause a decline in our financial condition and results of operations

While we generally invoice our foreign sales in U.S. dollars, we invoice some of our sales in Europe in Euros and other sales in the United Kingdom, Belgium, Canada, Japan, Hong Kong, Korea and China in local currencies. Since we have also elected to take payment from our customers in local currencies and may elect to take payment in other foreign currencies in the future, we are exposed to losses as the result of foreign currency fluctuations. We currently do not engage in foreign currency hedging transactions. We may in the future choose to limit our exposure by the purchase of forward foreign exchange contracts or through similar hedging strategies. No currency hedging strategy can fully protect against exchange-related losses. In addition, if the relative value of the U.S. dollar in comparison to the currency of our foreign customers should increase, the resulting effective price increase of our products to those foreign customers could result in decreased sales.

Furthermore, foreign countries may decide to prohibit, terminate or delay the construction of new broadband infrastructures for a variety of reasons. These reasons include environmental issues, economic downturns and availability of favorable pricing for other communications services or the availability and cost of related equipment. Any such action by foreign countries would reduce the market for our products.

Our stock price has been and is likely to continue to be highly volatile

The trading price of our common stock has been and is likely to continue to be highly volatile. Our stock price could be subject to extreme fluctuations in response to a variety of factors, including the following:

- actual or anticipated variations in quarterly operating results;
- announcements of technological innovations;
- new products or services offered by us or our competitors;
- changes in financial estimates by securities analysts;
- conditions or trends in the broadband services industry;
- changes in the economic performance and/or market valuations of Internet, online service or broadband service industries;
- our announcement of significant acquisitions, strategic partnerships, joint ventures or capital commitments;
- adoption of industry standards and the inclusion or compatibility of our technology with such standards;
- adverse or unfavorable publicity regarding us or our products;
- additions or departures of key personnel;
- sales of common stock; and
- other events or factors that may be beyond our control.

In addition, the stock markets in general, and the Nasdaq National Market and the stock price of broadband services and technology companies in particular, have experienced extreme price and volume volatility. This volatility and decline has affected many companies irrespective of or disproportionately to the operating performance of these companies. Additionally, industry factors may materially adversely affect the market price of our common stock, regardless of our actual operating performance.

We have adopted a stockholder rights plan, which, together with provisions in our charter documents and Delaware law, may delay or prevent an acquisition of us, which could decrease the value of our stock

We adopted a stockholder rights plan pursuant to which we distributed one right for each outstanding share of common stock held by stockholders of record as of February 20, 2001. Because the rights may substantially dilute the stock ownership of a person or group attempting a take-over of us, even if such a change in control is beneficial to our stockholders, without the approval of our board of directors, the plan could make it more difficult for a third party to acquire us, or a significant percentage of our outstanding capital stock, without first negotiating with our board of directors. Additionally, provisions of our Certificate of Incorporation and our Bylaws could make it more difficult for a third party to acquire control of us in a transaction not approved by our Board of Directors, and we are subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law, which could also have the effect of delaying or preventing our acquisition by a third party.

We rely on complex information technology systems and networks to operate our business. Any significant system or network disruption could have a material adverse impact on our operations, sales and operating results

We rely on the efficient and uninterrupted operation of complex information technology systems and networks. All information technology systems are potentially vulnerable to damage or interruption from a variety of sources, including but not limited to computer viruses, security breach, energy blackouts, natural disasters, terrorism, war and telecommunication failures. There also may be system or network disruptions if new or upgraded business management systems are defective or are not installed properly. We have implemented various measures to manage our risks related to system and network disruptions, but a system failure or security breach could negatively impact our operations and financial results. In addition, we may incur additional costs to remedy the damages caused by these disruptions or security breaches.

We are vulnerable to earthquakes, disruptions to our power supply, labor issues and other unexpected events

Our corporate headquarters, as well as the majority of our research and development activities and some manufacturing operations are located in California, an area known for seismic activity. In addition, the operations of some of our key suppliers and manufacturers are also located in this area and in other areas known for seismic activity, such as Taiwan. An earthquake, or other significant natural disaster, could result in an interruption in our business or the operations of one or more of our key suppliers. Our California operations may also be subject to disruptions in power supply, such as those that occurred in 2001. Our business may also be impacted by labor issues related to our operations and/or those of our suppliers, service providers, or customers. Such an interruption could harm our operating results. We may not carry sufficient business interruption insurance to compensate for any losses that we may sustain as a result of any natural disasters or other unexpected events.

