TERAYON COMMUNICATION SYSTEMS
Form 10-Q
November 09, 2004

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTERLY PERIOD ENDED September 30, 2004
OR

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

FOR THE TRANSITION PERIOD FROM_________ TO _________.

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 x No o

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

As of October 31, 2004 registrant had outstanding 76,168,800 shares of Common Stock.

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 negativ 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.

ITEM 1. FINANCIAL STATEMENTS

PART I. FINANCIAL INFORMATION

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TERAYON COMMUNICATION SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	September 30, 2004	December 31, 2003
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 64,150	$ 30,188
Short-term investments	47,757	108,452
Accounts receivable, net	19,752	29,199
Accounts receivable from related parties	723	600
Other current receivables	926	3,662
Inventory	15,529	16,364
Other current assets	2,660	2,883
Total current assets	151,497	191,348
Property and equipment, net	9,134	11,871
Restricted cash	8,727	9,212
Other assets, net	2,138	2,809
Total assets	$ 171,496	$ 215,240
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 11,128	$ 26,049
Accrued payroll and related expenses	4,368	6,537
Deferred revenues	4,345	3,423
Warranty reserves	4,043	5,509
Accrued executive severance and restructuring charges	7,914	4,500
Accrued vendor cancellation charges	2,133	2,869
Other accrued liabilities	4,459	5,036
Interest payable and current portion of long-term debt	542	1,358
Other current obligations		124
Total current liabilities	38,932	55,405
Long-term obligations	3,417	3,366
Convertible subordinated notes	65,081	65,081
Commitments and contingencies		
Stockholders equity:		
Common stock	76	75

Additional paid in capital	1,083,420	1,082,036
Accumulated deficit	(1,016,188)	(987,560)
Deferred compensation		(22)
Treasury stock, at cost	(773)	(773)
Accumulated other comprehensive loss	(2,469)	(2,368)
Total stockholders equity	64,066	91,388
Total liabilities and stockholders equity	$ 171,496	$ 215,240

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,	
	2004	**2003**	**2004**	**2003**
Revenues	$ 35,659	$37,168	$116,218	$ 87,568
Related party revenues	1,543	460	4,933	2,927
Total revenues	37,202	37,628	121,151	90,495
Cost of revenues	30,393	27,296	86,014	69,500
Cost of related party revenues	539	138	1,348	1,262
Total cost of revenues	30,932	27,434	87,362	70,762
Gross profit	6,270	10,194	33,789	19,733
Operating expenses:				
Research and development	8,696	9,363	26,680	32,797
Sales and marketing	6,222	6,452	18,854	19,741
General and administrative	2,993	2,783	8,381	9,510
Executive severance, restructuring costs and asset write-offs	1,463	(244)	8,409	2,803
Total operating expenses	19,374	18,354	62,324	64,851
Loss from operations	(13,104)	(8,160)	(28,535)	(45,118)
Interest income	525	583	1,437	2,394
Interest expense	(812)	(787)	(2,456)	(2,438)
Other income (expense)	(46)	1,238	1,155	1,038
Loss before income tax expense	(13,437)	(7,126)	(28,399)	(44,124)
Income tax expense	(83)	(84)	(229)	(214)
Net loss	$(13,520)	$ (7,210)	$ (28,628)	$(44,338)

Net loss per share, basic and diluted	$ (0.18)	$ (0.10)	$ (0.38)	$ (0.60)
Shares used in per share calculation, basic and diluted	76,164	74,551	75,744	73,994

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,	
	2004	**2003**
Operating activities:		
Net loss	$ (28,628)	$ (44,338)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	4,788	7,155
Amortization related to stock options	17	17
Lower of cost or market inventory reserve (recovery)	6,432	(8,138)
Write-off and disposal of fixed assets	210	497
Changes in operating assets and liabilities:		
Accounts receivable, net	9,447	(13,031)
Accounts receivable from related parties	(123)	642
Inventory	(5,597)	12,826
Other current and non-current assets	4,116	5,844
Accounts payable	(14,921)	(590)
Accrued payroll and related expenses	(2,169)	(180)
Deferred revenues	922	1,675
Warranty reserves	(1,466)	(2,398)
Accrued executive severance and restructuring charges	3,414	(1,917)
Accrued vendor cancellation charges	(736)	(11,274)
Other accrued liabilities.	(1,338)	(3,911)
Net cash used in operating activities	(25,632)	(57,121)
Investing activities:		
Purchases of short-term investments	(77,748)	(200,239)
Proceeds from sales and maturities of short-term investments	138,160	182,231
Purchases of property and equipment	(2,261)	(2,716)
Net cash provided by (used in) investing activities	58,151	(20,724)
Financing activities:		
Principal payments on capital leases	(128)	(116)
Proceeds from issuance of common stock	1,390	2,411

Net cash provided by financing activities	1,262	2,295
Effect of exchange rate changes	181	909
Net increase (decrease) in cash and cash equivalents	33,962	(74,641)
Cash and cash equivalents at beginning of period	30,188	117,079
Cash and cash equivalents at end of period	$ 64,150	$ 42,438

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 the 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, manufactures, markets and sells equipment to broadband service providers who use the Company s products to deliver broadband voice, video and data services to residential and business subscribers.

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 financial statements at September 30, 2004 and for the three and nine months ended September 30, 2004 and 2003 have been included.

Results for the three and nine months ended September 30, 2004 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, 2004, as filed with the U.S. Securities and Exchange Commission. The accompanying balance sheet at December 31, 2003 is derived from audited consolidated financial statements at that date.

Reclassifications

Certain amounts in the 2003 financial statements have been reclassified to conform to the 2004 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. 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 warranty and 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 (APB) Opinion No. 25, Accounting for Stock Issued to Employees, (APB No. 25), and includes the disclosure-only provisions as required under Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock-Based Compensation (SFAS No. 123). The Company provides additional pro forma disclosures as required under SFAS No. 123 and SFAS No. 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 No. 123, the Company s net loss applicable to common stockholders and net loss per share applicable to common stockholders would have been increased to the pro forma amounts indicated below (in thousands, except per share data):

	Three months ended September 30,		Nine months ended September 30,	
	2004	**2003**	**2004**	**2003**
Net loss, as reported	$(13,520)	$ (7,210)	$(28,628)	$(44,338)
Add: Stock-based compensation under APB No. 25		9	17	17
Deduct: Stock option compensation expense determined under fair value-based method	(3,071)	(5,602)	(11,284)	(17,201)
Employee stock purchase plan compensation expense determined under fair value-based method	(159)	(366)	(872)	(1,646)
Pro forma net loss	$(16,750)	$(13,169)	$(40,767)	$(63,168)
Net loss per share, basic and diluted, as reported	$ (0.18)	$ (0.10)	$ (0.38)	$ (0,60)
Pro forma net loss per share, basic and diluted	$ (0.22)	$ (0.18)	$ (0.54)	$ (0.85)
Shares used in computing pro forma net loss per share, basic and diluted	76,164	74,551	75,744	73,994

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, 2004	December 31, 2003
Raw materials	$ 683	$ 1,440
Work-in-process	159	660
Finished goods	14,687	14,264
Total inventory	$15,529	$16,364

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During the three and nine months ended September 30, 2004, the Company reversed approximately $0.6 million and $1.9 million, respectively, of inventory reserves, which were previously recorded as cost of goods sold. During the three and nine months ended September 30, 2003, the Company reversed approximately $1.0 million and $2.7 million, respectively of inventory reserves. The Company reversed these reserves as it was able to sell inventory originally considered to be excess or obsolete.

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 September 30, 2004, $26.5 million of purchase obligations were outstanding. The Company accrues for vendor cancellation charges in amounts, which represent management s estimate of the Company s exposure to vendors when management curtails or ceases production of certain products or terminates a vendor or supplier agreement. Estimates of exposure are determined using vendor inventory data. At September 30, 2004, accrued vendor cancellation charges were $2.1 million and the remaining $24.4 million was attributable to open purchase orders in the normal course of business. The remaining obligations are expected to become payable at various times through the first quarter of 2005. For the three and nine months ended September 30, 2004, the Company reversed approximately $23,000 and $3.4 million, respectively, of vendor cancellation charges. For the three and nine months ended September 30, 2003, the Company reversed $1.0 million and $5.4 million, respectively, of accrued vendor cancellation charges. The Company reversed these amounts as a result of favorable negotiations with vendors.

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):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net loss	$(13,520)	$ (7,210)	$(28,628)	$(44,338)
Shares used in computing basic and diluted net loss per share	76,164	74,551	75,744	73,994
Basic and diluted net loss per share	$ (0.18)	$ (0.10)	$ (0.38)	$ (0.60)

Options and warrants to purchase 17,664,919 and 17,634,021 shares of common stock were outstanding at September 30, 2004 and September 30, 2003, respectively, but were not included in the computation of diluted net

loss per share, since the effect would have been antidilutive.

Accumulated Other Comprehensive Loss

Accumulated other comprehensive loss presented in the accompanying condensed consolidated balance sheets consist 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 September 30,		Nine Months Ended September 30,	
	2004	2003	2004	2003
Net loss	$(13,520)	$(7,210)	$(28,628)	$(44,338)
Cumulative translation adjustments	(188)	360	180	910
Change in unrealized loss on available- for-sale investments	252	(67)	(282)	(478)
Total comprehensive net loss	$(13,456)	$(6,917)	$(28,730)	$(43,906)

Impact of Recently Issued Accounting Standards

In March 2004, the FASB issued a proposed Statement, Share-Based Payment, an amendment of FASB Statements Nos. 123 and 95, that addresses the accounting for share-based payment transactions in which a Company receives employee services in exchange for either equity instruments of the Company or liabilities that are based on the fair value of the Company s equity instruments or that may be settled by the issuance of such equity instruments. The proposed statement would eliminate the ability to account for share-based compensation transactions using the intrinsic method that the Company currently uses and generally would require that such transactions be accounted for using a fair-value-based method and recognized as expense in the consolidated statement of operations. The effective date of the proposed standard is for periods beginning after June 15, 2005. It is expected that the final standard will be issued before December 31, 2004 and should it be finalized in its current form, it will have a significant impact on the Company s consolidated statement of operations as the Company will be required to expense the fair value of stock option grants.

