UTSTARCOM INC
Form 10-Q
November 09, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

ý	**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the quarterly period ended September 30, 2004
	OR
o	**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
	For the transition period from to
	COMMISSION FILE NUMBER 000-29661

UTSTARCOM, INC.
(Exact name of registrant as specified in its charter)

DELAWARE (State of Incorporation)	**52-1782500** (I.R.S. Employer Identification No.)
1275 HARBOR BAY PARKWAY **ALAMEDA, CALIFORNIA** (Address of principal executive offices)	**94502** (zip code)

Registrant s telephone number, including area code: **(510) 864-8800**

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

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

As of November 5, 2004 there were 114,274,019 shares of the registrant s common stock outstanding, par value $0.00125.

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PART I FINANCIAL INFORMATION

ITEM 1 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

UTSTARCOM, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands, except share and per share data)

	September 30, 2004	December 31, 2003
ASSETS		
Current assets:		
Cash and cash equivalents	$ 751,320	$ 373,974
Short-term investments	44,883	48,617
Accounts receivable, net of allowances for doubtful accounts of $48,238 and $31,172 at September 30, 2004 and December 31, 2003, respectively	691,160	324,921
Accounts receivable, related parties	46,339	43,944
Notes receivable	24,877	11,362
Inventories	439,412	257,038
Deferred costs/Inventories at customer sites under contracts	168,903	558,977
Prepaids	79,849	136,262
Restricted cash and short-term investments	36,799	24,404
Other current assets	41,313	52,408
Total current assets	2,324,855	1,831,907
Property, plant and equipment, net	255,029	186,076
Long-term investments	25,428	24,066
Goodwill	113,544	100,180
Intangible assets, net	60,543	44,052
Other long-term assets	53,427	40,677
Total assets	$ 2,832,826	$ 2,226,958
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Notes payable and short-term debt	$ 176,566	$ 1
Accounts payable	336,444	251,175
Income taxes payable	16,783	16,780
Customer advances	279,631	458,654
Deferred revenue	57,874	44,958
Other current liabilities	191,606	173,139
Total current liabilities	1,058,904	944,707
Convertible subordinated notes	402,500	402,500
Total liabilities	1,461,404	1,347,207
Commitments and contingencies (Note 16)		
Minority interest in consolidated subsidiaries	687	560
Stockholders equity:		
Common stock: $0.00125 par value; authorized: 750,000,000 shares; issued and outstanding: 113,963,558 and 104,272,477 at September 30, 2004 and December 31, 2003, respectively	143	131

Additional paid-in capital		1,115,433		653,624
Deferred stock compensation		(7,233)		(7,761)
Retained earnings		260,371		229,777
Accumulated other comprehensive income		2,021		3,420
Total stockholders equity		1,370,735		879,191
Total liabilities, minority interest and stockholders equity	$	2,832,826	$	2,226,958

See accompanying notes to condensed consolidated financial statements.

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UTSTARCOM, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(In thousands, except per share data)

	Three months ended September 30, 2004	Three months ended September 30, 2003	Nine months ended September 30, 2004	Nine months ended September 30, 2003
Net sales:				
Unrelated parties	$ 613,016	$ 558,328	$ 1,892,298	$ 1,176,014
Related parties	32,000	26,054	64,637	144,722
	645,016	584,382	1,956,935	1,320,736
Cost of sales	507,882	398,280	1,467,496	884,445
Gross profit	137,134	186,102	489,439	436,291
Operating expenses:				
Selling, general and administrative	74,916	57,371	209,689	129,917
Research and development	56,026	44,723	154,276	107,613
In-process research and development		161	1,400	10,809
Amortization of intangible assets	3,639	3,081	9,946	5,259
Total operating expenses	134,581	105,336	375,311	253,598
Operating income	2,553	80,766	114,128	182,693
Interest income	1,339	530	4,530	2,172
Interest expense	(1,206)	(1,506)	(3,428)	(3,463)
Other income, net	1,162	670	14,211	4,118
Equity in loss of affiliated companies	(727)	(1,560)	(2,925)	(4,280)
Income before income taxes and minority interest	3,121	78,900	126,516	181,240
Income tax expense (benefit)	(1,906)	19,725	22,773	45,310
Minority interest in earnings of consolidated subsidiaries	(40)	(35)	(127)	(35)
Net income	$ 4,987	$ 59,140	$ 103,616	$ 135,895
Basic earnings per share	$ 0.04	$ 0.58	$ 0.91	$ 1.31
Diluted earnings per share	$ 0.04	$ 0.46	$ 0.78	$ 1.12
Weighted average shares used in per-share calculation:				
- Basic	113,945	102,814	114,110	103,607
- Diluted	133,226	131,914	136,214	124,043

See accompanying notes to condensed consolidated financial statements.

