UTSTARCOM INC
Form 10-K/A
April 13, 2005

# UNITED STATES
# SECURITIES AND EXCHANGE COMMISSION

**WASHINGTON, D. C. 20549**

---

FORM 10-K/A
(Amendment No. 1)

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

**For the Fiscal Year Ended December 31, 2003.**

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

**For the transition period from to**

**Commission File Number: 000-29661**

---

# UTSTARCOM, INC.

(Exact name of registrant as specified in its charter)

| | |
|---|---|
| **Delaware** | **52-1782500** |
| (State or other jurisdiction<br>Of incorporation or organization) | (I.R.S. Employer<br>Identification No.) |
| **1275 Harbor Bay Parkway**<br>**Alameda, California** | **94502** |
| (Address of principal executive offices) | (Zip Code) |

**(510) 864-8800**

(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: **None**

Securities registered pursuant to Section 12(g) of the Act:

**Common stock, $0.00125 par value**

(Title of class)

---

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act). Yes x No o

The aggregate market value of the voting stock held by non-affiliates of the registrant as of the last business day of the registrant s most recently completed second fiscal quarter was approximately $2,893,028,280 based upon the closing price of $35.64 reported for such date on The NASDAQ National Market. For purposes of this disclosure, shares of Common Stock held by persons who hold more than 10% of the outstanding shares of Common Stock and shares held by officers and directors of the registrant, have been excluded in that such persons may be deemed to be affiliates. This determination is not necessarily conclusive for other purposes.

As of February 29, 2004 the registrant had 117,110,056 outstanding shares of Common Stock.

**DOCUMENTS INCORPORATED BY REFERENCE**

Portions of the Proxy Statement for the Annual Meeting of Shareholders to be held on May 7, 2004 are incorporated herein by reference in Part III.

**EXPLANATORY NOTE**

UTStarcom, Inc. ( UTStarcom or the Company ) is filing this Amendment No. 1 to its Annual Report on Form 10-K for the year ended December 31, 2003 (this Amendment ) to reflect the restatement of its consolidated financial statements for the year ended December 31, 2003 and the quarters ended March 31, 2003, June 30, 2003 and September 30, 2003 and certain corresponding changes described below.

As part of the financial closing process for the year ended December 31, 2004, the Company identified certain errors resulting in a restatement which decreased the provision for income taxes and increased net income by $20.7 million for the year ended December 31, 2003. In addition, as a result of the correction of the tax provision, retained earnings was increased by $20.7 million, additional paid-in capital was increased $0.9 million, income taxes payable was decreased by $2.5 million, other long-term assets were increased by $21.6 million, prepaids were increased by $2.8 million and other current assets were reduced by $5.3 million. There was no net effect on cash provided from operating activities as a result of this error.

During the evaluation of the errors related to the income tax provision, the Company determined that an additional reclassification of reported 2003 results was required. Specifically, cost of sales and other income both increased by $3.5 million for the year ended December 31, 2003 to properly classify certain incentive payments received for exports and value-added taxes in China.

In addition to the errors in the 2003 tax provision, the Company had not correctly identified a related party that is deemed a variable interest entity and for whom the Company is considered the primary beneficiary in accordance with FASB Interpretation No. 46 ( FIN 46 ). The Company has corrected its 2003 financial statements to reflect the consolidation of this variable interest entity, MDC Holding Limited ( MDC Holding ) and its affiliated entities (MDC Holding and such affiliated entities are referred to, collectively, as MDC ). At December 31, 2003, this consolidation resulted in a $5.5 million increase in total assets and a $0.7 million increase in total liabilities. There was no effect on net income as a result of this consolidation.

Furthermore, an impairment charge of $7.4 million, net of taxes of $1.3 million, was recorded to reflect an impairment of MDC equipment subject to a revenue share arrangement. Due to the uncertainties surrounding the customer s subscriber income and ability to pay under this arrangement, the Company determined that an impairment charge should have been recorded in 2003 when these conditions should have been identified. Accordingly, an impairment charge of $7.4 million, net of tax, was recorded, which decreased both total assets and equity by $7.4 million, at December 31, 2003.

In addition, the Company identified the following revisions in classification during the preparation of the restated consolidated financial statements:

(1) Cost of sales for related party revenue transactions is presented separately from cost of sales for non-related party revenue transactions for all years presented;

(2) Certain other long-term assets increased and intangible assets decreased by $1.7 million at December 31, 2003;

(3) Changes in restricted cash had been incorrectly categorized as a part of operating cash flows instead of investing cash flows in accordance with Statement of Financial Accounting Standards No. 95, Statement of Cash Flows, ( SFAS 95 ). Accordingly, the Company has reflected this change in categorization in the Consolidated Statement of Cash Flows for each of the three years in the period ended December 31, 2003. The change for 2003 and 2002 is an increase in cash flows from operating activities and a decrease in cash flows from investing activities of $3.2 million and $21.3 million, respectively, and there was no change for 2001; and

(4) A related party which is 31% owned by an individual related to a member of the Company s Board of Directors and associated transactions have been identified. See Note 22 to the Consolidated Financial Statements.

A discussion of the restatement is set forth in Note 24 to the Consolidated Financial Statements included in this Amendment. Changes also have been made to the following items in this Amendment as a result of the restatement:

**Part II**

- Item 6 Selected Consolidated Financial Data (page 3)
- Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations (pages 4-41)
- Item 7A Quantitative and Qualitative Disclosures About Market Risk (pages 41-43)
- Item 8 Financial Statements and Supplementary Data (pages 44-92)
- Item 9A Controls and Procedures (pages 93-102)

Items filed in the original Form 10-K that are not impacted by the restatement are not included in this amended filing.

**Part IV**

- Item 15 Exhibits, Financial Statement Schedules and Reports on Form 8-K (pages 103-107)

This Amendment does not reflect events that have occurred after the March 9, 2004 filing date of the Annual Report on Form 10-K that the Company originally filed with the Securities and Exchange Commission, or modify or update the disclosures presented in the original Form 10-K, except to reflect the corrections described above. Accordingly, this Form 10-K/A should be read in conjunction with our filings with the Securities and Exchange Commission subsequent to the filing of the original Form 10-K.

**ITEM 6 SELECTED CONSOLIDATED FINANCIAL DATA**

You should read the selected consolidated financial data set forth below in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and our Consolidated Financial Statements and the Notes thereto included elsewhere in this report. Historical results are not necessarily indicative of results that may be expected for any future period.

| | Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2003 | 2002 | 2001 | 2000 | 1999 |
| | Restated(1) | | | | |
| | (in thousands, except per share data) | | | | |
| **Consolidated Statement of Operations Data:** | | | | | |
| Net sales | $ 1,965,187 | $ 981,806 | $ 626,840 | $ 368,646 | $ 187,516 |
| Gross profit | 624,385 | 345,472 | 224,548 | 128,181 | 74,813 |
| Operating income | 261,738 | 145,962 | 76,728 | 33,780 | 16,719 |
| Income from continuing operations | 215,532 | 107,862 | 56,954 | 27,993 | 13,119 |
| Net income (loss) available to common stockholders | 215,532 | 107,862 | 56,954 | 27,013 | (18,514) |
| Basic earnings (loss) per share: | | | | | |
| Income (loss) from continuing operations | $ 2.08 | $ 0.98 | $ 0.56 | $ 0.35 | $ (1.94) |
| Income (loss) from discontinued operations | | | | | (0.19) |
| Cumulative effect on prior years of the application of SAB 101 Revenue Recognition in Financial Statements | | | | (0.01) | |
| Net income (loss)[2] | $ 2.08 | $ 0.98 | $ 0.56 | $ 0.34 | $ (2.13) |
| Diluted earnings (loss) per share: | | | | | |
| Income (loss) from continuing operations | $ 1.75 | $ 0.94 | $ 0.52 | $ 0.28 | $ (1.94) |
| Income (loss) from discontinued operations | | | | | (0.19) |
| Cumulative effect on prior years of the application of SAB 101 Revenue Recognition in Financial Statements | | | | (0.01) | |
| Net income (loss) | $ 1.75 | $ 0.94 | $ 0.52 | $ 0.27 | $ (2.13) |
| Proforma amounts assuming application of SAB101 Revenue Recognition in Financial Statements is applied retroactively: | | | | | |
| Net income (loss) available to common stockholders | $ 215,532 | $ 107,862 | $ 56,954 | $ 27,993 | $ (19,494) |
| Earnings (loss) per share: | | | | | |
| Basic | $ 2.08 | $ 0.98 | $ 0.56 | $ 0.35 | $ (2.25) |
| Diluted | $ 1.75 | $ 0.94 | $ 0.52 | $ 0.27 | $ (2.25) |
| Weighted average shares used in per share calculations: | | | | | |
| Basic | 103,659 | 109,566 | 101,433 | 79,696 | 8,678 |
| Diluted | 124,909 | 114,407 | 108,612 | 101,867 | 8,678 |

| | As of December 31, | | | | |
|---|---|---|---|---|---|
| | 2003 | 2002 | 2001 | 2000 | 1999 |
| | Restated(1) | | | | |
| | (in thousands) | | | | |
| **Consolidated Balance Sheet Data:** | | | | | |
| Cash and cash equivalents | $ 377,747 | $ 231,944 | $ 321,136 | $ 149,112 | $ 87,364 |
| Working capital | 883,334 | 568,215 | 591,103 | 369,861 | 128,973 |
| Total assets | 2,244,050 | 1,305,552 | 1,005,880 | 591,837 | 271,788 |
| Total short-term debt | 1 | | 58,434 | 43,381 | 43,338 |
| Long-term debt | 410,655 | | 12,048 | 12,048 | |
| Total stockholders equity | 893,331 | 766,395 | 681,887 | 412,319 | 165,720 |

(1) See Note 24 to the Consolidated Financial Statements.

(2) Net loss available to common stockholders for 1999 includes a one-time charge for approximately $30.0 million related to the issuance of Series F preferred stock in 1999 that included a beneficial conversion feature pursuant to which the preferred shares converted into common shares on a one-for-one basis at a price below the expected offering price upon the completion of our initial public offering. This reduced diluted earnings per share available to common stockholders by $3.45.

3

**ITEM 7 MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

As discussed in Note 24 to the Consolidated Financial Statements, the Company has restated its Consolidated Financial Statements for the year ended December 31, 2003 and the quarters ended March 31, 2003, June 30, 2003 and September 30, 2003 to correct errors and reflect certain corresponding changes described below.

As part of the financial closing process for the year ended December 31, 2004, the Company identified certain errors in the calculation of the Company s 2003 income tax provision resulting in a restatement which decreased the provision for income taxes and increased net income by $20.7 million for the year ended December 31, 2003. In addition, as a result of the correction of the tax provision retained earnings was increased by $20.7 million, additional paid-in capital was increased $0.9 million, income taxes payable was decreased by $2.5 million, other long-term assets were increased by $21.6 million, prepaids were increased by $2.8 million and other current assets were reduced by $5.3 million. There was no net effect on cash provided from operating activities as a result of this error.

During the evaluation of the errors related to the income tax provision, the Company determined that an additional reclassification of reported 2003 results was required. Specifically, cost of sales and other income both increased by $3.5 million for the year ended December 31, 2003 to properly classify certain incentive payments received for exports and value-added taxes in China.

In addition to the errors in the 2003 tax provision, the Company had not correctly identified a related party that is deemed a variable interest entity and for whom the Company is considered the primary beneficiary in accordance with FASB Interpretation No. 46 ( FIN 46 ). The Company has corrected its 2003 financial statements to reflect the consolidation of this variable interest entity, MDC Holding Limited ( MDC Holding ) and its affiliated entities (MDC Holding and such affiliated entities are referred to, collectively, as MDC ). At December 31, 2003, this consolidation resulted in a $5.5 million increase in total assets and a $0.7 million increase in total liabilities. There was no effect on net income as a result of this consolidation.

Furthermore, an impairment charge of $7.4 million, net of taxes of $1.3 million, was recorded to reflect an impairment of MDC equipment subject to a revenue share arrangement. Due to the uncertainties surrounding the customer s subscriber income and ability to pay under this arrangement, the Company determined that an impairment charge should have been recorded in 2003 when these conditions should have been identified. Accordingly, an impairment charge of $7.4 million, net of tax, was recorded, which decreased both total assets and equity by $7.4 million, at December 31, 2003.

In addition, the Company identified the following revisions in classification during the preparation of the restated consolidated financial statements:

(1) Cost of sales for related party revenue transactions is presented separately from cost of sales for non-related party revenue transactions for all years presented;

(2) Certain other long-term assets increased and intangible assets decreased by $1.7 million at December 31, 2003;

(3) Changes in restricted cash had been incorrectly categorized as a part of operating cash flows instead of investing cash flows in accordance with Statement of Financial Accounting Standards No. 95, Statement of Cash Flows, ( SFAS 95 ). Accordingly, the Company has reflected this change in categorization in the Consolidated Statement of Cash Flows for each of the three years in the period ended December 31, 2003. The change for 2003 and 2002 is an increase in cash flows from operating activities and a decrease in cash flows from investing activities of $3.2 million and $21.3 million, respectively, and there was no change for 2001; and

(4) A related party which is 31% owned by an individual related to a member of the Company s Board of Directors and associated transactions have been identified. See Note 22 to the Consolidated Financial Statements.

The accompanying Management s Discussion and Analysis gives effect to this restatement.

**FORWARD-LOOKING STATEMENTS**

This Annual Report on Form 10-K contains forward-looking statements within the meaning of the federal securities laws. These statements are based on information that is currently available to management. We intend such forward-looking statements to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, and we are including this statement for purposes of complying with those provisions. The forward-looking statements include, without limitation, those concerning the following: our expectations as to the nature of possible trends; our expectations regarding continued growth in our business and operations; our expectation that there will be fluctuations in our overall gross profit, gross margin, product mix, quarter to quarter results, customer base and selling prices; our plans for expanding the direct sales organization and our selling and marketing campaigns and activities; our expectation that we may use our cash, debt or securities to acquire or invest in complementary businesses, technologies or product offerings; our expectation that there will be increases in selling, marketing, research and development, and general and administrative expenses; our expectations regarding future growth of our business and operations; our expectation that we will continue to invest significantly in research and development; our expectations regarding the status of products under development; our expectations regarding our future investments; our expectations regarding our future levels of cash and cash equivalents, as well as our expectation that existing cash and cash equivalents will be sufficient to finance our operations for the foreseeable future; our expectations regarding licensing requirements and our ability to receive licenses in China for our PAS system and other products; our expectations regarding the development of a 3G network in China; our expectations regarding the impact of a reorganization of China Netcom; our expectation that our business will continue to be significantly influenced by the political, economic and legal environment in China, as well as expectations about the nature of political, economic and legal reform in China; our expectations regarding the future allocation of net sales by product group; our expectations regarding efficiencies we hope to achieve in supply chain and inventory purchasing, as well as trends in inventory growth; and our expectations regarding our expansion into new markets around the world. Additional forward-looking statements may be identified by the words, anticipate, expect, believe, intend, will and similar expressions, as they relate to us or our management. Investors cautioned that these forward-looking statements are inherently uncertain. These statements are subject to risks and uncertainties that may cause actual results and events to differ materially. For a detailed discussion of these risks and uncertainties, see the Factors Affecting Future Operating Results section of this Form 10-K. We do not guarantee future results and undertake no obligation to update the forward-looking statements to reflect events or circumstances occurring after the date of this Form 10-K.

**EXECUTIVE SUMMARY**

We design, manufacture and sell telecommunications equipment and products and provide services associated with their operation. Our products are deployed and installed exclusively by telecommunications wireless and wireline service providers. We provide an extensive range of products for transportation of voice, data and video traffic for service providers around the world. Our business is conducted globally in China, Japan, India, the Central and Latin American region, North America, the European, Middle Eastern and African region and southeastern and northern Asia. Our objective is to be a leading global provider of Internet Protocol ( IP ) networking products and services. We differentiate ourselves with products designed, developed and commercialized to reduce network complexity, integrate high performance capabilities and that allow a simple transition to next generation networks. This results in deployment, maintenance and upgrades that are both economical and efficient, allowing operators to earn a high return on their investment.

Our technologies and products fall into three major categories:

- wireless, a technology that enables end users, or subscribers, to send and receive voice and data while mobile and using wireless devices;

- wireline, a technology that satisfies customer demand for high-speed, cost effective data, voice and media transport and carriage; and

- switching, a diverse assembly of software and hardware based networking elements designed to replace central office telephone switches.

Our products within each of these categories include multiple hardware and software subsystems that can be offered in various combinations to suit individual subscriber needs. Our system technologies and products are based on widely adopted global communications standards and are designed to allow service providers to quickly and cost-efficiently integrate our systems into their existing networks and deploy our systems in new broadband, Internet Protocol ( IP ) and wireless network rollouts. Our system technologies are also designed to allow timely and cost efficient transition to future next-generation network technologies, enabling our service provider customers to protect their initial infrastructure investments.

Historically, substantially all of our sales have been to service providers in China. 86% of our sales for the year ended December 31, 2003 were derived from China and 10% of our sales were from Japan. However, we are currently expanding our sales efforts to include other communications markets such as in the Central and Latin American region, the European, Middle Eastern and African region, North America and southeastern and northern Asia. We intend to penetrate these markets through direct sales offices located in key market regions, by licensing our technology to local manufacturers where import taxation is favorable, by developing local sales agency and distributor relationships within specific market regions, and by establishing sales relationships with original equipment manufacturers. Our sales division began establishing regional offices and local direct sales representative offices to provide support for our expanding global sales operations.

In a telecommunications industry that has experienced a period of contraction over the last few years, we experienced significant growth in revenue and profit during this period. In 2003, we had approximately $2.0 billion of revenue, a 100% increase over 2002. This growth in revenue was driven by China s growing telecommunications market. China, which we believe to be one of the fastest growing telecommunications markets in the world, continued to experience increasing fixed-line and mobile telephone and Internet subscriber growth, from 480.1 million subscribers in 2002 to 611.5 million subscribers in 2003, according to China s Ministry of Information Industry. We believe this subscriber growth led to increased demand for our PAS services and handsets. We use subscriber growth statistics to gauge future inventory purchasing requirements as well as to forecast our anticipated revenue growth. We expect this subscriber growth trend to continue in 2004 as China s teledensity rates remain low in comparison to that of developed countries.

The number of competitors for communications access and switching systems and handsets in China grew in 2003 in line with China s growing telecommunications market. This growth led to competitive pricing pressure, causing our average selling prices to decrease in 2003 relative to 2002 levels. At the same time, a larger percentage of our revenue was derived from handsets sales, which generally have a lower margin than communications access and switching systems, contributing to decreased margins overall from 2001 to 2003. We continued to develop products with more advanced features and to enhance the features of our existing products in 2003, which we believe will enable us to offer our customers a more advanced product at a higher average selling price than otherwise would be possible. In addition, we worked in 2003, and intend to continue to strive to, reduce the cost of manufacturing our products by streamlining our design and engineering functions.

In an effort to penetrate new markets around the world, support our growing business and expand our product offerings, we continued to invest resources in our selling, administrative and research and development groups in 2003. While these costs increased significantly from 2001 to 2003 in line with increased business levels, we reduced these costs as a percentage of our revenues during this period. Operating costs as a percentage of revenue were 18% in 2003 compared to 20% in 2002.

We continued to operate on a positive cash flow basis in 2003, despite increased accounts receivable and inventory balances. Our increased inventory levels were, in part, attributable to our increased backlog. We typically funded our inventory requirements with customer advances, which we received upon signing new contracts. Our accounts receivable balance continued to increase in 2003, but at the same time our cash collections from customers increased as our days sales outstanding continued to improve, enabling us to continue to obtain net cash provided by our operations.

***ACQUISITIONS AND OTHER KEY TRANSACTIONS***

*Acquisitions and in-process research and development ( IPR&D )*

Since our incorporation, we have focused our resources on developing products for the global communications market, with an emphasis on the China communications market. We have made several key strategic acquisitions to acquire additional resources to further this development. These acquisitions were accounted for as purchases and the results of operations have been included in our consolidated financial statements from the closing dates of the acquisitions. Acquisitions prior to 2003 including HUTS, GUTS, Issanni and Advanced Communications Devices Corporation have not had a significant ongoing impact on our consolidated results of operations.

Our acquisitions often result in a one-time charge to operating expenses related to products under development but have not yet reached technological feasibility, or in-process research and development ( IPR&D ). A project is classified as IPR&D if there are significant risks associated with completing the development of the acquired technology including both technological and commercial risks. When assessing IPR&D projects, we consider the key project characteristics as well as its future prospects, the rate at which technology changes in the telecommunications equipment industry, product life cycles and the product s development stage.

In connection with acquisitions, we often issue stock-based incentives that vest according to terms established in the acquisition agreement. Historically, our stock-based incentives have vested based upon the achievement of product development milestones, of meeting revenue targets or on the duration of employment.

*CommWorks*

On May 23, 2003, we completed our acquisition from 3Com Corporation, a Delaware corporation, ( 3Com ) of selected assets and liabilities from 3Com s CommWorks division ( CommWorks ). We funded the consideration for the acquisition from cash on hand, and paid $100.0 million in cash and incurred related transaction and other related costs of $9.3 million.

Selected assets acquired included CommWorks s portfolio of carrier-focused voice and data networking products and customer support and professional services. In addition, we acquired or licensed all of the 3Com intellectual property used by CommWorks. CommWorks develops and deploys carrier-class, IP-based multi-service access and service-creation platforms for telecommunications service providers.

The amount of the purchase price allocated to IPR&D of $1.3 million, based on an independent valuation was charged to the Company s results of operations, as no alternative future uses existed at the acquisition date.

As of the date of the acquisition, CommWorks had two projects under development that qualified for IPR&D, SLAP and High Density Voice ( HDV ) 2.0. SLAP is an IPR&D project in the Wireless division of CommWorks. It is an interface that connects our products with radio switch manufacturers products in China in order to connect a cellular network to the Internet. HDV 2.0 is an IPR&D project in the Wireline product line of CommWorks. HDV 2.0 utilizes software technology to increase data capacity for Voice over Internet Protocol ( VoIP ) solutions.

There are significant risks associated with those technologies. The technological risks stem from the fact that the new technologies are in an early stage of development. As of the closing date, CommWorks SLAP IPR&D project was approximately 60% complete and HDV 2.0 was approximately 40% complete. Therefore, there are significant risks associated with reaching the technological milestones on time and on budget. Commercial risks are associated with the competitive nature of the telecommunications equipment market.

Additional costs will be required to complete the IPR&D projects. The SLAP product is now expected to be commercialized in the first quarter of fiscal 2004. Remaining costs required to complete the project, are estimated to be $0.1 million. The HDV 2.0 product is now expected to be commercialized in the first quarter of fiscal 2004. Remaining costs required to complete the project are estimated to be $0.2 million.

*RollingStreams*

On June 30, 2003, we completed the acquisition of RollingStreams Systems, Ltd. ( RollingStreams ), a development-stage company, pursuant to a share exchange agreement. RollingStreams designs streaming, end-to-end TV-over-Internet-Protocol ( TVoIP ) products and services for telecommunications operators and broadband service providers. Our investment in RollingStreams was $0.4 million prior to the acquisition. The purchase consideration for all the outstanding shares of RollingStreams, other than those already held by us prior to the acquisition, was 301,074 shares of our common stock. In addition, we assumed all outstanding RollingStreams options, which became options to purchase an aggregate of 12,742 shares of our common stock, valued at $0.5 million. Of the 301,074 shares, 164,115 shares valued at $5.8 million, were issued at the closing, 28,696 of which are held in escrow for any undisclosed liabilities or contingencies incurred by RollingStreams prior to the closing or for any breach of the share exchange agreement. These shares will be distributed to the former shareholders of RollingStreams within ten days of the six-month anniversary of the closing, after deducting any claims. Up to 136,959 of the 301,074 shares will be payable in the form of an earnout after an earnout period expiring 18 months after the closing, subject to the achievement of certain revenue milestones during such earnout period.

The amount of the purchase price allocated to in-process research and development was $6.2 million, based on an independent valuation. This amount was charged to our results of operations, as no alternative future uses existed at the acquisition date.

As of the date of the acquisition, RollingStreams had one project under development that qualified for in-process research and development, MediaSwitch. MediaSwitch is an end-to-end solution designed for telecom operators and broadband service providers to deliver broadcast quality TV and on-demand entertainment services over Internet Protocol networks.

MediaSwitch is considered an IPR&D project because there are significant risks associated with the development of this technology. These risks include technological and commercial risks. The technological risks stem from the fact that the technology is 70% complete. Therefore, there are significant risks associated with reaching the technological milestones on time and on budget. Commercial risks are associated with the lack of market acceptance for the TVoIP concept.

In addition to the technological and commercial risks stated above, significant additional costs will be required to complete the IPR&D project. MediaSwitch is now expected to be commercialized in the second quarter of 2004. Remaining costs required to complete the project are estimated to be $4.5 million. Remaining engineering tasks include adding new features and functionalities and stabilizing the software code.

*Xebeo*

On May 7, 2003, we completed the purchase of all of the assets of Xebeo Communications, Inc. ( Xebeo ) for $2.4 million in cash. Xebeo develops and manufactures optical packet switches that enable telecommunications carriers to provide single fiber, multi-service access to customers. In addition, an amount up to $0.7 million may be payable based on future contingencies related to employment.

The amount of the purchase price allocated to in-process research and development of $1.9 million, based on an independent valuation, was charged to our results of operations, as no alternative future uses existed at the acquisition date.

As of the date of the acquisition, Xebeo was focusing its resources on the development of its first product, MetroBridge, an optical packet switching solution, and was considered in the development stage. The development of MetroBridge was 60% complete as of the closing date. The technological feasibility of the technology was not established and the technology had no future alternative uses, therefore the development of MetroBridge is considered IPR&D. The product achieved its technical milestones as of November 2003, and is now available for customer trials and evaluations. It is expected to be marketed and sold in the third quarter of 2004. Commercial risks are associated with the lack of market acceptance with a product with these features and for its use in TVoIP implementations.

*Shanghai Yi Yun*

On October 16, 2002, we acquired the assets and intellectual property of Shanghai Yi Yun Telecom Technology Co. Ltd. ( Shanghai Yi Yun ), a provider of synchronous digital hierarchy equipment. Consideration was $0.2 million of cash and 342,854 shares of restricted stock valued at $6.0 million. In connection with the acquisition, Shanghai Yi Yun and each of the stockholders that received the 342,854 shares of restricted stock executed an indemnity escrow agreement in our favor and such shares of restricted stock were placed in escrow. In addition, we issued 514,290 shares of restricted stock valued at that time at $9.0 million to the Shanghai Yi Yun employees that were hired by one of our subsidiaries. Such shares of restricted stock vest over five years, with accelerated vesting upon the achievement of specified milestones. We have treated these 514,290 shares of restricted stock as deferred compensation.

*Debt Issuance*

On March 12, 2003, we completed an offering of $402.5 million of convertible subordinated notes due March 1, 2008 to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933. The notes bear interest at a rate of 7/8% per annum and are convertible into our common stock at a conversion price of $23.79 per share and are subordinated to all of our present and future senior debt. Holders of the notes may convert their notes only if: (i) the price of our common stock issuable upon conversion of a note reaches a specified threshold, (ii) specified corporate transactions occur, or (iii) the trading price for the notes falls below certain thresholds. At the initial conversion price, each $1,000 principal amount of notes will be convertible into approximately 42.0345 shares of common stock.

Concurrent with the issuance of the convertible notes, we entered into convertible bond hedge and call option transactions with respect to our common stock. Both the bond hedge and call option transactions may be settled at our option either in cash or net shares and expire on March 1, 2008. The convertible bond hedge and call option transactions are expected to reduce the potential dilution from conversion of the notes. The options have been included in stockholders equity in accordance with the guidance in Emerging Issues Task Force Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock.

*Transactions with Softbank*

We recognized revenue of $184.4 million, $123.0 million, and $13.9 million during the years ended December 31, 2003, 2002 and 2001, respectively, with respect to sales of telecommunications equipment to Softbank BB Corporation ( SBBC ), an affiliate of SOFTBANK CORP. and SOFTBANK America Inc., a significant stockholder of ours. SBBC offers asynchronous digital subscriber line ( ADSL ) coverage throughout Japan, which is marketed under the name YAHOO BB! . The majority of the products we provide to SBBC is associated with ADSL technology. The contract was competitively bid and the terms of this contract were on terms no more favorable than those with unrelated parties. Included in accounts receivable at December 31, 2003 and 2002 were $43.9 million and $0.8 million, respectively, related to this agreement. There were no amounts included in deferred revenue in respect to this agreement at December 31, 2003 and 2002.

During 2000, we invested $10.0 million in Softbank China, an investment fund established by SOFTBANK CORP. focused on investments in Internet companies in China. This investment permits us to participate in the anticipated growth of Internet-related businesses in China. Our investment constitutes 10% of the funding for Softbank China, with SOFTBANK CORP. contributing the remaining 90%. The fund has a separate management team, and none of our employees are employed by the fund. Many of the fund s investments are and will be in privately held companies, many of which are still in the start-up or development stages. These investments are inherently risky as the market for the technologies or products the companies have under development are typically in the early stages and may never materialize. We account for this investment under the cost method and recorded losses of $0.2 million, $2.8 million and $1.7 million due to an other-than-temporary decline in the carrying value of this investment in 2003, 2002 and 2001, respectively. The balance in this investment was $5.3 million at December 31, 2003.

During the first quarter of fiscal 2002, we invested $2.0 million in Restructuring Fund No. 1, a venture capital investment limited partnership established by SOFTBANK INVESTMENT CORP., an affiliate of SOFTBANK CORP. The fund focuses on leveraged buyout investments in companies in Asia undergoing restructuring or bankruptcy proceedings. The total fund offering is expected to be between approximately $150.0 million and $226.0 million, with each investor contributing a minimum of $0.8 million. The fund has a separate management team, and none of our employees are employed by the fund. We account for this investment under the equity method of accounting. During the year ended December 31, 2003 we recorded equity losses of $0.1 million, and recorded no losses for the year ended December 31, 2002. The balance in this investment is $1.9 million at December 31, 2003.

On August 29, 2002, we completed the repurchase of 6.0 million shares of our common stock for $72.9 million from our largest shareholder, SOFTBANK America Inc. As part of this transaction, SOFTBANK signed a voluntary lock up agreement stipulating that it would not sell any of our common stock within the next six months.

This lock up agreement, which ended on March 1, 2003, coincided with the start of our blackout period in which insiders are not permitted to sell shares. The blackout period began March 1, 2003 and ended commencing at the close of business on the second trading day following the public release of our first quarter fiscal 2003 results on April 16, 2003.

On April 5, 2003, we repurchased 8.0 million shares of our common stock beneficially owned by SOFTBANK America Inc., at a purchase price of $17.385 per share. The total cost of the repurchase was $139.6 million including transaction fees. In connection with this repurchase transaction, SOFTBANK America Inc. entered into an agreement with us not to offer, sell or otherwise dispose of our common stock for a period of one year, subject to a number of exceptions. As of December 31, 2003, SOFTBANK America Inc. beneficially owned approximately 14.1% of our outstanding stock.

On July 17, 2003, we entered into a Mezzanine Loan Agreement with BB Modem Rental PLC ( BB Modem ), an affiliate of SOFTBANK CORP. Under the terms of the agreement we loaned BB Modem $10.1 million, for the purposes of investing in a portfolio of ADSL modems and associated modem rental agreements, from SOFTBANK BB CORP., formerly BB Technologies, an affiliate of SOFTBANK CORP. SOFTBANK BB CORP. will continue to service such modems and modem rental agreements. Our loan is subordinated to certain senior lenders of BB Modem, and repayments are payable to us over a forty-two month period through January 31, 2007, with a substantial portion of the principal amount of the loan schedule to be repaid during the last 16 months of this period. Our recourse for nonpayment of the loan is limited to the assets of BB Modem, the account into which subscriber payments are made and its rights under the securitization transaction documents. The value of BB Modem s modems that serve as collateral for the loan may decrease over time and may not be sufficient upon sale to pay the outstanding amounts on the loans. We assess the loan for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. We periodically review the underlying quality of the asset pool securing the loan to assess whether impairment has incurred and needs to be recorded. During 2003, we recorded $0.5 million in interest income in respect of this loan. The loan receivable at December 31, 2003 was approximately $11.2 million based on a foreign exchange rate of approximately $1.07 for 100 Japanese Yen.

*Subsequent Event*

On January 14, 2004, we sold 12.1 million shares of common stock at $39.25 per share to Banc of America Securities LLC, for net proceeds of approximately $474.2 million. We intend to use the net proceeds for strategic and general corporate purposes, including, but not limited to, acquisitions, investments, working capital or capital expenditures.

**RESULTS OF OPERATIONS**

Approximately 86%, 84% and 90% of our net sales for the years ended December 31, 2003, 2002 and 2001, respectively, were in China. Accordingly, our business, financial condition and results of operations are likely to be influenced by the political, economic and legal environment in China, and by the general state of China s economy for the foreseeable future. Our results may be adversely affected by, among other things, changes in the political, economic, competitive and social conditions in China, including changes in governmental policies with respect to laws and regulations, changes in the telecommunications industry and regulatory rules and policies, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation. We extend credit to our customers in China without requiring collateral. We monitor our exposure for credit losses and maintain allowances for doubtful accounts. Business activity in China and many other countries in Asia declines considerably during the first quarter of each year in observance of the Lunar New Year. As a result, sales during the first quarter of our fiscal year have typically been lower than sales during the fourth quarter of the preceding year, and we expect this trend to continue.

Cost of sales consists primarily of material costs, payments to agents, costs associated with manufacturing, assembly and testing of products, costs associated with installation and customer training and overhead and warranty costs. Cost of sales also includes import taxes and tariffs on components and assemblies. Some components and materials used in our products are purchased from a single supplier or a limited group of suppliers and, in some cases, are subject to our obtaining Chinese import permits and approvals. We also rely on third party manufacturers in China to manufacture and assemble most of our handsets.

Our gross profit has been affected by product mix, average selling prices and material costs. Our gross profit, as a percentage of net sales, varies among our product families. We expect that our overall gross profit, as a percentage of net sales, will fluctuate from period to period as a result of shifts in product mix, anticipated decreases in average selling prices and our ability to reduce cost of sales.

Selling, general and administrative expenses include compensation and benefits, professional fees, sales commissions, provision for doubtful accounts receivable and travel and entertainment costs. A large percentage of our costs are fixed and are difficult to quickly reduce in periods of reduced sales. We intend to pursue aggressive selling and marketing campaigns and to expand our direct sales organization, and, as a result, our sales and marketing expenses will increase in future periods. We also expect that in support of our continued growth, general and administrative expenses will continue to increase for the foreseeable future.

Research and development expenses consist primarily of salaries and related costs of employees engaged in research, design and development activities, the cost of parts for prototypes, equipment depreciation and third party development expenses. A large percentage of our costs are fixed and are difficult to quickly reduce in periods of reduced sales. We believe that continued investment in research and development is critical to our long-term success. Accordingly, we expect that our research and development expenses will increase in future periods.

**NET SALES**

The following table summarizes our net sales by geographic region and by product line:

| | Years ended December 31, | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **2003** | | | | **2002** | | | | **2001** | | | |
| | **Restated(1)** | | | | | | | | | | | |
| | **(in thousands)** | | | | | | | | | | | |
| *Sales by region* | | | | | | | | | | | | |
| China | $ | 1,680,821 | 86 | % | $ | 822,299 | 84 | % | $ | 565,880 | 90 | % |
| Japan | 194,894 | | 10 | % | 130,104 | | 13 | % | 16,303 | | 3 | % |
| Other | 89,472 | | 4 | % | 29,403 | | 3 | % | 44,657 | | 7 | % |
| **TOTAL NET SALES** | **$** | **1,965,187** | **100** | **%** | **$** | **981,806** | **100** | **%** | **$** | **626,840** | **100** | **%** |
| *Sales by product line* | | | | | | | | | | | | |
| Wireless infrastructure | $ | 720,555 | 37 | % | $ | 447,096 | 46 | % | $ | 376,538 | 60 | % |
| Subscriber handsets | 968,192 | | 49 | % | 376,805 | | 38 | % | 187,902 | | 30 | % |
| Wireline products | 276,440 | | 14 | % | 157,905 | | 16 | % | 62,400 | | 10 | % |
| **TOTAL NET SALES** | **$** | **1,965,187** | **100** | **%** | **$** | **981,806** | **100** | **%** | **$** | **626,840** | **100** | **%** |

(1) See Note 24 to the Consolidated Financial Statements.

*Fiscal 2003 vs. 2002*

This increase in sales was primarily attributable to increased demand for our products and services, the continued strength of our sales in China, as well as an increase in our global sales. Net sales growth was due to an increase in subscribers, which required telecommunication providers to expand their telecommunication infrastructures. As a result, we had more sales to customers that were expanding their existing networks in 2003. Approximately 30% of our sales in 2003 were attributable to new customers compared to 54% of sales to new customers in 2002. In addition to increasing the amount of infrastructure sales, this increase in subscribers also led to an increase in customer demand for handsets.

