TERAYON COMMUNICATION SYSTEMS
Form 10-Q
July 27, 2004

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED June 30, 2004
OR

[_] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE TRANSITION PERIOD FROM ______________ TO ______________.

TERAYON COMMUNICATION SYSTEMS, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

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

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

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

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

As of July 20, 2004 registrant had outstanding 75,562,071 shares of Common Stock.

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SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

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

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

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

	June 30, 2004	December 31, 2003
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 47,783	$ 30,188
Short-term investments	68,489	108,452
Accounts receivable, net	26,779	29,199
Accounts receivable from related parties	1,105	600
Other current receivables	2,339	3,662
Inventory	21,403	16,364
Other current assets	1,982	2,883
Total current assets	169,880	191,348
Property and equipment, net	10,045	11,871
Restricted cash	9,212	9,212
Other assets, net	2,220	2,809
Total assets	$ 191,357	$ 215,240
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 16,480	$ 26,049
Accrued payroll and related expenses	4,919	6,537
Deferred revenues	5,091	3,423
Warranty reserves	4,191	5,509
Accrued executive severance and restructuring charges	9,070	4,500
Accrued vendor cancellation charges	713	2,869
Other accrued liabilities	4,382	5,036
Interest payable and current portion of long-term debt	1,356	1,358
Other current obligations	6	124
Total current liabilities	46,208	55,405
Long-term obligations	3,156	3,366
Convertible subordinated notes	65,081	65,081
Commitments and contingencies		
Stockholders equity:		
Common stock	76	75
Additional paid in capital	1,082,811	1,082,036

Accumulated deficit	(1,002,668)	(987,560)
Deferred compensation		(22)
Treasury stock, at cost	(773)	(773)
Accumulated other comprehensive loss	(2,534)	(2,368)
Total stockholders equity	76,912	91,388
Total liabilities and stockholders equity	$ 191,357	$ 215,240

See accompanying notes.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	2003	2004	2003
Revenues	$40,138	$ 29,964	$ 80,560	$ 50,404
Related party revenues	2,644	635	3,389	2,463
Total revenues	42,782	30,599	83,949	52,867
Cost of revenues	27,046	23,549	55,598	42,200
Cost of related party revenues	614	187	832	1,128
Total cost of revenues	27,660	23,736	56,430	43,328
Gross profit	15,122	6,863	27,519	9,539
Operating expenses:				
Research and development	8,516	10,432	17,984	23,434
Sales and marketing	5,411	6,560	12,632	13,290
General and administrative	2,953	3,000	5,388	6,728
Executive severance, restructuring costs and asset write-offs	3,579	(115)	6,946	3,046
Total operating expenses	20,459	19,877	42,950	46,498
Loss from operations	(5,337)	(13,014)	(15,431)	(36,959)
Interest income	460	909	912	1,811
Interest expense	(826)	(814)	(1,643)	(1,651)
Other income (expense)	921	(160)	1,200	(200)
Loss before income tax expense	(4,782)	(13,079)	(14,962)	(36,999)
Income tax expense	(79)	(60)	(146)	(129)
Net loss	$ (4,861)	$(13,139)	$(15,108)	$(37,128)
Net loss per share, basic and diluted	$ (0.06)	$ (0.18)	$ (0.20)	$ (0.50)

Shares used in per share calculation, basic and diluted	75,551	73,721	75,534	73,715

See accompanying notes.

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

	Six Months Ended June 30,	
	2004	**2003**
Operating activities:		
Net loss	$ (15,108)	$ (37,128)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation	3,319	5,155
Amortization related to stock options	17	8
Lower of cost or market inventory (provision) recovery	969	(5,828)
Write-off and disposal of fixed assets	130	485
Changes in operating assets and liabilities:		
Accounts receivable	2,420	(6,845)
Accounts receivable from related parties	(505)	277
Inventory	(6,008)	8,560
Other current and non-current assets	2,813	6,573
Accounts payable	(9,569)	(4,087)
Accrued payroll and related expenses	(1,618)	52
Deferred revenues	1,668	1,047
Accrued warranty	(1,318)	(434)
Accrued executive severance and restructuring	4,570	(1,248)
Accrued vendor cancellation charges	(2,156)	(8,685)
Other accrued liabilities	(806)	(1,836)
Net cash used in operating activities	(21,182)	(43,934)
Investing activities:		
Purchases of short-term investments	(78,000)	(107,058)
Proceeds from sales and maturities of short-term investments	117,429	102,631
Purchases of property and equipment	(1,623)	(1,355)
Net cash provided by (used in) investing activities	37,806	(5,782)
Financing activities:		
Principal payments on capital leases	(178)	(63)
Proceeds from issuance of common stock	781	619

Net cash provided by financing activities	603	556
Effect of exchange rate changes	368	547
Net increase (decrease) in cash and cash equivalents	17,595	(48,613)
Cash and cash equivalents at beginning of period	30,188	117,079
Cash and cash equivalents at end of period	$ 47,783	$ 68,466

See accompanying notes.

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

1. Organization and Summary of Significant Accounting Policies

Description of Business

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

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

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial statements at June 30, 2004 and for the three and six months ended June 30, 2004 and 2003 have been included.

Results for the three and six months ended June 30, 2004 are not necessarily indicative of results for the entire fiscal year or future periods. These financial statements should be read in conjunction with the consolidated financial statements and the accompanying notes included in the Company s Form 10-K dated March 15, 2004, as filed with the U.S. Securities and Exchange Commission. The accompanying balance sheet at December 31, 2003 is derived from audited consolidated financial statements at that date.

Reclassifications

Certain amounts in the 2003 financial statements have been reclassified to conform to the 2004 presentation.

