TERAYON COMMUNICATION SYSTEMS
Form 10-Q
May 10, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

Form 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007
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: 000-24647
TERAYON COMMUNICATION SYSTEMS, INC.
(Exact Name of Registrant as Specified in Its Charter)

Delaware	**77-0328533**
(State or Other Jurisdiction of Incorporation or Organization)	*(IRS Employer Identification No.)*

2450 WALSH AVENUE
SANTA CLARA, CALIFORNIA 95051
(408) 235-5500
(Address, Including Zip Code, and Telephone Number, Including Area Code, of the Registrant s Principal Executive Offices)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer o Accelerated Filer þ Non-Accelerated Filer o

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

APPLICABLE ONLY TO CORPORATE ISSUERS:

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date: Common Stock, $0.001 par value, 77,637,177 shares outstanding as of May 1, 2007.

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PART I. FINANCIAL INFORMATION

Item 1. ***Financial Statements***

TERAYON COMMUNICATION SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)

	March 31, 2007 (unaudited)	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	$ 12,547	$ 8,362
Short-term investments	7,975	11,951
Accounts receivable, net of allowance for doubtful accounts	8,073	10,914
Other current receivables	1,515	1,296
Inventory, net	2,816	2,324
Deferred cost of goods sold	2,267	2,289
Deposits	1,442	8,248
Other current assets	1,110	1,532
Total current assets	37,745	46,916
Property and equipment, net	3,141	3,309
Restricted cash	380	395
Long-term deferred cost of goods sold	784	1,338
Other assets, net	12	12
Total assets	$ 42,062	$ 51,970
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 4,434	$ 5,495
Accrued payroll and related expenses	3,683	3,650
Deferred revenues	9,351	9,329
Accrued warranty expenses	1,143	1,246
Accrued restructuring and executive severance	143	149
Accrued vendor cancellation charges	10	124
Accrued other liabilities	3,752	4,071
Total current liabilities	22,516	24,064
Long-term obligations	1,208	1,399
Accrued restructuring and executive severance	160	193
Long-term deferred revenue	5,077	6,492
Total liabilities	28,961	32,148
Contingencies (Note 3)		
Stockholders equity:		

Preferred stock, $0.001 par value: 5,000,000 shares authorized; no shares issued and outstanding				
Common stock: $0.001 par value, 200,000,000 shares authorized issued 77,793,844 shares issued; 77,637,177 shares outstanding		78		78
Additional paid-in capital		1,089,632		1,089,278
Accumulated deficit		(1,073,251)		(1,066,269)
Treasury stock, at cost; 156,009 shares		(773)		(773)
Accumulated other comprehensive loss		(2,585)		(2,492)
Total stockholders equity		13,101		19,822
Total liabilities and stockholders equity	$	42,062	$	51,970

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended March 31,	
	2007	**2006**
Revenues	$ 12,776	$ 21,490
Cost of goods sold	4,580	10,716
Gross profit	8,196	10,774
Operating expenses:		
Research and development	3,005	4,069
Sales and marketing	3,323	5,184
General and administrative	8,149	5,150
Restructuring charges, executive severance and asset write-offs		34
Total operating expenses	14,477	14,437
Loss from operations	(6,281)	(3,663)
Interest income, net	215	301
Other income (expense), net	(895)	(553)
Loss before income tax expense	(6,961)	(3,915)
Income tax expense	(21)	(29)
Net loss	$ (6,982)	$ (3,944)
Basic and diluted net loss per share	$ (0.09)	$ (0.05)
Shares used in computing basic and diluted net loss per share	77,637	77,637

See accompanying Notes to Condensed Consolidated Financial Statements.

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

	Three Months Ended March 31,	
	2007	**2006**
Cash flows from operating activities:		
Net loss	$ (6,982)	$ (3,944)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	450	487
Stock based compensation	354	792
Amortization of subordinated convertible notes premium		(286)
Accretion of discounts on short-term investments		(126)
Inventory provision	134	2,399
Provision for doubtful accounts	(90)	50
Restructuring provision		34
Write-off of fixed assets		41
Warranty provision	462	149
Vendor cancellation provision	34	(1,040)
Changes in operating assets and liabilities:		
Accounts receivable, net	2,712	446
Inventory	(626)	(761)
Other current assets	7,250	(5,311)
Long-term deferred cost of goods sold	554	637
Other assets	15	7,526
Accounts payable	(1,061)	(695)
Accrued payroll and related expenses	33	(209)
Deferred revenues	(1,393)	(4,658)
Accrued warranty expense	(565)	(535)
Accrued restructuring charges	(39)	(506)
Accrued vendor cancellation charges	(148)	(124)
Other accrued liabilities	(510)	(2,333)
Net cash provided by (used in) operating activities	584	(7,967)
Cash flows from investing activities:		
Proceeds from sales and maturities of short-term investments	4,000	54,033
Purchases of property and equipment	(282)	(170)
Net cash provided by investing activities	3,718	53,863
Cash flows from financing activity:		
Debt extinguishment of convertible debt		(65,081)

Net cash used in financing activity		(65,081)
Effect of foreign currency exchange rate changes	(117)	34
Net increase (decrease) in cash and cash equivalents	4,185	(19,151)
Cash and cash equivalents at beginning of period	8,362	28,867
Cash and cash equivalents at end of period	$ 12,547	$ 9,716
Supplemental disclosures of cash flow information:		
Cash paid for income taxes	$ 27	$ 28
Cash paid for interest	$	$ 461

See accompanying Notes to Condensed Consolidated Financial Statements.

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

1. Organization

Description of Business

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

The Company develops, markets and sells digital video equipment to network operators and content aggregators who offer video services.

In 2004, the Company refocused to make digital video the core of its business. As part of this strategic refocus, the Company elected to continue selling its home access solutions (HAS) product, including cable modems, embedded multimedia terminal adapters (eMTA) and home networking devices, but ceased future investment in its cable modem termination systems (CMTS) product line. In January 2006, the Company announced it was discontinuing its HAS product line.

On April 21, 2007, the Company entered into an Agreement and Plan of Merger (Merger Agreement) with Motorola, Inc., (Motorola), and Motorola GTG Subsidiary VI Corporation, a wholly-owned subsidiary of Motorola (Merger Sub), pursuant to which Merger Sub will be merged with and into the Company (Merger), with the Company continuing as the surviving corporation and as a wholly-owned subsidiary of Motorola.

Pursuant to the Merger Agreement, at the effective time of the Merger, each share of the Company s common stock, par value $0.001 per share, issued and outstanding immediately prior to the effective time (other than shares held by the Company, Motorola or Merger Sub, which will be canceled without payment of any consideration) will be converted into the right to receive $1.80 in cash, without interest.

The Merger has been approved by the Company s Board of Directors. The Merger is subject to the adoption of the Merger Agreement and the approval of the Merger by the stockholders of the Company, the termination or expiration of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, and other closing conditions.

2. Summary of Significant Accounting Policies

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles (GAAP) for interim financial information and in accordance with the instructions to Quarterly Reports on Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by GAAP for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the condensed consolidated financial statements at March 31, 2007 and for the three months ended March 31, 2007 and 2006 have been included.

Results for the three months ended March 31, 2007 are not necessarily indicative of results for the entire fiscal year or future periods. These financial statements should be read in conjunction with the consolidated financial statements and the accompanying notes included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006, as amended (2006 Form 10-K), as filed with the United States Securities and Exchange Commission (Commission). The accompanying condensed consolidated balance sheet at December 31, 2006 is derived from audited consolidated financial statements at that date.

Basis of Consolidation

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

Use of Estimates

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

Fair Value of Financial Instruments

The Company s financial instruments consist of cash equivalents, accounts receivable, inventory, accounts payable and other accrued liabilities. The Company does not have any derivative financial instruments. The Company believes the reported carrying amounts of its financial instruments approximate fair value due to their short-term maturities.

Revenue Recognition

In accordance with Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition (SAB 101), as amended by SAB 104, for all products and services, the Company recognizes revenue when persuasive evidence of an arrangement exists, delivery has occurred or services were rendered, the fee is fixed or determinable, and collectibility is reasonably assured. In instances where final acceptance of the product, system, or solution is specified by the customer, revenue is not recognized until all acceptance criteria have been met. Contracts and customer purchase orders are used to determine the existence of an arrangement. Delivery occurs when product is delivered to a common carrier. Certain products are delivered on a free-on-board (FOB) destination basis and the Company does not recognize revenue associated with these transactions until the delivery has occurred to the customers premises. The Company assesses whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to adjustment. The Company assesses collectibility based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer s payment history.

In establishing its revenue recognition policies for its products, the Company assesses software development efforts, marketing and the nature of post contract support (PCS). Based on its assessment, the Company determined that the software in the HAS and CMTS products is incidental and therefore, the Company recognizes revenue on HAS and CMTS products under SAB 101, as specifically amended by SAB 104. Additionally, based on its assessment of the digital video solutions (DVS) products, the Company determined that software was more than incidental, and therefore, the Company recognizes revenue on the DVS products under American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, Software Revenue Recognition (SOP 97-2) and SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1).

The Company determined that the software in the DVS products is more than incidental because the DVS platforms contained multiple embedded software applications, the software is actively marketed and the Company has a practice of providing upgrades and enhancements for the software to its existing users periodically. While the software is not sold on a stand-alone basis with the ability to operate on a third party hardware platform, the software is marketed and sold separately in the form of software license keys to activate embedded software applications. Additionally, as part of the Company s customer support contracts, the Company routinely provides its customers with unspecified software upgrades and enhancements.

When a sale involves multiple elements, such as sales of products that include services, the entire fee from the arrangement is allocated to each respective element based on its fair value and recognized when revenue recognition criteria for each element are met. Fair value for each element is established based on the sales price charged when the same element is sold separately. In order to recognize revenue from individual elements within a multiple element arrangement under SOP 97-2, the Company must establish vendor specific objective evidence (VSOE) of fair value for each element.

Prior to 2006, for the DVS product, the Company determined that it did not establish VSOE of fair value for the undelivered element of PCS, which required the Company to amortize the sale price of both the hardware element and PCS element ratably over the period of the customer support contract. The Company amortized the cost of goods sold

for the DVS product ratably over the period of the customer support contract. Revenue and the related cost of goods sold for DVS products that contain multiple element arrangements in each quarter of 2004 and 2005 were deferred and recognized ratably over the contract service period.

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Beginning in the first quarter of 2006, the Company determined that it established VSOE of fair value of the PCS element for DVS product sales as a result of maintaining consistent pricing practices for PCS, including consistent pricing of renewal rates for PCS. For DVS products sold beginning in 2006 that contain a multiple element arrangement, the Company recognizes revenue and the cost of goods sold for shipments when all criteria of SAB 104 and SOP 97-2 have been met and recognizes revenue related to PCS element ratably over the period of the support contract.