UTSTARCOM, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)

	Nine months ended September 30, 2004	2003
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 103,616	$ 135,895
Adjustment to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	52,563	30,293
Non-qualified stock option exercise tax benefits	3,612	12,605
Net loss on sale of assets	7	744
Loss on sale of notes receivable		1,931
In-process research and development costs	1,400	10,809
Amortization of debt issuance costs	1,749	1,359
Warrants adjustment to fair value	(46)	(64)
Loss (gain) on sale of investment	(2,116)	73
Net loss on long-term investments	1,608	63
Stock compensation expense	327	3,236
Provision for doubtful accounts	17,552	1,150
Inventory provision	21,190	9,715
Equity in loss of affiliated companies	2,925	4,280
Deferred income taxes	(6,865)	(2,960)
Minority interest in earnings of consolidated subsidiary	127	35
Changes in operating assets and liabilities:		
Accounts receivable	(385,010)	(92,786)
Inventories	(202,171)	(222,870)
Deferred costs/Inventories at customer sites under contracts	390,074	(335,644)
Other current and non-current assets	54,729	(157,134)
Accounts payable	82,639	145,057
Income taxes payable	15	11,312
Customer advances	(183,054)	345,318
Deferred revenue	12,862	25,426
Other current liabilities	12,663	70,989
Net cash used in operating activities	(19,604)	(1,168)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property, plant and equipment	(105,209)	(71,440)
Additions to long-term investments	(6,000)	(661)
Purchase of businesses, net of cash acquired	(43,980)	(112,415)
Issuance of notes receivable		(10,071)
Proceeds from disposal of property		21
Purchase of intellectual property licenses	(3,775)	
Change in restricted cash	(7,512)	3,844
Purchase of short-term investments	(170,704)	(64,643)
Proceeds from sale of investments	170,280	177,923
Net cash used in investing activities	(166,900)	(77,442)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of stock, net of expenses	18,402	51,229
Purchase of bond hedge and call option		(43,792)
Net proceeds from borrowing	215,000	414,821
Repayments of borrowings	(40,000)	
Repurchases of stock	(107,567)	(139,609)
Proceeds from equity offering	474,554	
Proceeds from stockholder notes		28

Net cash provided by financing activities		560,389		282,677
Effect of exchange rate changes on cash		3,461		74
Net increase in cash and cash equivalents		377,346		204,141
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD		373,974		231,944
CASH AND CASH EQUIVALENTS AT END OF PERIOD	$	751,320	$	436,085

See accompanying notes to condensed consolidated financial statements.

UTSTARCOM, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. BASIS OF PRESENTATION:

The accompanying unaudited condensed consolidated financial statements include the accounts of UTStarcom, Inc. (the Company) and its wholly and majority owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in the preparation of the condensed consolidated financial statements. The minority interests in consolidated subsidiaries and equity in affiliated companies are shown separately in the condensed consolidated financial statements. Investments in affiliated companies are accounted for using the cost or equity method, as applicable.

The accompanying financial statements as of September 30, 2004 and for the three and nine months ended September 30, 2004 and 2003 have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission (SEC). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The December 31, 2003 balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. These condensed consolidated financial statements should be read in conjunction with the Company s audited December 31, 2003 financial statements, including the notes thereto, and the other information set forth in the Company s Annual Report on Form 10-K for the year ended December 31, 2003. Certain reclassifications have been made to prior period balances in order to conform to the current year presentation.

In the opinion of management, the accompanying condensed consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) considered necessary for a fair presentation of the Company s financial condition, the results of its operations and its cash flows for the periods indicated. The results of operations for the three and nine months ended September 30, 2004 are not necessarily indicative of the operating results for the full year.

2. REVENUE RECOGNITION:

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

Sales may be generated from complex contractual arrangements that require significant revenue recognition judgments, particularly in the areas of multiple element arrangements. Where multiple elements exist in an arrangement, the arrangement fee is allocated to the different elements based upon verifiable objective evidence of the fair value of the elements, as governed under EITF 00-21, and SEC Staff Accounting Bulletin No. 104 (SAB 104). Multiple element arrangements primarily involve the sale of Personnel Access Systems (PAS), a family of wireless access handsets, wireless consumer products and core infrastructure equipment or Internet Protocol-based PAS (iPAS) wireless access systems that

employ micro cell radio technology and specialized handsets, allowing service providers to offer subscribers both mobile and fixed access to telephone services. These multiple element arrangements include the sale of PAS or iPAS equipment with handsets, installation and training and the provision of such equipment to different locations for the same customer. Revenue is recognized as each element is earned, namely upon installation and acceptance of equipment or delivery of handsets, provided that the fair value of the undelivered element(s) has been determined, the delivered elements has stand-alone value, there is no right of return on delivered element(s), and the vendor is in control of the undelivered element(s). For arrangements that include service elements, including promotional support and installation, for which verifiable objective evidence of fair value does not exist, revenue is deferred until such services are deemed complete.

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

Where multiple elements exist in an arrangement that includes software and the software is considered more than incidental to the equipment or services in the arrangement, software and software-related elements are recognized under the

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

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

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

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

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

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

3. EARNINGS PER SHARE:

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

and unvested acquisition-related stock options.

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

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	Three months ended September 30,		Nine months ended September 30,	
	2004	2003	2004	2003
Numerator:				
Net income (for basic EPS computation)	$ 4,987	$ 59,140	$ 103,616	$ 135,895
Effect of dilutive securities 7/8% Convertible Subordinated Notes	816	1,098	2,663	2,473
Net income adjusted for dilutive securities	$ 5,803	$ 60,238	$ 106,279	$ 138,368
Denominator:				
Shares used to compute basic EPS	113,945	102,814	114,110	103,607
Dilutive common stock equivalent shares:				
Stock options	1,994	8,352	4,442	6,407
Written call option		3,341	349	849
Conversion of convertible subordinated notes	16,919	16,919	16,919	12,581
Warrants		30	12	29
Unvested acquisition-related stock	368	458	382	570
Shares used to compute diluted EPS	133,226	131,914	136,214	124,043
Basic earnings per share	$ 0.04	$ 0.58	$ 0.91	$ 1.31
Diluted earnings per share	$ 0.04	$ 0.46	$ 0.78	$ 1.12