Basis of Consolidation

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

Use of Estimates

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

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Stock-Based Compensation

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

For purposes of pro forma disclosures, the estimated fair value of the options granted and employee stock purchase plan shares to be issued is amortized to expense over their respective vesting periods. Had compensation cost for the Company s stock-based compensation plans been determined based on the fair value at the grant dates for awards under those plans consistent with the method of SFAS No. 123, the Company s net loss applicable to common stockholders and net loss per share applicable to common stockholders would have been increased to the pro forma amounts indicated below (in thousands, except per share data):

	Three months ended June 30,		Six months ended June 30,	
	2004	**2003**	**2004**	**2003**
Net loss, as reported	$ (4,861)	$(13,139)	$(15,108)	$(37,128)
Add: Stock-based compensation under APB 25		3		8
Deduct: Stock option compensation expense determined under fair value-based method	(3,703)	(5,411)	(8,213)	(11,588)
Employee stock purchase plan compensation expense determined under fair value-based method	(357)	(301)	(713)	(1,280)
Pro forma net loss	$ (8,921)	$(18,848)	$(24,034)	$(49,998)
Pro forma net loss per share, basic and diluted	$ (0.12)	$ (0.26)	$ (0.32)	$ (0.68)
Shares used in computing pro forma net loss per share, basic and diluted	75,551	73,721	75,534	73,715

Inventory

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

	June 30, 2004	December 31, 2003
Raw materials	$ 3,597	$ 1,440
Work-in-process	211	660
Finished goods	17,595	14,264
Total inventory	$21,403	$16,364

Purchase Obligations

The Company has purchase obligations to certain of its suppliers that support the Company s ability to manufacture its products. The obligations consist of purchase orders placed with vendors for

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goods and services and require the Company to purchase minimum quantities of the suppliers products at a specified price. As of June 30, 2004, $27.0 million of purchase obligations were outstanding. The Company accrues for vendor cancellation charges in amounts, which represent management s estimate of the Company s exposure to vendors for its inventory commitments. At June 30, 2004, accrued vendor cancellation charges were $0.7 million and the remaining $26.3 million was attributable to open purchase orders in the normal course of business. The remaining obligations are expected to become payable at various times throughout 2004.

For the three and six months ended June 30, 2004, the Company reversed approximately $0.8 million and $2.1 million, respectively of accrued vendor cancellation charges, which were previously recorded as cost of goods sold. For the three and six months ended June 30, 2003, the Company reversed approximately $2.1 million and $4.4 million, respectively of accrued vendor cancellation charges. The Company reversed these charges as it was able to negotiate downward certain vendor cancellation to more favorable terms. Additionally, during the three and six months ended June 30, 2004, the Company reversed approximately $0.3 million and $0.8 million, respectively, of inventory provisions, which were previously recorded as cost of goods sold. During the three and six months ended June 30, 2003, the Company reversed approximately $1.0 million and $1.7 million, respectively of inventory provisions. The Company reversed these provisions as it was able to sell inventory originally considered to be excess or obsolete.

Net Loss Per Share

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
Net loss	$ (4,861)	$ (13,139)	$ (15,108)	$ (37,128)
Shares used in computing basic and diluted net loss per share	75,551	73,721	75,534	73,715
Basic and diluted net loss per share	$ (0.06)	$ (0.18)	$ (0.20)	$ (0.50)

Options and warrants to purchase 15,836,009 and 17,394,492 shares of common stock were outstanding at June 30, 2004 and June 30, 2003, respectively, but were not included in the computation of diluted net loss per share, since the effect would have been antidilutive.

Accumulated Other Comprehensive Loss

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

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2004	**2003**	**2004**	**2003**
Net loss	$(4,861)	$(13,139)	$(15,108)	$(37,128)
Cumulative translation adjustments	444	516	368	547
Change in unrealized loss on available-for-sale investments	(537)	(188)	(534)	(411)
Total comprehensive net loss	$(4,954)	$(12,811)	$(15,274)	$(36,992)

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Impact of Recently Issued Accounting Standards

In January 2003, the Financial Accounting Standards Board (FASB) issued FASB Interpretation No. 46 (FIN No. 46), Consolidation of Variable Interest Entities, an interpretation of ARB No. 51 . FIN No. 46 requires existing unconsolidated variable interest entities to be consolidated by their primary beneficiaries if the entities do not effectively disperse risks among parties involved. Variable interest entities that effectively disperse risk will not be consolidated unless a single party holds an interest or combination of interests that effectively recombines risks that were previously dispersed. FIN No. 46 also requires enhanced disclosure requirements related to variable interest entities. FIN No. 46 was revised in December 2003 and is effective for the first financial reporting period ending after March 15, 2004. The Company adopted the provisions of FIN No. 46 for the fiscal quarter ending March 31, 2004, and the adoption did not have a material impact on the Company s financial statements.

In March 2004, the FASB issued an exposure draft of a proposed standard that, if adopted, will significantly change the accounting for employee stock options and other equity-based compensation. The proposed standard would require companies to expense the fair value of stock options on the grant date and would be effective at the beginning of the Company s 2005 fiscal year. The Company will evaluate the requirements of the final standard, which is expected to be finalized in late 2004, to determine its impact on the Company s results of operations.

2. Contingencies

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

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

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

On October 16, 2000, a lawsuit was filed against the Company and the individual defendants (Zaki Rakib, Selim Rakib and Raymond Fritz) in the California Superior Court, San Luis Obispo County. This

lawsuit is titled *Bertram v. Terayon Communications Systems, Inc*. The factual allegations in the *Bertram* complaint were similar to those in the federal class action, but the *Bertram* complaint sought remedies under state law. Defendants removed the *Bertram* case to the United States District Court, Central District of California, which dismissed the complaint and transferred the case to the United States District Court, Northern District of California. That Court eventually issued an order dismissing the case. Plaintiffs have appealed this order, and their appeal was heard on April 16, 2004. On June 9, 2004, the United States Court of Appeals for the Ninth Circuit affirmed the order dismissing the *Bertram* case.

The Court of Appeals opinion affirming dismissal of the *Bertram* case does not end the class action, and the plaintiffs in the *Bertram* case may still seek review of the Court of Appeals decision. The Company believes that the allegations in both the class action and the *Bertram* case are without merit, and the Company intends to contest these matters vigorously. These matters, however, could prove costly and time consuming to defend, and there can be no assurances about the eventual outcome.

