

INFINERA CORP  
Form 10-Q  
August 03, 2009  
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**UNITED STATES**  
**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 27, 2009

OR

.. **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: 001-33486

**Infinera Corporation**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

169 Java Drive

**77-0560433**  
(IRS Employer  
Identification No.)

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Sunnyvale, CA 94089

(Address of principal executive offices, including zip code)

(408) 572-5200

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of accelerated filer, large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of July 24, 2009, 95.7 million shares of the registrant's Common Stock, \$0.001 par value, were issued and outstanding.

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**INFINERA CORPORATION**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE FISCAL QUARTER ENDED JUNE 27, 2009**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements****INFINERA CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except par value)****(Unaudited)**

	<b>June 27, 2009</b>	<b>December 27, 2008</b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 94,151	\$ 166,770
Short-term investments	117,032	68,232
Short-term restricted cash	1,533	720
Accounts receivable, net of allowance for doubtful accounts of \$1,488 as of June 27, 2009 and \$1,700 as of December 27, 2008	54,059	69,354
Other receivables	618	1,085
Inventories, net	72,532	58,986
Deferred inventory costs	3,267	1,744
Prepaid expenses and other current assets	7,427	6,311
<b>Total current assets</b>	<b>350,619</b>	<b>373,202</b>
Property, plant and equipment, net	48,102	46,820
Intangible assets	1,143	1,276
Deferred inventory costs, non-current	2,072	2,493
Long-term investments	71,831	74,684
Long-term restricted cash	2,534	2,179
Other non-current assets	6,177	6,413
<b>Total assets</b>	<b>\$ 482,478</b>	<b>\$ 507,067</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 34,112	\$ 34,048
Accrued expenses	17,220	16,092
Accrued compensation and related benefits	14,117	13,472
Accrued warranty	5,573	5,205
Deferred revenue	15,682	14,683
<b>Total current liabilities</b>	<b>86,704</b>	<b>83,500</b>
Accrued warranty, non-current	4,797	4,735
Deferred revenue, non-current	7,362	7,724
Other long-term liabilities	6,712	5,645
Commitments and contingencies (Note 10)		

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Stockholders' equity:		
Preferred stock, \$0.001 par value		
Authorized shares 25,000 and no shares issued and outstanding		
Common stock, \$0.001 par value		
Authorized shares 500,000 as of June 27, 2009 and December 27, 2008		
Issued and outstanding shares 95,508 as of June 27, 2009 and 94,163 as of December 27, 2008	96	94
Additional paid-in capital	721,402	699,705
Accumulated other comprehensive loss	(2,418)	(3,598)
Accumulated deficit	(342,177)	(290,738)
Total stockholders' equity	376,903	405,463
Total liabilities and stockholders' equity	\$ 482,478	\$ 507,067

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

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**INFINERA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share data)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
<b>Revenue:</b>				
Product	\$ 61,074	\$ 86,505	\$ 120,222	\$ 150,633
Ratable product and related support and services	845	69,581	2,314	141,967
Services	7,013	5,023	12,976	6,762
<b>Total revenue</b>	<b>68,932</b>	<b>161,109</b>	<b>135,512</b>	<b>299,362</b>
<b>Cost of revenue:</b>				
Cost of product	45,699	47,124	89,564	86,789
Cost of ratable product and related support and services	358	32,169	1,088	68,000
Cost of services	2,617	2,032	4,632	3,222
<b>Total cost of revenue</b>	<b>48,674</b>	<b>81,325</b>	<b>95,284</b>	<b>158,011</b>
<b>Gross profit</b>	<b>20,258</b>	<b>79,784</b>	<b>40,228</b>	<b>141,351</b>
<b>Operating expenses:</b>				
Sales and marketing	11,458	10,860	22,581	21,106
Research and development	24,763	17,787	46,760	36,080
General and administrative	11,478	8,502	21,605	16,919
Amortization of intangible assets	37	37	74	74
<b>Total operating expenses</b>	<b>47,736</b>	<b>37,186</b>	<b>91,020</b>	<b>74,179</b>
<b>Income (loss) from operations</b>	<b>(27,478)</b>	<b>42,598</b>	<b>(50,792)</b>	<b>67,172</b>
<b>Other income (expense), net:</b>				
Interest income	597	2,258	1,515	5,561
Interest expense				(3)
Total other-than-temporary impairment losses	(2,747)		(2,747)	
Portion of loss recognized in other comprehensive loss	1,814		1,814	
Net credit impairment losses recognized in earnings	(933)		(933)	
Other gain (loss), net	806	296	(1,008)	1,176
<b>Total other income (expense), net</b>	<b>470</b>	<b>2,554</b>	<b>(426)</b>	<b>6,734</b>
<b>Income (loss) before income taxes</b>	<b>(27,008)</b>	<b>45,152</b>	<b>(51,218)</b>	<b>73,906</b>
Provision for income taxes	103	2,267	221	3,427
<b>Net income (loss)</b>	<b>\$ (27,111)</b>	<b>\$ 42,885</b>	<b>\$ (51,439)</b>	<b>\$ 70,479</b>
<b>Net income (loss) per common share:</b>				
Basic	\$ (0.28)	\$ 0.47	\$ (0.54)	\$ 0.77

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Diluted	\$ (0.28)	\$ 0.44	\$ (0.54)	\$ 0.73
<b>Weighted average shares used in computing net income (loss) per common share:</b>				
Basic	95,161	92,124	94,718	91,687
Diluted	95,161	97,284	94,718	96,988

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

**Table of Contents****INFINERA CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	<b>Six Months Ended</b>	
	<b>June 27, 2009</b>	<b>June 28, 2008</b>
<b>Cash Flows from Operating Activities:</b>		
Net income (loss)	\$ (51,439)	\$ 70,479
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	7,898	5,469
Net credit impairment losses recognized in earnings	933	
Accretion of investment discount	95	(725)
Stock-based compensation expense	15,648	11,288
Put Rights	1,549	
Unrealized holding gains for trading securities	(1,522)	
Excess tax benefit from stock option transactions		(559)
Tax benefit from stock option transactions		623
Gain on disposal of assets	(46)	(770)
Other gain		(15)
Changes in assets and liabilities:		
Accounts receivable	15,770	(16,949)
Inventories, net	(12,563)	479
Prepaid expenses and other current assets	(1,088)	(1,782)
Deferred inventory costs	(1,172)	54,143
Other non-current assets	241	(314)
Accounts payable	(81)	4,901
Accrued liabilities and other expenses	2,983	(6,902)
Deferred revenue	636	(104,528)
Accrued warranty	430	568
Net cash provided by (used in) operating activities	(21,728)	15,406
<b>Cash Flows from Investing Activities:</b>		
Purchase of available-for-sale investments	(83,937)	(123,624)
Proceeds from sale of available-for-sale investments		69,543
Proceeds from maturities and call of investments and restricted cash	36,839	82,304
Proceeds from disposal of assets	103	771
Purchase of property and equipment	(8,759)	(7,283)
Net cash provided by (used in) investing activities	(55,754)	21,711
<b>Cash Flows from Financing Activities:</b>		
Proceeds from issuance of common stock	4,762	7,164
Excess tax benefit from stock option transactions		559
Repurchase of common stock	(15)	(30)
Net cash provided by financing activities	4,747	7,693
Effect of exchange rate changes on cash	116	(56)
Net change in cash and cash equivalents	(72,619)	44,754
Cash and cash equivalents at beginning of period	166,770	91,209



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Cash and cash equivalents at end of period	\$ 94,151	\$ 135,963
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**Supplemental disclosures of cash flow information:**

Cash paid for interest	\$	\$ 3
Cash paid for income taxes	\$ 1,113	\$ 593

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

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**INFINERA CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Description of Business**

Infinera Corporation ( *Infinera* or the *Company* ), headquartered in Sunnyvale, California, was founded in December 2000 and incorporated in the State of Delaware. Infinera has developed a digital optical networking system ( *DTN System* ) and began commercial shipment of its DTN System in November 2004. Infinera's DTN System is unique in its use of a breakthrough semiconductor technology: the photonic integrated circuit ( *PIC* ). Infinera's DTN System and PIC technology are designed to provide optical networks with simpler and more flexible engineering and operations, faster time-to-service, and the ability to rapidly deliver differentiated services without reengineering their optical infrastructure.

**2. Basis of Presentation**

***Basis of Financial Statements***

The condensed consolidated financial statements include accounts of the Company and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated. The accompanying condensed consolidated balance sheet as of June 27, 2009, the condensed consolidated statements of operations for the three and six months ended June 27, 2009 and June 28, 2008, and the condensed consolidated statements of cash flows for the six months ended June 27, 2009 and June 28, 2008 are unaudited. The condensed consolidated balance sheet as of December 27, 2008 was derived from the audited consolidated financial statements included in the Company's Annual Report on Form 10-K ( *Form 10-K* ) for the year ended December 27, 2008. The accompanying condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes contained in such Form 10-K filed with the U.S. Securities and Exchange Commission ( *SEC* ) on February 17, 2009.

The accompanying condensed consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ( *U.S. GAAP* ) and pursuant to the rules and regulations of the SEC. Not all of the financial information and footnotes required for complete financial statements have been presented. Management believes the unaudited condensed consolidated financial statements have been prepared on a basis consistent with the audited consolidated financial statements and include all adjustments necessary of a normal and recurring nature for a fair presentation of the Company's condensed consolidated balance sheet as of June 27, 2009, the condensed consolidated statements of operations for the three and six months ended June 27, 2009 and June 28, 2008, and the condensed consolidated statements of cash flows for the six months ended June 27, 2009 and June 28, 2008.

The Company has evaluated subsequent events, as defined by Statement of Financial Accounting Standards ( *SFAS* ) No. 165, *Subsequent Events*, through the date that the condensed consolidated financial statements were issued on August 3, 2009.

***Use of Estimates***

The condensed consolidated financial statements are prepared in accordance with U.S. GAAP. These accounting principles require the Company to make certain estimates, assumptions and judgments that can affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the condensed consolidated financial statements, as well as the reported amounts of revenue and expenses during the periods presented. Significant estimates, assumptions and judgments made by management include revenue recognition, stock-based compensation, inventory valuation, allowances for doubtful accounts, accrued warranty, fair value measurement of investments, cash, cash equivalents and short and long-term investments, other-than-temporary impairments and accounting for income taxes. Management believes that the estimates and judgments upon which they rely are reasonable based upon information available to them at the time that these estimates and judgments are made. To the extent there are material differences between these estimates and actual results, the Company's condensed consolidated financial statements will be affected.

**3. Accounting Changes**

In April 2009, the Financial Accounting Standards Board ( *FASB* ) issued FASB Staff Position No. FAS 157-4 ( *FSP FAS 157-4* ), *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly*. FSP FAS 157-4 amends FASB Statement No. 157, *Fair Value Measurement* to provide additional guidance on estimating fair value when the volume and level of activity for an asset or liability have significantly decreased in relation to normal market activity for the

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asset and liability. It also provided additional guidance on circumstances that may indicate that a transaction is not orderly, and required additional disclosure about fair value measurements in annual and interim reporting periods. FSP FAS 157-4 is effective for interim and annual reporting periods ending after June 15, 2009. The Company adopted FSP FAS 157-4 beginning in the second quarter of 2009, and the adoption of this standard had no significant impact on the Company's condensed consolidated financial statements.

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In April 2009, the FASB issued FASB Staff Position No. FAS 107-1 ( FSP FAS 107-1 ), *Interim Disclosures About Fair Value of Financial Instruments*. FSP FAS 107-1 requires interim disclosures regarding the fair values of financial instruments that are within the scope of FASB Statement No. 107 ( FAS 107 ), *Disclosure about Fair Value of Financial Instruments*. FSP FAS 107-1 extends the disclosure requirements of FAS 107 to interim financial statements of publicly traded companies. Additionally, FSP FAS 107-1 requires disclosure of the methods and significant assumptions used to estimate the fair value of financial instruments on an interim basis as well as changes of the methods and significant assumptions from prior periods. FSP FAS 107-1 is effective for interim and annual reporting periods ending after June 15, 2009. The Company adopted FSP FAS 107 beginning in the second quarter of 2009, and the adoption of this standard had no significant impact on the Company's condensed consolidated financial statements.

In April 2009, the FASB issued FASB Staff Position No. FAS 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* ( FSP FAS 115-2 ). FSP FAS 115-2 amends the requirements for the recognition and measurement of an other-than-temporary impairment ( OTTI ) for debt securities by modifying the pre-existing intent and ability indicator. FSP FAS 115-2 states that an OTTI write-down of debt securities, where fair value is below amortized cost, is triggered in circumstances where (1) an entity has the intent to sell a security, (2) it is more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis, or (3) the entity does not expect to recover the entire amortized cost basis of the security. If an entity intends to sell a security or if it is more likely than not the entity will be required to sell the security before recovery, an OTTI write-down is recognized in earnings equal to the entire difference between the security's amortized cost basis and its fair value. If an entity does not intend to sell the security and it is not more likely than not that it will be required to sell the security before recovery of its remaining amortized cost basis, the entity must determine whether it will recover its remaining amortized cost basis. If an entity concludes that it will not recover its remaining amortized cost basis, a credit loss exists and the resulting OTTI is separated into an amount representing the credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income (loss). FSP FAS 115-2 is effective for interim and annual reporting periods ending after June 15, 2009. The Company adopted FSP FAS 115-2 beginning in the second quarter of 2009. As of June 27, 2009, the Company determined that it does not intend to sell a portion of its ARS and it is not more likely than not that it will be required to sell the securities before recovery of its amortized cost. As a result, the Company recognized an OTTI of \$2.7 million and recorded a credit impairment loss of \$0.9 million as a component of Other income (loss), net in the Company's condensed consolidated statements of operations for the three and six months ended June 27, 2009. The non-credit related portion of this OTTI of \$1.8 million was recognized in Accumulated other comprehensive loss in the Company's condensed consolidated balance sheet at June 27, 2009. See Note 5, Fair Value Measurements and Other-Than-Temporary Impairments, to the Notes to Condensed Consolidated Financial Statements for further discussion.

**4. Summary of Significant Accounting Policies**

The Company believes the following critical accounting policies reflect its more significant judgments and estimates used in the preparation of its condensed consolidated financial statements.

**Revenue Recognition**

The Company's networking products are generally integrated with software that is more than incidental to the functionality of the equipment. Accordingly, the Company accounts for revenue in accordance with Statement of Position ( SOP ) No. 97-2, *Software Revenue Recognition* ( SOP 97-2 ), as amended by SOP No. 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions* ( SOP 98-9 ). The Company recognizes product revenue when all of the following have occurred: (1) it has entered into a legally binding arrangement with a customer; (2) delivery has occurred, which is when product title and risk of loss have transferred to the customer; (3) customer payment is deemed fixed or determinable; and (4) collectability is reasonably assured. Revenue is recognized net of cash discounts.

Substantially all of the Company's product sales are sold in combination with software support services comprised of either software warranty or software subscription services. In addition, the Company periodically sells training, installation and deployment services, spares management and on-site hardware replacement services with its product sales. Software warranty provides customers with maintenance releases and patches during the warranty support period. Software subscription also includes maintenance releases and patches and in addition, provides customers with rights to receive unspecified software product upgrades released during the support period. Training services include the right to a specified number of training classes over the term of the arrangement. Installation and deployment services may include customer site assessments, equipment installation and testing. Spares management and on-site hardware replacement services include the replacement of defective units at customer sites in accordance with specified service level agreements.



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Product revenue consists of products that are sold without services or bundled products that are sold with services for which vendor specific objective evidence ( VSOE ) of fair value has already been established and therefore, is recognized upfront under the residual method in accordance with SOP No. 97-2, as amended by SOP 98-9. The Company uses the residual method to recognize revenue when a sales agreement includes one or more elements to be delivered at a future date and VSOE of fair value of all undelivered elements exists. VSOE of fair value for software warranty, software subscription, training and installation and deployment services, spares management and on-site hardware replacement services is determined by reference to the price the customer will be required to pay when these services are sold separately.

Prior to the first quarter of 2008, the Company had not established VSOE of fair value for its support services, and therefore recognized all revenue for transactions bundled with these services ratably over the longest remaining support period which ranges from one to five years. Revenue related to these arrangements is included in ratable product and related support and services revenue. The Company determined that it had established VSOE of fair value for software subscription in the first quarter of 2008, for training and installation and deployment services in the second quarter of 2008 and for spares management and on-site hardware replacement services in the fourth quarter of 2008. For arrangements with multiple elements which include product and software subscription services and or training and installation and deployment services, spares management and on-site hardware replacement services, the Company allocates revenue to the undelivered elements using the residual method based on VSOE of fair value for each such element and the remainder is recognized as product revenue. However, when these transactions also include undelivered services for which VSOE of fair value has not been established, revenue is deferred and recognized ratably over the longest remaining support period. Upon completion of the services for which VSOE of fair value has not been established, the difference between the VSOE of fair value for the remaining related service periods and the remaining unrecognized portion of the arrangement fee is recognized as ratable product and related support and services revenue.

Services revenue includes software subscription services, training, installation and deployment services, spares management and on-site hardware replacement services and extended hardware warranty services. Revenue from software subscription, spares management and on-site hardware replacement services and extended hardware warranty contracts is deferred and is recognized ratably over the contractual support period, which is generally one year. A majority of the Company's customers have exercised the option to purchase software subscription services on an ongoing basis. Revenue related to training and installation and deployment services is recognized as the services are completed.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. In addition, shipping documents and customer acceptance, when applicable, are used to verify delivery and transfer of title. Revenue is recognized only when title and risk of loss pass to customers. In instances where acceptance of the product occurs upon formal written acceptance, revenue is deferred until such written acceptance has been received. The Company assesses whether the fee is fixed or determinable based on the payment terms associated with the transaction. Payment terms to customers generally range from net 30 to 120 days from invoice, which are considered to be standard payment terms. However, payment terms greater than 120 days but less than or equal to one year from invoice may be considered standard if payment is supported by an irrevocable commercial letter of credit ( LOC ) issued by a credit-worthy bank or the LOC has been accepted and confirmed by a credit-worthy bank. In the event payment terms are provided that differ from the Company's standard business practices, the fees are deemed to not be fixed or determinable and, therefore, revenue is not recognized until the fees become fixed or determinable which the Company believes is when they are legally due and payable. The Company assesses the ability to collect from its customers based primarily on the creditworthiness and past payment history of the customer.

For sales to resellers, the same revenue recognition criteria apply. It is the Company's practice to identify an end-user prior to shipment to a reseller. The Company does not offer rights of return or price protection to its resellers.

Shipping charges billed to customers are included in product revenue and in ratable product and related support and services revenue.

***Stock-Based Compensation***

The Company accounts for stock-based employee compensation plans under the fair value recognition and measurement provisions of SFAS No. 123, *Share-Based Payments* ( SFAS 123(R) ). In accordance with SFAS 123(R), stock-based compensation cost is measured at the grant date, based on the fair value of the award, and is recognized as expense over the requisite service period (generally the vesting period). Under SFAS 123(R), the Company estimates the fair value of the stock options granted and rights to acquire stock under its Employee Stock Purchase Plan ( ESPP ) using the Black-Scholes option pricing formula and a single option award approach. For new-hire grants, options typically vest with respect to 25% of the shares one year after the option's vesting commencement date and the remainder ratably on a monthly basis over three years, commencing one year after the vesting commencement date. For annual refresh grants, options typically vest ratably on a monthly basis

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over four or five years after the vesting commencement date. The Company's ESPP typically provides for consecutive six-month offering periods, except for the first such offering period which commenced on June 7, 2007 and ended on February 15, 2008.

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**INFINERA CORPORATION**

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

The Company makes a number of estimates and assumptions related to SFAS 123(R) including the following:

The expected forfeiture rate is estimated based on the Company's historical forfeiture data and compensation costs are recognized only for those equity awards expected to vest. The estimation of the forfeiture rate requires judgment, and to the extent actual forfeitures differ from expectations, changes in estimate will be recorded as an adjustment in the period when such estimates are revised. Actual results may differ substantially from the estimates.

The expected term of options granted represents the period of time that options granted are expected to be outstanding, which incorporates the contractual terms, grant vesting schedules and expected employee and director behaviors. Commencing in June 2007, the Company elected to use the simplified method to estimate the expected term as permitted by SEC Staff Accounting Bulletin No. 110 ( SAB 110 ) due to increased liquidity of the underlying options in the post IPO era as compared to the Company's historical grants.

Expected volatility of the Company's stock is based on the weighted average implied and historical volatility of the Company and the Company's peer group. The peer group is comprised of similar companies in the same industrial sector. Peer group data is used because the Company does not yet have sufficient historical volatility data for its own common stock.

In the future, when the Company gains sufficient historical volatility data and there is sufficient historical data on the actual term employees hold their options, the expected volatility and expected term will be derived based on this information and therefore may be subject to change. This could substantially change the grant-date fair value of future awards of stock options and ultimately the expense recorded by the Company.

The Company issued performance share units ( PSUs ) in the first quarter of 2009, as part of the Company's annual refresh grant process. The PSUs entitle the Company's executive officers and board members to receive a number of shares of the Company's common stock based on the Company's stock price performance over a three-year or four-year period as compared to the NASDAQ Composite index ( NASDAQ ) for the same period. The PSUs cliff vest after three or four years and the number of shares to be issued upon vesting ranges from 0.5 to 2.0 times the number of PSUs granted depending on the relative performance of the Company's common stock price compared to NASDAQ. This performance metric is classified as a market condition under SFAS 123(R). The Company estimates the fair value of the PSUs granted using the Monte Carlo simulation model and recognizes the related expenses on a straight-line amortization basis.

The Monte Carlo simulation model is based on a discounted cash flow approach, with the simulation of a large number of possible Company and NASDAQ stock price outcomes. The use of the Monte Carlo simulation model requires the input of a number of assumptions including expected volatility of the Company's stock price, expected volatility of NASDAQ, correlation between changes in the Company's stock price and changes in NASDAQ, risk free interest rate, and expected dividends. Expected volatility of the Company's stock is based on the weighted average implied and historical volatility of the Company's peer group in the industry in which the Company does business. Expected volatility of NASDAQ is based on the historical and implied data. Correlation is based on the historical relationship between the Company's peer group stock price and NASDAQ price. The risk-free interest rate is based upon the treasury zero-coupon yield appropriate for the term of the PSU as of the grant date. The expected dividend yield is zero for the Company as it does not expect to pay dividends in the future. The expected dividend yield for NASDAQ is the annual dividend yield expressed as a percentage of the price of NASDAQ on the grant date.

***Inventory Valuation***

Inventories, net consist of raw materials, work-in-process and finished goods and are stated at standard cost adjusted to approximate the lower of actual cost (first-in, first-out method) or market. Market value is based upon an estimated selling price reduced by the estimated cost of disposal. The determination of market value involves numerous judgments including estimated average selling prices based upon recent sales volumes, industry trends, existing customer orders, current contract price, future demand and pricing and technological obsolescence of the Company's products.



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Inventory that is obsolete or in excess of the Company's forecasted demand or is anticipated to be sold at a loss is written down to its estimated net realizable value based on historical usage and expected demand.

The Company's inventory reserve balances for excess and obsolete inventory in the condensed consolidated balance sheets at June 27, 2009 and December 27, 2008 were \$7.8 million and \$6.3 million, respectively. The Company's inventory reserve balances for lower of cost or market adjustment in the condensed consolidated balance sheets at June 27, 2009 and December 27, 2008 were \$8.3 million and \$5.0 million, respectively.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In valuing its deferred inventory costs, the Company considered the valuation of inventory using the guidance of Accounting Research Bulletin 43, *Restatement and Revision of Accounting Research Bulletins* ( ARB 43 ). In particular, the Company considered ARB 43, Chapter 4, Statement 5 and whether the utility of the products delivered or expected to be delivered at less than cost, primarily comprised of common equipment, had declined. The Company concluded that, in the instances where the utility of the products delivered or expected to be delivered was less than cost, it was appropriate to value the inventory costs and deferred inventory costs at cost or market, whichever is lower, thereby recognizing the cost of the reduction in utility in the period in which the reduction occurred or can be reasonably estimated. The Company has, therefore, recorded inventory write-downs as necessary in each period in order to reflect common equipment inventory at the lower of cost or market. In addition, the Company considered the guidance provided in ARB 43, Chapter 4, Statement 10 relating to losses on firm purchase commitments related to inventory items. Given that the expected selling price of common equipment in the future remains below cost, the Company has also recorded losses on these firm purchase commitments in the period in which the commitment is made. When the inventory parts related to these firm purchase commitments are received, that inventory is recorded at the purchase price less the accrual for the loss on the purchase commitment.

If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

***Allowances for Doubtful Accounts***

Management makes judgments as to its ability to collect outstanding receivables and provides allowances for a portion of receivables when collection becomes doubtful. Provisions are made based upon a specific review of all significant outstanding invoices. At June 27, 2009 and December 27, 2008, the Company's allowance for doubtful accounts was \$1.5 million and \$1.7 million, respectively, associated with accounts receivable deemed uncollectible relating to one customer.

***Accrued Warranty***

The Company warrants that its products will operate substantially in conformity with product specifications. Upon delivery of the Company's products, the Company provides for the estimated cost to repair or replace products or the related components that may be returned under warranty. The Company's hardware warranty periods range from 1 to 5 years from date of acceptance for hardware and 90 days to 60 months for software warranty. The hardware warranty reserve is based on actual historical returns experience and the application of those historical return rates to the Company's in-warranty installed base. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. The Company has software warranty support obligations to a small number of its customers and the costs associated with providing these software warranties are immaterial to the Company's condensed consolidated financial statements to date.

***Cash, Cash Equivalents and Short and Long-term Investments***

The Company considers all highly liquid instruments with an original maturity at the date of purchase of 90 days or less to be cash equivalents. The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

The Company considers all debt instruments with original maturities at the date of purchase greater than 90 days and remaining time to maturity of one year or less to be short-term investments. The Company classifies debt instruments with remaining maturities greater than one year as long-term investments. At June 27, 2009 and December 27, 2008, cash equivalents and short and long-term investments consisted primarily of money market funds, commercial paper, corporate bonds, U.S. agency notes, U.S. treasuries, adjustable rate securities ( ARS ) and Put Rights.