2. Contingencies

Beginning in April 2000, several plaintiffs filed class action lawsuits in federal court against the Company and certain of its 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

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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 also has initiated discovery pursuant to the Court s February 23, 2004 order.

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 the Company 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 the Company s 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 *Campbell* and *O Brien* derivative complaints.

On January 19, 2003, Omniband Group Limited, a Russian company, or Omniband, filed a request for arbitration with the Zurich Chamber of Commerce, claiming damages in an amount of $2,094,970 allegedly caused by the Company s breach of an agreement to sell to Omniband certain equipment pursuant to an agreement between Omniband and Radwiz, Ltd., one of the Company s wholly-owned subsidiaries. On December 18, 2003, the panel of arbiters with the Zurich Chamber of Commerce allowed the arbitration proceeding to continue against Radwiz. Omniband appealed the Zurich Chamber of Commerce s decision, which was affirmed in its ruling of October 15, 2004. The Company believes that the allegations are without merit and intends to present a vigorous defense in the arbitration proceedings.

From time to time, the Company receives letters claiming that the Company s technology and products may infringe on intellectual property rights of third parties. The Company also 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 the Company s 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 the Company s reputation, any one of which could materially and adversely affect the Company s

business, results of operations and financial condition.

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 other 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 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.

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3. Operating Segment Information

The Company operates as one business segment.

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands)	**2004**	**2003**	**2004**	**2003**
Revenues by product:				
CMTS products	$ 6,492	$16,825	$ 27,917	$29,979
CPE products	18,899	15,654	67,658	46,320
Video products	10,802	4,577	24,381	11,109
Other products	1,009	572	1,195	3,087
Total revenues	$37,202	$37,628	$121,151	$90,495
Revenues by geographic areas:				
United States	$25,130	$16,653	$ 68,188	$47,832
Canada	401	370	2,239	1,106
Europe, Middle East, Africa Region (EMEA), excluding Israel	3,379	5,173	18,344	15,873
Israel	1,663	638	10,879	1,449
Japan	3,876	11,047	9,563	17,859
Asia, excluding Japan	2,743	3,246	11,875	5,856
South America	10	501	63	520
Total	$37,202	$37,628	$121,151	$90,495

	September 30,	December 31,
	2004	**2003**
Long-lived assets:		
United States	$ 15,874	$ 19,630
Canada	494	810
Europe	157	175
Israel	3,344	3,104
Asia	130	173
Total long-lived assets	19,999	23,892

Total current assets	151,497	191,348
Total assets	$171,496	$215,240

Three customers accounted for 10% or more of total revenues (20%, 15%, and 14%) for the three months ended September 30, 2004. Two customers accounted for 10% or more of total revenues (21% and 11%) for the nine months ended September 30, 2004. Three customers accounted for 10% or more of total revenues (29%, 13%, and 13%) for the three months ended September 30, 2003. Three customers accounted for 10% or more of total revenues (20%, 17%, and 12%) for the nine months ended September 30, 2003.

4. Executive Severance, Restructuring Charges and Asset Write-offs

Executive Severance

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In June 2004, the Company entered into an employment agreement with an executive officer. The executive officer resigned effective as of October 1, 2004. The Company recorded a severance provision of $1.4 million related to termination costs for this officer in the third quarter of 2004. Most of the separation costs related to this officer are expected to be paid in the fourth quarter of 2004 with nominal amounts for employee benefits paid into the fourth quarter of 2005.

In June 2004, the Company entered into separation agreements with two other executive officers. Both executive officers resigned from the Company during the third quarter of 2004. The Company recorded a severance provision of $1.7 million related to termination costs for these officers in the second quarter of 2004. Most of the separation costs were paid in the third quarter of 2004 with nominal amounts for employee benefits paid through the third quarter of 2005.

Restructuring

First and Second Quarter 2004 Restructurings

During the first quarter of 2004, the Company approved a restructuring plan. The Company incurred restructuring charges in the amount of $3.3 million in the first quarter of 2004, of which $1.0 million related to employee termination costs, $0.9 million related to costs to exit an aircraft lease, and $1.4 million related to costs for excess leased facilities. The Company incurred restructuring charges in the amount of $1.15 million in the second quarter of 2004 related to additional costs for excess leased facilities, which were contemplated in the first quarter restructuring plan. Net costs accrued under this restructuring plan, included estimated sublease income from the aircraft and the excess leased facilities. As of September 30, 2004, the employment of 58 employees had been terminated, and the Company had paid $0.8 million in termination costs. The amount of net costs accrued under the first quarter 2004 restructuring plan assumed that the Company would successfully sublease the aircraft and excess leased facilities. The reserve for the aircraft lease and excess leased facilities was based on information provided by the Company s brokers that estimated, based on assumptions relevant to the aircraft and real estate market conditions as of the date of the Company s restructuring plan, the time it would likely take to fully sublease the aircraft and excess facilities. In the third quarter of 2004, the Company entered into an agreement with a third party to sublease the aircraft. Even though it is the intent of the Company to sublease its interests in the excess facilities at the earliest possible time, the Company cannot determine with certainty a fixed date by which this event may occur. In light of this uncertainty, based on estimates, the Company periodically re-evaluates and adjusts the reserve, as necessary. The Company currently anticipates the remaining restructuring accrual related to employee termination costs to be substantially utilized by the end of 2004. The remaining restructuring accrual related to the aircraft lease is expected to be substantially utilized for servicing operating lease payments of operating lease commitments, through January 2007, and the remaining restructuring accrual related to excess leased facilities, is expected to be utilized for servicing operating lease payments through October 2009.

In the second and third quarters of 2004, the Company re-evaluated the first and second quarter 2004 restructuring charges for the excess facilities and the aircraft lease termination. Based on market conditions, new assumptions provided by the Company s broker, and the terms of the aircraft sublease agreement, which the Company entered into in the third quarter of 2004, the Company increased the restructuring charge by a total of $0.85 million in the nine months ended September 30, 2004.

A summary of the first and second quarter 2004 accrued restructuring charges is as follows (in thousands):

	Involuntary	Aircraft Lease	Excess Leased

	Terminations	Termination	Facilities	Total
Total charge for the first quarter of 2004	$ 952	$ 934	$ 1,375	$ 3,261
Additional charges for the second quarter of 2004			1,148	1,148
Cash payments	(795)	(947)	(549)	(2,291)
Revaluation		899	(54)	845
Balance at September 30, 2004	$ 157	$ 886	$ 1,920	$ 2,963

2003 Restructuring

During the first quarter of 2003, a restructuring plan was approved. The Company incurred restructuring charges in the amount of $2.7 million related to employee termination costs. All accrued restructuring costs related to the 2003 restructuring had been paid as of December 31, 2003.

2002 and 2001 Restructurings

During 2001, a restructuring plan was approved and the Company incurred restructuring charges in the amount of $12.7 million of which $2.3 million remained accrued at September 30, 2004, for excess leased facilities. During 2002, another restructuring plan was approved, which increased the reserve for excess leased facilities due to the exiting of additional space within the same facility. The Company incurred restructuring charges in the amount of $3.6 million for the 2002 restructuring of which $1.2 million remained accrued at September 30, 2004 for excess leased facilities. The Company currently anticipates the remaining restructuring accrual relating to excess leased facilities, will be utilized for servicing operating lease payments or negotiating a buyout of operating lease commitments, through 2005.

The following table summarizes the costs and activities during 2004, related to the 2002 and 2001 restructuring (in thousands):

	Excess Leased Facilities
Balance at December 31, 2003	$ 4,500
Cash Payments	(940)
Balance at September 30, 2004	$ 3,560

Asset Write-offs

For the nine months ended September 30, 2004, the Company wrote off $0.1 million, of fixed assets, which were determined to have no remaining useful life. For the nine months ended September 30, 2003, the Company wrote off $0.4 million of fixed assets, which were determined to have no remaining useful life. For the three months ended September 30, 2003, the Company wrote off $17,000 of fixed assets, which were determined to have no remaining useful life. The Company did not write-off any fixed assets during the three months ended September 30, 2004.

5. Related Party Transactions

Lewis Solomon, a member of the Company s Board of Directors and a member of the Company s Nominating and Governance Committee and Compensation Committee, 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 three and nine months ended September 30, 2004, related party revenue included $1.5 million and $4.9 million, respectively, of revenue from Harmonic. For the three and nine months ended September 30, 2003, related party revenue included $0.5 million and $1.5 million, respectively, of revenue from Harmonic.

Alek Krstajic, a member of the Company s Board of Directors, was the Senior Vice President of Interactive Services, Sales and Product Development for Rogers Communications, Inc. (Rogers) until January 2003. Beginning

April 1, 2003, the Company no longer recognized revenues related to Rogers as related party revenue because Rogers was no longer considered to be a related party. For the first quarter of 2003, the Company recognized $1.4 million of Rogers s related party revenue, net of amortization of co-marketing expense.

In the nine months ended September 30, 2004, the Company paid Mr. Krstajic $30,000 for consulting services provided to the Company.

