TERAYON COMMUNICATION SYSTEMS
Form 10-Q
August 14, 2002

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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 June 30, 2002**
**OR**

**[ ]** **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 [ ]

As of July 30, 2002, registrant had outstanding 72,776,546 shares of Common Stock.

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SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This report on Form 10-Q contains forward-looking statements of Terayon Communication Systems, Inc. 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. The forward-looking statements include, but are not limited to: statements related to industry trends and future growth in the markets for cable modem systems; our strategies for reducing the cost of our products; our product development efforts; the effect of GAAP accounting pronouncements on our recognition of revenues; our future research and development; the timing of our introduction of new products; the timing and extent of deployment of our products by our customers; and future profitability. We usually use words such as may, will, should, expect, plan, anticipate, believe, estimate, predict, future, intend, or certain or the negative of these terms or similar expressions to identify forward-looking statements. Discussions containing such forward-looking statements may be found throughout the document. These forward-looking statements involve certain risks and uncertainties that could cause actual results to differ materially from those in such forward-looking statements. We disclaim any obligation to update these forward-looking statements as a result of subsequent events. The business risks discussed in Part 1, Item 2 of this Report on Form 10-Q, among other things, should be considered in evaluating our prospects and future financial performance.

## PART I. FINANCIAL INFORMATION

## ITEM 1. FINANCIAL STATEMENTS

TERAYON COMMUNICATION SYSTEMS, INC.
INDEX TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

| | June 30, 2002 | December 31, 2001 |
|---|---|---|
| | (unaudited) | |
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | $ 76,525 | $ 100,274 |
| Short-term investments | 194,329 | 233,614 |
| Accounts receivable, net | 27,062 | 48,386 |
| Accounts receivable from related parties | 301 | 4,006 |
| Other current receivables | 9,782 | 7,476 |
| Inventory | 10,578 | 16,658 |
| Other current assets | 11,925 | 13,462 |
| Total current assets | 330,502 | 423,876 |
| Property and equipment, net | 21,628 | 25,279 |
| Intangibles and other assets, net | 18,059 | 17,491 |
| Total assets | $ 370,189 | $ 466,646 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | $ 33,046 | $ 42,821 |
| Accrued payroll and related expenses | 8,714 | 9,441 |
| Deferred revenues | 2,853 | 4,169 |
| Accrued warranty | 8,477 | 8,368 |
| Accrued vendor cancellation charges | 19,898 | 17,291 |
| Accrued restructuring | 6,400 | 8,197 |
| Other accrued liabilities | 9,781 | 14,015 |
| Interest payable on long-term debt | 2,117 | 3,273 |
| Current portion of capital lease obligations | 169 | 126 |
| Total current liabilities | 91,455 | 107,701 |
| Long-term obligations | 4,348 | 4,267 |
| Long-term portion of capital lease obligations | 102 | 233 |
| Convertible subordinated notes | 100,141 | 174,141 |
| Commitments and contingencies | | |
| Stockholders equity: | | |
| Common stock | 73 | 73 |
| Additional paid in capital | 1,077,549 | 1,074,203 |
| Accumulated deficit | (900,769) | (892,994) |
| Deferred compensation | (130) | (458) |
| Treasury stock, at cost | (773) | (768) |
| Accumulated other comprehensive (loss) income | (1,807) | 248 |
| Total stockholders equity | 174,143 | 180,304 |
| Total liabilities and stockholders equity | $ 370,189 | $ 466,646 |