The Company sells its products directly to broadband service providers, and to a lesser extent, resellers. Revenue arrangements with resellers are recognized when product meets all criteria of SAB 104 and SOP 97-2.

Deferred Revenue, Deferred Cost of Goods Sold

Deferred revenue and deferred cost of goods sold are a result of the Company recognizing revenues on the DVS product under SOP 97-2. Under SOP 97-2, the Company must establish VSOE of fair value for each element of a multiple element arrangement. Until the first quarter of 2006, the Company did not establish VSOE of fair value for PCS when PCS was sold as part of a multiple element arrangement. As such, for DVS products sold with PCS, revenue and the cost of goods sold related to the delivered element, the hardware component, were deferred and recognized ratably over the period of the PCS.

Stock-Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards (SFAS) No. 123(R) which is a revision of SFAS 123, Share-Based Payment (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan based on estimated fair values. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board (APB) Opinion 25, Accounting for Stock Issued to Employees (APB 25), for periods beginning January 1, 2006. In March 2005, the Commission issued SAB No. 107, Share-based Payment (SAB 107), relating to SFAS 123(R). SAB 107 provides guidance on the initial implementation of SFAS 123(R). In particular, the statement includes guidance related to share-based payment awards with non-employees, valuation methods and selecting underlying assumptions such as expected volatility and expected term. It also gives guidance on the classification of compensation expense associated with share-based payment awards and accounting for the income tax effects of share-based payment awards upon the adoption of SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

Under the modified prospective method of adoption for SFAS 123(R), the compensation cost recognized by the Company beginning in 2006 includes (a) compensation cost for all equity incentive awards granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), and (b) compensation cost for all equity incentive awards granted on or subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). The Company uses the straight-line attribution method to recognize share-based compensation costs over the service period of the award. Upon exercise, cancellation, or expiration of stock options, deferred tax assets for options with multiple vesting dates are eliminated for each vesting period on a first-in, first-out basis as if each vesting period was a separate award.

Options currently granted by the Company generally expire six years from the grant date and vest over a three year period. Options granted prior to the second quarter of 2005 generally expire ten years from the grant date and vest over a four to five year period. The Company may use other types of equity incentives, such as restricted stock and stock appreciation rights. The Company s equity incentive awards also allow for performance-based vesting.

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards (FAS 123(R)-3). The Company has elected to adopt the alternative transition method provided in FAS 123(R)-3 for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC Pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC Pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that

are outstanding upon adoption of SFAS 123(R).

Share-based compensation recognized in 2006 and 2007 as a result of the adoption of SFAS 123(R) as well as share-based compensation calculated for pro forma disclosures according to the original provisions of SFAS 123 for periods prior to the adoption of SFAS 123(R) use the Black-Scholes valuation methodologies for estimating fair value of options granted under the Company s equity incentive plans and rights to acquire stock granted under the Company s stock participation plan.

Accounts Receivable, Net of Allowance for Doubtful Accounts

The Company evaluates its trade receivables based upon a combination of factors generally requiring no collateral. The Company assesses collectibility based on a number of factors, including history, the number of days an amount is past due (based on invoice due date), changes in credit ratings of customers, current events and circumstances regarding the business of its clients customers and other factors that it believes are relevant. Credit losses have historically been within management s expectations. When the Company becomes aware of a customer s inability to pay, such as in the case of bankruptcy or a decline in the customer s operating results or financial position, it records an allowance to reduce the related receivable to an amount it reasonably believes is collectible. The Company maintains an allowance for potentially uncollectible accounts receivable based on an estimate of collectibility. If circumstances related to a specific customer change, its estimates of the recoverability of receivables could be further altered. In addition, the Company made other adjustments to the allowance for doubtful accounts to offset the accounts receivable and related reserve related to customers who were granted extended payment terms, experiencing financial difficulties or where collectibility was not reasonably assured.

Inventory

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

	March 31, 2007	December 31, 2006
	(unaudited)	
Raw materials	$ 176	$ 203
Finished goods	2,640	2,121
Inventory, net	$ 2,816	$ 2,324

Purchase Obligation

The Company has purchase obligations to certain of its suppliers that support the Company s ability to manufacture its products. The obligations consist of purchase orders placed with vendors for goods and services and require the Company to purchase minimum quantities of the suppliers products at a specified price. As of March 31, 2007, $6.7 million of purchase obligations were outstanding which become payable at various times throughout the remainder of 2007.

Net Loss Per Share

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

	Three Months Ended March 31,	
	2007	2006
Net loss	$ (6,982)	$ (3,944)
Shares used in computing basic and diluted net loss per share	77,637	77,637
Basic and diluted net loss per share	$ (0.09)	$ (0.05)

Options to purchase 12,110,616 and 12,852,574 shares of common stock were outstanding at March 31, 2007 and March 31, 2006, respectively, and these common stock equivalents were not included in the computation of diluted net loss per share since the effect would have been anti-dilutive.

Comprehensive Loss

Comprehensive loss consists of net income (loss), net unrealized gain (loss) on short-term investments and net foreign currency translation gain (loss).

The following are the components of comprehensive loss during the three months ended March 31, 2007 and 2006 (in thousands) (unaudited):

	Three months ended March 31,	
	2007	**2006**
Net Loss	$ (6,982)	$ (3,944)
Change in cumulative translation adjustments, net	(117)	34
Change in unrealized gain on available-for-sale investments, net	24	249
Total comprehensive loss	$ (7,075)	$ (3,661)

Accumulated other comprehensive loss presented in the accompanying consolidated balance sheets consists of net unrealized gain (loss) on cash equivalents and short-term investments and accumulated net foreign currency translation losses.

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

	March 31, 2007	**December 31, 2006**
	(unaudited)	
Cumulative translation adjustments	$ (2,560)	$ (2,443)
Unrealized gain on available- for-sale investments	(25)	(49)
Total accumulated other comprehensive loss	$ (2,585)	$ (2,492)

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Impact of Recently Issued Accounting Standards

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS 155) which amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133) and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS 140). Specifically, SFAS 155 amends SFAS 133 to permit fair value remeasurement for any hybrid financial instrument with an embedded derivative that otherwise would require bifurcation, provided the whole instrument is accounted for on a fair value basis. Additionally, SFAS 155 amends SFAS 140 to allow a qualifying special purpose entity to hold a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 applies to all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006, with early application allowed. The adoption of SFAS 155 is not expected to have a material impact on the Company s results of operations or financial position.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets (SFAS 156), to simplify accounting for separately recognized servicing assets and servicing liabilities. SFAS 156 amends SFAS 140. Additionally, SFAS 156 applies to all separately recognized servicing assets and liabilities acquired or issued after the beginning of an entity s fiscal year that begins after September 15, 2006, although early adoption is permitted. The adoption of SFAS 156 is not expected to have a material impact on the Company s results of operations or financial position.

In July 2006, the FASB issued FASB Interpretation 48, Accounting for Uncertainty in Income Taxes (FIN 48) an interpretation of FASB Statement No. 109, Accounting for Income Taxes (FASB 109). FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return, including a decision on whether or not to file in a particular jurisdiction. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB 109, Accounting for Income Taxes. The provisions of FIN 48 are to be applied to all tax positions upon initial adoption of this standard. Only tax positions that meet a more-likely-than- not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of FIN 48. The cumulative effect of applying the provisions of FIN 48 is reported as an adjustment to the opening balance of retained earnings.

The Company adopted FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company reduced its deferred tax assets reported as of December 31, 2006 by $13.9 million. The reduction was fully offset by a valuation allowance and therefore, did not have an impact to the Company s financial statements. In addition, the Company did not recognize any adjustment to the liability for uncertain tax positions nor did the Company have any unrecognized tax benefits and therefore did not record any adjustment to the beginning balance of retained earnings on the balance sheet.

The Company files income tax returns in the U.S. federal jurisdiction, in the state of California, in various other states in the United States and in various foreign jurisdictions in which the Company has an office or physical location.

The Company has elected to record interest and penalties recognized in accordance with FIN 48 in the financial statements as a component of income tax expense. Any subsequent change in classification of interest and penalties will be treated as a change in accounting principle subject to the requirements of SFAS No. 154, Accounting Changes and Error Corrections .

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. Earlier adoption is permitted, provided the company has not yet issued financial statements, including for interim periods, for that fiscal year. The Company is currently evaluating the impact of SFAS 157, but does not expect the adoption of SFAS 157 to have a material impact on its consolidated financial position, results of operations or cash flows.

In September 2006, the Commission released Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 provides guidance on how the effects of prior-year uncorrected financial statement misstatements should be considered in quantifying a current year misstatement. SAB 108 requires registrants to quantify misstatements using both an income statement (rollover) and balance sheet (iron curtain) approach and evaluate whether either approach results in a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. If prior year errors that had been previously considered immaterial are now considered material based on either approach, no restatement is required as long as management properly applied its previous approach and all relevant facts and circumstances were considered. If prior years are not restated, the cumulative effect adjustment is recorded in opening retained earnings as of the beginning of the fiscal year of adoption. SAB 108 is effective for fiscal years ending on or after November 15, 2006. The adoption of SAB 108 did not have a material impact on the Company s financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Liabilities (SFAS 159), which includes an amendment to FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. SFAS 159 provides companies with an irrevocable option to report selected financial assets and liabilities at fair value with changes in fair value reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. The Company is currently evaluating the impact of SFAS 159, but does not expect adoption to have a material impact on its consolidated financial position, results of operations or cash flows.

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3. Contingencies

Litigation

Beginning in April 2000, several plaintiffs filed class action lawsuits in federal court against the Company and specific officers and directors of the Company. Later that year, the cases were consolidated in the United States District Court for the Northern District of California (Court) as In re Terayon Communication Systems, Inc. Securities Litigation. The Court then appointed lead plaintiffs who filed an amended complaint. In 2001, the Court granted in part and denied in part defendants motion to dismiss, and plaintiffs filed a new complaint. In 2002, the Court denied defendants motion to dismiss that complaint, which, like the earlier complaints, alleged that the defendants violated the federal securities laws by issuing materially false and misleading statements and failing to disclose material information regarding the Company s technology. On February 24, 2003, the Court certified a plaintiff class consisting of those who purchased or otherwise acquired the Company s securities between November 15, 1999 and April 11, 2000. On September 8, 2003, the Court heard defendants motion to disqualify two of the lead plaintiffs and to modify the definition of the plaintiff class. On September 10, 2003, the Court issued an order vacating the hearing date for the parties summary judgment motions, and, on September 22, 2003, the Court issued another order staying all discovery until further notice and vacating the trial date, which had been scheduled for November 4, 2003. On February 23, 2004, the Court issued an order disqualifying two of the lead plaintiffs and ordered discovery, which was conducted. In February 2006, the Company mediated the case with plaintiffs counsel. As part of the mediation, the Company reached a settlement of $15.0 million. After this mediation, the Company s insurance carriers agreed to tender their remaining limits of coverage, and the Company contributed approximately $2.2 million to the settlement. On March 17, 2006, the Company, along with plaintiffs counsel, submitted the settlement to the Court and the shareholder class for approval. As a result, the Company accrued $2.2 million to litigation settlement expense in the fourth quarter of 2005. The Court held a hearing to review the settlement of the shareholder litigation on September 25, 2006. To date, the Court has not approved the settlement.