In December 2001, the Company entered into a co-marketing arrangement with Rogers to promote the Company s brand its products. The Company paid $0.9 million to Rogers, and recorded this amount as other current assets. In July 2002, the Company began amortizing this prepaid asset and

charging it against revenue in accordance with the Emerging Issues Task Force 01-09, Accounting for Consideration given by a Vendor to a Customer or Reseller in Connection with the Purchase or Promotion of the Vendor s Products. Amounts charged against revenues in the three and nine months ended September 30, 2003, totaled approximately $1.4 million and $4.2 million, respectively. This asset was fully amortized during 2003.

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 $0.7 million at September 30, 2004. None of the related parties is a supplier to the Company.

6. Sale of Assets

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 $0.15 million. 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.

7. Product Warranties

The Company provides for estimated product warranty expenses when it sells the related products. Because warranty estimates are forecasts based on the best available information mostly historical claims experience claims costs may differ from amounts provided. An analysis of changes in the liability for product warranties for the nine months ended September 30, 2003 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
Nine months ended September 30, 2003					
Warranty reserve	$ 8,607	1,350		(3,748)	$ 6,209
Nine months ended September 30, 2004					
Warranty reserve	$ 5,509	2,943	(1,829)	(2,580)	$ 4,043

7. Subsequent Event

In October 2004, the Company announced its intention to cease investment in future development of its Cable Modem Termination System (CMTS) product line. In connection with this announcement, the Company initiated a worldwide reduction in force, which is expected to result in a restructuring charge of approximately $3.2 million to $3.6 million in the quarter ending December 31, 2004.

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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 develop manufacture, market and sell cable modem termination systems (CMTS), digital video management systems and customer premise equipment (CPE), including cable modems to broadband service providers who use the Company s products to deliver broadband voice, video and data services to residential and business subscribers. Our revenues have been generated principally from sales of these three major product groups either directly to broadband service providers through direct sales forces primarily in North America, Europe and Asia or indirectly through resellers.

In October 2004, after careful evaluation of our overall product portfolio and strategy, we announced our intention to cease investment in future development of our CMTS product line and halt development on future hardware upgrades. In connection with this action, we initiated a worldwide reduction in force, which is likely to result in a restructuring charge of approximately $3.2 million to $3.6 million in the quarter ending December 31, 2004. Although we currently expect the outcome of this action to generate future savings, we will incur additional material charges associated with our decision to cease investment in the CMTS product line and the currently anticipated employee termination costs may increase, perhaps materially.

Our gross margins fluctuate from period to period primarily as a result of the sales volume and mix of products we sell. Specifically, we derive substantially higher margins from sales of our CMTS and digital video equipment products than we do from sales of our CPE products, which are subject to intense price competition. Due to disappointing CMTS sales in the third quarter, we undertook an evaluation of our overall product portfolio and strategy and decided to cease investing in our current CMTS product line. Moreover, to date a majority of our total revenues have been generated from sales of our CPE products. Historically, erosion of average selling prices (ASPs) of our CPE products has had a negative impact on our gross margins. However, we believe that the decline of ASPs will continue to decline moderately in the future. We are working to mitigate pressures on our gross margins by focusing on increasing sales of our higher margin digital video equipment and by continuing to focus on product manufacturing cost reductions for our CPE products. In the first quarter of 2004, we largely completed our transition to a new original design manufacturer (ODM) in Asia for our CPE products. To the extent that the containment of our product costs do not keep pace with ASP declines, our gross margins will be adversely affected.

We have not been profitable since our inception. For the three and nine months ended September 30, 2004, we had a net loss of $13.5 million and $28.6 million, respectively. We believe our ability to achieve profitability in the long term will depend primarily on three factors. The first factor is our ability to achieve improved gross margins through an improved sales mix by increasing sales of higher margin digital video products relative to the sales of CPE products. To increase sales of digital video products, we are targeting new markets such as the broadcast sector and promoting new applications such as high definition television (HDTV) and digital insertion to cable and satellite operators. To the extent that sales of CPE products continue to comprise a greater proportion of our total revenues, our ability to achieve profitability in the future could be adversely affected. Second, we will continue to focus on lowering product costs for our CPE products through our ODM relationships in Asia. Finally, as discussed below, we expect to benefit from a lower expense base resulting in part from restructuring activities in the first, second and fourth quarters of 2004 combined with continued focus on cost containment. Furthermore, as part of our restructuring efforts, we will continue to divest and cease investment in unprofitable product lines in an effort to focus on growing our business and redirect our resources.

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However, despite these efforts, we may not succeed in attaining profitability in the near future, if at all.

At September 30, 2004, we had approximately $111.9 million in cash, cash equivalents and short-term investments as compared to approximately $138.6 million at December 31, 2003. The decrease in the first nine months of 2004 primarily resulted from the use of cash for operating activities. Although we believe that our current cash balances will be sufficient to satisfy our cash requirements for at least the next 12 months, 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 requirements. There can be no assurance 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.

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 the continued recovery of the communications industry. A more detailed description of the risks to our business can be found in the section captioned Risk Factors .

In the third quarter of 2004, after the resignation of Zaki Rakib, our former Chief Executive Officer, Jerry Chase was appointed as our Chief Executive Officer. During the same period, Arthur Taylor, our Chief Financial Officer, and Douglas Sabella, our Chief Operating Officer, resigned. On October 1, 2004, Shlomo Rakib, our President and Chief Technology Officer, resigned.

Critical Accounting Policies

Inventory Valuation and Purchase Obligations

We record losses on commitments to purchase inventory in accordance with Statement 10 of Chapter 4 of Accounting Research Bulletin No. 43. Our policy for valuation of inventory and commitments to purchase inventory, including the determination of obsolete or excess inventory, requires us to perform a detailed assessment of inventory at each balance sheet date, which assessment includes a review of, among other factors, an estimate of future demand for products within specific time horizons, generally six months 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 our customers and therefore demand for our products, we believe that assessing the value of inventory using generally a six month time horizon is appropriate.

The estimates of future demand that we use in the valuation of inventory are the basis for our revenue forecast, which is also consistent with our short-term manufacturing plan. Based on this analysis, we reduce the cost of inventory that we specifically identify and consider obsolete or excessive to fulfill future sales estimates. We define obsolete 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 our best estimate of future demand at the time, based upon information then available.

We purchase components from a variety of suppliers and use several contract manufacturers to provide manufacturing services for the manufacture of our products. During the normal course of business, in order to manage manufacturing lead times (often ranging from three to six months) and to help ensure adequate component supply, we enter into agreements with contract manufacturers and suppliers that either allow them to procure inventory based upon criteria as defined by us or that establish the parameters defining our component supply requirements. If we were to curtail or cease production of certain products or terminate these agreements, we may be liable for vendor

cancellation charges.

We accrue for vendor cancellation charges (which increase cost of goods sold) which represent management s estimate of our financial exposure to vendors when our management curtails or ceases production of certain products or terminates a vendor or supplier agreement. Estimates of exposure are determined using

vendor inventory data. Should we change our short-term manufacturing plans such that further products or components would no longer be used, additional vendor cancellation charges may occur. At September 30, 2004, accrued vendor cancellation charges were $4.3 million which are expected to become payable in the next three to six months. Historically, we have been able to reverse portions of our vendor cancellation accrual as we were able to negotiate downward certain vendor cancellations to more favorable terms. Such reversals of vendor cancellation charges cause a decrease in cost of goods sold in the period during which such charges are settled. For the three and nine months ended September 30, 2004, we reversed approximately $23,000 and $3.4 million, respectively, of vendor cancellation charges as a result of favorable negotiations with vendors.

There have been no material change to any of our critical accounting policies and estimates as disclosed in our annual report on Form 10-K for the year ended December 31, 2003.

Results of Operations

Three and Nine Months Ended September 30, 2004 and September 30, 2003

Revenues

(in thousands)	For the three months ended September 30,		For the nine months ended September 30,		% Change for the three months ended September 30,	% Change for the nine months ended September 30,
	2004	2003	2004	2003	2004/2003	2004/2003
Revenues	$37,202	$37,628	$121,151	$90,495	(1)%	34%

We sell directly to our customers, principally broadband service providers and broadcasters, and to a lesser extent, indirectly through resellers. Revenues from sales of our products are recognized when: (1) persuasive evidence of a sales arrangement exists, (2) product delivery has occurred or services have been rendered, (3) the selling price is fixed or determinable, and (4) collectibility of revenue is reasonably assured. A provision is made for estimated product returns as product warranty shipments are made. Our existing agreements typically do not grant return rights beyond those provided by our product warranty. Revenue from product sales to resellers are generally recognized when product is shipped as we generally do not grant return rights beyond those provided by the warranty.

Our revenues decreased 1% to $37.2 million for the quarter ended September 30, 2004 compared to $37.6 million in the quarter ended September 30, 2003, primarily due to decreased deployments of our CMTSs by cable operators across all geographics, which decline in CMTS revenue was offset by increased sales of our video products and CPE.

Our revenues increased 34% to $121.2 million for the nine months ended September 30, 2004 compared to $90.5 million for the nine months ended September 30, 2003, primarily due to increased sales of our CPE and video products, and increased sales of our legacy circuit-switch voice product, which increased sales were offset by decreased sales of our CMTS products due to decreased deployments of our CMTSs by cable operators across all geographics. We expect total revenues to continue to decline in the fourth quarter of 2004 compared to the third quarter of 2004 primarily due to a slow-down in the market for our products as well as our decision to cease investment in future development of our CMTS product line.