Available-for sale investments are stated at fair market value with unrealized gains and losses reported in Accumulated other comprehensive loss as a separate component in the accompanying condensed consolidated balance sheets under Stockholders' equity in accordance with the provisions of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities* ( SFAS 115 ). The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity, both of which are included in interest income. Gains and losses are recognized when realized in the Company's condensed consolidated statements of operations under the specific identification method. The Company evaluates its available-for-sale marketable debt securities for other-than-temporary impairments as discussed below. Trading securities investments are stated at fair value with unrealized gains and losses reported in earnings, in accordance with SFAS 115.



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**INFINERA CORPORATION**

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

***Fair Value Measurement of Investments***

Effective December 30, 2007, the Company adopted FASB Statement No. 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements and, accordingly, does not require any new fair value measurements. FASB Staff Position No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*, ( FSP FAS 157-3 ) and FSP FAS 157-4 clarify the application of SFAS 157 in an inactive market.

The fair values of the Company's financial instruments reflect the estimates of amounts that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The fair value estimates presented in the Company's condensed consolidated financial statements are based on information available to us as of June 27, 2009.

In accordance with SFAS 157 and related pronouncements, the Company applies a fair value hierarchy based on three levels of inputs as follows:

- Level I - Quoted prices in active markets for identical assets or liabilities.
- Level II - Inputs other than Level I that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. In addition, Level II could include unobservable inputs that are not significant to the fair value of the assets or liabilities.
- Level III - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company measures its cash equivalents, debt securities and Put Rights at fair value and classifies its securities in accordance with the fair value hierarchy of FAS 157 and related pronouncements.

The Company's money market funds and U.S. treasuries are classified within Level I of the fair value hierarchy and are valued based on quoted prices in active markets for identical securities.

The Company classifies its commercial paper, corporate bonds and U.S. agency notes within Level II of the fair value hierarchy as follows:

***Commercial Paper***

The Company reviews market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day and then follows a revised accretion schedule to determine the fair market value at period end. In the absence of any observable market transactions for a particular security, the fair market value at period end is derived by accreting from the last observable market price. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data accreted mathematically to par, and result in the classification of these securities as Level II of the fair value hierarchy.

***Corporate Bonds***

The Company reviews trading activity and pricing for each of the corporate bond securities in its portfolio as of the measurement date and determines if pricing data of sufficient frequency and volume in an active market exists in order to support Level I classification of these securities. When sufficient quoted pricing for identical securities is not available, the Company obtains market pricing and other observable market inputs for similar securities from a number of industry standard data providers. In instances where multiple prices exist for similar securities, these prices are used as inputs into a distribution-curve to determine the fair market value at period end. As a result, the Company classifies its corporate bonds as Level II of the fair value hierarchy.

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### *U.S. Agency Notes*

The Company reviews trading activity and pricing for its U.S. agency notes as of the measurement date. When sufficient quoted pricing for identical securities is not available, the Company uses market pricing and other observable market inputs for similar securities obtained from a number of industry standard data providers. These inputs represent quoted prices for similar assets in active markets or these inputs have been derived from observable market data, and result in the classification of these securities as Level II of the fair value hierarchy.

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**INFINERA CORPORATION**

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

The Company classifies its ARS and related Put Rights within Level III of the fair value hierarchy as follows:

*Auction Rate Securities*

The Company's ARS are classified within Level III because they are valued, in part, by using inputs that are unobservable in the market and are significant. The recent uncertainties in the credit markets have affected all of the Company's ARS and auctions for these securities have failed to settle on their respective settlement dates. In light of these developments, to determine the fair value for the Company's ARS, the Company used a combination of the market approach and income approach. The market approach uses pricing based on transactions in an inactive secondary market for similar or comparable securities. In addition, the Company performed its own discounted cash flow analysis. Management determined that it was most appropriate to value the ARS using the market approach and income approach equally given the facts and circumstances as of June 27, 2009, and therefore incorporated both valuations in the Company's fair value measurement.

The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of the Company's ARS, as of June 27, 2009, are as follows:

*Contractual cash flow*

The model assumed that the principal amount or par value for these securities would be repaid at the end of the estimated workout period. In addition, future interest payments were estimated as described in each individual prospectus and based on the then current U.S. Treasury Bill ( T-Bill ) rate adjusted for a failed auction premium of 120 basis points ( bps ) for all the Company's ARS, except 150 bps for A3 rated securities.

*ARS discount rate*

The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the estimated workout period of the securities. As of the measurement date, these rates were then adjusted by a total of 350 bps to 500 bps which included an estimate of the market student loan spread and a discount factor to reflect the lack of liquidity and the credit risk of the securities. As of June 27, 2009, most of the Company's ARS were AAA rated, except for \$17.0 million (par value) of securities held with two issuers whose credit rating were downgraded to A3 and Aa1 ratings during the six months ended June 27, 2009. The Company's ARS are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. The discount rate does, however, include a discount factor to reflect the issuer's credit risk and its potential inability to perform its obligations under the terms of the ARS agreements. The Company's other-than-temporary impairment analysis for two of its available-for-sale ARS indicates that the estimated credit risk element included in the discount rate for an AAA rated security is approximately 150 bps and 250 bps for an A3 rated security.

*Estimated maturity*

The Company estimated the workout period of its ARS as the weighted average life of the underlying trust loan portfolio where this information was available from servicing and other trust reports. In a small number of instances where this information was not available, the Company used the weighted average life of the loan portfolio of a similar trust. The estimated time to maturity of the securities as of the measurement date ranged from 10.1 years to 19.0 years.

*Put Rights*

Put Rights associated with the Company's UBS ARS are classified as Level III because they are valued, in part, by using inputs that are unobservable in the market and are significant. The fair value of the Put Rights is equal to the difference between the fair value of the UBS ARS calculated as described above and their value including the impact of the Put Rights. The Company performed its own discounted cash flow analysis to calculate the fair value of the UBS ARS including the impact of the Put Rights.

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The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of the UBS ARS including the impact of the Put Rights as of June 27, 2009 are as follows:

### *Contractual cash flow*

The model assumed that the principal amount or par value for the ARS would be repaid on June 30, 2010, based on the Company's current intent to exercise its Put Rights and sell these securities to UBS on that date. In addition, future interest payments were estimated as described in each individual prospectus and based on the then current T-Bill rate adjusted for a failed auction premium of 120 bps for all of the Company's ARS, except for 150 bps for A3 rated securities.

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**INFINERA CORPORATION**

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

*Discount rate*

The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the expected sale date of these securities. As of the measurement date, this rate was adjusted by a total of 120 bps which represented a discount factor to reflect UBS credit risk and UBS potential inability to perform its obligations under the Put Rights agreement.

The Company believes that the fair value of its ARS and Put Rights could change significantly in the future, based on market conditions and continued uncertainties in the financial markets. UBS credit risk may be subject to significant volatility and it is difficult to predict future fluctuations. A 10% deterioration in UBS credit risk would result in a \$0.1 million net loss in the Company's condensed consolidated statements of operations for the three months ended June 27, 2009. Deterioration in the ARS discount rate or a change in the estimated time to maturity would have no impact on the Company's condensed consolidated statements of operations.

*Other-Than-Temporary Impairments*

It is the Company's policy to review its available-for-sale marketable debt securities on a regular basis to evaluate whether or not any security has experienced an other-than-temporary decline in fair value. To determine if an OTTI exists, the Company first determines if it has the intent or if it is more likely than not that it will be required to sell the security prior to recovery of its amortized cost basis. If the Company intends to sell the security or it is more likely than not that it will be required to sell the security before recovery of the amortized cost basis, then the total amount of the fair market value write-down is determined to represent an OTTI and is recognized in earnings in the period.

In instances where the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of the amortized cost basis, the Company must determine if it expects to recover the entire amortized cost basis of the security. If the present value of the cash flows expected to be collected is less than the amortized cost basis of the security, then an OTTI is considered to have occurred. This OTTI write-down is then separated into an amount representing credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income (loss). In determining if a credit loss has occurred, it is the Company's policy to isolate the credit loss related portion of the discount rate used to derive the fair market value of the security and apply this to the expected cash flows in order to determine the portion of the OTTI that is credit loss related. This credit related portion of the discount rate is derived based on the financial condition of the issuer, including changes in rating agency ratings for the security or increases in credit related yield spreads on similar securities offered by the same issuer.

As of June 27, 2009, the Company held \$10.0 million of available-for-sale ARS held with two issuers, one of which is AAA rated and the other one is A3 rated. As of June 27, 2009, the Company determined that it does not intend to sell these securities and it is not more likely than not that it will be required to sell the securities before recovery of its amortized cost. However, given that the present value of the expected cash flows for these securities was below their amortized cost basis, an OTTI of \$2.7 million, equal to the difference between the fair value and the amortized cost basis has occurred. The Company recognized a credit impairment loss of \$0.9 million in the Company's condensed consolidated statements of operations for the three and six months ended June 27, 2009. The non-credit related portion of this OTTI of \$1.8 million was recognized in Accumulated comprehensive loss in the Company's condensed consolidated balance sheet at June 27, 2009.

A 10% deterioration in the ARS student loan credit spread would result in \$0.2 million of additional OTTI credit loss in the Company's condensed consolidated statements of operations for the second quarter of 2009.

*Accounting for Income Taxes*

As part of the process of preparing the Company's condensed consolidated financial statements, the Company is required to estimate its taxes in each of the jurisdictions in which it operates. The Company estimates actual current tax expense together with assessing temporary differences resulting from different treatment of items, such as accruals and allowances not currently deductible for tax purposes. These differences result in deferred tax assets and liabilities, which are included in the Company's condensed consolidated balance sheets. In general, deferred tax assets represent future tax benefits to be received when certain expenses previously recognized in the Company's condensed consolidated statements of operations become deductible expenses under applicable income tax laws or loss or credit carryforwards are utilized. Accordingly, realization of the Company's deferred tax assets is dependent on future taxable income within the respective jurisdictions against which these deductions, losses and credits can be utilized within the applicable future periods.





**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company must assess the likelihood that some portion or all of its deferred tax assets will be recovered from future taxable income within the respective jurisdictions, and to the extent the Company believes that recovery does not meet the more-likely-than-not standard, it must establish a valuation allowance. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management judgment is required in determining the Company's provision for income taxes, its deferred tax assets and liabilities and any valuation allowance recorded against its net deferred tax assets. At June 27, 2009 and December 27, 2008, certain of the Company's domestic net deferred tax assets were fully reserved with a valuation allowance because, based on the available evidence, the Company believed at that time it was more likely than not that it would not be able to utilize those deferred tax assets in the future. The Company intends to maintain a valuation allowance until sufficient evidence exists to support the reversal of the valuation allowance. The Company makes estimates and judgments about its future taxable income, by jurisdiction, based on assumptions that are consistent with its plans and estimates. Should the actual amounts differ from the Company's estimates, the amount of its valuation allowance could be materially impacted.

***Concentration of Credit Risk***

Financial instruments that are potentially subject to concentrations of credit risk consist primarily of cash, cash equivalents, short-term investments, long-term investments and accounts receivable. Investment policies have been implemented that limit investments to investment grade securities.

At June 27, 2009, the Company held \$75.5 million (par value) of investments comprised of ARS, which are variable-rate debt securities and have a long-term maturity with the interest rate being reset through auctions that are typically held every 7, 28 or 35 days. These securities have historically traded at par and are callable at par at the option of the issuer. Interest was typically paid at the end of each auction period or semiannually. Since February 2008, most of the auctions for these securities have failed and there is no assurance that future auctions will succeed. As a result, the Company's ability to liquidate its investment in the near term is limited. In addition, it could take until final maturity of the ARS (up to 38 years) to realize the Company's investments' par value or the Company may not be able to fully recover the par value of its ARS. At June 27, 2009, most of the \$75.5 million (par value) of ARS that the Company held were AAA rated, except for \$11.9 million (par value) of ARS that were downgraded to A3 rating and \$5.1 million (par value) of ARS that were downgraded to Aa1 rating during the six months ended June 27, 2009. The Company's ARS are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. See Note 5, Fair Value Measurements and Other-Than-Temporary Impairments, to the Notes to Condensed Consolidated Financial Statements for more information.

The risk with respect to accounts receivable is mitigated by ongoing credit evaluations that the Company performs on its customers. As the Company expands its sales internationally, it may experience increased levels of customer credit risk associated with those regions. Collateral is generally not required for accounts receivable but may be used in the future to mitigate credit risk associated with customers located in certain geographical regions. Level 3 Communications (Level 3) accounted for approximately 20% and 25% of the Company's revenue in the three and six months ended June 27, 2009, respectively, and 21% and 27% of the Company's revenue in the three and six months ended June 28, 2008, respectively. In the three months ended June 27, 2009, the Company had one other customer that represented over 10% of the Company's revenue. In the six months ended June 27, 2009, Level 3 was the only customer that represented over 10% of the Company's revenue. In the three months ended June 28, 2008, the Company had two other customers that represented over 10% of the Company's revenue. In the six months ended June 28, 2008, the Company had one other customer that represented over 10% of the Company's revenue.

At June 27, 2009, the Company had amounts due from one customer that represented over 10% of the Company's accounts receivable balance. At December 27, 2008, the Company had amounts due from two customers that represented over 10% of the Company's accounts receivable balance.

The Company depends on a single or limited number of suppliers for components and raw materials. The Company generally purchases these single or limited source components and materials through standard purchase orders and has no long-term guarantee supply agreements with its suppliers. While the Company seeks to maintain sufficient reserve stock of such products, the Company's business and results of operations could be adversely affected by a stoppage or delay in receiving such components and materials, the receipt of defective parts, an increase in price of such components and materials or the Company's inability to obtain reduced pricing from its suppliers in response to competitive pressures.

***Derivative Instruments***

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The Company applies SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities* ( SFAS 133 ), which sets forth accounting and reporting standards for derivative instruments. All derivatives, whether designated in a hedging relationship or not, are required to be recorded on the balance sheet at fair value.

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Derivatives are financial instruments whose values are derived from one or more underlying financial instruments, such as foreign currency. Beginning in the second quarter of 2009, the Company established a foreign currency risk management program to reduce the impact of foreign exchange fluctuations on earnings from accounts receivable balances denominated in foreign currency. The Company enters into derivative transactions, specifically foreign currency exchange forward contracts, to manage its exposure to fluctuations in foreign exchange rates that arise primarily from its Euro denominated receivables. Gains and losses on these contracts are intended to offset the impact of foreign exchange rate changes on the underlying foreign currency denominated accounts receivable, and therefore, do not subject the Company to material balance sheet risk. The forward contracts are with one high quality institution and the Company monitors the creditworthiness of the party consistently. The forward contracts entered into during the three months ended June 27, 2009 were primarily denominated in Euro and typically had maturities of no more than 30 days. The contracts were settled for U.S. dollars at maturity of the contracts at rates agreed to at inception of the contracts. The Company does not enter into or hold derivatives for trading or speculative purposes. The Company does not designate foreign currency exchange forward contracts as hedges for accounting purposes, and accordingly changes in the fair value of these instruments are recognized immediately in earnings. Gains and losses on these forward contracts are included in Other gain (loss), net in the accompanying condensed consolidated statements of operations. Net realized gains and losses associated with exchange rate fluctuations on these forward contracts were immaterial for all periods presented. The Company did not enter into any foreign currency exchange forward contracts in 2008.

As of June 27, 2009, there was a \$15.2 million notional amount of foreign currency exchange forward contracts outstanding with an immaterial fair value amount due to the fact that the contract was entered and valued at the same date. For the three months ended June 27, 2009, the amount of gain (loss) recorded from these forward exchange contracts was \$0.3 million. In addition, the Company may selectively hedge forecasted revenue and expense transactions denominated in other foreign currencies in the future.

	June 27, 2009 (In thousands)
<b>Derivatives not designated as hedging instruments under SFAS 133:</b>	
Notional amount of foreign currency exchange forward contracts	\$ 15,183
Fair value of foreign currency exchange forward contracts	\$

**Foreign Currency Translation and Transactions**

The accounts of the Company's foreign subsidiaries are translated in accordance with SFAS No. 52, *Foreign Currency Translation* (SFAS 52). The Company considers the functional currencies of its foreign subsidiaries to be the local currency. Assets and liabilities recorded in foreign currencies are translated at the exchange rate as of the balance sheet date, and costs and expenses are translated at average exchange rates in effect during the year. Equity transactions are translated using historical exchange rates. The effects of foreign currency translation adjustments are recorded as a separate component of Stockholders' equity in the accompanying condensed consolidated balance sheets.

For all non-functional currency account balances, the re-measurement of such balances to the functional currency will result in either a foreign exchange transaction gain or loss which is recorded to Other gain (loss), net in the same period that the re-measurement occurred. Aggregate foreign currency transaction losses recorded in the three and six months ended June 27, 2009 was \$0.2 million and \$1.0 million, respectively. Commencing in the second quarter of 2009, the Company entered into foreign currency exchange forward contracts to reduce the impact of foreign exchange fluctuations on earnings from accounts receivable balances primarily denominated in Euro. The foreign currency transaction loss on these forward contracts amounted to \$0.3 million in the three and six months ended June 27, 2009 and substantially offset the transaction gain (loss) from the re-measurement of accounts receivables. If the Company had not entered into these foreign currency exchange forward contracts, the aggregate foreign currency transaction recorded in the three and six months ended June 27, 2009, would have been a gain of \$0.1 million and a loss of \$0.7 million, respectively, to Other gain (loss), net in the accompanying condensed consolidated statements of operations. Aggregate foreign currency transaction gains (losses) recorded in the three and six months ended June 28, 2008 were not material.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****5. Fair Value Measurements and Other-Than-Temporary Impairments****Fair Value Measurements**

A summary of the carrying values and balance sheet classification was as follows as of June 27, 2009 and December 27, 2008:

	June 27, 2009	December 27, 2008
	(In thousands)	
Cash in banks	\$ 23,637	\$ 26,885
Restricted cash	4,067	2,899
<b>Total cash and cash equivalents and restricted cash</b>	<b>\$ 27,704</b>	<b>\$ 29,784</b>
Available-for-sale investments	194,749	218,047
ARS - trading	50,311	48,888
Put Rights	14,317	15,866
<b>Total investments</b>	<b>\$ 259,377</b>	<b>\$ 282,801</b>
<b>Total cash and cash equivalents, investments and restricted cash</b>	<b>\$ 287,081</b>	<b>\$ 312,585</b>
<b>Reported as:</b>		
Cash and cash equivalents	\$ 94,151	\$ 166,770
Short-term investments	117,032	68,232
Short-term restricted cash	1,533	720
Long-term investments	71,831	74,684
Long-term restricted cash	2,534	2,179
<b>Total cash and cash equivalents, investments and restricted cash</b>	<b>\$ 287,081</b>	<b>\$ 312,585</b>

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Investments were as follows as of June 27, 2009 and December 27, 2008:

	Adjusted Amortized Cost	Non-Credit Related OTTI Losses	June 27, 2009 Other Gross Unrealized Gains (In thousands)	Other Gross Unrealized Losses	Estimated Fair Value
Money market funds	\$ 67,514	\$	\$	\$	\$ 67,514
Commercial paper	49,669		5	(13)	49,661
Corporate bonds	30,327		87	(32)	30,382
U.S. agency notes	5,000		18		5,018
U.S. treasuries	34,969		3	(1)	34,971
ARS	9,017 <sup>(1)</sup>	(1,814)			7,203 <sup>(2)</sup>
Total available-for-sale investments	\$ 196,496	\$ (1,814)	\$ 113	\$ (46)	\$ 194,749
ARS - trading	65,550			(15,239)	50,311
Put Rights			14,317		14,317
Total investments	\$ 262,046	\$ (1,814)	\$ 14,430	\$ (15,285)	\$ 259,377

<sup>(1)</sup> Amount represents the purchase amortized cost less \$0.9 million of credit-related OTTI recognized through earnings.

<sup>(2)</sup> Amount reflects investments in a continuous loss position for twelve months or longer.

	Amortized Cost	December 27, 2008 Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(In thousands)				
Money market funds	\$ 92,257	\$	\$	\$ 92,257
Commercial paper	51,581		(52)	51,529
Corporate bonds	25,578	49	(183)	25,444
U.S. treasuries	41,443	13		41,456
ARS	10,000		(2,639)	7,361
Total available-for-sale investments	\$ 220,859	\$ 62	\$ (2,874)	\$ 218,047
ARS - trading	65,650		(16,762)	48,888
Put Rights		15,866		15,866
Total investments	\$ 286,509	\$ 15,928	\$ (19,636)	\$ 282,801

Investments in commercial paper, corporate bonds and U.S. treasuries have a contractual maturity term of less than one year, while ARS have contractual maturity terms of up to 38 years. As discussed in Note 4, Summary of Significant Accounting Policies, of the Notes to Condensed Consolidated Financial Statements, the Company adopted FSP FAS 115-2 beginning in the second quarter of 2009 and recorded credit-related OTTI in earnings. Realized gains (losses) on short and long-term investments were not material for the three and six months ended June 27, 2009 and June 28, 2008.

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As of June 27, 2009, the Company held \$75.5 million (par value) of investments comprised of ARS, which are variable-rate debt securities and have a long-term maturity with the interest rate being reset through auctions that are typically held every 7, 28 or 35 days. The securities have historically traded at par and are callable at par at the option of the issuer. Interest was typically paid at the end of each auction period or semiannually. Since February 2008, most of the auctions for these securities have failed. At June 27, 2009, most of the \$75.5 million (par value) of ARS that the Company held was AAA rated, except for \$11.9 million (par value) of ARS that were downgraded to an A3 rating and \$5.1 million (par value) of ARS that were downgraded to Aa1 rating during the six months ended June 27, 2009. The Company's ARS are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. During the three months ended June 27, 2009, an immaterial amount of ARS was called by one issuer.

In October 2008, the Company elected to participate in a rights offering by UBS, one of the Company's brokers, which provides the Company with the Put Rights to sell UBS \$65.7 million of the Company's ARS portfolio at par value, which the Company purchased through UBS, at any time during a two-year sale period beginning June 30, 2010. By electing to participate in the rights

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

offering, the Company granted UBS the right, exercisable at any time prior to June 30, 2010 or during the two-year sale period, to purchase or cause the sale of the Company's ARS ( Call Right ). UBS has agreed to pay the Company the par value of its ARS within one day of settlement of any Call Right transaction. The Company's Put Rights are required to be recognized as a free-standing asset, separate from the Company's ARS. The Company elected to treat this portion of the ARS portfolio as trading securities and elected to measure the Put Rights at fair value under SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115* ( SFAS 159 ), which permits an entity to elect the fair value option for recognized financial assets, in order to match the changes in the fair value of the ARS. This allows any changes in the fair value of the Put Rights to be offset partially with changes in the fair value of the related ARS in the Company's condensed consolidated statements of operations. The ARS covered by the UBS settlement and the related Put Rights are revalued to fair market value on a quarterly basis. For the three and six months ended June 27, 2009, the Company recorded a \$0.4 million increase and a \$1.5 million decrease in the fair value of the Put Rights, respectively, in Other gain (loss), net in the accompanying condensed consolidated statements of operations. In addition, the Company recorded \$0.6 million and \$1.5 million of unrealized holding gains related to ARS trading securities in the three and six months ended June 27, 2009, respectively, in Other gain (loss), net in the accompanying condensed consolidated statements of operations.

As of June 27, 2009, the remaining \$10.0 million of ARS which are not subject to the UBS settlement were deemed to be other-than-temporarily impaired in accordance with FSP FAS 115-2. See section below titled, Other-Than-Temporary Impairments for further discussion.

In accordance with SFAS 157, the following table represents the Company's fair value hierarchy for its marketable securities measured at fair value as of June 27, 2009 and December 27, 2008:

	June 27, 2009			Total
	Level I	Level II	Level III	
(In thousands)				
Available-for-sale investments:				
Money market funds	\$ 67,514	\$	\$	\$ 67,514
Commercial paper		49,661		49,661
Corporate bonds		30,382		30,382
U.S. agency notes		5,018		5,018
U.S. treasuries	34,971			34,971
ARS			7,203	7,203
Total available-for-sale investments	\$ 102,485	\$ 85,061	\$ 7,203	\$ 194,749
ARS - trading			50,311	50,311
Put Rights			14,317	14,317
Total investments measured at fair value	\$ 102,485	\$ 85,061	\$ 71,831	\$ 259,377

	December 27, 2008			Total
	Level I	Level II	Level III	
(In thousands)				
Available-for-sale investments:				
Money market funds	\$ 92,257	\$	\$	\$ 92,257
Commercial paper		51,529		51,529
Corporate bonds		25,444		25,444
U.S. treasuries	41,456			41,456
ARS			7,361	7,361
Total available-for-sale investments	\$ 133,713	\$ 76,973	\$ 7,361	\$ 218,047
ARS - trading			48,888	48,888



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Put Rights			15,866	15,866
Total investments measured at fair value	\$ 133,713	\$ 76,973	\$ 72,115	\$ 282,801

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## INFINERA CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table summarizes the change in balance sheet carrying value associated with Level III financial instruments carried at fair value during the three and six months ended June 27, 2009:

	Three Months Ended						Net Unrealized Gains (Losses) Included in Net Income (Loss) relating to Assets and Liabilities Held at Period End
	March 28, 2009	Total Net Gains (Losses) Included In Other Comprehensive		Payments, Purchases (Sales), Net	Transfers In (Out), Net	June 27, 2009	
		Net Income (Loss)	Income (Losses)				
	(In thousands)						
ARS - available-for-sale	\$ 6,892	\$ (933) <sup>(1)</sup>	\$ 1,294 <sup>(2)</sup>	\$ (50)	\$	\$ 7,203	\$ (933)
ARS - trading	49,860	550 <sup>(4)</sup>		(99)		50,311	(15,239) <sup>(6)</sup>
Put Rights	13,899	418 <sup>(5)</sup>				14,317	14,317 <sup>(6)</sup>
Total	\$ 70,651	\$ 35	\$ 1,294	\$ (149)	\$	\$ 71,831	\$ (1,855)

	Six Months Ended						Net Unrealized Gains (Losses) Included in Net Income (Loss) relating to Assets and Liabilities Held at Period End
	December 27, 2008	Total Net Gains (Losses) Included In Other Comprehensive		Payments, Purchases (Sales), Net	Transfers In (Out), Net	June 27, 2009	
		Net Income (Loss)	Income (Losses)				
	(In thousands)						
ARS - available-for-sale	\$ 7,361	\$ (933) <sup>(1)</sup>	\$ 825 <sup>(3)</sup>	\$ (50)	\$	\$ 7,203	\$ (933)
ARS - trading	48,888	1,522 <sup>(4)</sup>		(99)		50,311	(15,239) <sup>(6)</sup>
Put Rights	15,866	(1,549) <sup>(5)</sup>				14,317	14,317 <sup>(6)</sup>
Total	\$ 72,115	\$ (960)	\$ 825	\$ (149)	\$	\$ 71,831	\$ (1,855)

(1) Amount represents the credit loss related to OTTI recorded as a component of Other income (expense), net in the accompanying condensed consolidated statements of operations.