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

On June 23, 2006, a putative class action lawsuit was filed against the Company in the United States District Court for the Northern District of California by I.B.L. Investments Ltd. purportedly on behalf of all persons who purchased the Company s common stock between October 28, 2004 and March 1, 2006. Zaki Rakib, Jerry D. Chase, Mark Richman and Edward Lopez are named as individual defendants. The lawsuit focuses on the Company s March 1, 2006 announcement of the restatement of financial statements for the year ended December 31, 2004, and for the four quarters of 2004 and the first two quarters of 2005. On November 8, 2006, Adrian G. Mongeli was appointed lead plaintiff in the case, replacing I.B.L. Investments Ltd. On January 8, 2007, Mongeli filed an amended complaint, purportedly on behalf of all persons who purchased the Company s common stock between June 28, 2001 and March 1, 2006. The amended complaint adds Ray Fritz, Carol Lustenader, Matthew Miller, Shlomo Rakib, Doug Sabella, Christopher Schaepe, Mark Slaven, Lewis Solomon, Howard W. Speaks, Arthur T. Taylor and David Woodrow as individual defendants, and also names Ernst & Young as a defendant. The amended complaint incorporates the prior allegations and includes new allegations relating to the restatement of the Company s consolidated historical financial statements as reported in the Company s Form 10-K filed on December 29, 2006. The plaintiffs are seeking damages, interest, costs and any other relief deemed proper by the court. An unfavorable ruling in this legal matter could materially and adversely impact the Company s results of operations. On March 9, 2007, Terayon and the individual defendants filed a motion to dismiss the amended complaint. On March 23, 2007, Ernst & Young filed a motion to dismiss the amended complaint. Both motions are scheduled to be heard on July 24, 2007.

On April 22, 2005, the Company filed a lawsuit in the Superior Court of California, County of Santa Clara against Adam S. Tom (Tom) and Edward A. Krause (Krause) and a company founded by Tom and Krause, RGB Networks, Inc. (RGB). The Company sued Tom and Krause for breach of contract and RGB for intentional interference with contractual relations based on breaches of the Noncompetition Agreements entered into between the Company and Tom and Krause, respectively. On May 24, 2006, RGB, Tom and Krause filed a Notice of Motion and Motion For Leave To File a Cross-Complaint, in which the defendants stated that they intended to file counter-claims against the Company for misappropriation of trade secrets, unfair competition, tortious interference with contractual relations and tortious interference with prospective economic advantage. On July 6, 2006, the court granted the defendants motion, and on July 20, defendants filed a cross-complaint for misappropriation of trade secrets, unfair competition, tortious interference with contractual relations and tortious interference with prospective economic advantage. On August 21, 2006, the Company filed a demurrer to certain of those claims. The court granted the Company s demurrer as to RGB s request for declaratory judgment. On November 9, 2006, the Company filed the Company s answer to RGB s complaint. On March 26, 2007, the Company entered into a stipulation for settlement with RGB amicably resolving all outstanding litigation between the parties. On April 10, 2007 the Company entered into a formal settlement agreement. The Company recorded the settlement as of March 31, 2007 and the settlement amount is included in other income and expense.

On September 13, 2005, a case was filed by Hybrid Patents, Inc. (Hybrid) against Charter Communications, Inc. (Charter) in the United States District Court for the Eastern District of Texas for patent infringement related to Charter s use of equipment (cable modems, cable modem termination systems (CMTS) and embedded multimedia terminal adapters (eMTAs)) meeting the Data Over Cable System Interface Specification (DOCSIS) standards and certain video equipment. Hybrid has alleged that the use of such products violates its patent rights. Charter has requested that the Company and others supplying it with equipment indemnify Charter for these claims. The Company and others have agreed to contribute to the payment of the legal costs and expenses related to this case and the Company has entered into a joint defense agreement with all named defendants in the suit. On May 4, 2006, Charter filed a cross-complaint asserting its indemnity rights against the Company and a number of companies that supplied Charter with cable modems. To date, this cross-complaint has not been dismissed. Trial is scheduled on Hybrid s claims for July 3, 2007. At this point, the outcome is uncertain and the Company cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Hybrid is successful in its claim against Charter and then elects to pursue other cable operators that use the allegedly infringing products.

On July 14, 2006, a case was filed by Hybrid against Time Warner Cable (TWC), Cox Communications Inc. (Cox), Comcast Corporation (Comcast), and Comcast of Dallas, LP (together, the MSOs) in the United States District Court for the Eastern District of Texas for patent infringement related to the MSOs use of data transmission systems and certain video equipment. Hybrid has alleged that the use of such products violate its patent rights. To date, the Company has not been named as a party to the action. The MSOs have requested that the Company and others supplying them with cable modems and equipment indemnify the MSOs for these claims. The Company and others have agreed to contribute to the payment of legal costs and expenses related to this case and the Company has entered into a joint defense and cost sharing agreement with all named defendants in the suit. Trial is scheduled on Hybrid s claims for July 3, 2007. At this point, the outcome is uncertain and the Company cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Hybrid is successful in its claim against the MSOs and then elects to pursue other cable operators that use the allegedly infringing products.

On September 16, 2005, a case was filed by Rembrandt Technologies, LP (Rembrandt) against Comcast in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, Rembrandt alleged that products and services sold by Comcast infringe certain patents related to cable modem, voice-over internet, and video technology applications. To date, the Company has not been named as a party in the action, but the Company has received a subpoena for documents and a deposition related to the products the Company sold to Comcast. The Company continues to comply with this subpoena. Comcast has made a request for indemnity related to the products that the Company and others sold to them. The Company and others have agreed to contribute to the payment of legal costs and expenses related to this case and the Company has entered into a joint defense and cost sharing agreement with all named defendants in the suit. On February 1, 2007, the Court entered an order

disqualifying Rembrandt s counsel and vacated all scheduled dates pending Rembrandt obtaining new counsel. At this point, the outcome is uncertain and the Company cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Rembrandt is successful in its claim against Comcast and then elects to pursue other cable operators that use the allegedly infringing products.

On June 1, 2006, a case was filed by Rembrandt against Charter, Cox, CSC Holdings, Inc. (CSC) and Cablevisions Systems Corp. (Cablevision) in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, Rembrandt alleged that products and services sold by Charter infringe certain patents related to cable modem, voice-over internet, and video technology applications. To date, the Company has not been named as a party in the action, but Charter has made a request for

indemnity related to the products that the Company and others have sold to them. The Company has not received an indemnity request from Cox, CSC, and Cablevision but the Company expects that such request will be forthcoming shortly. To date, the Company and others have not agreed to contribute to the payment of legal costs and expenses related to this case. A trial date is not set at this time. At this point, the outcome is uncertain and the Company cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Rembrandt is successful in its claim against Charter and then elects to pursue other cable operators that use the allegedly infringing products.

On June 1, 2006, a case was filed by Rembrandt against TWC in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, Rembrandt alleged that products and services sold by TWC infringe certain patents related to cable modem, voice-over internet, and video technology applications. To date, the Company has not been named as a party in the action, but TWC has made a request for indemnity related to the products that the Company and others have sold to them. The Company and others have agreed to contribute to the payment of legal costs and expenses related to this case. A trial date is not set at this time. At this point, the outcome is uncertain and the Company cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Rembrandt is successful in its claim against TWC and then elects to pursue other cable operators that use the allegedly infringing products.

On September 13, 2006, a second case was filed by Rembrandt against TWC in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, Rembrandt alleged that products and services sold by TWC infringe certain patents related to the DOCSIS standard. To date, the Company has not been named as a party in the action, but TWC has made a request for indemnity related to the products that the Company and others have sold to them. The Company and others have agreed to contribute to the payment of legal costs and expenses related to this case. A trial date is not set at this time. At this point, the outcome is uncertain and the Company cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Rembrandt is successful in its claim against TWC and then elects to pursue other cable operators that use the allegedly infringing products.

On January 31, 2007, a case was filed by GPNE Corp. (GPNE) against Time Warner Inc. (TWI), Comcast and Charter in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, GPNE alleged that products and services sold by TWI, Comcast and Charter infringe certain patents related to the DOCSIS standard (data transmission). To date, the Company has not been named as a party in the action, but TWC has made a request for indemnity related to the products that the Company and others have sold to them. The Company believes that Comcast and Charter will also make indemnity requests. The Company and others have agreed to contribute to the payment of legal costs and expenses related to this case. Trial date of this matter is not known at this time. On February 2, 2007, TWC filed a lawsuit against GPNE in the United States District Court for the District of Delaware requesting a declaratory judgment of non-infringement. At this point, the outcome is uncertain and the Company cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if GPNE is successful in its claim against TWI, Comcast and Charter and then elects to pursue other cable operators that use the allegedly infringing products.

On May 9, 2007, the Company entered into a settlement agreement with Dolby Laboratories Licensing Corporation (Dolby) for $0.3 million to settle the Company s past infringement of certain Dolby patents and copyrighted works. Additionally, the Company and Dolby are entering into a license agreement to license such patents and copyrighted works beginning January 1, 2007. The Company recorded the settlement as of March 31, 2007 and the settlement is included in general and administrative expenses.

The Company has received letters and other communications claiming that its technology infringes the intellectual property rights of others. The Company has consulted with its patent counsel and reviewed the allegations made by such third parties. If these allegations were submitted to a court, the court could find that the Company s products infringe third party intellectual property rights. If the Company is found to have infringed third party rights, the Company could be subject to substantial damages and/or an injunction preventing the Company from conducting its business. In addition, other third parties may assert infringement claims against the Company in the future. A claim of infringement, whether meritorious or not, could be time-consuming, result in costly litigation, divert the Company s

management s resources, cause product shipment delays or require the Company to enter into royalty or licensing arrangements. These royalty or licensing arrangements may not be available on terms acceptable to the Company, if at all.