Revenues by Groups of Similar Products

(in thousands)	For the three months ended September 30,		For the nine months ended September 30,		% Change for the three months ended September 30,	% Change for the nine months ended September 30,
	2004	2003	2004	2003	2004/2003	2004/2003
Revenues by product:						
CMTS products	$6,492	$16,825	$27,917	$29,979	(61)%	(7)%

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(in thousands)	For the three months ended September 30, 2004	For the three months ended September 30, 2003	For the nine months ended September 30, 2004	For the nine months ended September 30, 2003	% Change for the three months ended September 30, 2004/2003	% Change for the nine months ended September 30, 2004/2003
CPE products	18,899	15,654	67,658	46,320	21%	46%
Video products	10,802	4,577	24,381	11,109	136%	119%
Other products	1,009	572	1,195	3,087	76%	(61%)
Total revenues	$37,202	$37,628	$121,151	$90,495	(1)%	34%

CMTS revenues decreased 61% and 7%, respectively for the three and nine months ended September 30, 2004 compared to the three and nine months ended September 30, 2003. This decrease was due to slower CMTS deployments by existing customers and our ongoing challenge in winning new CMTS accounts. In October 2004, we announced our intention to cease investment in future development of our CMTS product line. Consequently, we expect CMTS revenues to significantly decrease in the fourth quarter of 2004 and future periods.

CPE revenues increased 21% for the quarter ended September 30, 2004 compared to the quarter ended September 30, 2003, due to an increase in modem sales. The number of modems sold increased from approximately 0.3 million units in the third quarter of 2003 to approximately 0.5 million units in the third quarter of 2004. CPE revenues increased 46% for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003, due to an increase in modem sales, as well as an increase in sales of our legacy circuit-switch voice product especially in the second quarter of 2004. The number of modems sold increased from approximately 0.9 million units in the nine months ended September 30, 2003 to approximately 1.5 million units in the nine months ended September 30, 2004. The intensely competitive nature of the market for our products has led to significant ASP erosion for our CPE products over time, and we expect this price erosion to continue, but to a lesser extent. We believe that our full transition to an ODM in Asia, which was substantially completed in the first quarter of 2004, may allow us to remain competitive in the marketplace and maintain favorable margins on these products. Additionally, during the second quarter of 2004, we experienced exceptionally strong demand for our legacy Multigate circuit-switch product line, which is sold primarily to one customer in Europe. Going forward, we anticipate the level of circuit switch business to continue to remain relatively low. We expect total CPE revenues to decline in the fourth quarter of 2004 due to lower expected sales and continued ASP declines.

Revenues from video products increased 136% for the quarter ended September 30, 2004 compared to the quarter ended September 30, 2003, and increased 119% for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003, due to increased sales of our DM 6400 Cherrypicker video product to US multiple system operators MSOs as well as revenue recognized in the third quarter of 2004 from shipments of our BP5100 platform through August 31, 2004. We currently anticipate that video revenues will likely be flat in the fourth quarter of 2004 when compared to the third quarter of 2004 due to the rapid growth in video revenues in the third quarter of 2004. However, we are encouraged by the prospects for our video business to grow in the future and currently believe that we will continue to see increased sales of video products as demand for high definition television (HDTV) and other digital video services, including digital ad insertion, grows in 2005.

We had $1.0 million of sales of our legacy telecom products in the third quarter of 2004, up 76% from the same period in 2003. Other revenues decreased 61% for the nine months ended September 30, 2004 compared to the nine months ended September 30, 2003, due to significantly decreased sales of our legacy telecom products. We expect sales of telecom products to be minimal in the fourth quarter of 2004.

Revenues by Geographic Region

(in thousands)	For the three months ended September 30,		For the nine months ended September 30,		% Change for the three months ended September 30,	% Change for the nine months ended September 30,
	2004	2003	2004	2003	2004/2003	2004/2003
Revenues by geographic areas:						

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(in thousands)	For the three months ended September 30,		For the nine months ended September 30,		% Change for the three months ended September 30,	% Change for the nine months ended September 30,
	2004	2003	2004	2003	2004/2003	2004/2003
North America	$25,531	$17,023	$ 70,427	$48,938	50%	44%
Europe, Middle East, Africa Region (EMEA), excluding Israel	3,379	5,173	18,344	15,873	(35)%	16%
Israel	1,663	638	10,879	1,449	161%	651%
Asia	6,619	14,293	21,438	23,715	(54)%	(10)%
South America	10	501	63	520	(98)%	(88)%
Total	$37,202	$37,628	$121,151	$90,495	(1)%	34%

Revenues in North America increased 50% to $25.5 million in the third quarter of 2004 compared to the same period in 2003, and increased 44% to $70.4 million in the nine months ended September 30, 2004, compared to the same period in 2003, primarily due to increased sales of our CPE and video products to US MSOs and sales of our BP5100 to our broadcast customer, Fox. Revenues in Israel increased due to increased sales of our legacy Multigate circuit-switch product. Revenues in Asia decreased due to decreased sales of DOCSIS 2.0 CMTS products. During the nine months ended September 30, 2004, we emphasized sales to our US customers while placing a lower emphasis on sales internationally due to our increased success with US opportunities. We expect revenue in international locations to continue declining in the fourth quarter of 2004, especially since we announced our decision to stop investing in our CMTS product line. Overall revenues are expected to be significantly lower in the fourth quarter of 2004, due to decreased deployment of our CPE and video products and our intention to cease investment in future development of our CMTS product line. Three customers accounted for 10% or more of total revenues (20%, 15%, and 14%) for the three months ended September 30, 2004. Two customers accounted for 10% or more of total revenues (21% and 11%) for the nine months ended September 30, 2004. Three customers accounted for 10% or more of total revenues (29%, 13%, and 13%) for the three months ended September 30, 2003. Three customers accounted for 10% or more of total revenues (20%, 17%, and 12%) for the nine months ended September 30, 2003. No other customer accounted for more than 10% of revenues during these periods.

Related Party Revenues

(in thousands)	For the three months ended September 30,		For the nine months ended September 30,		% Change for the three months ended September 30,	% Change for the nine months ended September 30,
	2004	2003	2004	2003	2004/2003	2004/2003

Related party revenues:						
Harmonic revenues	$1,543	$460	$4,933	$1,474	235%	235%
Rogers revenues				1,453		
Total related party revenues	$1,543	$460	$4,933	$2,927	235%	69%

Related party revenues increased 235% in the third quarter of 2004, compared to the third quarter of 2003. Related party revenues increased 69% in the nine months ended September 30, 2004, compared to the nine months ended September 30, 2003. Related party revenues in the first quarter of 2003 included revenues from Rogers Communications, Inc. (Rogers) and Harmonic, Inc. (Harmonic). Alek Krstajic, a member of our board of directors, was the Senior Vice President of Interactive Services, Sales and Product Development for Rogers until January 2003. Effective in April 2003, Rogers was no longer a related party to us. Consequently, revenues attributable to Rogers were not classified as related party revenues after the first quarter of 2003. Lewis Solomon, another member of our board of directors, is a member of the board of directors of Harmonic. All revenues attributable to Harmonic were included in related party revenues in 2004 and 2003. The increase in related party revenues was primarily due to an increase in sales of our video

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products to Harmonic in 2004 as compared to the same periods in 2003. None of our related parties is a supplier to us.

In December 2001, we entered into a co-marketing arrangement with Rogers. We paid $0.9 million to Rogers, and recorded this amount as other current assets. In July 2002, we began amortizing this prepaid asset and charging it against related party revenues in accordance with Emerging Issues Task Force (EITF) 01-09, Accounting for Consideration given by a Vendor to a Customer or Reseller in Connection with the Purchase or Promotion of the Vendor s Products. We charged $0.15 million per quarter of the amortization of this asset against total revenues through December 31, 2003. Approximately $0.15 million of amortization was charged against total revenues in the first quarter of 2003. No further amounts of this co-marketing arrangement were included in other current assets after December 31, 2003 and no further amortization has or will occur in 2004.

Cost of Goods Sold and Gross Profit

(in thousands)	For the three months ended September 30,		For the nine months ended September 30,		% Change for the three months ended September 30,	% Change for the nine months ended September 30,
	2004	2003	2004	2003	2004/2003	2004/2003
Cost of revenues	30,393	27,296	86,014	69,500	13%	23%
Cost of related party revenues	539	138	1,348	1,262	291%	7%
Total cost of goods sold	30,932	27,434	87,362	70,762	13%	23%
Gross profit	$ 6,270	$10,194	$33,789	$19,733	(38)%	71%

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 nine months ended September 30, 2004, cost of goods sold was approximately 83% and 72% of revenues, respectively, compared to 73% and 78% of revenues, respectively, in the same periods in 2003. For the three and nine months ended September 30, 2004, we reversed approximately $23,000 and $3.4 million, respectively, of vendor cancellation charges. For the three and nine months ended September 30, 2003, we reversed $1.0 million and $5.4 million, respectively, of vendor cancellation charges. We reversed these charges as we were able to negotiate downward certain vendor cancellation to more favorable terms. Additionally, during the three and nine months ended September 30, 2004, we reversed approximately $0.6 million and $1.9 million, respectively, of inventory reserves, which were previously recorded as cost of goods sold. During the three and nine months ended September 30, 2003, we reversed approximately $1.0 million and $2.7 million, respectively of inventory reserves. We reversed these reserves as we were able to sell inventory originally considered to be excess or obsolete.

In the three and nine months ended September 30, 2004, related party cost of revenues increased compared to the same periods in 2003 primarily due to higher sales of our video products to Harmonic.