Certain potential shares related to employee stock options outstanding during the three and nine months ended September 30, 2004 and 2003 were excluded in the diluted per share computations, since their exercise prices were greater than the average market price of the Company s common stock during the period and, accordingly, their effect is anti-dilutive. For the three months ended September 30, 2004 and 2003, these shares totaled 12.5 million with a weighted average exercise price of $25.87 per share and 0.2 million shares with a weighted average exercise price of $43.16 per share, respectively. For the nine months ended September 30, 2004 and 2003, these shares totaled 3.5 million with a weighted average exercise price of $33.07 per share and 17.4 million shares with a weighted average exercise price of $32.19 per share, respectively.

On September 30, 2004, the Company s 7/8% convertible subordinated notes outstanding was eligible for conversion into shares of common stock. For each $1,000 of aggregate principal amount of notes converted, the Company will deliver approximately 42.0345 shares of common stock, if the Company s closing stock price exceeds a specified threshold as of the last trading day of the immediately preceding fiscal quarter. At June 30, 2004, the closing price of the Company s common stock was above the specified threshold. In September 2004, the EITF reached a consensus related to EITF No. 04-8 The Effect of Contingently Convertible Debt on Diluted Earnings per Share. The consensus will require contingently convertible debt instruments with a market price trigger to be treated the same as traditional convertible debt instruments for purposes of computed earnings per share using the if converted method. The EITF pronouncement will be effective for reporting periods ending after December 15, 2004. The Company entered into convertible bond hedge and call option transactions to reduce the potential dilution from conversion of the notes. Both the bond hedge and call option transactions may be settled at the Company s option either in cash or net shares and expire on March 1, 2008.

During the three months ended September 30, 2004, the average price of the Company s stock was below the specified strike prices of both the convertible bond hedge and call option transactions, that the Company entered into to reduce the potential dilution from conversion of the notes.

For the three months ended September 30, 2003, however, the average price of the Company s stock exceeded both the specified strike prices of the convertible bond hedge and call option. Using the treasury stock method, under Statement of Financial Accounting Standards No. 128, Earnings Per Share (SFAS 128), for the three months ended September 30, 2003, this would have the effect of decreasing the denominator for diluted earnings per share by 6.8 million for the bond hedge transaction, and increasing the denominator for diluted earnings per share by 3.3 million shares for the call option transaction. However, only the dilutive effect of the 3.3 million shares with respect to the call option transaction is included in the Company s diluted earnings per share calculation above. The convertible bond hedge, under FAS 128, is always anti-dilutive.

For the nine months ended September 30, 2004, the dilutive and anti-dilutive effects of the call option and the bond hedge were derived by taking the weighted average of the first, second, and third quarters, in accordance with SFAS 128. For the nine months ended September 30, 2004, this would have the effect of decreasing the denominator for diluted earnings per share by 2.7 million shares for the bond hedge transaction, and increasing the denominator for diluted earnings per share by 0.3 million shares for the call option transaction. For the nine months ended September 30, 2003, this would have the effect of decreasing the denominator for diluted earnings per share by 2.1 million shares for the bond hedge transaction, and increasing the denominator for diluted earnings per share by 0.8 million shares for the call option transaction. However, only the dilutive effect of the 0.3 million shares for the nine months ended September 30, 2004, and the 0.8 million shares for the nine months ended September 30, 2003, with respect to the call option transaction, were included in the Company s diluted earnings per share calculation above. The convertible bond hedge, under SFAS 128, is always anti-dilutive.

The net income for the diluted EPS computation reflects the reduction in interest expense of $0 and $2.6 million for the three and nine months ended September 30, 2004, respectively, that would result from an assumed conversion of the 7/8% convertible subordinated notes. The net income for the diluted if converted EPS computation reflects the reduction in interest expense of $0.8 million for the three months ended September 30, 2004, that would result from an assumed conversion of the 7/8% convertible subordinated notes. The net income for the diluted EPS computation reflects the reduction in interest expense of $1.1 million and $2.5 million for the three and nine months ended September 30, 2003, respectively, that would result from an assumed conversion of the 7/8% convertible subordinated notes.

4. STOCK-BASED COMPENSATION:

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

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

The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of SFAS 123 to stock-based employee compensation (in thousands, except per share data):

	Three months ended September 30, 2004	2003	Nine months ended September 30, 2004	2003
Basic				
Net income:				
As reported	$ 4,987	$ 59,140	$ 103,616	$ 135,895
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	59	115	257	2,304
Deduct: Total compensation expense determined under fair value based method for all awards, net of related tax effects	(8,817)	(7,199)	(25,471)	(21,409)
Pro forma net income (loss)	$ (3,771)	$ 52,056	$ 78,402	$ 116,790
Basic income per share:				
As reported	$ 0.04	$ 0.58	$ 0.91	$ 1.31
Pro forma	$ (0.03)	$ 0.51	$ 0.69	$ 1.13
Diluted				
Net income:				
As reported	$ 4,987	$ 59,140	$ 103,616	$ 135,895
Effect of dilutive securities 7/8% Convertible subordinated notes		1,098	2,663	2,473
Add: Stock-based employee compensation expense included in reported net income, net of related tax effects	59	115	257	2,304
Deduct: Total compensation expense determined under fair value based method for all awards, net of related tax effects	(8,817)	(7,199)	(25,471)	(21,409)
Pro forma net income (loss)	$ (3,771)	$ 53,154	$ 81,065	$ 119,263
Diluted income (loss) per share:				
As reported	$ 0.04	$ 0.46	$ 0.78	$ 1.12
Pro forma	$ (0.03)	$ 0.41	$ 0.61	$ 0.99