(2) For the three months ended June 27, 2009, the amount includes the reversal of \$3.1 million of an unrealized loss balance as of March 28, 2009 and the recording of \$1.8 million of non-credit loss related to OTTI recorded in Accumulated other comprehensive loss in the accompanying condensed consolidated balance sheets.

(3) For the six months ended June 27, 2009, the amount includes the reversal of \$2.6 million of an unrealized loss balance as of December 27, 2008 and the recording of \$1.8 million of non-credit loss related to OTTI recorded in Accumulated other comprehensive loss in the accompanying condensed consolidated balance sheets.

(4)

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Amount represents the increase in the fair value of ARS trading securities recorded as Other gain (loss), net in the accompanying condensed consolidated statements of operations.

- (5) Amount represents the increase (decrease) in fair value of the Put Rights recorded as Other gain (loss), net in the accompanying condensed consolidated statements of operations.
- (6) Amount represents the cumulative gain recorded to date as Other gain (loss), net in the accompanying condensed consolidated statements of operations.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table summarizes the change in balance sheet carrying value associated with Level III financial instruments carried at fair value during the three and six months ended June 28, 2008:

	March 29, 2008	Three Months Ended			Transfers In (Out), Net	June 28, 2008
		Net Income (Loss)	Total Net Gains (Losses) Included In Other Comprehensive Income (losses) (In thousands)	Payments, Purchases (Sales), Net		
ARS - available-for-sale	\$ 71,556	\$	\$ (694)	\$	\$	\$ 70,862

  

	December 29, 2007	Six Months Ended			Transfers In (Out), Net	June 28, 2008
		Net Income (Loss)	Total Net Gains (Losses) Included In Other Comprehensive Income (losses) (In thousands)	Payments, Purchases (Sales), Net		
ARS - available-for-sale	\$ 96,150	\$	\$ (4,788)	\$ (20,500)	\$	\$ 70,862

**Other-Than-Temporary Impairments**

As of June 27, 2009, the Company held \$10.0 million of available-for-sale ARS with two issuers, one of which is AAA rated and the other one is A3 rated. As of June 27, 2009, the Company determined that it does not intend to sell these securities and it is not more likely than not that it will be required to sell the securities before recovery of its amortized cost. However, given that the present value of the expected cash flows for these securities was below their amortized cost basis, an OTTI of \$2.7 million, equal to the difference between the fair value and the amortized cost basis has occurred. The Company recognized a credit impairment loss of \$0.9 million in the Company's condensed consolidated statements of operations for the three and six months ended June 27, 2009. The non-credit related portion of this OTTI of \$1.8 million was recognized in Accumulated other comprehensive loss in the Company's condensed consolidated balance sheet at June 27, 2009.

The Company did not recognize OTTI charges on any of its securities prior to the second quarter of 2009. Activity related to the credit component recognized in earnings on available-for-sale debt securities held for which a portion of other-than-temporary impairment was recognized in Accumulated comprehensive loss for the three months ended June 27, 2009 is as follows:

	Three Months Ended June 27, 2009 Credit Related OTTI Recognized in Other Interest (Expense), Net
Beginning balance	\$
Addition	(933)
Reduction	
Ending balance	\$ (933)

**6. Balance Sheet Components****Restricted Cash**

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As of June 27, 2009, the Company had short-term restricted cash of \$1.5 million and long-term restricted cash of \$2.5 million. As of December 27, 2008, the Company had short-term restricted cash of \$0.7 million and long-term restricted cash of \$2.2 million. The Company's restricted cash balances are comprised of certificates of deposit, of which the majority are not FDIC insured. These amounts primarily collateralize the Company's issuances of stand-by and commercial letters of credit.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Inventories, Net***

Inventories, net consist of the following:

	June 27, 2009	December 27, 2008
	(In thousands)	
Raw materials	\$ 10,115	\$ 9,107
Work in process	40,151	37,902
Finished goods	22,266	11,977
Total inventory	\$ 72,532	\$ 58,986

Included in finished goods inventory at June 27, 2009 and December 27, 2008 were \$10.5 million and \$2.4 million, respectively, of inventory at customer locations for which product acceptance had not occurred.

***Property, Plant and Equipment, Net***

Property, plant and equipment, net is comprised of the following:

	June 27, 2009	December 27, 2008
	(In thousands)	
Computer hardware	\$ 5,535	\$ 5,304
Computer software	4,759	4,083
Laboratory and manufacturing equipment	75,045	68,830
Furniture and fixtures	636	644
Leasehold improvements	15,907	14,203
	\$ 101,882	\$ 93,064
Less accumulated depreciation and amortization	(53,780)	(46,244)
Property, plant and equipment, net	\$ 48,102	\$ 46,820

Property, plant and equipment, net includes approximately \$1.1 million in asset retirement obligations recorded as of June 27, 2009 and December 27, 2008. These asset retirement obligations are related to various office leases in California, Maryland and Pennsylvania.

***Accrued Expenses***

Accrued expenses are comprised of the following:

	June 27, 2009	December 27, 2008
	(In thousands)	
Loss contingency related to non-cancelable purchase commitments	\$ 1,892	\$ 2,257
Tax payable	8,855	7,332

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Other accrued expenses	6,473	6,503
Total accrued expenses	\$ 17,220	\$ 16,092

### 7. Comprehensive Income (Loss)

Total comprehensive income (loss) consists of other comprehensive income (loss) and net income (loss). Other comprehensive income (loss) includes certain changes in equity that are excluded from net income (loss). Specifically, cumulative foreign currency translation adjustments and unrealized holding gains (losses) on available-for-sale investments are included in Accumulated other comprehensive income (loss) in the condensed consolidated balance sheets.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table reconciles net income (loss) to comprehensive income (loss) for the three and six months ended June 27, 2009 and June 28, 2008:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands)			
Net income (loss)	\$ (27,111)	\$ 42,885	\$ (51,439)	\$ 70,479
Change in foreign currency translation gain (loss)	226	(168)	117	(339)
Change in unrealized gains (losses) on available-for-sale securities	1,609	(1,117)	1,063	(4,874)
Total comprehensive income (loss)	\$ (25,276)	\$ 41,600	\$ (50,259)	\$ 65,266

The components of accumulated other comprehensive loss are as follows:

	June 27, 2009	December 27, 2008
	(In thousands)	
Accumulated net unrealized loss on foreign currency translation adjustment	\$ (670)	\$ (786)
Accumulated unrealized non-credit related other-than-temporary impairment losses on available-for-sale investments	(1,814)	
Accumulated unrealized holding gain (loss) on available-for-sale investments	66	(2,812)
Total accumulated other comprehensive loss	\$ (2,418)	\$ (3,598)

**8. Basic and Diluted Net Income (Loss) Per Common Share**

Basic and diluted shares are calculated in accordance with SFAS No. 128, *Earnings per Share*, using the treasury method. Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per common share was computed using net income (loss) and the weighted average number of common shares outstanding plus potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include the assumed exercise of outstanding stock options, assumed vesting of outstanding restricted stock units ( RSUs ) and performance stock units ( PSUs ), assumed exercise of outstanding warrants, and assumed issuance of stock under the stock purchase plan using the treasury stock method.



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The following table sets forth the computation of net income (loss) per common share:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands)			
<b>Numerator - Basic and Diluted</b>				
Net income (loss)	\$ (27,111)	\$ 42,885	\$ (51,439)	\$ 70,479
<b>Denominator</b>				
Basic weighted average common shares outstanding	95,161	92,124	94,718	91,687
Effect of dilutive securities:				
Employee equity plans		4,707		4,861
Warrants to purchase common stock		453		440
Diluted weighted average common shares outstanding	95,161	97,284	94,718	96,988
Net income (loss) per common share - basic	\$ (0.28)	\$ 0.47	\$ (0.54)	\$ 0.77
Net income (loss) per common share - dilutive	\$ (0.28)	\$ 0.44	\$ (0.54)	\$ 0.73

The Company incurred a net loss for the three and six months ended June 27, 2009. Potential common shares from stock awards and warrants totaling 18.5 million shares were not included in the net loss per common share calculation, as their inclusion would have been antidilutive. For the three and six months ended June 28, 2008, the Company excluded 5.6 million shares, of outstanding stock awards, from the calculation of diluted net income per common share because the exercise prices of these stock options were greater than the average market value of the Company's common stock.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****9. Deferred Revenue and Deferred Inventory Costs**

Deferred revenue and deferred inventory costs consist of the following:

	June 27, 2009	December 27, 2008
	(In thousands)	
Deferred product and ratable product and related support and services, current	\$ 5,835	\$ 6,413
Deferred service revenue, current	9,847	8,270
<b>Deferred revenue, current</b>	<b>\$ 15,682</b>	<b>\$ 14,683</b>
Deferred product and ratable product and related support and services, non-current	5,530	7,724
Deferred services revenue, non-current	1,832	
<b>Deferred revenue, non-current</b>	<b>7,362</b>	<b>7,724</b>
<b>Total deferred revenue</b>	<b>\$ 23,044</b>	<b>\$ 22,407</b>
Deferred inventory costs, current	\$ 3,267	\$ 1,744
Deferred inventory costs, non-current	2,072	2,493
<b>Total deferred inventory costs</b>	<b>\$ 5,339</b>	<b>\$ 4,237</b>

Deferred ratable product and related support and services revenue primarily consists of revenue on transactions where VSOE of fair value of support and other services has not been established at the time of shipment and, therefore, the entire arrangement is being recognized ratably over the longest bundled support or service period or shipments where the revenue arrangement is not complete and revenue cannot therefore be recognized. Deferred services revenue primarily consists of invoiced services which will be amortized over the remaining contractual period.

**10. Commitment and Contingencies*****Contractual Obligations***

The Company has service agreements with its major production suppliers, where the Company is committed to purchase certain parts. As of June 27, 2009 and December 27, 2008, these non-cancelable purchase commitments were \$23.5 million and \$17.3 million, respectively. The contractual obligation table below excludes the Company's FIN 48 tax liabilities of \$0.5 million because the Company is unable to determine the timing of settlement if any, of these future payments with a reasonably reliable estimate.

The following is a summary of the Company's contractual obligations as of June 27, 2009:

	Total	Less than 1 year	Payments Due by Period		More than 5 years
			1 - 3 years	3 - 5 years	
	(In thousands)				
Purchase obligations	\$ 23,524	\$ 23,524	\$	\$	\$
Operating leases	13,563	4,089	5,871	2,284	1,319

Total contractual obligations	\$ 37,087	\$ 27,613	\$ 5,871	\$ 2,284	\$ 1,319
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***Legal Matters***

On May 9, 2006, the Company and Level 3 were sued by Cheetah in the U.S. District Court for the Eastern District of Texas Texarkana Division for alleged infringement of patent No. 6,795,605, and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of the Company's DTN System and to recover all damages caused by the alleged willful infringement including any and all compensatory damages available by law, such as actual and punitive damages, attorneys' fees, associated interest and Cheetah's costs incurred in the lawsuit. Cheetah's complaint does not request a specific dollar amount for these compensatory damages. The Company is contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent its product is found to infringe, and it has assumed the defense of this matter. On July 20, 2006, the Company and Level 3 filed an amended response denying all infringement claims under patent No. 6,795,605 and asserting that the claims of the patent are invalid and that the DTN System does not infringe the patent. On November 28, 2006, Cheetah filed a second amended

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**INFINERA CORPORATION**

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

complaint and added patent No. 7,142,347 to the lawsuit. On December 18, 2006, the Company and Level 3 filed responses to Cheetah's second amended complaint denying all infringement claims under patent No. 7,142,347 and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims are invalid and that the DTN System does not infringe the patents.

On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, the Company and Level 3 filed responses to Cheetah's third amended complaint denying all infringement claims, and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims of the patents are invalid and that the DTN System does not infringe the patents.

On March 14, 2007, the Company submitted requests to the U.S. Patent and Trademark Office for inter parts reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347 asking the U.S. Patent and Trademark Office to reexamine the patents based on prior art in order to invalidate the patents or limit the scope of each patent's claims. On March 21, 2007, the Company and Level 3 filed a motion with the court to stay all proceedings in the lawsuit pending the reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347.

On April 11, 2007, the Company, Level 3 and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. Patent and Trademark Office as to whether it will reexamine U.S. Patent Nos. 6,795,605 and 7,142,347; and (2) if the U.S. Patent and Trademark Office decides to reexamine either U.S. Patent No. 6,795,605 or 7,142,347, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. Patent and Trademark Office. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. On June 26, 2007, the U.S. Patent and Trademark Office ordered reexamination of U.S. Patent No. 6,795,605. On August 1, 2007, the U.S. Patent and Trademark Office ordered reexamination of U.S. Patent No. 7,142,347. As a result, all proceedings in this lawsuit are stayed until the final resolution of these reexaminations. The Company believes the suit is without merit and intends to defend itself vigorously, but it is unable to predict the likelihood of an unfavorable outcome.

In addition to the matters described above, the Company is subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material effect on its results of operations, financial position or cash flows.

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## INFINERA CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## 11. Stockholder s Equity

*Equity Incentive Plans*

As of June 27, 2009, there was a total of 8,631,248 shares available for grant under the Company s 2007 Equity Incentive Plan ( 2007 Plan ). The following tables summarize the Company s stock award activity and related information for the six months ended June 27, 2009:

	Number of Options	Weighted-Average Exercise Price per Share	Aggregate Intrinsic Value
	(In thousands, except per share data)		
<b>Outstanding at December 27, 2008</b>	11,366	\$ 8.13	\$ 34,125
Options granted	1,676	\$ 7.08	
Options exercised	(402)	\$ 1.76	\$ 2,597
Options canceled	(236)	\$ 11.15	

<b>Outstanding at June 27, 2009</b>	12,404	\$ 8.14	\$ 37,135
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Vested and expected to vest	12,186		\$ 36,752
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	Number of Restricted Stock Units	Weighted-Average Grant Date Fair Value Per Share	Aggregate Intrinsic Value
	(In thousands, except per share data)		
<b>Outstanding at December 27, 2008</b>	2,298	\$ 13.71	\$ 19,646
RSUs granted	2,172	\$ 7.24	
RSUs released	(260)	\$ 13.14	\$ 2,146
RSUs canceled	(120)	\$ 12.32	

<b>Outstanding at June 27, 2009</b>	4,090	\$ 10.35	\$ 37,209
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Vested and expected to vest	3,710		\$ 33,757
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	Number of Performance Stock Units	Weighted-Average Grant Date Fair Value per Share	Aggregate Intrinsic Value
	(In thousands, except per share data)		
<b>Outstanding at December 27, 2008</b>		\$	
PSUs granted	2,376	\$ 9.94	
PSUs canceled	(15)	\$ 10.09	

<b>Outstanding at June 27, 2009</b>	2,361	\$ 9.94	\$ 21,487
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The aggregate intrinsic value of unexercised options, unreleased RSUs and PSUs is calculated as the difference between the closing price of the Company s common stock of \$9.10 at June 27, 2009 and the exercise price of the underlying equity awards. The aggregate intrinsic value of the options which have been exercised and RSUs released is calculated as the difference between the fair market value of the common stock at the date of exercise or release and the exercise price of the underlying equity awards.

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During the six months ended June 27, 2009, the Company granted 2.4 million shares of PSUs to members of the Company's board of directors and executive officers, with the shares cliff vesting at the end of a three-year or four-year period. The number of shares to be issued upon vesting of the PSUs ranges from 0.5 to 2.0 times the number of PSUs granted depending on the relative performance of the Company's common stock price compared to NASDAQ over a three-year or four-year period.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Employee Stock Options**

During the three and six months ended June 27, 2009, the Company granted options to employees and directors to purchase an aggregate of 0.1 million and 1.7 million shares of common stock, at a weighted average exercise price of \$8.72 and \$7.08 per share, respectively. These options have exercise prices equal to the closing market prices of the Company's common stock on the dates these options were granted. Amortization of stock-based compensation for the three and six months ended June 27, 2009 was approximately \$4.3 million and \$8.3 million, respectively, net of estimated forfeitures. As of June 27, 2009, the total stock-based compensation cost related to options granted under SFAS 123(R) to employees and directors but not yet amortized was \$40.2 million, net of estimated forfeitures of \$2.1 million. These costs will be amortized on a straight-line basis over a weighted average period of approximately 2.7 years.

The ranges of estimated values of employee stock options granted, as well as ranges of assumptions used in calculating these values during the three and six months ended June 27, 2009 and June 28, 2008, were based on estimates as follows:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
<b>Employee and Director Stock Options</b>				
Volatility	63%	65% - 72%	63% - 72.5%	65% - 74%
Risk-free interest rate	2.52%	3.12% - 3.53%	2.13% - 2.52%	3.07% - 3.53%
Expected life	6.1 years	5.3 - 6.3 years	5.5 - 6.1 years	5.3 - 6.3 years
Estimated fair value	\$5.00 - \$5.27	\$7.66 - \$9.44	\$4.06 - \$5.87	\$7.31 - \$9.44

**Employee Stock Purchase Plan**

Compensation costs related to the ESPP under SFAS 123(R) were approximately \$0.8 million and \$1.5 million for the three and six months ended June 27, 2009, respectively, and \$0.6 million and \$1.0 million for the three and six months ended June 28, 2008, respectively. The fair value of the ESPP shares was estimated at the date of grant using the following assumptions:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
<b>Employee Stock Purchase Plan</b>				
Volatility	95%	65%	95%	65%
Risk-free interest rate	0.54%	2.12%	0.54%	2.12%
Expected life	0.5 years	0.5 years	0.5 years	0.5 years
Estimated fair value	\$2.83	\$4.42	\$2.83	\$4.42

**Restricted Stock Units**

During the three and six months ended June 27, 2009, the Company granted RSUs to employees to purchase an aggregate of 0.6 million and 2.2 million shares of common stock, respectively, at no cost, vesting annually over four or five years. The Company accounted for the fair value of the RSUs using the closing market price of the Company's common stock on the date of grant. Amortization of stock-based compensation related to RSUs in the three and six months ended June 27, 2009 was approximately \$2.3 million and \$4.2 million, respectively. As of June 27, 2009, total stock-based compensation cost related to RSU awards to employees but not yet amortized was approximately \$32.3 million, net of estimated forfeitures of \$4.3 million. These costs will be amortized on a straight-line basis over a weighted average period of approximately 3.6 years.

**Performance Stock Units**

During the six months ended June 27, 2009, the Company granted 2.4 million PSUs to members of the Company's board of directors and executive officers, with the shares cliff vesting at the end of a three-year or four-year period. No PSUs were granted during the three months

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ended June 27, 2009. The number of shares to be issued upon vesting of the PSUs ranges from 0.5 to 2.0 times the number of PSUs granted depending on the relative performance of the Company's common stock price compared to NASDAQ over a three-year or four-year period. Amortization of PSU stock-based compensation in the three and six months ended June 27, 2009 was approximately \$1.8 million and \$2.5 million, respectively. As of June 27, 2009, total stock-based compensation cost related to PSUs granted to members of the Company's board of directors and executive officers, but not yet amortized was approximately \$19.4 million, net of estimated forfeitures of \$1.3 million. These costs will be amortized on a straight-line basis over a weighted average period of approximately 2.7 years.



**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The grant date fair value of PSUs was estimated using the Monte Carlo simulation model with the following assumptions:

	<b>Six Months Ended June 27,</b>
<b>Performance Stock Unit Grants</b>	<b>2009</b>
Infinera volatility	70% - 75%
NASDAQ volatility	30% - 35%
Risk-free interest rate	1.25% - 1.71%
Correlation between Infinera and NASDAQ	0.60
Estimated fair value	\$9.65 - \$10.76

**Stock-Based Compensation**

The following table summarizes the effects of stock-based compensation related to awards granted to employees, members of the Company's board of directors and other non-employees on the Company's condensed consolidated balance sheets and statements of operations for the three and six months ended June 27, 2009 and June 28, 2008:

	<b>Three Months Ended June 27, 2009</b>	<b>June 28, 2008</b>	<b>Six Months Ended June 27, 2009</b>	<b>June 28, 2008</b>
	(In thousands)			
<b>Stock-based compensation effects in inventory</b>				
Beginning balance	\$ 2,417	\$ 1,854	\$ 1,801	\$ 2,215
Stock-based compensation expense added to inventory	1,269	821	2,382	1,393
Stock-based compensation expense recognized as cost of revenue	(901)	(905)	(1,398)	(1,623)
Stock-based compensation expense released from inventory to deferred inventory costs		(12)		(227)
Ending balance	\$ 2,785	\$ 1,758	\$ 2,785	\$ 1,758
<b>Stock-based compensation effects in deferred inventory cost</b>				
Beginning balance	\$ 32	\$ 730	\$ 101	\$ 947
Stock-based compensation expense added from inventory		12		227
Stock-based compensation expense recognized as cost of revenue	(3)	(314)	(72)	(746)
Ending balance	\$ 29	\$ 428	\$ 29	\$ 428
<b>Stock-based compensation effects in income (loss) before income taxes</b>				
Cost of revenue	\$ 477	\$ 271	\$ 856	\$ 479
Sales and marketing	1,599	1,164	3,013	2,014
Research and development	2,419	1,629	4,151	2,852
General and administration	3,513	2,072	6,158	3,574
	8,008	5,136	14,178	8,919
Cost of revenue - amortization from balance sheet*	904	1,219	1,470	2,369
Total stock-based compensation expense	\$ 8,912	\$ 6,355	\$ 15,648	\$ 11,288

\* Stock-based compensation expense deferred to inventory and deferred inventory costs in prior periods and recognized in the current period.

**12. Income Taxes**

The effective tax rate of (0.4)% for the three and six months ended June 27, 2009 differs from the statutory rate of 35% primarily related to unbenefited U.S. losses, non-deductible stock compensation charges under SFAS No. 123(R) and foreign taxes provided on foreign subsidiary earnings, offset by anticipated benefit related to refundable research and development tax credits due to the enactment of the American Recovery and Reinvestment Act of 2009, signed into law on February 17, 2009.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The realization of tax benefits of deferred tax assets is dependent upon future levels of taxable income, of an appropriate character, in the periods the items are scheduled to be deductible or taxable. Based on the available objective evidence, management believes it is more likely than not that the domestic net deferred tax assets will not be realizable. Accordingly, the Company has provided a full valuation allowance against its domestic deferred tax assets, net of deferred tax liabilities, as of June 27, 2009 and December 27, 2008. In determining future taxable income, the Company makes assumptions to forecast federal, state and international operating income, the reversal of temporary differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with the Company's forecasts used to manage its business. The Company intends to maintain the remaining valuation allowance until sufficient further positive evidence exists to support a reversal of, or decrease, in the valuation allowance.

**13. Segment Information**

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is the Company's chief executive officer. The Company's chief executive officer reviews financial information presented on a condensed consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. The Company has one business activity, and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, the Company is considered to be in a single reporting segment and operating unit structure.

Revenue by geographic region is based on the shipping address of the customer. The following table sets forth revenue and long-lived assets by geographic region:

**Revenue**

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands)			
North America	\$ 44,296	\$ 130,664	\$ 93,620	\$ 242,032
Europe, Middle East and Africa	19,666	24,505	35,329	49,309
Asia Pacific	4,970	5,940	6,563	8,021
Total revenue	\$ 68,932	\$ 161,109	\$ 135,512	\$ 299,362

**Property, plant and equipment, net**

	June 27, 2009	December 27, 2008
	(In thousands)	
North America	\$ 46,231	\$ 45,489
Asia Pacific	1,871	1,331
Total property, plant and equipment, net	\$ 48,102	\$ 46,820

**14. Guarantees****Product Warranties**

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Upon delivery of products, the Company provides for the estimated cost to repair or replace products or the related components that may be returned under the hardware warranty. In general, hardware warranty periods range from 1 to 5 years. Hardware warranties provide the purchaser with protection in the event that the product does not perform to product specifications. During the

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warranty period, the purchaser's sole and exclusive remedy in the event of such defect or failure to perform is limited to the correction of the defect or failure by repair, refurbishment or replacement, at the Company's sole option and expense. The Company estimates its hardware warranty obligations based on the Company's historical experience of known product failure rates, use of materials to repair or replace defective products, and service delivery costs incurred in correcting product failures. In addition, from time to time, specific hardware warranty accruals may be made if unforeseen technical problems arise with specific products. Management periodically assesses the adequacy of the Company's recorded warranty liabilities and adjusts the amounts as necessary. Changes in product warranty liability in the three and six months ended June 27, 2009 and June 28, 2008 are summarized below.

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands)			
Balance at the beginning of the period	\$ 9,702	\$ 11,027	\$ 9,940	\$ 9,992
Charges to operations	3,872	2,619	6,516	5,465
Utilization	(1,617)	(1,985)	(2,979)	(3,630)
Changes in estimate	(1,587) <sup>(1)</sup>	(1,101) <sup>(2)</sup>	(3,107) <sup>(1)</sup>	(1,267) <sup>(2)</sup>
Balance at the end of the period	\$ 10,370	\$ 10,560	\$ 10,370	\$ 10,560

<sup>(1)</sup> This favorable change in estimate primarily represented lower than expected costs of replacing defective products due to increased usage of lower cost repaired products in the repair process and reductions in the costs associated with repairing those units. In addition, to a lesser extent, the Company experienced some continued improvements in average return rates.