Our gross profit decreased 38% to $6.3 million or 17% of sales in the three months ended September 30, 2004 compared to $10.2 million, or 27% of sales in the same period in 2003. Our gross profit increased 71% to $33.8 million or 28% of sales in the nine months ended September 30, 2004 compared to $19.7 million, or 22% of sales in the same period in 2003. The decrease in our gross profit for the three months ended September 30, 2004 compared to the same period in 2003, was primarily related to relatively flat revenues and an unfavorable product line sales mix. The increase in our gross profit for the nine months ended September 30, 2004 was primarily related to an increase in revenues compared to the same period in 2003, as well as a favorable product line sales mix, as we generated a larger proportion of sales from our higher margin digital video products, and the continued effective cost management of our CPE products due largely to the benefits gained from moving manufacturing operations to on ODM in Asia. For the three and nine months ended September 30, 2004, we accrued $2.0 million and $3.3 million, respectively, of vendor cancellation charges. For the three months ended September 30, 2003, we did not accrue any vendor cancellation charges. For the nine months ended September 30, 2003, we accrued $2.2 million of vendor cancellation charges. We accrued these charges, which represent management s estimate of our exposure to vendors should we curtail or cease production of certain products or terminate a vendor or supplier agreement. Additionally, during the three and nine months ended September 30, 2004, we accrued $5.5 million and $7.7 million, respectively, of inventory reserves to cost of goods sold. During the three and nine months ended September 30, 2003, we accrued $1.0 million and $3.6 million, respectively of inventory reserves to cost of goods sold. Based on a detailed analysis of our inventory, we accrued these reserves to reduce the cost of our inventory by the amounts we specifically identified and considered obsolete or excessive to fulfill future sales estimates.

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 primarily for our CPE products, which may provide us with more competitive component pricing, economies of scale, and improved manufacturing capabilities. However, there are no assurances that we will succeed in selling a greater percentage of higher margin products or reducing our product manufacturing costs. Primarily due to our intention to cease investment in future development of our CMTS product line and halt development on future hardware upgrades, we believe our lower margin CPE products will comprise a larger percentage of our revenue and cost of good sold. Consequently, we expect margins to decline beginning in the fourth quarter of 2004.

Operating Expenses

(in thousands)	For the three months ended September 30,		For the nine months ended September 30,		% Change for the three months ended September 30,	% Change for the nine months ended September 30,
	2004	2003	2004	2003	2004/2003	2004/2003
Research and development	$8,696	$9,363	$26,680	$32,797	(7)%	(19%)
Sales and marketing	$6,222	$6,452	$18,854	$19,741	(4)%	(4)%
General and administrative	$2,993	$2,783	$ 8,381	$ 9,510	8%	(12)%

Research and Development. Research and development expenses consist primarily of personnel costs, internally designed prototype material expenditures, and expenditures for outside engineering consultants, and equipment and supplies required to develop and enhance our products. Research and development expenses decreased 7% to $8.7 million or 23% of sales in the three months ended September 30, 2004 from $9.4 million or 25% of sales in the same period in 2003. The $0.7 million decrease in research and development expenses was attributable to $0.5 million of reductions in employee related expenses. The decrease in research and development expenses also included reductions of $0.5 million in purchases of materials, costs incurred to develop prototypes, and other research and development expenses, and a decrease of $0.1 million of outside engineering consultants, partially offset by an increase of $0.4 million related to the implementation of an incentive compensation plan for research and development personnel in the third quarter of 2004.

Research and development expenses decreased 19% to $26.7 million or 22% of sales in the nine months ended September 30, 2004 from $32.8 million or 36% of sales in the same period in 2003. The $6.1 million decrease in research and development expenses was attributable to $2.6 million of reductions in employee related expenses due to restructuring actions in 2004. The decrease in research and development expenses also included reductions of $0.3 million of outside engineering consultants and $3.6 million of reductions in purchases of materials, costs incurred to develop prototypes, and other research and development expenses partially offset by an increase of $0.4 million related to the implementation of an incentive compensation plan for research and development personnel in the third quarter of 2004. In connection with our intention to cease investment in future development of our CMTS product line and halt development on future CMTS hardware upgrades, we currently expect research and development expenses to continue to decrease in the fourth quarter of 2004. However, we believe it is critical for us 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 specifically related to our video and CPE product lines.

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 trade shows, consulting and travel. Sales and marketing expenses decreased 4% to $6.2 million or 17% of sales in the three months ended September 30, 2004 from $6.5 million or 17% of sales in the same period in 2003. The $0.3 million decrease in sales and marketing expenses was primarily due to $0.2 million of decreased travel costs, $0.7 million of reductions related to leased aircraft costs now included in restructuring charges, and $0.2 million of overall sales and marketing cost reductions. These reductions were partially offset by $0.2 million in increased employee expenses in sales and marketing and $0.5 million of increased spending for outside consultants, and $0.1 million related to the implementation of an incentive compensation plan for sales and marketing personnel in the third quarter of 2004.

Sales and marketing expenses decreased 4% to $18.9 million or 16% of sales in the nine months ended September 30, 2004 from $19.7 million or 22% of sales in the same period in 2003. The $0.9 million decrease in sales and marketing expenses was primarily due to $1.6 million of reductions related to leased aircraft costs now included in restructuring charges, $0.2 million of decreased travel costs, a decrease in accrued bonuses in 2004 of $0.1 million due to the discontinuation of the executive bonus plan in 2004, and $1.0 million of overall sales and marketing cost reductions. These reductions were partially offset by $0.8 million in increased employee expenses in sales and marketing, and $1.2 million of increased spending for outside consultants. We currently expect sales and marketing expenses to be slightly higher for the fourth quarter of 2004 compared to the third quarter of 2004.

General and Administrative. General and administrative expenses consist primarily of salary and benefits for administrative and support personnel, travel expenses and legal, accounting and consulting fees. Overall general and administrative expenses increased 8% to $3.0 million or 8% of sales for the three months ended September 30, 2004 from $2.8 million or 7% of sales in the same period in 2003. Prior to the second quarter of 2004, we included severance expense related to the termination of an executive officer in general and administrative expenses. In the first quarter of 2003, $0.3 million of general and administrative expense included severance expense related to the termination of the executive officer. Beginning the second quarter of 2004, we now record all severance expenses associated with the termination of executive officers in the statements of operations under the caption, Executive Severance, Restructuring Costs and Asset Write-offs . The $0.2 million increase in general and administrative expenses for the three months ended September 30, 2004, compared to the same period in 2003 was primarily due to $0.7 million of increased spending for outside consultants, $0.1 million of increased severance expense, $0.1 million increase of travel and other expenses, partially offset by a $0.2 million decrease related to the discontinuation of the executive bonus plan in 2004, and $0.5 million in decreased employee expenses.

General and administrative expenses decreased by $1.1 million to $8.4 million or 7% of sales for the nine months ended September 30, 2004 from $9.5 million or 11% of sales in the same period in 2003. The $1.1 million decrease was primarily due to $1.6 million in reduced employee expenses including a decrease of $0.5 million of accrued bonuses in 2004 due to the discontinuation of the executive bonus plan in 2004, $0.2 million of decreased severance cost, and $0.8 million of overall general and administrative cost decreases, partially offset by $1.3 million of increased spending for outside consultants and $0.2 million increase of travel expenses. We currently expect general and administrative expenses to be slightly lower for the fourth quarter of 2004 compared to the third quarter of 2004.

Executive Severance, Restructuring Costs and Asset Write-offs

(in thousands)	**For the three months ended September 30,**		**For the nine months ended September 30,**	
	2004	**2003**	**2004**	**2003**
Executive severance charges	$1,366	$	$3,048	$
Restructuring charges (recovery)		(261)	4,409	2,398
Long-lived assets written-off		17	106	405
Revaluation of restructuring charges	97		846	
Executive severance, restructuring costs and asset write-offs	$1,463	$(244)	$8,409	$2,803

Executive Severance Charges In June 2004, we entered into an employment agreement with an executive officer. Although this executive officer resigned effective as of October 1, 2004, we recorded a severance provision of $1.4 million related to termination cost for this officer in the third quarter of 2004. Most of the separation costs related to this officer are expected to be paid in the fourth quarter of 2004 with nominal amounts for employee benefits paid into the fourth quarter of 2005.

In June 2004, we entered into separation agreements with two executive officers. Both executive officers resigned in the third quarter of 2004. We recorded a severance provision of $1.7 million related to termination costs for these officers in the second quarter of 2004. Most of the separation costs were paid in the third quarter of 2004 with nominal amounts for employee benefits paid through the third quarter of 2005.

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Restructuring Costs During the first quarter of 2004, we initiated a 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 exit costs for an aircraft lease, and $1.4 million related to costs for excess leased facilities. We incurred restructuring charges in the amount of $1.15 million in the second quarter of 2004 related to additional costs for excess leased facilities, which were contemplated in the first quarter restructuring plan. As of September 30, 2004, the employment of 58 employees had been terminated, and we paid $0.8 million in termination costs, $0.9 million of costs related to the aircraft lease, and $0.6 million of costs related to excess leased facilities. We anticipate the remaining restructuring accrual related to the aircraft lease to be substantially utilized for servicing operating lease payments, through January 2007, and the remaining restructuring accrual related to excess leased facilities to be utilized for servicing operating lease payments or negotiating a buyout of operating lease commitments through October 2009. In the second and third quarters of 2004, we re-evaluated the first and second quarter 2004 restructuring charges for the excess facilities and the aircraft lease termination. Based on market conditions, new assumptions provided by our broker, and the terms of aircraft sublease agreement, which we entered into in the third quarter of 2004, we increased the restructuring charge by a total of $0.8 million in the nine months ended September 30, 2004.

The amount of net costs accrued under the 2004 restructuring plan assumes that we will successfully sublease the aircraft and excess leased facilities. The reserve for the aircraft lease and excess leased facilities approximates the difference between our current costs for the aircraft and excess leased facilities and the estimated income derived from subleasing, which is based on information derived by our brokers that estimated, based on assumptions relevant to the aircraft lease and real estate market conditions as of the date of our implementation of the restructuring plan, the time it would likely take to fully sub-lease the aircraft and excess leased facilities. In the third quarter of 2004, we entered into an agreement with a third party to sublease the aircraft. Even though it is our intent to sublease our interests in the excess facility at the earliest possible time, we cannot determine with certainty a fixed date by which such events will occur, if at all. In light of this uncertainty, we will continue to periodically re-evaluate and adjust the reserve, as necessary.