Our independent auditors recently notified us of their intention to resign, and our business will be harmed if we are unable to retain a replacement auditing firm in a timely manner.

On July 26, 2005, Ernst & Young LLP informed us that they will resign as our independent registered public accounting firm following the earlier of the completion of services related to the review of our interim financial statements for the quarter ending September 30, 2005 or the filing due date of that quarterly report. The Audit Committee of our Board of Directors has begun the process of considering other national and regional independent accounting firms to replace Ernst & Young LLP, with the goal of selecting a replacement firm prior to the end of this fiscal year, but we are unable to predict when a replacement will be retained. The failure to do so in a timely manner, and any transition issues or other disruptions caused by the resignation of Ernst & Young LLP or the retention of a new independent accounting firm, could make it more difficult or impossible for us to raise capital or effect other corporate transactions, could otherwise disrupt our business, and could cause us to incur additional costs and expenses, any of which could have a materially adverse effect on our business and the value of our common stock.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk.

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. The primary objective of our investment activities is to preserve principal while maximizing yields without significantly increasing risk. This is accomplished by investing in widely diversified short-term investments, consisting primarily of investment grade securities, substantially all of which mature within the next twenty-four months. A hypothetical 50 basis point increase in interest rates would result in an approximate $432,000 decline (less than 1%) in the fair value of our available-for-sale securities.

Foreign Currency Risk.

A substantial majority of our revenue, expense and capital purchasing activity are transacted in U.S. dollars. However, we do enter into transactions from Belgium, United Kingdom, Hong Kong and Canada denominated in local currencies. A hypothetical adverse change of 10% in exchange rates would result in an increase in loss of income before taxes of approximately $34,000.

All of the potential changes noted above are based on sensitivity analyses performed on our financial positions at June 30, 2005. Actual results may differ materially.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures.

Under the supervision and with the participation of our senior management, including our CEO and CFO, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of June 30, 2005. Based on that evaluation, as of the date of the evaluation, our management, including our CEO and CFO, concluded that our disclosure controls and procedures were effective as of June 30, 2005.

In the first quarter of 2005, we identified material weaknesses described below. Following the first quarter of 2005, we remediated these material weaknesses, as further described below. Additionally as disclosed in our 2004 Annual Report on Form 10-K, we identified two material weaknesses in the evaluation of our disclosure controls and procedures as of December 31, 2004. The first material weakness related to the identification, capture, and timely communication of financially significant information between certain parts of our organization and the finance department. The second material weakness related to our procedures and controls over the preparation and review of the Annual Report on Form 10-K.

As part of the evaluation of our disclosure controls and procedures as of June 30, 2005, we determined that we have remediated the material weakness related to our procedures and controls over the preparation and review of our consolidated financial statements and accompanying footnote disclosures contained in this Quarterly Report on Form 10-Q. The insufficient controls, which were originally identified during the preparation of the Annual Report on Form 10-K, included a lack of sufficient personnel with technical accounting expertise in our finance department and inadequate review and approval procedures to prepare external financial statements in accordance with GAAP. As a result of the new procedures and controls we implemented for the preparation and review of this Quarterly Report on Form 10-Q and the remediation steps described below, we believe we have remediated this material weakness. Senior management will continue to monitor the technical accounting expertise of finance personnel staff closely to ensure that adequate review and approval of our financial statements is maintained.

During their review of our interim financial results for the three months ended March 31, 2005, our independent registered public accounting firm identified two significant adjustments to our financial statements as part of their quarterly review procedures. These two adjustments were the result of the continued lack of communication within the Company with regards to certain severance obligations and our policy for the allowance for doubtful accounts. These two adjustments were corrected prior to the issuance of our financial statements for the three months ended March 31, 2005. As part of an evaluation we conducted at June 30, 2005, we determined, however, that we have completed implementation of the changes we believe are required to remediate the previously reported material weakness related to the inadequacy of communication between our senior management and the finance department, which caused these two adjustments.

Remediation Steps

During the quarter ended June 30, 2005 and through to the date of the filing of this Form 10-Q, and in response to the material weaknesses identified as of December 31, 2004 and March 31, 2005, we implemented the following steps to remediate the deficiencies in our disclosure controls and procedures and material weaknesses in our internal control over financial reporting.