5. COMPREHENSIVE INCOME:

The reconciliation of net income to comprehensive income for the three and nine months ended September 30, 2004 and 2003 is as follows (in thousands):

	Three Months Ended September 30, 2004	2003	Nine Months Ended September 30, 2004	2003
Net income	$ 4,987	$ 59,140	$ 103,616	$ 135,895
Unrealized gains (losses) on investments	(1,829)	(309)	(1,350)	874
Change in cumulative translation adjustments	(550)	663	(48)	619
Total comprehensive income	$ 2,608	$ 59,494	$ 102,218	$ 137,388

6. CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS:

Cash and cash equivalents consist of instruments with maturities of three months or less at the date of purchase. There were no available-for-sale securities included in cash and cash equivalents at September 30, 2004 or December 31, 2003. Short-term investments, consisting entirely of available-for-sale securities, were $44.9 million and $48.6 million at September 30, 2004 and December 31, 2003, respectively. These available-for-sale securities consist of government-backed notes, commercial paper, floating rate corporate bonds and fixed income corporate bonds. These investments are recorded at

fair value. Any unrealized holding gains or losses are reported as a component of comprehensive other income. Realized gains and losses are reported in earnings.

The Company accepts bank notes receivable with maturity dates between three and six months from its customers in China in the normal course of business. Bank notes receivable were $39.2 million and $11.5 million at September 30, 2004 and December 31, 2003, respectively, and have been included in either cash and cash equivalents or short-term investments. The Company may discount these notes with banking institutions in China. A sale of these notes is reflected as a reduction of cash and cash equivalents or short-term investments and the proceeds of the settlement of these notes are included in cash flows from operating activities in the consolidated statement of cash flows. There were no bank notes receivable sold during the three and nine months ended September 30, 2004; there were $65.1 million and $176.4 million of bank notes receivable sold during the three and nine months ended September 30, 2003, respectively. Any notes that have been sold are not included in the Company s consolidated balance sheets as the criteria for sale treatment established by Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (SFAS 140), have been met. Under SFAS 140, upon a transfer, the transferor or entity must derecognize financial assets when control has been surrendered and the transferee obtains control over the assets. In addition, the transferred assets have been isolated from the transferor, beyond the reach of its creditors, and the transferee has the right, without conditions or constraints, to pledge or exchange the assets it has received. The costs of settling or transferring these notes receivable were $0.5 million and $0.9 million for the three and nine months ended September 30, 2003, respectively.

7. RESTRICTED CASH AND SHORT-TERM INVESTMENTS:

At September 30, 2004, the Company had restricted cash and short-term investments of $36.8 million primarily comprised of $25.3 million of restricted short-term investments held for standby letters of credit, $11.0 million of restricted cash held for standby letters of credit and $0.5 million of restricted cash. At December 31, 2003, the Company had restricted cash and short-term investments of $24.4 million primarily comprised of $20.5 million of restricted short-term investments for standby letters of credit and restricted cash of a $3.7 million time deposit required for Japanese tax purposes.

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

8. ACCOUNTS AND NOTES RECEIVABLE:

The Company accepts commercial notes receivable with maturity dates between three and six months from its customers in China in the normal course of business. Notes receivable available for sale were $24.5 million and $11.4 million at September 30, 2004 and December 31, 2003, respectively. The Company may discount these notes with banking institutions in China. A sale of these notes is reflected as a reduction of notes receivable and the proceeds of the settlement of these notes are included in cash flows from operating activities in the consolidated statement of cash flows. There were no notes receivable sold during the three and nine months ended September 30, 2004; there were $94.0 million and $138.5 million of notes receivable sold during the three and nine months ended September 30, 2003, respectively. Any notes that have been sold are not included in the Company s consolidated balance sheets as the criteria for sale treatment established by SFAS 140, has been met. The costs of settling or transferring these notes receivable were $0.7 million and $1.2 million for the three and nine months ended September 30, 2003, respectively.

9. SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:

	Nine months ended September 30,	
(in thousands)	**2004**	**2003**
Cash paid during the period for:		
Interest	$ 3,860	$ 2,627
Income taxes	$ 9,137	$ 37,178

	Nine months ended September 30,	
(in thousands)	**2004**	**2003**
Non-cash operating activities were as follows:		
Accounts receivable transferred to notes receivable	$ 64,003	$ 256,526

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10. INVENTORIES AND DEFERRED COSTS/INVENTORIES AT CUSTOMER SITES UNDER CONTRACTS:

As of September 30, 2004 and December 31, 2003, total inventories and deferred costs/inventories at customer sites under contracts consist of the following:

	September 30, 2004		December 31, 2003	
	(in thousands)			
Inventories				
Raw materials	$	183,468	$	66,753
Work-in-process		84,508		51,116
Finished goods		56,268		48,206
Finished goods on consignment at reseller		7,569		
Inventories at customer sites without contracts		107,599		90,963
	$	439,412	$	257,038
Deferred costs/Inventories at customer sites under contracts	$	168,903	$	558,977

11. ACQUISITIONS

TELOS Technology, Inc.