During 2003, the China provincial-level telecommunications service entities continued to consolidate telecommunications purchasing decisions by province. As a result of this consolidation trend, we grouped all of our China customers together by province, and treated each province as one customer. At December 31, 2003 and 2002, we had approximately 31 such customers. Giving effect to this consolidation, in 2003, the Hei Long Jiang province accounted for 11% of our net sales. In 2002, sales to the Zhejiang province accounted for 18% and sales to SBBC accounted for 13% of our net sales. We expect our sales to grow at a moderate rate through 2004, with our global sales growing at a higher rate than our China sales. Our handset sales increased as a result of increased subscribers, from approximately 12 million subscribers in 2002 to approximately 35 million subscribers in 2003, and we expect this growth rate to continue into 2004.

We expect that 2004 net sales will be comprised of approximately 35% to 40% wireless infrastructure sales, approximately 40% to 50% subscriber handset sales and approximately 10% to 20% wireline products.

*Fiscal 2002 vs. 2001*

International sales of telecommunications equipment increased primarily due to sales of equipment to SBBC in Japan to support its ADSL rollout. In 2002, sales to the Zhejiang province accounted for 18% and sales to SBBC accounted for 13% of our net sales. In 2001, sales to the Zhejiang and Guangdong provinces accounted for 28% and 10% of our net sales, respectively.

Our handset sales increased as a result of subscriber growth and the increased popularity of our PAS system.

**GROSS PROFIT**

The following table summarizes our gross profit:

| | Years ended December 31, | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| | **Restated(1)** | | |
| | **(in thousands)** | | |
| Gross profit | $ 624,385 | $ 345,472 | $ 224,548 |
| Gross profit percentage | 32 % | 35 % | 36 % |

(1) See Note 24 to the Consolidated Financial Statements.

*Fiscal 2003 vs. 2002*

Our gross profit varies across our different product lines and is affected by product mix, average selling prices and the cost of materials. The decrease in gross profit as a percent of net sales in 2003 from 2002 is attributable to increased competitive market pricing pressures and lower margins on our iPAS and PAS systems as well as to our having a higher volume of sales of our lower margin handset products. The telecommunications market experienced continued pricing pressures in 2003. We anticipate that this pricing pressure will continue on both our iPAS and PAS systems and on our handset products. Our gross profit also decreased in 2003 due to an increased cost of sales from foreign exchange losses resulting from our purchasing significant amounts of inventory denominated in Japanese Yen. We believe that our overall gross profit as a percentage of net sales will continue to fluctuate from period to period as a result of shifts in product mix, anticipated decreases in average selling prices and our ability to reduce cost of sales. We expect that there will be continued competitive market pricing pressures on our products in line with current trends in the industry. Additionally, we expect that handsets will continue to represent 40% to 50% of our net sales.

*Fiscal 2002 vs. 2001*

The decrease in gross profit, as a percentage of net sales, was primarily due to increased sales of lower margin handsets, which comprised 38% of net sales in 2002 compared to 30% in 2001.

**OPERATING EXPENSES**

The following table summarizes our operating expenses:

| | Years ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2003 | % of 2003 net sales | 2002 | % of 2002 net sales | 2001 | % of 2001 net sales |
| | Restated(1) | | | | | |
| | (in thousands) | | | | | |
| Selling, general and administrative ( SG&A ) | $ 188,339 | 9 % | $ 110,263 | 11 % | $ 75,764 | 12 % |
| Research and development ( R&D ) | 155,252 | 8 % | 86,182 | 9 % | 59,809 | 10 % |
| In-process research and development ( IPR&D ) | 10,686 | 1 % | 670 | 0 % | 4,720 | 1 % |
| Amortization of intangible assets | 8,370 | 0 % | 2,395 | 0 % | 7,527 | 1 % |
| **TOTAL OPERATING EXPENSES** | $ 362,647 | 18 % | $ 199,510 | 20 % | $ 147,820 | 24 % |

(1) See Note 24 to the Consolidated Financial Statements.

*Selling, general and administrative*

*Fiscal 2003 vs. 2002*

Selling, general and administrative expenses include compensation and benefits, professional fees, sales commissions, provision for doubtful accounts receivable and travel and entertainment costs. The increase in absolute dollars of selling, general and administrative expenses is due to expanding our overall business activities both in China and globally. To support our expanding global business, we hired approximately 1,150 additional selling, general and administrative employees in 2003, which also contributed to the increased selling, general and administrative expenses. The decrease in selling, general and administrative expenses as a percentage of net sales was primarily due to economies of scale associated with the significant increase in net sales.

*Fiscal 2002 vs. 2001*

The increase in selling, general and administrative expenses in 2002 was primarily due to the growth in net sales and the expansion of our overall level of business activities globally. The decrease in selling, general and administrative expenses as a percentage of net sales was primarily due to economies of scale associated with the significant increase in net sales.

*Research and development*

*Fiscal 2003 vs. 2002*

The increase in absolute dollars of research and development expenses was primarily due to the hiring in 2003 of approximately 950 additional technical personnel to support our increased business levels. The decrease of research and development expenses as a percentage of net sales was due to the majority of the new personnel being hired in China, where labor costs are less expensive than in the United States, as well as to increased economies of scale associated with increased business levels.

*Fiscal 2002 vs. 2001*

The increase in research and development expenses was primarily due to the hiring in 2002 of an additional 303 technical personnel, and increased prototype expenses and licensing fees to support our research and development efforts. As a percentage of net sales, research and development expenses decreased to 9% in 2002 from 10% in 2001. The reduction in research and development expenses as a percent of net sales was attributable to increased economies of scale associated with increased business levels.

*In-process research and development costs*

*Fiscal 2003 vs. 2002*

The IPR&D charge for 2003 resulted from our acquisition of CommWorks, a former division of 3Com, and three smaller acquisitions: RollingStreams, Xebeo and Shanghai Yi Yun Telecom Technology Co. Ltd., which accounted for $1.3 million, $6.2 million, $1.9 million and $1.3 million, respectively, and were based on independent valuations. The charge for 2002 arose from our acquisition of Issanni Communications, Inc. on April 19, 2002 and was based on independent valuation.

Refer to the acquisitions and other key transactions section of the MD&A for additional detail on our IPR&D costs incurred in 2003.

*Fiscal 2002 vs. 2001*

2002 IPR&D costs resulted from our acquisition of Issanni on April 19, 2002. 2001 in-process research and development costs resulted from our acquisition of ACD in November 2001. These charges were based upon independent valuations.

*Amortization of intangible assets*

*Fiscal 2003 vs. 2002*

The increase in amortization of intangible assets was primarily due to an additional $44.9 million of intangibles recorded upon our acquisition of CommWorks in May 2003. The estimated useful lives of these purchased intangibles are from one to ten years. Estimated amortization expense for the next five years, beginning with the year ended December 31, 2004, is $10.7 million, $7.6 million, $5.8 million, $5.6 million and $4.0 million, respectively.

*Fiscal 2002 vs. 2001*

The decrease in amortization of intangible assets was primarily due to the elimination of goodwill amortization upon the adoption of SFAS No. 142 on January 1, 2002 of $7.4 million, offset by an increase in amortization of intangibles of $2.0 million. Had SFAS No. 142 been in effect during the year ended December 31, 2001, amortization expense would have been $0.2 million.

**OTHER INCOME (EXPENSES)**

*Interest income (expense), net*

*Fiscal 2003 vs. 2002*

Interest income was $3.2 million in 2003 compared to interest income of $5.5 million in 2002. Interest income has decreased due to lower average cash and short-term investment balances of $319.2 million in 2003 compared to $372.5 million in 2002, as well as due to a reduction in interest rates on deposits.

Interest expense was $4.7 million in 2003 compared to $1.3 million in 2002. The increase of $3.4 million in interest expense was primarily attributable to the interest associated with our convertible debt issued in March 2003, which accrues at a rate of approximately $1.4 million per quarter. $0.6 million of interest was capitalized in 2003.

*Fiscal 2002 vs. 2001*

Interest income was $5.5 million in 2002 compared to interest income of $8.6 million in 2001. Interest expense was $1.3 million in 2002 compared to $3.9 million in 2001. The decrease in interest income was primarily due to a reduction in cash and cash equivalents and short-term investments of $58.3 million and a reduction in interest rates on deposits. The decrease of $2.7 million in interest expense was related to debt balances that were paid off in September 2002. At December 31, 2002, we did not have any debt.

*Other income (expense), net*

*Fiscal 2003 vs. 2002*

Net other income was $4.9 million in 2003, compared to net other expense of $9.9 million in 2002. Net other income in 2003 was primarily comprised of a reinvestment incentive payment received in China of $3.9 million, incentive payments for exports and value added taxes in China of $6.1 million, government incentive related to our operations in Japan of $6.2 million, offset by foreign exchange losses of approximately $8.7 million and expenses attributable to selling or transferring of notes receivable of $2.3 million.

*Fiscal 2002 vs. 2001*

Net other expense was $9.9 million in 2002, compared to net other expense of $0.3 million in 2001. Net other expense in 2002 was primarily comprised of impairment write-downs of $4.4 million relating to our investment portfolio and foreign exchange losses of $5.4 million.

*Equity in net income (loss) of affiliated companies*

*Fiscal 2003 vs. 2002*

Consolidated equity in net loss of affiliated companies was $5.3 million in 2003 and $4.1 million in 2002. The equity loss for 2003 was primarily comprised of our share of losses relating to our joint venture with one of our stockholders, Matsushita Communication Industrial Co., Ltd., to jointly design and develop, manufacture and sell telecommunications products. We have a 49% ownership interest in the joint venture company, which has a registered share capital of $10.0 million. The equity loss for 2002 was related to losses relating to our interests in investment funds and to our share of losses generated by GUTS prior to our acquisition of the remaining 49% ownership interest in this entity.

*Fiscal 2002 vs. 2001*

Consolidated equity in net loss of affiliated companies was $4.1 million in 2002 and $3.0 million in 2001. This included equity losses of $2.9 million and $1.7 million in 2002 and 2001, respectively, related to our interest in investment funds. In May 2002, we acquired the remaining 49% ownership interest in GUTS, which is now a wholly-owned subsidiary. Its results of operations are included in our consolidated financial statements beginning June 1, 2002. Prior to May 2002, GUTS was accounted for using the equity method of accounting. On July 5, 2002, we entered into a joint venture agreement with Matsushita Communication Industrial Co., Ltd., and Matsushita Electric Industrial Co., Ltd., to jointly design, develop, manufacture and sell telecommunication products. We have a 49% ownership interest in this joint venture company. The investment in and results of operations of the joint venture company were accounted for using the equity method of accounting, commencing October 2002.

*Income tax expense*

*Fiscal 2003 vs. 2002*

Income tax expense was $45.4 million in 2003 and $27.3 million in 2002. The primary reason for the increase in income tax expense was that our income increased 91% in 2003 from 2002. Our effective tax rate was 17% in 2003 compared to 20% in 2002. The decrease in the effective tax rate is primarily the result of permanent differences and tax credits, offset partially by the fact that more of our revenue has become subject to higher tax rate jurisdictions as we expand our business globally.

*Fiscal 2002 vs. 2001*

Income tax expense was $27.3 million in 2002 and $19.8 million in 2001. The increase in income tax expense was due to our increased income. Our effective tax rate was 20% in 2002 compared to 25% in 2001. The reduction in our effective tax rate can be attributed to the increased portion of our net income derived from our operations in Chinese jurisdictions, which have granted us temporary tax holidays.

*Minority interest in losses (earnings) of consolidated subsidiaries*

*Fiscal 2003 vs. 2002*

Minority interest in losses (earnings) of consolidated subsidiaries was $1.0 million in 2003 and ($1.2) million in 2002. The change was due primarily to the minority interest in losses in 2003 related to MDC, a variable interest entity included in our consolidated financials in the third quarter of 2003, and to the acquisition of the remaining 12% ownership interest in our Zhejiang manufacturing joint venture, UTStarcom Telecom Co., Ltd. ( HUTS ) during 2002. Minority interest in losses of consolidated subsidiaries for 2003 represented the minority interest in losses of MDC, as well as the 10% share of earnings of CUTS, our Chongqing manufacturing joint venture, attributable to our joint venture partner. Minority interest in earnings of consolidated subsidiaries for 2002 represented the share of earnings in HUTS, our Zhejiang manufacturing joint venture, attributable to our joint venture partner, prior to our acquisition of the remaining 12% ownership interest in HUTS in May 2002. HUTS is now a wholly-owned subsidiary.

*Fiscal 2002 vs. 2001*

Minority interest in losses (earnings) of consolidated subsidiaries was ($1.2) million in 2002 and ($1.3) million in 2001. The decrease is due to the acquisition of the remaining 12% ownership interest in HUTS in May 2002. HUTS is now a wholly-owned subsidiary. The expected decrease was offset by an increase in HUTS net income for the four months ended April 30, 2002 as compared to the corresponding period in 2001.

**Liquidity and Capital Resources**

*Operating Activities*

*2003*

Net cash provided by operating activities for the year ended December 31, 2003 was $45.2 million. Operating cash was affected by changes in accounts receivable, inventory, accounts payable, other assets and offset by changes in deferred revenue. The $151.9 million increase in our accounts receivable balance, attributable to a 100% increase in sales in 2003, reduced our net cash provided by operations. In 2003, we sold $298.8 million of our notes receivable with associated expenses of $2.3 million. Cash provided by operating activities was also reduced by a $81.6 million and $301.1 million increase in inventory and deferred costs, respectively. Inventory and deferred costs increased in absolute dollars in 2003 over 2002 to support our increased backlog. Operating cash also decreased due to a $5.9 million decrease in accounts payable. Historically, the majority of our accounts payables have been comprised of inventory related payables. In mid-2003, we implemented a just in time inventory process to increase efficiencies in inventory purchasing. Going forward, we expect to continue to improve the efficiencies surrounding our supply chain and inventory process. As such, inventory will grow at a slower rate than we have historically experienced. The decrease in operating cash in 2003 was offset by an increase in customer advances and deferred revenue of $294.2 million and $27.4 million, respectively. We collected approximately $2.5 billion in cash from our customers in 2003. Customer advances are comprised of cash we have collected from our customers for which we have not yet recognized revenue; the increase was attributable to an increase in customer contracts.

*2002*

Net cash provided by operating activities in fiscal 2002 was $178.6 million. Net cash provided by operations was mainly due to a $170.5 million and $87.8 million increase in accounts payable and customer advances, respectively, offset by increases in inventories, deferred costs, accounts receivable and other assets of $76.1 million, $137.8 million, $34.2 million and $24.6 million, respectively.

*2001*

Net cash provided by operating activities in fiscal 2001 was $40.2 million. Net cash provided by operations was mainly due to a $39.1 million, $42.8 million and $41.4 million increase in accounts payable, customer advances and other liabilities, respectively, offset by increases in inventories, deferred costs, accounts receivable and other assets of $60.4 million, $60.8 million, $39.2 million and $43.0 million, respectively.

*Investing Activities*

*2003*

Net cash used in investing activities was $176.5 million for the year ended December 31, 2003. Net cash used in investing activities was affected by increased business acquisitions and property, plant and equipment purchases. We spent $106.7 million for business acquisitions in 2003. This was primarily attributable to our May 2003 CommWorks acquisition, which was $109.3 million including transaction and transition fees, offset partially by $3.8 million in cash added from the consolidation of MDC. In addition to business acquisitions, net cash used in investing activities increased due to $123.2 million of property, plant and equipment purchases. $45.5 million of these property, plant and equipment purchases were construction costs incurred on our Hangzhou manufacturing facility. Net cash used in investing activities also increased due to $147.5 million of purchases of short-term investments. Offsetting net cash used in investing activities was $217.2 million of proceeds from the sale of our short-term investments.

*2002*

Net cash used in investing activities in fiscal 2002 was $165.4 million. This was mainly due to $75.3 million of property, plant and equipment purchases; $17.7 million of business acquisitions, primarily attributable to our purchase of the remaining interest in HUTS; $28.9 million of investments in affiliates which primarily comprised investments in public and private technology companies offset by $22.4 million of net purchases of short-term investments.

*2001*

Net cash used in investing activities in fiscal 2001 of $43.7 million was primarily due to $30.2 million of property, plant and equipment purchases, $9.8 million of investments in affiliates, which primarily comprised investments in public and private technology companies offset by $2.1 million of net purchases of short-term investments.

*Financing Activities*

*2003*

Net cash provided by financing activities was $275.3 million for the year ended December 31, 2003 due to proceeds raised from a convertible subordinated notes issuance and stock option exercises offset by a repurchase of our common stock and the purchase of a bond hedge and call option. Net cash provided by financing activities was primarily attributable to $391.4 million in net proceeds received from issuing convertible subordinated notes in March 2003. In addition to the proceeds received from our notes issuance, we received $58.9 million for the issuance of common stock through stock option and ESPP exercises. Offsetting cash provided by financing activities, we used a portion of the capital raised to repurchase 8.0 million shares of our common stock that was beneficially owned by SOFTBANK America, Inc. at a purchase price of $17.385 per share. The total cost of the repurchase was $139.6 million, including transaction fees. We used the remainder of the funds raised to fund 2003 business acquisitions. Net cash provided by financing activities was also offset by our purchase of a call spread for $43.8 million, which was purchased to minimize shareholder dilution upon conversion of the convertible subordinated notes.

*2002*

Net cash used in financing activities in fiscal 2002 was $102.4 million. This was primarily due to the repurchase of our shares and related transaction costs of $72.9 million and net payments of $70.5 million on borrowings under our lines of credit. This was offset by $40.9 million in proceeds from the underwritten sale of common stock in conjunction with 10.0 million shares of our common stock sold by SOFTBANK America, Inc. through an underwriter and the issuance of common stock through stock option exercises.

*2001*

Net cash provided by financing activities of $175.5 million was primarily due to $160.6 million of proceeds from our follow-on public offering of common stock in August 2001, stock option exercises, and net proceeds from borrowings under our line of credit arrangements of $15.1 million.

*Liquidity*

Our working capital was $883.3 million and $568.2 million at December 31, 2003 and 2002, respectively. This increase in working capital is due to increased cash on hand, from $231.9 million in cash and cash equivalents and $107.3 of short-term investments in 2002, to $377.7 million of cash and cash equivalents and $48.6 million of short-term investments. Our working capital also increased due to larger accounts receivable and inventory balances, which was offset by larger customer advances and deferred revenue balances. We anticipate having more working capital and cash on hand in 2004 as a result of our $474.2 million equity offering in January 2004. Going forward, this cash will position us to take advantage of strategic investment opportunities. We had lines of credit totaling $583.7 million available for future borrowings expiring between 2004 and 2010 with interest rates ranging from approximately 4.5% to 6.0%, and we had not guaranteed any debt not included in the consolidated balance sheet.

*Income taxes*

Our subsidiaries and joint ventures located in China enjoy tax benefits in China which are generally available to foreign investment enterprises, including full exemption from national enterprise income tax for two years starting from the first profit-making year and/or a 50% reduction in national income tax rate for the following three years. In addition, local enterprise income tax is often waived or reduced during this tax holiday/incentive period. Under current regulations in China, foreign investment enterprises that have been accredited as technologically advanced enterprises are entitled to additional tax incentives. These tax incentives vary in different locales and could include preferential national enterprise income tax treatment at 50% of the usual rates for different periods of time. The tax holidays discussed above are applicable to UTStarcom (Chongqing) Co., Ltd. ( CUTS ), HUTS, Hangzhou UTStarcom Telecom Co., Ltd. ( HSTC ) and UTStarcom China Co., Ltd. ( UTSC ), our active subsidiaries in China, as those entities qualify as accredited technologically advanced enterprises. Specifically, HUTS currently enjoys a 15% tax rate that will continue indefinitely provided they remain as a technologically advanced enterprise and the Government does not change the tax laws. UTSC currently enjoys a 10% holiday tax rate that expires on December 31, 2005. HSTC and CUTS are currently exempt from income tax until December 31, 2004, at which point they will be subject to a 7.5% tax rate, which will expire on December 31, 2007.

*Contractual obligations and other commercial commitments*

Our obligations under contractual obligations and commercial commitments are primarily with regard to leasing arrangements and standby letters of credit and are as follows:

| | December 31, 2003 Payments Due by Period (in thousands) | | | |
|---|---|---|---|---|
| | Total Restated(1) | Less than 1 year | 1-3 years Restated(1) | 3-5 years |
| *Contractual Obligations* | | | | |
| Notes Payable | $ 1 | $ 1 | $ | $ |
| Convertible Subordinated Notes | $ 402,500 | $ | $ | $ 402,500 |
| Bank Loan | $ 8,155 | $ | $ 8,155 | $ |
| Operating leases | $ 25,724 | $ 10,154 | $ 15,131 | $ 439 |
| *Other Commercial Commitments* | | | | |
| Standby letters of credit | $ 20,461 | $ 15,353 | $ 5,108 | $ |
| Purchase Commitments | $ 2,261 | $ 2,261 | $ | $ |

(1) See Note 24 to the Consolidated Financial Statements.

Certain sales contracts include provisions under which customers would be indemnified by us in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to our products. There are no limitations on the maximum potential future payments under these guarantees. We have not accrued any amounts in relation to these provisions as no such claims have been made and we believe we have valid enforceable rights to the intellectual property embedded in our products.

Our $402.5 million of convertible subordinated notes, due March 1, 2008, bear interest at a rate of 7⁄8% per annum, payable semiannually on May 1 and September 1, are convertible into the Company s common stock at a conversion price of $23.79 per share and are subordinated to all present and future senior debt of the Company. The principal is due only at maturity of the notes.

We recorded a bank loan in connection with a purchase of inventory resulting from the consolidation of MDC. On January 10, 2003, a third party established a bank loan with Shanghai Pudong Development

Bank for the purchase of the inventory. We assumed the obligations of the bank loan and related inventory on January 23, 2003, which were subsequently transferred to MDC on December 31, 2003. The bank loan of $8.2 million bears interest at a rate of 4.94% per annum, and expires on January 10, 2006. For the year ended December 31, 2003, we recorded total interest expense related to this bank loan amounted to $0.4 million. We do not serve as legal obligor for the bank loan.

We issue standby letters of credit primarily to support international sales activities outside of China. When we submit a bid for a sale, often the potential customer will require that we issue a bid bond or a standby letter of credit to demonstrate our commitment through the bid process. In addition, we may be required to issue standby letters of credit as guarantees for advance customer payments upon contract signing or performance guarantees. The standby letters of credit usually expire six to nine months from date of issuance without being drawn by the beneficiary thereof.

*Accounts receivable transferred to notes receivable*

We accept bank notes receivable and commercial notes receivable, with maturity dates between three and six months, from our customers in China in the normal course of business. We may discount these notes with banking institutions in China. A sale of these notes is reflected as a reduction of other current assets and the proceeds of the settlement of these notes are included in cash flows from operating activities in the consolidated statement of cash flows. Notes receivable sold during the years ended December 31, 2003 and 2002 were $298.8 million and $2.5 million, respectively. These notes are not included in our consolidated balance sheets as the criteria for sale treatment established by Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities ( SFAS 140 ), has been met. Under SFAS 140, upon a transfer, the transferor or entity must derecognize financial assets when control has been surrendered and the transferee obtains control over the assets. In addition, the transferred assets have been isolated from the transferor, beyond the reach of its creditors, and the transferee has the right, without conditions or constraints, to pledge or exchange the assets it has received. The costs of settling or transferring these notes receivable were $2.3 million and immaterial for the years ended December 31, 2003 and 2002, respectively, and were included in other income (expense), net in the Consolidated Statements of Operations. Notes receivable available for sale were $11.4 million and $12.0 million at December 31, 2003 and December 31, 2002, respectively.

*Investment commitments*

As of December 31, 2003, we had invested a total of $2.0 million in Global Asia Partners L.P. that is recorded as a long-term investment. The fund size is anticipated to be $100 million and the fund was formed to make private equity investments in private or pre-IPO technology and telecommunications companies in Asia. We have a commitment to invest up to a maximum of $5.0 million. The remaining amount is due at such times and in such amounts as shall be specified in one or more future capital calls to be issued by the general partner.

*Purchase commitments*

We are obligated to purchase raw materials and work-in-process inventory under various orders from one supplier, all of which are expected to be fulfilled with no adverse consequences material to our operations or financial condition. As of December 31, 2003 total open commitments under these purchase orders were approximately $2.3 million.

**DISCUSSION AND ANALYSIS OF QUARTERLY RESULTS OF OPERATIONS, AS RESTATED**

*Three months ended March 31, 2003 and 2002*

Income tax expense for the three months ended March 31, 2003 was previously reported as $12.4 million and has been restated to $8.6 million, a decrease of $3.8 million. The decrease in income tax expense is due to the correction of the 2003 effective tax rate from 25% to 17%. See Note 24 to the consolidated financial statements.

Income tax expense was $4.5 million for the corresponding period in 2002. The increase in income tax expense from the three months ended March 31, 2002 to the three months ended March 31, 2003 was due to our increasing income. The effective tax rate was 17% and 20% for the three months ended March 31, 2003 and 2002, respectively. The decrease in our effective tax rate was primarily due to permanent differences consisting of deductible expenses related to original issuance discount on convertible notes and the China Super R&D deductions as well as foreign and R&D tax credits, offset partially by the fact that more of our revenue has become subject to higher tax rate jurisdictions as we expand globally.

*Three months and six months ended June 30, 2003 and 2002*

Income tax expense for the three months ended June 30, 2003 was previously reported as $13.1 million and has been restated to $9.1 million, a decrease of $4.0 million. Income tax expense for the six months ended June 30, 2003 was $25.6 and has been restated to $17.7 million, a decrease of $7.9 million. The decrease in income tax expense for the three months and six months ended June 30, 2003 is due to the correction of the 2003 effective tax rate from 25% to 17%. See Note 24 to the consolidated financial statements.

Income tax expense was $6.6 million and $11.1 million for the three and six months ended June 30, 2002, respectively. The increase in income tax expense from the three months and six months ended June 30, 2002 to the three months and six months ended June 30, 2003 was due to our increasing income. The effective tax rate was 17% for three months and six months ended June 30, 2003 and 20% for the three and six months ended June 30, 2002, respectively. The decrease in our effective tax rate was due primarily to permanent differences consisting of deductible expenses related to original issuance discount on convertible notes and the China Super R&D deductions as well as foreign and R&D tax credits, offset partially by the fact that more of our revenue has become subject to higher tax rate jurisdictions as we expand globally.

*Three months and nine months ended September 30, 2003 and 2002*

Income tax expense for the three months ended September 30, 2003 was previously reported as $19.7 million and has been restated to $13.7 million, a decrease of $6.0 million. Income tax expense for the nine months ended September 30, 2003 was $45.3 million and has been restated to $31.4 million, a decrease of $13.9 million. The decrease in income tax expense for the three months and nine months ended September 30, 2003 is due to the correction of the 2003 effective tax rate from 25% to 17%. See Note 24 to the consolidated financial statements.

Income tax expense was $7.7 million and $18.8 million for the three and nine months ended September 30, 2002, respectively. The increase in income tax expense from the three months and nine months ended September 30, 2002 to the three months and nine months ended September 30, 2003 was due to our increasing income. The effective tax rate was 17% for three months and nine months ended June 30, 2003 and 20% for the three and six months ended June 30, 2002, respectively. The decrease in our effective tax rate was due primarily to permanent differences consisting of deductible expenses related to original issuance discount on convertible notes and the China Super R&D deductions as well as foreign and R&D tax credits, offset partially by the fact that more of our revenue has become subject to higher tax rate jurisdictions as we expand globally.

| **Income Tax Expense** | **As Previously Reported (in thousands)** | **As Restated(1)** |
|---|---|---|
| Three months ended: | | |
| March 31, 2003 | $ 12,447 | $ 8,622 |
| March 31, 2002 | 4,514 | 4,514 |
| Three months ended: | | |
| June 30, 2003 | 13,138 | 9,100 |
| June 30, 2002 | 6,590 | 6,590 |
| Six months ended: | | |
| June 30, 2003 | 25,585 | 17,722 |
| June 30, 2002 | 11,104 | 11,104 |
| Three months ended: | | |
| September 30, 2003 | 19,725 | 13,661 |
| September 30, 2002 | 7,686 | 7,686 |
| Nine months ended: | | |
| September 30, 2003 | 45,310 | 31,383 |
| September 30, 2002 | 18,790 | 18,790 |

(1) Restated See Note 24 to Consolidated Financial Statements

**CRITICAL ACCOUNTING POLICIES AND ESTIMATES**

Our financial condition and results of operations are based on certain critical accounting policies and estimates, which include judgments, estimates, and assumptions on the part of management. Estimates are based on historical experience, knowledge of economic and market factors and various other assumptions that management believes to be reasonable under the circumstances. Actual results may differ from those estimates. The following summary of critical accounting policies and estimates highlights those areas of significant judgment in the application of our accounting policies that affect our financial condition and results of operations.

**Revenue Recognition and Product Warranty**

We recognize revenues from sales of telecommunications equipment when persuasive evidence of an arrangement exists, delivery of the product has occurred, customer acceptance has been obtained, the fee is fixed or determinable and collectibility is reasonably assured. If the payment due from the customer is not fixed or determinable due to extended payment terms, revenue is recognized as payments become due from the customer, assuming all other criteria for revenue recognition are met. Normal payment terms differ for various reasons amongst different customer regions depending upon the common business practices for customers within a region. Shipping and handling costs are recorded as revenues and costs of revenues. Any expected losses on contracts are recognized immediately.

Final acceptance is required in our complex multiple element contractual arrangements since installation stretches over a time frame of six to twelve months, terms and deliverables are not finalized until project completion, and customers extensively test the systems after installation. Final acceptance indicates that the customer has fully accepted delivery of equipment and that we are entitled to the full payment. We will not recognize revenue before final acceptance is granted by the customer if acceptance is considered substantive to the transaction. Additionally, we do not recognize revenue when cash payments are received from customers for transactions that do not have the customer s final acceptance. We record these cash receipts as customer advances, and defer revenue recognition until final acceptance is received.

Sales may be generated from complex contractual arrangements that require significant revenue recognition judgments, particularly in the areas of multiple element arrangements. Where multiple elements exist in an arrangement, the arrangement fee is allocated to the different elements based upon verifiable objective evidence of the fair value of the elements, as governed under EITF 00-21 and SEC Staff Accounting Bulletin No. 104 ( SAB 104 ). Multiple element arrangements primarily involve the sale of PAS or iPAS equipment with handsets, installation and training and the provision of such equipment to different locations for the same customer. Revenue is recognized as each element is earned, namely upon installation and acceptance of equipment or delivery of handsets; provided that the fair value of the undelivered element(s) has been determined, the delivered element has stand-alone value, there is no right of return on delivered element(s), and we are in control of delivery of the undelivered element(s).

Where multiple elements exist in an arrangement that includes software, and the software is considered more than incidental to the equipment or services in the arrangement, software and software-related elements are recognized under the provisions of Statement of Position 97-2, as amended, and Emerging Issues Task Force Issue No. 03-05. The Company allocates revenues to each element of software arrangements based on vendor-specific objective evidence ( VSOE ). VSOE of each element is based on the price charged when the same element is sold separately. We use the residual method to recognize revenue when an arrangement includes one or more elements to be delivered at a future date and VSOE of the fair value of all the undelivered elements exists. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. If evidence of fair value of one or more undelivered elements does not exist, revenue is deferred and recognized when delivery of those elements occurs or when fair value can be established.

We also sell products, primarily handsets, through resellers. Revenue is generally recognized when the standard price protection period has lapsed, which ranges from 30 to 90 days. If collectibility cannot be reasonably assured in a reseller arrangement, revenue is recognized upon sell-through to the end customer and receipt of cash. In China, there may be additional obligations in reseller arrangements such as inventory rotation, or stock exchange rights on the product. As such, revenue is recognized in accordance with Statement of Financial Accounting Standards No. 48 Revenue Recognition When Right of Return Exists . We have developed reasonable estimates for stock exchanges. Estimates are derived from historical experience with similar types of sales of similar products.

We recognize revenue for system integration, installation and training upon completion of performance if all other revenue recognition criteria are met. Other service revenue, such as that related to maintenance and support contracts, is recognized ratably over the contract term.

The assessment of collectibility is also a factor in determining whether revenue should be recognized. We assess collectibility based on a number of factors, including payment history and the creditworthiness of the customer. We do not request collateral from our customers in China. In global sales outside of China, we often require letters of credit that can be drawn on demand if a customer defaults on its payment. If we determine that collection of a fee is not reasonably assured, we recognize revenue upon receipt of cash.

Because of the nature of doing business in China and other emerging markets, our billings and/or customer payments may not correlate with the contractual payment terms and we generally do not enforce contractual payment terms on complex, multiple-element arrangements prior to final acceptance. Accordingly, these accounts receivable are not booked until we recognize the related customer revenue. Advances from customers are recognized when we have collected cash from the customer prior to recognizing revenue.

We provide a warranty on our equipment and handset sales for a period generally ranging from twelve to eighteen months from the time of final acceptance. We provide for the expected cost of product warranties at the time that we recognize revenue, based on our assessment of past warranty experience. We continually monitor the level of our warranty expenses. If, however, there were to be a material adverse change in our product failure rates, an additional warranty provision would be required. Historically, our warranty experience has been within our expectations.

**Variable Interest Entities**

In January 2003, the Financial Accounting Standards Board issued Interpretation No. 46, Consolidation of Variable Interest Entities, ( FIN 46 ). FIN 46 provides accounting guidance for consolidation of variable interest entities, ( VIE ). FIN 46 applies to public and private business enterprises that have a controlling interest or business or contractual relationship with a VIE. FIN 46 requires consolidation of existing non-controlled affiliates if the VIE is unable to finance its operations without investor support, or where other investors do not have exposure to the significant risks and rewards of ownership. The Company adopted FIN 46 for the quarter ended, December 31, 2003. Upon adoption of FIN 46, the Company consolidated a related party that is deemed a VIE and for whom the Company is a primary beneficiary. (See Note 24 to the Consolidated Financial Statements.)

**Receivables**

We are required to estimate the collectibility of our trade receivables and notes receivable. We maintain an allowance for doubtful accounts for the estimated losses on the trade receivables and notes receivable. We assess collectibility of the receivable by determining whether the creditworthiness of the customer has deteriorated and could result in an inability to collect payment; if collectibility is doubtful, we record an allowance against the receivable. If the financial condition of our customers was to deteriorate and their ability to make payments suffers as a result, we may need to increase our allowances for our receivables.

**Inventories**

Inventories consist of inventories held at our manufacturing facility, warehouses or at customer sites prior to signing of contracts. We may ship inventory to existing customers that require additional equipment to expand their existing networks prior to the signing of an expansion contract. Our inventories are stated at the lower of cost or net realizable value, net of write-downs for excess, slow moving and obsolete inventory. Inventory is written down for estimated obsolescence or unmarketable inventory equal to the difference between inventory cost and the estimated market value. Write-downs are based on our assumptions about future market conditions and customer demand, including projected changes in average selling prices resulting from competitive pricing pressures. We continually monitor inventory valuation for potential losses and obsolete inventory at our manufacturing facilities as well as at customer sites.

**Deferred costs/Inventories at customer sites under contracts**

Inventories at customer sites under contracts awaiting final acceptance are classified as deferred costs, separate from what we have historically considered inventory. These are stated at the lower of cost or net realizable value, net of reserves based upon assessment of potential losses and obsolescence during the lengthy acceptance process. The title and risk of loss of this inventory is transferred to the customer upon delivery. Revenue and cost of sales are recorded when we receive final acceptance from the customer.

**Research and Development and Capitalized Software Development Costs**

Our research and development costs are charged to expense as incurred. We capitalize software development costs incurred in the development of software that will ultimately be sold between the time technological feasibility has been attained and the related product is ready for release. Management judgment is required in assessing technological feasibility, expected future revenues, estimated product lives and changes in product technologies, and the ultimate recoverability of our capitalized software development costs.

**Deferred Income Taxes**

We recognize deferred income taxes as the difference between the tax bases of assets and liabilities and their financial statement amounts based on enacted tax rates. Management judgment is required in the assessment of the recoverability of our deferred tax assets based on our assessment of projected taxable income. Numerous factors could affect our results of operations in the future. If there was a significant decline in our future operating results, our assessment of the recoverability of our deferred tax assets would need to be revised, and any such adjustment to our deferred tax assets would be charged to income in that period. If necessary, we record a valuation allowance to reduce deferred tax assets to an amount management believes is more likely than not to be realized.

**Goodwill and Intangibles**

We have recorded goodwill and intangible assets in connection with our business acquisitions. Management judgment is required in the assessment of the related useful lives, assumptions regarding our ability to successfully develop and ultimately commercialize acquired technology, and assumptions regarding the fair value and the recoverability of these assets. We perform our annual goodwill impairment review in the fourth quarter of each year or when changes in circumstances indicate a potential impairment. We currently operate as a single reportable segment without reporting units, as our management evaluates performance, makes operating decisions and allocates resources based on consolidated financial data. As such, we determine whether impairment to goodwill is necessary on a consolidated basis. When assessing potential impairment to goodwill, we compare our book value to our fair market value. Fair market value is our market capitalization at the date impairment is assessed. Historically, our fair market value has exceeded our book value and no impairment has been necessary.