<sup>(2)</sup> Change in estimate is primarily due to continued improvements in average return rates and to a lesser extent, some on-going reduction in the cost of replacement products.

**15. Subsequent Event**

On July 21, 2009, the Company announced a restructuring plan under which it will close its Maryland based semi-conductor fabrication plant (FAB ) and consolidate these activities into its primary FAB location in Sunnyvale, California. This consolidation of activities into one location is expected to facilitate collaboration across integration platforms in support of the Company's next generation products. As a result, in the third and fourth quarters of 2009, the Company expects to record a restructuring charge and other associated costs of approximately \$8.0 million. This amount reflects the fair value of the remaining rent payments for office space, net of expected sublease income, accelerated depreciation on property and equipment, severance costs and other restructuring costs. The Company expects to complete the restructuring in the fourth quarter of 2009.

On July 29, 2009, the Company was informed by Level 3 Communications (Level 3) that they intend to use another DWDM vendor in their network. Level 3 has informed the Company that they intend to continue to purchase products and services from the Company, including equipment to fill the capacity on their existing Infinera DTN systems. The Company expects that the introduction of another vendor will impact the revenue it will receive from Level 3 beginning in the first half of 2010.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This quarterly report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include any expectation of earnings, revenues, gross margins, expenses, restructuring charges and associated costs, or other financial items; any statements of the plans, strategies and objectives of management for future operations and personnel; factors that may affect our operating results; statements concerning new products or services; statements related to capital expenditures; statements related to future economic conditions or performance; statements related to market growth; statements related to repayment of our adjustable rate securities; statements as to industry trends and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. These statements are often identified by the use of words such as anticipate, believe, continue, could, estimate, expect, intend, may, or will, and similar expressions or variations. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included elsewhere in this Form 10-Q and in our other Securities and Exchange Commission filings, including our annual report on Form 10-K for the year ended December 27, 2008 filed on February 17, 2009. Such forward-looking statements speak only as of the date of this report. We disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. The following discussion and analysis should be read in conjunction with our Selected Condensed Consolidated Financial Data and condensed consolidated financial statements and notes thereto included elsewhere in this quarterly report on Form 10-Q.*

**Executive Overview**

Infinera Corporation ( we or Infinera ) has developed a solution that we believe will change the economics, operating simplicity, flexibility, reliability and scalability of optical communications networks. At the core of our Digital Optical Network architecture is what we believe to be the world's only commercially-deployed, large-scale photonic integrated circuit ( PIC ). Our PICs transmit and receive 100 Gbps of optical capacity and incorporate the functionality of over 60 discrete optical components into a pair of indium phosphide chips approximately the size of a child's fingernail. We have used our PIC technology to design a new digital optical communications system called the DTN System. The DTN System is architected to improve significantly communications service providers' economics and service offerings as compared to traditional systems. Our DTN System is designed to provide faster service delivery and network management flexibility. Our carrier-class DTN System runs our Infinera IQ Network Operating System and is integrated with our Infinera Management Suite software, which together enhance and simplify network monitoring, management and control. In 2008, we introduced the Infinera Line System 2 ( ILS2 ) which is designed to extend the reach and optical capacity of our DTN System.

Our goal is to establish our Digital Optical Network, based on photonic integrated circuits, as a leading architecture for optical communications networks. We believe that photonic integrated circuits will significantly change optical communications networks in a fashion similar to the integrated circuit's impact on electronics beginning in the 1950's. As of June 27, 2009, we have sold our DTN System for deployment in the optical networks of 62 customers worldwide, including Cox Communications, Deutsche Telekom, Global Crossing, Interoute and Level 3 Communications ( Level 3 ). We do not have long-term purchase commitments with our customers. To date, a few of our customers have accounted for a significant portion of our revenue. In the three and six months ended June 27, 2009, Level 3 accounted for approximately 20% and 25% of our revenue, respectively. In the three and six months ended June 28, 2008, Level 3 accounted for approximately 21% and 27% of our revenue, respectively. On July 29, 2009, we were informed by Level 3 that they intend to use another DWDM vendor in their network. We believe that this vendor will be given a significant portion of Level 3's new network deployments commencing in the first half of 2010. Level 3 has informed us that they intend to continue to purchase products and services from us, including equipment to fill the capacity on their existing Infinera DTN Systems. We believe that the introduction of another vendor will impact the revenue we will receive from Level 3 beginning in the first half of 2010.

We believe that rapid growth of communications traffic and proliferation of next-generation bandwidth-intensive services such as video will expand the need and increase demand for optical network capacity. Our DTN System is designed to serve as the key element for long-haul and metro core optical transport networks of U.S. and international communications service providers. Customer deployments of our DTN System have ranged from two to thousands of network locations.

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We are headquartered in Sunnyvale, California, with employees located throughout the United States, Europe and the Asia Pacific region. We expect to continue to add personnel in the United States and internationally to develop our product and provide additional geographic sales and technical support coverage. We primarily sell our products through our direct sales force, with a small portion sold indirectly through resellers. We derived 85% and 90% of our revenue from direct sales to customers for the three and six months ended June 27, 2009, respectively. We derived 97% of our revenue from direct sales to customers for the three and six months ended June 28, 2008, respectively. We expect to continue generating a substantial majority of our revenue from direct sales in the future.

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Our historical revenue trends have been significantly impacted by the timing of our attainment of vendor specific objective evidence ( VSOE ) of fair value for most of our services and are not indicative of revenue trends in 2009 and future periods. Prior to the first quarter of 2008, revenue from product sales sold in combination with services ( bundled product sales ) was deferred and recognized ratably over a period of approximately one year. This resulted in the accumulation of \$174.4 million of deferred revenue and \$81.6 million of associated deferred inventory costs on the balance sheet as of December 29, 2007. We recognized \$165.8 million of this deferred revenue and \$78.4 million of associated deferred inventory costs in 2008. In addition, the attainment of VSOE of fair value for most of our services beginning in the first quarter of 2008 required us to recognize a majority of our 2008 product sales as revenue in the period in which the bundled products were accepted by the customer. The combined effect of the recognition of the deferred revenue from prior periods and the upfront recognition of revenue from bundled product sales in 2008 resulted in increased levels of revenue, gross margin and net income for 2008. We do not expect to recognize significant amounts of product related deferred revenue and deferred gross profit in the future.

The table below illustrates our 2008 results excluding the impact of the recognition of deferred amounts from prior periods:

	Year Ended December 27, 2008		
	As Reported Results	Pre-VSOE Deferred Adjustments	Deferred Revenue and Inventory Costs Excluded
	(In thousands, except gross margin)		
Revenue	\$ 519,212	\$ (165,787)	\$ 353,425
Cost of revenue	285,657	(78,401)	207,256
Gross profit	\$ 233,555	\$ (87,386)	\$ 146,169
Gross margin	45%		41%
Income (loss) from operations	\$ 73,433	\$ (87,386)	\$ (13,953)
Net income (loss)	\$ 78,728	\$ (87,386)	\$ (8,658)

We believe that these adjusted amounts, as presented in the Deferred Revenue and Inventory Costs Excluded column of the table above, are more indicative of the revenue and gross margins generated directly from our 2008 sales and invoiced shipment activities. We expect our future product revenues and gross margins to approximate our invoiced shipment results with no further significant releases of deferred amounts from prior periods. Our future product revenues will therefore be largely driven by our underlying invoiced shipment trends. Our near term year-over-year and quarter-over-quarter growth in invoiced shipments will likely be volatile and may be impacted by several factors including general economic and market conditions, the timing of large product deployments, acquisitions of new customers and development of new products.

We will continue to make significant investments in the business, and management believes that operating expenses will be approximately \$48 million to \$52 million per quarter for the remainder of 2009.

On July 21, 2009, we announced a restructuring plan under which we will close our Maryland based semi-conductor fabrication plant ( FAB ) and consolidate these activities into our primary FAB location in Sunnyvale, California. This consolidation of activities in one location is expected to facilitate collaboration across integration platforms in support of our next generation products. As a result, in the third and fourth quarters of 2009, we expect to record a restructuring charge and other associated costs of approximately \$8.0 million. This amount reflects the fair value of the remaining rent payments for office space, net of expected sublease income, accelerated depreciation on property and equipment, severance costs and other restructuring costs. We expect to complete the restructuring in the fourth quarter of 2009.

**Overview of Condensed Consolidated Financial Data***Revenue*

We derive our revenue from sales of our products, support and services. Our revenue is comprised of three components: (1) product revenue, (2) ratable product and related support and services revenue, or ratable revenue and (3) services revenue. Product revenue primarily relates to bundled products that are sold only with services for which VSOE of fair value has already been established and therefore, is recognized upfront under the residual method in accordance with Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*. Product revenue also includes products that are sold without services or a small amount of product sales where software is considered incidental and is recognized under Staff Accounting





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Our DTN System is integrated with software that is more than incidental to the functionality of our equipment. We refer to the integration of our DTN System with our software and related support and services as a bundled product. We recognize the majority of our revenue pursuant to Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*, or SOP 97-2. For arrangements with multiple elements which include product and services for which VSOE of fair value has been established, we allocate revenue to the undelivered element using the residual method based on VSOE of fair value for each of the undelivered elements. However, when these transactions also include undelivered services for which VSOE has not been established, product revenue is deferred and recognized ratably over the longest remaining service period.

Services revenue is comprised of (1) revenue related to services for which VSOE of fair value has been established, (2) revenue related to services which were sold on a standalone basis or (3) revenue related to extended hardware warranty sales.

The following table illustrates our revenue for the three and six months ended June 27, 2009 and June 28, 2008:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands)			
Revenue:				
Product	\$ 61,074	\$ 86,505	\$ 120,222	\$ 150,633
Ratable product and related support and services	845	69,581	2,314	141,967
Services	7,013	5,023	12,976	6,762
<b>Total of revenue</b>	<b>\$ 68,932</b>	<b>\$ 161,109</b>	<b>\$ 135,512</b>	<b>\$ 299,362</b>

**Total Revenue.** Total revenue for the three and six months ended June 28, 2008 of \$161.1 million and \$299.4 million, respectively, was unusually high due to the impact of the attainment of VSOE of fair value for software subscription services in the first quarter of 2008 and for training and installation and deployment services in the second quarter of 2008. These changes resulted in the recognition of incremental revenue of \$70.3 million and \$113.1 million in the three and six months ended June 28, 2008, respectively, related to reductions in the deferred revenue balance for each period. Excluding this deferred revenue impact, revenue in the three and six months ended June 28, 2008 would have been \$90.8 million and \$186.3 million, respectively. This compares to total revenue of \$68.9 million and \$135.5 million, respectively, for the three and six months ended June 27, 2009. The reduction in total revenue for the first and second quarters of 2009 as compared to the same periods in 2008 was primarily due to reduced sales of our DTN Systems to existing customers and the timing of revenue recognition on a number of large deployments with new customers that had not been completed at the end of the first and second quarters in 2009. We expect to recognize revenue related to one of these large deployments in the third quarter of 2009 and we expect to see some increase in revenues from existing customers over those levels experienced in the first and second quarters of 2009.

**Product Revenue.** Product revenue consists of products that are sold without services or bundled products that are sold with services for which VSOE of fair value has already been established and therefore, is recognized upfront under the residual method in accordance with Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transaction*. We use the residual method to recognize revenue when a sales agreement includes one or more elements to be delivered at a future date and VSOE of fair value of all undelivered elements exists. VSOE of fair value for software warranty, software subscription, training, installation and deployment services, spares management and on-site hardware replacement services is determined by reference to the price the customer will be required to pay when these services are sold separately.

As discussed above, we attained VSOE of fair value for software subscription services in the first quarter of 2008. This resulted in the recognition of \$86.5 million and \$150.6 million of product revenue for the three and six months ended June 28, 2008, respectively, from sales of bundled products and services where software subscription was the only undelivered element.

As of the first quarter of 2009, we had established VSOE of fair value for most of our services and as a result have recognized the majority of our product sales as product revenue at the time of customer acceptance. This resulted in the recognition of \$61.1 million and \$120.2 million for the three and six months ended June 27, 2009, respectively, of product revenue and reflects a reduction in underlying invoiced shipments for the period. This was primarily due to reduced sales of our DTN Systems to existing customers and the fact that a number of large deployments with new customers had not been completed at the end of the first and second quarters of 2009. Although we expect to recognize revenue related to these large deployments in the third quarter of 2009, we expect this increase to continue to be somewhat offset by lower revenues from existing

customers.

*Ratable Product and Related Support and Services Revenue.* Substantially all of our product sales are sold in combination with support services, which consist of software warranty or software subscription services. In addition, we have sold training, installation and deployment services, spares management and on-site hardware replacement services with a significant number of these bundled sales.

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VSOE of fair value for support services, training and installation and deployment services is determined by reference to the price the customer is required to pay when these services are sold separately. Support services are comprised of software warranty and software subscription services. Software warranty provides customers with maintenance releases and patches during the warranty support period. Software subscription also includes maintenance releases and patches and provides customers with rights to receive unspecified software product upgrades released during the support period. In order to establish VSOE for these services, we are required to establish a history of selling these services separately at a consistent price.

In the first quarter of 2008, we established VSOE for software subscription services. As a result, we were no longer required to ratably recognize product revenue for sales transactions where products were sold with software subscription. Product revenue from these transactions was recognized upon acceptance, and software subscription service revenue was deferred and recognized over the term of the arrangement which is generally 12 months. In instances where acceptance of the product occurred upon formal written acceptance, revenue was deferred until such written acceptance had been received. Revenue allocated to product sales was included in product revenue; revenue allocated to services was included in services revenue. However, when these transactions also included undelivered training or installation and deployment services for the period, product revenue was deferred and recognized ratably over the longest remaining support period until the training or installation and deployment services were complete. Upon completion of these services, the difference between the VSOE of fair value for the remaining software subscription period and the remaining unrecognized portion of the arrangement fee was recognized as ratable product and related support and services revenue.

The attainment of VSOE of fair value on software subscription services in the first quarter of 2008 resulted in a large proportion of the underlying invoiced shipments being recognized as revenue in that period. Product revenue increased due to our ability to recognize and allocate revenue related to bundled shipments where software subscription was the only undelivered element. In addition, the weighted average revenue deferral period for current period shipments of bundled products and services was approximately 90 days. These changes resulted in a significant increase in the amount of ratable revenue recognized from invoiced shipments in the first quarter of 2008 and a significant reduction in additions to the deferred revenue balance for the period. This change combined with a reduction in the deferred revenue balance of \$42.7 million resulted in the recognition of \$72.4 million of ratable revenue in the first quarter of 2008.

We established VSOE for our training and installation and deployment services in the second quarter of 2008. This allowed us to recognize most of our shipments in that period as revenue at the time of acceptance and to allocate that revenue to the appropriate revenue category in our condensed consolidated statements of operations. This resulted in increased levels of product and services revenue in the second quarter of 2008 offset by a reduction in ratable revenue. This change combined with a reduction in the deferred revenue balance of \$70.3 million resulted in the recognition of \$69.6 million of ratable revenue in the second quarter of 2008.

We had established VSOE of fair value for most of our services by the end of 2008 and as a result, during the first and second quarters of 2009, we recognized the majority of invoiced shipments for these quarters as product revenue at the time of customer acceptance. Ratable revenue for these periods related primarily to a small portion of our shipments where products are sold in combination with software warranty and other services for which VSOE has not yet been established and amounted to \$0.8 million and \$2.3 million for the three and six months ended June 27, 2009, respectively.

*Services Revenue.* Services revenue is comprised of (1) revenue related to bundled services for which VSOE of fair value has been established, (2) revenue related to services which were sold on a standalone basis or (3) revenue related to extended hardware warranty and other non-bundled services. Following the attainment of VSOE of fair value for software subscription services in the first quarter of 2008, attainment of VSOE of fair value for training and installation and deployment services in the second quarter of 2008 and the attainment of VSOE of fair value for spares management and on-site hardware replacement services in the fourth quarter of 2008, we have recognized revenue from delivered training and installation and deployment services, software subscription services, spares management services, and on-site hardware replacement services as services revenue in our condensed consolidated statements of operations.

*Deferred Revenue.* Following the attainment of VSOE of fair value on software subscription in the first quarter of 2008, the attainment of VSOE of fair value for training and installation and deployment services in the second quarter of 2008, and the attainment of VSOE of fair value for spares management and on-site hardware replacement services in the fourth quarter of 2008, the majority of our invoiced shipments are recognized as revenue in the same period in which they are accepted by the customer. As a result, our future deferred revenue balance will represent a small portion of our shipments where products are sold in combination with software warranty and other services for which VSOE has not yet been established or shipments where the revenue arrangement is not complete and revenue therefore cannot be recognized.

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Our services deferred revenue balance relates to deferred software subscription, extended hardware warranty and spares management and on-site hardware replacement services sales which will be recognized as service revenue on a ratable basis over the remaining contractual period and also relates to deferred training and deployment and installation services which will be recognized as services revenue upon delivery of the services.

The following table illustrates the increase (decrease) in deferred revenue for the three and six months ended June 27, 2009:

Deferred Revenue	Pre Mar. 29, 2008	Three Months Ended June 27, 2009			
	Product/Ratable Revenue	Post Mar. 29, 2008	Product/Ratable Revenue	Services Revenue	Total
			(In thousands)		
Beginning balance	\$ 6,706	\$	3,441	\$ 10,447	\$ 20,594
Additions to deferred revenue			3,087	6,470	9,557
Amortization to revenue	(707)		(1,162)	(5,238)	(7,107)
Ending balance	\$ 5,999	\$	5,366	\$ 11,679	\$ 23,044
<b>Change in deferred revenue balance</b>	<b>\$ (707)</b>	<b>\$</b>	<b>1,925</b>	<b>\$ 1,232</b>	<b>\$ 2,450</b>

Deferred Revenue	Pre Mar. 29, 2008	Six Months Ended June 27, 2009			
	Product/Ratable Revenue	Post Mar. 29, 2008	Product/Ratable Revenue	Services Revenue	Total
			(In thousands)		
Beginning balance	\$ 8,650	\$	4,177	\$ 9,580	\$ 22,407
Additions to deferred revenue			3,297	11,923	15,220
Amortization to revenue	(2,651)		(2,108)	(9,824)	(14,583)
Ending balance	\$ 5,999	\$	5,366	\$ 11,679	\$ 23,044
<b>Change in deferred revenue balance</b>	<b>\$ (2,651)</b>	<b>\$</b>	<b>1,189</b>	<b>\$ 2,099</b>	<b>\$ 637</b>

*Cost of Revenue*

Our cost of revenue is comprised of three components: cost of product revenue, cost of ratable product and related support and services and cost of services revenue.

The following table illustrates our cost of revenue for the specified periods:

Cost of revenue:	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands)			
Cost of product	\$ 45,699	\$ 47,124	\$ 89,564	\$ 86,789

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Cost of ratable product and related support and services	358	32,169	1,088	68,000
Cost of services	2,617	2,032	4,632	3,222
<b>Total cost of revenue</b>	<b>\$ 48,674</b>	<b>\$ 81,325</b>	<b>\$ 95,284</b>	<b>\$ 158,011</b>

*Total Cost of Revenue.* Total cost of revenue consists primarily of the costs of manufacturing network components, such as personnel costs, stock-based compensation, raw materials, overhead, services costs and period costs. Period costs consist primarily of freight and logistics costs, manufacturing ramp-up costs, expenses for inventory obsolescence, lower of cost or market ( LCM ) adjustments, and warranty obligations, and are recognized in the period in which they are incurred or can be reasonably estimated. All other costs of revenue are recognized in the same period as the corresponding revenue. We may experience some increase in inventory write-downs in future periods as we complete a number of major product transitions. In addition, the cost of some of our products may increase in future periods due to changes in yields and production volumes for those products.

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The initial deployment of our DTN System involves the installation of common equipment, including a chassis, optical line amplifiers and related equipment. This common equipment is typically sold at low or negative gross margins. When we sell equipment at a loss, the losses are recognized in the period in which they are incurred or can be reasonably estimated and often in advance of the recognition of related revenue. We refer to these losses as lower of cost or market adjustments, or LCM adjustments.

*Cost of Product Revenue.* Cost of product revenue consists of the costs of manufacturing network components, such as personnel costs, stock-based compensation, raw materials, overhead and period costs related to those sales recognized as product revenue in the period. Period costs consist primarily of shipping fees, logistics costs, manufacturing ramp-up costs, expenses for inventory obsolescence, LCM adjustments, and warranty obligations, and are recognized in the period in which they are incurred or can be reasonably estimated.

*Cost of Ratable Product and Related Support and Services Revenue.* Cost of ratable revenue consists primarily of the costs of manufacturing our network equipment, including personnel costs, stock-based compensation, raw materials, overhead and period costs related to those sales recognized as ratable revenue as described above. Period costs associated with ratable revenue are recognized in the period in which they are incurred or can be reasonably estimated. All other costs of ratable revenue are initially recorded as deferred inventory costs and are subsequently recognized in the same period as the corresponding revenue.

*Cost of Services Revenue.* Cost of service revenue consists primarily of the costs of providing our service offerings, including personnel costs, stock-based compensation and costs associated with third party service providers.

*Deferred Inventory Cost.* Deferred inventory cost increases by the cost of invoiced shipments of bundled products and services in a period and decreases as cost of ratable revenue is amortized in that period.

The following table illustrates the increase (decrease) in our deferred inventory cost for the three and six months ended June 27, 2009:

Deferred Inventory Cost	Three Months Ended June 27, 2009		
	Pre Mar. 29, 2008 Product/Ratable Revenue	Post Mar. 29, 2008 Product/Ratable Revenue (In thousands)	Total
Beginning balance	\$ 2,802	\$ 700	\$ 3,502
Additions to deferred inventory cost		2,188	2,188
Amortized to cost of revenue	(304)	(47)	(351)
Ending balance	\$ 2,498	\$ 2,841	\$ 5,339
<b>Change in deferred inventory cost balance</b>	<b>\$ (304)</b>	<b>\$ 2,141</b>	<b>\$ 1,837</b>

Deferred Inventory Cost	Six Months Ended June 27, 2009		
	Pre Mar. 29, 2008 Product/Ratable Revenue	Post Mar. 29, 2008 Product/Ratable Revenue (In thousands)	Total
Beginning balance	\$ 3,221	\$ 1,016	\$ 4,237
Additions to deferred inventory cost		2,191	2,191
Amortized to cost of revenue	(723)	(366)	(1,089)
Ending balance	\$ 2,498	\$ 2,841	\$ 5,339
<b>Change in deferred inventory cost balance</b>	<b>\$ (723)</b>	<b>\$ 1,825</b>	<b>\$ 1,102</b>





**Table of Contents***Gross Margin*

Gross margins have been and will continue to be affected by a variety of factors, including the product mix, average selling prices of our products, new product introductions and enhancements, changes to our manufacturing costs, including the impact of fluctuations in yields and production volumes, the amount of revenue that is recognized up front versus ratably and the period over which that revenue is recognized ratably, and the amount of common equipment sold at a loss causing an LCM adjustment.

The following table illustrates our gross margin for the specified periods:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands, except %)			
Revenue	\$ 68,932	\$ 161,109	\$ 135,512	\$ 299,362
Cost of revenue	48,674	81,325	95,284	158,011
<b>Gross profit</b>	<b>\$ 20,258</b>	<b>\$ 79,784</b>	<b>\$ 40,228</b>	<b>\$ 141,351</b>
Gross margin	29%	50%	30%	47%

The table below illustrates our three and six months ended June 27, 2008 results excluding the impact of the recognition of deferred amounts from prior periods.

	Three Months Ended June 28, 2008		
	As Reported Results	Pre-VSOE Deferred Adjustments	Deferred Revenue and Inventory Costs Excluded
	(In thousands, except %)		
Revenue	\$ 161,109	\$ (70,349)	\$ 90,760
Cost of revenue	81,325	(32,090)	49,235
<b>Gross profit</b>	<b>\$ 79,784</b>	<b>\$ (38,259)</b>	<b>\$ 41,525</b>
Gross margin	50%		46%

	Six Months Ended June 28, 2008		
	As Reported Results	Pre-VSOE Deferred Adjustments	Deferred Revenue and Inventory Costs Excluded
	(In thousands, except %)		
Revenue	\$ 299,362	\$ (113,097)	\$ 186,265
Cost of revenue	158,011	(55,112)	102,899
<b>Gross profit</b>	<b>\$ 141,351</b>	<b>\$ (57,985)</b>	<b>\$ 83,366</b>
Gross margin	47%		45%

As illustrated in the tables above, revenue and gross profit in the three and six months ended June 28, 2008 were unusually high due to the impact of the attainment of VSOE of fair value for software subscription services in the first quarter of 2008 and for training and installation and deployment services in the second quarter of 2008. This change resulted in the recognition of \$38.3 million and \$58.0 million of gross profit related to reductions in the deferred revenue and deferred inventory cost balances in the three and six months ended June 28, 2008, respectively.

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In addition, the change resulted in the recognition of \$41.5 million of gross profit in the three months ended June 28, 2008 and \$83.4 million in the six months ended June 28, 2008 from invoiced shipments in those periods. Gross profit of \$20.3 million and \$40.2 million for the three and six months ended June 27, 2009, respectively, primarily reflects invoiced shipments in the period and does not include the recognition of significant amounts of deferred gross profit from prior periods. Excluding the prior period impact described above, gross margin for the three and six months ended June 28, 2008 would have been 46% and 45%, respectively, compared to gross margin of 29% and 30% for the three and six months ended June 27, 2009, respectively.

