

TERAYON COMMUNICATION SYSTEMS

Form 10-Q

November 10, 2003

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

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**FORM 10-Q**

☒ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934**

**FOR THE QUARTERLY PERIOD ENDED September 30, 2003  
OR**

☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**

**FOR THE TRANSITION PERIOD FROM \_\_\_\_\_ TO \_\_\_\_\_.**

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**TERAYON COMMUNICATION SYSTEMS, INC.**

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

**DELAWARE**  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

77-0328533  
(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)

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ☒ No ☐

Indication by check mark whether the registrant is an accelerated file (as defined by Rule 12b-2 of the Exchange Act) Yes ☒ No ☐

As of October 31, 2003, registrant had outstanding 74,875,623 shares of Common Stock.

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**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; the effect of GAAP accounting pronouncements on our recognition of revenues; 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; and future profitability. We usually use words such as "may," "will," "should," "expect," "plan," "anticipate," "believe," "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.

**PART I. FINANCIAL INFORMATION**

**ITEM 1. FINANCIAL STATEMENTS**

TERAYON COMMUNICATION SYSTEMS, INC.  
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## TERAYON COMMUNICATION SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS  
(in thousands)

	September 30, 2003	December 31, 2002
	(unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 42,438	\$ 117,079
Short-term investments	106,954	89,424
Accounts receivable, net	29,386	16,355
Accounts receivable from related parties	200	842
Inventory	5,508	8,257
Other current assets	7,503	10,860
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Total current assets	191,989	242,817
Property and equipment, net	12,970	17,906
Restricted cash and other assets, net	12,500	14,987
	<hr/>	<hr/>
Total assets	\$ 217,459	\$ 275,710
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 23,330	\$ 23,920
Accrued payroll and related expenses	6,047	6,227
Deferred revenues	2,172	497
Accrued warranty	6,209	8,607
Accrued restructuring	4,837	6,754
Accrued vendor cancellation charges	3,930	13,865
Other accrued liabilities	6,204	8,609
Other current obligations	659	1,509
	<hr/>	<hr/>
Total current liabilities	53,388	69,988
Long-term obligations	3,327	3,499
Convertible subordinated notes	65,081	65,081
Commitments and contingencies		
Stockholders' equity:		
Common stock	75	73
Additional paid in capital	1,080,628	1,078,144
Accumulated deficit	(981,545)	(937,207)
Deferred compensation	(83)	(25)
Treasury stock, at cost	(773)	(773)
Accumulated other comprehensive loss	(2,639)	(3,070)
	<hr/>	<hr/>
Total stockholders' equity	95,663	137,142
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Total liabilities and stockholders' equity	\$ 217,459	\$ 275,710
	<hr/>	<hr/>

See accompanying notes.

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## TERAYON COMMUNICATION SYSTEMS, INC.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2003	2002	2003	2002
Product revenues	\$ 37,168	\$ 23,820	\$ 87,568	\$ 97,449
Related party product revenues	460	655	2,927	6,651
	<u>37,628</u>	<u>24,475</u>	<u>90,495</u>	<u>104,100</u>
Cost of product revenues	27,296	23,632	69,500	72,085
Cost of related party product revenues	138	547	1,262	6,255
	<u>27,434</u>	<u>24,179</u>	<u>70,762</u>	<u>78,340</u>
Total cost of goods sold				
	<u>27,434</u>	<u>24,179</u>	<u>70,762</u>	<u>78,340</u>
Gross profit	10,194	296	19,733	25,760
Operating expenses:				
Research and development	9,363	14,315	32,797	45,959
Sales and marketing	6,452	9,026	19,741	28,020
General and administrative	2,783	4,467	9,510	11,653
Restructuring costs (recovery) and asset write-offs	(244)	4,950	2,803	8,922
	<u>18,354</u>	<u>32,758</u>	<u>64,851</u>	<u>94,554</u>
Total operating expenses				
	<u>18,354</u>	<u>32,758</u>	<u>64,851</u>	<u>94,554</u>
Loss from operations	(8,160)	(32,462)	(45,118)	(68,794)
Interest income	583	1,526	2,394	5,636
Interest expense	(787)	(990)	(2,438)	(5,347)
Other income (expense)	1,238	268	1,038	(4,197)
Gain on early retirement of debt		15,813		49,089
	<u>(7,126)</u>	<u>(15,845)</u>	<u>(44,124)</u>	<u>(23,613)</u>
Loss before income tax expense				
Income tax expense	(84)	(127)	(214)	(134)
	<u>(7,210)</u>	<u>(15,972)</u>	<u>(44,338)</u>	<u>(23,747)</u>
Net loss				
	<u>\$ (7,210)</u>	<u>\$ (15,972)</u>	<u>\$ (44,338)</u>	<u>\$ (23,747)</u>
Net loss per share, basic and diluted	\$ (0.10)	\$ (0.22)	\$ (0.60)	\$ (0.33)
	<u>\$ (0.10)</u>	<u>\$ (0.22)</u>	<u>\$ (0.60)</u>	<u>\$ (0.33)</u>
Shares used in per share calculation, basic and diluted	74,551	73,122	73,994	72,828
	<u>74,551</u>	<u>73,122</u>	<u>73,994</u>	<u>72,828</u>