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

The Company believes that there are many defects in the *Campbell* and *O Brien* derivative complaints.

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

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

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3. Operating Segment Information

The Company operates as one business segment.

(in thousands)

	Three months ended June 30,		Six months ended June 30,	
	2004	2003	2004	2003
Revenues by product:				
CMTS products	$10,291	$ 8,631	$21,588	$13,199
CPE products	24,983	17,004	48,597	30,649
Video products	7,508	3,699	13,579	6,532
Other products		1,265	185	2,487
Total revenues	$42,782	$30,599	$83,949	$52,867
Revenues by geographic areas:				
United States	$21,226	$17,672	$43,058	$31,179
Canada	224	(309)	1,838	736
Europe, Middle East, Africa Region (EMEA), excluding Israel	7,041	7,369	14,965	10,700
Israel	5,931	399	9,215	811
Japan	3,294	3,646	5,688	6,812
Asia, excluding Japan	5,037	1,811	9,132	2,610
South America	29	11	53	19
Total	$42,782	$30,599	$83,949	$52,867

	June 30, 2004	December 31, 2003
Long-lived assets:		
United States	$ 17,311	$ 19,630
Canada	576	810
Europe	138	175
Israel	3,391	3,104
Asia	61	173
Total long-lived assets	21,477	23,892

Total current assets	169,880	191,348
Total assets	$191,357	$215,240

Two customers accounted for 10% or more of total revenues (25% and 12%) for the three months ended June 30, 2004. Two customers accounted for 10% or more of total revenues (23% and 10%) for the six months ended June 30, 2004. Five customers accounted for 10% or more of total revenues (16%, 13%, 13%, 13%, and 12%) for the three months ended June 30, 2003. Three customers accounted for 10% or more of total revenues (28%, 11%, and 10%) for the six months ended June 30, 2003.

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

Executive Severance

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

Restructuring

First and Second Quarter 2004 Restructurings

During the first quarter of 2004, the Company approved a restructuring plan. The Company incurred restructuring charges in the amount of $3.3 million in the first quarter of which $1.0 million related to employee termination costs, $0.9 million related to costs to exit an aircraft lease, and $1.4 million related to costs for excess leased facilities. The Company incurred restructuring charges in the amount of $1.15 million in the second quarter related to additional costs for excess leased facilities, which were contemplated in the first quarter plan. Net costs accrued under this restructuring plan, included estimated sublease income from the aircraft and the excess leased facilities. As of June 30, 2004, the employment of 58 employees had been terminated, and the Company had paid $0.8 million in termination costs. The amount of net costs accrued under the first quarter 2004 restructuring plan assumes that the Company will successfully sublease the aircraft and excess leased facilities. The reserve for the aircraft lease and excess leased facilities was based on information provided by the Company s brokers that estimated, based on

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assumptions relevant to the aircraft and real estate market conditions as of the date of the Company s plan, the time it would be likely to take until the aircraft and excess facilities would be fully sub-leased. Even though it is the intent of the Company to sublease, assign or sell its interests in the aircraft and excess facilities at the earliest possible time, the Company cannot determine with certainty a fixed date by which such events will occur. In light of this uncertainty, based on estimates, the Company periodically re-evaluates and adjusts the reserve, as necessary. The Company currently anticipates the remaining restructuring accrual related to employee termination costs to be substantially utilized by the end of 2004. The remaining restructuring accrual related to the aircraft lease is expected to be substantially utilized for servicing operating lease payments of operating lease commitments, through January 2007, and the remaining restructuring accrual related to excess leased facilities, is expected to be utilized for servicing operating lease payments through October 2009.

In the second quarter of 2004, the Company re-evaluated the first quarter 2004 restructuring charge for the aircraft lease termination. Based on market conditions and new assumptions provided by the Company s broker, the Company increased the charge for the aircraft lease termination by $0.8 million.

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

	Involuntary Terminations	Aircraft Lease Termination	Excess Leased Facilities	Total
Total charge for the first quarter of 2004	$ 952	$ 934	$ 1,375	$ 3,261
Additional charges for the second quarter of 2004			1,148	1,148
Cash payments	(795)	(618)	(238)	(1,651)
Revaluation		812	(63)	749
Balance at June 30, 2004	$ 157	$ 1,128	$ 2,222	$ 3,507

2003 Restructuring

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

2002 and 2001 Restructurings

During 2001, a restructuring plan was approved and the Company incurred restructuring charges in the amount of $12.7 million of which $2.7 million remained accrued at June 30, 2004, for excess leased facilities. During 2002, another restructuring plan was approved, which increased the reserve for excess leased facilities due to the exiting of additional space within the same facility. The Company incurred restructuring charges in the amount of $3.6 million for the 2002 restructuring of which $1.2 million remained accrued at June 30, 2004 for excess leased facilities. The Company currently anticipates the remaining restructuring accrual relating to excess leased facilities, will be utilized

for servicing operating lease payments or negotiating a buyout of operating lease commitments, through 2005.

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

	Excess Leased Facilities
Balance at December 31, 2003	$ 4,500
Cash Payments	(619)
Balance at June 30, 2004	$ 3,881

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Asset Write-offs

For the six months ended June 30, 2004, the Company wrote off $0.1 million, of fixed assets, which were determined to have no remaining useful life. For the six months ended June 30, 2003, the Company wrote off $0.5 million of fixed assets, which were determined to have no remaining useful life. The Company did not write-off any fixed assets during the three months ended June 30, 2004 or June 30, 2003.

5. Related Party Transactions

Lewis Solomon, a member of the Company s Board of Directors and a member of the Company s Nominating and Governance Committee and Compensation Committee, is also a member of the Board of Directors of Harmonic, Inc. (Harmonic). Additionally, Harmonic is an authorized, non-exclusive reseller of certain of the Company s video products. For the three and six months ended June 30, 2004, related party revenue included $2.6 million and $3.4 million, respectively, of revenue from Harmonic. For the three and six months ended June 30, 2003, related party revenue included $0.6 million and $1.0 million, respectively, of revenue from Harmonic.