Furthermore, the Company has in the past agreed to, and may from time to time in the future agree to, indemnify a customer of its technology or products for claims against the customer by a third party based on claims that its technology or products infringe intellectual property rights of that third party. These types of claims, meritorious or not, can result in costly and time-consuming litigation, divert management s attention and other resources, require the Company to enter into royalty arrangements, subject the Company to damages or injunctions restricting the sale of its products, require the Company to indemnify its customers for the use of the allegedly infringing products, require the Company to refund payment of allegedly infringing products to its customers or to forgo

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future payments, require the Company to redesign certain of its products, or damage its reputation, any one of which could materially and adversely affect its business, results of operations and financial condition.

The Company has also provided an indemnity to ATI where the Company s liability is set at $14.0 million for breaches of representations and warranties made by the Company and assumed by the Company. This indemnity is provided for a period of three years for non-tax issues and six years for tax issues.

The Company may, in the future, take legal action to enforce its patents and other intellectual property rights, to protect its trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could negatively affect the Company s business, results of operations and financial condition

In December 2005, the Commission issued a formal order of investigation in connection with the Company s accounting review of a series of contractual agreements with Thomson Broadcast. These matters were previously the subject of an informal Commission inquiry. The Company cooperated fully with the Commission in order to bring the investigation to a conclusion as promptly as possible. On April 2, 2007, the Company received written notification from the staff of the Commission that the Commission s investigation has been terminated and no enforcement action has been recommended at this time. The decision of the Commission to terminate the investigation is not a finding or judgment regarding the matters investigated, and should not be construed that the Company has been exonerated or that no action may ultimately result from the Commission s investigation of the matter.

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

4. Employee Equity Incentive Plans

Stock Option Program Description

The Company s 1995 Stock Option Plan (1995 Plan) and 1997 Equity Incentive Plan (1997 Plan) provide for incentive stock options and nonqualified stock options to be issued to employees, directors and consultants of the Company. Exercise prices of incentive stock options may not be less than the fair market value of the common stock at the date of grant. Exercise prices of nonqualified stock options may not be less than 85% of the fair market value of the common stock at the date of grant. Options are immediately exercisable and vest over a period not to exceed five years from the date of grant. Any unvested stock issued is subject to repurchase by the Company at the original issuance price upon termination of the option holder s employment. Unexercised options expire six to ten years after the date of grant. The 1997 Plan also provides for the sale of restricted shares of common stock to employees, directors and consultants, and the Company has provided such awards in prior years. The 1995 Plan expired in 2005 and only stock options that were granted under the 1995 Plan prior to its expiration remain outstanding. The 1997 Plan expired on March 25, 2007 and only stock options that were granted under the 1997 Plan prior to its expiration remain outstanding.

The Company s 1998 Non-Employee Directors Stock Option Plan (1998 Plan) provides for non-discretionary nonqualified stock options to be issued to the Company s non-employee directors automatically as of the effective date of their election to the Board of Directors and annually following each annual stockholder meeting. Exercise prices of nonqualified options may not be less than 100% of the fair market value of the common stock at the date of grant. Options generally vest and become exercisable over a period not to exceed three years from the date of grant. Unexercised options expire ten years after the date of grant.

The Company s 1999 Non-Officer Equity Incentive Plan (1999 Plan) provides for nonqualified stock options to be issued to non-officer employees and consultants of the Company. Prices for nonqualified stock options may not be less than 85% of the fair market value of the common stock at the date of the grant. Options generally vest and become exercisable over a period not to exceed five years from the date of grant. Unexercised options expire ten years

after date of grant. The 1999 Plan also provides for the sale of restricted shares of common stock to employees, directors and consultants and the Company has provided such awards in prior years and may provide such awards in the future.

General Option Information

The following table presents a summary of option activity during the three months ended March 31, 2007 (unaudited):

	Options Available for Grant	Options Outstanding Number of Shares	Options Outstanding Weighted Average Exercise Price
December 31, 2006	9,421,592	12,136,816	$ 4.58
Authorized			
Granted			
Exercised			
Cancelled	26,200	(26,200)	$ 2.72
Expired	(7,495,347)		
March 31, 2007	1,952,445	12,110,616	$ 4.79

Valuation and Expense Information under SFAS 123(R)

Effective January 1, 2006, the Company adopted SFAS 123(R), which requires the measurement and recognition of compensation expense for all share-based payment awards made to the Company s employees and directors including employee stock options and employee stock purchases related to the stock option plans based on estimated fair values. The Company elected to adopt SFAS 123(R) using the modified prospective recognition method, which requires the Company to recognize compensation cost for new and unvested stock options, restricted stock, restricted stock units and employee stock purchase plan shares. The following table summarizes stock-based compensation expense related to employee stock options and employee stock purchases under SFAS 123(R) for the three months ended March 31, 2007 which is allocated as follows (in thousands, except per share data) (unaudited):

	Three Months Ended March 31, 2007	Three Months Ended March 31, 2006
Cost of goods sold	$ 61	$ 84
Research and development	73	176
Sales and marketing	48	327
General and administrative	172	205
Share-based compensation effect in income before taxes	$ 354	$ 792
Income taxes		
Net share-based compensation effect in net loss	$ 354	$ 792
Impact on net loss per share:		
Basic and diluted	$ 0.00	$ 0.01
Shares outstanding	77,637	77,637

At March 31, 2007, unamortized compensation expense related to outstanding unvested stock options that are expected to vest was approximately $2.5 million. This unamortized compensation expense is expected to be recognized over a weighted average period of approximately 2.2 years.

Share-based compensation recognized in 2006 and 2007 as a result of the adoption of SFAS 123(R) uses the Black-Scholes option pricing model for estimating fair value of options granted under the Company s equity incentive plans and rights to acquire stock granted under the Company s stock purchase plan. The weighted average estimated values of employee stock option grants and right granted under the stock purchase plan, as well as the weighted average assumptions that were used in calculating such values during 2007 and 2006, were based on the estimates at the date of grant as follows (unaudited):

	Three Months Ended March 31,	
	2007	**2006**
Weighted average estimated fair value of grant (1)	N/A	$ 0.90
Expected life (in years)	2.2	2.2
Risk-free interest rate	4.68%	4.40%
Volatility	76.45%	72.60%
Dividend yield	0%	0%

(1) There were no options granted during the three months ended March 31, 2007. If the Company had granted options during the quarter ended March 31, 2007, these variables would have been used to calculate the fair value of the options.

The Company used its historical stock price volatility as the expected volatility assumption. The expected life of employee stock options represents the weighted average period the stock options are expected to remain outstanding. The expected term is based on the observed and expected time to post-vesting exercise of options by employees. The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of the Company s employee stock options.

Options outstanding that have vested and are expected to vest as of March 31, 2007 are as follows (unaudited):

	Number of Shares	**Weighted Average Exercise Price**	**Weighted Average Remaining Contractual Life (in years)**	**Aggregate Intrinsic Value(1)**
Vested	10,521,324	$ 5.11	5.13	$ 82,274
Expected to vest	1,387,824	$ 2.66	5.85	22,539
Total	11,909,148	$ 4.83	5.21	$ 104,813

(1) These amounts represent the differences between the exercise price and $1.75, the closing price of the Company s stock on March 30, 2007 as reported on the Pink Sheets, for all in-the-money options outstanding.

5. Operating Segment Information

In late 2000, the worldwide telecom and satellite industries experienced severe downturns that resulted in significantly reduced purchases of equipment. Because of that decrease in demand, the Company refocused its efforts on sales of its data products to the cable industry and its digital video products to the cable and satellite industry, and significantly reduced and then ultimately eliminated its telecom and satellite businesses. Consequently, beginning in 2003, the Company s previously reported telecom segment no longer meets the quantitative threshold for disclosure and the Company now operates as one business segment.

Since 2004, the Company increased its focus on the development, marketing and sale of its digital video products versus its data products, which consisted of the CMTS, modem and eMTA products, and ultimately, refocused the Company as a digital video company. The decreased focus on the data products was due to the pressures of competing in a standards based marketplace versus a proprietary based marketplace. In 2001 and 2002, the Company switched from selling proprietary data products based on its Synchronous Code Division Multiple Access (S-CDMA) technology to Data Over Cable System Interface Specification (DOCSIS) compliant products. Additionally, in 2001, the Company licensed its S-CDMA technology to Cable Television Laboratories, Inc. (CableLabs) on a non-exclusive, perpetual, worldwide, royalty-free basis for inclusion in the DOCSIS 2.0 standard (and later standards) and therefore, any competitive edge previously provided by the proprietary technology was eliminated. In 2004, the Company ceased investment in its CMTS product line due to these competitive pressures, declining sales and costs associated with research and development efforts to develop the next generation of CMTS products. In January 2006, the Company discontinued its line of modems and eMTAs for the same reasons.

The Company operates solely in one business segment, the development and marketing of digital video products and related services. However, the Company will continue to sell through the existing inventory of its modem and eMTA products. The Company s foreign operations consist of sales, marketing and support activities through its foreign subsidiaries. The Company s Chief Executive Officer has responsibility as the chief operating decision maker (CODM) as defined by SFAS No. 131, Disclosures about Segments of an Enterprise and Related Information. The CODM reviews financial information presented on a consolidated basis, accompanied by disaggregated information about revenues and certain direct expenses by geographic region for purposes of making operating decisions and assessing financial performance. The Company s assets are primarily located in its corporate office in the United States and are not allocated to any specific region, therefore the Company does not produce reports for, or measure the performance of, its geographic regions based on any asset-based metrics.

6. Restructuring Charges and Asset Write-offs

Restructuring

The Company accrues for termination costs in accordance with paragraph 3 of SFAS No. 146, Accounting for Costs Associated with Exit or Disposal Activities, and SFAS No. 112, Employers Accounting for Post Employment Benefits. Liabilities are initially measured at their fair value on the date in which they are incurred based on plans approved by the Company s Board of Directors. Accrued employee termination costs principally consist of three components: (i) a lump-sum severance payment based upon the years of service (e.g., two weeks per year of service); (ii) COBRA insurance based on years of service and rounded up to the month; and (iii) an estimate of costs for outplacement services immediately provided to the affected employees. Substantially all employees were terminated on the date of notification, so there was no additional service period required to be included in the determination of accrued termination costs. Where such services were required for a period over 60 days, the Company amortized termination costs ratably over the required service period.