**Long-Term Investments**

We have invested in a fund focused on investments in Internet companies in China and a fund focused on investments in companies in Asia undergoing restructuring or bankruptcy procedures. We have also invested directly in a number of private technology-based companies in the early stages of development and in publicly listed technology companies traded on NASDAQ and NYSE. While quoted market prices are readily available to determine the fair value of our investments in these publicly traded companies, management judgment is required to determine when losses are other than temporary. Furthermore, management judgment is required in evaluating the carrying value of our private company investments for possible impairment. For our private technology company investments, we assess impairment based on an evaluation of the achievement of business objectives and milestones, the financial condition and prospects of these companies and other relevant factors. We continually monitor these investments for impairment, and charge to income any impairment amounts in the period such a determination is made.

**RECENT ACCOUNTING PRONOUNCEMENTS**

In April 2003, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 149 Amendment of Statement 133 on Derivative Instruments and Hedging Activities

( SFAS 149 ). This statement amends SFAS 133 to provide clarification on the financial accounting and reporting of derivative instruments and hedging activities. The adoption of SFAS 149, which was effective for contracts entered into or modified after June 30, 2003, did not have a material effect on the Company s consolidated financial condition or results of operations.

In May 2003, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity ( SFAS 150 ). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of these instruments were previously classified as equity. As the Company does not have any of these financial instruments, the adoption of SFAS 150 is not expected to have any impact on the Company s consolidated financial statements.

On December 17, 2003, the Staff of the SEC issued Staff Accounting Bulletin No. 104 ( SAB 104 ), Revenue Recognition, which supercedes SAB 101, Revenue Recognition in Financial Statements. SAB 104 s primary purpose is to rescind accounting guidance contained in SAB 101 related to multiple element revenue arrangements, superceded as a result of the issuance of EITF 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. Additionally, SAB 104 rescinds the SEC s Revenue Recognition in Financial Statements Frequently Asked Questions and Answers ( the FAQ ) issued with SAB 101 that had been codified in SAB 101 Topic 13. Selected portions of the FAQ have been incorporated into SAB 104. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104. The adoption of SAB 104 did not materially affect our revenue recognition policies, nor our results of operations, financial position or cash flows.

**FACTORS AFFECTING FUTURE OPERATING RESULTS**

**RISKS RELATED TO OUR COMPANY**

***Our future product sales are unpredictable and, as a result, our operating results are likely to fluctuate from quarter to quarter.***

Our quarterly and annual operating results have fluctuated in the past and are likely to fluctuate in the future due to a variety of factors, some of which are outside of our control. Factors that may affect our future operating results, in addition to those described below, include:

- the timing and size of the orders for our products;
- changes in our customers subscriber growth rate;
- the lengthy and unpredictable sales cycles associated with sales of our products;
- cancellation, deferment or delay in implementation of large contracts;
- revenue recognition, which is based on acceptance, is unpredictable;
- a seasonal reoccurrence of an outbreak of severe acute respiratory syndrome (SARS) or other illnesses;
- the decline in business activity we typically experience during the Lunar New Year, which leads to decreased sales during our first fiscal quarter; and
- changes in accounting rules, such as recording expenses related to employee stock option compensation plans.

As a result of these and other factors, period-to-period comparisons of our operating results are not necessarily meaningful or indicative of future performance. Furthermore, it is possible that in some future quarters our operating results will fall below the expectations of securities analysts or investors. If this occurs, the trading price of our common stock could decline.

***Competition in our markets may lead to reduced prices, revenues and market share.***

We believe that we will continue to face intense competition from both domestic and international companies in our target markets, many of which may operate under lower cost structures or may be given preferential treatment by applicable governmental regulators and policies and have much larger sales forces than we do. Additionally, other companies not presently offering competing products may also enter our target markets. Many of our competitors have significantly greater financial, technical, product development, sales, marketing and other resources than we do. As a result, our competitors may be able to respond more quickly to new or emerging technologies and changes in service provider requirements. Our competitors may also be able to devote greater resources than we can to the development, promotion and sale of new products. These competitors may be able to offer significant financing arrangements to service providers, which may give them a competitive advantage in selling systems to service providers with limited financial and currency resources. In many of the developing markets in which we operate or intend to operate, relationships with local governmental telecommunications agencies are important to establish and maintain. In many such markets, our competitors may have or be able to establish better relationships with local governmental telecommunications agencies than we have, which could result in their ability to influence governmental policy formation and interpretation to their advantage. Additionally, our competitors might have better relationships with their third-party suppliers and obtain component parts at a reduced rate, allowing them to offer their end products at reduced prices. Increased competition is likely to result in price reductions, reduced gross profit as a percentage of net sales and loss of market share, any one of which could materially harm our business, financial condition, cash flows, and results of operations.

***The average selling prices of our products may decrease, which may reduce our revenues and our gross profit. As a result, we must introduce new products and reduce our costs in order to maintain profitability.***

The average selling prices for communications access and switching systems and handsets have historically declined as a result of a number of factors, including:

- increased competition;
- aggressive price reductions by competitors; and
- rapid technological change.

The average selling prices of our products may continue to decrease in the future in response to product introductions by us or our competitors or other factors, including price pressures from customers. Therefore, we must continue to develop and introduce new products and enhancements to existing products that incorporate features that can be sold at higher average selling prices. Failure to do so could cause our revenues and gross profit to decline.

Our cost reduction efforts may not allow us to keep pace with competitive pricing pressures or lead to improved gross profit, as a percentage of net sales. In order to be competitive, we must continually reduce the cost of manufacturing our products through design and engineering changes. We may not be successful in these efforts or in delivering our products to market in a timely manner. In addition, any redesign may not result in sufficient cost reductions to allow us to reduce the prices of our products to remain competitive or to improve or maintain our gross profit, as a percentage of net sales, which would cause our financial results to suffer.

***Sales in China have accounted for most of our total sales, and our business, financial condition and results of operations are to a significant degree subject to economic, political and social events in China.***

Approximately $1.7 billion, or 86%, and $822.3 million, or 84%, of our net sales in the year ended December 31, 2003 and 2002, respectively, occurred in China. While we anticipate expansion into other foreign markets, a significant majority of our net sales will be derived from China for the foreseeable future. In addition, we plan to continue to make further investments in China in the future. Therefore, our business, financial condition and results of operations are to a significant degree subject to economic, political, legal and social developments and other events in China. Please read the risks detailed below under the heading Risks Related to Conducting Business in China for additional information about the risks we face in connection with our China operations.

***Our market is subject to rapid technological change, and to compete effectively, we must continually introduce new products and product enhancements that achieve market acceptance.***

The market for communications equipment is characterized by rapid technological developments, frequent new product introductions and evolving industry and regulatory standards. Our success will depend in large part on our ability to enhance our network and broadband access and switching technologies and develop and introduce new products and product enhancements that anticipate changing service provider requirements and technological developments. We may need to make substantial capital expenditures and incur significant research and development costs to develop and introduce new products and enhancements. If we fail to develop and introduce new products or enhancements to existing products that effectively respond to technological change on a timely basis, our business, financial condition and results of operations could be materially adversely affected. Moreover, from time to time, our competitors or we may announce new products or product enhancements, technologies or services that have the potential to replace or shorten the life cycles of our products and that may cause customers to defer purchasing our existing products, resulting in inventory obsolescence. Future technological advances in the communications industry may diminish or inhibit market acceptance of our existing or future products or render our products obsolete.

Even if we are able to develop and introduce new products, they may not gain market acceptance. Market acceptance of our products will depend on various factors, including:

- our ability to obtain necessary approvals from regulatory organizations within the countries in which we operate and for any new technologies that we introduce;
- the length of time it takes service providers to evaluate our products, causing the timing of purchases to be unpredictable;
- our products being compatible with legacy technologies and standards existing in previously deployed network equipment;
- our ability to attract customers who may have preexisting relationships with our competitors;
- product cost relative to performance; and
- the level of customer service available to support new products.
- If our products fail to obtain market acceptance in a timely manner, our business could suffer.

***We depend on some sole source and other key suppliers, as well as international sources, for handsets, base stations, components and materials used in our products. If we cannot obtain adequate supplies of high quality products at competitive prices or in a timely manner from these suppliers or sources, our competitive position, reputation and business could be harmed.***

We have contracts with a single supplier or with a limited group of suppliers to purchase some components and materials used in our products. If any supplier is unwilling or unable to provide us with high-quality components and materials in the quantities required and at the costs specified by us, we may not be able to find alternative sources on favorable terms, in a timely manner, or at all. Our inability to obtain or to develop alternative sources if and as required could result in delays or reductions in manufacturing or product shipments. From time to time, there could be shortages of different products or components. For example, in 2001 and 2002 there was a worldwide shortage of handset components resulting from our third-party manufacturers inability to assemble and manufacture a sufficient quantity of handsets to keep pace with consumer demand. Moreover, our suppliers may supply us with inferior quality products. If an inferior product supplied by a third party is embedded in our end product and causes a problem, it might be difficult to identify the source of the problem as being due to the component parts. If any of these events occur, our competitive position, reputation and business could suffer.

Our ability to source a sufficient quantity of high-quality, cost-effective components used in our products may also be limited by import restrictions and duties in the foreign countries in which we manufacture our products. We require a significant number of imported components to manufacture our products, and imported electronic components and other imported goods used in the operation of our business may be limited by a variety of permit requirements, approval procedures, import duties and registration requirements. Moreover, import duties on such components increase the cost of our products and may make them less competitive.

***If we seek to secure additional financing and are not able to do so, our ability to expand strategically may be limited. If we are able to secure additional financing, our stockholders may experience dilution of their ownership interest, or we may be subject to limitations on our operations and increased leverage.***

We currently anticipate that our available cash resources, which include existing cash and cash equivalents, short-term investments and cash from operations, will be sufficient to meet our anticipated needs for working capital and capital expenditures for the foreseeable future. If we are unable to generate sufficient cash flows from operations, we may need to raise additional funds to develop new or enhanced products, respond to competitive pressures, take advantage of acquisition opportunities or raise capital for strategic purposes. If we raise additional funds through the issuance of equity securities, our stockholders will experience dilution of their ownership interest, and the newly issued securities may have rights superior to those of common stock. If we raise additional funds by issuing debt, we may be subject to limitations on our operations and increase our leverage. For example, in connection with the sale of convertible debt securities in March 2003, we incurred $402.5 million of indebtedness. As a result of this indebtedness, our principal and interest payment obligations have increased substantially. The degree to which we are leveraged could materially and adversely affect our ability to obtain financing for working capital, acquisitions or other purposes and could make us more vulnerable to industry downturns and competitive pressures. Our ability to meet our debt service obligations will be dependent upon our future performance, which will be subject to financial, business and other factors affecting our operations, many of which are beyond our control. Finally, additional sources of financing may not be available on reasonable terms or at all if and when we require it, which could harm our business.

***Our recent growth has strained our resources, and if we are unable to manage and sustain our growth, our operating results will be negatively affected.***

We have recently experienced a period of rapid growth and anticipate that we must continue to expand our operations to address potential market opportunities. Our expansion has placed and will continue to place a significant strain on our management, operational, financial and other resources. To manage our growth effectively, we will need to take various actions, including:

- enhancing management information systems and forecasting procedures;
- further developing our operating, administrative, financial and accounting systems and controls;
- managing our working capital and sources of financing to fund our expansion;
- maintaining close coordination among our engineering, accounting, finance, marketing, sales and operations organizations;
- expanding, training and managing our employee base;
- managing the expansion of both our direct and indirect sales channels in a cost-efficient and competitive manner; and
- fully review our new customers credit histories and ensure their financial stability before finalizing contracts.

If we fail to implement or improve systems or controls or to manage any future growth and expansion effectively, our business could suffer.

***Our success is dependent on continuing to hire and retain qualified personnel, and if we are not successful in attracting and retaining these personnel, our business will suffer.***

The success of our business depends in significant part upon the continued contributions of key technical and senior management personnel, many of whom would be difficult to replace. In particular, our success depends in large part on the knowledge, expertise and services of Hong Liang Lu, our Chairman of the Board, President and Chief Executive Officer, and Ying Wu, our Chairman and Chief Executive Officer of China Operations. The loss of any key employee, the failure of any key employee to perform satisfactorily in his or her current position or our failure to attract and retain other key technical and senior management employees could have a significant negative impact on our operations.

To effectively manage our recent growth as well as any future growth, we will need to recruit, train, assimilate, motivate and retain qualified employees both locally and internationally. Competition for qualified employees is intense, and the process of recruiting personnel with the combination of skills and attributes required to execute our business strategy can be difficult, time-consuming and expensive. As we grow globally, we must implement hiring and training processes that are capable of quickly deploying qualified local residents to knowledgeably support our products and services. Alternatively, if there is an insufficient number of qualified local residents available, we might incur substantial costs importing expatriates to service new global markets. For example, we have historically experienced difficulty finding qualified accounting personnel knowledgeable in both U.S. and Chinese accounting standards who are Chinese residents. If we fail to attract, hire, assimilate or retain qualified personnel, our business would be harmed.

Competitors and others have in the past, and may in the future, attempt to recruit our employees. In addition, companies in the telecommunications industry whose employees accept positions with competitors frequently claim that the competitors have engaged in unfair hiring practices. We may be the subject of these types of claims in the future as we seek to hire qualified personnel. Some of these claims may result in material litigation and disruption to our operations. We could incur substantial costs in defending ourselves against these claims, regardless of their merit.

***Any acquisitions that we undertake could be difficult to integrate, disrupt our business, dilute our stockholders and harm our operating results.***

We may acquire other businesses, products and technologies. For example, on May 23, 2003, we purchased certain assets and liabilities of the CommWorks division of 3Com Corporation for $100.0 million in cash and incurred related transaction and other related costs of $9.3 million. Any anticipated benefits of an acquisition may not be realized. We have in the past and will continue to evaluate acquisition prospects that would complement our existing product offerings, augment our market coverage, enhance our technological capabilities, or that may otherwise offer growth opportunities. Acquisitions may result in dilutive issuances of equity securities, use of our cash resources, the incurrence of debt and the amortization of expenses related to intangible assets. In addition, acquisitions involve numerous risks, including difficulties in the assimilation of operations, technologies, products and personnel of the acquired company, diversion of management s attention from other business concerns, risks of entering markets in which we have no direct or limited prior experience, and the potential loss of key employees of the acquired company.

***We may be unable to adequately protect the loss or misappropriation of our intellectual property, which could substantially harm our business.***

We rely on a combination of patents, copyrights, trademarks, trade secret laws and contractual obligations to protect our technology. We have applied for patents in the United States and internationally. Additional patents may not be issued from our pending patent applications, and our issued patents may not be upheld. In addition, we have, from time to time, chosen to abandon previously filed applications. Moreover, we may face difficulties in registering our existing trademarks in new jurisdictions in which we operate. We cannot guarantee that the intellectual property protection measures that we have taken will be sufficient to prevent misappropriation of our technology or trademarks or that our competitors will not independently develop technologies that are substantially equivalent or superior to ours. In addition, the legal systems of many foreign countries do not protect or honor intellectual property rights to the same extent as the legal system of the United States. For example, in China, the legal system in general, and the intellectual property regime in particular, are still in the development stage. It may be very difficult, time-consuming and costly for us to attempt to enforce our intellectual property rights in these jurisdictions.

***We may be subject to claims that we infringe the intellectual property rights of others, which could substantially harm our business.***

The industry in which we compete is moving towards aggressive assertion, licensing, and litigation of patents and other intellectual property rights. From time to time, we have become aware of the possibility or have been notified that we may be infringing certain patents or other intellectual property rights of others. Regardless of their merit, responding to such claims could be time consuming, divert management s attention and resources and cause us to incur significant expenses. In addition, although some of our supplier contracts provide for indemnification from the supplier with respect to losses or expenses incurred in connection with any infringement claim, some of our contracts do not provide for such protection. Moreover, certain of our sales contracts provide that we must indemnify our customers against claims by third parties for intellectual property rights infringement related to our products. There are no limitations on the maximum potential future payments under these guarantees. Therefore, we may incur substantial costs related to any infringement claim, which may substantially harm our results of operations and financial condition.

We may, in the future, become subject to litigation to defend against claimed infringements of the rights of others or to determine the scope and validity of the proprietary rights of others. Future litigation may also be necessary to enforce and protect our trade secrets and other intellectual property rights. Any intellectual property litigation or threatened intellectual property litigation could be costly, and adverse determinations or settlements could result in the loss of our proprietary rights, subject us to significant liabilities, require us to seek licenses from or pay royalties to third parties which may not be available on commercially reasonable terms, if at all, and/or prevent us from manufacturing or selling our products, which could cause disruptions to our operations.

In the event that there is a successful claim of infringement against us and we fail to develop non-infringing technology or license the propriety rights on commercially reasonable terms and conditions, our business, results of operations or financial condition could be materially and adversely impacted.

***Our multinational operations subject us to various economic, political, regulatory and legal risks.***

We market and sell our products globally, with the majority of our sales made in China. The expansion of our existing multinational operations and entry into new markets will require significant management attention and financial resources. Multinational operations are subject to a variety of risks, such as:

- the burden of complying with a variety of foreign laws and regulations;
- the burden of complying with United States laws and regulations for foreign operations, including the Foreign Corrupt Practices Act;
- difficulty complying with continually evolving and changing global product and communications standards and regulations for both our end products and their component technology;
- market acceptance of our new products, including longer product acceptance periods in new markets into which we enter;
- reliance on local original equipment manufacturers (OEMs), third-party distributors and agents to effectively market and sell our products;
- unusual contract terms required by customers in developing markets;
- changes in local governmental control or influence over our customers;
- changes to import and export regulations, including quotas, tariffs, licensing restrictions and other trade barriers;

- evolving and unpredictable nature of the economic, regulatory, competitive and political environments;
- reduced protection for intellectual property rights in some countries;
- longer accounts receivable collection periods; and
- difficulties and costs of staffing and managing multinational operations, including but not limited to internal control and compliance.

***We do business in markets that are not fully developed, which subjects us to various economic, political, regulatory and legal risks unique to developing economies.***

Less developed markets present additional risks, such as the following:

- customers that may be unable to pay for our products in a timely manner or at all;
- new and unproven markets for our products and the telecommunications services that our products enable;
- inconsistent infrastructure support;
- lack of a large, highly trained workforce;
- difficulty in controlling local operations from our headquarters;
- variable ethical standards and an increased potential for fraud;
- unstable political and economic environments; and
- a lack of a secure environment for our personnel, facilities and equipment.

In particular, these factors create the potential for physical loss of inventory and operating assets. We have in the past experienced cases of vandalism and armed theft of our equipment that had been or was being installed in the field. If disruptions for any of these reasons become too severe in any particular market, it may become necessary for us to terminate contracts and withdraw from that market and suffer the associated costs and lost revenue.

***We are subject to risks relating to currency rate fluctuations and exchange controls.***

Because most of our sales are made in foreign countries, we are exposed to market risk for changes in foreign exchange rates on our foreign currency-denominated accounts and notes receivable balances. We do not currently hedge our foreign currency-denominated transactions. Historically, the majority of our sales have been made in China and denominated in Renminbi; as such, the impact of currency fluctuations of Renminbi thus far has been insignificant as it is fixed to the U.S. dollar. However, in the future, China could choose to devalue the Renminbi versus the U.S. dollar, or the Renminbi-U.S. dollar exchange rate could float, and the Renminbi could depreciate relative to the U.S. dollar. Fluctuations in currency exchange rates in the future may have a material adverse effect on our results of operations.

We enter into transactions that may expose us to foreign currency rate fluctuation risk. Historically, the largest component of our foreign currency exchange loss has resulted from our purchasing inventory denominated in foreign currencies. If we continue to purchase inventory in foreign currencies, we may incur additional foreign currency exchange losses, causing our operating results to suffer.

Moreover, some of the foreign countries in which we do business might impose currency restriction that may limit the ability of our subsidiaries and joint ventures in such countries to obtain and remit foreign currency necessary for the purchase of imported components and may limit our ability to obtain and remit foreign currency in exchange for foreign earnings. For example, China employs currency

34

controls restricting Renminbi conversion, limiting our ability to engage in currency hedging activities in China. Various foreign exchange controls may also make it difficult for us to repatriate earnings, which could have a material adverse effect on our ability to conduct business globally.

***Business interruptions could adversely affect our business.***

Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, external interference with our information technology systems, incidents of terrorism and other events beyond our control. For example, our Hangzhou manufacturing facility s ability to produce sufficient products is dependent upon a continuous power supply, and the power required to source our manufacturing operations is inconsistent. The Hangzhou facility has in the past been subject to power shortages, which has affected our ability to produce and ship sufficient products. We do not have a detailed disaster recovery plan, and the occurrence of any events like these that disrupt our business could harm our operating results.

***We may suffer losses with respect to equipment held at customer sites, which could harm our business.***

We face the risk of loss relating to our equipment held at customer sites. In some cases, our equipment held at customer sites is under contract, pending final acceptance by the customer. We generally do not hold title or risk of loss on such equipment, as title and risk of loss are typically transferred to the customer upon delivery of our equipment. However, we do not recognize revenue and accounts receivable with respect to the sale of such equipment until we obtain acceptance from the customer. If we do not obtain final acceptance, we may not be able to collect the contract price and recover this equipment or its associated costs. In other cases, particularly in China, where governmental approval is required to finalize certain contracts, inventory not under contract may be held at customer sites. We hold title and risk of loss on this inventory until the contracts are finalized and, as such, are subject to any losses incurred resulting from any damage to or loss of this inventory. If our contract negotiations fail or if the government of China otherwise delays approving contracts, we may not recover or receive payment for this inventory. Moreover, our insurance may not cover all losses incurred if our inventory at customer sites not under contracts is damaged prior to contract finalization. If we incur a loss relating to inventory for any of the above reasons, our operating results could be harmed.

***We have been named as a defendant in securities litigation.***

We and various underwriters for our initial public offering are defendants in a purported shareholder class action. The complaint alleges undisclosed improper underwriting practices concerning the allocation of IPO shares, in violation of the federal securities laws. Similar complaints have been filed concerning the IPOs of more than 300 companies, and the litigation has been coordinated in United States District Court for the Southern District of New York as In re Initial Public Offering Securities Litigation, 21 MC 92. Although we believe we have valid defenses to the claims against us and intend to defend the litigation vigorously, until the matter is resolved, it will be necessary for us to continue to expend time and financial resources on the matter. Moreover, an adverse judgment in the litigation could materially harm our operations.

***Recently enacted and proposed changes in securities laws and regulations are likely to increase our costs.***

The Sarbanes-Oxley Act of 2002 has required and will continue to require changes in some of our corporate governance and securities disclosure or compliance practices. That Act also requires the SEC to promulgate new rules on a variety of subjects, in addition to rule proposals already made, and The Nasdaq National Market has revised its requirements for companies that are Nasdaq-listed. We expect these developments will require us to devote additional resources to our operational, financial and management information systems procedures and controls to ensure our continued compliance with current and future laws and regulations. We expect these developments to make it more difficult and more expensive for us to obtain director and officer liability insurance, and we may be required to accept reduced coverage, increase our level of self-insurance, or incur substantially higher costs to obtain coverage. These developments could make it more difficult for us to attract and retain qualified members of our board of directors, or qualified executive officers. We are presently evaluating and monitoring regulatory developments and cannot estimate the timing or magnitude of additional costs we may incur as a result.

**RISKS RELATED TO CONDUCTING BUSINESS IN CHINA**

***China s governmental and regulatory reforms may impact our ability to do business in China.***

The Chinese government, through the Ministry of Information Industry, the Chinese telecommunication industry s regulating body, has broad discretion and authority over all aspects of the telecommunications and information technology industry in China, with the power to permit or prohibit the sales of any of our products. Since 1978, the Chinese government has been in a state of evolution and reform. The reforms have resulted in and are expected to continue to result in significant economic and social development in China. Many of the reforms are unprecedented or experimental and may be subject to change or readjustment due to a variety of political, economic and social factors. While we anticipate that the basic principles underlying the reforms will remain unchanged, any of the following changes in China s political and economic conditions and governmental policies could have a substantial impact on our business:

- the promulgation of new laws and regulations and the interpretation of those laws and regulations;
- inconsistent enforcement and application of the telecommunications industry s rules and regulations by the Chinese government between foreign and domestic companies;
- the introduction of measures to control inflation or stimulate growth;
- the introduction of new guidelines for tariffs and service rates, which affect our ability to competitively price our products and services;
- changes in the rate or method of taxation;
- the imposition of additional restrictions on currency conversion and remittances abroad; or
- any actions which limit our ability to develop, manufacture, import or sell our products in China, or to finance and operate our business in China.

For example, in the year 2000, the Ministry of Information Industry temporarily halted deployment of our PAS systems and handsets, pending its review of personal handyphone system ( PHS )-based telecommunications equipment, a microcellular wireless communications technology. The Ministry of Information Industry later allowed the continued deployment of PHS-based systems, such as our PAS systems and handsets, in China s county-level cities, towns and villages but limited deployments within large and medium-sized cities to very limited areas of dense population, such as campuses, commercial buildings and special development zones. If in the future the Ministry of Information Industry determines to prohibit the sale or deployment of our PAS systems and handsets or our other products, or if it imposes additional limitations on their sale, our business and financial condition could suffer.

In addition to modifying the existing telecommunications regulatory framework, the Chinese government is currently preparing a draft of a standard, national telecommunications law (the Telecommunications Law ) to provide a uniform regulatory framework for the telecommunications industry. We do not yet know the final nature or scope of the regulation that would be created if the Telecommunications Law is passed. Accordingly, we cannot predict whether it will have a positive or negative effect on us or on some or all aspects of our business.

***China s changing economic environment may impact our ability to do business in China.***

Since 1978, the Chinese government has been reforming the economic system in China to increase emphasis placed on decentralization and the utilization of market forces in the development of China s economy. These reforms have resulted in significant economic growth. However, any economic reform policies or measures in China may from time to time be modified or revised by the Chinese government. While we may be able to benefit from the effects of some of these policies, these policies and other measures taken by the Chinese government to regulate the economy could also have a significant negative impact on economic conditions in China, which would result in a negative impact on our business. More recently, China s economic environment has been changing as a result of China s entry into the World Trade Organization (WTO), which was effective in December of 2001. Entry into the WTO requires that China reduce tariffs and eliminate non-tariff barriers, including quotas, licenses and other restrictions, by 2005 at the latest, and we cannot predict the impact of these changes on China s economy. Moreover, although China s entry into the WTO and the related relaxation of trade restrictions may lead to increased foreign investment, it may also lead to increased competition in China s markets from other foreign companies. If China s entry into the WTO results in increased competition or has a negative impact on China s economy, our business could suffer. In addition, although China is increasingly according foreign companies and foreign investment enterprises established in China the same rights and privileges as Chinese domestic companies as a result of its admission into the WTO, special laws, administrative rules and regulations governing foreign companies and foreign investment enterprises in China may still place foreign companies at a disadvantage in relation to Chinese domestic companies and may adversely affect our competitive position.

***Uncertainties with respect to the Chinese legal system may adversely affect us.***

We conduct our business in China primarily through our wholly-owned subsidiaries incorporated in China. Our subsidiaries are generally subject to laws and regulations applicable to foreign investment in China. Accordingly, our business might be affected by China s developing legal system. Since 1978, many new laws and regulations covering general economic matters have been promulgated in China, and government policies and internal rules promulgated by governmental agencies may not be published in time, or at all. As a result, we may operate our business in violation of new rules and policies without having any knowledge of their existence. In addition, there are uncertainties regarding the interpretation and enforcement of laws, rules and policies in China. The Chinese legal system is based on written statutes, and prior court decisions have limited precedential value. Because many laws and regulations are relatively new and the Chinese legal system is still evolving, the interpretations of many laws, regulations and rules are not always uniform. Moreover, the relative inexperience of China s judiciary in many cases creates additional uncertainty as to the outcome of any litigation, and the interpretation of statutes and regulations may be subject to government policies reflecting domestic political changes. Finally, enforcement of existing laws or contracts based on existing law may be uncertain and sporadic, and it may be difficult to obtain swift and equitable enforcement, or to obtain enforcement of a judgment by a court of another jurisdiction. Any litigation in China may be protracted and result in substantial costs and diversion of resources and management attention.

***We only have trial licenses to sell certain of our network access products in China.***

Under China s current regulatory structure, the communications products that we offer in China must meet government and industry standards, and a network access license for the equipment must be obtained. Without a license, telecommunications equipment is not allowed to be connected to public telecommunications networks or sold in China. Moreover, we must ensure that the quality of the telecommunications equipment for which we have obtained a network access license is stable and reliable, and will not lower the quality or performance of other installed licensed products. China s State Council s product quality supervision department, in concert with China s Ministry of Information Industry, performs spot checks to track and supervise the quality of licensed telecommunications equipment and publishes the results of such spot checks.

We have obtained a probationary network access license for our mSwitch product, and after the trial period, we anticipate that an official network access license will be issued if the trial demonstrates that mSwitch satisfies all the applicable government and industry standards. However, we cannot be certain that we will receive this license. Moreover, we only have trial licenses for our PAS systems and handsets. We have applied for, but have not yet received, a final official network access license for our PAS systems and handsets. Based upon conversations with China s Ministry of Information Industry, we understand that our PAS systems and handsets are considered to still be in the trial period and that sales of our PAS systems and handsets may continue to be made by us during this trial period, but that a license will ultimately be required. If we fail to obtain the required licenses, we could be prohibited from making further sales of the unlicensed products, including our PAS systems and handsets, in China, which would substantially harm our business, financial condition and results of operations. The regulations implementing these requirements are not very detailed, have not been applied by a court and may be interpreted and enforced by regulatory authorities in a number of different ways. Our counsel in China has advised us that China s governmental authorities may interpret or apply the regulations with respect to which licenses are required and the ability to sell a product while a product is in the trial period in a manner that is inconsistent with the information received by our counsel in China, and either of these conditions could have a material adverse effect on our business, financial condition and results of operations.

***If China Telecom or China Netcom obtain licenses allowing them to deliver mobile services, our ability to sell our PAS mobile systems and handsets could be impaired.***

China Telecom and China Netcom hold and operate the fixed line telephone and data communications assets in China, and currently do not have the licenses necessary to offer mobile services. However, China s media sources have widely reported that China s Ministry of Information Industry may grant mobile licenses to the new China Telecom or China Netcom, or to both toward the end of 2004. Furthermore, it is anticipated that the mobile license granted by the government will be used for 3G mobile network deployments.

If China Telecom or China Netcom obtain 3G mobile licenses, they may direct capital expenditures to build-out 3G networks, and capital expenditures to build-out PAS networks that utilize our existing products may decline. Moreover, they may elect not to deploy our PAS systems and handsets or other mobile services that we may offer in the future. In addition, it is possible that current PAS frequency bands utilized by PAS networks may be reallocated for use by 3G networks, which would have the effect of restricting or shutting down PAS networks. If this were to occur, we could lose current and potential future customers for our products, and our financial condition and results of operations could be significantly harmed.

***Promotional or incentive programs offered by mobile operators such as China Mobile and China Unicom may adversely impact the competitiveness and pricing of our PAS systems and related products.***

The official tariffs and per-minute usage rates charged to mobile users in China are generally set by the Ministry of Information Industry and the National Development and Reform Commission, and are usually adhered to by mobile operators. However, from time to time, certain mobile operators such as China Mobile and China Unicom have offered special promotional pricing or incentives to customers, such as free incoming calls or free mobile-to-mobile calls. The continued use of such incentive programs by mobile operators may adversely impact the competitiveness and pricing of our PAS systems and related products and their rollout by the new China Telecom and China Netcom. Such incentive programs may continue or be expanded in the future. We cannot be certain as to what impact such incentive programs may have on our financial condition. However, it is possible that the continuation or expansion of such programs may have a material adverse effect on our business or results of operations.

***If tax benefits available to our subsidiaries located in China are reduced or repealed, our business could suffer.***

The Chinese government is considering the imposition of a unified corporate income tax that would phase out, over time, the preferential tax treatment to which foreign investment enterprises, such as our company, are currently entitled. While it is not certain whether the government will implement such a unified tax structure or whether our company will be grandfathered into any new tax structure, if a new tax structure is implemented, a new tax structure may adversely affect our financial condition. Moreover, certain of our subsidiaries and joint ventures located in China enjoy tax benefits in China that are generally available to foreign investment enterprises. If these tax benefits are reduced or repealed due to changes in tax laws, our business could suffer.

**RISKS RELATED TO OUR STOCK PERFORMANCE AND CONVERTIBLE DEBT SECURITIES**

***Our stock price is highly volatile.***

The trading price of our common stock has fluctuated significantly since our initial public offering in March of 2000. Our stock price could be subject to wide fluctuations in the future in response to many events or factors, including those discussed in the preceding risk factors relating to our operations, as well as:

- actual or anticipated fluctuations in operating results, actual or anticipated gross profit as a percentage of net sales, levels of inventory, our actual or anticipated rate of growth and our actual or anticipated earnings per share;

- changes in expectations as to future financial performance or changes in financial estimates or buy/sell recommendations of securities analysts;

- changes in governmental regulations or policies in China, such as the temporary suspension of sales of our PAS systems that occurred in May and June of 2000, which caused our stock price to drop;

- our, or a competitor s, announcement of new products, services or technological innovations;

- the operating and stock price performance of other comparable companies; and

- news and commentary emanating from the media, securities analysts or government bodies in China relating to us and to the industry in general.

General market conditions and domestic or international macroeconomic factors unrelated to our performance may also affect our stock price. For these reasons, investors should not rely on recent trends to predict future stock prices or financial results. In addition, following periods of volatility in a company s securities, securities class action litigation against a company is sometimes instituted. This type of litigation could result in substantial costs and the diversion of management time and resources.

In addition, public announcements by China Telecom and China Netcom, each of which exert significant influence over many of our major customers in China, may contribute to volatility in the price of our stock. In 2002, China Telecom completed its initial public offering, which has caused that entity to issue press releases more frequently than in prior years. The price of our stock may react to such announcements. More recently, it has been reported that China Netcom has been restructuring its operations for its own initial public offering. More frequent public announcements from China Netcom relating to or resulting from their initial public offering could cause the price of our stock to become even more volatile.

***SOFTBANK CORP. and its related entities, including SOFTBANK America Inc., have significant influence over our management and affairs, which it could exercise against your best interests.***

SOFTBANK CORP. and its related entities, including SOFTBANK America Inc. (collectively, SOFTBANK ), beneficially owned approximately 14.1% of our outstanding stock as of December 31, 2003. As a result, SOFTBANK has the ability to influence all matters submitted to our stockholders for approval, as well as our management and affairs. Matters that could require stockholder approval include:

- election and removal of directors;
- merger or consolidation of our company; and
- sale of all or substantially all of our assets.

This concentration of ownership may delay or prevent a change of control or discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of our company, which could decrease the market price of our common stock.

***Delaware law and our charter documents contain provisions that could discourage or prevent a potential takeover, even if the transaction would benefit our stockholders.***

Other companies may seek to acquire or merge with us. An acquisition or merger of our company could result in benefits to our stockholders, including an increase in the value of our common stock. Some provisions of our Certificate of Incorporation and Bylaws, as well as provisions of Delaware law, may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable. These provisions include:

- authorizing the board of directors to issue additional preferred stock;
- prohibiting cumulative voting in the election of directors;
- limiting the persons who may call special meetings of stockholders;
- prohibiting stockholder action by written consent;
- creating a classified board of directors pursuant to which our directors are elected for staggered three year terms; and
- establishing advance notice requirements for nominations for election to the board of directors and for proposing matters that can be acted on by stockholders at stockholder meetings.

***The holders of our convertible subordinated notes due in 2008 and we face a variety of risks related to the notes.***

Holders of our convertible subordinated notes due 2008 (the notes ) and we face a variety of risks with respect to the notes, including the following:

- we may be limited in our ability to purchase the notes in the event of a change in control, either for cash or stock, which could result in our defaulting on the notes at the time of the change in control and purchases for stock would be subject to market risk;
- an event of default under our senior debt, including one of our subsidiaries, could restrict our ability to purchase or pay any or all amounts due on notes, and after paying our senior debt in full, we may not have sufficient assets remaining to pay any or all amounts due on the notes;
- there is no listed trading market for the notes, which could have a negative impact on the market price of the notes;

40

- we have significantly increased our leverage as a result of the sale of the notes which could have an adverse impact on our ability to obtain additional financing for working capital;

- hedging transactions related to the notes and our common stock and other transactions, as well as changes in interest rates and our creditworthiness, may affect the value of the notes and of our common stock; and

- the notes might not be rated or may receive a lower rating than anticipated by investors, ultimately having a negative affect on the price of the notes and of our common stock.

**ITEM 7A QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

We are exposed to the impact of interest rate changes, changes in foreign currency exchange rates and changes in the stock market.

*Interest Rate Risk.* Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. The fair value of our investment portfolio would not be significantly affected by either a 10% increase or decrease in interest rates due mainly to the short-term nature of most of our investment portfolio. However, our interest income can be sensitive to changes in the general level of U.S. interest rates since the majority of our funds are invested in instruments with maturities less than one year. Our policy is to limit the risk of principal loss and ensure the safety of invested funds by generally attempting to limit market risk. Funds in excess of current operating requirements are mostly invested in government-backed notes, commercial paper, floating rate corporate bonds, fixed income corporate bonds and tax exempt instruments. In accordance with our investment policy, all short-term investments are invested in investment grade rated securities with minimum A or better ratings. Currently, most of our short-term investments have AA or better ratings.