Alek Krstajic, a member of the Company s Board of Directors, was the Senior Vice President of Interactive Services, Sales and Product Development for Rogers Communications, Inc. (Rogers) until January 2003. Beginning April 1, 2003, the Company no longer recognized revenues related to Rogers as related party revenue because Rogers was no longer considered to be a related party. For the six months ended June 30, 2003, the Company recognized $1.5 million of Rogers s related party revenue, net of amortization of co-marketing expense.

In the six months ended June 30, 2004, the Company paid Mr. Krstajic $30,000 for consulting service provided to the Company.

In December 2001, the Company entered into a co-marketing arrangement with Rogers to promote the Company s brand and identify its products. The Company paid $0.9 million to Rogers, and recorded this amount as other current assets. In July 2002, the Company began amortizing this prepaid asset and charging it against revenue in accordance with the Emerging Issues Task Force 01-09, Accounting for Consideration given by a Vendor to a Customer or Reseller in Connection with the Purchase or Promotion of the Vendor s Products. Amounts charged against revenues in the three and six months ended June 30, 2003, totaled approximately $1.4 million and $2.8 million, respectively. This asset was fully amortized during 2003.

Cost of related party revenues in the Company s consolidated statements of operations consists of direct and indirect costs. Accounts receivable from Harmonic totaled approximately $1.1 million at June 30, 2004. None of the related parties is a supplier to the Company.

6. Sale of Assets

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

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7. Product Warranties

The Company provides for estimated product warranty expenses when it sells the related products. Because warranty estimates are forecasts based on the best available information mostly historical claims experience claims costs may differ from amounts provided. An analysis of changes in the liability for product warranties for the six months ended June 30, 2003 and 2004, is as follows (in thousands):

	Balance at Beginning of Period	Additions Charged to Expenses	Expiration of Accrued Warranty	Charges for Warranty Services Provided	Balance at End of Period
Six months ended June 30, 2003					
Warranty reserve	$8,607	1,010		(1,444)	$8,173
Six months ended June 30, 2004					
Warranty reserve	$5,509	1,922	(1,300)	(1,940)	$4,191

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

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

Overview

We develop, market and sell cable modem termination systems (CMTS), customer premise equipment (CPE) products, including cable modems, and digital video equipment. Our revenues are generated principally from sales of these three major product groups either directly to broadband service providers through direct sales forces primarily in North America, Europe and Asia or indirectly through resellers.

In 2003, we completed the transition from selling proprietary-based products to selling standards-based products using the Data Over Cable System Interface Specification (DOCSIS) 2.0 specification. Due primarily to the adoption of DOCSIS 2.0, we now generate DOCSIS CMTS and cable modem sales to U.S. cable operators as well as to global customers.

Our gross margins fluctuate from period to period primarily as a result of the mix of products we sell. Specifically, we derive substantially higher margins from sales of our CMTS and digital video equipment products than we do from sales of our CPE products, which are subject to intense price competition. To date a majority of our total revenues have been generated from sales of our CPE products. We anticipate that the erosion of average selling prices (ASPs) of our CPE products will continue. We also believe that the widespread adoption of industry specifications, such as the DOCSIS specifications, will further erode ASPs. We are working to mitigate pressures on our gross margins by continuing to focus on product manufacturing cost reductions, especially for our CPE products. In the first quarter of 2004, we largely completed our transition to a new original design manufacturer (ODM) in Asia for our CPE products. To the extent that the containment of our product costs do not keep pace with ASP declines, our gross margins will be adversely affected.

We have not been profitable since our inception. For the three and six months ended June 30, 2004, we had a net loss of $4.9 million and $15.1 million, respectively. We believe our ability to achieve profitability in the long term will depend primarily on three factors. The first factor is our ability to achieve improved gross margins through an improved sales mix by increasing sales of higher margin digital video and CMTS products relative to the sales of CPE products. To increase sales of digital video products, we are targeting new markets such as the broadcast sector and promoting new applications such as high definition television (HDTV) and digital insertion to cable and satellite operators. To grow the CMTS business, we will attempt to capitalize on our DOCSIS 2.0 expertise and provide application solutions for DOCSIS 2.0 advanced services, including voice over Internet Protocol (VoIP) and commercial services. To the extent that sales of CPE products continue to comprise a greater proportion of our total revenues, our ability to achieve profitability in the future could be adversely affected. Secondly, we will continue to focus on lowering product costs for our CPE products through our new ODM relationship in Asia and the introduction of our new lower cost semiconductor, which is used in our CPE products. In our CMTS business, we will continue to reduce costs through improved designs, better leveraging of our contract manufacturer supply network, and the reduction of sole source components. Finally, as discussed below, we expect to benefit from a lower expense base resulting in part from restructuring activities in the first and second quarters of 2004 combined with continued focus on cost containment. Beginning in the second quarter of 2004, we anticipate annual savings of approximately $10.0 million derived from restructuring activities. Furthermore, as part of our restructuring efforts to refocus our business, we will continue to divest unprofitable product lines in an effort to focus on growing our business and redirect our resources. However, despite these efforts, we may not succeed in attaining profitability in the near future, if at all.

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At June 30, 2004, we had approximately $116.3 million in cash, cash equivalents and short-term investments as compared to approximately $138.6 million at December 31, 2003. The decrease in the first half of 2004 primarily resulted from the use of cash for operating activities. Although we believe that our current cash balances will be sufficient to satisfy our cash requirements for at least the next 12 months, we may need to raise additional funds in order to support more rapid expansion, develop new or enhanced services, respond to competitive pressures, acquire complementary businesses or technologies or respond to unanticipated requirements. There can be no assurance that additional financing will be available on acceptable terms, if at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to continue operations, develop our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could have a material adverse effect on our business, financial condition and operating results.

Our ability to grow our business and attain profitability is dependent on our ability to effectively compete in the marketplace with our current products and services, develop and introduce new products and services, contain operating expenses and improve our gross margins, as well as the continued recovery of the communications industry. A more detailed description of the risks to our business can be found in the section captioned Risk Factors .