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The prices paid for our DTN Systems vary by customer. In addition, the quantity of DTN Systems purchased by each of our customers varies from quarter-to-quarter depending on our customers' needs for optical transport equipment. To the extent that a customer with lower contractual prices purchases significant quantities of our DTN Systems that comprise a significant portion of the DTN Systems we sell within a quarter, our gross margin for such a quarter would be lower. In addition, pricing for optical communications systems, such as our DTN System, is very competitive and we must often respond to these competitive pressures by decreasing the initial purchase price of our product. As a result of these competitive pressures and in order to gain new customers, our common equipment is typically sold at low margins or at a loss. Our Digital Line Modules ( DLMs ), Tributary Adapter Modules ( TAMs ), and Tributary Optical Modules ( TOMs ) are typically sold at higher gross margins. These higher margin sales positively impact overall gross margin. Because of the significant impact that changes in product and customer mix and the timing of new customer deployments have on our gross margin levels, we experience significant gross margin volatility on a quarter-over-quarter basis. In addition, forecasted sales of negative margin common equipment to new customers or forecasted usage of incremental common equipment discounts by existing customers can result in increased LCM adjustments in order to record inventory and purchase commitments at its net realizable value. These LCM adjustments are recorded in advance of the recognition of the related revenue and result in lower gross margins in the periods in which the LCM adjustments are recorded.

Although it is difficult to predict gross margins in future periods, we will continue to recognize revenue related to common equipment deployments in the third quarter of 2009 and this will negatively impact gross margins. We expect this to be somewhat offset by some increase in TAM sales over the volumes experienced in the second quarter of 2009.

### *Operating Expenses*

Operating expenses consist of sales and marketing, research and development and general and administrative expenses, and are recognized as incurred. Personnel-related costs are the most significant component of each of these expense categories. We expect personnel costs to continue to increase as we hire new employees to support our anticipated long-term growth. We expect total operating expenses to average approximately \$48 million to \$52 million per quarter for the remainder of 2009.

Research and development expenses are the largest component of our operating expenses and primarily include salary and related benefit costs, including stock-based compensation expense, and facilities costs and other related expenses. We expense research and development expenses as incurred. We are devoting substantial resources to the continued development of additional functionality for existing products and the development of new products. We intend to continue to invest significantly in our research and development efforts both in the United States and internationally because we believe that they are essential to maintaining our competitive position.

Sales and marketing expenses primarily include salary and related benefit costs, including stock-based compensation expense, sales commissions, marketing and facilities costs. We expect sales and marketing expenses to increase as we hire additional personnel both in the United States and internationally to support our expected revenue growth.

General and administrative expenses consist primarily of salary and related benefit costs, including stock-based compensation expense and facilities related to our executive, finance, human resource, information technology and legal organizations, and fees for professional services. Professional services principally consist of outside legal, audit and information technology consulting costs.

### *Other Income (expense), net*

Other income (expense), net includes interest income on our cash and short and long-term investment balances, gains or losses on sale of assets and investments, foreign currency transactions and translations, changes in the fair value of our Put Rights, unrealized holding gains or losses on our adjustable rate securities ( ARS ) and unrealized other-than-temporary credit impairment losses on available-for-sale ARS. If interest rates continue to fluctuate due to current global market conditions, we will experience volatility in future interest income from our cash and short and long-term investment balances, assuming consistent investment levels.

### *Provision for income taxes*

The effective tax rate of (0.4)% for the three and six months ended June 28, 2009 differs from the statutory rate of 35% primarily related to unbenefited U.S. losses, non-deductible stock compensation charges under SFAS No. 123(R) and foreign taxes provided on foreign subsidiary earnings, offset by anticipated benefit related to refundable research and development tax credits due to the enactment of the American Recovery and Reinvestment Act of 2009, signed into law on February 17, 2009. This compares to an effective tax rate of 5.0% and 4.6% for the three and six months ended June 28, 2008, respectively, which reflects tax benefits arising from the release of certain valuation allowance on domestic tax attribute carryforwards which was partially offset by the impact of certain non-deductible stock compensation charges under SFAS No. 123(R), federal alternative minimum tax and state income taxes.



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**Table of Contents****Critical Accounting Policies and Estimates**

Our condensed consolidated financial statements are prepared in accordance with United States generally accepted accounting principles, or U.S. GAAP. These accounting principles require us to make certain estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the condensed consolidated financial statements, as well as the reported amounts of revenue and expenses during the periods presented. Significant estimates and assumptions made by management include revenue recognition, stock-based compensation, inventory valuation, allowances for doubtful accounts, accrued warranty, fair value measurement of investments, cash, cash equivalents and short and long-term investments, other-than-temporary impairments and accounting for income taxes. Below, we further discuss our policies as well as the estimates and judgments related to stock-based compensation, fair value measurement and classification of investments, and other-than-temporary impairments. Our other policies are discussed in more detail under the caption Critical Accounting Policies and Estimates in our 2008 Annual Report on Form 10-K filed with the SEC on February 17, 2009. By their nature, these estimates and judgments are subject to an inherent degree of uncertainty. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that these estimates and judgments are made. To the extent there are material differences between these estimates and actual results, our condensed consolidated financial statements will be affected. For additional information on the recent accounting pronouncements impacting our business, see Note 3, Accounting Changes to the Notes to Condensed Consolidated Financial Statements.

***Stock-Based Compensation***

Under Statement of Financial Accounting Standards No. 123(R), *Share-Based Payments*, ( SFAS 123(R) ), we estimate the fair value of the stock options granted and rights to acquire stock under our Employee Stock Purchase Plan ( ESPP ) using the Black-Scholes option pricing formula and a single option award approach. For new-hire grants, options typically vest with respect to 25% of the shares one year after the option s vesting commencement date and the remainder ratably on a monthly basis over three years, commencing one year after the vesting commencement date. For annual refresh grants, options typically vest ratably on a monthly basis over four or five years after the vesting commencement date. ESPP typically provides for consecutive six-month offering periods, except for the first such offering period which commenced on June 7, 2007 and ended on February 15, 2008.

We make a number of estimates and assumptions related to SFAS 123(R) including the following:

The expected forfeiture rate is estimated based on our historical forfeiture data and compensation costs are recognized only for those equity awards expected to vest. The estimation of the forfeiture rate requires judgment, and to the extent actual forfeitures differ from expectations, changes in estimate will be recorded as an adjustment in the period when such estimates are revised. Actual results may differ substantially from the estimates.

The expected term of options granted represents the period of time that options granted are expected to be outstanding, which incorporates the contractual terms, grant vesting schedules and expected employee and director behaviors. Commencing in June 2007, we elected to use the simplified method to estimate the expected term as permitted by SEC Staff Accounting Bulletin No. 110 ( SAB 110 ) due to increased liquidity of the underlying options in the post IPO era as compared to our historical grants.

Expected volatility of our stock is based on the weighted average implied and historical volatility of our Company and our peer group. The peer group is comprised of similar companies in the same industrial sector. Peer group data is used because we do not yet have sufficient historical volatility data for our own common stock.

In the future, when we gain sufficient historical volatility data and there is sufficient historical data on the actual term employees hold their options, the expected volatility and expected term will be derived based on this information and therefore may be subject to change. This could substantially change the grant-date fair value of future awards of stock options and ultimately the expense recorded by us.

We issued performance share units ( PSUs ) in the first quarter of 2009, as part of our annual refresh grant process. The PSUs entitle our executive officers and board members to receive a number of shares of our common stock based on our stock price performance over a three-year or four-year period as compared to the NASDAQ Composite Index ( NASDAQ ) for the same periods. The PSUs cliff vest after three or four years and the number of shares to be issued upon vesting ranges from 0.5 to 2.0 times the number of PSUs granted depending on the relative performance of our common stock price compared to NASDAQ. This performance metric is classified as a market condition under SFAS 123(R). We estimate the fair value of the PSUs granted using the Monte Carlo simulation model and recognize the related expenses on a straight-line amortization basis.

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The Monte Carlo simulation model is based on a discounted cash flow approach, with the simulation of a large number of possible Company and NASDAQ stock price outcomes. The use of the Monte Carlo simulation model requires the input of a number of assumptions including expected volatility of our stock price, expected volatility of NASDAQ, correlation between changes in our stock price and changes in NASDAQ, risk free interest rate, and expected dividends. Expected volatility of our stock is based on the weighted average implied and historical volatility of our peer group in the industry in which we do business. Expected volatility of

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NASDAQ is based on the historical and implied data. Correlation is based on the historical relationship between our peer group's stock price and NASDAQ price. The risk free interest rate is based upon the treasury zero-coupon yield appropriate for the term of the PSU as of the grant date. Our expected dividend yield is zero as we do not expect to pay dividends in the future. The expected dividend yield for NASDAQ is the annual dividend yield expressed as a percentage of the price of NASDAQ on the grant date.

***Fair Value Measurement of Investments***

Effective December 30, 2007, we adopted FASB Statement No. 157, *Fair Value Measurements* ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value and expands disclosure of fair value measurements. SFAS 157 applies under other accounting pronouncements that require or permit fair value measurements and, accordingly, does not require any new fair value measurements. FASB Staff Position No. 157-3, *Determining the Fair Value of a Financial Asset When the Market for That Asset is Not Active*, ( FSP FAS 157-3 ) and FASB Staff Position No. 157-4, *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* ( FSP FAS 157-4 ), clarify the application of SFAS 157 in an inactive market.

The fair values of our financial instruments reflect the estimates of amounts that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The fair value estimates presented in our condensed consolidated financial statements are based on information available to us as of June 27, 2009.

In accordance with SFAS 157 and related pronouncements, we apply a fair value hierarchy based on three levels of inputs as follows:

- Level I - Quoted prices in active markets for identical assets or liabilities.
- Level II - Inputs other than Level I that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. In addition, Level II could include unobservable inputs that are not significant to the fair value of the assets or liabilities.
- Level III - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

We measure our cash equivalents, debt securities and Put Rights at fair value and classify our securities in accordance with the fair value hierarchy of FAS 157 and related pronouncements.

Our money market funds and U.S. treasuries are classified within Level I of the fair value hierarchy and are valued based on quoted prices in active markets for identical securities.

We classify our commercial paper, corporate bonds and U.S. agency notes within Level II of the fair value hierarchy as follows:

***Commercial Paper***

We review market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day and then follows a revised accretion schedule to determine the fair market value at period end. In the absence of any observable market transactions for a particular security, the fair market value at period end is derived by accreting from the last observable market price. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data accreted mathematically to par, and result in the classification of these securities as Level II of the fair value hierarchy.

***Corporate Bonds***

We review trading activity and pricing for each of the corporate bond securities in our portfolio as of the measurement date and determine if pricing data of sufficient frequency and volume in an active market exists in order to support Level I classification of these securities. When sufficient quoted pricing for identical securities is not available, we obtain market pricing and other observable market inputs for similar securities from a number of industry standard data providers. In instances where multiple prices exist for similar securities, these prices are used as inputs into a distribution-curve to determine the fair market value at period end. As a result, we classify our corporate bonds as Level II of the

fair value hierarchy.

*U.S. Agency Notes*

We review trading activity and pricing for our U.S. agency notes as of the measurement date. When sufficient quoted pricing for identical securities is not available, we use market pricing and other observable market inputs for similar securities obtained from a number of industry standard data providers. These inputs represent quoted prices for similar assets in active markets or these inputs have been derived from observable market data, and result in the classification of these securities as Level II of the fair value hierarchy.



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We classify our ARS and related Put Rights within Level III of the fair value hierarchy as follows:

### *Auction Rate Securities*

ARS are classified within Level III because they are valued, in part, by using inputs that are unobservable in the market and are significant. The recent uncertainties in the credit markets have affected all of our ARS and auctions for these securities have failed to settle on their respective settlement dates. In light of these developments, to determine the fair value for our ARS, we used a combination of the market approach and income approach. The market approach uses pricing based on transactions in an inactive secondary market for similar or comparable securities. In addition, we performed our own discounted cash flow analysis. Management determined that it was most appropriate to value the ARS using the market approach and income approach equally given the facts and circumstances as of June 27, 2009, and therefore incorporated both valuations in our fair value measurement.

The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of our ARS, as of June 27, 2009, are as follows:

#### *Contractual cash flow*

The model assumed that the principal amount or par value for these securities would be repaid at the end of the estimated workout period. In addition, future interest payments were estimated as described in each individual prospectus and based on the then current U.S. Treasury Bill ( T-Bill ) rate adjusted for a failed auction premium of 120 basis points ( bps ) for all our ARS, except 150 bps for A3 rated securities.

#### *ARS discount rate*

The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the estimated workout period of the securities. As of the measurement date, these rates were then adjusted by a total of 350 bps to 500 bps which included an estimate of the market student loan spread and a discount factor to reflect the lack of liquidity and the credit risk of the securities. Most of our ARS were AAA rated, except for \$17.0 million (par value) of securities held with two issuers whose credit ratings were downgraded to A3 and Aa1 ratings during the six months ended June 27, 2009. Our ARS are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. The discount rate does, however, include a discount factor to reflect the issuer's credit risk and its potential inability to perform its obligations under the terms of the ARS agreements. Our other-than-temporary impairment analysis for two of our available-for-sale ARS indicates that the estimated credit risk element included in the discount rate for an AAA rated security is approximately 150 bps and 250 bps for an A3 rated security.

#### *Estimated maturity*

We estimated the workout period of our ARS as the weighted average life of the underlying trust loan portfolio where this information was available from servicing and other trust reports. In a small number of instances where this information was not available, we used the weighted average life of the loan portfolio of a similar trust. The estimated time to maturity of the securities as of the measurement date ranged from 10.1 years to 19.0 years.

### *Put Rights*

Put Rights associated with our UBS ARS are classified as Level III because they are valued, in part, by using inputs that are unobservable in the market and are significant. The fair value of the Put Rights is equal to the difference between the fair value of the UBS ARS calculated as described above and their value including the impact of the Put Rights. We performed our own discounted cash flow analysis to calculate the fair value of the UBS ARS including the impact of the Put Rights.

The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of the UBS ARS including the impact of the Put Rights as of June 27, 2009 are as follows:

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### *Contractual cash flow*

The model assumed that the principal amount or par value for the ARS would be repaid on June 30, 2010, based on our current intent to exercise our Put Rights and sell these securities to UBS on that date. In addition, future interest payments were estimated as described in each individual prospectus and based on the then current T-Bill rate adjusted for a failed auction premium of 120 bps for all of our ARS, except for 150 bps for A3 rated securities.

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**Table of Contents***Discount rate*

The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the expected sale date of these securities. As of the measurement date, this rate was adjusted by a total of 120 bps which represented a discount factor to reflect UBS credit risk and UBS potential inability to perform its obligations under the Put Rights agreement.

We believe that the fair value of our ARS and Put Rights could change significantly in the future, based on market conditions and continued uncertainties in the financial markets. UBS credit risk may be subject to significant volatility and it is difficult to predict future fluctuations. A 10% deterioration in UBS credit risk would result in a \$0.1 million net loss in our condensed consolidated statements of operations as of June 27, 2009. Deterioration in the ARS discount rate or a change in the estimated time to maturity would have no impact on our condensed consolidated statements of operations.

*Other-Than-Temporary Impairments*

It is our policy to review our available-for-sale marketable debt securities on a regular basis to evaluate whether or not any security has experienced an other-than-temporary decline in fair value. To determine if an other-than-temporary impairment ( OTTI ) exists, we first determine if we have the intent or if we are more likely than not that we will be required to sell the security prior to recovery of its amortized cost basis. If we intend to sell the security or it is more likely than not that we will be required to sell the security before recovery of the amortized cost basis, then the total amount of the fair market value write-down is determined to represent an OTTI and is recognized in earnings in the period.

In instances where we do not intend to sell the security and it is not more likely than not that we will be required to sell the security before recovery of the amortized cost basis, we must determine if we expect to recover the entire amortized cost basis of the security. If the present value of the cash flows expected to be collected is less than the amortized cost basis of the security, then an OTTI is considered to have occurred. This OTTI write-down is then separated into an amount representing credit loss, which is recognized in earnings, and the amount related to all other factors, which is recognized in other comprehensive income (loss). In determining if a credit loss has occurred, it is our policy to isolate the credit loss related portion of the discount rate used to derive the fair market value of the security and apply this to the expected cash flows in order to determine the portion of the OTTI that is credit loss related. This credit related portion of the discount rate is derived based on the financial condition of the issuer, including changes in rating agency ratings for the security or increases in credit related yield spreads on similar securities offered by the same issuer.

As of June 27, 2009, we held \$10.0 million of available-for-sale ARS held with two issuers, one of which is AAA rated and the other one is A3 rated. As of June 27, 2009 we determined that we do not intend to sell these securities and it is not more likely than not that we will be required to sell the securities before recovery of its amortized cost. However, given that the present value of the expected cash flows for these securities was below their amortized cost basis, an OTTI of \$2.7 million, equal to the difference between the fair value and the amortized cost basis has occurred. We recognized a credit impairment loss of \$0.9 million in our condensed consolidated statements of operations for the three and six months ended June 27, 2009. The non-credit related portion of this OTTI of \$1.8 million was recognized in Accumulated other comprehensive loss in our condensed consolidated balance sheet at June 27, 2009.

A 10% deterioration in the ARS student loan credit spread would result in \$0.2 million of additional OTTI credit loss in our condensed consolidated statements of operations for the second quarter of 2009.

**Table of Contents****Results of Operations***Revenue*

The following table presents our revenue by type, geography and sales channel for the three and six months ended June 27, 2009 and June 28, 2008:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
<b>(In thousands, except %)</b>				
<b>Statements of Operations Data:</b>				
Revenue by type				
Product	\$ 61,074	\$ 86,505	\$ 120,222	\$ 150,633
Ratable product and related support and services	845	69,581	2,314	141,967
Services	7,013	5,023	12,976	6,762
Total	\$ 68,932	\$ 161,109	\$ 135,512	\$ 299,362
% Revenue by type				
Product	89%	54%	89%	50%
Ratable product and related support and services	1%	43%	2%	48%
Services	10%	3%	9%	2%
Total	100%	100%	100%	100%
Total revenue by geography				
Domestic	\$ 44,296	\$ 130,664	\$ 93,620	\$ 242,032
International	24,636	30,445	41,892	57,330
Total	\$ 68,932	\$ 161,109	\$ 135,512	\$ 299,362
% Revenue by geography				
Domestic	64%	81%	69%	81%
International	36%	19%	31%	19%
Total	100%	100%	100%	100%
Total revenue by sales channel				
Direct	\$ 58,297	\$ 156,828	\$ 122,394	\$ 290,613
Indirect	10,635	4,281	13,118	8,749
Total	\$ 68,932	\$ 161,109	\$ 135,512	\$ 299,362
% Revenue by sales channel				
Direct	85%	97%	90%	97%
Indirect	15%	3%	10%	3%
Total	100%	100%	100%	100%

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*Three Months Ended June 27, 2009 Compared to Three Months Ended June 28, 2008.*

Total revenue decreased to \$68.9 million for the three months ended June 27, 2009 from \$161.1 million for the corresponding period in 2008 primarily reflecting a decrease in revenue recognized from a reduction in the deferred revenue balance and, to a lesser extent, lower sales of our DTN Systems to existing customers and the timing of acceptance of deployments with new customers. International revenue increased to 36% in the three months ended June 27, 2009 from 19% in the corresponding period in 2008 as we experienced increased levels of sales to international customers during the second quarter of 2009. While we expect international revenues to continue to grow on an absolute dollar basis as we increase our sales activities in Europe and Asia, they may fluctuate as a percentage of total revenue.

Total product revenue decreased to \$61.1 million for the three months ended June 27, 2009 from \$86.5 million for the corresponding period in 2008 primarily due to reduced sales of our DTN Systems to existing customers and the timing of acceptance of deployments with new customers.

Total ratable revenue decreased to \$0.8 million for the three months ended June 27, 2009 from \$69.6 million for the corresponding period in 2008 due to the attainment of VSOE of fair value for most of our services during 2008. Since the second quarter of 2008, we have recognized the majority of our invoiced shipments as product revenue at the time of acceptance. Ratable revenue for the second quarter of 2009 related primarily to a small portion of our shipments where products are sold in combination with software warranty and other services for which VSOE has not yet been established and amounted to \$0.8 million for the quarter.

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Total services revenue increased to \$7.0 million for the three months ended June 27, 2009 from \$5.0 million for the corresponding period in 2008, reflecting the attainment of VSOE of fair value for most of our services commencing in the first quarter of 2008 which resulted in more revenue for these services being recorded separately.

*Six Months Ended June 27, 2009 Compared to Six Months Ended June 28, 2008.*

Total revenue decreased to \$135.5 million for the six months ended June 27, 2009 from \$299.4 million for the corresponding period in 2008. This decrease primarily reflected a decrease in revenue recognized from a reduction in the deferred revenue balance and, to a lesser extent, lower sales of our DTN Systems to existing customers and the timing of acceptance of deployments with new customers. International revenue increased to 31% for the six months ended June 27, 2009 from 19% for the corresponding period in 2008 as we experienced increased levels of sales to international customers during the first two quarters of 2009. While we expect international revenues to continue to grow on an absolute dollar basis as we increase our sales activities in Europe and Asia, they may fluctuate as a percentage of total revenue.

Total product revenue decreased to \$120.2 million for the six months ended June 27, 2009 from \$150.6 million for the corresponding period in 2008 primarily due to reduced sales of our DTN Systems to existing customers and the timing of acceptance of deployments with new customers.

Total ratable revenue decreased to \$2.3 million for the six months ended June 27, 2009 from \$142.0 million for the corresponding period of 2008 due to the attainment of VSOE of fair value for most of our services during 2008. As a result, commencing in the second quarter of 2008, we have recognized the majority of our invoiced shipments for the quarter as product revenue at the time of acceptance. Ratable revenue for the second quarter of 2009 related primarily to a small portion of our shipments where products are sold in combination with software warranty and other services for which VSOE has not yet been established.

Total services revenue increased to \$13.0 million for the six months ended June 27, 2009 from \$6.8 million for the corresponding period in 2008, reflecting the attainment of VSOE of fair value for most of our services commencing in the first quarter of 2008 and resulted in more revenue for these services being recorded separately.

*Cost of Revenue and Gross Margin*

The following table presents our revenue, cost of revenue by revenue source, gross profit and gross margin for the three and six months ended June 27, 2009 and June 28, 2008:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands, except %)			
Total revenue	\$ 68,932	\$ 161,109	\$ 135,512	\$ 299,362
Total cost of revenue:				
Cost of product	45,699	47,124	89,564	86,789
Cost of ratable product and related support and services	358	32,169	1,088	68,000
Cost of services	2,617	2,032	4,632	3,222
Gross profit	\$ 20,258	\$ 79,784	\$ 40,228	\$ 141,351
Gross margin	29%	50%	30%	47%

The table below illustrates our three and six months ended June 28, 2008 results as reported and excludes the impact of the recognition of deferred amounts from prior periods.

	Three Months Ended June 28, 2008		
	As Reported Results	Pre-VSOE Adjustments Deferred	Deferred Revenue and Inventory Costs Excluded

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	(In thousands, except %)		
Total revenue	\$ 161,109	\$ (70,349)	\$ 90,760
Total cost of revenue:			
Cost of product	47,124	(32,090)	15,034
Cost of ratable product and related support and services	32,169		32,169
Cost of services	2,032		2,032
Gross profit	\$ 79,784	\$ (38,259)	\$ 41,525
Gross margin	50%		46%

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	Six Months Ended June 28, 2008		
	As Reported Results	Pre-VSOE Deferred Adjustments	Deferred Revenue and Inventory Costs Excluded
		(In thousands, except %)	
Total revenue	\$ 299,362	\$ (113,097)	\$ 186,265
Total cost of revenue:			
Cost of product	86,789	(55,112)	31,677
Cost of ratable product and related support and services	68,000		68,000
Cost of services	3,222		3,222
Gross profit	\$ 141,351	\$ (57,985)	\$ 83,366
Gross margin	47%		45%

*Three Months Ended June 27, 2009 Compared to Three Months Ended June 28, 2008.*

Gross margin decreased to 29% in the three months ended June 27, 2009 from 50% in the corresponding period in 2008. As illustrated in the table above, revenue and gross profit in the second quarter of 2008 were unusually high due to the impact of the attainment of VSOE of fair value for software subscription services in the period. This change resulted in the recognition of \$38.3 million of gross profit related to reductions in the deferred revenue and deferred inventory cost balances in the period and \$41.5 million of gross profit from invoiced shipments in the current quarter. Excluding this prior period impact, gross margin for the second quarter of 2008 would have been 46% compared to gross margin of 29% in the second quarter of 2009. Gross profit of \$20.3 million in the second quarter of 2009 primarily reflects invoiced shipments in the period and does not include the recognition of significant amounts of deferred gross profit from prior periods.

This significant reduction in gross margin in the three months ended June 27, 2009 was partially due to lower sales of our higher gross margin TAMs in the period compared to the corresponding period in 2008. In addition, in the three months ended June 27, 2009, we recognized revenue and costs related to negative margin common equipment deployments. This resulted in a significant overall negative gross margin impact for the quarter, even though some of the inventory sold had been written-down for LCM adjustments in the first quarter of 2009. The impact of the sale of this previously written-down inventory, which was partially offset by the recognition of LCM adjustments for new on-hand inventory for the three months ended June 27, 2009, resulted in an increase to gross margin of 8%. Gross margins in the period were also negatively impacted by the usage of significant common equipment discounts. Additionally, included in cost of revenue were inventory write-downs for excess and obsolete inventory of \$0.8 million and \$1.8 million for the three months ended June 27, 2009 and June 28, 2008, respectively.

*Six Months Ended June 27, 2009 Compared to Six Months Ended June 28, 2008.*

Gross margin decreased to 30% in the six months ended June 27, 2009 from 47% in the corresponding period in 2008. As illustrated in the table above, revenue and gross profit in the six months ended June 28, 2008 were unusually high due to the impact of the attainment of VSOE of fair value for software subscription services in the period. This change resulted in the recognition of \$58.0 million of gross profit related to reductions in the deferred revenue and deferred inventory cost balances in the period and \$83.4 million of gross profit from invoiced shipments in the six months ended June 28, 2008. Gross profit of \$40.2 million in the six months ended June 27, 2009 primarily reflects invoiced shipments in the period and does not include the recognition of significant amounts of deferred gross profit from prior periods. Excluding this prior period impact, gross margin for the six months ended June 28, 2008 would have been 45% compared to gross margin of 30% in the six months ended June 29, 2009.