The table below represents carrying amounts and related weighted-average interest rates of our investment portfolio at December 31, 2003:

**(in thousands except interest rates)**

| | | |
|---|---|---|
| Restated(1) | | |
| Cash and cash equivalents | $ 377,747 | |
| Average interest rate | 1.19 | % |
| Restricted cash | 3,943 | |
| Average interest rate | 0.50 | % |
| Restricted short-term investments | 20,461 | |
| Average interest rate | 1.19 | % |
| Short-term investments | 48,617 | |
| Average interest rate | 1.36 | % |
| Total investment securities | 450,768 | |
| Average interest rate | 1.20 | % |

(1) See Note 24 to the Consolidated Financial Statements.

41

*Concentration of Credit Risk and Major Customers:*

The table below outlines our sales to, and the accounts receivable balances with respect to our largest customers:

| For the year ended December 31, | % of Net Sales | % of Accounts Receivable |
|---|---|---|
| **2003** | | |
| Customer A | 11 % | 3 % |
| **2002** | | |
| Customer B | 18 % | 6 % |
| Customer C | 13 % | 0 % |
| **2001** | | |
| Customer B | 28 % | 29 % |
| Customer D | 10 % | 8 % |

Approximately 76%, 84% and 90% of the Company s net sales during 2003, 2002 and 2001, respectively, were to entities affiliated with the government of China. Accounts receivable balances from these China government affiliated entities or state owned enterprises were $304.0 million and $238.0 million, respectively, as of December 31, 2003 and 2002. The Company extends credit to its customers in China generally without requiring collateral. In global sales outside of China, the Company often requires letters of credit from its customers. The Company monitors its exposure for credit losses and maintains allowances for doubtful accounts.

*Country Risks:*

Approximately 86%, 84% and 90% of the Company s sales for the year ended December 31, 2003, 2002 and 2001, respectively, were made in China. Accordingly, the political, economic and legal environment, as well as the general state of China s economy may influence the Company s business, financial condition and results of operations. The Company s operations in China are subject to special considerations and significant risks not typically associated with companies in the United States. These include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company s results may be adversely affected by, among other things, changes in the political, economic and social conditions in China, and by changes in governmental policies with respect to laws and regulations, changes in China s telecommunications industry and regulatory rules and policies, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation.

Approximately 10%, 13% and 3% of the Company s sales for the year ended December 31, 2003, 2002 and 2001, respectively, were made in Japan. Accordingly, the political, economic and legal environment and the general state of Japan s economy may influence the Company s business, financial condition and results of operations.

*Equity Investment Risk.* Our investment portfolio includes equity investments in publicly traded companies, the values of which are subject to market price volatility. Economic events could adversely affect the public equities market and general economic conditions may continue to worsen. Should the fair value of our publicly traded equity investments decline below their cost basis in a manner deemed to be other-than-temporary, our earnings may be adversely affected. We have also invested in several privately held companies as well as investment funds which invest primarily in privately held companies, many of which can still be considered in the start-up or development stages. These investments are inherently risky, as the market for the technologies or products they have under development are typically in the early stages and may never materialize.

*Debt Investment Risk.* Our debt investment portfolio consists of a $11.2 million note receivable from BB Modem Rental PLC ( BB Modem ), an affiliate of SOFTBANK CORP., pursuant to a Mezzanine Loan Agreement we entered into with BB Modem on July 17, 2003. Our loan is subordinated to certain senior lenders of BB Modem, and repayments are payable to us over a forty-two month period, with a substantial portion of the principal amount of the loan schedule to be repaid during the last 16 months of this period. Our recourse for nonpayment of the loan is limited to the assets of BB Modem, the account into which subscriber payments are made and its rights under the securitization transaction documents. The value of BB Modem s modems that serve as collateral for the loan may decrease over time and may not be sufficient upon sale to pay the outstanding amounts on the loan.

*Foreign Exchange Rate Risk.* We are exposed to foreign exchange rate risk because most of our sales in China are denominated in Renminbi and portions of our accounts payable are denominated in Japanese Yen. Due to the limitations on converting Renminbi, we are limited in our ability to engage in currency hedging activities in China. Although the impact of currency fluctuations of Renminbi to date has been insignificant, fluctuations in currency exchange rates in the future may have a material adverse effect on our results of operations. Although we are expanding our global operations outside of China, as of December 31, 2003, we have not experienced a material foreign exchange rate risk due to the fact that the significant majority of our business has remained in China. We have a multi-currency bank account in Japanese Yen for purchasing portions of our inventories and supplies. The balance of this Japanese Yen account at December 31, 2003 was approximately $28.6 million.

**ITEM 8 FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

**Index to Consolidated Financial Statements and Financial Statement Schedules**


| | **Page** |
|---|---|
| Financial Statements (Restated): | |
| Report of Independent Registered Public Accounting Firm | 45 |
| Consolidated Balance Sheets at December 31, 2003 and 2002 | 46 |
| Consolidated Statements of Operations for the years ended December 31, 2003, 2002 and 2001 | 47 |
| Consolidated Statements of Stockholders Equity for the years ended December 31, 2003, 2002 and 2001 | 48 |
| Condensed Consolidated Statements of Cash Flows for the years ended December 31, 2003, 2002 and 2001 | 49 |
| Notes to Consolidated Financial Statements | 50 |
| Financial Statement Schedules (Restated): | |
| For each of the three years in the period ended December 31, 2003 | |
| Report of Independent Registered Public Accounting Firm | 110 |
| I Condensed Financial Information of Registrant | 111 |
| II Valuation and Qualifying Accounts | 117 |


All other schedules are omitted because they are not applicable or the required information is shown in the consolidated financial statements or notes thereto.

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Board of Directors and Stockholders of UTStarcom, Inc.:

In our opinion, the consolidated financial statements listed in the accompanying index present fairly, in all material respects, the financial position of UTStarcom, Inc. and its subsidiaries (the Company ) at December 31, 2003 and 2002, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2003, in conformity with accounting principles generally accepted in the United States of America. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 24 to the Consolidated Financial Statements, the Company has restated its Consolidated Financial Statements for the year ended December 31, 2003.

As discussed in Note 2 to the Consolidated Financial Statements, the Company adopted FASB Interpretation No. 46 in 2003.

/s/ PricewaterhouseCoopers LLP
San Francisco, California
February 27, 2004, except for Note 24, as to which the date is April 12, 2005

**UTSTARCOM, INC.**
**CONSOLIDATED BALANCE SHEETS**
**(In thousands)**

| | December 31, 2003 | December 31, 2002 |
|---|---|---|
| | Restated(1) | |
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 377,747 | $ 231,944 |
| Short-term investments | 48,617 | 107,305 |
| Accounts receivable, net of allowances for doubtful accounts | 325,288 | 221,215 |
| Accounts receivable, related parties | 43,944 | 835 |
| Notes receivable | 11,362 | 12,048 |
| Inventories | 257,065 | 183,687 |
| Deferred costs/Inventories at customer sites under contracts | 542,060 | 240,979 |
| Prepaids | 139,103 | 52,272 |
| Restricted cash and short-term investments | 24,404 | 21,251 |
| Other current assets | 48,499 | 35,836 |
| Total current assets | 1,818,089 | 1,107,372 |
| Property, plant and equipment, net | 187,039 | 93,980 |
| Long-term investments | 24,066 | 35,360 |
| Goodwill | 100,180 | 44,806 |
| Intangible assets, net | 44,051 | 5,014 |
| Other long-term assets | 70,625 | 19,020 |
| Total assets | $ 2,244,050 | $ 1,305,552 |
| **LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 251,122 | $ 256,980 |
| Income taxes payable | 14,265 | 13,003 |
| Customer advances | 450,499 | 156,336 |
| Deferred revenue | 44,958 | 7,911 |
| Other current liabilities | 173,911 | 104,927 |
| Total current liabilities | 934,755 | 539,157 |
| Long-term debt | 410,655 | |
| Total liabilities | 1,345,410 | 539,157 |
| Commitments and contingencies (Note 14) | | |
| Minority interest in consolidated subsidiaries | 5,309 | |
| Stockholders equity: | | |
| Common stock: $0.00125 par value; authorized: 750,000,000 shares; issued and outstanding: 104,272,477 and 106,787,908 at December 31, 2003 and 2002, respectively | 131 | 135 |
| Additional paid-in capital | 654,483 | 658,546 |
| Deferred stock compensation | (7,761) | (11,766) |
| Retained earnings | 243,058 | 120,520 |
| Receivable from stockholders | | (282) |
| Accumulated other comprehensive income (loss) | 3,420 | (758) |
| Total stockholders equity | 893,331 | 766,395 |
| Total liabilities, minority interest and stockholders equity | $ 2,244,050 | $ 1,305,552 |

(1) See Note 24

See accompanying notes to consolidated financial statements.

46

**UTSTARCOM, INC.**
**CONSOLIDATED STATEMENTS OF OPERATIONS**
**(In thousands, except per share amounts)**

| | Year ended December 31, | | |
|---|---|---|---|
| | 2003 | 2002 | 2001 |
| | Restated(1) | | |
| Net sales | | | |
| Unrelated parties | $ 1,780,751 | $ 858,768 | $ 612,907 |
| Related parties | 184,436 | 123,038 | 13,933 |
| | 1,965,187 | 981,806 | 626,840 |
| Cost of sales | | | |
| Unrelated party | 1,261,284 | 587,799 | 394,956 |
| Related party | 79,518 | 48,535 | 7,336 |
| Gross profit | 624,385 | 345,472 | 224,548 |
| Operating expenses: | | | |
| Selling, general and administrative | 188,339 | 110,263 | 75,764 |
| Research and development | 155,252 | 86,182 | 59,809 |
| In-process research and development costs | 10,686 | 670 | 4,720 |
| Amortization of intangible assets | 8,370 | 2,395 | 7,527 |
| Total operating expenses | 362,647 | 199,510 | 147,820 |
| Operating income | 261,738 | 145,962 | 76,728 |
| Interest income | 3,194 | 5,522 | 8,572 |
| Interest expense | (4,671) | (1,251) | (3,909) |
| Other income (expenses), net | 4,921 | (9,908) | (330) |
| Equity in loss of affiliated companies | (5,260) | (4,053) | (2,962) |
| Income before income taxes and minority interest | 259,922 | 136,272 | 78,099 |
| Income tax expense | (45,399) | (27,254) | (19,823) |
| Minority interest in losses (earnings) of consolidated subsidiaries | 1,009 | (1,156) | (1,322) |
| Net income | $ 215,532 | $ 107,862 | $ 56,954 |
| Basic earnings per share | $ 2.08 | $ 0.98 | $ 0.56 |
| Diluted earnings per share | $ 1.75 | $ 0.94 | $ 0.52 |
| Weighted average shares used in per-share calculation: | | | |
| Basic | 103,659 | 109,566 | 101,433 |
| Diluted | 124,909 | 114,407 | 108,612 |

(1) See Note 24

See accompanying notes to consolidated financial statements.

47

**UTStarcom, Inc. and Subsidiaries**
**Consolidated Statements of Stockholders Equity**
**(In thousands, except share data)**

| | Common Stock Shares | Common Stock Amount | Additional Paid-in-Capital Restated(1) | Deferred Stock Compensation | Retained Earnings (Accumulated Deficit Restated(1) | Notes Receivable from stockholders | Accumulated Other Comprehensive Income/(Loss) | Total Stockholders Equity Restated(1) | Comprehensive Income Restated(1) |
|---|---|---|---|---|---|---|---|---|---|
| Balances, December 31, 2000 | 95,032,657 | $ 120 | $ 426,665 | $ (6,491 ) | $ (7,808 ) | $ (314 ) | $ 147 | $ 412,319 | |
| Common stock issued upon exercise of options | 5,363,601 | 8 | 18,756 | | | | | 18,764 | |
| Common stock issued upon ESPP purchases | 118,223 | | 1,866 | | | | | 1,866 | |
| Common stock issued related to acquisition of Stable Gain | 439,810 | | 10,700 | | | | | 10,700 | |
| Common stock issued upon secondary offering, net of expenses | 7,400,000 | 9 | 139,911 | | | | | 139,920 | |
| Common stock issued for ACD acquisition, net of expenses | 948,525 | 1 | 20,733 | | | | | 20,734 | |
| ACD deferred compensation | | | 5,000 | (5,000 ) | | | | | |
| Amortization of deferred compensation related to ACD acquisition | | | | 1,250 | | | | 1,250 | |
| Amortization of deferred stock compensation related to grants of stock options to employees | | | 23 | 3,928 | | | | 3,951 | |
| Cancellation of deferred compensation charges due to employee terminations | | | (268 ) | 268 | | | | | |
| Tax benefits for non-qualified stock option exercises | | | 15,311 | | | | | 15,311 | |
| Issuance of notes receivable from stockholders | | | | | | (67 ) | | (67 ) | |
| Net income | | | | | 56,954 | | | 56,954 | $ 56,954 |
| Other comprehensive income: | | | | | | | | | |
| Unrealized holding gain (net of tax of $95) | | | | | | | 211 | 211 | 211 |
| Translation adjustment | | | | | | | (26 ) | (26 ) | (26 ) |
| Total comprehensive income | | | | | | | | | $ 57,139 |
| Balances, December 31, 2001 | 109,302,816 | 138 | 638,697 | (6,045 ) | 49,146 | (381 ) | 332 | 681,887 | |
| Common stock issued upon exercise of options | 1,717,899 | 3 | 9,162 | | | | | 9,165 | |
| Common stock issued upon Softbank offering, net of expenses | 1,500,000 | 2 | 28,933 | | | | | 28,935 | |
| Common stock issued upon ESPP purchases | 182,437 | | 2,828 | | | | | 2,828 | |
| ACD acquisition-related stock issuances | 84,756 | | | | | | | | |
| Repurchase of Softbank shares, including fees | (6,000,000 ) | (8 ) | (36,433 ) | | (36,488 ) | | | (72,929 ) | |
| Cancellation of deferred compensation charges due to employee terminations | | | (1,282 ) | 1,282 | | | | | |
| Amortization of deferred stock compensation | | | 103 | 2,997 | | | | 3,100 | |
| Acquisition-related deferred compensation | | | 10,000 | (10,000 ) | | | | | |
| Tax benefits for non-qualified stock option exercises | | | 6,538 | | | | | 6,538 | |
| Collections on notes receivable from stockholders | | | | | | 99 | | 99 | |
| Net income | | | | | 107,862 | | | 107,862 | $ 107,862 |
| Other comprehensive income: | | | | | | | | | |
| Unrealized holding loss (net of tax of $298) | | | | | | | (952 ) | (952 ) | (952 ) |
| Translation adjustment | | | | | | | (138 ) | (138 ) | (138 ) |

| | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| Total comprehensive income | | | | | | | | | $ 106,772 |
| Balances, December 31, 2002 | 106,787,908 | 135 | 658,546 | (11,766 ) | 120,520 | (282 ) | (758 ) | 766,395 | |
| Common stock issued upon exercise of options | 4,490,195 | 6 | 55,053 | | | | | 55,059 | |
| Common stock issued upon ESPP purchases | 261,103 | | 3,839 | | | | | 3,839 | |
| Repurchase of Softbank Shares including fees | (8,000,000 ) | (10 ) | (46,605 ) | | (92,994 ) | | | (139,609 ) | |
| Purchase of convertible bond hedge and call option | | | (43,792 ) | | | | | (43,792 ) | |
| Common stock issued for RollingStreams acquisition | 164,115 | | 6,233 | | | | | 6,233 | |
| Shanghai Yi Yun acquisition-related stock issuance | 226,302 | | | | | | | | |
| Deferred Compensation related to RollingStream acquisition | | | | (434 ) | | | | (434 ) | |
| Cancellation of deferred compensation charges due to employee terminations | | | (156 ) | 156 | | | | | |
| Amortization of deferred stock compensation | | | | 4,283 | | | | 4,283 | |
| Common stock issued for Shanghai Yi Yun acquisition | 342,854 | | 6,001 | | | | | 6,001 | |
| Tax benefits for non-qualified stock option exercises | | | 15,364 | | | | | 15,364 | |
| Collections of notes receivable from stockholders | | | | | | 282 | | 282 | |
| Net income | | | | | 215,532 | | | 215,532 | $ 215,532 |
| Other comprehensive income: | | | | | | | | | |
| Unrealized holding gain (net of tax of $506) | | | | | | | 2,166 | 2,166 | 2,166 |
| Translation adjustment | | | | | | | 2,012 | 2,012 | 2,012 |
| Total comprehensive income | | | | | | | | | $ 219,710 |
| Balances, December 31, 2003 | 104,272,477 | $ 131 | $ 654,483 | $ (7,761 ) | $ 243,058 | $ | $ 3,420 | $ 893,331 | |

(1) See Note 24

See accompanying notes to the consolidated financial statements.

**UTSTARCOM, INC.**
**CONSOLIDATED STATEMENTS OF CASH FLOWS**
**(In thousands)**

| | Twelve months ended December 31, 2003 Restated(1) | December 31, 2002 | December 31, 2001 |
|---|---|---|---|
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income | $ 215,532 | $ 107,862 | $ 56,954 |
| Adjustment to reconcile net income to net cash provided by operating activities: | | | |
| Gain on change in ownership interest in subsidiary | | | (277) |
| Depreciation and amortization | 44,708 | 22,435 | 18,533 |
| Non-qualified stock option exercise tax benefits | 15,364 | 6,537 | 15,311 |
| Loss on sale of assets | 1,920 | 1,098 | 802 |
| Impairment of long-term assets | 8,762 | | |
| Loss on sale of notes receivable | 2,286 | | |
| In-process research and development costs | 10,686 | 670 | 4,720 |
| Amortization of debt issuance costs | 1,953 | | |
| Warrants adjustment to fair value | (424) | | |
| Loss on sale of investment | 73 | | |
| Impairment of long-term investment | 75 | 4,442 | 1,690 |
| Stock compensation expense | 4,302 | 3,100 | 5,200 |
| Allowance for doubtful accounts | 4,922 | 7,197 | 6,218 |
| Inventory reserve | 14,626 | 18,937 | 11,143 |
| Equity in loss of affiliated companies | 5,261 | 4,053 | 2,962 |
| Deferred income taxes | (10,675) | (14,704) | (9,629) |
| Minority interest in earnings of consolidated subsidiary | (1,009) | 1,156 | 1,322 |
| Changes in operating assets and liabilities, net of acquisitions: | | | |
| Accounts receivable | (151,863) | (34,207) | (39,196) |
| Inventories | (81,618) | (76,056) | (60,419) |
| Deferred costs/Inventories at customer sites under contracts | (301,081) | (137,806) | (60,779) |
| Other current and non-current assets | (120,206) | (24,551) | (42,990) |
| Accounts payable | (5,906) | 170,452 | 39,085 |
| Income taxes payable | 1,262 | 2,470 | 3,366 |
| Customer advances | 294,163 | 87,776 | 42,833 |
| Deferred revenue | 27,379 | 47 | 1,913 |
| Other current liabilities | 64,681 | 27,683 | 41,407 |
| Net cash provided by operating activities | 45,173 | 178,591 | 40,169 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Additions to property, plant and equipment | (123,214) | (75,271) | (30,199) |
| Investment in affiliates, net of cash acquired | (661) | (28,933) | (9,779) |
| Issuance of note receivable to related party | (10,071) | | |
| Purchase of minority interest | | | (705) |
| Purchase of businesses, net of cash acquired | (106,713) | (17,706) | |
| Proceeds from disposal of property, plant and equipment | 21 | 175 | 214 |
| Purchase of intangible assets | (2,340) | | (1,078) |
| Change in restricted cash | (3,153) | (21,251) | |
| Purchase of short-term investments | (147,544) | (140,583) | (89,625) |
| Proceeds from sale of short-term investments | 217,180 | 118,168 | 87,516 |
| Net cash used in investing activities | (176,495) | (165,401) | (43,656) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Issuance of stock, net of expenses | 58,878 | 40,928 | 160,550 |
| Purchase of convertible bond hedge and call option | (43,792) | | |
| Proceeds from borrowing | 422,976 | 39,621 | 137,108 |
| Payments for borrowing | (23,389) | (110,101) | (122,055) |
| Repurchase of stock | (139,609) | (72,929) | |
| Proceeds from stockholder notes | 282 | 99 | (67) |
| Net cash provided by (used in) financing activities | 275,346 | (102,382) | 175,536 |
| Effect of exchange rate changes on cash | 1,779 | | (25) |
| Net increase (decrease) in cash and cash equivalents | 145,803 | (89,192) | 172,024 |
| Cash and cash equivalents at beginning of period | 231,944 | 321,136 | 149,112 |
| Cash and cash equivalents at end of period | $ 377,747 | $ 231,944 | $ 321,136 |

(1) See Note 24

See accompanying notes to the consolidated financial statements.

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1 DESCRIPTION OF BUSINESS

UTStarcom Inc. (the Company ), a Delaware corporation, provides Internet Protocol ( IP ) networking product and service platforms and global service and support. The Company sells wireless, wireline and switching platforms to operators in both fast growth and established telecommunications markets around the world. The Company enables its customers to rapidly deploy revenue-generating access services using their existing infrastructure, while providing a migration path to cost-efficient end-to-end IP networks. Incorporated in 1991 and headquartered in Alameda, California, the Company has research and design operations in New Jersey, China, and India.

### NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The Company restated its Consolidated Financial Statements for the year ended December 31, 2003 to correct certain errors in the previously reported Annual Report on Form 10-K. The accompanying notes to the consolidated financial statements related to the restatement have been revised. See note 24 for a discussion of the restatement.

*Basis of Presentation:*

The accompanying consolidated financial statements include the accounts of the Company and its wholly and majority (over 50 percent) owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in the preparation of the consolidated financial statements. Minority interest in consolidated subsidiaries and equity in affiliated companies are shown separately in the consolidated financial statements. The Company also consolidates variable interest entities ( VIE ) as defined by Financial Accounting Standards Board Interpretation No. 46 ( FIN 46 ), Consolidation of Variable Interest Entities.

*Reclassifications:*

Certain reclassifications have been made in the prior years financial statements to conform to the 2003 presentation. Such reclassifications had no impact on previously reported net income or stockholders equity.

*Use of Estimates:*

The preparation of financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Cash and Cash Equivalents:*

Cash and cash equivalents consist of instruments with maturities of three months or less at the date of purchase.

*Short-term Investments:*

Short-term investments consist of investments with original maturities of less than twelve months. In accordance with the Company s investment policy, all short-term investments are invested in investment

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

grade rated securities with a minimum of A or better ratings. Currently, most of the Company s short-term investments have AA or better ratings. Marketable securities are classified as available-for-sale and are carried at fair value. Unrealized holding gains and losses on securities classified as available-for-sale are recorded as a separate component of stockholders equity. Unrealized losses on securities classified as available-for-sale that are determined to be other-than temporary losses are reported in earnings. Realized gains and losses are reported in earnings. The fair value of investments is based on quoted market prices. At December 31, 2003 and 2002, short-term investments in available-for-sale securities consisted of (in thousands):

| | December 31, 2003 | | |
|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Estimated Fair Value |
| Debt securities | $ 48,617 | $ | $ 48,617 |
| Total current available for-sale securities | $ 48,617 | $ | $ 48,617 |

| | December 31, 2002 | | |
|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Estimated Fair Value |
| Government and agency obligations | $ 11,006 | $ 12 | $ 11,018 |
| Debt securities | 96,233 | 54 | 96,287 |
| Total current available for-sale securities | $ 107,239 | $ 66 | $ 107,305 |

*Revenue Recognition:*

Revenues from sales of telecommunications equipment are recognized when persuasive evidence of an arrangement exists, delivery of the product has occurred, customer acceptance has been obtained, the fee is fixed or determinable and collectability is reasonably assured. If the payment due from the customer is not fixed or determinable due to extended payment terms, revenue is recognized as payments become due from the customer, assuming all other criteria for revenue recognition are met. Any payments received prior to revenue recognition are recorded as customer advances. Normal payment terms differ for various reasons amongst different customer regions, depending upon common business practices for customers within a region. Shipping and handling costs are recorded as revenues and costs of revenues. Any expected losses on contracts are recognized immediately.

Sales may be generated from complex contractual arrangements that require significant revenue recognition judgments, particularly in the areas of multiple element arrangements. Where multiple elements exist in an arrangement, the arrangement fee is allocated to the different elements based upon verifiable objective evidence of the fair value of the elements, as governed under EITF 00-21, and SEC Staff Accounting Bulletin No. 104 ( SAB 104 ). Multiple element arrangements primarily involve the sale of PAS or iPAS equipment with handsets, installation and training and the provision of such equipment to different locations for the same customer. Revenue is recognized as each element is earned, namely upon installation and acceptance of equipment or delivery of handsets, provided that the fair value of the undelivered element(s) has been determined, the delivered element has stand-alone value, there is no right of return on delivered element(s), and the vendor is in control of the undelivered element(s).

Final acceptance is required for revenue recognition when installation services are not considered perfunctory. Final acceptance indicates that the customer has fully accepted delivery of equipment and the

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

Company is entitled to the full payment. The Company will not recognize revenue before final acceptance is granted by the customer if acceptance is considered substantive to the transaction. Additionally, the Company does not recognize revenue when cash payments are received from customers for transactions that do not have the customer s final acceptance. The Company records these cash receipts as customer advances, and defers revenue recognition until final acceptance is received.

Where multiple elements exist in an arrangement that includes software, and the software is considered more than incidental to the equipment or services in the arrangement, software and software-related elements are recognized under the provisions of Statement of Position 97-2, as amended, and Emerging Issues Task Force Issue No. 03-05. The Company allocates revenues to each element of software arrangements based on vendor-specific objective evidence ( VSOE ). VSOE of each element is based on the price charged when the same element is sold separately. The Company uses the residual method to recognize revenue when an arrangement includes one or more elements to be delivered at a future date and VSOE of the fair value of all the undelivered elements exists. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the arrangement fee is recognized as revenue. If evidence of fair value of one or more undelivered elements does not exist, revenue is deferred and recognized when delivery of those elements occurs or when fair value can be established.

The Company recognizes revenue for system integration, installation and training upon completion of performance if all other revenue recognition criteria are met. Other service revenue, such as that related to maintenance and support contracts, is recognized ratably over the contract term. Revenues from services were less than 10% of revenues for all years.

The Company also sells products through resellers. Revenue is generally recognized when the standard price protection period which ranges from 30 to 90 days, has lapsed. If collectability cannot be reasonably assured in a reseller arrangement, revenue is recognized upon sell-through to the end customer and receipt of cash. In China, there may be additional obligations in reseller arrangements such as inventory rotation, or stock exchange rights on the product. As such, revenue is recognized in accordance with Statement of Financial Accounting Standards No. 48 Revenue Recognition When Right of Return Exists ( SFAS 48 ). The Company has developed reasonable estimates for stock exchanges. Estimates are derived from historical experience with similar types of sales of similar products.

The assessment of collectability is also a factor in determining whether revenue should be recognized. The Company assesses collectability based on a number of factors, including payment history and the credit-worthiness of the customer. The Company does not request collateral from its customers. In international sales, the Company often requires letters of credit from its customers that can be drawn on demand if the customer defaults on its payment. If the Company determines that collection of a payment is not reasonably assured, the Company recognizes revenue at the time collection becomes reasonably assured, which is generally upon receipt of cash.

Because of the nature of doing business in China and other emerging markets, the Company s billings and/or customer payments may not correlate with the contractual payment terms and the Company generally does not enforce contractual payment terms prior to final acceptance. Accordingly, accounts receivable are not booked until the Company recognizes the related customer revenue. Advances from customers are recognized when the Company has collected cash from the customer, prior to recognizing

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

revenue. Deferred revenue is recorded if there are undelivered elements after final acceptance has been obtained.

The Company provides a warranty on its equipment and handset sales for a period generally ranging from twelve to eighteen months from the time of final acceptance. The Company provides for the expected cost of product warranties at the time that revenue is recognized, based on an assessment of past warranty experience.

*Accounts and notes receivable:*

The Company accepts bank notes and commercial notes, with maturity dates between three and six months, from its customers in China in the normal course of business and estimates the collectability of its trade receivables and notes receivable. An allowance for doubtful accounts is maintained for the estimated losses on the trade receivables and notes receivable. The Company assesses collectability of the receivable by determining whether the creditworthiness of the customer has deteriorated and could result in an inability to collect payment; if collectability is doubtful, the Company records an allowance against the receivable. If a customer s financial condition were to deteriorate, causing their ability to make payments to suffer as a result, the allowances for receivables would be increased. Allowances for doubtful accounts were $31.2 million and $26.3 million at December 31, 2003 and 2002, respectively.

*Inventories:*

Inventories consist of inventories held at the Company s manufacturing facility, at warehouses or at customer sites prior to signing of contracts. The Company may ship inventory to existing customers that require additional equipment to expand their existing networks prior to the signing of an expansion contract. Inventories are stated at the lower of cost or net realizable value, net of write-downs for excess, slow moving and obsolete inventory. Cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis. Inventory is written down for estimated obsolescence or unmarketable inventory equal to the difference between inventory cost and the estimated market value.

*Deferred costs/Inventories at customer sites under contracts:*

Inventories at customer sites under contracts awaiting final acceptance are classified as deferred costs, separate from what was historically considered inventory. These are stated at the lower of cost or net realizable value, net of reserves based upon assessment of potential losses and obsolescence during the lengthy acceptance process. The title and risk of loss of this inventory is transferred to the customer upon delivery. Revenue and cost of sales are recorded when final acceptance is received from the customer.

*Research and Development and Capitalized Software Development Costs:*

Research and development costs are charged to expense as incurred. Costs incurred in the development of software that will ultimately be sold are capitalized between the time when technological feasibility has been attained and the related product is ready for release. During 2003 and 2002, the Company capitalized $4.2 million and $3.4 million of software development costs, respectively. Amortization of capitalized development costs was $1.8 million, $1.1 million and $0.3 million in 2003, 2002 and 2001, respectively. Unamortized capitalized software development costs for 2003 and 2002 were $7.5 million and $4.5 million, respectively. Direct costs of software developed for internal use are expensed during the preliminary project stage and capitalized during the application development stage.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

*Property, Plant and Equipment:*

Property, plant and equipment are recorded at cost and are stated net of accumulated depreciation. Depreciation is provided for on a straight-line basis over the estimated useful lives of the related assets. Land use rights related to property leased by the Company in China are amortized over the life of the lease. Leasehold improvements are amortized on a straight-line basis over the shorter of the useful life of the improvements or the term of the lease. When assets are disposed of, the cost and related accumulated depreciation are removed from the accounts and the resulting gains or losses are included in results of operations. The Company generally depreciates its assets over the following periods:

| | Years |
|---|---|
| Furniture, test or manufacturing equipment | 5 |
| Computers and software | 2-3 |
| Buildings | 39 |
| Automobiles | 5 |
| Land use rights | life of use rights |
| Leasehold improvements | lesser of 5 or remaining lease life |

The Company capitalizes interest incurred related to construction of property, plant or equipment until it is ready for use. As of December 31, 2003, the Company had recorded $0.6 million of interest to construction in progress applicable to the construction of its Hangzhou manufacturing facility and had incurred interest expenses associated with the building s construction of $2.8 million for the year ended December 31, 2003. The Company will continue to capitalize interest until the building is placed into service, upon which time amortization will begin. Capitalized interest will be amortized on a straight-line basis over the life of the building.

*Goodwill and Intangible Assets:*

The Company has recorded goodwill and intangible assets in connection with business acquisitions. Management judgment is required in the assessment of the related useful lives, assumptions regarding the ability to successfully develop and ultimately commercialize acquired technology, and assumptions regarding the fair value and the recoverability of these assets. An annual goodwill impairment review is performed in the fourth quarter of each year or when changes in circumstances indicate a potential impairment. The Company currently operates as a single reportable segment without reporting units, as its management evaluates performance, makes operating decisions and allocates resources based on consolidated financial data. As such, the Company determines whether impairment to goodwill is necessary on a consolidated basis. When assessing potential impairment to goodwill, book value is compared to fair value. Fair value is the Company s market capitalization at the date impairment is assessed. Historically, fair value has exceeded book value and no impairments have been necessary.

*Impairment of Long-Lived Assets:*

Long-lived assets and certain intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. If undiscounted expected future cash flows are less than the carrying value of the assets, an impairment loss will be recognized based on the excess of the carrying amount over the fair value of the assets. Long-lived assets that are to be disposed of by sale are measured at the lower of book value or fair value less cost to sell.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

*Stock-Based Compensation:*

The Company accounts for employee stock option grants in accordance with Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees ( APB 25 ) and has adopted the disclosure-only alternative of SFAS No. 123, as amended by SFAS No. 148, Accounting for Stock-Based Compensation ( SFAS 123 ). Under APB 25, compensation expense is based on the difference, if any, on the date of grant between the fair value of the common stock and the exercise price of the option.

The fair value of warrants, options or stock exchanged for services from non-employees is expensed over the period benefited. The warrants and options are valued using the Black-Scholes option pricing model.

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

| | Year ended December 31, | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| | **Restated(1)** | | |
| Basic | | | |
| Net income: | | | |
| As reported | $ 215,532 | $ 107,862 | $ 56,954 |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | 3,071 | 2,209 | 3,706 |
| Deduct: Total compensation expense determined under fair value based method for all awards, net of related tax effects | (30,290) | (20,060) | (15,827) |
| Pro forma net income | $ 188,313 | $ 90,011 | $ 44,833 |
| Basic income per share: | | | |
| As reported | $ 2.08 | $ 0.98 | $ 0.56 |
| Pro forma | $ 1.82 | $ 0.82 | $ 0.44 |
| Diluted | | | |
| Net income: | | | |
| As reported | $ 215,532 | $ 107,862 | $ 56,954 |
| Effect of dilutive securities 7/8% Convertible subordinated notes | 3,090 | | |
| Add: Stock-based employee compensation expense included in reported net income, net of related tax effects | 3,071 | 2,209 | 3,706 |
| Deduct: Total compensation expense determined under fair value based method for all awards, net of related tax effects | (30,290) | (20,060) | (15,827) |
| Pro forma net income | $ 191,403 | $ 90,011 | $ 44,833 |
| Diluted income per share: | | | |
| As reported | $ 1.75 | $ 0.94 | $ 0.52 |
| Pro forma | $ 1.57 | $ 0.81 | $ 0.42 |

(1) See Note 24

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

The following assumptions were used to calculate the fair value of the options granted:

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | **2003** | | **2002** | | **2001** | |
| Expected remaining term in years | 3.00 | | 3.00 | | 3.00 | |
| Weighted average risk-free interest rate | 1.91 | % | 3.43 | % | 4.04 | % |
| Expected dividend rate | 0.00 | % | 0.00 | % | 0.00 | % |
| Volatility | 64.00 | % | 67.50 | % | 86.07 | % |

The weighted average fair value per share of options granted in 2003, 2002 and 2001 was $11.41, $9.16 and $11.30, respectively.

***Comprehensive Income:***

Comprehensive income includes all changes in equity (net assets) during a period from non-owner sources. Accumulated other comprehensive income or loss is shown in the consolidated statement of stockholders equity

***Income Taxes:***

Deferred income taxes are recognized for the differences between the tax bases of assets and liabilities and their financial statement amounts based on enacted tax rates. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

The Company does not provide for U.S. Federal taxes on undistributed earnings of its foreign subsidiaries or affiliates as they are considered reinvested for an indefinite period.

***Segment Reporting:***

The Company operates in a single segment, selling wireless, wireline and switching platforms to operators in both fast growth and established telecommunications markets around the world.

***Disclosures About Fair Value of Financial Instruments:***

Financial instruments consist of cash and cash equivalents, short and long-term investments, notes receivable, accounts receivable and payable, convertible subordinated debt, purchased and written call options and accrued liabilities. The carrying amounts of cash and cash equivalents, short-term investments, accounts receivable and payable and accrued liabilities approximate their fair values because of the short-term nature of those instruments. The carrying amounts of the loan receivable approximates its fair value based on the discounted value of future cash flow expected to be received from this loan.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

The following table summarizes the Company s carrying values and fair values of its other financial instruments:

| | December 31, | | | |
|---|---|---|---|---|
| | 2003 Restated(1) | | 2002 | |
| | Carrying value | Fair value | Carrying value | Fair value |
| | (In thousands) | | | |
| Convertible debt | $ (402,500) | $ (686,263) | $ | $ |
| Bank note | (8,155) | (8,155) | | |
| Convertible bond hedge | 125,040 | 356,314 | | |
| Written call option | (81,248) | (283,730) | | |
| Long-term investments | 24,066 | 35,545 | 35,360 | 57,894 |

(1) See Note 24

***Foreign Currency Translation:***

Operations of the Company s subsidiaries are conducted primarily in China and the financial statements of those subsidiaries are translated from China s Renminbi, the functional currency, into U.S. Dollars in accordance with SFAS No. 52, Foreign Currency Translation. Accordingly, all foreign currency assets and liabilities are translated at the period-end exchange rate and all revenues and expenses are translated at the average exchange rate for the period. The effects of translating the financial statements of foreign subsidiaries into U.S. Dollars are reported as a cumulative translation adjustment, a separate component of comprehensive income in stockholders equity. Some inventory purchases are made in Japan and consequentially, portions of accounts payable are denominated in Japanese Yen. Foreign currency transaction gains and losses are reported in earnings and were $8.7 million and $5.4 million of losses in 2003 and 2002, respectively. They were not material for 2001.