In the third quarter of 2004, Jerry Chase was appointed as the Company s new Chief Executive Officer, and Arthur Taylor, the Company s Chief Financial Officer, resigned.

Critical Accounting Policies

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

Results of Operations

Three and Six Months Ended June 30, 2004 and June 30, 2003

Revenues

(in thousands)

	For the three months ended June 30,		For the six months ended June 30,		% Change for the three months ended June 30,	% Change for the six months ended June 30,
	2004	2003	2004	2003	2004/2003	2004/2003
Revenues	$42,782	$30,599	$83,949	$52,867	40%	59%

We sell directly to broadband service providers, and to a lesser extent, indirectly through resellers. Revenues related to our sales are recognized when: (1) persuasive evidence of an arrangement exists, (2) delivery has occurred or services rendered, (3) the selling price is fixed or determinable, and (4) collectibility is reasonably assured. A provision is made for estimated product returns as product shipments are made. Our existing agreements typically do

not grant return rights beyond those provided by the warranty. Revenue arrangements with resellers are generally recognized when product is shipped to the resellers as we generally do not grant return rights beyond those provided by the warranty.

Our revenues increased 40% to $42.8 million for the quarter ended June 30, 2004 compared to $30.6 million in the quarter ended June 30, 2003, primarily due to increased sales of our DOCSIS modems and video products, increased deployments of our CMTSs by cable operators, and increased sales of our legacy Multigate circuit-switch product, slightly offset by the lack of sales of our proprietary S-CDMA products in the second quarter of 2004 which were present in 2003.

Our revenues increased 59% to $83.9 million for the six months ended June 30, 2004 compared to $52.9 million for the six months ended June 30, 2003, primarily due to increased sales of our DOCSIS modems and video products, increased deployments of our CMTSs by cable operators, and increased sales of our legacy circuit-switch voice product, slightly offset by decreased sales of our proprietary S-CDMA products. We expect total revenues to decline slightly in the third quarter of 2004 compared to the first and

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second quarters of 2004 primarily due to a decrease in sales of our CPE products including our Multigate circuit-switch product line, partially offset by increased sales of our video products.

Revenues by Groups of Similar Products

(in thousands)

	For the three months ended June 30, 2004	For the three months ended June 30, 2003	For the six months ended June 30, 2004	For the six months ended June 30, 2003	% Change for the three months ended June 30, 2004/2003	% Change for the six months ended June 30, 2004/2003
Revenues by product:						
CMTS products	$10,291	$ 8,631	$21,588	$13,199	19%	64%
CPE products	24,983	17,004	48,597	30,649	47%	59%
Video products	7,508	3,699	13,579	6,532	103%	108%
Other products		1,265	185	2,487		(93%)
Total revenues	$42,782	$30,599	$83,949	$52,867	40%	59%

CMTS revenues increased 19% for the quarter ended June 30, 2004 compared to the quarter ended June 30, 2003, and increased 64% for the six months ended June 30, 2004 compared to the six months ended June 30, 2003. This increase was due to additional deployment of our DOCSIS products into new markets, primarily in the U.S. We have intensified our efforts to win new CMTS business through more direct engagement with key potential customers, specifically in Asia, Japan, and Europe. We are optimistic this may continue to yield improved results in the near future as we generate additional revenues from existing customers, acquire new customers, and increase the amount of sales into second and third tier North American-based multiple system operators (MSOs). Additionally, we are reviewing the opportunities available in the CMTS market and are assessing potentially viable strategies for growth and profitability, including leveraging what we believe to be a leadership position in commercial services. We expect CMTS revenues to be relatively flat in the third quarter of 2004 compared to the first and second quarters of 2004.

CPE revenues increased 47% for the quarter ended June 30, 2004 compared to the quarter ended June 30, 2003, due to an increase in modem sales, and to a lesser extent, an increase in sales of our legacy circuit-switch voice product in Europe. The number of DOCSIS modems sold increased from approximately 0.3 million units in the

second quarter of 2003 to approximately 0.5 million units in the second quarter of 2004. CPE revenues increased 59% for the six months ended June 30, 2004 compared to the six months ended June 30, 2003, due to an increase in modem sales and an increase in sales of our legacy circuit-switch voice product. The number of DOCSIS modems sold increased from approximately 0.6 million units in the six months ended June 30, 2003 to approximately 1.0 million units in the six months ended June 30, 2004. The intensely competitive nature of the market for broadband products has resulted in significant price erosion of ASPs. However, we believe that our full transition to an ODM in Asia, which was substantially completed in the first quarter of 2004, and the introduction of our new lower cost modem semiconductor, which is used in out CPE products, may allow us to remain competitive in the marketplace and maintain favorable margins on these products. Additionally, during the second quarter we experienced exceptionally strong demand for our legacy Multigate circuit-switch product line, which is sold primarily to one customer in Europe. We anticipate revenue generated by the legacy circuit-switch business to be substantially lower going forward. Consequently, we expect total CPE revenues to decline in the third quarter of 2004 compared to the first and second quarters of 2004.

Revenues from video products increased 103% for the quarter ended June 30, 2004 compared to the quarter ended June 30, 2003, and increased 108% for the six months ended June 30, 2004 compared to the six months ended June 30, 2003, due to increased sales to United States MSOs of our DM 6400 Cherrypicker video product. We are encouraged by the prospects for the video business to grow and

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currently believe that we will continue to see increased sales of video products as demand for high definition television (HDTV) and other digital video services, including digital ad insertion, grows in 2004. We currently anticipate video revenues will increase in the third quarter of 2004 compared to the first and second quarters of 2004, primarily due to revenues associated with video product deployment at Fox Broadcasting Company.

The Company had no sales of its legacy telecom products in the second quarter of 2004. Other revenues decreased 93% for the six months ended June 30, 2004 compared to the six months ended June 30, 2003, due to significantly decreased sales of our legacy telecom products. We expect sales of telecom products to be minimal in 2004.