This significant reduction in gross margins in the six months ended June 27, 2009 was partially due to lower sales of our higher gross margin TAMs in the period compared to the corresponding period in 2008. In addition, in the six months ended June 27, 2009, we recognized revenue and costs related to negative margin common equipment deployments. This resulted in a significant overall negative gross margin impact for the period. The net impact of LCM inventory write-downs for the six months ended June 27, 2009 was a 3% decrease in gross margin primarily due to lower forecasted average selling prices ( ASPs ) for negative margin common equipment deployments which are expected to be recognized as revenue in the third quarter of 2009. Gross margins in the period were also negatively impacted by the usage of significant common equipment discounts. Additionally, included in cost of revenue were inventory write-downs for excess and obsolete inventory of \$3.3 million and \$3.7 million for the six months ended June 27, 2009 and June 28, 2008, respectively.





**Table of Contents***Research and Development Expenses*

The following table presents our research and development expenses in absolute dollars and as a percent of total revenue for the three and six months ended June 27, 2009 and June 28, 2008:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands, except %)			
Research and development expenses	\$ 24,763	\$ 17,787	\$ 46,760	\$ 36,080
Percent of total revenue <sup>(1)</sup>	36%	11%	35%	12%

<sup>(1)</sup> Research and development expenses as a percent of total revenue is not a meaningful trend indicator because of the impact of our revenue recognition policy on the timing and amount of revenue recorded in each period.

*Three Months Ended June 27, 2009 Compared to Three Months Ended June 28, 2008.*

Research and development expenses increased by \$7.0 million in the three months ended June 27, 2009 compared to the corresponding period in 2008 due primarily to increased headcount and personnel-related costs of \$2.9 million, including \$1.8 million of cash compensation, \$0.8 million of stock-based compensation and \$0.3 million of incremental facilities and infrastructure costs. In addition, in the three months ended June 27, 2009, we incurred \$3.8 million of increased prototype and new product spending and \$0.3 million of incremental expenses related to software development services that we purchased from a third party to enable our products to operate in a regional bell operating company infrastructure.

*Six Months Ended June 27, 2009 Compared to Six Months Ended June 28, 2008.*

Research and development expenses increased by \$10.7 million in the six months ended June 27, 2009 compared to the corresponding period in 2008 due primarily to increased headcount and personnel-related costs of \$6.1 million, including \$3.9 million of cash compensation, \$1.3 million of stock-based compensation and \$0.9 million of incremental facilities and infrastructure costs. In addition, in the six months ended June 27, 2009, we incurred \$4.0 million of increased prototype and new product spending and \$0.6 million of incremental expenses related to software development services that we purchased from a third party to enable our products to operate in a regional bell operating company infrastructure.

*Sales and Marketing Expenses*

The following table presents our sales and marketing expenses in absolute dollars and as a percent of total revenue for the three and six months ended June 27, 2009 and June 28, 2008:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands, except %)			
Sales and marketing expenses	\$ 11,458	\$ 10,860	\$ 22,581	\$ 21,106
Percent of total revenue <sup>(1)</sup>	17%	7%	17%	7%

<sup>(1)</sup> Sales and marketing expenses as a percent of total revenue is not a meaningful trend indicator because of the impact of our revenue recognition policy on the timing and amount of revenue recorded in each period.

*Three Months Ended June 27, 2009 Compared to Three Months Ended June 28, 2008.*

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Sales and marketing expenses increased by \$0.6 million in the three months ended June 27, 2009 compared to the corresponding period in 2008 primarily due to stock-based compensation expense of \$0.4 million, an increase of \$0.1 million in personnel-related expenses and \$0.1 million related to demonstration units used in potential customer lab trials.

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*Six Months Ended June 27, 2009 Compared to Six Months Ended June 28, 2008.*

Sales and marketing expenses increased by \$1.5 million in the six months ended June 27, 2009 compared to the corresponding period in 2008 primarily due to stock-based compensation expense of \$1.0 million, \$0.3 million related to demonstration units used in potential customer lab trials and an increase of \$0.1 million in personnel-related expenses.

*General and Administrative Expenses*

The following table presents our general and administrative expenses in absolute dollars and as a percent of total revenue for the three and six months ended June 27, 2009 and June 28, 2008:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands, except %)			
General and administrative expenses	\$ 11,478	\$ 8,502	\$ 21,605	\$ 16,919
Percent of total revenue <sup>(1)</sup>	17%	5%	16%	6%

<sup>(1)</sup> General and administrative expenses as a percent of total revenue is not a meaningful trend indicator because of the impact of our revenue recognition policy on the timing and amount of revenue recorded in each period.

*Three Months Ended June 27, 2009 Compared to Three Months Ended June 28, 2008.*

General and administrative expenses increased by \$3.0 million in the three months ended June 27, 2009 compared to the corresponding period in 2008 primarily due to \$1.4 million of stock-based compensation expenses, increased personnel-related costs including \$1.0 million of cash compensation, \$0.3 million of depreciation and amortization expense and \$0.3 million related to other external costs.

*Six Months Ended June 27, 2009 Compared to Six Months Ended June 28, 2008.*

General and administrative expenses increased by \$4.7 million in the six months ended June 27, 2009 compared to the corresponding period in 2008 primarily due to \$2.6 million of stock-based compensation expenses, increased personnel-related costs including \$1.2 million of cash compensation, \$0.7 million of depreciation and amortization expense and \$0.2 million of other external costs.

*Other Income (Expense), Net*

The following table presents our interest income, interest expense, net credit impairment loss recognized in other income (expense), net for the three and six months ended June 27, 2009 and June 28, 2008:

	Three Months Ended		Six Months Ended	
	June 27, 2009	June 28, 2008	June 27, 2009	June 28, 2008
	(In thousands)			
Interest income	\$ 597	\$ 2,258	\$ 1,515	\$ 5,561
Interest expense				(3)
Total other-than-temporary impairment losses	(2,747)		(2,747)	
Portion of loss recognized in other comprehensive loss	1,814		1,814	
Net credit impairment losses recognized in earnings	(933)		(933)	
Other gain (loss), net	806	296	(1,008)	1,176
Total other income (expense), net	\$ 470	\$ 2,554	\$ (426)	\$ 6,734

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*Three Months Ended June 27, 2009 Compared to Three Months Ended June 28, 2008.*

Interest income decreased by \$1.7 million in the three months ended June 27, 2009 compared to the corresponding period in 2008 due to lower interest rates on investments and lower investment balances. We also recognized net credit impairment losses of \$0.9 million in the three months ended June 27, 2009, related to the other-than-temporary impairment for our available-for-sale ARS, as discussed in Note 5, Fair Value Measurements and Other-than-Temporary Impairments, of the Notes to Condensed Consolidated Financial Statements. Other gain (loss), net for the quarter ended June 27, 2009 included a \$0.4 million gain related to increase in the

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fair value of the Put Rights and a \$0.6 million unrealized holding gain related to ARS trading securities. Additionally, we recorded \$0.2 million of unrealized and realized losses due to foreign currency exchange re-measurement. Other gain (loss), net for the three months ended June 28, 2008 included a loss of \$0.1 million on our foreign currency receivable and a gain of \$0.4 million related to the sale of assets.

*Six Months Ended June 27, 2009 Compared to Six Months Ended June 28, 2008.*

Interest income decreased by \$4.0 million in the six months ended June 27, 2009 compared to the corresponding period in 2008 due to lower interest rates on investments and lower investment balances. We also recognized net credit impairment losses of \$0.9 million in the six months ended June 27, 2009 related to the determination that our available-for-sale ARS were other-than-temporary, as discussed in Note 5, Fair Value Measurements and Other-Than-Temporary Impairments, of the Notes to Condensed Consolidated Financial Statements. Other gain (loss), net for the six months ended June 27, 2009 included \$1.5 million loss due to decrease in the fair value of the Put Rights offset by a \$1.5 million unrealized holding gain to ARS trading securities. Additionally, we recorded \$1.0 million of unrealized and realized losses due to foreign currency exchange re-measurement. Other gain (loss), net for the six months ended June 28, 2008 included a gain of \$0.3 million on our foreign currency receivable and a gain of \$0.7 million related to the sales of assets.

**Income Tax Provision**

The effective tax rate of (0.4)% for the three and six months ended June 27, 2009 differs from the statutory rate of 35% primarily related to unbenefited U.S. losses, non-deductible stock compensation charges under SFAS No. 123(R) and foreign taxes provided on foreign subsidiary earnings, offset by anticipated benefit related to refundable research and development tax credits due to the enactment of the American Recovery and Reinvestment Act of 2009, signed into law on February 17, 2009. This compares to an effective tax rate of 5.0% and 4.6% for the three and six months ended June 28, 2008, respectively, which reflects tax benefits arising from the release of certain valuation allowance on domestic tax attribute carryforwards which was partially offset by the impact of certain non-deductible stock compensation charges under SFAS No. 123(R), federal alternative minimum tax and state income taxes.

**Liquidity and Capital Resources**

	June 27, 2009	December 27, 2008
	(In thousands)	
Working capital	\$ 263,915	\$ 289,702
Cash and cash equivalents	\$ 94,151	\$ 166,770
Short and long-term investments	188,863	142,916
Short and long-term restricted cash	4,067	2,899
Total cash and cash equivalents, investments and restricted cash	\$ 287,081	\$ 312,585

	Six Months Ended	
	June 27, 2009	June 28, 2008
	(In thousands)	
Cash provided by (used in) operating activities	\$ (21,728)	\$ 15,406
Cash provided by (used in) investing activities	(55,754)	21,711
Cash provided by financing activities	4,747	7,693

At June 27, 2009, we had \$94.2 million in cash and cash equivalents, \$188.9 million in short-term and long term investments and \$4.1 million in restricted cash. In comparison, at December 27, 2008, we had \$166.8 million in cash and cash equivalents, \$142.9 million in short and long-term investments and \$2.9 million in restricted cash. Cash, cash equivalents, restricted cash and short and long-term investments consist of highly liquid investments in money market funds, commercial paper, corporate bonds, U.S. agency notes and U.S. treasuries. Additionally, long-term investments include ARS, which are illiquid, and Put Rights. The restricted cash balance amounts are pledged as collateral for certain stand-by and commercial letters of credit.

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Our historical revenue and profitability trends have been significantly impacted by our revenue recognition policy and the timing of our attainment of vendor specific objective evidence ( VSOE ) of fair value for most of our services. Prior to the first quarter of 2008, revenue from product sales sold in combination with services ( bundled product sales ) was deferred and recognized ratably over a period of approximately one year. This resulted in the accumulation of \$174.4 million of deferred revenue, \$81.6 million of associated deferred inventory costs and \$92.8 million of gross margin on the balance sheet as of December 29, 2007. We

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recognized \$165.8 million of this deferred revenue and \$78.4 million of associated deferred inventory costs in 2008, but the cash flow impact of these transactions occurred in 2006 and 2007 when the transactions occurred and payments were made, not when the majority of the revenue was recognized in the condensed consolidated statements of operations in 2008. This resulted in a cash flow trend that was driven primarily by the timing and profitability of our underlying invoiced shipments rather than the timing of the recognition of revenue and gross margin from these transactions in our condensed consolidated statements of operations. This disconnect between the timing of revenue recognition and the underlying cash collections resulted in higher levels of cash from operations experienced in 2007 when the net loss in our condensed consolidated statements of operations amounted to \$55.3 million as compared to 2008 when net income amounted to \$78.7 million.

We expect our future product revenues and gross margins to more closely approximate our invoiced shipment results with no further significant releases of deferred amounts from prior periods and therefore also expect cash flow trends that are more consistent with the timing of when revenue and gross profits are recognized in the condensed consolidated statements of operations.

*Operating Activities*

We experienced negative cash flows from operations of \$21.7 million in the first six months of 2009. We generated a net loss for the period of \$51.4 million and we had non-cash charges of \$24.6 million consisting primarily of stock-based compensation expense of \$15.6 million, depreciation and amortization expenses of \$7.9 million, \$0.9 million net credit-related OTTI and \$1.5 million decrease in the fair value of the Put Rights offset by \$1.5 million unrealized holding gain from ARS trading securities.

Accounts receivable decreased by \$15.8 million which was partially offset by an increase in inventory of \$12.6 million. Our working capital requirements can fluctuate significantly depending on the timing of large deployments and the terms associated with billings and collections. We expect some improvement in TAM volumes and in gross margins in the third quarter of 2009, and this combined with somewhat lower working capital requirements for the period, should result in lower net cash used in operating activities for the third quarter of 2009 as compared to the second quarter of 2009.

We experienced positive cash flows from operations of \$15.4 million in the first six months of 2008. We generated net income for the period of \$70.5 million, and we had non-cash charges of \$15.3 million consisting primarily of depreciation and amortization expenses of \$5.5 million and stock-based compensation expense of \$11.3 million offset by investment discount accretion of \$0.7 million. In addition, net income reflects the release of non-cash gross margin from invoiced shipments of bundled products and services deferred in prior periods of \$50.4 million. Accounts receivable increased by \$16.9 million due to the non-linearity of invoicing in the quarter and this was partially offset by an increase in accounts payable of \$4.9 million. Accrued liabilities and other expenses decreased by \$6.9 million due to the timing of payroll and other payments in the period.

*Investing Activities*

Net cash used in investing activities in the first six months of 2009 was \$55.8 million, primarily consisting of net usage from the purchase, maturity and call of investments in the period of \$47.1 million and additions to property, plant and equipment for the period of \$8.8 million.

Net cash provided by investing activities was \$21.7 million in the first six months of 2008 and primarily represented net proceeds from the purchase, maturity and sale of investments in the period of \$28.2 million reflecting our switch to money market funds during the period. Additions to property, plant and equipment amounted to \$7.3 million.

*Financing Activities*

Net proceeds from financing activities in the first six months of 2009 were \$4.7 million primarily due to proceeds from the issuance of common stock under our employee stock purchase plan, or ESPP, and other equity plans.

Net proceeds from financing activities in the first six months of 2008 were \$7.7 million and primarily related to proceeds from the issuance of common stock under our ESPP plan and other equity plans.

*Adjustable Rate Securities*

At June 27, 2009, we held \$75.5 million (par value) of investments comprised of ARS, which are variable-rate debt securities and have a long-term maturity with the interest rate being reset through auctions that are typically held every 7, 28 or 35 days. These securities have historically traded at par and were callable at par at the option of the issuer. Interest was typically paid at the end of each auction period or semiannually. Since February 2008, most of the auctions for these securities have failed and there is no assurance that future auctions will



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succeed. As a result, our ability to liquidate our investment in the near term is limited. In addition, it could take until final maturity of the ARS (up to 38 years) to realize our investments par value or we may not be able to fully recover the par value of our ARS. At June 27, 2009, most of the \$75.5 million (par value) ARS we held were AAA rated, except for \$11.9 million (par value) of our ARS that were downgraded to A3 rating and \$5.1 million (par value) of ARS that were downgraded to Aa1 rating during the six months ended June 27, 2009. Our ARS were mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. During the three months ended June 27, 2009, an immaterial amount of ARS was called by one issuer.

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The ARS of \$65.5 million (par value) covered by the UBS settlement and the related Put Rights were revalued to fair value on a quarterly basis. We recorded a \$0.4 million increase and a \$1.5 million decrease in the fair value of the Put Rights in the three and six months ended June 27, 2009, respectively, in Other gains (loss), net in the accompanying condensed consolidated statements of operations. In addition, we recorded \$0.6 million and \$1.5 million of unrealized holding gains on our ARS trading securities in the three and six months ended June 27, 2009, respectively, in Other gains (loss), net in the accompanying condensed consolidated statements of operations.

As of June 27, 2009, we held \$10.0 million of available-for-sale ARS held with two issuers, one of which is AAA rated and the other one is A3 rated. As of June 27, 2009 we determined that we do not intend to sell these securities and it is not more likely than not that we will be required to sell the securities before recovery of its amortized cost. However, given that the present value of the expected cash flows for these securities was below their amortized cost basis, an OTTI of \$2.7 million, equal to the difference between the fair value and the amortized cost basis has occurred. We recognized a credit impairment loss of \$0.9 million in our condensed consolidated statements of operations for the three and six months ended June 27, 2009. The non-credit related portion of this OTTI of \$1.8 million was recognized in Accumulated other comprehensive loss in our condensed consolidated balance sheet at June 27, 2009.

These failed auctions result in a lack of liquidity in the ARS but do not affect the underlying collateral of the securities. We do not anticipate that any potential lack of liquidity in our ARS, even for an extended period of time, will affect our ability to finance our operations, including our continued investments in research and development and planned capital expenditures. We continue to monitor efforts by the financial markets to find alternative means for restoring the liquidity of these investments. These investments are classified as non-current assets until we have better visibility as to when their liquidity will be restored or when it falls within one year of the Put Right exercise date.

**Liquidity**

For the remainder of 2009, capital expenditures are expected to be in the range of approximately \$8 million to \$12 million, primarily for product development and manufacturing expansion and upgrades. In addition, we have experienced a lack of liquidity related to \$75.5 million (par value) of our ARS as described above. We believe that our current cash and cash equivalents and investments, excluding our ARS, will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least 12 months. If these sources of cash are insufficient to satisfy our liquidity requirements beyond 12 months, we may require additional capital from equity or debt financings to fund our operations, respond to competitive pressures or strategic opportunities or otherwise. We may not be able to secure timely additional financing on favorable terms, or at all. The terms of any additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer dilution in their percentage ownership of us, and any new securities we issue could have rights, preferences and privileges senior to those of holders of our common stock.

**Contractual Obligations**

The following is a summary of our contractual obligations as of June 27, 2009:

	Total	Less than 1 year	Payments Due by Period		
			1 - 3 years (In thousands)	3 - 5 years	More than 5 years
Purchase obligations <sup>(1)</sup>	\$ 23,524	\$ 23,524	\$	\$	\$
Operating leases	13,563	4,089	5,871	2,284	1,319
<b>Total contractual obligations <sup>(2)</sup></b>	<b>\$ 37,087</b>	<b>\$ 27,613</b>	<b>\$ 5,871</b>	<b>\$ 2,284</b>	<b>\$ 1,319</b>

<sup>(1)</sup> We have service agreements with our major production suppliers under which we are committed to purchase certain parts.

<sup>(2)</sup> FIN 48 tax liabilities of \$0.5 million are not included in the table because we are unable to determine the timing of settlement if any, of these future payments with a reasonably reliable estimate.

We had \$4.0 million of standby letters of credit outstanding as of June 27, 2009. These consisted of \$1.5 million related to a customer proposal guarantee, \$1.4 million related to a value added tax license and duty and \$1.1 million related to property leases. We had \$2.9 million of standby letters of credit outstanding as of December 27, 2008. These consisted of \$1.1 million related to property leases, \$1.4 million related to a value

added tax license and duty and \$0.4 million related to customer proposal guarantee.

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### **Off-Balance Sheet Arrangements**

As of June 27, 2009, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

### **Item 3. *Quantitative and Qualitative Disclosures about Market Risk***

#### *Foreign Currency Risk*

A majority of our revenue, expense and capital purchasing activities are transacted in U.S. dollars. However, we do incur some immaterial operating costs in other currencies. In addition, certain of our sales contracts are priced in Euros and, therefore, a portion of our revenue is subject to foreign currency risks. Our operating expenses and cash flows are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the India Rupee, Chinese Yuan, British pound and the Euro.

The effect of an immediate 10% adverse change in exchange rates on foreign denominated transactions for the second quarter of 2009 would result in a loss of approximately \$0.6 million, excluding the amounts related to foreign denominated accounts receivable. Beginning in the second quarter of 2009, we established a foreign currency risk management program to help protect against the impact of foreign currency exchange rate movements on our operating results. We enter into foreign currency exchange forward contracts to reduce the impact of foreign currency fluctuations on accounts receivable denominated in currencies other than our functional currency, which is the U.S. dollar. As a result, we do not expect a significant impact to our results from a change in exchange rates on foreign denominated accounts receivable balances in the near-term. Fluctuations in our currency exchange rates could impact our business in the future.

#### *Interest Rate Sensitivity*

We had cash, cash equivalents, short and long-term investments and short and long-term restricted cash totaling \$287.1 million and \$312.6 million at June 27, 2009 and December 27, 2008, respectively. These amounts were invested primarily in certificates of deposit, money market funds, commercial paper, corporate bonds, U.S. agency notes, U.S. treasuries, ARS and associated Put Rights. The unrestricted cash and cash equivalents are held for working capital purposes. We do not enter into investments for speculative purposes. We believe that we do not have any material exposure to changes in the fair value as a result of changes in interest rates. Declines in interest rates, however, will reduce future investment income. If overall interest rates fell by 10% in the three months ended June 27, 2009, our interest income would have declined approximately \$0.2 million, assuming consistent investment levels.

At June 27, 2009 and December 27, 2008, we had no debt outstanding.

#### *Adjustable Rate Securities and Put Rights*

At June 27, 2009, we held \$75.5 million (par value) of investments comprised of adjustable rate securities, or ARS, which are variable-rate debt securities and have a long-term maturity with the interest rate being reset through auctions that are typically held every 7, 28 or 35 days. These securities have historically traded at par and were callable at par at the option of the issuer. Interest was typically paid at the end of each auction period or semiannually. At June 27, 2009, most of the \$75.5 million (par value) ARS we held were AAA rated, except for \$11.9 million (par value) of our ARS that were downgraded to A3 rating and \$5.1 million (par value) of ARS that were downgraded to Aa1 rating during the six months ended June 27, 2009. Our ARS holdings are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program.

Since February 2008, most of the auctions for these securities have failed and there is no assurance that future auctions will succeed. As a result, our ability to liquidate our investment in the near term is limited. In addition, it could take until final maturity of the ARS (up to 38 years) to realize the investments' par value or we may not be able to fully recover the par value of our ARS. In the event we need to access these funds, we may not be able to do so until a future auction on these investments is successful, a secondary market develops or the securities are redeemed by the broker dealer.

In October 2008, we elected to participate in a rights offering by UBS, one of our brokers, which provides us with Put Rights to sell UBS \$65.7 million (par value) of the ARS, which we purchased through UBS back to UBS at par value, at any time during a two-year sale period beginning June 30, 2010. By electing to participate in the rights offering, we granted UBS the right, exercisable at any time prior to June 30, 2010 or during the two-year sale period, to purchase or cause the sale of our ARS ( "Call Right" ). UBS has agreed to pay us the par value of our ARS within one

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day of settlement of any Call Right transaction. We elected to adopt SFAS 159 on the Put Rights and elected to treat this portion of our ARS portfolio as trading securities. As such, we recorded a gain of \$15.9 million related to the Put Rights provided by the settlement and a gross unrealized loss of \$16.8 million on the \$65.7 million (par value) portion of our ARS portfolio as we may decide not to hold these securities until final maturity because of the opportunity provided by the Put Rights. The ARS and Put Rights are revalued to fair market value on a quarterly basis until the sale of these securities has been completed. For the three and six months ended June 27, 2009, we recorded a \$0.4 million increase and \$1.5 million

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decrease in the fair value of the Put Rights, respectively, and \$0.6 million and \$1.5 million of unrealized holding gains to ARS trading securities, respectively, in our condensed consolidated statements of operations. The fair value of our investment in these securities could change significantly in the future, based on market conditions and continued uncertainties in the financial markets. See Note 5, Fair Value Measurements and Other-Than-Temporary Impairment, to the Notes to Condensed Consolidated Financial Statements for further information.

As of June 27, 2009, we held \$10.0 million of available-for-sale ARS held with two issuers, one of which is AAA rated and the other one is A3 rated. As of June 27, 2009 we determined that we do not intend to sell these securities and it is not more likely than not that we will be required to sell the securities before recovery of its amortized cost. However, given that the present value of the expected cash flows for these securities was below their amortized cost basis, an OTTI of \$2.7 million, equal to the difference between the fair value and the amortized cost basis has occurred. We recognized a credit impairment loss of \$0.9 million in our condensed consolidated statements of operations for the three and six months ended June 27, 2009. The non-credit related portion of this OTTI of \$1.8 million was recognized in Accumulated comprehensive loss in our condensed consolidated balance sheet at June 27, 2009.

We believe that the fair value of our ARS, Put Rights and OTTI could change significantly in the future, based on market conditions and continued uncertainties in the financial markets. UBS credit risk may be subject to significant volatility and it is difficult to predict future fluctuations. A 10% deterioration in UBS credit risk would result in a \$0.1 million net loss in our condensed consolidated statements of operations for the three months ended June 27, 2009. Deterioration in the ARS discount rate or a change in the estimated time to maturity would have no impact on our condensed consolidated statements of operations. A 10% deterioration in the ARS student loan credit spread would result in \$0.2 million of additional OTTI credit loss in our condensed consolidated statements of operations for the three months ended June 27, 2009.

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### **Item 4. *Controls and Procedures***

#### **Evaluation of Disclosure Controls and Procedures**

As of June 27, 2009, an evaluation was performed by management, with the participation of our Chief Executive Officer ( CEO ) and our Chief Financial Officer ( CFO ), of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d - 15(e) under the Securities Exchange Act of 1934, as amended). Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the 1934 Act is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms. Based on this evaluation, our CEO and CFO have concluded that, as of the end of the fiscal period covered by this quarterly report on Form 10-Q, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the U.S. Securities and Exchange Commission s rules and forms and that such information is accumulated and communicated to management, including the CEO and CFO, as appropriate, to allow timely decisions regarding required disclosures.

#### **Changes in Internal Control over Financial Reporting:**

There were no changes to our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

#### **Inherent Limitations of Internal Controls**

Our management, including our CEO and CFO, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within us have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving our stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

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**Table of Contents****PART II. OTHER INFORMATION****Item 1. *Legal Proceedings***

On May 9, 2006, the Company and Level 3 were sued by Cheetah in the U.S. District Court for the Eastern District of Texas for alleged infringement of patent No. 6,795,605, and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of the Company's DTN System and to recover all damages caused by the alleged willful infringement including any and all compensatory damages available by law, such as actual and punitive damages, attorneys' fees, associated interest and Cheetah's costs incurred in the lawsuit. Cheetah's complaint does not request a specific dollar amount for these compensatory damages. The Company is contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent its product is found to infringe, and it has assumed the defense of this matter. On July 20, 2006, the Company and Level 3 filed an amended response denying all infringement claims under patent No. 6,795,605 and asserting that the claims of the patent are invalid and that the DTN System does not infringe the patent. On November 28, 2006, Cheetah filed a second amended complaint and added patent No. 7,142,347 to the lawsuit. On December 18, 2006, the Company and Level 3 filed responses to Cheetah's second amended complaint denying all infringement claims under patent No. 7,142,347 and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims are invalid and that the DTN System does not infringe the patents.