See accompanying notes.

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## TERAYON COMMUNICATION SYSTEMS, INC.

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

	Nine Months Ended September 30,	
	2003	2002
Operating activities:		
Net loss	\$ (44,338)	\$ (23,747)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	7,155	9,059
Write-off and amortization of intangible assets		3,972
Amortization related to stock options	17	469
Gain on early retirement of debt		(49,088)
Recovery of inventory reserves	(8,138)	(13,111)
Impairment of investment		4,500
Write-off and disposal of fixed assets	497	2,257
Changes in operating assets and liabilities:		
Accounts receivable	(13,031)	20,160
Accounts receivable from related parties	642	3,558
Inventory	12,826	25,102
Other current and non-current assets	5,844	(6,253)
Accounts payable	(590)	(21,701)
Accrued payroll and related expenses	(180)	(3,334)
Deferred revenues	1,675	(2,994)
Accrued warranty	(2,398)	1,733
Accrued restructuring	(1,917)	(762)
Accrued vendor cancellation charges	(11,274)	2,597
Other accrued liabilities	(3,099)	(6,142)
Interest payable	(812)	(2,731)
Net cash used in operating activities	(57,121)	(56,456)
Investing activities:		
Purchases of short-term investments	(200,239)	(236,081)
Proceeds from sales and maturities of short-term investments	182,231	379,966
Purchases of property and equipment	(2,716)	(5,855)
Net cash provided by (used in) investing activities	(20,724)	138,030
Financing activities:		
Principal payments on capital leases	(116)	(94)
Proceeds from issuance of common stock	2,411	3,541
Retirement of debt		(57,627)
Net cash provided (used in) by financing activities	2,295	(54,180)
Effect of exchange rate changes	909	942
Net increase (decrease) in cash and cash equivalents	(74,641)	28,336
Cash and cash equivalents at beginning of period	117,079	100,274
Cash and cash equivalents at end of period	\$ 42,438	\$ 128,610

See accompanying notes.



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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

**1. Organization and Summary of Significant Accounting Policies**

***Description of Business***

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

The Company develops, markets and sells Cable Modem Termination Systems, or CMTSs, customer premise equipment, or CPE, including cable modems and digital video equipment. Our CMTS and CPE products enable cable operators to provision, deliver and manage cost-effective broadband Internet access and voice over Internet Protocol, or VoIP. Our digital video equipment allows cable and satellite operators to provide advanced digital video services to subscribers.

***Basis of Presentation***

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States 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 generally accepted accounting principles in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial statements at September 30, 2003 and for the three and nine months ended September 30, 2003 and 2002 have been included.

Results for the three and nine months ended September 30, 2003 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 27, 2003, as filed with the U.S. Securities and Exchange Commission. The accompanying balance sheet at December 31, 2002 is derived from audited consolidated financial statements at that date.

***Reclassifications***

Certain amounts in the 2002 financial statements have been reclassified to conform to the 2003 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 generally accepted accounting principles in the United States 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. Actual results could differ from those estimates. Areas that are particularly significant include the Company's valuation of its accounts receivable and inventory reserves, the assessment of recoverability and the measurement of impairment of fixed assets, and the recognition of restructuring reserves.

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### Stock-based compensation

The Company accounts for stock-based compensation for its employees using the intrinsic value method presented in Accounting Principles Board, or APB, Statement No. 25, Accounting for Stock Issued to Employees, or APB No. 25, and related interpretations, and complies with the disclosure provisions of Statement of Financial Accounting Standards, or SFAS, Interpretation No. 123, Accounting for Stock-Based Compensation, or SFAS No. 123, and with the disclosure provisions of SFAS No. 148, Accounting for Stock-Based Compensation Transition and Disclosure Amendment of SFAS No. 123. Under APB No. 25, compensation expense is based on the difference, as of the date of the grant, between the fair value of the stock and the exercise price. The Company accounts for stock options issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force, or EITF, Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.