2004 Restructurings

During the quarter ended March 31, 2004, the Company initiated a restructuring plan to bring operating expenses in line with revenue levels and incurred restructuring plan charges related to employee termination costs, termination costs for an aircraft lease, and costs for excess leased facilities. In the quarter ended December 31, 2004, to further conform the Company s expenses to its revenue and to cease investment in the CMTS product line, the Company s Board of Directors approved a restructuring plan related to employee terminations. Additionally, in 2004, the Company re-evaluated and adjusted restructuring charges incurred in the first and second quarters of 2004 related to employee severance, excess facilities and the aircraft lease termination.

The Company anticipates the remaining restructuring accrual related to excess leased facilities to be utilized for servicing operating lease payments through October 2009.

The amount of net charges accrued under the 2004 restructuring plans assumes that the Company will successfully sublease excess leased facilities. The reserve for the excess leased facilities includes the estimated income derived from subleasing, which is based on information from the Company s real estate brokers, who estimated it based on assumptions relevant to the real estate market conditions as of the date of the Company s implementation of the restructuring plan and the time it would likely take to sublease the excess leased facility. The Company sub-subleased

its former principal executive offices in August 2006.

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The following table summarizes the accrued restructuring balances related to the 2004 restructurings as of March 31, 2007 (in thousands) (unaudited):

	Excess Leased Facilities
Balance at December 31, 2006	$ 343
Charges	
Cash payments	(39)
Charges in estimate	
Balance at March 31, 2007	$ 304

7. Product Warranty

The Company provides a standard warranty for most of its products, ranging from one to five years from the date of purchase. The Company estimates product warranty expenses at the time revenue is recognized. The Company s warranty obligations are affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. The estimate of costs to service its warranty obligations is based on historical experience and the Company s expectation of future conditions. Should actual product failure rates, material usage or service delivery costs differ from the Company s estimates, revision to the warranty liability would be required.

8. Corporate Aircraft

In 2002, the Company entered into an operating lease arrangement to lease a corporate aircraft (Aircraft Lease). This lease arrangement was secured by a $9.0 million letter of credit at December 31, 2002. The letter of credit was reduced to $7.5 million in February 2003. The $7.5 million letter of credit was converted to a cash deposit in 2004. In August 2004, the Company entered into a 28-month aircraft sublease terminating on December 31, 2006, which was amended in December 2006 to terminate on January 14, 2007. On January 14, 2007, the last day of the operating lease, the Company returned the corporate aircraft to the lessor of the aircraft, General Electric Capital Corporation (GECC), and no additional rental payments were due to the lessor after October 2006.

On March 22, 2007, the Company entered into a Termination Agreement with GECC, terminating the Aircraft Lease. Pursuant to the Termination Agreement, On March 28, 2007, GECC returned to the Company $6.8 million of the $7.5 million cash deposit held by GECC as collateral for the aircraft lease. GECC will retain $0.7 million in collateral (Repair Collateral) subject to GECC s completion of repairs, tests, inspections, and corrections to the aircraft, which GECC has estimated will cost $0.6 million. The remaining amount of the Repair Collateral, if any, will be returned to the Company.

9. RGB Litigation Settlement

On March 26, 2007, the Company entered into a stipulation for settlement with RGB Networks, Inc. amicably resolving all outstanding litigation between the parties. On April 10, 2007 the Company entered into a formal settlement agreement.

10. Director Compensation

In January 2007, the Board of Directors approved cash payments to the Company s outside directors in lieu of stock options that had been historically granted to the outside directors pursuant to the Company s automatic, non-discretionary option grant policy applicable to outside directors for service on the Board of Directors and as the chairman or member of one or more committees of the Board of Directors for the years 2005, 2006 and 2007. Options were not granted in 2005 or 2006, and the Company does not anticipate granting options in 2007 by the date of the annual stockholder meeting to its outside directors due to the Company s inability to grant stock options during the restatement of the Company s financial statements for certain prior periods and the related unavailability of the Company s registration statements. The Board of Directors also approved effective as of January 27, 2007 a quarterly advance cash retainer policy applicable to outside directors that will replace the Company s cash compensation policy in effect in 2006. Please see Director Compensation in Part III, Item 11 in Amendment No. 1 to the Company s Annual

Report on Form 10-K for the year ended December 31, 2006.

11. Subsequent Events

Merger Agreement with Motorola

On April 21, 2007, the Company entered into an Agreement and Plan of Merger (Merger Agreement) with Motorola, Inc., (Motorola), and Motorola GTG Subsidiary VI Corporation, a wholly-owned subsidiary of Motorola (Merger Sub), pursuant to which Merger Sub will be merged with and into the Company (Merger), with the Company continuing as the surviving corporation and as a wholly-owned subsidiary of Motorola.

Pursuant to the Merger Agreement, at the effective time of the Merger, each share of the Company s common stock, par value $0.001 per share, issued and outstanding immediately prior to the effective time (other than shares held by the Company, Motorola or Merger Sub, which will be canceled without payment of any consideration) will be converted into the right to receive $1.80 in cash, without interest.

The Merger has been approved by the Company s Board of Directors. The Merger is subject to the adoption of the Merger Agreement and the approval of the Merger by the stockholders of the Company, the termination or expiration of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, and other customary closing conditions.

If the Merger Agreement is terminated under certain circumstances specified in the Merger Agreement, the Company may be required to pay Motorola a termination fee of $5.25 million.

As a result of entering into the Merger Agreement, the Company accrued $1.6 million of expense related to certain contractual commitments it had in place which are contingent on the completion of the Merger.

Under the terms of the Merger Agreement, Motorola has agreed to assume certain bonus programs the Company had in place at the time the agreement was signed. If the Merger does not close by December 30, 2007, the Company would be required to pay a maximum of $0.9 million related to these bonus programs which is not currently accrued for on the Company s books.

Dolby Settlement and License

General and administrative expenses for the three months ended March 31, 2007 included an expense of $0.3 million for the settlement on May 9, 2007 of patent infringement and copyrighted works claims that the Company had received from Dolby Laboratories Licensing Corporation (Dolby) in January 2007. The claims related to the Company s non-payment of license fees to Dolby for software functionality embedded in certain of the Company s DVS products. Additionally, the parties are entering into a license agreement to license such patents and copyrighted works beginning January 1, 2007**.**

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

Forward-Looking Statements

The following discussion and analysis should be read in conjunction with our condensed consolidated financial statements and notes thereto. This discussion and analysis may contain predictions, estimates and other forward-looking statements that involve a number of risks and uncertainties, including those discussed under Risk Factors in Part II, Item 1A in this Quarterly Report on Form 10-Q and Item 1A of the Annual Report on Form 10-K for the year ended December 31, 2006, as amended (2006 Form 10-K). The words believe, expect, anticipate, intend estimate, plan and other expressions, that are predictions or indicate future events, identify forward-looking statements, which are based on the current expectations, estimates, forecasts and projections of future Company or industry performance based on management s judgment, beliefs, current trends and market conditions. The forward-looking statements involve known and unknown risks, uncertainties and other factors, which may cause our actual outcomes and results to differ materially from what is expressed, expected, anticipated, or implied in any forward-looking statement. These statements include those related to our products, product sales, expenses, our revenue recognition policies, material weaknesses or deficiencies in internal control over financial reporting, and the proposed acquisition of us by Motorola, Inc. (Motorola). For example, there can be no assurance that our product sales efforts or recognized revenues or expenses will meet any expectations or follow any trend(s), that our internal controls over financial reporting will be effective or produce reliable financial information on a timely basis, that our ability to compete effectively and maximize stockholder value will be successful or yield preferred results, or that the proposed acquisition of us by Motorola will be completed. Our ongoing or future litigation may have an adverse effect on our results of operations and financial results. In addition, our financial results, liquidity and stock price may suffer as a result of our announced proposed acquisition by Motorola, the restatements, the cost of completing the restatements and the audit and review of our financial statements, our ability to control operating expenses and maintain adequate cash balances for operating the business going forward, any adverse response of our vendors, customers, stockholders, media and others relating to the announcement of the proposed acquisition by Motorola and the delay or restatements of our financial statements, the review and application of our accounting processes, policies and procedures, and additional uncertainties related to accounting. We undertake no intent or obligation to publicly update or revise any of these forward-looking statements, whether as a result of new information, future events or otherwise. This caution is made under the safe harbor provisions of Section 21E of the Securities Exchange Act of 1934, as amended (Exchange Act).

Executive Overview

We currently develop, market and sell digital video equipment to network operators and content aggregators who offer video services. Our primary products include the Network CherryPicker® line of digital video processing systems and the CP 7600 line of digital-to-analog decoders. Our products are used for multiple digital video applications, including the rate shaping of video content to maximize the bandwidth for standard definition (SD) and high definition (HD) programming, grooming customized channel line-ups, carrying local ads for local and national advertisers, and branding by inserting corporate logos into programming. Our products are sold primarily to cable operators, telecom carriers and satellite providers in the United States, Europe (including the Middle East) and Asia.

In 2004, we refocused the Company to make digital video products and applications the core of our business. In particular, we began expanding our focus beyond cable operators to more aggressively pursue opportunities for our digital video products with television broadcasters, telecom carriers and satellite television providers. As part of this strategic refocus, we elected to continue selling our home access solutions (HAS) product, including cable modems, embedded multimedia terminal adapters (eMTA) and home networking devices, but ceased future investment in our CMTS product line. This decision was based on weak sales of the CMTS products and the anticipated extensive research and development investment required to support the product line in the future. As part of our decision to cease investment in the CMTS product line, we incurred severance, restructuring and asset impairment charges. In March 2005, we sold certain modem semiconductor assets to ATI Technologies, Inc. and terminated our internal semiconductor group.

In January 2006, we announced that the Company would focus solely on digital video product lines, and as a result, we discontinued our HAS product line. We determined that there were no short- or long-term synergies between our

HAS product line and digital video product lines which made the HAS products increasingly irrelevant given our core business of digital video. Though we continued to sell our remaining inventory of HAS products and CMTS products in 2006, the profit margins for our cable modems and eMTAs have continued to decrease due to competitive pricing pressures and the ongoing commoditization of the products.

We have not been profitable since our inception. At March 31, 2007, our accumulated deficit was $1.1 billion. We had a net loss of $7.0 million or $0.09 per share for the quarter ended March 31, 2007 and a net loss of $3.9 million or $0.05 per share for the quarter

ended March 31, 2006. Our ability to grow our business and attain profitability is dependent on our ability to effectively compete in the marketplace with our current products and services, develop and introduce new products and services, contain operating expenses and improve our gross margins, as well as continued investment in equipment by network operators and content aggregators. Finally, we expect to benefit from a lower expense base resulting in part from the series of cost reduction initiatives that occurred in 2005 and 2006, along with continued focus on cost containment. However, despite these efforts, we may not succeed in attaining profitability in the near future, or at all.