On May 19, 2004, the Company completed its acquisition of substantially all of the assets and certain liabilities of TELOS Technology, Inc. and its subsidiaries (TELOS). TELOS is a provider of mobile switching products and services for voice and data communication networks to developing rural, enterprise and emerging wireless markets. The total consideration for the acquisition, funded from cash on hand, was approximately $30.1 million. The Company paid $29.0 million in cash, in addition to $1.1 million of acquisition-related transaction costs. Within one year of the acquisition date, additional payments totaling a maximum of $19.0 million may become payable based upon revenue recognized from the sale of TELOS products. In the event these revenue milestones are met, the original purchase price will be adjusted for the amount of the contingent payment in accordance with Statement of Financial Accounting Standards No. 141 (SFAS 141), Business Combinations.

The existing technology acquired included the entire TELOS product family of code division multiple access (CDMA) softswitch technology products, supporting servers and operations maintenance centers. CDMA technology is the common platform on which second and third-generation wireless data services and applications are built. By assigning unique codes to each communication to differentiate it from others in the same spectrum, CDMA technology allows many users to occupy the same time and frequency allocations in a given band or space. The TELOS product line will be integrated with the Company s suite of CDMA products, strengthening the Company s existing CDMA product portfolio. In addition to developed product technology, the Company acquired fixed assets, in-process research and development (IPR&D), an assembled workforce of approximately 60 employees, customer relationships and recorded goodwill.

Subsequent to the May 19, 2004 acquisition of TELOS, the Company completed the allocation of the purchase price based in part upon an independent valuation. The amount of the purchase price allocated to IPR&D of $1.4 million was charged to the Company s results of operations,

as no alternative future uses existed at the acquisition date. The Company initially recorded goodwill of $6.6 million in connection with the acquisition. During the third quarter of 2004, the Company reduced both the purchase price and goodwill associated with this acquisition by $0.2 million to reflect the difference between the estimated and actual professional services fees incurred related to this acquisition. In total, the Company recorded $6.4 million of goodwill related to this acquisition. The results of operations of TELOS have been included in the Company s consolidated results of operations beginning on the acquisition date of May 19, 2004.

In assessing TELOS IPR&D projects, the Company considered key product characteristics including the product s development stage at the acquisition date, the product s life cycle and the product s future prospects. The Company also considered the rate at which technology changes in the telecommunications equipment industry, the industry s competitive

environment and the economic outlook for both local and global markets.

As of the acquisition date, TELOS had two projects under development that qualified for IPR&D: the Sonata SE product family and the iCell product. The objective of both projects is to enhance the functionality of products designed to comply with the CDMA2000 technology standard. Specifically, the objective of the Sonata SE product family is to provide additional features to operation maintenance center products. The objective of the iCell product is to enhance iCell base station features.

The projects under development are enhancements to existing products that do not affect the functionality of those existing products. As such, the significant risk the Company faces is to complete these projects within the scope of the budget. As of the closing date, the Sonata SE and the iCell projects were approximately 20% and 30% complete, respectively. As of the closing, the anticipated completion dates and estimated costs to complete the Sonata SE and iCell projects were June 2005 and $1.1 million and December 2004 and $0.2 million, respectively.

The following table summarizes the allocation of the purchase price for TELOS based upon the independent valuation (in thousands):

Fair value of tangible net assets		
Inventory	$	1,382
Property, plant and equipment		2,010
Other tangible assets		1,327
Customer relationships		5,000
Existing technology		15,900
In-process research and development		1,400
Liabilities assumed		(3,380)
Excess of costs of acquiring TELOS over fair value of identified net assets acquired (goodwill)		6,449
	$	30,088

The estimated useful lives of the customer relationships and existing technology intangible assets are five years.

Refer to the consolidated table below for the pro forma results of operations reflecting the combined results of the Company and TELOS for the three and nine months ended September 30, 2004 and 2003 as if the business combination occurred at the beginning of the period. These results do not purport to be indicative of what would have occurred had the acquisition been made as of that date or the results of operations which may occur in future periods.

Hyundai Syscomm, Inc.

On April 27, 2004, the Company completed its acquisition of the assets, substantially all of the intellectual property, certain employees and certain contracts related to Hyundai Syscomm, Inc. s (HSI) CDMA infrastructure business for markets outside of Korea. Subject to the attainment of certain milestones and the transfer of certain know-how, the total consideration for this transaction was approximately $12.3 million excluding transaction costs of $2.1 million. There was $7.3 million in cash payable at the closing date and an additional $3.0 million in

cash payable one year from the closing date. The remaining purchase price was comprised of $2.0 million payable upon the completion of technical training by HSI employees to Company manufacturing staff in China under the terms of a Training Services Agreement and $2.1 million of transaction costs. Not included in the purchase price was $2.0 million payable upon the completion of certain revenue milestones. In the event these revenue milestones are met, the original purchase price will be adjusted for the amount of the contingent payment in accordance with Statement of Financial Accounting Standards No. 141, Business Combinations (SFAS 141). In conjunction with this transaction, the Company loaned HSI $3.2 million at an effective interest rate of 12% per annum, which was used by HSI to satisfy outstanding debt obligations. The principal amount of the loan is due in April 2005. The Company may offset HSI s payment obligations against the outstanding $3.0 million of the purchase price and any other liabilities.