Revenues by Geographic Region

(in thousands)

	For the three months ended June 30,		For the six months ended June 30,		% Change for the three months ended June 30,	% Change for the six months ended June 30,
	2004	2003	2004	2003	2004/2003	2004/2003
Revenues by geographic areas:						
United States	$21,226	$17,672	$43,058	$31,179	20%	38%
Canada	224	(309)	1,838	736	172%	150%
Europe, Middle East, Africa Region (EMEA), excluding Israel	7,041	7,369	14,965	10,700	(4)%	40%
Israel	5,931	399	9,215	811	1,386%	1,036%
Japan	3,294	3,646	5,688	6,812	(10)%	(17)%
Asia, excluding Japan	5,037	1,811	9,132	2,610	178%	250%
South America	29	11	53	19	164%	184%
Total	$42,782	$30,599	$83,949	$52,867	40%	59%

Revenues in the United States increased 20% to $21.2 million in the second quarter of 2004 compared to the same period in 2003, and increased 38% to $43.1 million in the six months ended June 30, 2004, compared to the same period in 2003, due to increased sales of DOCSIS 2.0 CMTSs and modems as well as video products to United States MSOs. Revenues in Canada and Asia, excluding Japan, also increased due to increased sales of DOCSIS 2.0 CMTSs products. Revenues in Israel increased due to increased sales of our legacy Multigate circuit-switch product. During the first half of 2004, we emphasized sales to our United States and other Asian customers while placing a lower emphasis on other locations such as Canada, EMEA, and South America. In 2004, we currently expect revenues to continue to increase in the United States and Asian markets. However, overall revenues are expected to be flat or

down in the third quarter of 2004. Two customers accounted for 10% or more of total revenues (25% and 12%) for the three months ended June 30, 2004. Two customers accounted for 10% or more of total revenues (23% and 10%) for the six months ended June 30, 2004. Five customers accounted for 10% or more of total revenues (16%, 13%, 13%, 13%, and 12%) for the three months ended June 30, 2003. Three customers accounted for 10% or more of total revenues (28%, 11%, and 10%) for the six months ended June 30, 2003. No other customer accounted for more than 10% of revenues during these periods.

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Related Party Revenues

(in thousands)

	For the three months ended June 30,		For the six months ended June 30,		% Change for the three months ended June 30,	% Change for the six months ended June 30,
	2004	2003	2004	2003	2004/2003	2004/2003
Related party revenues:						
Harmonic revenues	$2,644	$635	$3,389	$1,010	316%	236%
Rogers revenues				1,453		
Total related party revenues	$2,644	$635	$3,389	$2,463	316%	38%

Related party revenues increased 316% in the second quarter of 2004, compared to the second quarter of 2003. Related party revenues increased 38% in the six months ended June 30, 2004, compared to the six months ended June 30, 2003. Related party revenues in the first quarter of 2003 included revenues from Rogers Communications, Inc. (Rogers) and Harmonic, Inc. (Harmonic). Alek Krstajic, a member of our board of directors, was the Senior Vice President of Interactive Services, Sales and Product Development for Rogers until January 2003. Effective in April 2003, Rogers was no longer a related party to us. Consequently, revenues attributable to Rogers were classified as revenues after the first quarter 2003. Lewis Solomon, another member of our board of directors, is a member of the board of directors of Harmonic. All revenues attributable to Harmonic were included in related party revenues in 2004 and 2003. The increase in related party revenues was primarily due to an increase in sales of our video products to Harmonic in 2004 as compared to the same periods in 2003. None of our related parties is a supplier to us.

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

Cost of Goods Sold and Gross Profit

(in thousands)

	For the three months ended June 30,		For the six months ended June 30,		% Change for the three months ended June 30,	% Change for the six months ended June 30,
	2004	2003	2004	2003	2004/2003	2004/2003
Cost of revenues	$27,046	$23,549	$55,598	$42,200	15%	32%
Cost of related party revenues	614	187	832	1,128	228%	(26)%
Total cost of goods sold	$27,660	$23,736	$56,430	$43,328	(17)%	(30)%
Gross profit	$15,122	$ 6,863	$27,519	$ 9,539	120%	188%

Cost of goods sold consists of direct product costs as well as the cost of our manufacturing operations. The cost of manufacturing includes contract manufacturing, test and quality assurance for products, warranty costs and associated costs of personnel and equipment. In the three and six months ended June 30, 2004, cost of goods sold was approximately 65% and 67% of revenues, respectively, compared to 78% and 82% of revenues, respectively, in the same periods in 2003. Additionally, during the three and six months ended June 30, 2004, we reversed approximately $0.3 million and $0.8 million, respectively, of inventory provisions, which were previously recorded as cost of goods sold. During the three and six months ended June 30, 2003, we reversed approximately $1.0 million and $1.7 million, respectively of inventory provisions. We reversed these provisions as we were able to sell inventory originally considered to be excess or obsolete.

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For the three and six months ended June 30, 2004, we reversed approximately $0.8 million and $2.1 million, respectively, of accrued vendor cancellation charges, which were previously recorded as cost of goods sold. For the three and six months ended June 30, 2003, we reversed approximately $2.1 million and $4.4 million, respectively, of accrued vendor cancellation charges. We were able to negotiate downward certain vendor cancellation claims to terms more favorable to us.

In the three months ended June 30, 2004, related party cost of revenues increased compared to the same period in 2003 due to higher sales of our video products to Harmonic. In the six months ended June 30, 2004, related party cost of revenues decreased compared to the same period in 2003 due to classification of cost of revenues to Rogers as related party cost of sales in the first quarter of 2003.

Our gross profit increased 120% to $15.1 million or 35% of sales in the three months ended June 30, 2004 compared to $6.9 million, or 22% of sales in the same period in 2003. Our gross profit increased 188% to $27.5 million or 33% of sales in the six months ended June 30, 2004 compared to $9.5 million, or 18% of sales in the same period in 2003. The increase in our gross profit was primarily related to a favorable product line sales mix as we recorded a larger proportion of sales from our higher margin video and Multigate products, as well as lower product manufacturing costs for our modem business due largely to the benefits gained from moving to a large manufacturer ODM model, a more moderate rate of modem ASP erosion and the benefits from the reversal of inventory and vendor cancellation claims, described above.