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 June 30, | | Six Months Ended June 30, | |
|---|---|---|---|---|
| | 2002 | 2001 | 2002 | 2001 |
| Revenues: | | | | |
| Product revenues | $ 22,193 | $ 40,119 | $ 73,802 | $ 84,008 |
| Related party product revenues | 214 | 25,614 | 5,823 | 35,709 |
| Total revenues | 22,407 | 65,733 | 79,625 | 119,717 |
| Cost of goods sold: | | | | |
| Cost of product revenues | 22,417 | 35,889 | 60,451 | 84,803 |
| Cost of related party product revenues | 17 | 16,871 | 5,153 | 22,810 |
| Special charges | | 28,704 | (11,443) | 28,704 |
| Total cost of goods sold | 22,434 | 81,464 | 54,161 | 136,317 |
| Gross profit (loss) | (27) | (15,731) | 25,464 | (16,600) |
| Operating expenses: | | | | |
| Research and development | 14,704 | 19,152 | 31,644 | 41,779 |
| Sales and marketing | 10,141 | 16,334 | 18,994 | 31,817 |
| General and administrative | 3,552 | 8,664 | 7,186 | 16,611 |
| Goodwill amortization | | 322 | | 22,804 |
| Restructuring costs and asset write-offs | 3,972 | 2,549 | 3,972 | 577,293 |
| Total operating expense | 32,369 | 47,021 | 61,796 | 690,304 |
| Loss from operations | (32,396) | (62,752) | (36,332) | (706,904) |
| Interest income | 2,013 | 4,512 | 4,110 | 11,246 |
| Interest expense | (2,177) | (4,304) | (4,357) | (10,048) |
| Other income (expense) | (4,400) | 317 | (4,465) | (121) |
| Gain on early retirement of debt | 33,276 | | 33,276 | 121,494 |
| Loss before tax (expense) benefit | (3,684) | (62,227) | (7,768) | (584,333) |
| Income tax (expense) benefit | (1) | (277) | (7) | 13,629 |
| Net loss | ($3,685) | ($62,504) | ($7,775) | ($570,704) |
| Basic and diluted net loss per share | ($0.05) | ($0.93) | ($0.11) | ($8.45) |
| Shares used in computing basic and diluted net loss per share | 72,761 | 67,493 | 72,682 | 67,542 |

See accompanying notes.

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

| | Six Months Ended June 30, | |
|---|---|---|
| | 2002 | 2001 |
| Operating activities: | | |
| Net loss | $ (7,775) | $ (570,704) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 5,734 | 4,903 |
| Write-off and amortization of intangible assets | 3,972 | 611,427 |
| Amortization related to stock options | 366 | 1,892 |
| Compensation expense related to warrant issuance | | 753 |
| Gain on early retirement of debt | (33,276) | (121,494) |
| Provision for inventory | 4,532 | |
| Impairment of investment | 4,500 | |
| Loss on disposal of fixed assets | 1,115 | |
| Interest payable | 3,198 | 8,193 |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | 21,324 | 11,495 |
| Accounts receivable from related parties | 3,705 | 1,979 |
| Interest paid | (4,354) | (12,951) |
| Inventory | 4,550 | 48,365 |
| Other assets | (11,312) | 15,300 |
| Accounts payable | (9,775) | (71,669) |
| Accrued payroll and related expenses | (727) | (250) |
| Deferred revenues | (1,316) | (601) |
| Accrued warranty | 109 | 2,519 |
| Accrued restructuring | (1,797) | |
| Accrued vendor cancellation charges | (753) | |
| Deferred taxes | | (18,110) |
| Other accrued liabilities | (3,876) | 14,716 |
| Other non-current liabilities | 81 | (15,700) |
| Net cash used in operating activities | (21,775) | (89,937) |
| Investing activities: | | |
| Purchases of short-term investments | (204,524) | (171,862) |
| Proceeds from sales and maturities of short-term investments | 243,310 | 238,502 |
| Purchases of property and equipment | (3,198) | (4,182) |
| Net cash provided by investing activities | 35,588 | 62,458 |
| Financing activities: | | |
| Principal payments on capital leases | (88) | (34) |
| Payments on repurchase of common stock | (5) | |
| Exercise of options to purchase common stock | 1,693 | 453 |
| Proceeds from issuance of common stock through employee stock purchase plan | 1,614 | |
| Principal payment on stockholders note receivable | | 3 |
| Retirement of debt | (39,220) | (68,459) |
| Net cash used in financing activities | (36,006) | (68,037) |

| | | |
|---|---|---|
| Effect of exchange rate changes | (1,556) | (621) |
| Net decrease in cash and cash equivalents | (23,749) | (96,137) |
| Cash and cash equivalents at beginning of period | 100,274 | 347,015 |
| Cash and cash equivalents at end of period | $ 76,525 | $ 250,878 |

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. (Company) was incorporated under the laws of the State of California on January 20, 1993. In July 1998, the Company reincorporated in the State of Delaware.

The Company develops, markets and sells equipment to cable television operators, telecom carriers and satellite network operators 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 generally accepted accounting principles in the United States for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial statements at June 30, 2002 and for the three and six months ended June 30, 2002 and 2001 have been included.

Results for the three and six months ended June 30, 2002 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 April 1, 2002, as filed with the U.S. Securities and Exchange Commission. The accompanying balance sheet at December 31, 2001 is derived from audited consolidated financial statements at that date.

***Reclassifications***

Certain amounts in the 2001 financial statements have been reclassified to conform to the 2002 presentation. See Note 7.

***Use of Estimates***

The preparation of the condensed consolidated financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. See Critical Accounting Policies in Management s Discussion and Analysis of Financial Condition and Results of Operations.