Under the terms of the transaction with HSI, the Company acquired existing technologies and entered into non-compete

and licensing agreements. The existing technologies acquired were the base transceiver station (BTS) and base station controller (BSC) product lines. BTS is the antenna and radio equipment that enables wireless devices to communicate with a land-based transmission network in a given range. BSC performs radio signal management functions for BTS, managing functions such as frequency assignment and handoff. As part of the asset purchase agreement, the Company and HSI entered into a training services agreement, whereby HSI employees will provide technical training to Company manufacturing staff in China for the ninth-month period subsequent to the acquisition. This technology and technological know-how will strengthen the Company s existing CDMA product portfolio and the development of future CDMA technology.

In addition to acquiring existing technology, the Company entered non-compete and licensing agreements with HSI. The non-compete agreement prohibits HSI from competing against the Company in all countries except Korea for four years from the valuation date. The licensing agreement requires that HSI pay the Company 1% of revenue as royalty for the usage of the intellectual property that the Company acquired under the terms of the acquisition for fifteen years subsequent to the valuation date.

Subsequent to the April 27, 2004 acquisition of HSI, the Company completed the allocation of the purchase price based in part upon an independent valuation. The Company initially recorded goodwill of $6.8 million in connection with the acquisition. During the third quarter of 2004, the Company increased both the purchase price and the goodwill associated with the acquisition by $0.3 million to reflect the excess of the actual professional fees incurred compared to the estimated fees related to the acquisition. In total, the Company recorded $2.1 million of professional services fees related to the acquisition. The results of operations of HSI have been included in the Company s consolidated results of operations beginning on the acquisition date of April 27, 2004.

The following table summarizes the final allocation of the purchase price for HSI based upon the final independent valuation (in thousands):

Fair value of tangible net assets		
Property, plant and equipment	$	1,440
Other tangible assets		673
Existing technology		3,559
Non-compete intangible asset		760
IP license agreement		890
Excess of costs of acquiring HSI over fair value of identified net assets acquired (goodwill)		7,055
	$	14,377

The intangible assets have estimated useful lives ranging from three to five years as follows: existing technology, five years; non-compete agreement, three years; intellectual property license agreement, three years.

Refer to the consolidated table below for pro forma results of operations reflecting the combined results of the Company and HSI for the three and nine months ended September 30, 2004 and 2003 as if the business combination occurred at the beginning of the period. These results do not purport to be indicative of what would have occurred had the acquisition been made as of that date or the results of operations which may occur in future periods.

The proforma results of operations include historical operations of the Company, TELOS and HSI. Certain non-recurring charges were recorded by TELOS and included $2.3 million of expense for warrants issued in conjunction with an issuance of senior convertible notes in the second quarter of 2003 and $0.1 million of restructuring costs incurred in the first quarter of 2003.

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(In thousands, except per share data)	UT Starcom, Inc. Nine Months Ended September 30, 2004	UT Starcom, Inc. Nine Months Ended September 30, 2003	TELOS Technology, Inc. For the period from January 1 to May 18, 2004	TELOS Technology, Inc. Nine Months Ended September 30, 2003	Hyundai Syscomm, Inc. For the period from January 1 to April 27, 2004	Hyundai Syscomm, Inc. Nine Months Ended September 30, 2003
Pro forma adjusted net revenue	$ 1,956,935	$ 1,320,736	$ 1,689	$ 5,837	$ 2,872	$ 16,327
Pro forma adjusted net income (loss)	$ 103,616	$ 135,895	$ (3,953)	$ (7,712)	$ (4,548)	$ (10,267)
Pro forma adjusted basic earnings (loss) per share	$ 0.91	$ 1.31				
Pro forma adjusted diluted earnings (loss) per share	$ 0.78	$ 1.12				

(In thousands, except per share data)	Pro Forma adjustments to reflect depreciation and amortization of acquired assets Nine Months Ended September 30, 2004	Pro Forma adjustments to reflect depreciation and amortization of acquired assets Nine Months Ended September 30, 2003	Pro Forma Results Nine Months Ended September 30, 2004	Pro Forma Results Nine Months Ended September 30, 2003
Pro forma adjusted net revenue			$ 1,961,496	$ 1,342,900
Pro forma adjusted net income (loss)	$ 2,123	$ (3,993)	$ 92,992	$ 113,923
Pro forma adjusted basic earnings (loss) per share			$ 0.81	$ 1.10
Pro forma adjusted diluted earnings (loss) per share			$ 0.70	$ 0.94

Audiovox Communications, Inc.

On June 14, 2004, the Company announced an agreement to acquire Audiovox Communications Corporation (ACC), the wireless handset division of Audiovox Corporation. On November 1, 2004, the Company completed its acquisition of ACC and acquired select assets and liabilities, including inventories, prepaids, third-party payables, accrued expenses and the right to hire approximately 250 employees for $165.1 million in cash. The Company acquired ACC s sales, service and support infrastructure, its CDMA handset brand, access to supply-chain channels, product marketing expertise and key relationships with CDMA operators in North and South America. Refer to Note 24, Subsequent Event.