The following table illustrates the effect on net loss and loss per share if the Company had applied the fair value recognition provisions of SFAS No. 123 to stock-based employee compensation (in thousands, except per share amounts):

	Three months ended September 30		Nine months ended September 30,	
	2003	2002	2003	2002
Net loss, as reported	\$ (7,210)	\$ (15,972)	\$ (44,338)	\$ (23,747)
Add: Stock-based compensation under APB 25	9	103	17	469
Deduct: Stock option compensation expense determined under fair value-based method	(5,602)	(8,341)	(17,201)	(27,576)
Employee stock purchase plan compensation expense determined under fair value-based method	(366)	(381)	(1,646)	(1,685)
Pro forma net loss	\$ (13,169)	\$ (24,591)	\$ (63,168)	\$ (52,539)
Pro forma net loss per share, basic and diluted	\$ (0.18)	\$ (0.34)	\$ (0.85)	\$ (0.72)
Shares used in computing pro forma net loss per share, basic and diluted	74,551	73,122	73,994	72,828

### Inventory

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

	September 30, 2003	December 31, 2002
Finished goods	\$4,457	\$5,915
Work-in-process	553	769
Raw materials	498	1,573
	\$5,508	\$8,257



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***Purchase Obligations***

The Company records losses on commitments to purchase inventory in accordance with Statement 10 of Chapter 4 of Accounting Release Bulletin No. 43. The Company's policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires it to perform a detailed assessment of inventory at each balance sheet date which includes a review of, among other factors, an estimate of future demand for products within specific time horizons, generally six months or less as well as product lifecycle and product development plans. Given the rapid technological change in the technology and communications equipment industries as well as significant, unpredictable changes in capital spending by the Company's customers, the Company believes that assessing the value of inventory using generally a six month time horizon is appropriate.

The estimates of future demand that the Company uses in the valuation of inventory are the basis for the revenue forecast, which is also consistent with its short-term manufacturing plan. Based on this analysis, the Company reduces the cost of inventory that it specifically identifies and considers obsolete or excessive to fulfill future sales estimates. The Company defines excess inventory as inventory that will no longer be used in the manufacturing process. Excess inventory is generally defined as inventory in excess of projected usage, and is determined using the Company's best estimate of future demand at the time, based upon information then available.

For the three and nine months ended September 30, 2003, the Company reversed approximately \$2.0 million and \$8.1 million, respectively, of inventory provisions, which were previously recorded as cost of goods sold. For the three and nine months ended September 30, 2002, the Company reversed approximately \$0.6 million and \$13.1 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.

On February 26, 2003, the Company entered into an agreement with Solecron Corporation, or Solecron to settle all outstanding obligations under two manufacturing agreements between the Company and Solecron. Under the terms of the settlement agreement, the Company paid Solecron approximately \$3.9 million, and each party released all claims that it may have had against the other party. Additionally, the Company received selected inventory from Solecron. The Company previously accrued \$6.0 million toward the settlement of the Solecron matter as a vendor cancellation charge in the fourth quarter of 2000 and the second quarter of 2001. In the first quarter of 2003, in connection with the Solecron settlement, the Company reversed \$2.1 million of the accrued vendor cancellation charges.

On September 29, 2003, the Company entered into an agreement with Flextronics (Israel) Ltd., an Israeli company, or Flextronics, to purchase inventory from Flextronics and settle all outstanding claims between the Company and Flextronics. Under the terms of the settlement agreement, the Company paid Flextronics approximately \$1.5 million to be applied toward the purchase of future inventory from Flextronics, if any. Additionally, each party released all claims that it may have had against the other party. The Company previously accrued \$2.0 million toward the settlement of the Flextronics matter as a vendor cancellation charge in the second quarter of 2001. In the third quarter of 2003, in connection with the Flextronics settlement, the Company reversed \$0.5 million of the accrued vendor cancellation charges included in cost of goods sold.

As of September 30, 2003, the Company had \$53.0 million of purchase obligations, of which \$3.9 million are included on the balance sheet as accrued vendor cancellation charges. The remaining obligations are expected to become payable at various times through the first quarter of 2004.

***Net Loss Per Share***

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

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**Three Months Ended  
Septemb**

**Nine Months Ended**