***Basis of Consolidation***

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

***Concentrations of Credit Risk, Customers, Suppliers, and Products***

The Company operates in two principal operating segments: Cable Broadband Access Systems (Cable) and Telecom Access Systems (Telecom). The Company sells primarily to customers within the cable and telecommunications industries, including related parties. The Company performs ongoing credit

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evaluations of its customers and generally requires no collateral. A relatively small number of customers account for a significant percentage of the Company s revenues and accounts receivable. The Company expects that the sale of its products to a limited number of customers and resellers may continue to account for a high percentage of revenues for the foreseeable future.

Currently, the Company relies on single source suppliers of materials and labor for the significant majority of its product inventory but is actively pursuing additional supplier alternatives. As a result, should the Company s current suppliers not produce and deliver inventory for the Company to sell on a timely basis, operating results may be adversely impacted.

A majority of the Company s revenues have been attributable to sales of its Cable products, primarily modems and headend equipment. These products are expected to account for a significant part of the Company s revenues for the foreseeable future. As a result, a decline in demand for or failure to achieve broad market acceptance of the Company s Cable products would adversely affect operating results.

In addition, market acceptance of the Company s products may be affected by the emergence and evolution of industry standards. While the Company expects its products to become compliant with industry standards, its inability to do so may adversely affect operating results.

The Company invests its excess cash in debt instruments of governmental agencies, and corporations with credit ratings of AA/AA- or better or A1/P1 or better, respectively. The Company has established guidelines relative to diversification and maturities that attempt to maintain safety and liquidity. The Company has not experienced any significant losses on its cash equivalents or short-term investments.

***Revenue Recognition***

The Company sells its products directly to broadband access service providers, system resellers and distributors and recognizes revenue upon shipment to the customer when title is transferred. Revenues related to product sales are generally recognized when: (1) persuasive evidence that an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the seller s price to the buyer is fixed or determinable, and (4) collectibility is reasonably assured. The Company s existing agreements with its system resellers and distributors do not contain price protection provisions and do not grant return rights beyond those provided by the Company s standard warranty.

***Warranty Reserves***

The Company provides a standard warranty for most of its products, generally lasting one year from the date of purchase. The Company provides for the estimated cost of product warranties at the time revenue is recognized. The Company s warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Reserve estimates are based on historical experience and expectations of future conditions.

***Cash Equivalents and Short-Term Investments***

The Company invests its excess cash in money market accounts and debt instruments and considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Investments with an original maturity at the time of purchase of over three months are classified as short-term investments regardless of maturity date as all investments are classified as available-for-sale and can be readily liquidated to meet current operational needs.

The Company accounts for investments in accordance with Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities . Management determines the appropriate classification of debt securities at the time of purchase and reevaluates such designation as of each balance sheet date. The Company s short-term investments, which consist primarily of commercial paper, U.S. government and U.S. government agency obligations and fixed income corporate securities, are classified as available-for- sale and are carried at amortized cost which

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approximates fair market value. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in interest income. The cost of securities sold is based on the specific identification method. The Company had no investments in equity securities at either June 30, 2002 or December 31, 2001.

***Inventory***

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

| | June 30, 2002 | December 31, 2001 |
|---|---|---|
| Finished goods | $ 9,308 | $ 6,433 |
| Work-in-process | 212 | 236 |
| Raw materials | 1,058 | 9,989 |
| | $10,578 | $16,658 |

Cost of goods sold for the six months ended June 30, 2002 included a reversal of approximately $11.4 million in special charges taken in 2001 for vendor cancellation charges and inventory previously reserved for as obsolete. The Company was able to reverse the provision as it was able to sell inventory originally considered to be excess. In addition, the Company was able to negotiate downward certain vendor cancellation claims to terms more favorable to the Company. In the second quarter of 2002, the Company recorded an additional inventory reserve of $4.5 million to reduce certain inventories to the lower of cost or market as average selling prices fell below the cost of these products.

***Net Loss Per Share***

Basic and diluted net loss per share were computed using the weighted average number of common shares outstanding. Options to purchase 18,811,454 and 34,993,219 shares of common stock were outstanding at June 30, 2002 and June 30, 2001, respectively. Warrants to purchase 2,408,300 and 2,684,700 shares of common stock were outstanding at June 30, 2002 and June 30, 2001, respectively. Neither the options nor warrants were included in the computation of diluted net loss per share, since the effect would be antidilutive.

***Comprehensive Net Income (Loss)***

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

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

| | Three Months Ended | Six Months Ended |
|---|---|---|