During the first quarter of 2003, we initiated a restructuring program. We incurred restructuring charges in the amount of $2.7 million related to employee termination costs and paid $2.7 million in termination costs. At September 30, 2004, no restructuring charges remain accrued.

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 facilities. We incurred additional restructuring charges of $3.6 million in 2002. 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 September 30, 2004, restructuring charges of $1.2 million remained accrued. As of September 30, 2004, the employment of 153 employees had been terminated, and we paid $2.2 million in termination costs and $0.2 million in excess facility costs. We currently anticipate the remaining restructuring accrual, primarily relating to excess leased facilities, will be utilized for servicing operating lease payments or negotiating a buyout of operating lease commitments, through 2005.

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 September 30, 2004, restructuring charges of $2.4 million remained accrued. We anticipate utilizing the remaining restructuring accrual, which relates to servicing operating lease payments or negotiating a buyout of operating lease commitments, through 2005.

In October 2004, we announced our intention to cease investment in future development of our CMTS product line. In connection with this announcement, we initiated a worldwide reduction in force, which is expected to result in a restructuring charge of approximately $3.2 million to $3.6 million related to employee termination costs in the quarter ending December 31, 2004. We may incur additional material charges associated, and may further reduce our workforce in connection, with this determination.

Asset Write-offs For the nine months ended September 30, 2004 and September 30, 2003, we wrote off $0.1 million and $0.4 million, respectively, of fixed assets, which were determined to have no remaining useful life. We did not write-off any fixed assets during the three months ended September 30, 2004. For the nine months ended September 30, 2003, we wrote off $17,000 of fixed assets, which were

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determined to have no remaining useful life. We did not write-off any fixed assets during the three months ended September 30, 2003.

Non-Operating Expenses

(in thousands)	For the three months ended September 30,		For the nine months ended September 30,		% Change for the three months ended September 30, 2004/2003	% Change for the nine months ended September 30, 2004/2003
	2004	2003	2004	2003		
Interest income	$ 525	$ 583	$ 1,437	$ 2,394	(10%)	(40%)
Interest expense	$(812)	$ (787)	$(2,456)	$(2,438)	3%	1%
Other income (expense)	$ (46)	$1,238	$ 1,155	$ 1,038		11%

Interest Income. Interest income decreased 10% to $0.5 million in the third quarter of 2004 compared to $0.6 million in the same period in 2003. Interest income decreased 40% to $1.4 million in the nine months ended September 30, 2004 compared to $2.4 million in the same period in 2003. The decrease in interest income in both periods was primarily due to lower invested average cash balances, slightly off-set by 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 third quarter of 2004 and the nine months ended September 30, 2004, compared to the same periods in 2003 as no Notes were repurchased in 2003 or 2004.

Other Income (Expense). Other income (expense) is generally comprised of the impact of foreign currency transaction gains and losses and realized gains or losses on investments. In the second quarter of 2004, we sold all of our 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 $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

(in thousands)	For the three months ended September 30,		For the nine months ended September 30,	
	2004	2003	2004	2003
Income tax expense	$(83)	$(84)	$(229)	$(214)

We have generated losses since our inception. In the three and nine months ended September 30, 2004 and 2003, we recorded an income tax expense related primarily to foreign taxes.

Litigation

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 also have 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.

On January 19, 2003, Omniband Group Limited, a Russian company, or Omniband, filed a request for arbitration with the Zurich Chamber of Commerce, claiming damages in an amount of $2,094,970 allegedly caused by our breach of an agreement to sell to Omniband certain equipment pursuant to an agreement between Omniband and Radwiz, Ltd., one of our wholly-owned subsidiaries. On December 18, 2003, the panel of arbiters with the Zurich Chamber of Commerce allowed the arbitration proceeding to continue against Radwiz. Omniband appealed the Zurich Chamber of Commerce s decision, which was affirmed in its ruling of October 15, 2004. We believe that the allegations are without merit and intend to present a vigorous defense in the arbitration proceedings.

From time to time, we receive letters claiming that our technology and products may infringe on intellectual property rights of third parties. We also have in the past agreed to, and may from time to time in the future agree to, indemnify a customer of our 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 its products, require us to indemnify its 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.

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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 position and overall results of operations for any of the above legal proceedings could change in the future.

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 September 30, 2004, we had approximately $64.1 million in cash and cash equivalents and $47.8 million in short-term investments.

Cash used in operating activities for the nine months ended September 30, 2004 was $25.6 million compared to $57.1 million used in the same period in 2003. In the nine months ended September 30, 2004, significant uses of cash from operating activities included $28.6 million loss from operations, $14.9 million decrease in accounts payable, and $5.6 million of increase in gross inventory, offset by a $6.4 million write-off of CMTS and modem inventories in 2004. In the nine months ended September 30, 2003, significant uses of cash from operating activities included a $44.3 million loss from operations, and a $11.3 million decrease in vendor cancellation reserves as we paid down these obligations, $13.0 million decrease in accounts receivable, partially offset by a $5.8 million increase in other assets, and $4.7 million net increase in inventory.

Cash provided by investing activities for the nine months ended September 30, 2004, was $58.2 million compared to cash used in investing activities of $20.7 million in the same period in 2003. Investing activities consisted primarily of net purchases and sales of short-term investments in 2004 and 2003. The increase in cash provided by investing activities in the nine months ended September 30, 2004, was primarily due to the maturity of short-term investments during the period. The decrease in cash used in investing activities in the nine months ended September 30, 2003 was primarily due to movement of short-term investments to cash and cash equivalents to fund operations.

Cash provided by financing activities was $1.3 million in the nine months ended September 30, 2004 compared to $2.3 million in the same period in 2003 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 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 $15.5 million.

Through September 30, 2004, 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. We did not repurchase any Notes in 2003 or 2004.

We believe that our current cash balances will be sufficient to satisfy our cash requirements for at least the next 12 months. In order to obtain profitability in the future, we will need to increase revenues from the sale of our more profitable products while decreasing costs. We also may need to raise additional funds in order to support more rapid expansion, develop new or enhanced products and services, respond to competitive pressures, acquire complementary businesses or technologies or respond to unanticipated 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, or services 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 September 30, 2004, 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	$ 26.5	$26.5	$	$	$
Long Term Debt	68.5		1.6	65.1	1.8
Operating Lease Obligations	19.7	6.6	6.5	6.2	0.4
Aircraft Lease	3.4	1.5	1.9		
Total Contractual Commitments	$118.1	$34.6	$10.0	$71.3	$2.2

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 September 30, 2004, we had approximately $26.5 million of purchase obligations, of which $2.1 million is included in the consolidated balance sheets as accrued vendor cancellation charges, and the remaining $24.4 million is attributable to open purchase orders in the ordinary course of business. The remaining obligations are expected to become payable at various times through the first quarter of 2005.

In the third quarter of 2004, the Company entered into an agreement with a third party to sublease the aircraft. The aircraft lease commitment above does not include an estimated reduction of $100,000 per month related to this sublease income.

We had restricted cash of $8.7 million at September 30, 2004. Restricted cash related to 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	$1.0	$ 0.3	$0.7	$	$
Standby Letters of Credit	7.7			7.5	0.2
Total Commercial Commitments	$8.7	$ 0.3	$0.7	$7.5	$0.2

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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. This lease commitment is included in the table above. As discussed above, in the third quarter of 2004, we entered into an agreement with a third party to sublease the aircraft.

Impact of Recently Issued Accounting Standards

In March 2004, the FASB issued a proposed Statement, Share-Based Payment, an amendment of FASB Statements Nos. 123 and 95, that addresses the accounting for share-based payment transactions in which a Company receives employee services in exchange for either equity instruments of the Company or liabilities that are based on the fair value of the Company s equity instruments or that may be settled by the issuance of such equity instruments. The proposed statement would eliminate the ability to account for share-based compensation transactions using the intrinsic method that the Company currently uses and generally would require that such transactions be accounted for using a fair-value-based method and recognized as expense in the consolidated statement of operations. The effective date of the proposed standard is for periods beginning after June 15, 2005. It is expected that the final standard will be issued before December 31, 2004 and should it be finalized in its current form, it will have a significant impact on our consolidated statement of operations as we will be required to expense the fair value of stock option grants.

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 September 30, 2004, we had an accumulated deficit of $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, which was, in large part, due to the erosion of average selling prices (ASPs) of our products and a drop in CMTS sales volume due to our transition from a proprietary platform to the DOCSIS standards platform. Although our revenues increased in the first half of 2004 as compared to 2003, we still incurred losses of $13.5 million and $28.6 million, respectively, in the three and nine months ended September 30, 2004. As a result of the operating deficiencies, we have had to use available cash and cash equivalents to supplement the operation of our business. Cash used in operating activities for the nine months ended September 30, 2004 was $25.6 million compared to $57.1 million used in the same period in 2003. 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. We record an inventory charge to reduce our inventory to the lower of cost or market if ASPs fall below the cost of these 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.

Our business may be adversely affected by delays in, or our failure to, commercialize new products, or reduce the cost of manufacturing our current products. Moreover, given the conditions in the broadband equipment market, the profit potential of our business remains unproven.

We may 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 are outside our 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;
- the 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.