We will continue to focus on improving sales of higher margin products and reducing product-manufacturing costs. We are now partnering with contract manufacturers in Asia and the U.S. for our CMTS, CPE, and video products, which may provide us with more competitive component pricing, economies of scale, and improved manufacturing capabilities. Our endeavor to shift our product mix from CPE revenues to higher margin CMTS and digital video product revenues, should enable us to increase our margins. However, there are no assurances that we will succeed in selling a greater percentage of higher margin products or reducing our product manufacturing costs.

Operating Expenses

(in thousands)

	For the three months ended June 30,		**For the six months ended June 30,**		**% Change for the three months ended June 30,**	**% Change for the six months ended June 30,**
	2004	**2003**	**2004**	**2003**	**2004/2003**	**2004/2003**
Research and development	$8,516	$10,432	$17,984	$23,434	(18)%	(23%)
Sales and marketing	$5,411	$ 6,560	$12,632	$13,290	(18)%	(5)%
General and administrative	$2,953	$ 3,000	$ 5,388	$ 6,728	(2)%	(20)%

Research and Development. Research and development expenses consist primarily of personnel costs, internally designed prototype material expenditures, and expenditures for outside engineering consultants, equipment and supplies required to develop and enhance our products. Research and development expenses decreased 18% to $8.5 million or 20% of sales in the three months ended June 30, 2004 from $10.4 million or 34% of sales in the same period in 2003. The $1.9 million decrease in research and development expenses was attributable to $0.8 million of reductions in employee related expenses. The

decrease in research and development expenses also included reductions of $1.2 million in purchases of materials, costs incurred to develop prototypes, and other research and development expenses, partially offset by an increase of $0.1 million of outside engineering consultants.

Research and development expenses decreased 23% to $18.0 million or 21% of sales in the six months ended June 30, 2004 from $23.4 million or 44% of sales in the same period in 2003. The $5.4 million decrease in research and development expenses was attributable to $2.1 million of reductions in employee related expenses. The decrease in research and development expenses also included reductions of $0.2 million of outside engineering consultants and $3.1 million of reductions in purchases of materials, costs incurred to develop prototypes, and other research and development expenses. We believe it is critical for the Company to continue to make significant investments in research and development to create innovative technologies and products that meet the current and future requirements of our customers. Accordingly, we intend to continue our investment in research and development although at slightly lower levels. In connection with our worldwide restructuring plans in the first and second quarters of 2004, we currently expect research and development expenses to continue to decrease in 2004.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries and commissions for sales personnel, and marketing and support personnel, and costs related to trade shows, consulting and travel. Sales and marketing expenses decreased 18% to $5.4 million or 13% of sales in the three months ended June 30, 2004 from $6.6 million or 21% of sales in the same period in 2003. The $1.1 million decrease in sales and marketing expenses was primarily due to $0.1 million of decreased travel costs, $0.7 million of reductions related to aircraft costs now included in restructuring charges, and $0.7 million of overall sales and marketing cost reductions. These reductions were partially offset by $0.2 million in increased employee expenses in sales and marketing and $0.2 million of increased spending for outside consultants.

Sales and marketing expenses decreased 5% to $12.6 million or 15% of sales in the six months ended June 30, 2004 from $13.3 million or 25% of sales in the same period in 2003. The $0.7 million decrease in sales and marketing expenses was primarily due to $0.8 million of reductions related to aircraft costs now included in restructuring charges, and $0.9 million of overall sales and marketing cost reductions. These reductions were partially offset by $0.4 million in increased employee expenses in sales and marketing and $0.6 million of increased spending for outside consultants. We currently expect sales and marketing expenses to continue to remain flat for the remainder of 2004.

General and Administrative. General and administrative expenses consist primarily of salary and benefits for administrative officers and support personnel, travel expenses and legal, accounting and consulting fees. Overall general and administrative expenses remained flat at $3.0 million or 7% of sales for the three months ended June 30, 2004 from $3.0 million or 10% of sales in the same period in 2003. Prior to the second quarter of 2004, we included severance expense related to the termination of an executive officer in general and administrative expenses. In the first quarter of 2003, $0.3 million of general and administrative expense included severance expense related to the termination of an executive officer. Beginning in the second quarter of 2004, we now record all severance expenses associated with the termination of executive officers in "Executive Severance, Restructuring Costs and Asset Write-offs."

General and administrative expenses decreased by $1.3 million to $5.4 million or 6% of sales for the six months ended June 30, 2004 from $6.7 million or 13% of sales in the same period in 2003. The decrease was primarily due to $1.2 million in reduced employee expenses including $0.3 million of severance expense in the first quarter of 2003 related to the termination of an executive officer, $0.9 million of overall general and administrative cost decreases, partially offset by $0.7 million of increased spending for outside consultants and $0.1 million increase of travel expenses. In connection with our worldwide restructuring plans in the first and second quarters of 2004, we currently expect general and administrative expenses to continue to be lower than in 2003.

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Executive Severance, Restructuring Costs and Asset Write-offs

(in thousands)

	For the three months ended June 30,		For the six months ended June 30,	
	2004	2003	2004	2003
Executive severance charges	$ 1,682	$	$1,682	$
Restructuring charges	1,148		4,409	2,676
Long-lived assets written-off			106	485
Revaluation of restructuring charges	749	(115)	749	(115)
Executive severance, restructuring costs and asset write-offs	$ 3,579	$ (115)	$6,946	$3,046

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

Restructuring Costs During the first quarter of 2004, we initiated a restructuring plan to conform expenses to revenue levels. We incurred restructuring charges in the amount of $3.3 million of which $1.0 million related to employee termination costs, $0.9 million related to exit costs for an aircraft lease, and $1.4 million related to costs for excess leased facilities. We incurred restructuring charges in the amount of $1.15 million in the second quarter of 2004 related to additional costs for excess leased facilities, which were contemplated in the first quarter plan. As of June 30, 2004, the employment of 58 employees had been terminated, and we paid $0.8 million in termination costs, $0.6 million of costs related to the aircraft lease, and $0.3 million of costs related to excess leased facilities. We anticipate the remaining restructuring accrual related to the aircraft lease to be substantially utilized for servicing operating lease payments or negotiating buyouts of operating lease commitments, through January 2007, and the remaining restructuring accrual related to excess leased facilities to be utilized for servicing operating lease payments or negotiating a buyout of operating lease commitments through October 2009. Additionally, in the second quarter of 2004, we revalued the restructuring reserve in accordance with SFAS 146 and recorded an additional provision to increase restructuring costs, primarily associated with the aircraft lease, by $0.7 million.