At March 31, 2007, we had $20.5 million in cash, cash equivalents and short-term investments as compared to $20.3 million at December 31, 2006. The $0.2 million increase from December 31, 2006 to March 31, 2007 was driven by the release of $6.8 million of a deposit that was included in current assets which related to a previously leased jet aircraft. Although we believe that our current cash balances will be sufficient to satisfy our cash requirements for at least the next 12 months, we may need to raise additional funds in order to support more rapid expansion, develop new or enhanced services, respond to competitive pressures, acquire complementary businesses or technologies or respond to unanticipated requirements. There can be no assurance that additional financing will be available on acceptable terms, if at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to continue operations, develop products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could have a material adverse effect on our business, financial condition, operating results and liquidity.

Merger Agreement with Motorola

On April 21, 2007, we entered into an Agreement and Plan of Merger (Merger Agreement) with Motorola, and Motorola GTG Subsidiary VI Corporation, a wholly-owned subsidiary of Motorola (Merger Sub), pursuant to which Merger Sub will be merged with and into the Company (Merger), with the Company continuing as the surviving corporation and as a wholly-owned subsidiary of Motorola.

Pursuant to the Merger Agreement, at the effective time of the Merger, each share of our common stock, par value $0.001 per share, issued and outstanding immediately prior to the effective time (other than shares held by us, Motorola or Merger Sub, which will be canceled without payment of any consideration) will be converted into the right to receive $1.80 in cash, without interest.

The Merger has been approved by our Board of Directors. The Merger is subject to the adoption of the Merger Agreement and the approval of the Merger by our stockholders, the termination or expiration of the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976, as amended, and other closing conditions.

A more detailed description of the risks to our business can be found in the sections captioned Risk Factors in this Quarterly Report on Form 10-Q and our 2006 Form 10-K.

Critical Accounting Policies and Estimates

The preparation of our financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires our management to make judgments and estimates that affect the amounts reported in our financial statements and accompanying notes. Our management believes that we consistently apply these judgments and estimates and the financial statements and accompanying notes fairly represent all periods presented. However, any differences between these judgments and estimates and actual results could have a material impact on our statement of income and financial condition. Critical accounting estimates, as defined by the Securities and Exchange Commission (Commission), are those that are most important to the portrayal of our financial condition and results of operations and require our management s most difficult and subjective judgments and estimates of matters that are inherently uncertain.

We describe our critical accounting policies regarding revenue recognition, deferred revenue and deferred cost of goods sold, critical accounting estimates regarding stock-based compensation and accounts receivable, net of allowance for doubtful accounts below. For a discussion of our remaining critical accounting policies, see Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies in our 2006 Form 10-K.

Revenue Recognition

In accordance with Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition (SAB 101), as amended by SAB 104, for all products and services, we recognize revenue when persuasive evidence of an arrangement exists, delivery has occurred or services are

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rendered, the fee is fixed or determinable, and collectibility is reasonably assured. In instances where final acceptance of the product, system, or solution is specified by the customer, revenue is not recognized until all acceptance criteria have been met. Contracts and customer purchase orders are used to determine the existence of an arrangement. Delivery occurs when product is delivered to a common carrier. Certain products are delivered on a free-on-board (FOB) destination basis and the Company does not recognize revenue associated with these transactions until the delivery has occurred to the customers premises. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to adjustment. We assess collectibility based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer s payment history.

In establishing its revenue recognition policies for our products, we assess software development efforts, marketing and the nature of post contract support (PCS). Based on its assessment, we determined that the software in the HAS and CMTS products is incidental and therefore, we recognize revenue on HAS and CMTS products under SAB 101, as specifically amended by SAB 104. Additionally, based on our assessment of the DVS products, we determined that software was more than incidental, and therefore, we recognize revenue on the DVS products under American Institute of Certified Public Accountants Statement of Position (SOP) 97-2, Software Revenue Recognition (SOP 97-2) and SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1).

We determined that the software in the DVS products is more than incidental because the DVS platforms contained multiple embedded software applications, the software is actively marketed and we have a practice of providing upgrades and enhancements for the software to its existing users periodically. While the software is not sold on a stand-alone basis with the ability to operate on a third party hardware platform, the software is marketed and sold separately in the form of software license keys to activate embedded software applications. Additionally, as part of our customer support contracts, we routinely provide our customers with unspecified software upgrades and enhancements.

When a sale involves multiple elements, such as sales of products that include services, the entire fee from the arrangement is allocated to each respective element based on its fair value and recognized when revenue recognition criteria for each element are met. Fair value for each element is established based on the sales price charged when the same element is sold separately. In order to recognize revenue from individual elements within a multiple element arrangement under SOP 97-2, we must establish vendor specific objective evidence (VSOE) of fair value for each element.

Prior to 2006, for DVS products, we determined that we did not establish VSOE of fair value for the undelivered element of PCS, which required us to recognize revenue and the cost of goods sold of both the hardware element and PCS element ratably over the period of the customer support contract. We amortized the cost of goods sold for DVS products ratably over the period of the customer support contract. Revenue and the related cost of goods sold for DVS products that contain multiple element arrangements in each quarter of 2003, 2004 and 2005 were restated to reflect this accounting policy.

Beginning in the first quarter of 2006, we determined that we established VSOE of fair value of the PCS element for DVS product sales as a result of maintaining consistent pricing practices for PCS, including consistent pricing of renewal rates for PCS. For DVS products sold beginning in 2006 that contain a multiple element arrangement, we recognize revenue from the hardware component when all criteria of SAB 104 and SOP 97-2 have been met and revenue related to PCS element ratably over the period of the PCS.

We sell our products directly to broadband service providers, and to a lesser extent, resellers. Revenue arrangements with resellers are recognized when product meets all criteria of SAB 104 and SOP 97-2.

Deferred Revenue, Deferred Cost of Goods Sold

Deferred revenue and deferred cost of goods sold are a result of our recognizing revenues on the DVS under SOP 97-2. Under SOP 97-2, we must establish VSOE of fair value for each element of a multiple element arrangement. Until the first quarter of 2006, we did not establish VSOE of fair value for PCS when PCS was sold as part of a multiple element arrangement. As such, for DVS products sold with PCS, revenue and the cost of goods sold related to the delivered element, the hardware component, were deferred and recognized ratably over the period of the PCS.

Stock-Based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123(R) which is a revision of SFAS 123, Share-Based Payment (SFAS 123(R)), which requires the measurement and recognition of compensation expense for all share-

based payment awards made to employees and directors, including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan based on estimated fair values. SFAS 123(R) supersedes our previous accounting under Accounting Principles Board (APB) Opinion 25, Accounting for Stock Issued to Employees (APB 25), for periods beginning January 1, 2006. In March 2005, the Commission issued SAB No. 107, Share-based Payment (SAB 107), relating to SFAS 123(R). SAB 107 provides guidance on the initial implementation of SFAS 123(R). In particular, the statement includes guidance related to share-based payment awards with non-employees, valuation methods and selecting underlying assumptions such as expected volatility and expected term. It also gives guidance on the classification of compensation expense associated with share-based payment awards and accounting for the income tax effects of share-based payment awards upon the adoption of SFAS 123(R). We have applied the provisions of SAB 107 in its adoption of SFAS 123(R).

Under the modified prospective method of adoption for SFAS 123(R), the compensation cost recognized by us beginning in 2006 includes (a) compensation cost for all equity incentive awards granted prior to, but not yet vested as of January 1, 2006, based on the grant-date fair value estimated in accordance with the original provisions of SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123), and (b) compensation cost for all equity incentive awards granted on or subsequent to January 1, 2006, based on the grant-date fair value estimated in accordance with the provisions of SFAS 123(R). We use the straight-line attribution method to recognize share-based compensation costs over the service period of the award. Upon exercise, cancellation, or expiration of stock options, deferred tax assets for options with multiple vesting dates are eliminated for each vesting period on a first-in, first-out basis as if each vesting period was a separate award.

Options currently granted by us generally expire six years from the grant date and vest over a three year period. Options granted prior to the second quarter of 2005 generally expire ten years from the grant date and vest over a four to five year period. We may use other types of equity incentives, such as restricted stock and stock appreciation rights. Our equity incentive awards also allow for performance-based vesting.

On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards (FAS 123(R)-3). We have elected to adopt the alternative transition method provided in FAS 123(R)-3 for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods to establish the beginning balance of the additional paid-in capital pool (APIC Pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC Pool and Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R).

Share-based compensation recognized in 2006 and 2007 as a result of the adoption of SFAS 123(R) as well as share-based compensation calculated for pro forma disclosures according to the original provisions of SFAS 123 for periods prior to the adoption of SFAS 123(R) use the Black-Scholes valuation methodologies for estimating fair value of options granted under our equity incentive plans and rights to acquire stock granted under our stock participation plan.

Accounts Receivable, Net of Allowance for Doubtful Accounts

We evaluate our trade receivables based upon a combination of factors generally requiring no collateral. We assess collectibility based on a number of factors, including history, the number of days an amount is past due (based on invoice due date), changes in credit ratings of customers, current events and circumstances regarding the business of our clients customers and other factors that it believes are relevant. Credit losses have historically been within management s expectations. When we become aware of a customer s inability to pay, such as in the case of bankruptcy or a decline in the customer s operating results or financial position, we record an allowance to reduce the related receivable to an amount we reasonably believe is collectible. We maintain an allowance for potentially uncollectible accounts receivable based on an estimate of collectibility. If circumstances related to a specific customer change, our estimates of the recoverability of receivables could be further altered. In addition, we made other adjustments to the allowance for doubtful accounts to offset the accounts receivable and related reserve related to customers who were granted extended payment terms, experiencing financial difficulties or where collectibility was not reasonably assured. At March 31, 2007 and 2006, the allowance for potentially uncollectible accounts was $0.2 million and $3.7 million,

respectively.

Results of Operations

Comparison of Three Months Ended March 31, 2007 and March 31, 2006

Revenues

Our revenues decreased to $12.8 million for the three months ended March 31, 2007, compared to $21.5 million for the three months ended March 31, 2006. Revenue decreased across all products with the largest decrease in legacy products, as revenue from the sale of HAS and CMTS products declined $4.9 and $1.4 million, respectively, while revenue from DVS products decreased $2.4 million. We expect overall revenues to decrease in 2007 compared to 2006 due to decreased sales of our HAS and CMTS products following our discontinuation of both product lines. We expect revenues from the sale of our DVS products to increase in 2007 compared to 2006, primarily due to the introduction of new software applications, sales to an expanded customer base which includes telecommunication and broadcast satellite companies, increased international opportunities and additional sales to MSOs as they continue to build out their digital networks.