12. GOODWILL AND INTANGIBLE ASSETS:

As of September 30, 2004 and December 31, 2003, goodwill and other acquired intangible assets consisted of the following (in thousands):

(in thousands)	September 30, 2004	December 31, 2003
Goodwill	$ 126,367	$ 113,003
Less accumulated amortization	(12,823)	(12,823)
	$ 113,544	$ 100,180
Identified intangible assets:		
Existing technology	$ 43,081	$ 23,630
Less accumulated amortization	(13,098)	(7,254)
	$ 29,983	$ 16,376
Customer relationships	$ 32,820	$ 27,820
Less accumulated amortization	(4,043)	(1,623)
	$ 28,777	$ 26,197
Trade names	$ 940	$ 940
Less accumulated amortization	(627)	(274)
	$ 313	$ 666
Backlog	$ 1,950	$ 1,950
Less accumulated amortization	(1,950)	(1,137)
	$	$ 813
Non-compete agreement	$ 760	$
Less accumulated amortization	(106)	
	$ 654	$
Royalty licenses	$ 890	$
Less accumulated amortization	(74)	
	$ 816	$
Total intangible assets	$ 60,543	$ 44,052

Amortization expense was $3.6 million and $3.1 million for the three months ended September 30, 2004 and 2003, respectively, and was $9.9 million and $5.3 million for the nine months ended September 30, 2004 and 2003, respectively. The estimated aggregate amortization expense for intangibles for each of the five years beginning the year ended December 31, 2005 through 2009 is $12.1 million, $11.0 million, $10.8 million, $9.0 million and $4.8 million.

The estimated useful life of purchased technology is from one to five years, the estimated useful life of customer relationships is five years to ten years, the estimated useful life of non-compete agreements is three years, the estimated useful lives of backlog and trade names are from one to two years and the estimated useful lives of royalty licenses are five years.

13. LONG-TERM INVESTMENTS:

The Company s investments are as follows (in thousands):

	September 30, 2004	December 31, 2003
Softbank China	$ 5,294	$ 5,308
Infinera	1,902	
Cellon International	8,000	8,000
Restructuring Fund No. 1	1,836	1,861
Global Asia Partners L.P.	1,150	1,653
Fiberxon Inc.	3,000	2,000
InterWave Communications International Ltd.	790	3,319
Joint Venture with Matsushita		517
Immenstar	2,000	
Other	1,456	1,408
Total	$ 25,428	$ 24,066

Softbank China

The Company has a $5.3 million investment in Softbank China, an investment fund established by SOFTBANK CORP. focused on investments in Internet companies in China. This investment is intended to enable the Company to participate in the anticipated growth of Internet-related businesses in China. SOFTBANK CORP. and its related companies are significant stockholders of the Company. The Company s investment constitutes 10% of the funding for Softbank China, with SOFTBANK CORP. contributing the remaining 90%. The fund has a separate management team, and none of the Company s employees are employed by the fund. Many of the fund s investments are and will be in privately held companies, many of which are still in the start-up or development stages. These investments are inherently risky as the markets for the technologies or products the companies have under development are typically in the early stages and may never materialize. The Company accounts for this investment under the cost method and recorded insignificant losses in the carrying value of this investment during the three and nine months ended September 30, 2004. The Company recorded losses of $0.1 million and $0.2 million due to an other-than-temporary decline in the carrying value of this investment during the three and nine months ended September 30, 2003, respectively. Refer to Note 19, Related Party Transaction.

Infinera

In July 2004, the Company invested $3 million in 1,339,285 shares of Infinera Corporation (Infinera) Series D Preferred Stock at $2.24 per share. The investment represents an approximately 2% interest in Infinera, which develops optical telecommunications systems using photonic integrated circuits. This investment is accounted for under the cost method.

In September 2004, Infinera closed a Series E Preferred Stock round at $0.60 per share. As a result of the close proximity between the Series D and Series E preferred stock financing rounds and the decrease in the share price between rounds, Infinera and the Company entered into an exchange agreement whereby the Company exchanged 669,643 shares of Series D preferred stock for 2,500,000 shares of Series E preferred stock. After the exchange, the Company owns a total of 669,643 shares Series D and 2,500,000 shares of Series E preferred stock.

In the three months ended September 30, 2004, the Company recorded a loss of $1.1 million to reflect the other than temporary decrease in the fair value of its remaining Series D shares.

Cellon

In September 2001, the Company invested $2.0 million in Cellon International Holdings Corporation (Cellon). Cellon designs wireless terminals and related technology for handset manufacturers and private distributors. The Company invested an additional $3.0 million in each of April and December 2002. As of September 30, 2004, the Company had a 9% ownership interest in Cellon. This investment is accounted for under the cost method, and its carrying value is evaluated for possible impairment based on the achievement of business objectives and milestones, the financial condition and prospects of the company and other relevant factors. As of September 30, 2004, the Company has not recorded any impairment of this investment. The Company has outstanding purchase commitments with Cellon. Refer to Note 19, Related Party Transactions.

Restructuring Fund No. 1

During fiscal 2002, the Company invested $2.0 million in Restructuring Fund No. 1, a venture capital investment limited partnership established by SOFTBANK INVESTMENT CORP., an affiliate of SOFTBANK CORP. SOFTBANK America Inc., an entity affiliated with SOFTBANK CORP., is a significant stockholder of the Company. The fund focuses on leveraged buyout investments in companies in Asia undergoing restructuring or bankruptcy procedures. The total fund offering is expected to be between approximately $150.0 million and $226.0 million, with each investor contributing a minimum of $0.8 million. The fund has a separate management team, and none of the Company s employees are employed by the fund. The Company accounts for this investment under the equity method of accounting. There were no significant gains or losses during the three and nine months ended September 30, 2004. During the three and nine months ended September 30, 2003, the Company recorded equity losses of $0.1 million.