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 September 30, 2004, $26.5 million of purchase obligations were outstanding. 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 products declined considerably in 2002, 2003, and 2004, and we anticipate that unit ASPs of our 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 off-set the decline in ASPs 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 head-end equipment, such as digital video management systems, and lower margin, higher volume Customer Premise Equipment (CPE) products, such as modems. We are attempting to increase our gross margin by shifting our product mix from CPE revenues to higher margin digital video product revenues, and cease investment in our CMTS product line. However there are no assurances that we will succeed. For the reminder of 2004 and 2005, we expect that sales of our low-margin CPE products will continue to make up a significant portion of our revenues. Revenues for our video products will remain flat for the remainder of 2004. Moreover, we are in the early stages of development with respect to our video product line. Historically, video product revenues represented less than 30% of our total revenues. If our video product line does not receive broader market acceptance and we do not generate a greater percentage of total revenues from video product revenues, we will not succeed in greatly improving our gross margin.

We are dependent on a small number of customers 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. Three customers accounted for 10% or more of total revenues (20%, 15%, and 14%) for the three months ended September 30, 2004. Two customers accounted for 10% or more of total revenues (21% and 11%) for the nine months ended September 30, 2004. Three customers accounted for 10% or more of total revenues (29%, 13%, and 13%) for the three months ended September 30, 2003. Three customers accounted for 10% or more of total revenues (20%, 17%, and 12%) for the nine months ended September 30, 2003.

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 can likewise have a material adverse affect on our results of operations.

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 face losing existing customers or business from our existing customers because of our decision to cease investment in our CMTS product line.

The sales cycle for certain of our products is lengthy, which makes forecasting of our customer orders and revenue 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 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. The competition for some of these personnel is intense. The loss of any of these individuals may significantly disrupt and be harmful to our business. 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.

Highly skilled employees with the education and training that we require, especially employees with significant experience and expertise in video, data networking and radio frequency design, are in high demand. We may incur additional expenses to attract and retain key personnel. We cannot assure you that the additional expenses we may incur will enable us to attract and retain qualified personnel necessary for the development of 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. Although a few of our executive officers have limited non-competition agreements with us, our employees generally are not bound by non-competition agreements.

Additionally, we have recently experienced and may continue to experience significant changes in key personnel, including the resignation of our Chief Executive Officer and his appointment as Chairman of the Board of Directors, the resignation of our Chairman, President and Chief Technology Officer although he remains a member of the Board, and the resignation of our Chief Operating Officer and Chief Financial Officer, as well as the appointment of a new Chief Executive Officer and the appointment of our General Counsel and Head of Human Resources as the Acting Chief Financial Officer. Turnover in personnel, and the recruitment and retention of a new senior management staff, has created and could continue to create a number of transitional challenges for us. For instance, we are currently actively engaged in the search for a new Chief Financial Officer. Although we have an Acting Chief Financial Officer, we may experience transitional difficulties in financial management and administration during the period until a new Chief Financial Officer is appointed. These transitional issues have caused, and may cause, disruptions to our business. We cannot assure you that the steps we have taken will succeed in establishing a smooth transition of our senior management staff, or result in the orderly continuation of our operations during the interim period. As a result of these and other changes, including the search for a new Chief Financial Officer, we also may experience additional turnover in management. Further, we cannot assure you 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.

There are many risks associated with our participation in industry standards.

In connection with the development of the DOCSIS 2.0 specification by Cable Television Laboratories, Inc., a cable industry consortium that establishes cable technology standards and administers compliance testing (CableLabs), 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.

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 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. An alternate 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 equipment that is not certified or qualified as compliant with these specifications. 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. Consequently, 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 fashion and in a 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 be DOCSIS, EuroDOCSIS or PacketCable certified or qualified. If we are unable to certify or qualify our products as DOCSIS, EuroDOCSIS or PacketCable compliant 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 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 to this situation, 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.

Average selling prices of broadband equipment continue to decline, which is decreasing our gross margins.

The broadband equipment market has been characterized by erosion of product ASPs, particularly for CPE devices. This erosion may continue. The ASPs for our products are likely to continue to decline

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due to competitive pricing pressures, promotional programs and customers possessing strong negotiating positions who 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 CPE products become commodity products. 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 declined year-over year 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. Our failure to do this could cause our revenues and gross margin to decline further.

We must achieve cost reductions or increase revenues to attain profitability.

In prior years, we have experienced a decrease in revenue, which was, in large part, due to declining product ASPs and a drop in CMTS sales volume due to our transition from a proprietary platform to the DOCSIS standards platform. Most recently, we have experienced a decrease in revenue derived from our DOCSIS CMTS sales. This has resulted in increased losses and made it difficult for us to attain profitability. 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 first and second quarters of 2004, that have focused on cost reductions and operating efficiencies, our operating expenses are still higher than our gross margins. 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. In that event, our business, financial condition and results of operations could be materially and adversely affected.

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 margin. 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.

Broadband services delivered by cable operators have not achieved widespread market acceptance, and other competing service providers exist.

Our success will depend upon the widespread acceptance of broadband services delivered by cable television operators. The markets for these services are growing, but are not fully developed nor exploited. Additionally, these markets may not grow as cable operators may elect not to increase available bandwidth over which they can offer new services, such as high-speed Internet access, High Definition Television (HDTV), Video on Demand, and internet telephony. Cable operators may elect not to provide any or all of these new services to their customers or may not aggressively market these services to their customers. If cable operators elect not to deploy such new services or if customers elect not to subscribe to such services, it may affect our ability to sell products to cable operators as their existing equipment may meet their current infrastructure demands. We depend on cable operators to provide new

services and maintain their infrastructure in such a manner that allows us to continue to sell products to them.

Cable operators must also compete with other service providers in the delivery of services to their customers. Regional Bell Operating Companies (RBOCs), Competitive Local Exchange Carriers (CLECs), Incumbant Local Exchange Carriers (ILECs), satellite TV and other broadband service providers are aggressively competing with the cable industry to deliver broadband services via Digital Subscriber Lines or satellite broadcast technologies. We cannot accurately predict the future growth rate or the ultimate size of the market for broadband services delivered via cable. The success of RBOCs, CLECs, ILECs, satellite TV and other broadband service providers may slow or hamper the continued acceptance of cable operators in delivering broadband services, which in turn may impact demand for our products by cable operators.

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

The vast majority of our sales are to large cable operators. However, we currently have limited access to smaller or geographically diverse cable operators. Although we intend to establish strategic relationships with leading distributors worldwide to access these 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 depend on cable industry capital spending for a substantial portion of our revenue and any decrease or delay in capital spending by cable operators would negatively impact our operating results and financial condition.

Historically, almost all of our sales had been derived from sales to 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 cable television operators. These capital spending patterns are dependent 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.

In recent years, the cable market has been characterized by consolidation. Furthermore, cable operators may undertake additional business combinations to expand their business. We cannot predict the effect, if any, this will have on overall capital spending patterns by cable operators. The effect on our business of further industry consolidations and combinations also is uncertain.

We may fail to accurately forecast customer demand for our products.

The nature of the cable 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 had purchase obligations of approximately $26.5

million as of September 30, 2004, 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 may have financial exposure to litigation.

We and/or our directors and officers are defendants in a number of lawsuits, including securities litigation lawsuits. 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). However, the availability of D&O Insurance is becoming more difficult for companies to attain as a number of insurance underwriters no longer offer D&O Insurance and the remaining insurance underwriters offering D&O Insurance have significantly increased the premiums of such coverage. In recent years, we have experienced a significant increase in the cost of our D&O Insurance. Although the cost of our D&O insurance decreased in fiscal year 2003, our coverage amount did as well. There can be no assurance that D&O Insurance will be available to us in the future or, if D&O Insurance is available, it may 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. In October 2001, one of the insurance underwriters from which we purchased D&O Insurance, Reliance Insurance Co. (Reliance), was placed into liquidation by the state of Pennsylvania. Reliance was the underwriter for one excess layer of our D&O Insurance for the period covering the claims made against us and our officers in the pending securities litigation. Because Reliance is in liquidation, in 2003 we paid for the amount insured under the Reliance policy, which was $2.5 million.

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. 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.

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 three months ended September 30, 2004 and September 30, 2003, approximately 32% and 56%, respectively, of our net revenues were from customers outside of the U.S. For the nine months ended September 30, 2004 and September 30, 2003, approximately 44% and 47%, 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;
- 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.

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, China and

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Brazil 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. Additionally, we have an Israel based operation whose expenses are denominated in Israeli NIS. 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 cable 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 business may be affected by conditions in Israel.

We have significant operations in Israel. Our operations in Israel consist primarily of research and development, and to a lesser extent sales and manufacturing. Revenues generated by our business in Israel were $1.0 million and $3.5 million for the three months ended September 30, 2004 and September 30, 2003, respectively. Revenues generated by our business in Israel were $9.7 million and $9.0 million for the nine months ended September 30, 2004 and September 30, 2003, respectively. Our research and development operations may be significantly affected by conditions in Israel. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors and a state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. Hostilities within Israel have continued over the past year, which could disrupt some of our operations. We could be adversely affected by any major hostilities involving Israel. As a result of the hostilities and unrest presently occurring within Israel, the future of the peace efforts between Israel and its Arab neighbors is uncertain. A number of our employees based in Israel are currently obligated to perform annual military reserve duty and are subject to being called to active duty at any time under emergency circumstances. We cannot assess the full impact of these requirements and the hostilities on our workforce, business or operations if conditions should change, and we cannot predict the effect of any expansion or reduction of these obligations or the hostilities.

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. We may not have adequate 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 product to existing customers or gaining new customers.

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, ADC, Arris, BigBand Networks, Motorola, Scientific-Atlanta and Toshiba. 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.

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Our business is subject to the risks of product 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. We cannot be assured 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. We cannot be assured 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.