***Earnings Per Share:***

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of shares of the Company s common stock outstanding during the period. Diluted earnings per share is determined by adjusting net income as reported by the effect of dilutive securities and increasing the number of shares by potentially dilutive common shares outstanding during the period. Potentially dilutive common shares consist of employee stock options, a written call option, warrants and convertible subordinated notes.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

The following is a summary of the calculation of basic and diluted earnings per share (in thousands, except per share data):

| | Year ended December 31. | | |
|---|---|---|---|
| | **2003** | **2002** | **2001** |
| | **Restated(1)** | | |
| Numerator: | | | |
| Net income (for basic EPS computation) | $ 215,532 | $ 107,862 | $ 56,954 |
| Effect of Dilutive Securities | | | |
| 7/8% Convertible Subordinated Notes | 3,090 | | |
| Net income adjusted for dilutive securities | $ 218,622 | $ 107,862 | $ 56,954 |
| Denominator: | | | |
| Shares used to compute basic EPS | 103,659 | 109,566 | 101,433 |
| Dilutive common stock equivalent shares: | | | |
| Stock options | 5,770 | 4,510 | 7,151 |
| Written call option | 1,235 | | |
| Conversion of convertible subordinated notes | 13,674 | | |
| Warrants | 29 | 28 | 28 |
| Other | 542 | 303 | |
| Shares used to compute diluted EPS | 124,909 | 114,407 | 108,612 |
| Basic earnings per share | $ 2.08 | $ 0.98 | $ 0.56 |
| Diluted earnings per share | $ 1.75 | $ 0.94 | $ 0.52 |

(1) See Note 24

Certain potential shares related to employee stock options and warrants outstanding during the years ended December 31, 2003, 2002 and 2001 were excluded in the diluted per share computations, since their exercise prices were greater than the average market price of the common shares during the period and, accordingly, their effect is anti-dilutive. For the years ended December 31, 2003, 2002 and 2001, these shares totaled 17.6 million with a weighted average exercise price of $32.22 per share, 2.8 million shares with a weighted average exercise price of $23.35 per share and 1.8 million shares with a weighted average exercise price of $24.18 per share, respectively. The Company has outstanding warrants for issuance of 32,000 shares at the exercise price of $2.50 per share.

On December 31, 2003, each of the Company 5/8% convertible subordinated notes outstanding was eligible for conversion into shares of common stock. For each $1,000 of aggregate principal amount of notes converted, the Company will deliver approximately 42.0345 shares of common stock, if the Company s stock price exceeds a specified threshold. At December 31, 2003 the closing price of the Company s common stock exceeded the specified threshold, which had the effect of increasing the denominator for diluted earnings per share by 13.7 million. Additionally, during the year ended December 31, 2003, the average price of the Company s stock exceeded the specified strike prices of the convertible bond hedge and call option transactions that the Company entered into to reduce the potential dilution from conversion of the notes. Both the bond hedge and call option transactions may be settled at the Company s option either in cash or net shares and expire on March 1, 2008. Using the treasury stock method, under FAS 128, this would have the effect of decreasing the denominator for diluted earnings per

58

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 2 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)**

share by 3.1 million shares for the bond hedge transaction, and increasing the denominator for diluted earnings per share by 1.2 million shares for the call option transaction. However, only the dilutive effect of the 1.2 million shares with respect to the call option transaction is included in the Company s diluted earnings per share calculation above. The convertible bond hedge, under FAS 128, is always anti-dilutive.

The net income for the diluted EPS computation reflects the reduction in interest expense of $3.1 million for the year ended December 31, 2003, that would result from an assumed conversion of the 7⁄8% convertible subordinated notes.

The Company sold 12.1 million shares of common stock in January 2004, which would have a dilutive effect on the earnings per share calculation. Refer to Note 23 for additional detail on this stock issuance.

***Recent Accounting Pronouncements:***

In April 2003, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 149 Amendment of Statement 133 on Derivative Instruments and Hedging Activities ( SFAS 149 ). This statement amends SFAS 133 to provide clarification on the financial accounting and reporting of derivative instruments and hedging activities. The adoption of SFAS 149, which was effective for contracts entered into or modified after June 30, 2003, did not have a material effect on the Company s consolidated financial condition or results of operations.

In May 2003, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity ( SFAS 150 ). SFAS 150 establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of these instruments were previously classified as equity. As the Company does not have any of these financial instruments, the adoption of FAS 150 is not expected to have any impact on the Company s consolidated financial statements.

On December 17, 2003, the Staff of the SEC issued Staff Accounting Bulletin No. 104 ( SAB 104 ), Revenue Recognition, which supercedes SAB 101, Revenue Recognition in Financial Statements. SAB 104 s primary purpose is to rescind accounting guidance contained in SAB 101 related to multiple element revenue arrangements, superceded as a result of the issuance of EITF 00-21, Accounting for Revenue Arrangements with Multiple Deliverables. Additionally, SAB 104 rescinds the SEC s Revenue Recognition in Financial Statements Frequently Asked Questions and Answers ( the FAQ ) issued with SAB 101 that had been codified in SAB 101 Topic 13. Selected portions of the FAQ have been incorporated into SAB 104. While the wording of SAB 104 has changed to reflect the issuance of EITF 00-21, the revenue recognition principles of SAB 101 remain largely unchanged by the issuance of SAB 104. The adoption of SAB 104 did not materially affect the Company s revenue recognition policies, nor the Company s results of operations, financial position or cash flows.

**NOTE 3 FOLLOW-ON PUBLIC OFFERING AND RESALE PUBLIC OFFERING**

On August 3, 2001, the Company completed a follow-on public offering and sold an aggregate of 7,400,000 shares of common stock at $20.00 per share. Selling stockholders sold an additional 2,950,000 shares of common stock in the offering. The aggregate net proceeds to the Company were $139.9 million. On February 28, 2002, the Company sold 1,500,000 shares of common stock in connection with the resale

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 3 FOLLOW-ON PUBLIC OFFERING AND RESALE PUBLIC OFFERING (Continued)**

public offering of 10,000,000 shares of our common stock by SOFTBANK America Inc., one of the Company s stockholders. The aggregate net proceeds to the Company were $28.9 million.

**NOTE 4 SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION**

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2003 | | 2002 | | 2001 | |
| | (In thousands) | | | | | |
| Cash paid during the period for: | | | | | | |
| Interest | $ | 2,795 | $ | 1,492 | $ | 3,798 |
| Income taxes | $ | 47,192 | $ | 18,442 | $ | 10,832 |

Non-cash activities were as follows:

| | Year ended December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2003 | | 2002 | | 2001 | |
| | (in thousands) | | | | | |
| Noncash operating activities were as follows: | | | | | | |
| Accounts receivable transferred to notes receivable | $ | 92,181 | $ | 14,545 | $ | |
| Noncash investing and financing activities were as follows: | | | | | | |
| Common stock issued in conjunction with acquisitions | $ | 12,234 | $ | | $ | 31,434 |

**NOTE 5 RESTRICTED CASH AND SHORT-TERM INVESTMENTS**

At December 31, 2003, the Company had restricted cash and short-term investments of $24.4 million primarily comprised of $20.5 million of restricted short-term investments for standby letters of credit and a $3.7 million time deposit required for Japanese tax purposes. At December 31, 2002, the Company had restricted cash of $21.3 million comprised of $9.8 million of standby letters of credit, and an $11.5 million deposit required by China regulatory authorities.

The Company issues standby letters of credit primarily to support international sales activities outside of China. When the Company submits a bid for a sale, often the potential customer will require that the Company issue a bid bond or a standby letter of credit to demonstrate its commitment through the bid process. In addition, the Company may be required to issue standby letters of credit as guarantees for advance customer payments upon contract signing or performance guarantees. The standby letters of credit usually expire six to nine months from date of issuance without being drawn by the beneficiary thereof.

**NOTE 6 ACQUISITIONS AND DIVESTITURES OF COMPANIES**

***2003***

***CommWorks***

On May 23, 2003, the Company completed its acquisition of selected assets and liabilities of the CommWorks division ( CommWorks ) from 3Com Corporation, a Delaware corporation, ( 3Com ). The Company paid $100.0 million in cash and incurred related transaction and other related costs of $9.3 million. The Company funded the consideration for the acquisition from cash on hand.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 6 ACQUISITIONS AND DIVESTITURES OF COMPANIES (Continued)**

Selected assets acquired included CommWork s portfolio of carrier-focused voice and data networking products and customer support and professional services. In addition, the Company acquired or licensed all of the 3Com intellectual property used by CommWorks. CommWorks develops and deploys carrier-class, IP-based multi-service access and service-creation platforms for telecommunications service providers.

The Company made a preliminary allocation of the purchase price based in part upon a preliminary independent appraisal. During the three months ended September 30, 2003, the Company completed the allocation of the purchase price of CommWorks. The estimated amounts for intangible assets and goodwill changed due to revised assumptions of future revenues from existing customers. The amount of the purchase price allocated to in-process research and development ( IPR&D ) of $1.3 million was charged to the Company s results of operations, as no alternative future uses existed at the acquisition date. The Company recorded goodwill of $52.3 million, the excess of costs of acquiring CommWorks and the fair value of identified net assets acquired, in connection with the acquisition. Goodwill is expected to be deductible for tax purposes. The results of operations of CommWorks have been included in the Company s consolidated results of operations beginning on the acquisition date of May 23, 2003.

In assessing CommWorks IPR&D projects, the key characteristics of the products under development were considered as well as future prospects, the rate at which technology changes in the telecommunications equipment industry, product life cycles, and the projects stages of development.

As of the date of the acquisition, CommWorks had two projects under development that qualified for IPR&D, SLAP and High Density Voice ( HDV ) 2.0. SLAP is an IPR&D project in the Wireless division of CommWorks. The objective of SLAP is to develop an interface that connects UTStarcom s products with radio switch manufacturers products in China in order to connect a cellular network to the Internet. HDV 2.0 is an IPR&D project in the Wireline product line of CommWorks. HDV 2.0 utilizes software technology to increase data capacity for Voice over Internet Protocol ( VoIP ) solutions.

There are significant risks associated with those technologies. The technological risks stem from the fact that the new technologies are in an early stage of development. As of the closing date, CommWorks SLAP IPR&D project was approximately 60% complete and HDV 2.0 was approximately 40% complete. Therefore, there are significant risks associated with reaching the technological milestones on time and on budget. Commercial risks are associated with the competitive nature of the telecommunications equipment market.

Significant additional costs will be required to complete the IPR&D projects. The SLAP product is approximately 80% complete as of December 31, 2003 and commercialization is expected in the first quarter of fiscal 2004. Remaining costs required to complete the project are estimated to be $0.1 million. The HDV 2.0 product is approximately 50% complete as of December 31, 2003. Commercialization is expected in the first quarter of fiscal 2004. Remaining costs required to complete the project are estimated to be $0.2 million.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 6 ACQUISITIONS AND DIVESTITURES OF COMPANIES (Continued)**

The following table summarizes the final allocation of the purchase price for CommWorks based upon the final independent valuation. The final valuation resulted in changes in estimated fair value, changes in the estimated useful lives of the intangible assets acquired and a change in the amount attributable to goodwill, mainly due to revised assumptions of future revenues from existing customers. The Company also recorded additional employee-related liabilities. The estimated useful life of purchased technology is from one to five years, the estimated useful life of customer relationships is ten years, and the estimated useful lives of backlog and trade names are from one to two years.

| | (in thousands) |
|---|---|
| Fair value of tangible net assets | |
| Property, plant and equipment | $ 10,973 |
| Other tangible assets | 6,522 |
| Deferred transition costs | 6,588 |
| Fair value of identified intangible assets | |
| Customer relationships | 27,820 |
| Backlog | 1,950 |
| Trade names | 940 |
| Existing technology | 14,190 |
| In-process research and development | 1,290 |
| Liabilities assumed | (13,315 ) |
| Excess of costs of acquiring CommWorks over fair value of identified net assets acquired (goodwill) | 52,349 |
| | $ 109,307 |

The following pro forma results of operations reflect the combined results of the Company and CommWorks for the years ended December 31, 2003 and 2002 as if the business combination occurred at the beginning of the period. These results do not purport to be indicative of what would have occurred had the acquisition been made as of that date or the results of operations which may occur in future periods.

| | Year ended December 31, | |
|---|---|---|
| | 2003 Restated(1) | 2002 |
| | (In thousands, except per share data) | |
| Pro forma adjusted net sales | $ 2,006,975 | $ 1,142,146 |
| Pro forma adjusted net income | $ 190,585 | $ 18,132 |
| Pro forma adjusted basic Earnings per share | $ 1.84 | $ 0.17 |
| Pro forma adjusted diluted Earnings per share | $ 1.55 | $ 0.16 |

(1) See Note 24

62

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 6 ACQUISITIONS AND DIVESTITURES OF COMPANIES (Continued)**

The pro forma results of operations include historical operations of the Company and CommWorks. Certain non-recurring charges were recorded by CommWorks and are included above including a $15.0 million restructuring charge in both the first and second quarter of 2002 and a $15.0 million and $6.1 million charge relating to goodwill impairment, which was recorded in the second quarter of 2002 and the first quarter of 2003, respectively.

***RollingStreams***

On June 30, 2003, the Company completed the acquisition of RollingStreams Systems, Ltd. ( RollingStreams ), a development-stage company, pursuant to a share exchange agreement. RollingStreams designs streaming, end-to-end TV-over-Internet-Protocol ( TVoIP ) solutions for telecommunications operators and broadband service providers. The Company s investment in RollingStreams was $0.4 million prior to the acquisition. The purchase consideration for all the outstanding shares of RollingStreams, other than those already held by the Company prior to the acquisition, was 301,074 shares of the Company s common stock. In addition, the Company assumed all outstanding RollingStreams options, which became options to purchase an aggregate of 12,742 shares of the Company s common stock, valued at $0.5 million. Of the 301,074 shares, 164,115 shares valued at $5.8 million, were issued at the closing, including 28,696 of which were held in escrow for any undisclosed liabilities or contingencies incurred by RollingStreams prior to the closing or for any breach of the share exchange agreement. Up to 136,959 of the 301,074 shares will be payable in the form of an earnout after an earnout period expiring 18 months after the closing, subject to the achievement of certain revenue milestones during such earnout period.

The amount of the purchase price allocated to IPR&D was $6.2 million. This amount was charged to the Company s results of operations, as no alternative future uses existed at the acquisition date. The results of operations of RollingStreams have been included in the Company s consolidated results of operations beginning on July 1, 2003.

As of the date of the acquisition, RollingStreams had one project under development that qualified for IPR&D, MediaSwitch. MediaSwitch is an end-to-end solution designed for telecom operators and broadband service providers to deliver broadcast quality TV and on-demand entertainment services over Internet Protocol networks.

MediaSwitch is considered an IPR&D project because there are significant risks associated with the development of this technology. These risks include technological and commercial risks. The technological risks stem from the fact that the technology was 70% complete as of December 31, 2003. Therefore, there are significant risks associated with reaching the technological milestones on time and on budget. Commercial risks are associated with the lack of market acceptance for the TVoIP concept.

In addition to the technological and commercial risks stated above, significant additional costs will be required to complete the IPR&D project. Commercialization of MediaSwitch is expected in the second quarter of 2004. Remaining costs required to complete the project are estimated to be $4.5 million. This involves adding new features and functionalities and stabilizing the software code.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 6 ACQUISITIONS AND DIVESTITURES OF COMPANIES (Continued)**

The following table represents the final allocation of the purchase price for RollingStreams. The allocation of the purchase price is based upon an independent valuation.

| | (in thousands) |
|---|---|
| Fair value of tangible net assets acquired | $ 34 |
| In-process research and development | 6,189 |
| Investment | (363 ) |
| Deferred compensation | 434 |
| Liabilities assumed | (3 ) |
| | $6,291 |

*Xebeo*

On May 7, 2003, the Company completed the purchase of all of the assets of Xebeo Communications, Inc. ( Xebeo ) for $2.4 million in cash. Xebeo develops and manufactures optical packet switches that enable telecommunications carriers to provide single fiber, multi-service access to customers. In addition, an amount up to $0.7 million may be payable based on future contingencies related to employment.

The amount of the purchase price allocated to IPR&D of $1.9 million was charged to the Company s results of operations, as no alternative future uses existed at the acquisition date.

As of the date of the acquisition, Xebeo was focusing its resources on the development of its first product, MetroBridge, an optical packet switching solution, and was considered in the development stage. The development of MetroBridge was 60% complete as of the closing date. The technological feasibility of the technology was not established and the technology had no future alternative uses, therefore the development of MetroBridge is considered IPR&D. The product achieved its technical milestones as of November 2003, and is now available for customer trials and evaluations. It is expected to be marketed and sold in the third quarter of 2004. Commercial risks are associated with the lack of market acceptance with a product with these features and for its use in TVoIP implementations.

The following table represents the final allocation of the purchase price for Xebeo based upon the independent valuation.

| | (in thousands) |
|---|---|
| Fair value of tangible net assets acquired | $ 659 |
| In-process research and development | 1,888 |
| Liabilities assumed | (129 ) |
| | $2,418 |

*Shanghai Yi Yun*

On October 16, 2002, the Company acquired the assets and intellectual property of Shanghai Yi Yun Telecom Technology Co. Ltd. ( Shanghai Yi Yun ), a provider of synchronous digital hierarchy equipment. Shortly thereafter, there was a claim surrounding potential infringement of the intellectual property acquired which led to a possible recission of the transaction, creating a contingency whose outcome was not determinable beyond a reasonable doubt. This transaction was recorded in March 2003, when the Company determined that none of the intellectual property acquired was subject to the claim.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 6 ACQUISITIONS AND DIVESTITURES OF COMPANIES (Continued)**

Consideration was $0.2 million of cash and 342,854 shares of restricted stock valued at $6.0 million. In connection with the acquisition, Shanghai Yi Yun and each of the stockholders that received part of the 342,854 shares of restricted stock executed an indemnity escrow agreement in favor of the Company and such shares of restricted stock were placed in escrow. In addition, the Company issued 514,290 shares of restricted stock valued at that time at $9.0 million to the Shanghai Yi Yun employees that were hired by one of the Company s subsidiaries. Such shares of restricted stock vest over five years through 2007, with accelerated vesting upon the achievement of specified milestones. The Company has treated these 514,290 shares of restricted stock as deferred compensation. During 2003, 226,302 of these shares vested upon achievement of specified milestones.

This acquisition will enable the Company to enter the synchronous digital hierarchy transport market with internally developed products. Goodwill of $3.0 million was recorded in connection with this acquisition and is expected to be deductible for tax purposes. The amount of the purchase price allocated to in-process research and development of $1.3 million was charged to the Company s results of operations, as no alternative future uses existed at the acquisition date.

The following represents the allocation of the purchase price for Shanghai Yi Yun:

| | (in thousands) | |
|---|---|---|
| Fair value of tangible net assets acquired | $ | 250 |
| Fair value of identified intangible assets technology | | 1,870 |
| In-process research and development | | 1,319 |
| Excess costs of acquiring Shanghai Yi Yun Telecom over fair value of net assets acquired (goodwill) | | 3,021 |
| | $ | 6,460 |

*2002*

*HUTS and GUTS*

On December 18, 2001, the Company entered into an agreement to acquire the remaining 49% ownership interest in GUTS, one of the Company s two primary manufacturing facilities in China, for a total consideration of $3.6 million in cash, in order to achieve 100% ownership in the joint venture. On January 21, 2002, the Company entered into an agreement to acquire the remaining 12% ownership interest in HUTS, one of the Company s two primary manufacturing facilities in China, for a total consideration of $14.5 million in cash. As a result of the GUTS and HUTS transactions, which closed in May 2003, the Company was able to conduct its operations in China through wholly owned subsidiaries.

*Issanni*

On April 19, 2002, the Company completed the purchase of Issanni Communications, Inc. ( Issanni ). The Company s investment in Issanni was $2.0 million prior to the acquisition. The purchase consideration for all the outstanding shares of Issanni, other than those already held by the Company prior to the acquisition, was $2.1 million in cash. In addition, $2.0 million will be payable in the form of an earnout to all Issanni shareholders of record at closing, subject to the completion of certain performance milestones during 2002, 2003 and 2004. This earnout will be recorded as additional purchase price when earned. No milestones have been met as of December 31, 2003. Furthermore, the Company adopted an incentive program providing for the issuance of 39,876 shares of common stock valued at $1.0 million to Issanni

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 6 ACQUISITIONS AND DIVESTITURES OF COMPANIES (Continued)**

employees who will continue to perform services for the Company. These shares vest at the earlier of five years or upon the achievement of certain performance milestones. The Company records this amount as compensation expense ratably over the vesting period and will accelerate the amortization if the milestones are met. The amount of the purchase price allocated to in-process research and development of $0.7 million was charged to the Company s results of operations, as no alternative future uses existed at the acquisition date. Goodwill of $0.2 million was recorded in connection with the acquisition and is expected to be deductible for tax purposes. The results of operations of Issanni were included in the Company s consolidated results of operations beginning on April 19, 2002.

*2001*

*Advanced Communication Devices Corporation*

In November 2001, the Company completed the purchase of Advanced Communication Devices Corporation ( ACD ) for $21.3 million, comprised of approximately one million shares of the Company s common stock valued at $19.9 million, $0.9 million of vested common stock options valued using the Black-Scholes pricing model, and $0.5 million of acquisition-related expenses. ACD was a System on Chip ( SoC ) semiconductor company focusing on LAN and IP switching technology whose then current markets included Taiwan, China and Korea. In addition, the Company adopted an incentive plan providing for the issuance of shares of common stock valued at $5 million to ACD employees who will continue to perform services for the Company. The acquisition has been accounted for as a purchase and the results of operations have been included in the Company s consolidated financial statements since the acquisition.

In association with its acquisition of ACD, the Company allocated $0.1 million to tangible net assets acquired, $4.3 million to identified intangible assets, $4.7 million of in-process research and development costs were charged to the Company s results of operations, as no alternative future use existed at the balance sheet date and $12.2 million was charged to goodwill, as this was the excess of costs of acquiring ACD over the fair value of identified net assets acquired.

**NOTE 7 INVENTORIES AND DEFERRED COSTS/INVENTORIES AT CUSTOMER SITES UNDER CONTRACTS**

As of December 31, 2003 and 2002, total inventories consist of the following (in thousands):

| | December 31, 2003 Restated(1) | December 31, 2002 |
|---|---|---|
| *Inventories* | | |
| Raw materials | $ 66,753 | $ 97,086 |
| Work-in-process | 51,116 | 37,467 |
| Finished goods | 48,206 | 9,131 |
| Inventories at customer sites without contracts | 90,990 | 40,003 |
| | $ 257,065 | $ 183,687 |
| *Deferred costs/Inventories at customer sites under contracts* | | |
| Finished goods | 542,060 | 240,979 |
| | $ 542,060 | $ 240,979 |

(1) See Note 24

66

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 8 ACCOUNTS AND NOTES RECEIVABLE**

The Company accepts bank notes receivable and commercial notes receivable, with maturity dates between three and six months, from its customers in China in the normal course of business. The Company may discount these notes with banking institutions in China. A sale of these notes is reflected as a reduction of other current assets and the proceeds of the settlement of these notes are included in cash flows from operating activities in the consolidated statement of cash flows. Notes receivable sold during the years ended December 31, 2003 and 2002 were $298.8 million and $2.5 million, respectively. These notes are not included in the Company s consolidated balance sheets as the criteria for sale treatment established by Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities ( SFAS 140 ), has been met. Under SFAS 140, upon a transfer, the transferor or entity must derecognize financial assets when control has been surrendered and the transferee obtains control over the assets. In addition, the transferred assets have been isolated from the transferor, beyond the reach of its creditors, and the transferee has the right, without conditions or constraints, to pledge or exchange the assets it has received. The costs of settling or transferring these notes receivable were $2.3 million and immaterial for the years ended December 31, 2003 and 2002, respectively, and were included in other income (expense), net in the Consolidated Statements of Operations. Notes receivable available for sale were $11.4 million and $12.0 million at December 31, 2003 and December 31, 2002, respectively.

**NOTE 9 PROPERTY, PLANT AND EQUIPMENT**

As of December 31, 2003 and 2002, property, plant and equipment consists of the following:

| (In thousands) | December 31, 2003 Restated(1) | December 31, 2002 |
|---|---|---|
| Buildings | $ 406 | $ 406 |
| Leasehold improvements | 10,446 | 7,052 |
| Automobiles | 5,587 | 4,846 |
| Software | 14,616 | 10,119 |
| Equipment and furniture | 119,796 | 61,614 |
| Construction in progress | 104,548 | 46,527 |
| | $ 255,399 | $ 130,564 |
| Less accumulated depreciation | (68,360) | (36,584) |
| | $187,039 | $ 93,980 |

(1) See Note 24

Depreciation expense was $34.3 million, $18.9 million and $10.7 million for the years ended December 31, 2003, 2002 and 2001, respectively.

67

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 10 LONG-TERM INVESTMENTS**

The Company s investments are as follows:

| | December 31, 2003 | December 31, 2002 |
|---|---|---|
| Softbank China | $ 5,308 | $ 5,526 |
| Cellon International | 8,000 | 8,000 |
| Restructuring Fund No. 1 | 1,861 | 1,981 |
| Global Asia Partners L.P. | 1,653 | 882 |
| Fiberxon Inc. | 2,000 | 2,000 |
| InterWave Communications International Ltd. | 3,319 | 1,546 |
| China Telecom | | 9,106 |
| Joint Venture with Matsushita | 517 | 4,683 |
| Others | 1,408 | 1,636 |
| Total | $ 24,066 | $ 35,360 |

*Softbank China*

The Company has a $5.3 million investment in Softbank China, an investment fund established by SOFTBANK CORP. focused on investments in Internet companies in China. This investment permits the Company to participate in the anticipated growth of Internet-related businesses in China. SOFTBANK CORP. and its related companies are significant stockholders of the Company. The Company s investment constitutes 10% of the funding for Softbank China, with SOFTBANK CORP. contributing the remaining 90%. The fund has a separate management team, and none of the Company s employees are employed by the fund. Many of the fund s investments are and will be in privately held companies, many of which are still in the start-up or development stages. These investments are inherently risky as the markets for the technologies or products the companies have under development are typically in the early stages and may never materialize. The Company accounts for this investment under the cost method and recorded losses of $0.2 million, $2.8 million and $1.7 million due to an other than temporary decline in the carrying value of this investment during the years ended December 31, 2003, 2002 and 2001, respectively.

*Restructuring Fund*

During the first quarter of fiscal 2002, the Company invested $2.0 million in Restructuring Fund No. 1, a venture capital investment limited partnership established by SOFTBANK INVESTMENT CORP., an affiliate of SOFTBANK CORP. SOFTBANK America Inc., an entity affiliated with SOFTBANK CORP., is a significant stockholder of the Company. The fund focuses on leveraged buyout investments in companies in Asia undergoing restructuring or bankruptcy procedures. The total fund offering is expected to be between approximately $150.0 million and $226.0 million, with each investor contributing a minimum of $0.8 million.

The fund has a separate management team, and none of the Company s employees are employed by the fund. The Company accounts for this investment under the equity method of accounting. During the year ended December 31, 2003 the Company recorded equity losses of $0.1 million, and recorded no losses for the year ended December 31, 2002. The balance in this investment is $1.9 million at December 31, 2003.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 10 LONG-TERM INVESTMENTS (Continued)**

*Global Asia Partners, L.P.*

In June 2002, the Company invested $1.0 million in Global Asia Partners L.P., and an additional $1.0 million in June 2003, with a commitment to invest up to a maximum of $5.0 million. The remaining amount is due at such times and in such amounts as shall be specified in one or more future capital calls to be issued by the general partner. The fund size is anticipated to be $100 million and the fund was formed to make private equity investments in private or pre-IPO technology and telecommunications companies. The fund s geographic focus is on technology investments in Asia, in particular India and China. The Company accounts for this investment under the equity method of accounting. The Company recorded equity losses of $0.2 million and $0.1 million for the years ended December 31, 2003 and 2002, respectively. The balance in this investment is $1.7 million at December 31, 2003.

*Interwave*

During 2002, the Company purchased approximately 5.8 million shares of common stock of InterWave Communications, Inc., a technology company listed on NASDAQ, for approximately $3.0 million. In addition, the Company received warrants to purchase 2.0 million shares of InterWave s common stock at $0.21 per share. The Company s holdings were adjusted for a 1:10 reverse stock split on April 30, 2003, and were 0.6 million shares of common stock and warrants to purchase 0.2 million shares of InterWave s common stock at $2.10 per share. The warrants were valued at $0.7 million at December 31, 2003, using the Black-Scholes option-pricing model. The Company recorded the increase in the carrying value of these common stock securities of $1.3 million for the year ended December 31, 2003, in comprehensive income in equity. The Company recorded a gain of $0.4 million in other income (expense) in 2003 to reflect the change in the fair value of the warrants and a loss of $1.4 million in 2002 in other income (expenses) to reflect an other than temporary decline in the carrying value of these marketable securities.

*Matsushita*

On July 5, 2002, the Company entered into a joint venture agreement with Matsushita Communication Industrial Co., Ltd., a stockholder of the Company, to jointly design and develop, manufacture and sell telecommunication products. The Company has a 49% ownership interest in the joint venture company, which has a registered share capital of $10.0 million. The cash consideration of $4.9 million payable by the Company was paid in October 2002. As the Company does not have voting control over significant matters of the joint venture company, the investment in and results of operations of the joint venture company are accounted for using the equity method of accounting. The Company recorded equity losses of $4.8 million and $0.2 million for the years ended December 31, 2003 and 2002, respectively.

*China Telecom*

In November 2002, the Company purchased approximately 0.5 million shares of common stock of China Telecom in its initial public offering for approximately $10.0 million. China Telecom is listed on the New York Stock Exchange. During the first and second quarters of 2003, the Company sold these shares realizing a loss of $0.1 million. China Telecom is the leading provider of wireline telephone, data and Internet and leased line services in four of the most economically developed regions of China, and its affiliates are customers of the Company.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 10 LONG-TERM INVESTMENTS (Continued)**

*Other investments*

The Company has also invested directly in a number of private technology-based companies in the early stages of development. These investments are accounted for on the cost basis. The Company continually evaluates the carrying value of these investments for possible impairment based on the achievement of business objectives and milestones, the financial condition and prospects of these companies and other relevant factors. During the year ended December 31, 2003, there were no impairment charges in respect of these private technology investments. During the years ended December 31, 2002 and 2001, impairment charges in respect of these private technology investments were $3.0 million and $1.7 million, respectively.

**NOTE 11 GOODWILL AND INTANGIBLE ASSETS**

As of December 31, 2003 and 2002, goodwill and other acquired intangible assets consisted of the following (in thousands):

| | December 31, 2003 Restated(1) | December 31, 2002 |
|---|---|---|
| Goodwill | $ 113,003 | $ 57,629 |
| Less accumulated amortization | (12,823) | (12,823) |
| | $ 100,180 | $ 44,806 |
| Identified intangible assets | | |
| Existing technology | $ 23,630 | $ 7,570 |
| Less accumulated amortization | (7,255) | (2,556) |
| | $ 16,375 | $ 5,014 |
| Customer relationships | $ 27,820 | $ |
| Less accumulated amortization | (1,623) | |
| | $ 26,197 | $ |
| Trade names | $ 940 | $ |
| Less accumulated amortization | (274) | |
| | $ 666 | $ |
| Backlog | $ 1,950 | $ |
| Less accumulated amortization | (1,137) | |
| | $ 813 | $ |
| Total intangible assets | $ 44,051 | $ 5,014 |

(1) See Note 24.

Amortization expense was $8.4 million, $2.4 million and $7.5 million for the years ended December 31, 2003, 2002 and 2001, respectively. The estimated aggregate amortization expense for intangibles for each of the five years beginning 2004 through 2008 is $10.7 million, $7.6 million, $5.8 million, $5.6 million and $4.0 million, respectively.

Goodwill increased by $55.4 million and intangible assets increased by $49.1 million during the year ended December 31, 2003. The increase during the year ended December 31, 2003 was mainly attributable to goodwill of $52.3 million and intangible assets of $44.9 million which was comprised of purchased

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 11 GOODWILL AND INTANGIBLE ASSETS (Continued)**

technology of $14.2 million, customer relationships of $27.8 million and other intangibles of $2.9 million that was recorded on the acquisition of CommWorks, based on the final purchase price allocation. The estimated useful life of purchased technology is from one to five years, the estimated useful life of customer relationships is ten years, and the estimated useful lives of backlog and trade names are from one to two years.

In July 2001, the FASB issued SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually. SFAS No. 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.

SFAS No. 142 was adopted by the Company on January 1, 2002. SFAS No. 142 had the effect of eliminating amortization of goodwill commencing January 1, 2002; however, impairment reviews may result in future periodic write-downs. The Company completed the required transitional assessment of goodwill during the first quarter of fiscal 2002. Based on this assessment, there was no transition goodwill impairment charge. The Company performed its annual impairment review in the fourth quarter of 2003 and 2002. No impairment in goodwill was noted.

The reconciliation of net income to adjusted net income as if there had been no goodwill amortization for the year ended December 31, 2001 is as follows (in thousands):

| | Year ended December 31, 2001 | |
|---|---|---|
| Reported net income | $ | 56,954 |
| Add back: goodwill amortization | 7,365 | |
| Adjusted net income | $ | 64,319 |
| Basic earnings per share: | | |
| Reported net income | $ | 0.56 |
| Goodwill amortization | 0.07 | |
| Adjusted net income | $ | 0.63 |
| Diluted earnings per share: | | |
| Reported net income | $ | 0.52 |
| Goodwill amortization | 0.07 | |
| Adjusted net income | $ | 0.59 |
| Average number of shares outstanding: | | |
| Basic | 101,433 | |
| Diluted | 108,612 | |

71

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 12 DEBT**

The following represents the outstanding borrowings at December 31, 2003 and 2002 (in thousands):

| Note | Rate | | Maturity | December 31, 2003 Restated(1) | | 2002 | |
|---|---|---|---|---|---|---|---|
| Notes Payable | N/A | | January 31, 2004 | $ | 1 | $ | |
| Convertible Subordinated Notes | 7/8 | % | March 1, 2008 | 402,500 | | | |
| Bank Loan | 4.94 | % | January 10, 2006 | 8,155 | | | |
| Total Debt | | | | $ | 410,656 | $ | |
| Long-term debt | | | | 410,655 | | | |
| Short-term debt | | | | $ | 1 | $ | |

(1) See Note 24

The Company has available borrowing facilities of $583.7 million as of December 31, 2003. $529.4 million of these facilities expire in 2004 and $54.3 million of these facilities expire between 2008 and 2010 with interest rates ranging from approximately 4.5% to 6.0%, and the Company has not guaranteed any debt not included in the consolidated balance sheet.

On March 12, 2003, the Company completed an offering of $402.5 million of convertible subordinated notes due March 1, 2008 to qualified buyers pursuant to Rule 144A under the Securities Act of 1933. The notes bear interest at a rate of 7/8% per annum and are convertible into the Company s common stock at a conversion price of $23.79 per share and are subordinated to all present and future senior debt of the Company. Holders of the notes may convert their notes only if: (i) the price of the Company s common stock issuable upon conversion of a note reaches a specified threshold, (ii) specified corporate transactions occur, or (iii) the trading price for the notes falls below certain thresholds. At the initial conversion price, each $1,000 principal amount of notes will be convertible into approximately 42.0345 shares of common stock.

The Company has a bank loan in connection with a purchase of inventory resulting from the consolidation of MDC. On January 10, 2003, a third party established a bank loan with Shanghai Pudong Development Bank for the purchase of the inventory. The Company assumed the obligations of the bank loan and related inventory on January 23, 2003, which were subsequently transferred to MDC on December 31, 2003. The bank loan of $8.2 million bears interest at a rate of 4.94% per annum, and expires on January 10, 2006. For the year ended December 31, 2003, total interest expense recorded by the Company related to this bank loan amounted to $0.4 million. At December 31, 2003, the Company did not serve as legal obligor for the bank loan. See Note 24 for a description of MDC.

Concurrent with the issuance of the convertible notes, the Company entered into convertible bond hedge and call option transaction at a cost of $43.8 million. The convertible bond hedge allows the company to purchase 16,918,873 shares of its common stock at $23.79 per share from the other party to the agreement. The written call option allows the holder to purchase 16,918,873 shares of the Company s common stock from the Company at $32.025 per share. Both the bond hedge and call option transactions may be settled at the Company s option either in cash or net shares and expire on March 1, 2008. The Company recorded these instruments at cost, and their carrying value at December 31, 2003 approximates their original cost. The convertible bond hedge and call option transactions are expected to reduce the potential dilution from conversion of the notes. The options have been included in stockholders equity in

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 12 DEBT (Continued)**

accordance with the guidance in Emerging Issues Task Force Issue No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company s Own Stock.

**NOTE 13 OTHER CURRENT LIABILITIES**

Other current liabilities at December 31, 2003 and 2002 consist of the following:

| | December 31, 2003 | December 31, 2002 |
|---|---|---|
| | Restated(1) | |
| Accrued contract costs | $ 67,950 | $ 45,756 |
| Accrued payroll and compensation | 34,200 | 24,633 |
| Accrued other taxes | 10,725 | 2,869 |
| Warranty costs | 26,267 | 13,297 |
| Accrued construction costs | 20,462 | 9,889 |
| Liability related to purchase of Xebeo and CommWorks | 2,690 | |
| Other | 11,617 | 8,483 |
| | $ 173,911 | $ 104,927 |

(1) See Note 24

Other current liabilities primarily consist of accrued contract costs, which relate to purchases of inventory, installation services and other testing and consulting work performed by outside vendors for which the Company has not yet received payment; accrued payroll and compensation costs, which relate to wages, bonuses, and commissions earned but not yet paid; warranty costs, which are estimated costs of equipment replacement and repair and accrued construction costs, which represent accruals for work performed and materials purchased in relation to the facility being built in Hangzhou.