(i) Established procedures to document the review of press releases to account for transactions in a complete and timely manner;

(ii) Engaged the former Assistant Controller, who has significant SEC reporting experience, to serve as our Controller, in part to supervise our financial reporting to ensure compliance with SEC requirements;

(iii) Promoted our Consolidations Reporting Manager to Director of Accounting to provide greater individual management of all accounting functions; and

(iv) Improved our internal process of drafting and reviewing periodic reports by implementing additional management and external legal counsel review prior to their submission to our independent registered public accounting firm.

47

Moreover, we implemented the following additional remediation steps to address the material weakness related to the inadequacy of communication between our senior management and the finance department;

(i) Continue to monitor the communication channels between our senior management and our finance department and take prompt action, as necessary, to further strengthen these communication channels;

(ii) Increase staffing in the finance department;

(iii) Re-allocate duties to persons within the finance organization to maximize their skills and experience;

(iv) Implement training procedures for new employees and/or consultants in the finance department on our disclosure procedures and controls, our Company and our actions in previous reporting periods; and

(v) Take steps to ensure that our senior management has timely access to all material financial and non-financial information concerning our business.

Changes in internal control over financial reporting. Other than as described above, there has been no change in our internal control over financial reporting during our most recently completed fiscal quarter that has materially affected or is likely to materially affect our internal control over financial reporting.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Beginning in April 2000, several plaintiffs filed class action lawsuits in federal court against us and certain of our officers and directors. Later that year, the cases were consolidated in the United States District Court, Northern District of California as In re Terayon Communication Systems, Inc. Securities Litigation. The Court then appointed lead plaintiffs who filed an amended complaint. In 2001, the Court granted in part and denied in part defendants motion to dismiss, and plaintiffs filed a new complaint. In 2002, the Court denied defendants motion to dismiss that complaint, which, like the earlier complaints, alleges that the defendants violated the federal securities laws by issuing materially false and misleading statements and failing to disclose material information regarding our technology. On February 24, 2003, the Court certified a plaintiff class consisting of those who purchased or otherwise acquired our securities between November 15, 1999 and April 11, 2000.

On September 8, 2003, the Court heard defendants motion to disqualify two of the lead plaintiffs and to modify the definition of the plaintiff class. On September 10, 2003, the Court issued an order vacating the hearing date for the parties summary judgment motions, and, on September 22, 2003, the Court issued another order staying all discovery until further notice and vacating the trial date, which had been November 4, 2003.

On February 23, 2004, the Court issued an order disqualifying two of the lead plaintiffs. The order also states that plaintiffs counsel must provide certain information to the Court about counsel s relationship with the disqualified lead plaintiffs, and it provides that defendants may serve certain additional discovery. On March 24, 2004, plaintiffs submitted certain documents to the Court in response to its order, and, on April 16, 2004, we responded to this submission. We have also initiated discovery pursuant to the Court s February 23, 2004 order.

On October 16, 2000, a lawsuit was filed against us and the individual defendants (Zaki Rakib, Selim Rakib and Raymond Fritz) in the California Superior Court, San Luis Obispo County. This lawsuit is titled Bertram v. Terayon Communications Systems, Inc. The factual allegations in the Bertram complaint were similar to those in the federal class action, but the Bertram complaint sought remedies under state law. Defendants removed the Bertram case to the United States District Court, Central District of California, which dismissed the complaint and transferred the case to the United States District Court, Northern District of California. That Court eventually issued an order dismissing the case. Plaintiffs have appealed this order, and their appeal was heard on April 16, 2004. On June 9, 2004, the United States Court of Appeals for the Ninth Circuit affirmed the order dismissing the Bertram case.

The Court of Appeals opinion affirming dismissal of the Bertram case does not end the class action. We believe that the allegations in the class action are without merit, and we intend to contest this matter vigorously. This matter, however, could prove costly and time consuming to defend, and there can be no assurances about the eventual outcome.

In 2002, two shareholders filed derivative cases purportedly on behalf of us against certain of our current and former directors, officers, and investors. (The defendants differed somewhat in the two cases.) Since the cases were filed, the investor defendants have been dismissed without prejudice, and the lawsuits have been consolidated as Campbell v. Rakib in the California Superior Court, Santa Clara County. We are a nominal defendant in these lawsuits, which allege claims relating to essentially the same purportedly misleading statements that are at issue in the pending securities class action. In the securities class action, we dispute making any misleading statements. The derivative complaints also allege claims relating to stock sales by certain of the director and officer defendants.