Revenues by Groups of Similar Products

The following table presents revenues for groups of similar products (in thousands, except percentages) (unaudited):

	Three months ended March 31,		Variance in Dollars	Variance in Percent
	2007	2006		
Revenues by product:				
DVS	$ 12,414	$ 14,824	$ (2,410)	(16.3)%
CMTS	346	1,713	(1,367)	(79.8)%
HAS	16	4,953	(4,937)	(99.7)%
Total revenues	$ 12,776	$ 21,490	$ (8,714)	(40.5)%

Revenues from the sale of HAS products were negligible in the three months ended March 31, 2007, compared to $5.0 million for the three months ended March 31, 2006. In January 2006, we announced that we were discontinuing our HAS product line to focus solely on digital video. As a result, we continue to sell our remaining HAS inventory and collect the remaining receivables with respect to our HAS products, and we expect revenue from the sale of our HAS products to continue to decline in 2007. We anticipate that all remaining HAS inventories will be sold during 2007. CMTS revenues also declined significantly to $0.3 million in the three months ended March 31, 2007 compared to $1.7 million in the three months ended March 31, 2006. CMTS product revenue consists primarily of sales of support services, and we do not believe that sales of CMTS products will be material in 2007.

Revenues from the sale of DVS products decreased to $12.4 million for the three months ended March 31, 2007, compared to $14.8 million for the three months ended March 31, 2006.

The following is a breakdown of DVS product revenue by period invoiced (in millions, except percentages) (unaudited):

	Three Months Ended March 31,		Variance in Dollars	Variance in Percent
	2007	2006		
DVS product revenue invoiced and recognized in current period:				
Total invoiced in current period	$ 10.6	$ 9.5	$ 1.1	11.6%
	1.2	1.1	0.1	9.1%

Less: Invoiced in current period and recognized in future periods				
Total invoiced and recognized in current period	$ 9.4	$ 8.4	$ 1.0	11.9%
DVS product revenue invoiced in prior fiscal years and recognized in current period	3.0	6.4	(3.4)	(53.1)%
Total DVS product revenue recognized in current period	$ 12.4	$ 14.8	$ (2.4)	(16.2)%

Although total revenue recognized from the sale of DVS products decreased in the three months ended March 31, 2007 compared to the same period in 2006, the amount of DVS product revenue invoiced in the three months ended March 31, 2007 increased compared to the same period in 2006. The decline in reported revenue is the result of a reduction in DVS product invoiced in prior fiscal years and recognized in the current period.

The amount of DVS product revenue invoiced in the three months ended March 31, 2007 and 2006 was $10.6 million and $9.5 million, respectively, representing an increase of 12%. Of the DVS product revenue invoiced during the three months ended March 31, 2007 and 2006, $9.4 million and $8.4 million, respectively, was recognized as revenue during the three months ended March 31, 2007 and 2006, while the remaining amounts of $1.2 million and $1.1 million, respectively, will be recognized as revenue in future periods. Additionally, $3.0 million and $6.4 million of DVS product revenue invoiced in prior fiscal years was recognized during the three months ended March 31, 2007 and 2006, respectively. As a result of establishing VSOE in the first quarter of 2006, the balance of revenue invoiced in prior periods and recognized in the current period will decline in 2007.

Revenues by Geographic Region

The following table is a breakdown of revenues by geographic region (in thousands, except percentages) (unaudited):

	Three months ended March 31,		Variance in Dollars	Variance in Percent
	2007	2006		
Revenues:				
United States	$ 11,200	$ 14,416	$ (3,216)	(22.3)%
Americas, excluding United States	268	782	(514)	(65.7)%
Europe, Middle East and Africa, (EMEA), excluding Israel	846	3,659	(2,813)	(76.9)%
Israel		653	(653)	(100.0)%
Asia excluding Japan	155	1,606	(1,451)	(90.3)%
Japan	307	374	(67)	(17.9)%
Total	$ 12,776	$ 21,490	$ (8,714)	(40.5)%

Revenues in the United States decreased to $11.2 million, or 88% of revenues for the three months ended March 31, 2007, compared to $14.4 million, or 67% of revenues for the three months ended March 31, 2006. The decrease in revenues in the United States was primarily attributable to the overall reduction in revenues from the sale of our DVS products, which are sold primarily in the United States. We expect that sales to MSOs in the United States will continue to be the main source of our overall revenues in 2007 due to the expected build-out of ADS networks by second- and third-tier MSOs and the increasing importance of ad insertion

within the United States market. The increase in revenues in the United States as a percentage of total revenue is attributable to a decline from the sale of our CMTS and HAS product revenues which were sold primarily outside the United States. We anticipate that total international revenues will continue to decrease in 2007 based on the continued decline in sales of our CMTS and HAS products as we exhaust the remaining inventory of these products. DVS product revenues outside the United States have been nominal, and we expect such revenues to continue to be nominal in the foreseeable future, in part because ad insertion is less popular and often not feasible outside the United States.

Significant Customers

Three customers, Comcast Corporation (Comcast), Ascent Media Corporation (Ascent) and Harmonic, Inc. (Harmonic), each accounted for 10% or more of total revenues (39%, 11% and 10%, respectively) for the three months ended March 31, 2007. Three customers, Harmonic, Comcast and CSC Holdings, Inc. (CSC), each accounted for 10% or more of total revenues (18%, 16% and 13%, respectively) for the three months ended March 31, 2006. No other customer accounted for more than 10% of revenues during these periods.

Two customers, Comcast and Ascent, each accounted for 10% or more of total accounts receivable (40% and 17%, respectively) as of March 31, 2007. Three customers, CSC, HOT Telecom and Comcast, each accounted for 10% or more of total accounts receivable (20%, 15% and 10%, respectively) as of March 31, 2006. No other customer accounted for more than 10% of accounts receivable as of March 31, 2007 and 2006.

Cost of Goods Sold and Gross Profit

Total cost of goods sold consists of direct product costs as well as the cost of our manufacturing operations. The cost of manufacturing includes contract manufacturing, test and quality assurance for products, warranty costs and associated costs of personnel and equipment.

Total cost of goods sold decreased to $4.6 million in the three months ended March 31, 2007 from $10.7 million in the three months ended March 31, 2006.

Direct cost of goods sold for our HAS products was negligible for three months ended March 31, 2007, compared to $4.5 million for the three months ended March 31, 2006. The direct cost of goods sold for our HAS products decreased due to declining sales of HAS products following our decision to discontinue the product line in January 2006. The direct cost of goods sold for our CMTS products were nominal for the three months ended March 31, 2007, compared to $1.0 million for the three months ended March 31, 2006.

Direct cost of goods sold related to our DVS products decreased to $2.9 million in the three months ended March 31, 2007, compared to $3.6 million in the three months ended March 31, 2006.

The following is a breakdown of DVS product cost of goods sold by period invoiced (in millions, except percentages) (unaudited):

	Three Months Ended March 31,		Variance in Dollars	Variance in Percent
	2007	2006		
DVS product cost of goods sold invoiced and recognized in current period:				
Total invoiced in current period	$ 2.2	$ 2.2	$ 0.0	0.0%
Less: invoiced in current period and recognized in future periods	0.0		0.0	
Total invoiced and recognized in current period	$ 2.2	$ 2.2	$ 0.0	0.0%
DVS product cost of goods sold invoiced in prior fiscal years and recognized in current period	0.7	1.4	(0.7)	(50.0)%
	$ 2.9	$ 3.6	$ (0.7)	(19.4)%

Total cost of goods sold related to DVS product
recognized in current period

In the three months ended March 31, 2007 and 2006, the cost of goods sold related to DVS products invoiced during the period remained flat at $2.2 million. Cost of goods sold related to revenue invoiced and recognized on DVS products during the three months ended March 31, 2007 and 2006 was also flat at $2.2 million. The $0.7 million decrease in cost of goods sold for the three months ended March 31, 2006 was due to a reduction in DVS product cost of goods sold invoiced in prior fiscal years and recognized in the current period of $0.7 million and $1.4 million for the three months ended March 31, 2007 and 2006, respectively.

For the three months ended March 31, 2007, gross profit was $8.2 million, or 64% of revenues. This represented a decrease of $2.6 million compared to the three months ended March 31, 2006, in which gross profit was $10.8 million, or 50% of revenues. The increase in our gross profit as a percentage of revenues was attributable to a higher percentage of revenues resulting from sales of our higher margin DVS products, and decreased revenues from our lower margin HAS and CMTS products.

During 2007, we will continue to focus on improving sales of our higher margin DVS products and reducing product manufacturing costs. As we complete the transition to a digital video company, our revenues will primarily consist of DVS products, and thus, we

expect our gross profit margin percentages to increase as a result of increased revenues from higher margin DVS products as a percentage of our overall revenues.

Operating Expenses

Research and development, sales and marketing, general and administrative expenses and restructuring charges, executive severance and asset write-offs are summarized in the following table (in thousands, except percentages) (unaudited):

	Three months ended March 31,		Variance in	Variance in
	2007	2006	Dollars	Percent
Research and development	$3,005	$4,069	$(1,064)	(26.1)%
Sales and marketing	$3,323	$5,184	$(1,861)	(35.9)%
General and administrative	$8,149	$5,150	$ 2,999	58.2%
Restructuring charges, executive severance and asset write-offs		$ 34	$ (34)	(100.0)%

Research and Development. Research and development expenses consist primarily of personnel costs, internally designed prototype material expenditures, expenditures for outside engineering consultants, and testing equipment and supplies required to develop and enhance our products. For the three months ended March 31, 2007, research and development expenses were $3.0 million, or 26% of revenues, compared to $4.1 million, or 19% of revenues for the three months ended March 31, 2006. The decrease in research and development expenses was attributable to a $0.5 million decrease in facilities expenses related to the move of our corporate headquarters to a less expensive building, as well as a decrease of $0.7 million in compensation expenses, which primarily resulted from the reduction of bonus accruals for missed engineering milestones and a decrease in CMTS product research and development. We believe it is critical for us to continue to make significant investments in research and development to create innovative technologies and products that meet the current and future requirements of our customers. While we anticipate that our overall research and development expenses will remain constant in 2007, we intend to increase our investment in research and development as it relates to DVS product development in 2007 and in future periods.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries and commissions for sales personnel, salaries for marketing and support personnel, costs related to marketing communications, consulting and travel. For the three months ended March 31, 2007, sales and marketing expenses were $3.3 million, or 26% of revenues, compared to $5.2 million, or 24% of revenues for the three months ended March 31, 2006. This decrease in sales and marketing expenses resulted from a $0.5 million decrease in facilities expenses related to the move of our corporate headquarters to a less expensive building and a $1.2 million reduction in compensation expense related to reductions in staffing, reduced bonus accrual and related stock based compensation expense. We expect sales and marketing expenses to be lower in 2007 compared to 2006 as a result of lower overall expenditures and headcount reductions.