**NOTE 14 WARRANTY OBLIGATIONS AND OTHER GUARANTEES**

Warranty obligations are as follows (in thousands):

| | |
|---|---|
| Balance at January 1, 2002 | $ 6,271 |
| Accruals for warranties issued during the period | 15,156 |
| Settlements made during the period | (8,130 ) |
| Balance at December 31, 2002 | $ 13,297 |
| Accruals for warranties issued during the period | 37,904 |
| Settlements made during the period | (24,934 ) |
| Balance at December 31, 2003 | $ 26,267 |

Certain of the Company s sales contracts include provisions under which customers would be indemnified by the Company in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to the Company s products. There are no limitations on the maximum potential future payments under these guarantees. The Company has accrued no amounts in relation to these provisions as no such claims have been made and the Company believes it has valid, enforceable rights to the intellectual property embedded in its products.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 14 WARRANTY OBLIGATIONS AND OTHER GUARANTEES** (Continued)

The Company issues standby letters of credit primarily to support international sales activities outside of China. When the Company submits a bid for a sale, often the potential customer will require that the Company issue a bid bond or a standby letter of credit to demonstrate its commitment through the bid process. In addition, the Company may be required to issue standby letters of credit as guarantees for advance customer payments upon contract signing or performance guarantees. The standby letters of credit usually expire six to nine months from date of issuance without being drawn by the beneficiary thereof.

**NOTE 15 PROVISION FOR INCOME TAXES**

United States and foreign income (loss) before income taxes, minority interest and cumulative effect of a change in accounting principle were as follows (in thousands):

| | Year ended December 31, | | |
|---|---|---|---|
| | 2003 | 2002 | 2001 |
| | Restated(1) | | |
| United States | $ 57,784 | $ 13,245 | $ (12,237) |
| Foreign | 202,138 | 123,027 | 90,336 |
| | $ 259,922 | $ 136,272 | $ 78,099 |

The components of the provision (benefit) for income taxes are as follows (in thousands):

| | Year ended December 31, | | |
|---|---|---|---|
| | 2003 | 2002 | 2001 |
| | Restated(1) | | |
| Current: | | | |
| Federal | $ 8,376 | $ 12,222 | $ 7,246 |
| State/Other | (242) | 1,515 | 621 |
| Foreign | 47,940 | 28,222 | 21,586 |
| Total current | 56,074 | 41,959 | 29,453 |
| Deferred: | | | |
| Federal | 7,214 | (6,665) | (8,002) |
| State | (1,351) | (315) | (172) |
| Foreign | (16,538) | (7,725) | (1,456) |
| Total deferred | (10,675) | (14,705) | (9,630) |
| Total | $ 45,399 | $ 27,254 | $ 19,823 |

(1) See Note 24

In establishing its deferred income tax assets and liabilities, the Company makes judgments and interpretations based on the enacted tax laws and published tax guidance applicable to its operations. The Company records deferred tax assets and liabilities and evaluates the need for valuation allowances to reduce the deferred tax assets to realizable amounts. The likelihood of a material change in the Company s expected realization of these assets is dependent on future taxable income, its ability to use foreign tax credit carryforwards and carrybacks, and the effectiveness of its tax planning strategies in the various relevant jurisdictions. Changes to the Company s income tax provision or in the valuation of the deferred tax assets and liabilities may affect its annual effective income tax rate.

74

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 15 PROVISION FOR INCOME TAXES (Continued)**

Deferred income taxes arise from temporary differences between the tax bases of assets and liabilities and their reported amounts in the consolidated financial statements. Current deferred tax assets are included in othe current assets, and non-current deferred tax assets are included in other long-term assets in the consolidated financial statements. A summary of the components of net deferred tax assets is as follows (in thousands):

| | U.S. | China | Other | Total |
|---|---|---|---|---|
| **December 31, 2003: Restated(1)** | | | | |
| Current deferred tax assets: | | | | |
| Allowances and reserves | $ 7,632 | $ 12,833 | $ | $ 20,465 |
| Deferred revenue, net | | 2,244 | | 2,244 |
| Total current deferred tax assets | $ 7,632 | $ 15,077 | $ | $ 22,709 |
| Current deferred tax liability | $ (199) | $ (4,331) | $ | $ (4,530) |
| Total current deferred tax assets (net) | $ 7,433 | $ 10,746 | $ | $ 18,179 |
| Non-current deferred tax assets: | | | | |
| Net operating loss carryforward | $ 1,186 | $ | $ 853 | $ 2,039 |
| Tax credit carryforwards | 3,830 | | | 3,830 |
| Fixed assets | 1,276 | 1,658 | | 2,934 |
| Demo equipment income | | 14,513 | | 14,513 |
| Accrued warranties | 1,360 | | | 1,360 |
| Investments | 2,849 | 319 | | 3,168 |
| Other | 897 | | | 897 |
| Total non-current deferred tax assets | 11,398 | 16,490 | 853 | 28,741 |
| Valuation allowance | (328) | | | (328) |
| Net non-current deferred tax assets | $ 11,070 | $ 16,490 | $ 853 | $ 28,413 |

(1) See Note 24

| | U.S. | China | Other | Total |
|---|---|---|---|---|
| **December 31, 2002:** | | | | |
| Current deferred tax assets(2): | | | | |
| Allowances and reserves | $ 8,586 | $ 8,184 | $ | $ 16,770 |
| Total current deferred tax assets | $ 8,586 | $ 8,184 | $ | $ 16,770 |
| Non-current deferred tax assets: | | | | |
| Net operating loss carryforward | $ 1,988 | $ | $ 2,974 | $ 4,962 |
| Future period compensation deductions | 1,575 | | | 1,575 |
| Tax credit carryforwards | 6,413 | | | 6,413 |
| Fixed assets | 356 | 461 | | 817 |
| Other | 3,967 | | | 3,967 |
| Total non-current deferred tax assets | 14,299 | 461 | 2,974 | 17,734 |
| Valuation allowances | (4,964) | | | (4,964) |
| Net non-current deferred tax assets | $ 9,335 | $ 461 | $ 2,974 | $ 12,770 |

(2) Certain reclassifications have been made to the 2002 financial statements to conform to the 2003 presentation, see Note 24.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 15 PROVISION FOR INCOME TAXES (Continued)**

Deferred taxes have not been recognized on undistributed earnings from foreign subsidiaries because the Company does not intend to repatriate such earnings. As of December 31, 2003, undistributed earnings from investments in foreign subsidiaries amounted to $472.0 million.

As of December 31, 2003, state net operating loss carryforwards were $0.9 million (tax effected). The state net operating loss carryforwards will expire in varying amounts between 2004 and 2006 and could not be utilized in 2003. As of December 31, 2003, the Company had foreign net operating loss carryforwards of approximately $0.8 million (tax effected), which do not expire and can be carried forward indefinitely. In 2003, the Company reversed all of its valuation allowances that were attributable to state research and development credits, because the Company believes that it will more likely than not have sufficient taxable income to utilize these credits.

The Company s subsidiaries UTSC, HUTS, CUTS and HSTC were granted tax holidays, which started to phase out in 1999. The net impact of these tax holidays was to decrease tax expense by approximately $38.0 million, $10.0 million and $6.7 million for the years ended December 31, 2003, 2002 and 2001, respectively.

The difference between the Company s effective income tax rate and the federal statutory rate is reconciled below:

| | Year ended December 31, | | | | | | |
|---|---|---|---|---|---|---|---|
| | 2003 | | | 2002 | | 2001 | |
| | Restated(1) | | | | | | |
| Federal statutory rate | | 35 | % | 34 | % | 34 | % |
| State taxes, net of federal income tax benefit | | 1 | | 0 | | 0 | |
| Permanent differences | | 1 | | 5 | | 5 | |
| Amortization of deferred compensation | | 0 | | 1 | | 2 | |
| Effect of difference in foreign tax rates | | (13 | ) | (16 | ) | (14 | ) |
| Tax credits and other | | (7 | ) | (4 | ) | (2 | ) |
| Effective rate | | 17 | % | 20 | % | 25 | % |

(1) See Note 24

In 2001, audits of the Company s federal income tax returns for the years ended December 31, 1999, 1998 and 1997 were completed. No audits of the Company s income tax returns were underway as of December 31, 2003.

**NOTE 16 COMMON STOCK AND STOCK INCENTIVE PLANS**

***Stock Option Plans***

***The 1995 Stock Plan.*** On July 31, 1995, the Board of Directors adopted, and in October 1995, the Company s stockholders approved, the Company s 1995 Stock Plan. Under the 1995 plan, officers, employees and consultants were eligible to acquire shares of common stock pursuant to options or stock purchase rights. At the time of adoption, 3,705,232 shares of common stock were reserved for issuance under the 1995 plan. In 1995 and 1996, the Company s Board and stockholders added an additional 5,400,000 shares to the 1995 plan, raising the total number of authorized shares reserved under the 1995 plan to 9,105,232. As of December 31, 2003, there were 6,711,744 shares authorized for issuance under the 1995 plan and options to purchase 88,885 shares of common stock were outstanding under the 1995 plan.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 16 COMMON STOCK AND STOCK INCENTIVE PLANS (Continued)**

On January 31, 1997, the Board of Directors elected not to grant any further options under the 1995 plan. Upon the adoption of the 1997 plan, all remaining unissued shares under the 1995 plan not already subject to options or other awards ceased to be reserved for issuance under the 1995 plan.

***The 1997 Stock Plan.*** On January 31, 1997, the Board of Directors adopted, and the Company s stockholders approved, the Company s 1997 Stock Plan. Under the 1997 plan, officers, employees and consultants are eligible to receive options to purchase shares of common stock and stock purchase rights. In December 1999, the Board of Directors amended the 1997 plan, which the Company s stockholders approved in February 2000. As of December 31, 2003, the Company is authorized to issue up to 25,464,775 shares subject to options. During the term of the 1997 plan, the number of shares issuable under the plan will be increased annually on the first day of each fiscal year beginning in 2001 by an amount equal to the lesser of 6,000,000 shares or 4% of the outstanding shares of common stock on that date, or a lesser amount determined by the Board. The plan terminates in January 2007, but may be terminated earlier by the Board of Directors. As of December 31, 2003, there were options to purchase 12,740,174 shares of common stock outstanding under the 1997 plan. The Compensation Committee administers the 1997 plan.

Options granted under the 1997 plan may be incentive stock options, or ISOs, which are intended to qualify for favorable federal income tax treatment under the provisions of Section 422 of the Internal Revenue Code of 1986, as amended, or non-qualified stock options, or NSOs, which do not so qualify. The Compensation Committee selects the eligible persons to whom options will be granted and determines the grant date, amounts, exercise prices, vesting periods and other relevant terms of the options, including whether the options will be ISOs or NSOs. The exercise price of ISOs granted under the 1997 plan may not be less than 100% of the fair market value of common stock on the grant date, while the exercise price of NSOs can be determined by the Compensation Committee in its discretion. Options are generally not transferable during the life of the optionee.

Options vest and become exercisable as determined by the Compensation Committee, generally over four years. Options may generally be exercised at any time after they vest and before their expiration date as determined by the Compensation Committee. However, no option may be exercised more than ten years after the grant date. Options will generally terminate (i) 12 months after the death or permanent disability of an optionee and (ii) 90 days after termination of employment for any other reason. The aggregate fair market value of the shares of common stock represented by ISOs that become exercisable in any calendar year by any one option holder may not exceed $100,000. Options in excess of this limit are treated as NSOs.

In the event the Company is merged with or into another corporation, or all or substantially all of the Company s assets are sold, each outstanding option will be assumed or an equivalent option or right will be substituted by the successor corporation or its parent or subsidiary. If the successor corporation refuses to assume or substitute for the option or right, the option or right will automatically vest and become exercisable in full for a period of at least fifteen days, after which time the option or right will terminate.

Under the 1997 plan, the Company may grant stock purchase rights to eligible participants. Any shares purchased pursuant to stock purchase rights will be subject to a restricted stock purchase agreement. Unless the Compensation Committee determines otherwise, this agreement will grant the Company a right to repurchase the stock upon the voluntary or involuntary termination of the employee for any reason, including death or disability. The purchase price for repurchased shares will be the original price paid and may be paid by cancellation of any indebtedness owed to the Company. The shares of stock

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 16 COMMON STOCK AND STOCK INCENTIVE PLANS (Continued)**

subject to the right of repurchase lapse over time. There were no stock purchase rights granted in 2003, 2002 or 2001.

***2001 Director Option Plan.*** On March 2, 2001, the Board of Directors adopted, and in May 2001, the Company s stockholders approved, the Company s 2001 Director Option Plan. Under the 2001 Director Option Plan, those directors who are not employees of the Company ( Outside Directors ) are eligible to receive options to purchase shares of common stock. Directors Horner, Atkins, Son and Toy are Outside Directors. All grants of options to Outside Directors are automatic and nondiscretionary. In July 2001, the Board of Directors amended the 2001 Director Option Plan. As of December 31, 2003, the Company is authorized to issue up to 1,200,000 shares pursuant to options under the 2001 Director Option Plan. The plan terminates in May 2011, but may be terminated earlier by the Board of Directors. As of December 31, 2003, there were options to purchase 320,000 shares of common stock outstanding under the 2001 Director Option Plan. The Compensation Committee administers the 2001 Director Plan.

Pursuant to the terms of the 2001 Director Option Plan, each Outside Director is automatically granted an option to purchase eighty thousand shares of common stock (the First Option ) on the date on which such person first becomes an Outside Director (the Anniversary Date ). A director who is an employee of the Company and ceases employment with the Company to become an Outside Director receives an option to purchase twenty thousand shares of common stock (a Subsequent Option ) at the Company s first annual meeting of stockholders following such conversion to an Outside Director and at each subsequent annual stockholder meeting thereafter, provided he or she is serving as an Outside Director on each such date. As such time as each Outside Director s First Option is fully vested, each Outside Director is automatically granted a Subsequent Option on the Anniversary Date of each year provided he or she is then an Outside Director.

Under the terms of the 2001 Director Option Plan, the exercise price of each option granted is equal to the market value of the common stock on the date of grant. Such options have terms of ten years, but terminate earlier if the individual ceases to serve as a director. The First Option grants vest as to 25% of shares subject to the First Option on each of the first four anniversaries of its date of grant. The Subsequent Option grants vest as to 100% of the shares subject to the Subsequent Option on the first anniversary of its date of grant.

***Issanni Communications, Inc. Incentive Program.*** The Issanni plan was established for the issuance of up to a total of 39,876 shares of UTStarcom s common stock to specified former employees of Issanni Communications, Inc. ( Issanni ) who became UTStarcom s employees in connection with UTStarcom s acquisition of Issanni. The Issanni plan is administered by the Board of Directors or a committee appointed by the Board. A participant in the Issanni plan is eligible to earn and vest in a designated number of shares that are subject to the award of shares made to a participant under the plan, based upon the attainment of one of six milestones related to the amount of revenue generated from Issanni products in 2002 and 2003 and subject to the participant s continued employment with Issanni, the Company or one of their subsidiaries through the day of the determination that the applicable milestone has been satisfied. In addition, each participant is entitled to receive the unearned shares, if any, on the fifth anniversary of the acquisition of Issanni if the employee continues to be employed with Issanni, the Company or any of their subsidiaries on such date regardless of whether any milestone is attained. The shares subject to an award will in any event become issuable, whether or not the milestones were achieved and whether or not the five-year vesting schedule has elapsed, upon (i) the sale or the discontinuation of the Company or UTStarcom International Products Inc., (ii) the sale of substantially all or any of the technology acquired

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 16 COMMON STOCK AND STOCK INCENTIVE PLANS (Continued)**

by UTStarcom International Products Inc. in connection with the acquisition of Issanni, or (iii) the employment termination of certain Issanni principals.

If, prior to the date on which all of a participant s shares are earned, the participant s service with Issanni, the Company or one of their subsidiaries is terminated (i) voluntarily or for cause, the Company may exercise its repurchase option with respect to any of the participant s unearned shares, (ii) other than voluntarily or for cause, death or disability, the participant will be entitled to receive the shares that the participant would have otherwise earned with respect to milestones achieved within 24 months of the participant s termination, or (iii) as a result of death or disability, the participant (or his estate) will be entitled to receive the unearned portion of his shares with respect to all milestones.

***Advanced Communication Devices Corporation Incentive Program.*** The ACD Plan provides for the issuance of an additional 73,637 shares of UTStarcom s common stock pursuant to awards of shares granted to designated former employees of Advanced Communication Devices Corporation ( ACD ) who became UTStarcom s employees in connection with UTStarcom s merger with ACD. The ACD plan is administered by the Board of Directors. The Company did not grant any shares under the plan in 2003 and granted 31,275 shares and 52,133 shares in 2002 and 2001, respectively.

A participant in the ACD plan is entitled to earn and vest in a designated number of shares subject to the award made to the participant upon the attainment of one of five milestones and subject to the participant s continued employment with ACD, the Company or any of their subsidiaries through the day of the determination that the applicable milestone has been satisfied. In addition, each participant is entitled to receive the unearned shares, if any, subject to the award on the fifth anniversary of the merger if the participant has continued to perform services for ACD, the Company or any of their subsidiaries on such date regardless of whether any milestone is obtained.

If a participant s service with ACD, the Company or any of their subsidiaries is terminated for cause by the applicable employer, voluntarily by the participant or as a result of death or disability, the participant will forfeit all of the shares subject to the award that were not yet earned and distributed. If the participant s service is terminated for any other reason, the participant will be entitled to receive the shares subject to the award with respect to any milestones achieved within 12 months following the participant s termination and will forfeit all other shares that were unearned as of the date of termination.

***The 2003 Non-Statutory Stock Option Plan.*** On April 15, 2003, the Board of Directors adopted the Company s 2003 Non-Statutory Stock Option Plan. Under the 2003 plan, directors, officers, employees and consultants of the Company are eligible to be granted options to purchase shares of the Company s common stock. Only non-statutory stock options, which do not qualify for favorable federal income tax treatment under the provisions of Section 422 of the Internal Revenue Code of 1986, as amended, may be granted under the 2003 plan. As of December 31, 2003, the Company was authorized to issue up to 1,500,000 shares pursuant to options granted under the 2003 plan, subject to adjustment in certain instances (including stock splits, stock dividends, business combinations or other changes in capitalization). As of December 31, 2003, options to purchase 1,438,300 shares of common stock were outstanding under the 2003 plan.

The 2003 plan is administered by the Compensation Committee of the Board of Directors. The Compensation Committee is charged with selecting the eligible persons to whom options will be granted and determines the number of shares subject to the option, exercise prices, vesting periods and other terms applicable to each option.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 16 COMMON STOCK AND STOCK INCENTIVE PLANS (Continued)**

Options granted under the 2003 plan generally vest and become exercisable over four years, and may be exercised at any time after they vest but before their expiration date. Options will generally terminate (i) 12 months after the death or employment termination due to disability of an option holder and (ii) 90 days after termination of an option holder s service for any other reason other than for disability or due to the option holder s death. However, no option may be exercised more than ten years after the grant date.

In the event the Company is merged with or into another corporation, or all or substantially all of the Company s assets are sold, the 2003 plan provides for each outstanding option to be assumed or an equivalent option or right to be substituted by the successor corporation or its parent or subsidiary. If the successor corporation refuses to assume or substitute for the option, the option will automatically vest and become exercisable in full for a period determined by the compensation committee, after which time the option will terminate.

A summary of activity under the Plans follows:

| | **Shares Available for Grant** | **Number of shares** | **Weighted average exercise price** |
|---|---|---|---|
| Options Outstanding, December 31, 2000 | 155,035 | 15,174,724 | $ 7.54 |
| Options Authorized in 2001 | 5,062,760 | | $ |
| Options Granted | (3,326,957) | 3,326,957 | $ 19.77 |
| Options Exercised | | (5,363,601) | $ 3.48 |
| Options Forfeited or Expired | 559,663 | (559,663) | $ 13.79 |
| Options Outstanding, December 31, 2001 | 2,450,501 | 12,578,417 | $ 12.22 |
| Options Authorized in 2002 | 4,372,167 | | $ |
| Options Granted | (4,977,723) | 4,977,723 | $ 19.46 |
| Options Exercised | | (1,717,899) | $ 5.38 |
| Options Forfeited or Expired | 915,326 | (915,326) | $ 18.40 |
| Options Outstanding, December 31, 2002 | 2,760,271 | 14,922,915 | $ 15.05 |
| Options Authorized in 2003 | 5,887,041 | | $ |
| Options Granted | (4,866,309) | 4,866,309 | $ 25.03 |
| Options Exercised | | (4,490,195) | $ 12.27 |
| Options Forfeited or Expired | 681,900 | (681,900) | $ 20.55 |
| Options Outstanding, December 31, 2003 | 4,462,903 | 14,617,129 | $ 18.97 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 16 COMMON STOCK AND STOCK INCENTIVE PLANS (Continued)**

The following table summarizes information with respect to stock options outstanding and exercisable as of December 31, 2003:

| | **Options Outstanding** | | | **Options Exercisable** | |
|---|---|---|---|---|---|
| **Range of Exercise Price** | **Outstanding at December 31, 2003 (in thousands)** | **Weighted Average Exercise Price** | **Weighted Average Remaining Contractual Life (in years)** | **Exercisable at December 31, 2003 (in thousands)** | **Weighted Average Exercise Price** |
| $ 0.06 - $ 0.06 | 36,519 | $ 0.06 | 4.8 | 36,519 | $ 0.06 |
| $ 0.25 - $ 0.25 | 27,764 | $ 0.25 | 5.1 | 27,764 | $ 0.25 |
| $ 0.85 - $ 0.85 | 88,885 | $ 0.85 | 1.8 | 88,885 | $ 0.85 |
| $ 1.71 - $ 2.50 | 197,303 | $ 2.28 | 3.8 | 197,054 | $ 2.28 |
| $ 3.39 - $ 4.71 | 920,116 | $ 4.30 | 5.4 | 920,116 | $ 4.30 |
| $ 5.65 - $ 5.65 | 5,785 | $ 5.65 | 4.4 | 5,785 | $ 5.65 |
| $ 9.38 - $13.61 | 1,660,131 | $ 11.74 | 6.5 | 1,269,637 | $ 11.47 |
| $14.23 - $21.31 | 7,534,310 | $ 18.34 | 8.2 | 2,368,827 | $ 17.79 |
| $21.85 - $32.67 | 3,657,867 | $ 26.23 | 8.6 | 779,747 | $ 24.44 |
| $34.40 - $45.21 | 488,449 | $ 39.23 | 9.6 | 33,958 | $ 42.91 |
| $ 0.06 - $45.21 | 14,617,129 | $ 18.97 | 7.9 | 5,728,292 | $ 14.27 |

***2000 Employee Stock Purchase Plan.*** In February 2000, the Company s stockholders approved the 2000 Employee Stock Purchase Plan. The purchase plan is intended to qualify as an employee stock purchase plan under Section 423 of the Internal Revenue Code.

The Company has reserved 2,000,000 shares of common stock for sale under the stock purchase plan. The number of shares reserved for sale under the plan will be increased annually on the first day of each fiscal year beginning in 2001 by an amount equal to the lesser of 4,000,000 shares or 2% of the outstanding shares of the Company s common stock on that date, or a lesser amount determined by the Board of Directors. The stock purchase plan will be administered by the Board or a committee appointed by the Board.

The stock purchase plan is implemented by offering periods, the duration of which may not exceed 24 months. Offering periods may contain interim purchase periods. Shares purchased under the stock purchase plan will be held in separate accounts for each participant. The first offering period began in March 2000 and ended on the last trading day before April 30, 2002. Subsequent consecutive overlapping offering periods begin on May 1 and November 1 annually. These offering periods end twenty-four months thereafter.

Employees will be eligible to participate in the stock purchase plan if they are employed by the Company for more than 20 hours per week and more than five months in a calendar year. The stock purchase plan permits eligible employees to purchase the Company s common stock through payroll deductions, which may not exceed 15% of the employee s total compensation. Stock may be purchased under the plan at a price equal to 85% of the fair market value of the Company s stock on either the date of purchase or the first day of the offering period, whichever is lower. However, the Board of Directors may in its discretion provide that the price at which shares of common stock are purchased under the plan shall be 85% of the fair market value of the Company s shares on the date of purchase. Participants may not purchase shares of common stock having a value greater than $25,000 during any calendar year.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 16 COMMON STOCK AND STOCK INCENTIVE PLANS** (Continued)

Participants may increase or decrease their payroll deductions at any time during an offering period, subject to limits imposed by the Board of Directors. If a participant withdraws from the stock purchase plan, any contributions that have not been used to purchase shares shall be refunded. A participant who has withdrawn may not participate in the stock purchase plan again until the next offering period. In the event of retirement or cessation of employment for any reason, any contributions that have not yet been used to purchase shares will be refunded to the participant, or to the participant s designated beneficiary in the case of death, and a certificate will be issued for the full shares in the participant s account.

The Board of Directors may terminate or amend the stock purchase plan, subject to stockholder approval in some circumstances. Unless terminated earlier by the Board, the stock purchase plan will have a term of ten years.

Total shares purchased under the plan were 261,103, 182,437 and 118,223 in 2003, 2002 and 2001, respectively. At December 31, 2003, there were 3,272,754 shares available for purchase under the plan.

**NOTE 17 DEFERRED STOCK COMPENSATION**

In connection with the grant of certain stock options and restricted common stock to employees, non-employees and members of the Board of Directors and in connection with certain acquisitions (see Note 6), the Company recorded net deferred stock compensation of $0.3 million, $8.7 million and $4.7 million for the years ended December 31, 2003, 2002 and 2001, respectively, representing the fair value of restricted stock and the difference between the fair value of common stock and the option exercise price of options at the date of grant. Deferred compensation is presented as a reduction of stockholders equity, with amortization recorded over the vesting period of the related restricted stock and options. The Company recorded stock compensation expense of $4.3 million, $3.1 million and $5.2 million for the year ended December 31, 2003, 2002 and 2001, respectively. At December 31, 2003, approximately $7.8 million remained to be amortized over the corresponding vesting period of each respective option or restricted share, generally four to five years.

**NOTE 18 401(K) PLAN**

On January 1, 2000, the Company adopted the UTStarcom, Inc. 401(k) Savings Plan (the 401(k) Plan ), a cash-or-deferred arrangement, which covers the Company s eligible employees who have attained the age of 21. The 401(k) Plan is intended to qualify under Sections 401(a), 401(m) and 401(k) of the Internal Revenue Code of 1986, as amended (the Code ), and the 401(k) Plan trust is intended to qualify under Section 501(a) of the Code. All contributions to the 401(k) Plan by eligible employees or by the Company, and the investment earnings thereon, are not taxable to such employees until withdrawn, and any contributions the Company may make are expected to be deductible by the Company. The Company s eligible employees may elect to reduce their current eligible compensation by one percent (1%) up to fifty percent (50%), subject to the maximum statutorily prescribed annual limit of $12,000 for participants under age 50 and $14,000 for participants age 50 and over for the year ended December 31, 2003 and $11,000 for participants under age 50 and $12,000 for participants age 50 and over for the year ended December 31, 2002, and to have such salary reductions contributed on their behalf to the 401(k) Plan. The 401(k) Plan permits, but does not require, the Company to make matching contributions on behalf of all eligible employees who make salary reduction contributions to the 401(k) Plan. Commencing with the plan year beginning January 1, 2001, the Company elected to begin making matching contributions on behalf of qualified employees who participate in the 401(k) Plan. The Company

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 18 401(K) PLAN (Continued)**

will contribute $0.50 for each dollar contributed by qualified employees to the 401(k) Plan, to a maximum of $5,500 and $3,000 for the 2003 and 2002 plan years, respectively. The Company s matching contributions are subject to a five-year vesting schedule based upon longevity of employee service with the Company. Matching contributions were $2.1 million, $0.7 million and $0.4 million for 2003, 2002 and 2001, respectively.

**NOTE 19 COMMITMENTS AND CONTINGENCIES**

*Leases:*

The Company leases certain facilities under non-cancelable operating leases which expire at various dates through 2008. The minimum future lease payments under the leases at December 31, 2003 are as follows:

| | **(in thousands)** |
|---|---|
| Years ending December 31: | |
| 2004 | $ 10,154 |
| 2005 | 8,057 |
| 2006 | 4,969 |
| 2007 | 2,105 |
| 2008 and after | 439 |
| Total minimum lease payments | $ 25,724 |

Rent expense for the years ended December 31, 2003, 2002 and 2001 was $11.5 million, $6.5 million and $3.8 million, respectively.

*Investment Commitments:*

As of December 31, 2003, the Company had invested a total of $2.0 million in Global Asia Partners L.P. The fund size is anticipated to be $100 million and the fund was formed to make private equity investments in private or pre-IPO technology and telecommunications companies in Asia. The Company has a commitment to invest up to a maximum of $5.0 million. The remaining amount is due at such times and in such amounts as shall be specified in one or more future capital calls to be issued by the general partner.

*Purchase Commitments*

The Company is obligated to purchase raw materials and work-in-process inventory under various orders from one supplier, all of which are expected to be fulfilled with no adverse consequences material to the operations or financial condition of the Company. As of December 31, 2003 total open commitments under these purchase orders are approximately $2.3 million.

*Litigation:*

On October 31, 2001, a complaint was filed in United States District Court for the Southern District of New York against the Company, some of its directors and officers and various underwriters for its initial public offering. Substantially similar actions were filed concerning the initial public offerings for more than

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 19 COMMITMENTS AND CONTINGENCIES (Continued)**

300 different issuers, and the cases were coordinated as In re Initial Public Offering Securities Litigation, 21 MC 92. In April 2002, a consolidated amended complaint was filed in the matter against the Company, captioned In re UTStarcom, Initial Public Offering Securities Litigation, Civil Action No. 01-CV-9604. Plaintiffs allege violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 through undisclosed improper underwriting practices concerning the allocation of IPO shares in exchange for excessive brokerage commissions, agreements to purchase shares at higher prices in the aftermarket, and misleading analyst reports. Plaintiffs seek unspecified damages on behalf of a purported class of purchasers of the Company s common stock between March 2, 2000 and December 6, 2000. The Company s directors and officers have been dismissed without prejudice pursuant to a stipulation. On February 19, 2003, the Court granted in part and denied in part a motion to dismiss brought by defendants including the Company. The order dismisses all claims against the Company except for a claim brought under Section 11 of the Securities Act of 1933, which alleges that the Company s initial public offering registration statement contained untrue statements of material fact and omitted to state material facts required to be stated in the registration statement, or necessary to make the statements therein not misleading. A proposal has been made for the settlement and release of claims against the issuer defendants, including UTStarcom. The settlement is subject to a number of conditions, including approval of the proposed settling parties and the court. If the settlement does not occur, and litigation against UTStarcom continues, UTStarcom believes it has valid defenses and intends to defend the case vigorously. The Company is unable to currently estimate the loss, if any, associated with the above litigation.

The Company is a party to other litigation matters and claims which are normal in the course of operations, and while the results of such litigation matters and claims cannot be predicted with certainty, the Company believes that the final outcome of such matters will not have a material adverse impact on its financial position or results of operations.

**NOTE 20 OPERATING RISKS**

*Financial Risks:*

Financial instruments, which potentially subject the Company to concentrations of credit risk, consist principally of cash, cash equivalents, short-term investments and accounts receivable. The Company places its temporary cash and short-term investments with several financial institutions. Approximately $350.0 million and $141.7 million of the Company s cash and short term investments was on deposit in foreign accounts at December 31, 2003 and 2002, respectively. The Company invests excess cash in highly liquid investments with original maturities of twelve months or less, such as certificates of deposit, government sponsored entities notes, commercial paper, floating rate corporate bonds, fixed income corporate bonds, and money market funds, which the Company believes have limited exposure to risk.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 20 OPERATING RISKS (Continued)**

*Concentration of Credit Risk and Major Customers:*

The table below outlines the Company s sales to and the accounts receivable balances with respect to the Company s largest customers:

| For the year ended December 31, | % of Net Sales | % of Accounts Receivable |
|---|---|---|
| **2003** | | |
| Customer A | 11 % | 3 % |
| **2002** | | |
| Customer B | 18 % | 6 % |
| Customer C | 13 % | 0 % |
| **2001** | | |
| Customer B | 28 % | 29 % |
| Customer D | 10 % | 8 % |

Approximately 76%, 84% and 90% of the Company s net sales during 2003, 2002 and 2001, respectively, were to entities affiliated with the government of China. Accounts receivable balances from these China government affiliated entities or state owned enterprises were $304.0 million and $238.0 million, respectively, as of December 31, 2003 and 2002. The Company extends credit to its customers in China generally without requiring collateral. In global sales outside of China, the Company often requires letters of credit from its customers. The Company monitors its exposure for credit losses and maintains allowances for doubtful accounts.

*Country Risks:*

Approximately 86%, 84% and 90% of the Company s sales for the year ended December 31, 2003, 2002 and 2001, respectively, were made in China. Accordingly, the political, economic and legal environment, as well as the general state of China s economy may influence the Company s business, financial condition and results of operations. The Company s operations in China are subject to special considerations and significant risks not typically associated with companies in the United States. These include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company s results may be adversely affected by, among other things, changes in the political, economic and social conditions in China, and by changes in governmental policies with respect to laws and regulations, changes in China s telecommunications industry and regulatory rules and policies, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation.

Approximately 10%, 13% and 3% of the Company s sales for the year ended December 31, 2003, 2002 and 2001, respectively, were made in Japan. Accordingly, the political, economic and legal environment and the general state of Japan s economy may influence the Company s business, financial condition and results of operations.

**NOTE 21 SEGMENT REPORTING**

The Company sells wireless, wireline and switching platforms to operators in both fast growth and established telecommunications markets around the world. The Company primarily operates in two

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 21 SEGMENT REPORTING (Continued)**

geographic areas, China and other regions. The chief operating decision makers evaluate performance, make operating decisions, and allocate resources based on consolidated financial data. Gross profit, operating income, income from operations, and income taxes are not allocated to specific individual departments within the organization. In accordance with SFAS No. 131 Disclosures about Segments of an Enterprise and Related Information, the Company is considered a single reportable segment. The Company is required to disclose certain information about product revenues, information about geographic areas, information about major customers, and information about long-lived assets.

China sales accounted for 86% and 84% of net sales for 2003 and 2002, respectively. During 2003, the provincial-level telecommunications service entities continued to consolidate telecommunications purchasing decisions by province. As a result of this consolidation trend, all customers were grouped together by province, and each province is treated as one customer. At December 31, 2003 and 2002, there were approximately 31 such customers. Giving effect to this consolidation, in 2003, the Hei Long Jiang province accounted for 11% of net sales. In 2002, sales to the Zhejiang province accounted for 18% and sales to Softbank BB Corporation ( SBBC ) accounted for 13% of net sales. In 2001, sales to the Zhejiang and Guangdong provinces accounted for 28% and 10% of net sales, respectively.

Geographical area and product sales data are as follows (in thousands):

| | Years ended December 31, | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2003 | | | | 2002 | | | | 2001 | | | |
| | Restated(1) | | | | | | | | | | | |
| | (in thousands) | | | | | | | | | | | |
| *Sales by region* | | | | | | | | | | | | |
| China | $ | 1,680,821 | 86 | % | $ | 822,299 | 84 | % | $ | 565,880 | 90 | % |
| Japan | 194,894 | | 10 | % | 130,104 | | 13 | % | 16,303 | | 3 | % |
| Other | 89,472 | | 4 | % | 29,403 | | 3 | % | 44,657 | | 7 | % |
| **TOTAL NET SALES** | **$** | **1,965,187** | **100** | **%** | **$** | **981,806** | **100** | **%** | **$** | **626,840** | **100** | **%** |
| *Sales by product line* | | | | | | | | | | | | |
| Wireless infrastructure | $ | 720,555 | 37 | % | $ | 447,096 | 46 | % | $ | 376,538 | 60 | % |
| Subscriber handsets | 968,192 | | 49 | % | 376,805 | | 38 | % | 187,902 | | 30 | % |
| Wireline products | 276,440 | | 14 | % | 157,905 | | 16 | % | 62,400 | | 10 | % |
| **TOTAL NET SALES** | **$** | **1,965,187** | **100** | **%** | **$** | **981,806** | **100** | **%** | **$** | **626,840** | **100** | **%** |

Long-lived assets by geography are as follows (in thousands):

| | December 31, 2003 | | December 31, 2002 | |
|---|---|---|---|---|
| | Restated(1) | | | |
| U.S. | $ | 155,240 | $ | 43,600 |
| Foreign | 184,407 | | 104,731 | |
| Total long-lived assets | $ | 339,647 | $ | 148,331 |

(1) See Note 24

86

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 22 RELATED PARTY TRANSACTIONS**

*Softbank*

The Company recognized revenue of $184.4 million, $123.0 million and $13.9 million during the years ended December 31, 2003, 2002 and 2001, respectively, with respect to sales of telecommunications equipment to SBBC, an affiliate of SOFTBANK America Inc., which is a significant stockholder of the Company. SBBC offers asynchronous digital subscriber line ( ADSL ) coverage throughout Japan, which is marketed under the name YAHOO BB! . The Company provides ADSL technology to SBBC. Included in accounts receivable at December 31, 2003 and 2002 were $43.9 million and $0.8 million, respectively, related to this agreement. There were no amounts included in deferred revenue in respect of this agreement at December 31, 2003 and 2002.