On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, the Company and Level 3 filed responses to Cheetah's third amended complaint denying all infringement claims, and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims of the patents are invalid and that the DTN System does not infringe the patents.

On March 14, 2007, the Company submitted requests to the U.S. Patent and Trademark Office for inter parts reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347 asking the U.S. Patent and Trademark Office to reexamine the patents based on prior art in order to invalidate the patents or limit the scope of each patent's claims. On March 21, 2007, the Company and Level 3 filed a motion with the court to stay all proceedings in the lawsuit pending the reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347.

On April 11, 2007, the Company, Level 3 and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. Patent and Trademark Office as to whether it will reexamine U.S. Patent Nos. 6,795,605 and 7,142,347; and (2) if the U.S. Patent and Trademark Office decides to reexamine either U.S. Patent No. 6,795,605 or 7,142,347, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. Patent and Trademark Office. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. On June 26, 2007, the U.S. Patent and Trademark Office ordered reexamination of U.S. Patent No. 6,795,605. On August 1, 2007, the U.S. Patent and Trademark Office ordered reexamination of U.S. Patent No. 7,142,347. As a result, all proceedings in this lawsuit are stayed until the final resolution of these reexaminations. The Company believes the suit is without merit and intends to defend itself vigorously, but it is unable to predict the likelihood of an unfavorable outcome.

In addition to the matters described above, the Company is subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material effect on its results of operations, financial position or cash flows.



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**Item 1A. Risk Factors**

*A description of the risks and uncertainties associated with our business is set forth below. This description includes any material changes to and supersedes the description of the risks and uncertainties associated with our business previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 27, 2008. You should carefully consider such risks and uncertainties, together with the other information contained in this report, our Annual Report on Form 10-K for the fiscal year ended December 27, 2008 and in our other public filings. If any of such risks and uncertainties actually occurs, our business, financial condition or operating results could differ materially from the plans, projections and other forward-looking statements included in the section titled Management's Discussion and Analysis of Financial Condition and Results of Operations and elsewhere in this report and in our other public filings. In addition, if any of the following risks and uncertainties, or if any other risks and uncertainties, actually occurs, our business, financial condition or operating results could be harmed substantially, which could cause the market price of our stock to decline, perhaps significantly.*

**We have a history of significant operating losses and may not maintain profitability on an annual basis in the future.**

Although we achieved profitability for the first time on an annual basis for the year ended December 27, 2008 and generated net income of \$78.7 million, this amount included \$87.4 million of gross profit deferred from prior periods, as described in the section titled, Management's Discussion and Analysis of Financial Condition and Results of Operations. Excluding the impact of this prior period amount, our results of operations for the year ended December 27, 2008 would have been a net loss of \$8.7 million. In addition, for the six months ended June 27, 2009, we recorded a net loss of \$51.4 million. As of June 27, 2009, our accumulated deficit was \$342.2 million. We expect to continue to make significant expenditures related to the continued development of our business. These expenditures may include the addition of personnel related to the sales, marketing and research and development of our DTN System and other costs related to the maintenance and expansion of our manufacturing facilities and research and development operations. We may therefore sustain significant operating losses and negative cash flows in the future. In addition, as a public company, we have incurred and will continue to incur significant legal, accounting and other expenses. We will have to sustain significant increased revenue and product gross margins to maintain profitability on an annual basis.

**Our revenue and operating results may fluctuate significantly, which could make our future results difficult to predict and could cause our operating results to fall below investor or analyst expectations.**

Our revenue and operating results may fluctuate due to a variety of factors, many of which are outside of our control. Over the past six fiscal quarters, our revenue and operating income (loss), adjusted for 2008, as described in the section titled, Management's Discussion and Analysis of Financial Condition and Results of Operations, has ranged from \$66.6 million to \$95.5 million and from \$(27.5) million to \$4.8 million, respectively. As a result, comparing our operating results on a period-to-period basis may not be meaningful. Fluctuations in our revenue can lead to even greater fluctuations in our operating results. Our budgeted expense levels depend in part on our expectations of long-term future revenue. Given relatively fixed operating costs related to our personnel and facilities, any substantial adjustment to our expenses to account for lower levels of revenue will be difficult and may take time. Consequently, if our revenue does not meet projected levels, our inventory levels and operating expenses would be high relative to revenue, resulting in additional operating losses.

In addition to other risks discussed in this section, factors that may contribute to fluctuations in our revenue and our operating results include:

fluctuations in demand, sales cycles and prices for our DTN System and our services;

fluctuations in our product mix, including the mix higher and lower margin products and significant mix changes resulting from new customer deployments;

reductions in customers' budgets for optical communications purchases and delays in their purchasing cycles;

order cancellations or reductions or delays in delivery schedules by our customers;

timeliness of our customers' payments for their purchases;

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our ability to control costs, including our operating expenses and the costs of components we purchase;

readiness of customer sites for installation of our DTN System;

the timing of product releases or upgrades by us or by our competitors;

any significant changes in the competitive dynamics of our market, including any new entrants, technological advances or substantial discounting of products;

our ability to establish vendor specific objective evidence, or VSOE, for any future service that we may offer to a customer and to recognize revenue once the other revenue recognition criteria have been met, rather than ratably over the longest undelivered service period;

availability of third party suppliers to provide contract engineering and installation services for us;

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the timing of recognizing revenue in any given quarter as a result of software revenue recognition requirements and any changes in U.S. generally accepted accounting principles or new interpretations of existing accounting rules; and

general economic conditions in domestic and international markets.

If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may in the future provide to the market, the price of our common stock may decline substantially.

**Our gross margin may fluctuate from quarter to quarter and may be adversely affected by a number of factors, some of which are beyond our control.**

Our gross margin fluctuates from period to period and varies by customer and by product specification. Over the past six fiscal quarters, our gross margins, adjusted for 2008, as described in the section titled, Management's Discussion and Analysis of Financial Condition and Results of Operations, have ranged from 29% to 46%. Our gross margins are likely to continue to fluctuate and will be adversely affected by a number of factors, including:

the mix in any period of higher and lower margin products and services;

significant new customer deployments, often with a higher portion of lower margin common equipment;

price discounts negotiated by our customers;

sales volume from each customer during the period;

the amount of equipment we sell or expect to sell for a loss in any given quarter;

charges for excess or obsolete inventory;

changes in the price or availability of components for our DTN System;

changes in our manufacturing costs, including fluctuations in yields and production volumes;

introduction of new products, with initial sales at relatively small volumes and higher product costs;

increased price competition, including competition from low-cost producers in China;

increased warranty or repair costs; and

the period of time over which ratable recognition of revenue occurs.

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It is likely that the average unit prices of our DTN System will decrease over time in response to competitive pricing pressures, increased negotiated sales discounts, new product introductions by us or our competitors or other factors. In addition, some of our customer contracts contain annual technology discounts that require us to decrease the sales price of our DTN System to these customers. In response, we will need to reduce the cost of our DTN System through manufacturing efficiencies, design improvements and cost reductions or change the mix of the DTN Systems we sell. If these efforts are not successful or if we are unable to reduce our costs to a greater extent than the reduction in the price of our DTN System, our revenue and gross margin will decline, causing our operating results to decline. Fluctuations in gross margin may make it difficult to manage our business and achieve or maintain profitability.

### **Aggressive business tactics by our competitors may harm our business.**

Increased competition in our markets has resulted in aggressive business tactics by our competitors, including:

aggressively pricing their products, including offering significant one-time discounts;

selling at a discount used equipment or inventory that a competitor had previously written down or written off;

announcing competing products prior to market availability combined with extensive marketing efforts;

offering to repurchase our equipment from existing customers;

providing financing, marketing and advertising assistance to customers; and

asserting intellectual property rights.

If we fail to compete successfully against our current and future competitors, or if our current or future competitors continue or expand aggressive business tactics, including those described above, demand for our DTN System could decline, we could experience delays or cancellations of customer orders, or we could be required to reduce our prices or increase our expenses.

### **Our ability to increase our revenue will depend upon continued growth of demand by consumers and businesses for additional network capacity.**

Our future success depends on factors such as the continued growth of the Internet and internet protocol traffic and the continuing adoption of high capacity, revenue-generating services to increase the amount of data transmitted over communications networks and the growth of optical communications networks to meet the increased demand for bandwidth. If demand for such

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bandwidth does not continue, or slows down, the need for increased bandwidth across networks and the market for optical communications network products may not continue to grow. If this growth does not continue or slows down, our DTN System sales would be negatively impacted. In addition, if general economic conditions weaken, this may cause our customers and potential customers to slow or delay their purchase decisions, which would have an adverse affect on our business and financial condition.

### **Recent turmoil in the financial markets and the global recession has adversely affected and may continue to adversely affect our industry, business and gross margins.**

The U.S. and world economic markets are undergoing a period of slowdown or recession, and the future economic environment may continue to be less favorable than that of recent years. Our business depends on the overall demand for additional bandwidth capacity and on the economic health and willingness of our customers and potential customers to make capital commitments to purchase our products and services. As a result of this slowdown, we may face new risks that we have not yet identified. In addition, a number of the risks associated with our business, which are disclosed in these risk factors, may increase in likelihood, magnitude or duration. If the conditions in the U.S. and world economic markets remain uncertain or continue to be volatile, or if they deteriorate further, our industry, business and gross margins may be adversely affected.

As a result of this economic slowdown and the continued tightening of credit markets, our customers may be delayed in obtaining, or may not be able to obtain, necessary financing for their purchases of our products. A lack of liquidity in the capital markets or the continued global recession may cause our customers to delay or cancel their purchases, increase the time they take to pay or default on their payment obligations, each of which would negatively affect our results. Continued weakness in the economy could cause some of our customers to become illiquid, delay payments or adversely affect our collection on their accounts, which could result in a higher level of bad debt expense. At June 27, 2009, \$1.5 million was reserved for accounts receivable bad debt associated with one customer as they were deemed uncollectible. In addition, currency fluctuations relating to the financial crisis could negatively affect our international customers' ability or desire to purchase our products.

Challenging economic conditions have from time to time contributed, and are currently contributing, to slowdowns in the telecommunications industry in which we operate. This slowdown may result in:

reduced demand for our products as a result of constraints on capital spending by our customers, particularly service providers;

increased price competition for our products, not only from our competitors, but also as a result of our customers or potential customers' utilization of inventoried or underutilized products, which could put additional pressure on our near term gross profits;

risk of excess or obsolete inventories;

excess manufacturing capacity and higher associated overhead costs as a percentage of revenue; and

more limited ability to accurately forecast our business and future financial performance.

The lack of liquidity and economic slowdown may adversely affect our suppliers or the terms on which we purchase products from these suppliers. It may also cause some of our suppliers to become illiquid. Any of these impacts could limit our ability to obtain components for our products from these suppliers and could adversely impact our supply chain or the delivery schedule to our customers. This also could require us to purchase more expensive components, or re-design our DTN System, which could cause increases in the cost of our systems and delays in the manufacturing and delivery of our systems. Such events could harm our gross margins and harm our reputation and our customer relationships, either of which could harm our business and operating results.

### **We have a limited operating history and limited history of selling our DTN System, both of which make it difficult to predict our future operating results.**

We were incorporated in December 2000 and shipped our first DTN System in November 2004. Our limited operating history gives you very little basis upon which to evaluate our ability to accomplish our business objectives. In making an investment decision, you should evaluate our business in light of the risks, expenses and difficulties frequently encountered by companies in early stages of development, particularly

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companies in the rapidly changing optical communications market. We may not be successful in addressing these risks. It is difficult to accurately forecast our future revenue and plan expenses accordingly and, therefore, predict our future operating results.

**The markets in which we compete are highly competitive and dominated by large corporations, and we may not be able to compete effectively.**

Competition in the optical communications equipment market is intense, and we expect such competition to increase. A number of very large companies historically have dominated the optical communications network equipment industry. Our competitors include current wavelength division multiplexing suppliers, such as Alcatel-Lucent, Ciena Corporation, Cisco Systems, Ericsson,

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Fujitsu Limited, Huawei Technologies Co., NEC Corporation, Nokia-Siemens Networks, Nortel Networks, Tellabs and ZTE Corporation. Competition in these markets is based on price, functionality, manufacturing capability, pre-existing installation, services, existing business and customer relationships, scalability and the ability of products and breadth and quality of services to meet our customers' immediate and future network requirements. Other companies have, or may in the future develop, products that are or could be competitive with our DTN System. In particular, if a competitor develops a photonic integrated circuit with similar functionality, our business could be harmed. Recent mergers from our competitors and any future acquisitions or combinations between or among our competitors may adversely affect our competitive position by strengthening our competitors.

Many of our competitors have substantially greater name recognition and technical, financial and marketing resources, greater manufacturing capacity and better established relationships with incumbent carriers and other potential customers than we have. Many of our competitors have more resources to develop or acquire, and more experience in developing or acquiring, new products and technologies and in creating market awareness for those products and technologies. In addition, many of our competitors have the financial resources to offer competitive products at below market pricing levels that could prevent us from competing effectively. Further, many of our competitors have built long-standing relationships with some of our prospective customers and have the ability to provide financing to customers and could, therefore, have an inherent advantage in selling products to those customers.

We also compete with low-cost producers in China that can increase pricing pressure on us and a number of smaller companies that provide competition for a specific product, customer segment or geographic market. These competitors often base their products on the latest available technologies. Due to the narrower focus of their efforts, these competitors may achieve commercial availability of their products more quickly than we can and may provide attractive alternatives to our customers.

**We are dependent on Level 3 Communications for a significant portion of our revenue and the loss of, or a significant reduction in orders from, Level 3 Communications or one or more of our key customers would reduce our revenue and harm our operating results.**

A relatively small number of customers account for a large percentage of our net revenue. In particular, for 2008, Level 3 Communications, or Level 3, accounted for approximately 25% of our revenue. We expect Level 3 to continue to represent a significant percentage of our revenue for the remainder of 2009. Our business will be harmed if we do not generate as much revenue as we expect from our key customers, if we experience a loss of Level 3 or of any of our other key customers or if we suffer a substantial reduction in orders from these customers. Our business also would be harmed if we fail to maintain our competitive advantage with our key customers. On July 29, 2009, we were informed by Level 3 that they intend to use another DWDM vendor in their network. We believe that this vendor will be given a significant portion of Level 3's new network deployments commencing in the first half of 2010 and further believe that the introduction of another vendor into Level 3's network will impact the revenue we will receive from Level 3 beginning in the first half of 2010.

Our ability to continue to generate revenue from our key customers will depend on our ability to maintain strong relationships with these customers and introduce new products that are desirable to these customers at competitive prices, and we may not be successful doing so. Because, in most cases, our sales are made to these customers pursuant to standard purchase agreements rather than long-term purchase commitments, orders may be cancelled or reduced readily. In the event of a cancellation or reduction of an order, we may not have enough time to reduce operating expenses to minimize the effect of the lost revenue on our business. Our operating results will continue to depend on our ability to sell our DTN System to our large customers.

**Our large customers have substantial negotiating leverage, which may require that we agree to terms and conditions that result in increased cost of sales, decreased revenue and lower average selling prices and gross margins, all of which would harm our operating results.**

Substantial changes in the optical communications industry have occurred over the last few years. Many potential customers have confronted static or declining revenue. Many of our customers have substantial debt burdens, many have experienced financial distress, and some have gone out of business or have been acquired by other service providers or announced their withdrawal from segments of the business. Consolidation in the markets in which we compete has resulted in changes in the structure of the communications networking industry, with greater concentration of purchasing power in a small number of large service providers, cable operators and government agencies. In addition, it has resulted in a substantial reduction in the number of our potential customers. For example, service providers, such as Level 3, have acquired a number of other communications service providers, including one of our other customers. This increased concentration among our customer base may also lead to increased negotiating power for our customers and may require us to decrease our average selling prices.

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Further, many of our customers are large communications service providers that have substantial purchasing power and leverage in negotiating contractual arrangements with us. Our customers have and may continue to seek advantageous pricing and other commercial terms and may require us to develop additional features in the products we sell to them. We have and may continue to be required to agree to unfavorable commercial terms with these customers, including reducing the average selling price of our DTN System in response to these commercial requirements or competitive pricing pressures. To maintain acceptable operating results, we will need to comply with these commercial terms, develop and introduce new products and product enhancements on a timely basis and continue to reduce our costs.



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We expect the factors described above to continue to affect our business and operating results for an indeterminate period, in several ways, including:

overall capital expenditures by many of our customers or potential customers may be flat or reduced;

we will continue to have only limited ability to forecast the volume and product mix of our sales;

managing expenditures and inventory will be difficult in light of the uncertainties surrounding our business; and

increased competition will enable customers to insist on more favorable terms and conditions for sales, including product discounts, extended payment terms or financing assistance, as a condition of procuring their business.

If we are unable to offset any reductions in our average selling prices or increases in our average costs with increased sales volumes and reduced production costs, or if we fail to develop and introduce new products and enhancements on a timely basis, or if we disagree on our interpretation and compliance with the commercial terms of our customer agreements, our relationships with our customers and our operating results would be harmed.

### **We are dependent on a single product, and the lack of continued market acceptance of our DTN System would harm our business.**

Our DTN System accounts for substantially all of our revenue and will continue to do so for the foreseeable future. As a result, our business could be harmed by:

any decline in demand for our DTN System;

the failure of our existing DTN System to achieve continued market acceptance;

the introduction of products and technologies that serve as a replacement or substitute for, or represent an improvement over, our DTN System;

technological innovations or new communications standards that our DTN System does not address; and

our inability to release enhanced versions of our DTN System on a timely basis.

### **If we fail to expand sales of our DTN System into international markets or to sell our products to new types of customers, such as U.S. regional bell operating companies and international postal, telephone and telegraph companies, our revenue will be harmed.**

We believe that, in order to grow our revenue and business and to build a large and diverse customer base, we must successfully sell our DTN System in international markets and to new types of customers, such as U.S. regional bell operating companies and international postal, telephone and telegraph companies. We have limited experience selling our DTN System internationally and to U.S. regional bell operating companies and international postal, telephone and telegraph companies. To succeed in these sales efforts, we believe we must hire additional sales personnel and develop and manage new sales channels through resellers, distributors and systems integrators. If we do not succeed in our efforts to sell to these target markets and customers, the size of our total addressable market will be limited. This, in turn, would harm our ability to grow our customer base and revenue.

**If we fail to protect our intellectual property rights, our competitive position could be harmed or we could incur significant expense to enforce our rights.**

We depend on our ability to protect our proprietary technology. We rely on a combination of trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. The steps we have taken to protect our proprietary rights may be inadequate to preclude misappropriation of our proprietary information or infringement of our intellectual property rights, and our ability to police such misappropriation or infringement is uncertain, particularly in countries outside of the United States. This is likely to become an increasingly important issue as we expand our operations and product development into countries that provide a lower level of intellectual property protection. We do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated. Moreover, the rights granted under any issued patents may not provide us with a competitive advantage, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future.

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Protecting against the unauthorized use of our DTN System, trademarks and other proprietary rights is expensive, difficult, time consuming and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity or scope of the proprietary rights of others. Such litigation could result in substantial cost and diversion of management resources, either of which could harm our business, financial condition and operating results. Furthermore, many of our current and potential competitors have the ability to dedicate substantially greater resources to enforce their intellectual property rights than we do. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property.

**Table of Contents****Claims by others that we infringe their intellectual property could harm our business.**

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In particular, many leading companies in the optical communications industry, including our competitors, have extensive patent portfolios with respect to optical communications technology. We expect that infringement claims may increase as the number of products and competitors in our market increases and overlaps occur. From time to time, third parties may assert exclusive patent, copyright, trademark and other intellectual property rights to technologies and related standards that are important to our business or seek to invalidate the proprietary rights that we hold. Competitors or other third parties have, and may continue to assert claims or initiate litigation or other proceedings against us or our manufacturers, suppliers or customers alleging infringement of their proprietary rights, or seeking to invalidate our proprietary rights, with respect to our DTN System and technology. In the event that we are unsuccessful in defending against any such claims, or any resulting lawsuit or proceedings, we could incur liability for damages and/or have valuable proprietary rights invalidated.

Any claim of infringement from a third party, even one without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from running our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment could also include an injunction or other court order that could prevent us from offering our DTN System. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms or at all. Alternatively, we may be required to develop non-infringing technology, which would require significant effort and expense and may ultimately not be successful. Any of these events could harm our business, financial condition and operating results. Competitors and other third parties have and may continue to assert infringement claims against our customers and sales partners. Any of these claims would require us to initiate or defend potentially protracted and costly litigation on their behalf, regardless of the merits of these claims, because we generally indemnify our customers and sales partners from claims of infringement of proprietary rights of third parties. If any of these claims succeed, we may be forced to pay damages on behalf of our customers or sales partners, which could have an adverse effect on our business, financial condition and operating results.

On May 9, 2006, we and Level 3 were sued by Cheetah in the United States District Court for the Eastern District of Texas Texarkana Division for alleged infringement of patent No. 6,795,605, and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of our DTN System, recovery of all damages caused by the alleged infringement and an award of any and all compensatory damages available by law, including damages, attorneys' fees, associated interest and Cheetah's costs incurred in the lawsuit. Cheetah's complaint does not request a specific dollar amount of damages. We are contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent our product is found to infringe the rights of a third party, and we have assumed the defense of this matter. On July 20, 2006, we and Level 3 filed an amended response. On November 28, 2006, Cheetah filed a second amended complaint and added patent No. 7,142,347 to the lawsuit. On December 18, 2006, we and Level 3 filed responses to Cheetah's second amended complaint. On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, we and Level 3 filed responses to Cheetah's third amended complaint.

On April 11, 2007, we, Level 3 and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. Patent and Trademark Office as to whether it will reexamine U.S. Patent Nos. 6,795,605 and 7,142,347; and (2) if the U.S. Patent and Trademark Office decides to reexamine either U.S. Patent No. 6,795,605 or 7,142,347, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. Patent and Trademark Office. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. On June 26, 2007, the U.S. Patent and Trademark Office ordered reexamination of U.S. Patent No. 6,795,605. On August 1, 2007, the U.S. Patent and Trademark Office ordered reexamination of U.S. Patent No. 7,142,347. As a result, all proceedings in this lawsuit are stayed until the final resolution of these reexaminations. We do not know when the U.S. Patent and Trademark Office reexamination process will be completed. In the event that Cheetah is successful in obtaining a judgment requiring us to pay damages or obtains an injunction preventing the sale of our DTN System, our business could be harmed.

**Our manufacturing process is very complex and the partial or complete loss of our manufacturing facility, or a reduction in yields or an inability to scale capacity to meet customer demands could harm our business.**

The manufacturing process for certain components of our products, including our PIC, and for our DTN System is technically challenging. In the event that any of these manufacturing facilities was fully or partially destroyed, as a result of fire, water damage, or otherwise, it would limit our ability to produce our DTN System. Because of the complex nature of our manufacturing facilities, such loss would take a considerable amount of time to repair or rebuild. The partial or complete loss of any of our manufacturing facilities, or an event causing the interruption in our use of such facility for any extended period of time would cause our business, financial condition and operating results to be harmed.

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Minor deviations in the manufacturing process can cause substantial decreases in yields and, in some cases, cause production to be suspended. We have had production interruptions and suspensions in the past and may have additional interruptions or suspensions in the future. We expect our manufacturing yield for our next generation PICs to be lower initially and increase as we achieve full production. Poor yields from our PIC manufacturing process or defects, integration issues or other performance problems in our DTN System could cause us customer relations and business reputation problems, harming our business and operating results.

On July 16, 2009, the Company announced its plan to restructure its Maryland based semiconductor fabrication plant (the Maryland FAB ). This restructuring is expected to include the closure of the Maryland FAB and the transfer of new technology to our existing PIC manufacturing facility in California. This restructuring is expected to be completed by our fiscal fourth quarter of 2009. If we are unable to successfully complete this restructuring, or if other integration issues or product performance problems result from this restructuring, it could harm our customer relationships, business reputation and could harm our business and operating results.

In addition, our manufacturing facilities may not have adequate capacity to meet the demand for our DTN System or we may not be able to increase our capacity to meet potential increases in demand for our DTN System. Our inability to obtain sufficient manufacturing capacity to meet demand, either in our own facilities or through foundry or similar arrangements with third parties, could harm our relationships with customers, our business and our operating results.

### **Our leadership transition may not go smoothly and could adversely impact our future operations.**

We had previously announced that Jagdeep Singh will step down as our President and Chief Executive Officer effective December 31, 2009, and will be replaced by Thomas Fallon, our current Chief Operating Officer. A significant leadership change is inherently risky and we may be unable to manage this transition smoothly which could adversely impact our future strategy and ability to function or execute and could materially and adversely affect our business, financial condition and results of operations.

### **If we fail to accurately forecast demand for our DTN System, we may have excess or insufficient inventory, which may increase our operating costs, decrease our revenue and harm our business.**

We are required to generate forecasts of future demands for our DTN System several months prior to the scheduled delivery to our prospective customers, which requires us to make significant investments before we know if corresponding revenue will be recognized. If we overestimate demand for our DTN System or particular elements of our DTN System and increase our inventory in anticipation of customer orders that do not materialize, we will have excess inventory, we will face a risk of obsolescence and significant inventory write-downs and our capital infrastructure will be depreciated across fewer units raising our per unit costs. If we underestimate demand for our DTN System, we will have inadequate inventory, which could slow down or interrupt the manufacturing of our DTN System and result in delays in shipments and our ability to recognize revenue. In addition, we may be unable to meet our supply commitments to customers which could result in a breach of our customer agreements and require us to pay damages. Lead times for materials and components, including application-specific integrated circuits, that we need to order for the manufacturing of our DTN System vary significantly and depend on factors such as the specific supplier, contract terms and demand for each component at a given time.