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

periodically re-evaluate and adjust the reserve, as necessary.

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

In the third quarter of 2002, we initiated a restructuring program. As part of this program, we restructured our worldwide operations including a worldwide reduction in workforce and the consolidation of excess facilities. We incurred additional restructuring charges of $3.6 million in 2002. Of the total restructuring charge, $2.3 million was related to employee termination costs. The remaining $1.3 million related primarily to costs for excess leased facilities. At June 30, 2004, restructuring charges of $1.2 million remained accrued. As of June 30, 2004, the employment of 153 employees had been terminated, and we paid $2.2 million in termination costs and $0.2 million in excess facility costs. We currently anticipate the remaining restructuring accrual, primarily relating to excess leased facilities, will be utilized for servicing operating lease payments or negotiating a buyout of operating lease commitments, through 2005.

In 2001 we incurred restructuring charges of $12.7 million. Of the total restructuring charges recorded, $3.2 million related to employee termination costs covering 293 technical, production, and administrative employees. The remaining $9.5 million of restructuring charges related primarily to costs for excess leased facilities. As of June 30, 2004, restructuring charges of $2.7 million remained accrued. We anticipate utilizing the remaining restructuring accrual, which relates to servicing operating lease payments or negotiating a buyout of operating lease commitments, through 2005.

Asset Write-offs For the six months ended June 30, 2004, we wrote off $0.1 million of fixed assets, which were determined to have no remaining useful life. We did not write-off any fixed assets during the three months ended June 30, 2004. For the six months ended June 30, 2003, we wrote off $0.5 million, of fixed assets, which were determined to have no remaining useful life. We did not write-off any fixed assets during the three months ended June 30, 2003.

Non-Operating Expenses

(in thousands)

	For the three months ended June 30,		For the six months ended June 30,		% Change for the three months ended June 30,	% Change for the six months ended June 30,
	2004	2003	2004	2003	2004/2003	2004/2003
Interest income	$ 460	$ 909	$ 912	$ 1,811	(49%)	(50%)
Interest expense	$(826)	$(814)	$(1,643)	$(1,651)	(1%)	
Other income (expense)	$ 921	$(160)	$ 1,200	$ (200)		

Interest Income. Interest income decreased 49% to $0.5 million in the second quarter of 2004 compared to $0.9 million in the same period in 2003. Interest income decreased 50% to $0.9 million in the six months ended June 30, 2004 compared to $1.8 million in the same period in 2003. The decrease in interest income in both periods was primarily due to lower invested average cash balances, as well as lower interest rates.

Interest Expense. Interest expense, which related primarily to interest on our Convertible Subordinated Notes (Notes) due in 2007, remained relatively flat in the second quarter of 2004 and the six months ended June 30, 2004, compared to the same periods in 2003 as no Notes were repurchased in 2003 or 2004.

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

Income Taxes

(in thousands)

	For the three months ended June 30,		For the six months ended June 30,	
	2004	2003	2004	2003
Income tax expense	$ (79)	$ (60)	$ (146)	$ (129)

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

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Litigation

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

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

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

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

The Court of Appeals opinion affirming dismissal of the *Bertram* case does not end the class action, and the plaintiffs in the *Bertram* case may still seek review of the Court of Appeals decision. We believe that the allegations in both the class action and the *Bertram* case are without merit, and we intend to contest these matters vigorously. These matters, however, could prove costly and time consuming to defend, and there can be no assurances about the eventual outcome.

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

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

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

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

Off-Balance Sheet Financings and Liabilities

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

Liquidity and Capital Resources

At June 30, 2004, we had approximately $47.8 million in cash and cash equivalents and $68.5 million in short-term investments.

Cash used in operating activities for the six months ended June 30, 2004 was $21.2 million compared to $43.9 million used in the same period in 2003. In the six months ended June 30, 2004, significant uses of cash from operating activities included $15.1 million loss from operations, $9.6 million decrease in accounts payable, and $6.0 million of increase in gross inventory. Inventory levels increased at June 30, 2004 when compared to December 31, 2003 due to increased CMTS and modem inventories in order to meet service levels established with our key customers. In the six months ended June 30, 2003, significant uses of cash from operating activities included a $37.1 million loss from operations, and a $8.7 million decrease in vendor cancellation reserves as we paid down these obligations, $4.1 million increase in accounts payable, partially offset by a $6.6 million decrease in other assets, and $8.6 million decrease in inventory.

Cash provided by investing activities for the six months ended June 30, 2004, was $37.8 million compared to cash used in investing activities of $5.8 million in the same period in 2003. Investing activities consisted primarily of net purchases and sales of short-term investments in 2004 and 2003. The increase in cash provided by investing activities in the six months ended June 30, 2004, was primarily due to the maturity of short term investments during the period. The decrease in cash used in investing activities in the six months ended June 30, 2003 was primarily due to movement of short-term investments to cash and cash equivalents to fund operations.

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Cash provided by financing activities was $0.6 million in the six months ended June 30, 2004 and 2003 primarily due to proceeds from the exercise of stock options and the sale of shares of common stock through our Employee Stock Purchase Plan.

In July 2000, we issued $500.0 million of Notes, resulting in net proceeds to us of approximately $484.4 million. The Notes are a general unsecured obligation and are subordinated in right of payment to all of our existing and future senior indebtedness and to all of the liabilities of our subsidiaries. The Notes are convertible into shares of our common stock at a conversion price of $84.01 per share at any time on or after October 24, 2000 through maturity