The Company has invested in Softbank China and Restructuring Fund No. 1, which are investment vehicles established by SOFTBANK CORP. and its affiliates. See Note 10.

On April 5, 2003, the Company repurchased 8.0 million shares of common stock beneficially owned by SOFTBANK America Inc., at a purchase price of $17.385 per share. The total cost of the repurchase was $139.6 million including transaction fees. In connection with this repurchase transaction, SOFTBANK America Inc. entered into an agreement with the Company not to offer, sell or otherwise dispose of the Company s common stock for a period of one year, subject to a number of exceptions. As of December 31, 2003, SOFTBANK America Inc. beneficially owned approximately 14.1% of the Company s outstanding stock.

On July 17, 2003, the Company entered into a Mezzanine Loan Agreement with BB Modem Rental PLC ( BB Modem ), an affiliate of SOFTBANK America, Inc. Under the terms of the agreement the Company loaned BB Modem $10.1 million at an effective interest rate of 12.01% per annum, for the purposes of investing in a portfolio of ADSL modems and associated modem rental agreements, from SOFTBANK BB CORP., formerly BB Technologies, an affiliate of SOFTBANK America, Inc. SOFTBANK BB CORP. will continue to service such modems and modem rental agreements. The Company s loan is subordinated to certain senior lenders of BB Modem, and repayments are payable to the Company over a forty-two month period through January 31, 2007, with a substantial portion of the principal amount of the loan schedule to be repaid during the last 16 months of this period. The Company s recourse for nonpayment of the loan is limited to the assets of BB Modem, the account into which subscriber payments are made and its rights under the securitization transaction documents. The value of BB Modem s modems that serve as collateral for the loan may decrease over time and may not be sufficient upon sale to pay the outstanding amounts on the loans. The Company assesses the loan for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The Company periodically reviews the underlying quality of the asset pool securing the loan to assess whether impairment has incurred and needs to be recorded. During 2003, the Company recorded $0.5 million in interest income in respect of this loan. The loan receivable at December 31, 2003 was approximately $11.2 million and is included in other long-term assets.

*StarcomProducts, Inc.*

The Company obtains engineering consulting and employee placement services from Starcom Products, Inc. ( Starcom ), which is 31% owned by an individual related to a member of the Company s Board of Directors. The Company paid $1.4 million in 2003, $0.7 million in 2002, and $0.7 million in 2001, for engineering consulting and employee placement services from Starcom.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 23 SUBSEQUENT EVENT**

On January 14, 2004, the Company sold 12.1 million shares of common stock at $39.25 per share to Banc of America Securities, LLC, for net proceeds of approximately $474.2 million. The Company intends to use the net proceeds for strategic and general corporate purposes, including, but not limited to, acquisitions, investments, working capital or capital expenditures.

**NOTE 24 RESTATEMENT OF FINANCIAL STATEMENTS**

The Company has restated its consolidated financial statements for the year ended December 31, 2003 and the quarters ended March 31, 2003, June 30, 2003 and September 30, 2003 to correct errors and reflect certain corresponding changes described below.

As part of the financial closing process for the year ended December 31, 2004, the Company identified certain errors in the calculation of the Company s 2003 income tax provision resulting in a restatement which decreased the provision for income taxes and increased net income by $20.7 million ($0.20 per basic share) for the year ended December 31, 2003. In addition, as a result of the correction of the tax provision retained earnings was increased by $20.7 million, additional paid-in capital was increased $0.9 million, income taxes payable was decreased by $2.5 million, other long-term assets were increased by $21.6 million, prepaids were increased by $2.8 million and other current assets were reduced by $5.3 million. There was no net effect on cash provided from operating activities as a result of this error. The identified errors were as follows:

(a) The Company incorrectly applied intercompany profit on sales from UTStarcom, Inc. (a U.S. company) to its Chinese affiliates as profit on sales between the Chinese affiliates. As a result, when the intercompany profit was eliminated, the income tax on these sales was eliminated at the lower Chinese blended income tax rate instead of the higher U.S. Company income tax rate. This error resulted in the taxes on intercompany profit not being fully eliminated and the consolidated income tax provision being overstated. In addition, the changes in the deferred tax balances related to intercompany profit in the beginning and ending inventory were not accurately calculated. The impact of the correction of these errors was a decrease in income tax expense of $10.7 million.

(b) The Company did not correctly record the generation and use of research and development credits and foreign tax credits in the preparation of the 2003 tax provision. The impact of the correction of this error was a decrease in income tax expense of $7.2 million.

(c) The Company incorrectly recognized permanent and temporary differences with respect to (1) earnings of a foreign subsidiary currently taxable in the U.S., (2) tax exempt interest income, and (3) amortization of intangible assets. The impact of the correction of these errors is a net decrease in income tax expense of $3.0 million.

(d) The original 2003 U.S. tax provision was computed using an incorrect pre-tax income amount resulting from the failure to properly account for certain intercompany transactions in consolidation, resulting in an increase in income tax expense of $1.6 million.

(e) The Company did not properly identify and account for certain permanent differences in the preparation of the 2003 income tax provision for the Chinese entities. The impact of the correction to these permanent differences is a net decrease in income tax expense of $1.4 million.

In addition to the tax matters described above, the Company also determined that a reclassification of reported 2003 results was required. Specifically, cost of sales and other income both increased by $3.5

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 24 RESTATEMENT OF FINANCIAL STATEMENTS (Continued)**

million for the year ended December 31, 2003 to properly classify certain incentive payments received for exports and value added taxes in China.

In addition, the Company had not correctly identified a related party that is deemed a variable interest entity ( VIE ) and for which the Company is considered the primary beneficiary as defined by FASB Interpretation No. 46 ( FIN 46 ).

In December 2002, UTStarcom was granted a warrant for ordinary shares in MDC Holding Limited ( MDC Holding ) with an exercise price of approximately $0.8 million for a 16% ownership interest. Upon further analysis of the Company s relationship with MDC Holding, management determined that certain of the Company s employees participated in MDC Holding s formation and initial capital contribution in 2001, and acquired an ownership interest representing, at that time, approximately 67%. In addition, the same employees participated in the formation and initial capital contribution of Beijing MDC Telecommunications Co, Ltd., an affiliate of MDC Holding ( MDC BJ ), in 2001. Certain of these employees held management positions at MDC and a Company executive, though not a shareholder of MDC, held an alternate Board of Director position at MDC. In 2002, a venture capital fund affiliated with a principal shareholder of the Company made an additional capital investment in MDC Holding. MDC Holding issued 16.5 million ordinary shares to investors who participated in the initial funding and 11.3 million preferred convertible shares to the venture capital fund.

As a subsequent event, on December 31, 2004, the Company exercised $0.8 million of outstanding warrants for common stock of MDC, which represents 16% of ownership interest.

Management has determined that MDC Holding and its affiliated entities, including MDC BJ (MDC Holding and such affiliated entities are referred to, collectively, as MDC ), are related parties of the Company and that MDC is a VIE as defined by FIN 46. Management has also concluded that the Company is the primary beneficiary because the Company and its related parties will absorb a majority of MDC s expected losses and receive a majority of MDC s expected returns and the Company s activities are most closely aligned with MDC s activities. Therefore, the Company has consolidated the results of MDC as of its adoption of FIN 46 in the fourth quarter of 2003.

The Company has corrected its 2003 financial statements to reflect this consolidation of the VIE, MDC. At December 31, 2003, this consolidation resulted in a $5.5 million increase in total assets and a $0.7 million increase in total liabilities. There was no effect on net income as a result of this consolidation.

Furthermore, an impairment charge of $7.4 million, net of taxes of $1.3 million, was recorded to reflect an impairment of MDC equipment subject to a revenue share arrangement. Due to the uncertainties surrounding the customer s subscriber income and ability to pay under this arrangement, the Company determined that an impairment charge should have been recorded in 2003 when these conditions should have been identified. Accordingly, an impairment charge of $7.4 million ($0.07 per basic share), net of tax, was recorded which decreased both total assets and equity by $7.4 million, at December 31, 2003.

In addition, the Company identified the following revisions in classification during the preparation of the restated consolidated financial statements:

(1) Cost of sales for related party revenue transactions is presented separately from cost of sales for non-related party revenue transactions for all years represented;

(2) Certain other long-term assets increased and intangible assets decrease by $1.7 million at December 31, 2003;

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 24 RESTATEMENT OF FINANCIAL STATEMENTS (Continued)**

(3) Changes in restricted cash had been incorrectly categorized as a part of operating cash flows instead of investing cash flows in accordance with Statement of Financial Accounting Standards No. 95, Statement of Cash Flows, ( SFAS 95 ). Accordingly, the Company has reflected this change in categorization in the Consolidated Statement of Cash Flows for each of the three years in the period ended December 31, 2003. The change for 2003 and 2002 is an increase in cash flows from operating activities and a decrease in cash flows from investing activities of $3.2 million and $21.3 million, respectively, and there was no change for 2001; and

(4) A related party which is 31% owned by an individual related to a member of the Company s Board of Directors and associated transactions have been identified. See Note 22 to the Consolidated Financial Statements.

In connection with the restatement of the 2003 Consolidated Financial Statements, certain 2002 financial statements amounts were reclassified to conform to the 2003 presentation. Specifically, prepaids at December 31, 2002, which were previously reported as $47.2 million increased to $52.3 million, and other current assets at December 31, 2002, which were previously reported as $40.9 million decreased to $35.8 million. This reclassification presented the tax effect on intercompany profit in ending inventory in 2002 on a basis consistent with 2003 and had no impact on previously reported net income or stockholders equity.

The following table shows the effect of the restatement and other revisions in classification (in thousands, except per share data):

| | **As Previously Reported** | **As Restated** |
|---|---|---|
| As of December 31, 2003: | | |
| Current assets: | | |
| Cash and cash equivalents | $ 373,974 | $ 377,747 |
| Accounts receivable, net | 324,921 | 325,288 |
| Inventories, net | 257,038 | 257,065 |
| Deferred costs/Inventories at customer sites under contracts | 558,977 | 542,060 |
| Prepaid expenses | 136,262 | 139,103 |
| Other current assets | 52,408 | 48,499 |
| Property, plant and equipment, net | 186,076 | 187,039 |
| Goodwill and intangible assets, net | 145,933 | 144,231 |
| Other long-term assets | 38,976 | 70,625 |
| Current liabilities: | | |
| Accounts payable | 251,176 | 251,122 |
| Income taxes payable | 16,780 | 14,265 |
| Customer advances | 458,654 | 450,499 |
| Other current liabilities | 173,139 | 173,911 |
| Long-term debt | 402,500 | 410,655 |
| Minority interest in consolidated subsidiaries | 560 | 5,309 |
| Stockholders equity: | | |
| Additional paid-in capital | 653,624 | 654,483 |
| Retained earnings | 229,777 | 243,058 |
| For the year ended December 31, 2003: | | |
| Net sales | 1,964,332 | 1,965,187 |

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**NOTE 24 RESTATEMENT OF FINANCIAL STATEMENTS (Continued)**

| | | |
|---|---|---|
| Cost of sales | 1,328,164 | 1,340,802 |
| Gross profit | 636,168 | 624,385 |
| Selling, general and administrative | 187,128 | 188,339 |
| Operating income | 274,732 | 261,738 |
| Interest expense | (4,281) | (4,671) |
| Other income (expenses), net | 1,384 | 4,921 |
| Income before income taxes and minority interest | 269,769 | 259,922 |
| Income tax expense | 67,442 | 45,399 |
| Minority interest in (earnings) loss of consolidated subsidiaries | (76) | 1,009 |
| Net Income | 202,251 | 215,532 |
| Earnings per share | | |
| Basic | 1.95 | 2.08 |
| Diluted | 1.64 | 1.75 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | 202,251 | 215,532 |
| Adjustment to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 44,595 | 44,708 |
| Non-qualified stock option exercise tax benefits | 14,505 | 15,364 |
| Impairment of long-term assets | | 8,762 |
| Deferred income taxes | 5,567 | (10,675) |
| Minority interest in earnings of consolidated subsidiary | 76 | (1,009) |
| Changes in operating assets and liabilities: | | |
| Accounts receivable | (151,737) | (151,863) |
| Inventories | (81,632) | (81,618) |
| Deferred costs/Inventories at customer sites under contracts | (317,998) | (301,081) |
| Other current and non-current assets | (102,583) | (120,206) |
| Accounts payable | (5,804) | (5,906) |
| Income taxes payable | 3,777 | 1,262 |
| Customer advances | 302,318 | 294,163 |
| Other current liabilities | 64,140 | 64,681 |
| Net cash provided by operating activities | 50,534 | 45,173 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Additions to property, plant and equipment | (122,339) | (123,214) |
| Purchase of businesses, net of cash acquired | (111,720) | (106,713) |
| Change in restricted cash | | (3,153) |
| Net cash used in investing activities | (177,474) | (176,495) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Proceeds from borrowing | 414,821 | 422,976 |
| Net cash provided by (used in) financing activities | 267,191 | 275,346 |
| Net increase (decrease) in cash and cash equivalents | 142,030 | 145,803 |
| Cash and cash equivalents at end of period | 373,974 | 377,747 |

**QUARTERLY RESULTS OF OPERATIONS (UNAUDITED)**

Amounts differ from that previously reported in the applicable quarters as reported in Quarterly Reports on Form 10-Q for each of the quarters ended March 31, June 30, and September 30, 2003 due to the correction of certain errors in the 2003 income tax provision calculation, the reclassification of certain incentive payments received for exports and value added taxes in China, the consolidation of a variable interest entity and an asset impairment charge in the fourth quarter of 2003. Quarterly financial data for the periods indicated are as follows:

| | Quarter ended | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Dec. 31, 2003 | | Sept. 30, 2003 | | June 30, 2003 | | March 31, 2003 | |
| | As Previously Reported | As Restated | As Previously Reported | As Restated | As Previously Reported | As Restated | As Previously Reported | As Restated |
| | (In thousands, except per share amounts) | | | | | | | |
| Revenues(1) | $ 643,596 | $ 644,451 | $ 584,382 | $ 584,382 | $ 405,834 | $ 405,834 | $ 330,520 | $ 330,520 |
| Gross profit(1)(2) | $ 199,877 | $ 188,094 | $ 186,102 | $ 186,102 | $ 137,504 | $ 137,504 | $ 112,685 | $ 112,685 |
| Net income(3) | $ 66,356 | $ 65,710 | $ 59,140 | $ 65,204 | $ 39,412 | $ 43,450 | $ 37,343 | $ 41,168 |
| Earnings per share:(4) | | | | | | | | |
| Basic | $ 0.64 | $ 0.63 | $ 0.58 | $ 0.63 | $ 0.39 | $ 0.43 | $ 0.35 | $ 0.38 |
| Diluted | $ 0.52 | $ 0.51 | $ 0.46 | $ 0.50 | $ 0.33 | $ 0.36 | $ 0.33 | $ 0.37 |

| | Quarter ended | | | |
|---|---|---|---|---|
| | Dec. 31, 2002 | Sept. 30, 2002 | June 30, 2002 | March 31, 2002 |
| | (In thousands, except per share amounts) | | | |
| Revenues | $ 301,095 | $ 265,513 | $ 231,508 | $ 183,690 |
| Gross profit | $ 101,101 | $ 92,817 | $ 85,912 | $ 65,642 |
| Net income | $ 33,852 | $ 30,749 | $ 25,735 | $ 17,526 |
| Earnings per share:(4) | | | | |
| Basic | $ 0.32 | $ 0.28 | $ 0.23 | $ 0.16 |
| Diluted | $ 0.30 | $ 0.27 | $ 0.22 | $ 0.15 |

(1) Revenues and gross profit in the fourth quarter of 2003 have been restated to reflect the consolidation of MDC as discussed in this Note 24.

(2) Amounts differ from that previously reported in the fourth quarter of 2003 as a result of the reclassification of $3.5 million of incentive payments received for exports and value added taxes in China. Originally these payments were included as an offset of cost of sales. These incentive payments have been reclassified as other income in the restated consolidated financial statements. Gross profit in the fourth quarter of 2003 has also been reduced by an asset impairment charge of $8.8 million.

(3) Net income has been restated to reflect the correction of certain errors, as discussed in this Note 24. These corrections increased net income by $3.8 million, $4.0 million, and $6.1 million for each of the first, second, and third quarters, respectively, and decreased net income by $0.6 million in the fourth quarter of 2003. Basic earnings per common shares increased $0.03, $0.04, $0.05 for each of the first, second and third quarters of 2003, respectively, and decreased $0.01 for the fourth quarter of 2003. Diluted earnings per common share increased $0.04, $0.03, and $0.04 for each of the first, second and third quarters of 2003, respectively, and decreased $0.01 for the fourth quarter of 2003.

(4) Earnings per share is computed independently for each of the quarters presented and, therefore, the sum of the quarterly net earnings per share may not equal the annual earnings per share.

92

**ITEM 9A CONTROLS AND PROCEDURES**

**Evaluation of Disclosure Controls and Procedures**

UTStarcom (the Company ) maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in our reports under the Securities Exchange Act of 1934, as amended (the Exchange Act ), is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission s rules and forms, and that such information is accumulated and communicated to the Company s management, including our Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), as appropriate, to allow timely decisions regarding required financial disclosure.

In connection with the preparation of this Annual Report on Form 10-K, the Company s management carried out an evaluation under the supervision and with the participation of the Company s management, including the CEO and CFO, as of December 31, 2003 of the effectiveness of the design and operation of the Company s disclosure controls and procedures, as such term is defined under Rules 13a-15(e) and 15d-15(e) under the Exchange Act. Based upon this evaluation, the CEO and CFO concluded that, as of December 31, 2003, the Company s disclosure controls and procedures were not effective because of the material weaknesses described below under Identification of Material Weaknesses.

The Company has restated its previously issued consolidated financial statements for the year ended December 31, 2003 and the four quarters of 2003 as described more fully below under The Restatement.

After giving effect to the adjustments and other revisions in classification described under The Restatement, the Company s management believes that the consolidated financial statements included in this Annual Report on Form 10-K fairly present in all material respects the Company s financial condition, results of operations and cash flows for the periods presented and that this Annual Report on Form 10-K does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report.

**Identification of Material Weaknesses**

In connection with the assessment by the Company s management of the effectiveness of the Company s internal control over financial reporting as of December 31, 2004, the Company s management identified the material weaknesses described below, certain of which contributed to the restatement of the Company s financial statements for each of the quarters in 2003 and year ended December 31, 2003, as more fully described under The Restatement.

1. *The Company did not maintain effective controls over the financial reporting process due to an insufficient complement of personnel with a level of accounting knowledge, experience and training in the application of generally accepted accounting principles commensurate with the Company s financial reporting requirements.* This material weakness contributed to the following control deficiencies relating to the preparation of the Company s financial statements which are individually considered to be material weaknesses:

(a) The Company did not maintain effective controls over its revenue and deferred revenue accounts and associated cost of sales. Specifically, the Company s controls over its processes and procedures related to the recording and review of its revenue and deferred revenue accounts were not adequate to ensure that such accounts were completely and accurately recorded.

(b) The Company did not maintain effective controls over its inventory, deferred costs, inventory reserve accounts and cost of sales. Specifically, the Company s controls failed to adequately

93

identify, document and analyze the conditions which should have been considered relative to the existence and expected recoverability of inventory and deferred costs.

(c) The Company did not maintain effective controls over its processes for accounting for goodwill. Specifically, the Company s controls over its processes and procedures related to its assessment of the impairment of its goodwill account were not sufficiently detailed to identify instances of impairment as required under generally accepted accounting principles.

(d) The Company did not maintain effective controls over the process for the translation of its accounts and transactions denominated in a currency other than U.S. dollars. Specifically, the Company s controls over its processes and procedures related to the translation of transactions and account balances denominated in a currency other than U.S. dollars failed to identify and utilize the appropriate foreign exchange rates primarily related to the cash, accounts receivable, accounts payable and other comprehensive income accounts.

(e) The Company did not maintain effective controls over the recording of accrued expenses, primarily in China and Japan. Specifically, the Company s controls over its processes and procedures related to accrued expenses failed to completely and accurately record expenses in the proper period. The review of open purchase orders and invoices received as part of the close process was insufficient to ensure that year-end accrued expense balances were completely and accurately recorded in the proper period.

(f) The Company did not maintain effective controls over the financial reporting process to ensure the accurate preparation and review of its consolidated financial statements. Specifically, the Company s controls over the completeness, accuracy and review of its documentation of close processes relating to reconciliations, journal entries, spreadsheets, international reporting packages and review and preparation of monthly expenditure reports were ineffective in their design and execution. In addition, the Company did not have effective controls over the process for identifying and accumulating all required supporting information to ensure the completeness of its footnote disclosures, including the support for the accounting positions taken on non-routine transactions, goodwill impairment, purchase accounting, segment reporting, accounting for potential variable interest entities, intercompany profit eliminations and income tax accounting and proper classification of inventory and deferred costs, deferred revenue and accounts receivable, and revenue and cost of goods sold. These control deficiencies resulted in certain audit adjustments to and additional disclosures made in the 2003 financial statements.

(g) The Company did not maintain effective controls over the completeness and accuracy of its income tax provision and related balance sheet accounts. Specifically, as part of its 2004 year-end close process, certain errors related to income taxes payable, deferred income tax assets and liabilities, other long-term assets, prepaids and other current assets were identified in the calculation of the Company s 2003 income tax provision. This control deficiency resulted in the restatement of the Company s financial statements for the quarters and full year of 2003 financial statements to adjust the provision for income taxes, stockholders equity, income taxes payable, other long-term assets, prepaids and other current assets.

(h) The Company did not maintain effective controls in relation to segregation of duties and user access to certain Oracle business process applications nor were there effective controls in place to monitor user access. There were instances in which either information technology or finance personnel maintained access to specific applications within the Oracle environment beyond that needed to perform their individual job responsibilities. This deficiency related to financial reporting, inventory and purchasing applications in China and financial reporting applications in the United States.

As discussed above, certain of these control deficiencies resulted in the restatement of the Company s financial statements for each of the quarters in 2003 and the year ended December 31, 2003, as more fully described under The Restatement. Additionally, the control deficiencies described above could individually or in the aggregate result in a material misstatement to the annual or interim financial statements that would not be prevented or detected. Accordingly, management has determined that these control deficiencies constitute material weaknesses.

2. *The Company did not maintain effective controls over the identification of and accounting for related party relationships and related party transactions.* Specifically, the Company s controls over its policies and procedures were ineffective in identifying all significant related party relationships and transactions on a timely basis in order for such relationships and transactions to be appropriately reflected in the Company s financial statements in accordance with generally accepted accounting principles. Specifically, a previously undisclosed significant related party relationship was identified and determined to be a variable interest entity in which the Company was determined to be the primary beneficiary. This control deficiency resulted in a restatement of the Company s financial statements for the year ended December 31, 2003. Additionally, this control deficiency could result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management has determined that this control deficiency constitutes a material weakness.

3. *The Company did not maintain effective controls over the monitoring of its accounting functions located outside of the U.S.* The Company s policies and procedures with respect to the review and supervision of its accounting operations in foreign locations, principally Japan and China, were inadequate. Specifically, corporate senior financial management did not provide adequate oversight of the accounting functions based principally in Japan and China nor was there sufficient and accurate information for monitoring the financial results of non-U.S. operations. Reviews of local financial results were inadequate in either their design or operation to detect errors to the Company s financial statements as described in items 1 and 2 above. Additionally, this control deficiency could result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management has determined that this control deficiency constitutes a material weakness.

4. *The Company did not maintain an effective control environment.* The financial reporting organizational structure was not adequate to support the size, complexity, operating activities or locations of the Company. Deficiencies in local accounting operations, such as the lack of a senior finance director in China with sufficient depth and skill in the application of U.S. generally accepted accounting principles and inadequate understanding of U.S. generally accepted accounting principles by local accounting staff resulted in the adjustments to the financial statements as discussed in items 1 3 above. In addition, in some cases, certain key finance positions were staffed with individuals who did not have the appropriate skills, training and experience to meet the objectives as outlined in their job descriptions or that should be expected of these roles. Further, the following specific areas are examples of some of the corporate departments in the Company where additional skilled resources are required: tax, external financial reporting, revenue recognition, treasury, financial planning and analysis and corporate accounting. This control deficiency, together with the material weaknesses described in items 1 3 above, indicate that the Company did not maintain an effective control environment. These control deficiencies could result in a material misstatement to annual or interim financial statements that would not be prevented or detected. Accordingly, management has determined that this control deficiency constitutes a material weakness.

**The Restatement**

The restatement of the consolidated financial statements for the year ended December 31, 2003 and the four quarters of 2003 related to the identification of certain errors in the calculation of the Company s 2003 income tax provision discovered as part of the 2004 financial close process. The discovered error also affected stockholders equity, income tax payable, other long-term assets, prepaids and other current assets. There was no net effect on cash provided from operating activities as a result of the restatement. The identified errors were as follows:

(a) The Company incorrectly applied intercompany profit on sales from UTStarcom, Inc. (a U.S. company) to its Chinese affiliates as profit on sales between the Chinese affiliates. As a result, when the intercompany profit was eliminated, the income tax on these sales was eliminated at the lower Chinese blended income tax rate instead of the higher U.S. Company income tax rate. This error resulted in the taxes on intercompany profit not being fully eliminated and the consolidated income tax provision being overstated. In addition, the changes in the deferred tax balances related to intercompany profit in the beginning and ending inventory were not accurately calculated. The impact of the correction of these errors was a decrease in income tax expense.

(b) The Company did not correctly record the generation and use of research and development credits and foreign tax credits in the preparation of the 2003 tax provision. The impact of the correction of this error was a decrease in income tax expense.

(c) The Company incorrectly recognized permanent and temporary differences with respect to (1) earnings of a foreign subsidiary currently taxable in the U.S., (2) tax exempt interest income, and (3) amortization of intangible assets. The impact of the correction of these errors is a net decrease in income tax expense.

(d) The original 2003 U.S. tax provision was computed using an incorrect pre-tax income amount resulting from the failure to properly account for certain intercompany transactions in consolidation, resulting in an increase in income tax expense.

(e) The Company did not properly identify and account for certain permanent differences in the preparation of the 2003 income tax provision for the Chinese entities. The impact of the correction to these permanent differences is a net decrease in income tax expense.

During the evaluation of the errors related to the income tax provision, the Company determined that an additional reclassification of reported 2003 results was required. Specifically, cost of sales and other income both increased for the year ended December 31, 2003 to properly classify certain incentive payments for exports and value-added taxes in China.

In addition to the errors in the 2003 tax provision, the Company had not correctly identified a related party that is deemed a variable interest entity and for whom the Company is considered the primary beneficiary in accordance with FASB Interpretation No. 46 ( FIN 46 ). The Company has corrected its 2003 financial statements to reflect the consolidation of this variable interest entity, MDC Holding Limited ( MDC Holding ) and its affiliated entities (MDC Holding and such affiliated entities are referred to, collectively, as MDC ). At December 31, 2003, this consolidation resulted in an in increase in both assets and total liabilities. There was no effect on net income as a result of this consolidation.

Furthermore, an impairment charge was recorded to reflect an impairment of MDC equipment subject to a revenue share arrangement. Due to the uncertainties surrounding the customer s subscriber income and ability to pay under this arrangement, the Company determined that an impairment charge should have been recorded in 2003 when these conditions should have been identified. Accordingly, an impairment charge was recorded, which decreased both total assets and equity at December 31, 2003.

In addition, the Company identified the following revisions in classification during the preparation of the restated consolidated financial statements:

(1) Cost of sales for related party revenue transactions is presented separately from cost of sales for non-related party revenue transactions for all years represented;

(2) Certain other long-term assets increased and intangible assets decreased at December 31, 2003;

96

(3) Changes in restricted cash had been incorrectly categorized as a part of operating cash flows instead of investing cash flows in accordance with Statement of Financial Accounting Standards No. 95, Statement of Cash Flows, ( SFAS 95 ). Accordingly, the Company has reflected this change in categorization in the Consolidated Statement of Cash Flows for each of the three years in the period ended December 31, 2003. The change for 2003 and 2002 is an increase in cash flows from operating activities and a decrease in cash flows from investing activities. There was no change for 2001; and

(4) A related party which is 31% owned by an individual related to a member of the Company s Board of Directors and associated transactions have been identified.

**Management s Remediation Initiatives**

In response to the matters discussed under Identification of Material Weaknesses above, the Company plans to continue to review and make necessary changes to the overall design of its control environment, including the roles and responsibilities of each functional group within the organization and reporting structure, as well as policies and procedures to improve the overall internal control over financial reporting. In particular, the Company has implemented and/or plans to implement subsequent to December 31, 2003 the specific measures described below to remediate the material weaknesses described above.

***Material weaknesses described in item 1 of Identification of Material Weaknesses***

The Company s failure to have a sufficient complement of personnel with a level of accounting knowledge, experience and training in the application of generally accepted accounting principles commensurate with the Company s financial reporting requirements contributed to the Company s failure to maintain effective controls over the financial reporting process. To remediate the material weaknesses described in item 1 of Identification of Material Weaknesses, the Company has implemented or plans to implement the measures described below, and will continue to evaluate and may in the future implement additional measures.

1. General plan for hiring and training of personnel The Company s planned remediation measures are intended to generally address this material weakness by ensuring that the Company will have sufficient personnel with knowledge, experience and training in the application of generally accepted accounting principles commensurate with the Company s financial reporting requirements. These measures include the following:

(a) The Company s chief financial officer, with assistance from senior financial staff and outside consultants, other than the Company s independent registered public accounting firm, has reviewed and will continue to review and adapt the overall design of the Company s financial reporting structure, including the roles and responsibilities of each functional group within the Company;

(b) The Company hired regional controllers with relevant accounting experience, skills and knowledge for each of the Asia-Pacific region, the Central America and Latin America region, the Europe, Middle East and Africa region and Japan in late 2004 and early 2005;

(c) The Company hired a consolidation manager in China with relevant accounting experience, skills and knowledge in February 2005;

(d) The Company hired a senior manager for SEC reporting with relevant accounting experience, skills and knowledge in February 2005;

(e) The Company promoted an individual within the Company with relevant accounting experience, skills and knowledge to become the controller of China operations in April 2005;

(f) The Company retained and intends to continue to retain the services of outside consultants, other than the Company s independent registered public accounting firm, with relevant accounting experience, skills and knowledge, working under the supervision and direction of the Company s management, to supplement the Company s existing accounting personnel;

(g) The Company plans to hire and is actively recruiting a vice president of finance for the Company s China operations with extensive relevant accounting experience, skills and knowledge;

(h) The Company plans to continue to hire, and has allocated resources to hire, additional accounting personnel in the U.S., China and Japan, in the areas of tax, external financial reporting, revenue recognition, treasury, financial planning and analysis and corporate accounting with relevant accounting experience, skills and knowledge; and

(i) The Company in February 2005 implemented an enhanced formal training process for the training of financial staff and plans to continue this process to ensure that personnel have the necessary competency, training and supervision for their assigned level of responsibility and the nature and complexity of the Company s business.

2. Revenue Recognition The Company s planned remediation measures are intended to address material weaknesses related to revenue and deferred revenue accounts and associated cost of sales. The Company s planned remediation measures include the following:

(a) The Company plans to design a contract review process in China requiring financial and legal staff to provide input during the contract negotiation process to ensure timely identification and accurate accounting treatment of non-standard contracts;

(b) In March 2005, the Company conducted a training seminar regarding revenue recognition, including identification of non-standard contracts, in the U.S., and, in April 2005, the Company conducted a similar seminar in China. Starting in May 2005, the Company plans to conduct additional training seminars in various international locations regarding revenue recognition and the identification of non-standard contracts; and

(c) At the end of 2004, the Company began requiring centralized retention of documentation evidencing proof of delivery and final acceptance for revenue recognition purposes.

3. Inventory Management The Company s planned remediation measures are intended to address material weaknesses related to inventory, deferred costs, inventory reserve accounts and cost of sales that have the potential of misstating inventory and deferred costs and expected recoverability of inventory in future financial periods. The Company s planned remediation measures include the following:

(a) The Company is in the process of continuing to upgrade and implement additional Oracle modules to more effectively track inventory and evaluate deferred costs;

(b) The Company implemented in late 2004, and plans to improve during 2005, its process to confirm the existence of off-site inventory by systematically obtaining customer confirmations, investigating discrepancies in the confirmed results, and properly recording and reporting the results of the investigation;

(c) During the fourth quarter of 2004, the Company initiated a process to accumulate information necessary to evaluate inventory and deferred cost contracts for impairment. The Company plans to continue to enhance this process in 2005 by better coordinating the accumulation of such information from non-U.S. locations;

(d) The Company plans to implement in 2005 more robust controls over the release of costs to the income statement by better utilizing the Oracle system;

(e) The Company is in the process of selecting a service provider with expertise and systems to more effectively manage and track the Company s inventory in Japan, to whom the Company plans to outsource this function in 2005; and

(f) The Company plans to deploy the Oracle system in Japan by the third quarter of 2005.

4. Accounting for Goodwill The Company s planned remediation measures are intended to address a material weakness related to the Company s accounting for goodwill that has the potential of misstating goodwill amounts and the impairment of the Company s goodwill in future financial periods. The Company s planned remediation measures include the following:

(a) In the first quarter of 2005, the Company implemented a process of reallocating goodwill to the Company s five reporting units in a manner reflective of the Company s new organization; and

(b) As part of the process described in (a) above, the Company retained an outside consultant, working under the supervision and direction of the Company s management, to assist in a valuation analysis that was used in the allocation process. The Company plans to use the consultant on at least an annual basis to assist in a valuation and impairment analysis with respect to goodwill.

5. Foreign Exchange Translations The Company s planned remediation measures are intended to address a material weakness related to the Company s controls over its processes and procedures related to the translation of its accounts and transactions denominated in a currency other than U.S. dollars that has the potential of misstating various accounts in future financial periods. The Company s planned remediation measures include the implementation in the first quarter of 2005 of an enhanced foreign exchange accounting process utilizing the actual month-end exchange rates.

6. Recording of Accrued Expenses and Open Purchase Orders The Company s planned remediation measures are intended to address a material weakness related to the Company s recording of accrued expenses, primarily in China and Japan, that has the potential of misstating accrued expenses and related income statement accounts in future financial periods. The Company s planned remediation measures include the implementation in the first quarter of 2005 of a process of enhanced review of open purchase orders and review of invoices and receipts after the end of each quarter to ensure proper recording of accrued expenses and open purchase order commitments.

7. Accurate Preparation and Review of Financial Statements, Reconciliations, Journal Entries and Segment Reporting The Company s planned remediation measures are intended to address material weaknesses related to the financial close and reporting process that have the potential of preventing the accurate preparation and review of the Company s consolidated financial statements in future financial periods. The Company s planned remediation measures include the following:

(a) During the first quarter of 2005, the Company began to implement, and plans to continue to improve, new and enhanced procedures to ensure that non-routine transactions are identified and escalated to senior financial management during the close process to help ensure proper accounting treatment. Specific steps include training and ongoing monitoring of financial staff, expansion of the officer sub-certifications and active review of contracts by knowledgeable financial and legal staff, from the contract negotiation process through recognition of revenue for such contracts;

(b) During the fourth quarter of 2004, the Company implemented, and plans to continue to enhance, its month-end closing procedures, including reconciliations and controls over spreadsheets, and standardized checklists to ensure such procedures are consistently and effectively applied throughout the organization; and

(c) The Company plans to enhance in 2005 the communication and distribution of its accounting policies and procedures and development of a process to more effectively accumulate and analyze information required for financial statement footnote disclosures.

8. Income Tax Analysis The Company s planned remediation measures are intended to address material weaknesses related to the calculation of its provision for income taxes that have the potential of misstating the provision for income taxes and related balance sheet accounts in future financial periods. The Company s planned remediation measures include the following:

(a) The Company plans to hire and train additional experienced tax managers and supporting staff in 2005 to closely monitor reporting from China and Japan, to assist in managing audits and to monitor tax compliance in China and Japan;

(b) During the first quarter of 2005, the Company utilized outside consultants, other than the Company s independent registered public accounting firm, to assist the Company s management, working under its supervision and direction, in its analysis and calculation of its income tax provision, and the Company plans to continue to utilize outside consultants, other than the Company s independent registered public accounting firm, to assist the Company s management, working under its supervision and direction, in its analysis of such matters in future periods; and

(c) The Company plans to develop a comprehensive process to accumulate and organize financial and tax data used in connection with income tax calculation and reporting.