CableLabs DOCSIS 2.0 specification includes two modulation techniques, 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 the industry in which we operate, we have been and may from time to time be notified of claims that we may be 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 a customer of our technology or products for claims against the customer 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; we may incur substantially more debt.

As of September 30, 2004, 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. The terms of our outstanding debt do not fully prohibit us from doing so. If new debt is added to our current levels, the related risks described above could intensify.

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 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 cash, cash equivalents, and short-term investments decreased to $111.9 million at September 30, 2004, from $138.6 million at December 31, 2003. 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. Given the current condition of the capital markets, there are 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. If we are unable to procure additional working capital, as necessary, we may be unable to continue operations.

On October 7, 2003, we filed a registration statement on Form S-3 with the Securities and Exchange Commission. This shelf registration statement, which was declared effective by the SEC on November 4, 2003, 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. On November 7, 2003, we filed a prospectus supplement with reference to our intention to offer 10,800,000 shares of common stock, which would have result in gross proceeds of $75.0 million. On November 14, 2003, we withdrew our previously announced public offering of 10,800,000 shares of common stock under the shelf registration statement.

Our restructuring efforts and recent changes in senior management could result in the erosion of employee morale, legal actions against us and management distractions, and could impair our ability to respond rapidly to growth opportunities in the future.

As a result of the significant economic downturn and the related uncertainties in the technology sector, we have implemented a number of restructuring plans, including the most recent in the first and second quarters of 2004, which has resulted in personnel reduction. We also have experienced a number of recent changes in senior management and other key personnel. These employee reductions and changes, 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 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.

Furthermore, in October 2004, we announced our intention to cease investment in future development of our CMTS product line and halt development on future hardware upgrades. In connection with this action, we initiated a worldwide reduction in force, which is likely to result in a restructuring charge of approximately $3.2 million to $3.6 million in the quarter ending December 31, 2004. We may incur additional material charges associated, and may further reduce our workforce in connection, with this determination. We also may face the same risks associated with our prior restructuring, as discussed above, in connection with our determination to cease investment in our CMTS product line.

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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. Specifically, we have reduced our investment in the telecom and satellite spaces. Beginning in July 2003, we entered into two transactions to further decrease our telecom business. In July 2003, we discontinued our Mainsail line of products and entered into an agreement with a third party to supply warranty services for the Mainsail products.

In July 2003, we entered into an agreement with Verilink Corporation (Verilink) to sell certain telecom assets associated with the Miniplex product line to Verilink. Additionally, Verilink agreed to purchase related inventory from us and assume all telecom warranty obligations with the exception of $2.4 million, which will continue to be our responsibility. To date, only nominal claims have been made against this warranty obligation and we believe that the likelihood of any material claim being made against us is remote.

On April 2, 2004, we sold all of our 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 $1.35 million of net liabilities related to these subsidiaries. We recorded a net gain of $1.3 million on this transaction in the second quarter of 2004.

In October 2004, we also announced our determination to cease investment in the CMTS product line and halt development of future CMTS hardware. In connection with this determination, we expect to incur charges in the range of $3.2 to $3.6 million related to employee termination costs, and may incur additional material charges in connection with this decision.

We cannot assure you that we correctly forecasted the right product lines to dispose of or discontinue or that our decision to dispose of or discontinue various investments and product lines is prudent if market conditions change. In addition, we cannot assure you that the discontinuance of various product lines will reduce our operating expenses or cause us to incur material charges associated with such decision. Furthermore, future plans to discontinue existing product lines entail 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 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 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 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. 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 (i) cost effective, (ii) brought to market in a timely manner, (iii) in accordance with evolving industry standards and architecture or (iv) 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 product, 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; acquisitions 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.

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.

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. Additionally, certain product groups have not achieved the level of technological development needed to be marketable or to expand the market. We recorded impairment losses of approximately $4.0 million and $572.8 million of intangible assets related to these acquisitions in December 31, 2002 and 2001, respectively. As of September 30, 2004, no intangible assets from these acquisitions remained.

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.

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.

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, we cannot assure you 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.

New laws and regulations affecting corporate governance may impede our ability to retain and attract board members and executive officers, and increase the costs associated with being a public company.

On July 30, 2002, President George W. Bush signed into law the Sarbanes-Oxley Act of 2002. The new act is designed to enhance corporate responsibility through new corporate governance and disclosure obligations, increase auditor independence, and tougher penalties for securities fraud. In addition, the Securities and Exchange Commission and Nasdaq have adopted rules in furtherance of the act. This act and the related new rules and regulations will likely have the effect of increasing the complexity and cost of our company s corporate governance and the time our

executive officers spend on such issues, and may increase the risk of personal liability for our board members, chief executive officer, chief

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financial officer and other executives involved in our company s corporate governance process. As a result, it may become more difficult for us to attract and retain board members and executive officers involved in the corporate governance process. In addition, we have experienced, and will continue to experience, increased costs associated with being a public company, including additional professional and independent auditor fees.

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.

In the event we are unable to satisfy regulatory requirements relating to internal controls, or if these internal controls over financial reporting are not effective, our business and our stock price could suffer.

Section 404 of Sarbanes-Oxley requires companies to do a comprehensive and costly evaluation of their internal controls. As a result, during our fiscal year ending December 31, 2004, we will be required to perform an evaluation of our internal controls over financial reporting and have our auditor publicly attest to such evaluation. We have prepared an internal plan of action for compliance, which includes a timeline and scheduled activities with respect to preparation of such evaluation. Our efforts to comply with Section 404 and related regulations regarding our management s required assessment of internal control over financial reporting and our independent auditors attestation of that assessment has required, and continues to require, the commitment of significant financial and managerial resources. While we anticipate being able to fully implement the requirements relating to internal controls and all other aspects of Section 404 in a timely fashion, we cannot be certain as to the timing of completion of our evaluation, testing and remediation actions or the impact of the same on our operations since there is no precedent available by which to measure compliance adequacy. If we fail to timely complete this evaluation, or if our auditors cannot timely attest to our evaluation, we could be subject to regulatory investigations or sanctions, costly litigation or a loss of public confidence in our internal controls, which could have an adverse effect on our business and our stock price.

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 $8,000 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, Canada, Japan, Brazil, Korea, China and Israel denominated in local currencies and invoice some of our sales in Europe in Euros. A hypothetical adverse change of 10% in exchange rates would result in a decline in income before taxes of approximately $36,000.

All of the potential changes noted above are based on sensitivity analyses performed on our financial positions at September 30, 2004. Actual results may differ materially.

ITEM 4. CONTROLS AND PROCEDURES

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer identified a deficiency in our disclosure controls and procedures as of September 30, 2004, due to an inadequacy of communication between certain parts of the organization and the finance department. In connection with the review of our financial statements for the third quarter of 2004, Ernst & Young LLP, our independent registered public accountants, advised our Audit Committee that they considered this deficiency to be a material weakness under standards established by the Public Company Accounting Oversight Board. This material weakness related to an accrual of severance for an executive officer in an incorrect reporting period, which Ernst & Young LLP believed to be related to the inadequacy of communication between certain parts of the organization and the finance department. The accrual is reflected in the condensed consolidated financial statements for the three and nine month period ended September 30, 2004.

Under the direction of our Audit Committee and with the participation of our senior management, we have taken steps designed to strengthen our disclosure controls and procedures and internal controls to address the material weakness identified by Ernst and Young. We have, on an immediate basis, taken steps to improve our internal controls and our control environment. We have implemented steps to ensure that senior members of our finance department review all press releases before they are released and all resignations of executive staff are communicated promptly to senior members of our finance department. We will continue to monitor the communication channels between our senior management and our finance department and will take prompt action, as necessary, to further strengthen our disclosure controls and procedures and internal controls to comply with Sarbanes-Oxley compliance procedures. Moreover, we will continue our efforts to identify, assess and correct any additional material weaknesses in our internal controls.

We believe the corrective steps taken to improve our disclosure controls and procedures and internal controls described above have enabled our Chief Executive Officer and Chief Financial Officer to conclude that our disclosure controls and procedures are now effective in timely alerting them to material information required to be included in this Quarterly Report on Form 10-Q for the quarter ended September 30, 2004.

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

We intend to review and evaluate the design and effectiveness of our disclosure controls and procedures on an ongoing basis and to improve our controls and procedures over time and to correct any deficiencies that we may discover in the future. Our goal is to ensure that our senior management has timely access to all material financial and non-financial information concerning our business. While we believe the present design of our disclosure controls and procedures is effective to achieve our goal, future events affecting our business may cause us to significantly modify our disclosure controls and procedures.

PART II. OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

See Litigation under Part I, Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations.

ITEM 5. OTHER INFORMATION

As reported in a recent Current Report on Form 8-K filed with the Securities and Exchange Commission, we had determined to defer the 2004 annual meeting of stockholders, originally scheduled for August 10, 2004, for a brief period of time. We have now scheduled the 2004 annual meeting for December 16, 2004, with a record date of October 20, 2004.

ITEM 6. EXHIBITS

(a) EXHIBITS

10.32	Employment Agreement dated August 2, 2004, between the Registrant and Edward Lopez.
10.33	Letter Agreement dated July 22, 2004, between the Registrant and Jerry Chase.
10.34	Severance Agreement dated July 22, 2004, between the Registrant and Jerry Chase.
10.35	Proprietary Information and Inventions Agreement dated July 22, 2004 between the Registrant and Jerry Chase.
10.36	Aircraft Sublease Agreement dated August 24, 2004 between the Registrant and United Furniture Equipment Rental, Inc.
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.

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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: November 9, 2004	TERAYON COMMUNICATION SYSTEMS, INC.
	By /s/ Edward Lopez
	Edward Lopez Acting Chief Financial Officer

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INDEX TO EXHIBITS

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