We believe that there are many defects in the Campbell and O Brien derivative complaints.

In January 2005, Adelphia Corporation (Adelphia) sued us in the District Court of the City and County of Denver, Colorado. Adelphia s complaint alleges, among other things, breach of contract and misrepresentation in connection with our sale of CMTS products to Adelphia and our announcement to cease future investment in the CMTS market. Adelphia seeks damages in excess of $25.0 million and declaratory relief. We moved to dismiss the complaint seeking an order blocking the case from going forward at a preliminary stage. The court denied our motion to dismiss the complaint, thereby permitting the case and discovery to go forward. We filed our response to Adelphia s complaint and discovery has begun. The case is currently set for trial to commence on May 15, 2006. As we believe that Adelphia s allegations are without merit, we intend to contest this matter vigorously. This matter, however, could prove costly and time consuming to defend, and there can be no assurances about the eventual outcome. Were an unfavorable ruling to occur in this legal matter, there exists the possibility of a material adverse impact on our results of operations for the period in which the ruling occurs.

We have received letters claiming that our technology infringes the intellectual property rights of others. We have consulted with our patent counsel and are in the process of reviewing the allegations made by such third parties. If these allegations were submitted to a court, the court could find that our products infringe third party intellectual property rights. If we are found to have infringed third party rights, we could be subject to substantial damages and/or an injunction preventing us from conducting our business. In addition, other third parties may assert infringement claims against us in the future. A claim of infringement, whether meritorious or not, could be time-consuming, result in costly litigation, divert our management s resources cause product shipment delays or require us to enter into royalty or licensing arrangements. These royalty or licensing arrangements may not be available on terms acceptable to us, if at all.

Furthermore, we have in the past agreed to, and may from time to time in the future agree to, indemnify a customer of ours technology or products for claims against the customer by a third party based on claims that our technology or products infringe intellectual property rights of that third party. These types of claims, meritorious or not, can result in costly and time-consuming litigation; divert management s attention and other resources; require us to enter into royalty arrangements; subject us to damages or injunctions restricting the sale of our products; require us to indemnify our customers for the use of the allegedly infringing products; require us to refund payment of allegedly infringing products to our customers or to forgo future payments; require us to redesign certain of our products; or damage our reputation, any one of which could materially and adversely affect our business, results of operations and financial condition.

We may, in the future, take legal action to enforce our patents and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could negatively affect our business, operating results, financial position and liquidity.

We are currently a party to various other legal proceedings, in addition to those noted above, and may become involved from time to time in other legal proceedings in the future. While we currently believe that the ultimate outcome of these other proceedings, individually and in the aggregate, will not have a material adverse effect on our financial position or overall results of operations, litigation is subject to inherent uncertainties. Were an unfavorable ruling to occur in any of our legal proceedings, there exists the possibility of a material adverse impact on our results of operations for the period in which the ruling occurs. The estimate of the potential impact on our financial condition and financial position and overall results of operations for any of the above legal proceedings could change in the future.

ITEM 5. OTHER INFORMATION

On July 26, 2005, we were advised by Ernst & Young LLP (Ernst & Young) that Ernst & Young will resign as our independent registered public accounting firm following the earlier of the completion of services related to the review of our interim financial statements for the quarter ending September 30, 2005 or the filing due date of that quarterly report. We filed a Form 8-K on August 1, 2005, reporting the foregoing.

The reports of Ernst & Young on our financial statements as of and for the years ended December 31, 2004 and 2003 did not contain an adverse opinion or a disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope, or accounting principles.

ITEM 6. EXHIBITS

Exhibit Number	Exhibit Description
10.22	Employment Agreement dated July 22, 2005 between Terayon Communication Systems, Inc. and Jerry D. Chase
10.23	Employment Agreement dated July 22, 2005 between Terayon Communication Systems, Inc. and Mark A. Richman
10.24	Employment Agreement dated July 27, 2005 between Terayon Communication Systems, Inc. and Matthew J. Aden.
10.26	Proprietary Information and Inventions Agreement dated July 27, 2005 between Terayon Communication Systems, Inc. and Matthew J. Aden.
31.1	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1	Certification of the Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

Table of Contents

SIGNATURES

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

Date: August 9, 2005	TERAYON COMMUNICATION SYSTEMS, INC.
	By /s/ Mark A. Richman
	Mark A. Richman Chief Financial Officer

Exhibit Index

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