9. Utilization of Automated Controls The Company s planned remediation measures are intended to address a material weakness related to the segregation of duties and user access to certain Oracle business process applications that have the potential of misstating of various accounts in future financial periods. The Company s planned remediation measures include the following:

(a) During the first quarter of 2005, the Company outsourced to a third-party expert the position of chief security officer to, among other duties, monitor access rights with respect to the Oracle system and manage ongoing provisioning and changes;

(b) The Company plans to improve utilization of current functionality and continue to upgrade and expand functionality of the Oracle financial reporting system through utilization of additional modules to reduce manual procedures and the utilization of spreadsheets;

(c) The Company plans to deploy the Oracle system in Japan by the third quarter of 2005;

(d) The Company is in the process of continuing to upgrade and implement additional Oracle modules to more effectively track inventory and evaluate deferred costs; and

(e) The Company plans to implement in 2005 more robust controls over the release of costs to the income statement by better utilizing the Oracle system.

***Material weakness described in item 2 of Identification of Material Weaknesses***

The Company s failure to ensure that key management fully understood the nature and potential significance of related parties and to ensure that a robust process for the identification of related party transactions contributed to the Company s failure to maintain effective controls over the identification of and accounting for related party relationships and related party transactions with the Company. To remediate the material weakness described in item 2 of Identification of Material Weaknesses, the Company has implemented or plans to implement the measures described below, and will continue to evaluate and may in the future implement additional measures.

1. The Company conducted an educational seminar with the Company s key management in March 2005 in which the Company s internal and outside legal counsel and members of the Audit Committee reviewed certain key objectives of the Company s Code of Conduct, including the identification, recognition and disclosure of related party transactions.

2. In the first quarter of 2005, the Company expanded the number of Company personnel required to certify to senior management with respect to identification, recognition and disclosure of related party transactions for SEC reporting purposes, and revised the Company s internal certification process concerning identification, recognition and disclosure of related party transactions.

3. The Company plans to continue to evaluate the Company s procedures to ensure the identification, recognition and disclosure of related party transactions.

4. The Company plans to conduct periodic training sessions with key managers and senior executives regarding the Code of Conduct, including the identification, recognition and disclosure of related party transactions.

5. The Company plans to provide key managers and senior executives with access to legal and accounting personnel to enable such managers and executives to more accurately and comprehensively comply with the Company s internal certification process for SEC reporting purposes.

***Material weakness described in item 3 of Identification of Material Weaknesses***

Lack of clarity in roles and responsibilities in certain areas affecting the Company s financial reporting structure contributed to a material weakness relating to the monitoring of non-U.S. operations. To remediate this material weakness, described in item 3 of Identification of Material Weaknesses, the Company has implemented or plans to implement the measures described under Material weaknesses described in item 1 of Identification of Material Weaknesses Remediation Measures 1. General plan for hiring and training of personnel, as well as those described below. The Company will continue to evaluate and may in the future implement additional measures.

1. The Company streamlined the reporting structure between all non-U.S. accounting functions and the comparable groups in the corporate headquarters, including tax, treasury and financial planning and analysis groups, in early 2005 to provide for direct reporting to, and oversight by, the U.S. corporate headquarters.

2. The Company plans to expand the size of the internal audit group and the scope of the internal audit group s responsibilities to monitor non-U.S. operations through reviews and audits of such locations.

3. The Company s chief financial officer, with assistance from senior financial staff and outside consultants, other than the Company s independent registered public accounting firm, has reviewed and will continue to review and adapt the overall design of the Company s financial

reporting structure, including the roles and responsibilities of each functional group within the Company.

4. The Company has implemented, and plans to continue to improve, a closing checklist to standardize its procedures for financial review to ensure that U.S. reviewers monitor financial information from non-U.S. locations in a consistent manner, through such measures as use of standardized reporting packages and review procedures.

***Material weakness described in item 4 of Identification of Material Weaknesses***

The Company s failure to have sufficient personnel with knowledge, experience and training in the application of generally accepted accounting principles commensurate with the Company s financial reporting requirements contributed to a material weakness relating to the Company s control environment. To remediate this material weakness, described in item 4 of Identification of Material Weaknesses, the Company has implemented or plans to implement the measures described under Material weaknesses described in item 1 of Identification of Material Weaknesses Remediation Measures 1. General plan for hiring and training of personnel, as well as those described below. The Company will continue to evaluate and may in the future implement additional measures.

1. The Company streamlined the reporting structure between all non-U.S. accounting functions and the comparable groups in the corporate headquarters, including tax, treasury and financial planning and analysis groups, in early 2005 to provide for direct reporting to, and oversight by, the U.S. corporate headquarters.

2. The Company plans to expand the size of the internal audit group and the scope of the internal audit group s responsibilities to monitor non-U.S. operations through reviews and audits of such locations.

3. The Company s chief financial officer, with assistance from senior financial staff and outside consultants, other than the Company s independent registered public accounting firm, has reviewed and will continue to review and adapt the overall design of the Company s financial reporting structure, including the roles and responsibilities of each functional group within the Company.

4. The Company has implemented, and plans to continue to improve, a closing checklist to standardize its procedures for financial review to ensure that U.S. reviewers monitor financial information from non-U.S. locations in a consistent manner, through such measures as use of standardized reporting packages and review procedures.

**Changes in Internal Control over Financial Reporting**

There have not been any significant changes in our internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fourth quarter of 2003 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. The discussion above under Management s Remediation Initiatives describes the material planned and actual changes to the Company s internal control over financial reporting subsequent to December 31, 2003 that have materially affected, or are reasonable likely to materially affect, the Company s internal control over financial reporting.

**PART IV**

**ITEM 15 EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K**

(a) (1) **Financial Statements** See Index to Consolidated Financial Statements and Financial Statement Schedules at page 44 of this Form 10-K/A.

(2) **Financial Statement Schedules** See Index to Consolidated Financial Statements and Financial Statement Schedules at page 44 of this Form 10-K/A.

| Exhibit Number | Description |
|---|---|
| 3.1(16) | Thirteenth Amended and Restated Certificate of Incorporation of UTStarcom, Inc., as amended. |
| 3.2(17) | First Amended and Restated Bylaws of UTStarcom, Inc., as amended. |
| 4.1 | See exhibits 3.1 and 3.2 for provisions of the Certificate of Incorporation and Bylaws defining the rights of holders of Common Stock. |
| 4.2(1) | Specimen Common Stock Certificate. |
| 4.3(1) | Third Amended and Restated Registration Rights Agreement dated December 14, 1999. |
| 4.4(12) | Convertible Subordinated Notes Indenture dated as of March 12, 2003 between UTStarcom, Inc. and U.S. Bank National Association, including the form of the 7/8% Convertible Subordinated Notes due 2008. |
| 4.5(12) | Registration Rights Agreement between UTStarcom, Inc. and the Initial Purchasers named therein dated as of March 12, 2003. |
| 4.6(16)* | Registration Rights Agreement, dated as of June 30, 2003, by and among UTStarcom, Inc. and the shareholders of RollingStreams Systems, Ltd. |
| 10.1(1) | Form of Indemnification Agreement. |
| 10.2(1) | 1992 Omnibus Equity Incentive Plan and form of related agreement. |
| 10.3(1) | 1995 Stock Plan and forms of related agreements. |
| 10.4(1) | 1997 Stock Plan, as amended, and forms of related agreements. |
| 10.5(1) | 2000 Employee Stock Purchase Plan and forms of related agreements. |
| 10.6(1) | Common Stock Purchase Warrant dated February 5, 1998 between UTStarcom, Inc. and Lintech Limited. |
| 10.7(1) | Common Stock Purchase Warrant dated September 20, 1999 between UTStarcom, Inc. and Talent Group International, Ltd. |
| 10.17(1)* | Loan Agreement dated June 15, 1998 between UTStarcom, Inc. and SOFTBANK Corp. |
| 10.18(a)(1)* | Loan Agreement dated March 9, 1999 between Bank of China and UTStarcom Hangzhou Telecommunications Co., Ltd. |
| 10.18(b)(1)* | Loan Agreement dated June 7, 1999 between Bank of China and UTStarcom Hangzhou Telecommunications Co., Ltd. |
| 10.18(c)(1)* | Loan Agreement dated June 29, 1999 between Bank of China and UTStarcom Hangzhou Telecommunications Co., Ltd. |
| 10.18(d)(1)* | Loan Agreement dated July 7, 1999 between Bank of China and UTStarcom Hangzhou Telecommunications Co., Ltd. |
| 10.18(e)(1)* | Loan Agreement dated July 14, 1999 between Bank of China and UTStarcom Hangzhou Telecommunications Co., Ltd. |

| | |
|---|---|
| 10.18(f)(1)* | Loan Agreement dated July 21, 1999 between Bank of China and UTStarcom Hangzhou Telecommunications Co., Ltd. |
| 10.18(g)(1)* | Loan Agreement dated August 5, 1999 between Bank of China and UTStarcom Hangzhou Telecommunications Co., Ltd. |
| 10.18(h)(1)* | Loan Agreement dated August 17, 1999 between Bank of China and UTStarcom Hangzhou Telecommunications Co., Ltd. |
| 10.18(i)(1)* | Loan Agreement dated September 2, 1999 between Bank of China and UTStarcom Hangzhou Telecommunications Co., Ltd. |
| 10.18(j)(1)* | Loan Agreement dated September 17, 1999 between Bank of China and UTStarcom Hangzhou Telecommunications Co., Ltd. |
| 10.22(1) | Lease dated December 23, 1997 between UTStarcom, Inc. and Tech Center Partners. |
| 10.23(1) | Lease Agreement dated April 1995, as amended, between UTStarcom, Inc. and Metro Park Associates. |
| 10.24(1)* | Lease Agreements dated December 31, 1997 and May 14, 1998 between Guangdong UTStarcom Telecom Co., Ltd. and Guangdong Southern Telecom Group Huizhou Company. |
| 10.25(1)* | Lease Contract dated December 15, 1996 between UTStarcom (Hangzhou) Telecommunications Co., Ltd. and Yile Village, Gudang Township. |
| 10.28(1)* | Payment Agent Contract dated June 11, 1998 among UTStarcom, UTStarcom (China) Ltd, Softbank Corporation and Jitong Communication Co., Ltd. |
| 10.29(1)* | Agreement on Termination of Contract dated August 30, 1999 among UTStarcom, Inc., UTStarcom (China) Ltd., Softbank Corporation and Jitong Communication Co., Ltd. |
| 10.30(1) | Exchange Agreement dated October 15, 1997 between UTStarcom, Inc. and certain investors. |
| 10.31(1) | Exchange Agreement dated October 15, 1997 between UTStarcom, Inc. and certain investors. |
| 10.39(2)* | Technical Collaboration Agreement between Sharp Corporation and UTStarcom, Inc., dated March 31, 2000. |
| 10.40(2)* | Parts Supply Agreement between Sharp Corporation and UTStarcom, Inc. undated. |
| 10.41(3)* | Joint Venture Agreement between SOFTBANK Corporation and UTStarcom, Inc. dated May 29, 2000. |
| 10.42(3)* | Land Use Right Assignment Agreement between the Administration Committee of Hangzhou Hi-Tech Industry Development Zone of Zhejiang Province of the People s Republic of China and UTStarcom, Inc. dated May 18, 2000. |
| 10.43(3)* | Supply Agreement between Matsushita Electric Industrial Co., Ltd., Matsushita Communications Industrial Co., Ltd., and UTStarcom, Inc. dated April 1, 2000. |
| 10.54(8)* | Software License Agreement between UTStarcom, Inc. and DDI Corporation, Inc. dated October 4, 2000. |
| 10.55(8)* | Strategic Alliance, Purchase and License Agreement between UTStarcom, Inc. and Telecommunication D Haiti S.A.M., dated December 5, 2000. |

104

| | |
|---|---|
| 10.56(4)* | Assignment Agreement between UTStarcom, Inc. and Stable Gain International Limited dated July 24, 2000. |
| 10.57(4)* | Amendment No.1 to July 24, 2000 Assignment Agreement between UTStarcom, Inc. and Stable Gain International Limited, dated March 2, 2001. |
| 10.58(4)* | Loan Agreement between China Merchant Bank and UTStarcom (China) Co., Ltd., dated March 14, 2001. |
| 10.59(4)* | Technical Service Agreement between UTStarcom (China) Co., Ltd. and Hainan Xinhuangpu Investment Co., Ltd., dated August 18, 2000. |
| 10.60(4)* | Assets Transfer Agreement between Hainan Xinhuangpu Investment Co., Ltd. and UTStarcom (China) Co., Ltd., dated August 18, 2000. |
| 10.61(4)* | Equity Transferring Agreement between Zhe Jiang Nantian Telecommunication Development Group Share Company and UTStarcom, dated February 5, 2001. |
| 10.65(6)* | Strategic Alliance, Purchase and License Agreement between UTStarcom, Inc. and Telecommunications D Haiti S.A.M. dated as of April 12, 2001. |
| 10.66(5) | Amended 2001 Director Option Plan. |
| 10.67(7)* | Purchase Contract between UTStarcom Inc. and Softbank BB Corporation, dated October 9, 2001. |
| 10.68(9)* | Comprehensive Credit-Extension Agreement between UTStarcom (China) Ltd. and China Everbright Bank, Chaoyang Branch, Beijing, dated November 30, 2001. |
| 10.71(9) | Lease Agreement between UTStarcom, Inc. and Legend Tech., dated September 12, 2001. |
| 10.73(10) | Change of Control Severance Agreement between Gerald Soloway and UTStarcom, Inc. dated April 12, 2002. |
| 10.74(10) | Change of Control Severance Agreement between Howard Kwock and UTStarcom, Inc. dated April 12, 2002. |
| 10.75(10) | Change of Control Severance Agreement between Michael J. Sophie and UTStarcom, Inc. dated April 12, 2002. |
| 10.78(11)* | Professional Services Agreement between UTStarcom, Inc. and N. Lohr Bangle, Jr. dated as of September 10, 2002. |
| 10.80(11)* | Joint Venture Contract between UTStarcom Telecom Co., Ltd., Matsushita Electric Industrial Co., Ltd. and Matsushita Communication Industrial Co., Ltd. dated as of July 5, 2002. |
| 10.82(14)* | Joint Development Agreement between Datang Mobile Communications Equipment Co., Ltd and UTStarcom (China) Co., Ltd. dated November 22, 2002. |
| 10.83(14)* | Broadband Access Network General Terms and Conditions between Reliance Infocomm Limited and UTStarcom, Inc. dated as of October 1, 2002. |
| 10.84(14)* | Broadband Access Equipment Contract between Reliance Infocomm Limited and UTStarcom, Inc. dated as of October 1, 2002. |
| 10.85(14)* | Broadband Access Services Contract between Reliance Infocomm Limited and UTStarcom, Inc. dated as of October 1, 2002. |

| | |
|---|---|
| 10.86(14)* | Broadband Access Software Contract between Reliance Infocomm Limited and UTStarcom, Inc. dated as of October 1, 2002. |
| 10.87(13)* | Equipment Purchase Agreement, dated as of February 4, 2003, by and between Tata Teleservices Limited and UTStarcom, Inc. |
| 10.88(15) | UTStarcom, Inc. 2003 Nonstatutory Stock Option Plan |
| 10.89(18) | Change of Control Severance Agreement, dated as of January 17, 2003, by and between Hong Liang Lu and UTStarcom, Inc. |
| 10.90(18) | Change of Control Severance Agreement, dated as of January 31, 2003, by and between Ying Wu and UTStarcom, Inc. |
| 10.91(18) | Change of Control Severance Agreement, dated as of January 31, 2003, by and between Shao-Ning Chou and UTStarcom, Inc. |
| 10.92(18) | Change of Control Severance Agreement, dated as of January 31, 2003, by and between William X. Huang and UTStarcom, Inc. |
| 10.93(18)* | Distributor Agreement, dated as of October 21, 2003, by and between UTStarcom, Inc. and Multidata. |
| 10.94(18)* | Amendment #1 to Distributor Agreement, dated as of December 17, 2003, by and between UTStarcom, Inc. and Multidata. |
| 10.95(18)* | Revenue Sharing Purchase Agreement, dated as of October 21, 2003 by and between UTStarcom, Inc. and Multidata. |
| 10.96(18)* | Amendment #1 to Revenue Sharing Purchase Agreement, dated as of December 17, 2003, by and between UTStarcom, Inc. and Multidata. |
| 21.1(18) | Subsidiaries of UTStarcom. |
| 23.1 | Consent of PricewaterhouseCoopers LLP. |
| 24.1 | Power of Attorney (included on signature page). |
| 31.1 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002. |

---

* Portions of the exhibit have been omitted pursuant to an order granted by the Securities and Exchange Commission for confidential treatment.

(1) Incorporated by reference to the registrant s Registration Statement on Form S-1 (No. 333-93069), which became effective March 2, 2000.

(2) Incorporated by reference to the registrant s Quarterly Report on Form 10-Q for the quarter ended March 31, 2000.

(3) Incorporated by reference to the registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2000.

(4) Incorporated by reference to the registrant s Quarterly Report on Form 10-Q for the quarter ended March 31, 2001.

(5) Incorporated by reference to the registrant s Quarterly Report on Form 10-Q for the quarter ended June 30, 2001.

(6) Incorporated by reference to the registrant s Registration Statement on Form S-3, which became effective July 18, 2001.

(7) Incorporated by reference to the registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 2001.

(8) Incorporated by reference to the registrant s Annual Report on Form 10-K for the year ended December 31, 2000.

(9) Incorporated by reference to the registrant s Annual Report on Form 10-K for the year ended December 31, 2001.

(10) Incorporated by reference to the registrant s Quarterly Report on Form 10-Q for the quarter ended March 31, 2002.

(11) Incorporated by reference to the registrant s Quarterly Report on Form 10-Q for the quarter ended September 30, 2002.

(12) Incorporated by reference to the registrant s Quarterly Report on Form 10-Q for the quarter ended March 31, 2003.

(13) Incorporated by reference to the registrant s Quarterly Report on Form 10-Q/A (Amendment No. 1) for the quarter ended March 31, 2003.

(14) Incorporated by reference to the registrant s Annual Report on Form 10-K/A (Amendment No. 1) for the year ended December 31, 2002.

(15) Incorporated by reference to the registrant s Registration Statement on Form S-8, which was filed on September 15, 2003.

(16) Incorporated by reference to the registrant s Current Report on Form 8-K, which was filed on December 12, 2003.

(17) Incorporated by reference to the registrant s Current Report on Form 8-K, which was filed on January 13, 2004.

(18) Previously filed on March 9, 2004.

(b) Reports on Form 8-K:

1. On December 12, 2003, UTStarcom filed with the SEC a Current Report on Form 8-K (dated December 12, 2003) under Items 5 and 7 in connection with its revised risk factors.

(c) Exhibits

See Item 15(a)(3) above.

107

**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, hereunto duly authorized.

| | | |
|---|---|---|
| | UTSTARCOM, INC. | |
| Date: April 13, 2005 | By: | /s/ MICHAEL J. SOPHIE |
| | Name: | Michael J. Sophie |
| | Title: | Senior Vice President of Finance and Chief Financial Officer |

108

**POWER OF ATTORNEY**

KNOW ALL PERSONS BY THESE PRESENT, that each person whose signature appears below constitutes and appoints Hong Liang Lu and Michael J. Sophie, jointly and severally, his or her attorneys-in-fact, each with the power of substitution, for him in any and all capacities, to sign any amendments to this report on Form 10-K/A, and to file the same, with exhibits thereto and other documents in connection therewith with the Securities and Exchange Commission, hereby ratifying and confirming all that each of said attorneys-in-fact, or his substitute or substitutes may do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

| Signature | | Title | | Date |
|---|---|---|---|---|
| /s/ HONG LIANG LU | | President and Chief Executive Officer (principal | | |
| Hong Liang Lu | | executive officer), Chairman of the Board of Directors | | April 13 , 2005 |
| /s/ MICHAEL J. SOPHIE | | Senior Vice President of Finance and Chief Financial | | |
| Michael J. Sophie | | Officer (principal financial and accounting officer) | | April 13 , 2005 |
| /s/ BETSY S. ATKINS | | Director | | |
| Betsy S. Atkins | | | | April 13 , 2005 |
| /s/ JEFF CLARKE | | Director | | |
| Jeff Clarke | | | | April 13 , 2005 |
| /s/ LARRY D. HORNER | | Director | | |
| Larry D. Horner | | | | April 13 , 2005 |
| /s/ ALLEN LENZMEIER | | Director | | |
| Allen Lenzmeier | | | | April 13 , 2005 |
| /s/ THOMAS J. TOY | | Director | | |
| Thomas J. Toy | | | | April 13 , 2005 |
| /s/ YING WU | | Director | | |
| Ying Wu | | | | April 13 , 2005 |

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON FINANCIAL STATEMENT SCHEDULES**

To the Board of Directors and Stockholders of UTStarcom, Inc.:

Our audits of the consolidated financial statements referred to in our report dated February 27, 2004, except for Note 24, as to which the date is April 12, 2005, appearing in this Annual Report on Form 10-K/A also included an audit of the financial statement schedules listed in Item 15(a)(2) of this Form 10-K. In our opinion, these financial statement schedules present fairly, in all material respects, the information set forth therein when read in conjunction with the related consolidated financial statements.

/s/ PricewaterhouseCoopers LLP
San Francisco, California
February 27, 2004, except for Note 24 to the consolidated financial statements, as to which the date is April 12, 2005

**SCHEDULE I**

**UTSTARCOM, INC. (UNCONSOLIDATED PARENT-COMPANY BASIS)**
**REGISTRANT BALANCE SHEETS**
**(in thousands, except share and per share data)**

| | December 31, 2003 Restated(1) | December 31, 2002 |
|---|---|---|
| **ASSETS** | | |
| Current assets: | | |
| Cash and cash equivalents | $ 71,230 | $ 117,003 |
| Short-term investments | 9,139 | 80,662 |
| Accounts receivable- unrelated party, net of allowances for doubtful accounts | 35,843 | 5,403 |
| Accounts receivable- related party | 43,944 | 835 |
| Accounts receivable- intercompany | 442,480 | 228,679 |
| Inventories | 15,427 | 9,668 |
| Deferred costs/Inventories at customer sites under contracts | 38,308 | 28,296 |
| Income tax receivable | 10,677 | |
| Prepaids | 19,599 | 9,959 |
| Restricted cash and short-term investments | 20,461 | 9,779 |
| Deferred tax assets | 7,432 | 8,586 |
| Other current assets | 962 | 4,359 |
| Total current assets | 715,502 | 503,229 |
| Property, plant and equipment, net | 32,031 | 12,254 |
| Note receivable | 11,222 | |
| Investment in affiliated companies | 493,163 | 346,645 |
| Goodwill | 98,015 | 43,542 |
| Intangible assets, net | 44,949 | 5,014 |
| Deferred tax assets | 11,070 | 9,335 |
| Other long-term assets | 19,226 | 6,076 |
| Total assets | $ 1,425,178 | $ 926,095 |
| **LIABILITIES AND STOCKHOLDERS EQUITY** | | |
| Current liabilities: | | |
| Accounts payable | $ 56,256 | $ 113,180 |
| Income taxes payable | | 6,099 |
| Customer advances | 13,940 | 17,141 |
| Deferred revenue | 24,966 | 1,793 |
| Other | 36,196 | 21,487 |
| Total current liabilities | 131,358 | 159,700 |
| Long-term debt | 402,500 | |
| Stockholders equity: | | |
| Common stock: $.00125 par value; authorized: 750,000,000 shares; issued and outstanding: 104,272,477 and 106,787,908 at December 31, 2003 and 2002, respectively | 131 | 135 |
| Additional paid-in capital | 654,483 | 658,546 |
| Deferred stock compensation | (7,761) | (11,766) |
| Retained earnings | 243,058 | 120,520 |
| Receivable from stockholders | | (282) |
| Accumulated other comprehensive income (loss) | 1,409 | (758) |
| Total stockholders equity | 891,320 | 766,395 |
| Total liabilities and stockholders equity | $ 1,425,178 | $ 926,095 |

(1) See Note 2

The accompanying notes are an integral part of these financial statements.

111

**SCHEDULE I**

**UTSTARCOM, INC. (UNCONSOLIDATED PARENT-COMPANY BASIS)**

**CONDENSED INFORMATION AS TO THE RESULTS OF OPERATIONS OF THE REGISTRANT**

**(in thousands)**

| | Years ended December 31, | | |
|---|---|---|---|
| | 2003 | 2002 | 2001 |
| | Restated(1) | | |
| Net sales | | | |
| Unrelated party | $ 100,115 | $ 35,365 | $ 46,999 |
| Related party | 184,436 | 16,038 | 13,900 |
| Inter-company | 724,708 | 307,862 | 290,474 |
| | 1,009,259 | 359,265 | 351,373 |
| Cost of sales | | | |
| Unrelated party | 50,157 | 24,306 | 26,908 |
| Related party | 79,518 | 8,635 | 7,336 |
| Inter-company | 646,016 | 276,603 | 260,751 |
| Gross profit | 233,568 | 49,721 | 56,378 |
| Operating expenses: | | | |
| Selling, general and administrative | 57,666 | 38,793 | 25,199 |
| Research and development | 46,588 | 9,146 | 56,937 |
| In-process research and development costs | 10,686 | 670 | 4,720 |
| Amortization of intangible assets | 8,370 | 2,395 | 7,440 |
| Total operating expenses | 123,310 | 51,004 | 94,296 |
| Operating income | 110,258 | (1,283) | (37,918) |
| Interest income | 2,709 | 4,454 | 7,832 |
| Interest expense | (4,142) | (16) | (644) |
| Other income (expenses), net | (18,404) | 18,964 | (1,737) |
| Equity in net income of affiliated companies | 144,520 | 98,396 | 99,506 |
| Income before income taxes | 234,941 | 120,515 | 67,039 |
| Income tax expense | 19,409 | 12,653 | 10,085 |
| Net income | $ 215,532 | $ 107,862 | $ 56,954 |

(1) See Note 2

The accompanying notes are an integral part of these financial statements.

112

**SCHEDULE I**

**UTSTARCOM, INC. (UNCONSOLIDATED PARENT-COMPANY BASIS)**
**CONDENSED INFORMATION AS TO THE CASH FLOWS OF THE REGISTRANT**
**(In thousands)**

| | Years ended December 31, | | |
|---|---|---|---|
| | 2003 Restated(1) | 2002 | 2001 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income | $ 215,532 | $ 107,862 | $ 56,954 |
| Adjustments to reconcile net income to net cash used in operating activities: | | | |
| Gain or change in ownership interest in subsidiary | | | (277) |
| Depreciation and amortization | 25,235 | 13,202 | 15,218 |
| Non-qualified stock option exercise tax benefits | 15,364 | 6,538 | 15,311 |
| In-process research and development costs | 10,686 | 670 | 4,720 |
| Impairment of long-term investments | 75 | 4,442 | 3,376 |
| Loss on sale of assets | 620 | 449 | 527 |
| Warrants adjustment to fair value | (424) | | |
| Loss on sale of investment | 73 | | |
| Amortization of debt issuance costs | 1,953 | | |
| Deferred income taxes | 4,471 | (6,980) | (8,173) |
| Allowance for doubtful accounts | 813 | 124 | |
| Inventory reserve | 3,328 | 5,446 | 11,143 |
| Stock compensation expense | 4,302 | 3,100 | 5,201 |
| Equity in net income of affiliated companies | (145,375) | (95,608) | (97,816) |
| Changes in operating assets and liabilities: | | | |
| Accounts receivable | (288,163) | (120,122) | (10,288) |
| Inventories | (2,742) | (9,626) | (11,583) |
| Deferred costs/Inventories at customer sites under contracts | (10,012) | (18,815) | 4,385 |
| Other current and non-current assets | (15,611) | (680) | (10,887) |
| Accounts payable | (56,924) | 98,947 | (7,440) |
| Income taxes payable | (6,099) | (1,356) | 3,459 |
| Customer advances | (3,201) | 14,511 | (4,935) |
| Deferred revenue | 13,505 | (4,451) | 2,352 |
| Other current liabilities | 10,637 | 4,649 | 2,956 |
| Net cash used in operating activities | (221,957) | 2,302 | (25,797) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Additions to property, plant and equipment | (29,745) | (980) | (19,853) |
| Investment in affiliates, net of cash acquired | (8,920) | (27,447) | (18,135) |
| Acquisition of business, net of cash acquired | (111,720) | (17,705) | |
| Purchase of intangible assets | (2,340) | | (1,078) |
| Issuance of note receivable to related party | (10,071) | | |
| Change in restricted cash | (10,682) | (9,779) | |
| Purchase of short-term investments | (10,775) | (85,688) | (89,625) |
| Sales of short-term investments | 93,246 | 89,916 | 87,516 |
| Net cash used in investing activities | (91,007) | (51,683) | (41,175) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Issuance of stock, net of expenses | 58,878 | 40,928 | 160,550 |
| Repurchase of stock | (139,609) | (72,929) | |
| Proceeds (payments) from borrowing, net | 391,431 | | (5) |
| Purchase of convertible bond hedge and call option | (43,792) | | |
| Proceeds from stockholder notes | 282 | 99 | (67) |
| Net cash provided by (used in) financing activities | 267,190 | (31,902) | 160,478 |
| Effects of exchange rates on cash | 1 | 1 | (26) |
| Net increase (decrease) in cash and cash equivalents | (45,773) | (81,282) | 93,480 |
| Cash and cash equivalents at beginning of period | 117,003 | 198,285 | 104,805 |
| Cash and cash equivalents at end of period | $ 71,230 | $ 117,003 | $ 198,285 |

(1) See Note 2

The accompanying notes are an integral part of these financial statements.

**SCHEDULE I**

**UTSTARCOM, INC.**
**NOTES TO CONDENSED FINANCIAL STATEMENTS**

## NOTE 1 BASIS OF PRESENTATION

UTStarcom, Inc., a Delaware corporation, is the parent company of all UTStarcom, Inc. subsidiaries. The accompanying condensed financial statements reflect the financial position, results of operations and cash flows of UTStarcom, Inc. on a separate basis. All subsidiaries of UTStarcom, Inc. are reflected as investments accounted for using the equity method. Accordingly, intercompany transactions have not been eliminated. Inventory balances at December 31, 2003, and 2002 include inter-company profit of $2.3 million and $1.9 million, respectively. No cash dividends were paid to UTStarcom, Inc. by its subsidiaries during the three years ended December 31, 2003. For accounting policies and other information, see the Notes to Consolidated Financial Statements included elsewhere herein.

## NOTE 2 RESTATEMENT OF FINANCIAL STATEMENTS

As discussed in Note 24 to the Consolidated Financial Statements, the Company has restated its Consolidated Financial Statements for the year ended December 31, 2003, and the quarters ended March 31, 2003, June 30, 2003 and September 30, 2003 to correct errors and reflect certain corresponding changes described below. See Note 24 to the Consolidated Financial Statements for a discussion of the errors and the effect on the Consolidated Financial Statements. The Condensed Financial Statements have been restated to reflect the effect of the restatement on the parent company.

The restatement corrects certain errors in the 2003 income tax provision calculation. The correction of these errors decreased the provision for income taxes by $20.2 million and increased equity in net income of affiliated companies by $0.6 million, resulting in an increase of net income of $20.7 million for the year ended December 31, 2003. In addition, as a result of the correction of the tax provision, in the aggregate, retained earnings was increased by $20.7 million, additional paid-in capital was increased $0.9 million, income tax receivable was increased by $4.7 million, prepaids were increased by $17.0 million, other current assets were reduced by $6.6 million, investment in affiliates was increased $0.6 million and other long-term assets were increased by $5.9 million. There was no net effect on cash provided from operating activities as a result of the restatement.

In addition to the errors in the 2003 tax provision, the Company did not correctly identify a related party who is deemed a variable interest entity and with whom the Company is considered the primary beneficiary in accordance with FASB Interpretation No. 46 ( FIN 46 ). The Company restated its 2003 financial statements to reflect the consolidation of MDC Holding Limited ( MDC Holding ) and its affiliated entities (MDC Holding and such affiliated entities are referred to, collectively, as MDC ). The correction to include MDC in the consolidated financial statements had no impact on parent-company basis financial statements of the parent, UTStarcom, Inc.

Furthermore, an impairment charge of $7.4 million, net of taxes of $1.3 million, was recorded to reflect an impairment of MDC equipment subject to a revenue share arrangement. At December 31, 2003 this impairment decreased equity in income of affiliated companies, net income, total assets, and equity by $7.4 million.

In addition, the Company identified the following revisions in classification during the preparation of the restated consolidated financial statements:

(1) Cost of sales for related party revenue transactions is presented separately from cost of sales for non-related party revenue transactions for all years presented;

(2) Certain other long-term assets increased and intangible assets decreased by $1.7 million at December 31, 2003;

(3) Changes in restricted cash had been incorrectly categorized as a part of operating cash flows instead of investing cash flows in accordance with Statement of Financial Accounting Standards No. 95, Statement of Cash Flows, ( SFAS 95 ). Accordingly, the Company has reflected this change in categorization in the Consolidated Statement of Cash Flows for each of the three years in the period ended December 31, 2003. The change for 2003 and 2002 is an increase in cash flows from operating activities and a decrease in cash flows from investing activities of $10.7 million and $9.8 million, respectively, and there was no change for 2001; and

(4) A related party which is 31% owned by an individual related to a member of the Company s Board of Director and associated transactions have been identified. See Note 22 to the Consolidated Financial Statements.

In connection with the restatement of the 2003 Consolidated Financial Statements, certain reclassifications have been made in the 2002 financial statements to conform to the 2003 presentation. As a result of this reclassification, prepaids at December 31, 2002 which were previously reported as $4.9 million increased to $10.0 million and deferred tax assets at December 31, 2002, which were previously reported as $13.6 million decreased to $8.6 million. This reclassification had no impact on previously reported net income or stockholders equity.

The following table shows the effect of the restatement and other revisions in classification (in thousands, except per share data):

| | As Previously Reported | As Restated |
|---|---|---|
| As of December 31, 2003: | | |
| Income tax receivable | $ 5,930 | $ 10,677 |
| Prepaids | 2,605 | 19,599 |
| Deferred tax assets current | 14,038 | 7,432 |
| Investment in affiliates | 500,036 | 493,163 |
| Intangible assets, net | 46,651 | 44,949 |
| Deferred tax assets | 5,192 | 11,070 |
| Other long-term assets | 17,524 | 19,226 |
| Additional paid-in capital | 653,624 | 654,483 |
| Retained earnings | 229,777 | 243,058 |
| For the year ended December 31, 2003: | | |
| Equity in income of affiliated companies | 151,393 | 144,520 |
| Income before income taxes | 241,814 | 234,941 |
| Income tax expense | 39,563 | 19,409 |
| Net Income | 202,251 | 215,532 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net income | 202,251 | 215,532 |
| Adjustment to reconcile net income to net cash provided by operating activities: | | |
| Non-qualified stock option exercise tax benefits | 14,505 | 15,364 |
| Deferred income taxes | 3,743 | 4,471 |
| Equity in net income of affiliated companies | (152,248) | (145,375) |
| Changes in operating assets and liabilities: | | |
| Other current and non-current assets | (4,552) | (15,611) |
| Net cash provided by operating activities | (232,639) | (221,957) |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | |
| Change in restricted cash | | (10,682) |
| Net cash used in investing activities | (80,325) | (91,007) |

**SCHEDULE II**

**UTSTARCOM, INC.**
**Valuation and Qualifying Accounts and Reserves**
**For the Years Ended December 31, 2003, 2002 and 2001.**
**(In thousands)**

| Description | Balance at beginning of the period | Additions charged to costs and expenses | Additions assumed upon acquisition | Deductions Restated(1) | Balance at end of the period Restated(1) |
|---|---|---|---|---|---|
| ***Year ended December 31, 2003*** | | | | | |
| Inventory reserve | $ 18,287 | $14,626 | $ 6,345 | $ 9,698 | $ 29,560 |
| Deferred cost reserve | $ 14,453 | $ | $ | $ 6,845 | $ 7,608 |
| Allowance for doubtful accounts | $ 26,250 | $ 5,025 | $ | $ 103 | $ 31,172 |
| Accrued product warranty costs | $ 13,297 | $ 36,523 | $ 1,381 | $ 24,934 | $ 26,267 |
| Tax valuation allowance | $ 4,964 | $ | $ | $ 4,636 | $ 328 |
| ***Year ended December 31, 2002*** | | | | | |
| Inventory reserve | $ 17,744 | $ 7,084 | $ | $ 6,541 | $ 18,287 |
| Deferred cost reserve | $ 2,600 | $ 11,853 | $ | $ | $ 14,453 |
| Allowance for doubtful accounts | $ 19,053 | $ 7,434 | $ | $ 237 | $ 26,250 |
| Accrued product warranty costs | $ 6,271 | $ 15,156 | $ | $ 8,130 | $ 13,297 |
| Tax valuation allowance | $ 4,787 | $ 177 | $ | $ | $ 4,964 |
| ***Year ended December 31, 2001*** | | | | | |
| Inventory reserve | $ 8,025 | $ 9,719 | $ | $ | $ 17,744 |
| Deferred cost reserve | $ 1,176 | $ 1,424 | $ | $ | $ 2,600 |
| Allowance for doubtful accounts | $ 12,835 | $ 6,218 | $ | $ | $ 19,053 |
| Accrued product warranty costs | $ 3,133 | $ 6,792 | $ | $ 3,654 | $ 6,271 |
| Tax valuation allowance | $ 4,153 | $ 634 | $ | $ | $ 4,787 |

(1) In connection with the correction of the tax provision calculation, the tax valuation allowance increased from zero to $0.3 million at December 31, 2003. See Note 24 to the consolidated financial statements.

117