### **Product performance problems, including undetected errors in our hardware or software, or deployment delays could harm our business and reputation.**

The development and production of new products with high technology content, such as our DTN System, is complicated and often involves problems with software, components and manufacturing methods. Complex hardware and software products, such as our DTN System, can often contain undetected errors when first introduced or as new versions are released. We have experienced errors in the past in connection with our DTN System, including failures due to the receipt of faulty components from our suppliers. We suspect that errors, including potentially serious errors, will be found from time to time in our DTN System. We have been shipping our DTN System since November 2004, which provides us with limited information on which to judge its reliability. Our DTN System may suffer degradation of performance and reliability over time.

If reliability, quality or network monitoring problems develop, a number of negative effects on our business could result, including:

delays in our ability to recognize revenue;

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costs associated with fixing software or hardware defects or replacing products;

high service and warranty expenses;

delays in shipments;

high inventory excess and obsolescence expense;

high levels of product returns;

diversion of our engineering personnel from our product development efforts;

delays in collecting accounts receivable;

payment of damages for performance failures;

reduced orders from existing customers; and

declining interest from potential customers.

Because we outsource the manufacturing of certain components of our DTN System, we may also be subject to product performance problems as a result of the acts or omissions of these third parties.

From time to time, we encounter interruptions or delays in the activation of our DTN System at a customers' site. These interruptions or delays may result from product performance problems or from issues with installation and activation, some of which are outside our control. If we experience significant interruptions or delays that we cannot promptly resolve, the associated revenue for these installations may be delayed or confidence in our DTN System could be undermined, which could cause us to lose customers and fail to add new customers.

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**We are dependent on sole source and limited source suppliers for several key components, and if we fail to obtain these components on a timely basis, we will not meet our customers' product delivery requirements.**

We currently purchase several key components from single or limited sources. In particular, we rely on our own production of certain components of our DTN System, such as PICs, and on third parties as sole source suppliers for certain of the components of our system, including: application-specific integrated circuits, field-programmable gate arrays, processors, and other semiconductor and optical components. We purchase these items on a purchase order basis and have no long-term contracts with most of these sole source suppliers. If any of our sole or limited source suppliers suffer from capacity constraints, lower than expected yields, work stoppages or any other reduction or disruption in output, they may be unable to meet our delivery schedule. Further, our suppliers could enter into exclusive arrangements with our competitors, refuse to sell their products or components to us at commercially reasonable prices or at all, go out of business or discontinue their relationships with us. We may be unable to develop alternative sources for these components.

If we do not receive critical components for our DTN System in a timely manner, we will be unable to deliver those components to our manufacturer in a timely manner and would, therefore, be unable to meet our prospective customers' product delivery requirements. In addition, the sourcing from new suppliers may require us to re-design our DTN System, which could cause delays in the manufacturing and delivery of our systems. In the past, we have experienced delivery delays because of lack of availability of components or reliability issues with components that we were purchasing. In addition, some of our sole suppliers have gone out of business, limited their supply of components to us, or indicated that they may be going out of business. These supplier disruptions may continue to occur in the future, which could limit our ability to produce the DTN System and cause us to fail to meet a customer's delivery requirements. Such events could harm our reputation and our customer relationships, either of which could harm our business and operating results.

**We have experienced delays in the development and introduction of our DTN System, and any future delays in releasing new products or in releasing enhancements to our DTN System may harm our business.**

Since our DTN System is based on complex technology, we may experience unanticipated delays in developing, improving, manufacturing or deploying it. Any modification to our PIC and to our DTN System entails similar development risks. At any given time, various new product introductions and enhancements to our DTN System are in the development phase and are not yet ready for commercial manufacturing or deployment. The maturing process from laboratory prototype to customer trials, and subsequently to general availability, involves a number of steps, including:

completion of product development;

the qualification and multiple sourcing of critical components;

validation of manufacturing methods and processes;

extensive quality assurance and reliability testing, and staffing of testing infrastructure;

validation of software; and

establishment of systems integration and systems test validation requirements.

Each of these steps, in turn, presents risks of failure, rework or delay, any one of which could decrease the speed and scope of product introduction and marketplace acceptance of our products. New versions of our PICs, specialized application-specific integrated circuits and intensive software testing and validation are important to the timely introduction of new product introductions and enhancements to our DTN System and to our ability to enter new markets, and schedule delays are common. In addition, unexpected intellectual property disputes, failure of critical design elements, and a host of other execution risks may delay or even prevent the introduction of enhancements to our DTN System. If we do not develop and successfully introduce products in a timely manner, our competitive position may suffer. In addition, if we do not develop and successfully introduce products in sufficient time so as to satisfy our customer's expectations, we may lose future business from such

customers and harm our reputation and our customer relationships, either of which could harm our business and operating results.



**Our investments in adjustable rate securities are subject to risks which may cause losses and affect the liquidity of these investments.**

At June 27, 2009, we held \$75.5 million (par value) of investments comprised of adjustable rate securities, or ARS, which are variable-rate debt securities and have a long-term maturity with the interest rate being reset through auctions that are typically held every 7, 28 or 35 days. These securities have historically traded at par and were callable at par at the option of the issuer. Interest was typically paid at the end of each auction period or semiannually. At June 27, 2009, most of the ARS we held were AAA rated, except for \$17.0 million of the ARS holdings were downgraded to A3 and Aa1 ratings during the six months ended June 27, 2009. Our ARS holdings were most collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program.

Since February 2008, most of the auctions for these securities have failed and there is no assurance that future auctions will succeed. As a result, our ability to liquidate our investment in the near term is limited. In addition, it could take until final maturity of the ARS (up to 38 years) to realize our investments par value or we may not be able to fully recover the par value of our ARS. In the event we need to access these funds, we may not be able to do so until a future auction on these investments is successful, a secondary market develops or the securities are redeemed by the broker dealer.

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In October 2008, we elected to participate in a rights offering by UBS Financial Services, Inc. ( UBS ), one of our brokers, which provides us with certain rights (the Put Rights ) to sell UBS \$65.7 million (par value) of the ARS, which we purchased through UBS back to UBS at par value, at any time during a two-year sale period beginning June 30, 2010. By electing to participate in the rights offering, we granted UBS the right, exercisable at any time prior to June 30, 2010 or during the two-year sale period, to purchase or cause the sale of our ARS ( Call Right ). As such, in the fourth quarter of 2008, we recorded a gain of \$15.9 million related to the Put Rights provided by the settlement and a gross unrealized loss of \$16.8 million related to the \$65.7 million (par value) portion of our ARS portfolio as we may decide not to hold these securities until final maturity because of the opportunity provided by the Put Rights. The ARS covered by the UBS settlement and the related Put Rights are revalued on a quarterly basis, and we recorded a \$0.4 million increase and \$1.5 million decrease in the fair value of the Put Rights, respectively, and \$0.6 million and \$1.5 million of unrealized holding gains to ARS trading securities, respectively, for the three months ended June 27, 2009 in Other gain (loss), net in the accompanying condensed consolidated statements of operations.

As of June 27, 2009, the remaining \$10.0 million of ARS which are not subject to the UBS settlement were deemed to be other-than-temporarily impaired in accordance with FSP FAS 115-2. As of June 27, 2009, we determined that we do not intend to sell these securities and it is not more likely than not that we will be required to sell the securities before recovery of its amortized cost. However, given that the present value of the expected cash flows for these securities was below their amortized cost basis, an OTTI of \$2.7 million, equal to the difference between the fair value and the amortized cost basis has occurred. We recognized a credit impairment loss of \$0.9 million in our condensed consolidated statements of operations for the three and six months ended June 27, 2009. The non-credit related portion of this OTTI of \$1.8 million was recognized in Accumulated other comprehensive loss in our condensed consolidated balance sheet at June 27, 2009.

If the issuers of the adjustable rate securities are unable to successfully close future auctions or refinance their debt in the near term and their credit ratings deteriorate, we may be required to record further impairment charges on these investments and may liquidate these investments for less than their face value. In addition, if UBS is unable to honor our Put Rights, the fair value of our Put Rights may be reduced to zero, thus adversely affecting our financial position and capital resources.

**We must respond to rapid technological change and comply with evolving industry standards and requirements for our DTN System to be successful.**

The optical communications equipment market is characterized by rapid technological change, changes in customer requirements and evolving industry standards. The introduction of new communications technologies and the emergence of new industry standards or requirements could render our DTN System obsolete. Further, in developing our DTN System, we have made, and will continue to make, assumptions with respect to which standards or requirements will be adopted by our customers and competitors. If the standards or requirements adopted by our prospective customers are different from those on which we have focused our efforts, market acceptance of our DTN System would be reduced or delayed and our business would be harmed.

We expect our competitors to continue to improve the performance of their existing products and to introduce new products and technologies. To be competitive, we must continue to invest significant resources in research and development, sales and marketing and customer support. We may not have sufficient resources to make these investments, we may not be able to make the technological advances necessary to be competitive and we may not be able to effectively sell our DTN System to customers who have prior relationships with our competitors.

**If we fail to maintain effective internal control over financial reporting in the future, the accuracy and timing of our financial reporting may be adversely affected.**

Assessing our processes, procedures and staffing in order to improve our internal control over financial reporting is an ongoing process. For the year ended December 27, 2008, management became obligated to comply for the first time with Section 404 of the Sarbanes-Oxley Act of 2002 and has issued a report that assesses the effectiveness of our internal control over financial reporting. Also, for the year ended December 27, 2008, an attestation report concerning the effectiveness of our internal control over financial reporting has been issued for the first time by Ernst & Young, LLP, Independent Registered Public Accounting Firm.

Preparing our financial statements involves a number of complex processes, many of which are done manually and are dependent upon individual data input or review. These processes include, but are not limited to, calculating revenue, deferred revenue and inventory costs. While we continue to automate our processes and enhance our review and put in place controls to reduce the likelihood for errors, we expect that for the foreseeable future many of our processes will remain manually intensive and thus subject to human error.

In the past, we have identified several material weaknesses in our internal control over financial reporting. We have remediated these identified material weaknesses, but we cannot give any assurances that all material weaknesses have been identified or that additional material weaknesses will not be identified in the future in connection with our compliance with the provisions of



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Section 404 of the Sarbanes-Oxley Act of 2002. The existence of one or more material weaknesses could preclude a conclusion by management that we maintained effective internal control over financial reporting. The existence or disclosure of any such material weakness could adversely affect our stock price.

### **If we lose key personnel or fail to attract and retain additional qualified personnel when needed, our business may be harmed.**

Our success depends to a significant degree upon the continued contributions of our key management, engineering, sales and marketing, and finance personnel, many of whom would be difficult to replace. For example, senior members of our engineering team have unique technical experience that would be difficult to replace. We do not have long-term employment contracts or key person life insurance covering any of our key personnel. Because our DTN System is complex, we must hire and retain a large number of highly trained customer service and support personnel to ensure that the deployment of our DTN System does not result in network disruption for our customers. We believe our future success will depend in large part upon our ability to identify, attract and retain highly skilled managerial, engineering, sales, marketing, finance and customer service and support personnel. Competition for these individuals is intense in our industry, especially in the San Francisco Bay Area. We may not succeed in identifying, attracting and retaining appropriate personnel. The loss of the services of any of our key personnel, the inability to identify, attract or retain qualified personnel in the future or delays in hiring qualified personnel, particularly engineers and sales personnel, could make it difficult for us to manage our business and meet key objectives, such as timely product introductions.

### **Our sales cycle can be long and unpredictable, which could result in an unexpected revenue shortfall in any given quarter.**

Our DTN System has a lengthy sales cycle, which can extend from six to twelve months and may take even longer for larger prospective customers such as U.S. regional bell operating companies, international postal, telephone and telegraph companies and U.S. competitive local exchange carriers. Our prospective customers conduct significant evaluation, testing, implementation and acceptance procedures before they purchase our DTN System. We incur substantial sales and marketing expenses and expend significant management effort during this time, regardless of whether we make a sale.

Because the purchase of our equipment involves substantial cost, most of our customers wait to purchase our equipment until they are ready to deploy it in their network. As a result, it is difficult for us to accurately predict the timing of future purchases by our customers. In addition, product purchases are often subject to budget constraints, multiple approvals and unplanned administrative processing and other delays. If sales expected from customers for a particular quarter are not realized in that quarter or at all, our revenue will be negatively impacted.

### **Our international sales and operations subject us to additional risks that may harm our operating results.**

We market, sell and service our DTN System globally. In 2008, 2007 and 2006, we derived approximately 21%, 19% and 14%, respectively, of our revenue from customers outside of the United States. For the three and six months ended June 27, 2009, we derived approximately 36% and 31%, respectively, of our revenue from customers outside of the United States. We have sales and support personnel in numerous countries worldwide. In addition, we have a large group of software development personnel located in Bangalore, India and a group of hardware and software development engineers located in Beijing, China. We expect that significant management attention and financial resources will be required for our international activities over the foreseeable future as we continue to expand our international presence. In some countries, our successes in selling the DTN System will depend in part on our ability to form relationships with local partners. Our inability to identify appropriate partners or reach mutually satisfactory arrangements for international sales of our DTN System could impact our ability to maintain or increase international market demand for our DTN System.

Our international operations are subject to inherent risks, and our future results could be adversely affected by a variety of factors, many of which are outside of our control, including:

greater difficulty in collecting accounts receivable and longer collection periods;

difficulties of managing and staffing international offices, and the increased travel, infrastructure and legal compliance costs associated with multiple international locations;

the impact of recessions in economies outside the United States;



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tariff and trade barriers and other regulatory requirements or contractual limitations on our ability to sell or develop our DTN System in certain foreign markets;

certification requirements;

greater difficulty documenting and testing our internal controls;

reduced protection for intellectual property rights in some countries;

potentially adverse tax consequences;

political and economic instability;

effects of changes in currency exchange rates which could negatively affect our financial results and cash flows.

service provider and government spending patterns.

International customers may also require that we comply with certain testing or customization of our DTN System to conform to local standards. The product development costs to test or customize our DTN System could be extensive and a material expense for us.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks could harm our international operations and reduce our international sales.

**If our contract manufacturers do not perform as we expect, our business may be harmed.**

Our future success will depend on our ability to have sufficient volumes of our DTN System manufactured in a cost-effective and quality-controlled manner. We have engaged third parties to manufacture certain elements of our DTN System and are in the process of qualifying non-U.S. contract manufacturing sites. There are a number of risks associated with our dependence on contract manufacturers, including:

reduced control over delivery schedules, particularly for international contract manufacturing sites;

reliance on the quality assurance procedures of third parties;

potential uncertainty regarding manufacturing yields and costs;

potential lack of adequate capacity during periods of excess demand;

potential uncertainty related to the use of international contract manufacturing sites;

limited warranties on components supplied to us;

potential misappropriation of our intellectual property; and

potential manufacturing disruptions.

Any of these risks could impair our ability to fulfill orders. Our contract manufacturers may not be able to meet the delivery requirements of our customers, which could decrease customer satisfaction and harm our DTN System sales. We do not have long-term contracts or arrangements with our contract manufacturers that will guarantee product availability, or the continuation of particular pricing or payment terms. If our contract manufacturers are unable or unwilling to continue manufacturing our DTN System in required volumes or our relationship with any of our contract manufacturers is discontinued for any reason, we would be required to identify and qualify alternative manufacturers, which could cause us to be unable to meet our supply requirements to our customers and result in the breach of our customer agreements. Qualifying a new contract manufacturer and commencing volume production is expensive and time-consuming and if we are required to change or qualify a new contract manufacturer, we would likely lose sales revenue and damage our existing customer relationships.

**Any acquisitions we make could disrupt our business and harm our financial condition and operations.**

We have made strategic acquisitions of businesses, technologies and other assets in the past. While we have no current agreements or commitments, we may in the future acquire businesses, product lines or technologies. In the event of any future acquisitions, we may not ultimately strengthen our competitive position or achieve our goals, or they may be viewed negatively by customers, financial markets or investors and we could:

issue stock that would dilute our current stockholders' percentage ownership;

incur debt and assume other liabilities; or

incur amortization expenses related to goodwill and other intangible assets and/or incur large and immediate write-offs.

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Acquisitions also involve numerous risks, including:

problems integrating the acquired operations, technologies or products with our own;

diversion of management's attention from our core business;

assumption of unknown liabilities;

adverse effects on existing business relationships with suppliers and customers

increased accounting compliance risk;

risks associated with entering new markets; and

potential loss of key employees.

We may not be able to successfully integrate any businesses, products, technologies or personnel that we might acquire in the future. Our failure to do so could have an adverse effect on our business, financial condition and operating results.

### **Our use and reliance upon development resources in India may expose us to unanticipated costs or liabilities.**

We have established a development center in India and expect to continue to increase hiring of personnel for this facility. There is no assurance that our reliance upon development resources in India will enable us to achieve meaningful cost reductions or greater resource efficiency. Further, our development efforts and other operations in India involve significant risks, including:

difficulty hiring and retaining appropriate engineering resources due to intense competition for such resources and resulting wage inflation;

the knowledge transfer related to our technology and exposure to misappropriation of intellectual property or confidential information, including information that is proprietary to us, our customers and other third parties;

heightened exposure to changes in the economic, security and political conditions of India;

fluctuation in currency exchange rates and tax risks associated with international operations; and

development efforts that do not meet our requirements because of language, cultural or other differences associated with international operations, resulting in errors or delays.

Difficulties resulting from the factors above and other risks related to our operations in India could expose us to increased expense, impair our development efforts, harm our competitive position and damage our reputation.



**Unforeseen health, safety and environmental costs could harm our business.**

Our manufacturing operations use substances that are regulated by various federal, state and international laws governing health, safety and the environment. If we experience a problem with these substances, it could cause an interruption or delay in our manufacturing operations or could cause us to incur liabilities for any costs related to health, safety or environmental remediation. We could also be subject to liability if we do not handle these substances in compliance with safety standards for storage and transportation and applicable laws. If we experience a problem or fail to comply with such safety standards, our business, financial condition and operating results may be harmed.

**We are subject to governmental export and import controls that could subject us to liability or impair our ability to compete in international markets.**

We are subject to export control laws that limit which products we sell and where and to whom we sell our DTN System. U.S. export control laws also limit our ability to conduct product development activities in certain countries. In addition, various countries regulate the import of certain technologies and have enacted laws that could limit our ability to distribute our DTN System or could limit our customers' ability to implement our DTN System in those countries. Changes in our DTN System or changes in export and import regulations may create delays in the introduction of our DTN System in international markets, prevent our customers with international operations from deploying our DTN System throughout their global systems or, in some cases, prevent the export or import of our DTN System to certain countries altogether. Any change in export or import regulations or related legislation, shift in approach to the enforcement or scope of existing regulations, or change in the countries, persons or technologies targeted by such regulations, could result in decreased use of our DTN System by, or in our decreased ability to export or sell our DTN System to, existing or potential customers with international operations. For example, we need to comply with Waste from Electrical and Electronic Equipment and Restriction of Hazardous Substances laws, which have been adopted by certain European Economic Area countries on a country-by-country basis. Failure to comply with these and similar laws on a timely basis, or at all, decreased use of our DTN System or any limitation on our ability to export or sell our products would adversely affect our business, financial condition and operating results.

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**If we need additional capital in the future, it may not be available to us on favorable terms, or at all.**

Our business requires significant capital. We have historically relied on significant outside debt and equity financing as well as cash flow from operations to fund our operations, capital expenditures and expansion. We may require additional capital from equity or debt financings in the future to fund our operations or respond to competitive pressures or strategic opportunities. We have a history of significant operating losses and for the six months ended June 27, 2009, we had a net loss of \$51.4 million. In the event that we require additional capital, we may be unable to liquidate our auction rate securities. We may not be able to secure timely additional financing on favorable terms, or at all. The terms of any additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer dilution in their percentage ownership of our company, and any new securities we issue could have rights, preferences and privileges senior to those of holders of our common stock. If we are unable to obtain adequate financing or financing on terms satisfactory to us, if and when we require it, our ability to grow or support our business and to respond to business challenges could be limited and our business will be harmed.

**We are subject to government regulations that could adversely impact our business.**

The Federal Communications Commission, or FCC, has jurisdiction over the entire U.S. communications industry and, as a result, our DTN System and our North American customers are subject to FCC rules and regulations. Current and future FCC regulations affecting communications services, our DTN System or our customers' businesses could negatively affect our business. In addition, international regulatory standards could impair our ability to develop products for international customers in the future. Delays caused by our compliance with regulatory requirements could result in postponements or cancellations of product orders. Further, we may not be successful in obtaining or maintaining any regulatory approvals that may, in the future, be required to operate our business. Any failure to obtain such approvals could harm our business and operating results.

**Natural disasters, terrorist attacks or other catastrophic events could harm our operations.**

Our headquarters and the majority of our infrastructure, including our PIC manufacturing facility, are located in Northern California, an area that is susceptible to earthquakes and other natural disasters. Further, a terrorist attack aimed at Northern California or at our nation's energy or telecommunications infrastructure could hinder or delay the development and sale of our DTN System. In the event that an earthquake, terrorist attack or other catastrophe were to destroy any part of our facilities, or certain of our contract manufacturers' facilities, destroy or disrupt vital infrastructure systems or interrupt our operations for any extended period of time, our business, financial condition and operating results would be harmed.

**The trading price of our common stock has been volatile and is likely to be volatile in the future.**

The trading prices of our common stock and the securities of other technology companies have been and may continue to be highly volatile. Further, our common stock has limited prior trading history. Factors affecting the trading price of our common stock include:

variations in our operating results;

announcements of technological innovations, new services or service enhancements, strategic alliances or agreements by us or by our competitors;

the gain or loss of customers;

recruitment or departure of key personnel;

changes in the estimates of our future operating results or external guidance on those results or changes in recommendations by any securities analysts that elect to follow our common stock;

market conditions in our industry, the industries of our customers and the economy as a whole; and

adoption or modification of regulations, policies, procedures or programs applicable to our business.

In addition, if the market for technology stocks or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, financial condition or operating results. The trading price of our common stock might also decline in reaction to events that affect other companies in our industry even if these events do not directly affect us. Each of these factors, among others, could harm the value of your investment in our common stock. Some companies that have had volatile market prices for their securities have had securities class action lawsuits filed against them. If a suit were filed against us, regardless of its merits or outcome, it could result in substantial costs and divert management's attention and resources.

**If securities or industry analysts do not publish research or publish misleading or unfavorable research about our business, our stock price and trading volume could decline.**

The trading market for our common stock depends in part on the research and reports that securities or industry analysts publish about us or our business. If no or few securities or industry analysts cover our company, the trading price for our stock would be negatively impacted. If one or more of the analysts who covers us downgrades our stock or publishes misleading or unfavorable research about our business, our stock price would likely decline. If one or more of these analysts ceases coverage of our company or fails to publish reports on us regularly, demand for our stock could decrease, which could cause our stock price or trading volume to decline.

**Table of Contents****Anti-takeover provisions in our charter documents and Delaware law could discourage delay or prevent a change in control of our company and may affect the trading price of our common stock.**

We are a Delaware corporation and the anti-takeover provisions of the Delaware General Corporation Law, which apply to us, may discourage, delay or prevent a change in control by prohibiting us from engaging in a business combination with an interested stockholder for a period of three years after the person becomes an interested stockholder, even if a change of control would be beneficial to our existing stockholders. In addition, our amended and restated certificate of incorporation and amended and restated bylaws may discourage, delay or prevent a change in our management or control over us that stockholders may consider favorable. Our amended and restated certificate of incorporation and amended and restated bylaws:

authorize the issuance of blank check convertible preferred stock that could be issued by our board of directors to thwart a takeover attempt;

establish a classified board of directors, as a result of which the successors to the directors whose terms have expired will be elected to serve from the time of election and qualification until the third annual meeting following their election;

require that directors only be removed from office for cause and only upon a supermajority stockholder vote;

provide that vacancies on the board of directors, including newly-created directorships, may be filled only by a majority vote of directors then in office rather than by stockholders;

prevent stockholders from calling special meetings; and

prohibit stockholder action by written consent, requiring all actions to be taken at a meeting of the stockholders.

**Item 4. Submission of Matters to a Vote of Security Holders**

The 2009 Annual Meeting of Stockholders was held on June 11, 2009. At the meeting, Dr. Dan Maydan and Mr. Jagdeep Singh were elected by the stockholders to continue to serve as members of the Company's Board of Directors until 2012; in addition, the stockholders approved the ratification of the appointment of Ernst & Young LLP as the Company's independent registered public accounting firm for the fiscal year ending December 26, 2009 and authorized the Board of Directors to implement a stock option exchange program consistent with the parameters set forth in the proxy statement. Voting results are as follows:

## 1. Election of Class II Directors

	Votes in favor	Votes Against	Abstentions
Dan Maydan, Ph.D.	86,600,781	1,128,590	105,554
Jagdeep Singh	87,145,652	574,032	115,240

The following director, in addition to Dr. Maydan and Mr. Singh, will continue to serve as members of the Board of Directors until the expiration of their respective terms or until their respective successors have been duly elected and qualified: Alexandre Balkanski, Kenneth A. Goldman, Reed E. Hundt and Carl Redfield.

## 2. Ratification of the appointment of

Votes in favor	Votes Against	Abstentions
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Ernst & Young LLP as Infinera's Independent registered public accounting firm for the fiscal year ending December 26, 2009	87,648,935	110,118	75,872
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### 3. Approval of Stock Option Exchange Program

	<b>Votes in favor</b>	<b>Votes Against</b>	<b>Abstentions</b>	<b>Broker Non-Votes</b>
	35,987,027	27,795,530	63,919	23,988,449

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**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

The certification attached as Exhibit 32.1 that accompanies this Quarterly Report on Form 10-Q is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Infinera Corporation under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date of this Quarterly Report on Form 10-Q, irrespective of any general incorporation language contained in such filing.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**Infinera Corporation**

By: /s/ Duston M. Williams  
*Duston M. Williams*  
*Chief Financial Officer*  
(Duly Authorized Officer and Principal

Financial Officer)

Date: August 3, 2009