Global Asia Partners, L.P.

In June 2002, the Company invested $1.0 million in Global Asia Partners L.P., and an additional $1.0 million in June 2003, with a commitment to invest up to a maximum of $5.0 million. The remaining amount is due at such times and in such amounts as shall be specified in one or more future capital calls to be issued by the general partner. The fund size is anticipated to be $10.1 million and the fund was formed to make private equity investments in private or pre-IPO technology and telecommunications companies. The fund s geographic focus is on technology investments in Asia, in particular India and China. The Company accounts for this investment under the equity method of accounting. There were no losses and $0.5 million of losses related to other-than-temporary impairment for the three and nine months ended September 30, 2004 respectively. During the three and nine months ended September 30, 2003, the Company recorded equity losses of $0.1 million.

Fiberxon

In September 2002, the Company invested $2.0 million in Fiberxon, Inc.(Fiberxon), a company that develops and sells optical modules and related systems. In March 2004, the Company invested an additional $1.0 million in Fiberxon. This investment is accounted for under the cost method, and its carrying value is evaluated for possible impairment based on the achievement of business objectives and milestones, the financial condition and prospects of the company and other relevant factors. As of September 30, 2004, the Company has not recorded any impairment in respect of this investment. The Company has outstanding purchase commitments with Fiberxon. Refer to Note 19, Related Party Transactions.

InterWave

During 2002, the Company purchased approximately 5.8 million shares of common stock of InterWave Communications, International Ltd. Inc., a technology company listed on Nasdaq, for approximately $3.0 million. In

addition, the Company received warrants to purchase 2.0 million shares of InterWave s common stock at $0.21 per share. The Company s holdings were adjusted for a 1:10 reverse stock split on April 30, 2003, and were 0.6 million shares of common stock and warrants to purchase 0.2 million shares of InterWave s common stock at $2.10 per share.

During the third quarter of 2004, the Company sold its shares of Interwave common stock at an average price of $5.65 per share. The Company recorded a $2.1 million gain as a result of this sale within other income.

The warrants were valued at $0.8 million at September 30, 2004, using the Black-Scholes option-pricing model. The Company recorded $0.1 million for both the three months ended September 30, 2004 and 2003, to reflect the change in the fair value of the warrants. The Company recorded income of $0.1 million for both the nine months ended September 30, 2004 and 2003, to reflect the change in the fair value of the warrants.

Matsushita

In July, 2002, the Company entered into a joint venture agreement with Matsushita Communication Industrial Co., Ltd., a stockholder of the Company, to jointly design and develop, manufacture and sell telecommunication products. The Company has a 49% ownership interest in the joint venture company, which has a registered share capital of $10.0 million. The cash consideration of $4.9 million payable by the Company was paid in October 2002. As the Company does not have voting control over significant matters of the joint venture company, the investment in and results of operations of the joint venture company are accounted for using the equity method of accounting. The Company has committed to fund an additional $9.3 million during the fiscal year 2004. The Company accrued additional equity losses of $0.7 million during the three months ended September 30, 2004 for cumulative losses of $2.9 million recorded within other current liabilities.

ImmenStar

On September 28, 2004, the Company invested $2 million in the Series A preferred stock of ImmenStar, Inc. (ImmenStar). ImmenStar is a development stage company that is designing a chip which can be used in the Company s product. The Company has reviewed the criteria of FASB Interpretation 46, Consolidation of Variable Interest Entities (FIN 46) and evaluated its relationship with ImmenStar. Based on its review, the Company has determined that ImmenStar is a variable interest entity and that the Company is the primary beneficiary. Consequently, the results of operations and accounts of Immenstar will be consolidated within the Company s accounts.

Other investments

The Company has also invested directly in a number of private technology-based companies in the early stages of development. These investments are accounted for on the cost basis. The Company continually evaluates the carrying value of these investments for possible impairment based on the achievement of business objectives and milestones, the financial condition and prospects of these companies and other relevant factors. During the three and nine months ended September 30, 2004 and 2003, there were no valuation adjustments in respect of these private technology investments. The Company also invests in publicly traded technology-based companies and accounts for these as available-for-sale securities on a fair market value basis. There were insignificant changes in the value of these investments for the three and nine months ended September 30, 2004 and 2003.

14. DEBT:

The following represents the outstanding borrowings at September 30, 2004 and December 31, 2003 (in thousands):

Note	Rate	Maturity	Sept. 30, 2004	December 31, 2003
Bank of China	2.58%	February 26, 2005	$ 40,000	$
Bank of China	2.77%	March 28, 2005	$ 30,000	$
CITIC Industrial Bank	2.78%	February 27, 2005	$ 10,000	$
CITIC Industrial Bank	2.97%	March 29, 2005	$ 20,000	$
Shanghai Pudong Development Bank	2.91%	March 24, 2005	$ 30,000	$
Industrial and Commercial Bank of China	3.04%	September 24, 2005	$ 45,000	$
Notes Payable	0.00%	October-December 2004	$ 1,566	$ 1
Convertible Subordinated Notes	7/8%	March 1, 2008	402,500	402,500
Total Debt			$ 579,066	$ 402,501
Long-term debt			402,500	402,500
Short-term debt			$ 176,566	$ 1