General and Administrative. General and administrative expenses consist primarily of salary and benefits for administrative officers and support personnel, travel expenses and legal, accounting and consulting fees. For the three months ended March 31, 2007, general and administrative expenses were $8.1 million, or 58% of revenues, compared to $5.2 million, or 24% of revenues for the three months ended March 31, 2006. The increase in general and administrative expense was generally attributable to an increase in investor relations charges of $0.2 million, and an increase in outside service fees of $2.4 million, which consisted of an increase of $1.9 million for contractors and an increase of $0.5 million for audit fees, partially offset by a decrease of $0.1 million in outside legal fees. General and administrative expenses for the three months ended March 31, 2007 also included an expense of $0.3 million for the settlement of patent infringement claims that we received from Dolby Laboratories Licensing Corporation (Dolby) in January 2007. The claims, which were settled on May 9, 2007, related to our non-payment of license fees to Dolby for software functionality embedded in certain of our DVS products.

Restructuring Charges, Executive Severance and Asset Write-offs.

There were no restructuring charges, executive severance and asset write-offs for the three months ended March 31, 2007, and such amounts were nominal for the three months ended March 31, 2006.
For further detail, refer to Note 6, Restructuring Charges and Asset Write-offs, to Condensed Consolidated Financial Statements.

Non-Operating Expenses

Interest income (expense), net and other income, net were as follows (in thousands, except percentages) (unaudited):

	Three months ended March 31,		Variance in Dollars	Variance in Percent
	2007	2006		
Interest income, net	$ 215	$ 301	$ (86)	(28.6)%
Other income (expense), net	$(895)	$(553)	$ (342)	(62.0)%

Interest income, net relates primarily to $0.2 million of income generated from investments in high-quality fixed income securities. We expect our interest income, net to decrease in future periods based upon reduced cash invested in such high-quality fixed income securities.

Other income, net is generally comprised of realized foreign currency gains and losses, realized gains or losses on investments, and income attributable to non-operational gains and losses. The increase in other expense, net for the quarter ended March 31, 2007 compared to the year ended March 31, 2006 was largely attributable to transaction expenses related to the proposed acquisition by Motorola, partially offset by the gain from a litigation settlement.

Income Tax Expense

With the exception of the three months ended June 30, 2006, we have generated losses since our inception. We have not recorded a tax provision based on net income for the year ended December 31, 2006, due to the large net operating loss carry forwards we have to offset any federal and state tax liability. In each of the three months ended March 31, 2007 and 2006, we recorded nominal income tax expense related primarily to foreign taxes.

We adopted SFAS Interpretation 48, Accounting for Uncertainty in Income Taxes, (FIN 48), on January 1, 2007. As a result of the implementation of FIN 48, we reduced our deferred tax assets reported as of December 31, 2006 by $13.9 million. The reduction was fully offset by a valuation allowance and therefore, did not have an impact to our financial statements. In addition, we did not recognize any adjustment to the liability for uncertain tax positions nor did we have any unrecognized tax benefits and therefore did not record any adjustment to the beginning balance of retained earnings on the balance sheet.

We file income tax returns in the U.S. federal jurisdiction, in the state of California, in various other states in the United States and in various foreign jurisdictions in which we have an office or physical location.

We have elected to record interest and penalties recognized in accordance with FIN 48 in the financial statements as a component of income tax expense. Any subsequent change in classification of interest and penalties will be treated as a change in accounting principle subject to the requirements of SFAS No. 154, Accounting Changes and Error Corrections.

Stock-Based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standards (SFAS) No. 123(R), Share-Based Payment, (SFAS 123(R)), which requires the measurement and recognition of stock-based compensation expense for share-based payment awards. We elected to adopt SFAS 123(R) using the modified prospective recognition method. The modified prospective recognition method requires us to recognize compensation cost for new and unvested stock options, restricted stock, restricted stock units and employee stock purchase plan shares. Under the modified prospective recognition method, prior period financial statements are not restated.

Prior to the adoption of SFAS 123(R) on January 1, 2006, we accounted for stock-based compensation using the intrinsic value method prescribed in Accounting Principles Board (APB) Opinion 25, Accounting for Stock Issued to Employees (APB 25). Under APB 25, compensation cost was measured as the excess, if any, of the quoted market price of our stock at the date of grant over the exercise price of the stock option granted. Under APB 25, compensation cost for stock options, if any, was recognized over the vesting period using the straight-line single option method.

During the three months ended March 31, 2007, we recorded total stock-based compensation of $0.4 million, compared to $0.8 million for the same period in 2006. At March 31, 2007, unamortized compensation expense related to outstanding unvested stock options that are expected to vest was approximately $2.5 million, compared to $4.8 million for the same period in 2006. This unamortized compensation expense is expected to be recognized over a weighted average period of approximately 2.2 years.

Litigation

See Part II, Item 1 Legal Proceedings.

Off-Balance Sheet Financings and Liabilities

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

Liquidity and Capital Resources

At March 31, 2007, we had $20.5 million in cash, cash equivalents and short-term investments as compared to $20.3 million at December 31, 2006. The $0.2 million increase from December 31, 2006 to March 31, 2007 was driven the release of $6.8 million of a deposit that was included in current assets and which related to a previously

leased jet aircraft.

Cash provided in operating activities for the quarter ended March 31, 2007 was $0.6 million compared to cash used in operating activities of $8.0 million in the same period in 2006. In the first quarter of 2007, cash used in operating activities was affected by a $7.0 million net loss, a decrease in deferred revenues of $1.4 million and a decrease in accounts payable of $1.1 million, offset by a decrease in accounts receivable of $2.7 million and a decrease in other assets of $7.3 million. In the first quarter of 2006, cash used in operating activities was affected by a $3.9 million net loss, a decrease in deferred revenues of $4.7 million and a $2.3 million decrease in accrued other liabilities, and offset by $2.4 million in non-cash inventory provisions included in net loss and a $7.5 million decrease in other assets.

In connection with our operating lease arrangement to lease a corporate aircraft, we deposited and pledged an aggregate amount of $7.5 million in cash in 2004 with the aircraft lessor, General Electric Capital Corporation (GECC), to secure our obligations under the lease. On March 28, 2007, GECC returned to us $6.8 million of the $7.5 million cash deposit held by GECC as collateral for the aircraft lease. GECC will retain $0.7 million in collateral (Repair Collateral) subject to GECC s completion of repairs, tests, inspections, and corrections to the aircraft, which GECC has estimated will cost $0.6 million. The remaining amount of the Repair Collateral, if any, will be returned to us.

Investing activities consisted primarily of net purchases and sales of short-term investments in the three months ended March 31, 2007 and 2006. Cash provided by investing activities for the three months ended March 31, 2007 was $3.7 million compared to cash provided by investing activities of $53.9 million in the same period in 2006. The proceeds from the sale of short-term investments in the first quarter of 2006 were required to repay all of our 5% convertible subordinated notes (Notes) in the first quarter of 2006.

There was no cash financing activities in the three months ended March 31, 2007. Cash used by financing activities in the three months ended March 31, 2006 was $65.1 million, due to the repayment of $65.1 million of face value for the Notes in the first quarter of 2006.

We currently believe that our current unrestricted cash, cash equivalents and short-term investment balances will be sufficient to satisfy our cash requirements for at least the next 12 months. In order to achieve profitability in the future, we will need to increase revenues, primarily through sales of more profitable products, and decrease costs and operating expenses. These statements are forward-looking in nature and involve risks and uncertainties. Actual results may vary as a result of a number of factors, including those discussed under Risk Factors in this Quarterly Report on Form 10-Q and our 2006 Form 10-K. We may need to raise additional funds in order to support more rapid expansion, develop new or enhanced services, respond to competitive pressures, acquire complementary businesses or technologies or respond to unanticipated requirements. We may seek to raise additional funds through private or public sales of securities, strategic relationships, bank debt, and financing under leasing arrangements or otherwise. If additional funds are raised through the issuance of equity securities, the percentage ownership of our current stockholders will be reduced, stockholders may experience additional dilution or such equity securities may have rights, preferences or privileges senior to those of the holders of our common stock. We cannot assure that additional financing will be available on acceptable terms, if at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to continue operations, develop our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could have a material adverse effect on our business, financial condition and operating results.

Contractual Obligations

The following table summarizes our contractual obligations as of March 31, 2007, and the effect such obligations are expected to have on our liquidity and cash flows in future periods (in millions) (unaudited):

	Payments Due by Period				
	Total	Less than 1 year	1-3 years	4-5 years	After 5 years
Unconditional Purchase Obligations	$ 6.7	$ 6.7	$ 0.0	$	$
Operating Lease Obligations	10.0	3.9	6.1		
Total Contractual Commitments	$ 16.7	$ 10.6	$ 6.1	$	$

We have unconditional purchase obligations to certain of our suppliers that support our ability to manufacture our products. The obligations require us to purchase minimum quantities of the suppliers products at a specified price. As of March 31, 2007, we had approximately $6.7 million of purchase obligations payable at various times throughout the remainder of 2007.

We entered into a lease agreement for $2.3 million to lease a facility of approximately 63,000 square feet for our main corporate headquarters from October 2006 through September 2009. We entered into a sub-sublease for

$6.7 million to sub-sublease a facility of approximately 141,000 square feet from October 2006 through October 2009.

The following table presents other commercial commitments, primarily required to support operating leases (in millions) (unaudited):

	Total Amounts Commited	Amount of Commitment Experation Per Period			
		Less than 1 year	1-3 years	4-5 years	After 5 years
Deposits	$ 0.7	$ 0.7	$	$	$
Standby Letters of Credit	0.4		0.4		
Total Commercial Commitments	$ 1.1	$ 0.7	$ 0.4	$	$

In 2002, we entered into an operating lease arrangement to lease a corporate aircraft. This lease arrangement was secured by a $9.0 million letter of credit. The letter of credit was reduced to $7.5 million in February 2003. During 2004, the $7.5 million letter of credit was converted to a cash deposit. In March 2004, in connection with our worldwide restructuring, we notified GECC of our intentions to locate a purchaser for our remaining obligations under this lease. In August 2004, we entered into an agreement with a third party to sublease the corporate aircraft through December 31, 2006, which sublease was subsequently extended through January 14, 2007. On

March 28, 2007, GECC returned to us $6.8 million of the $7.5 million cash deposit held by GECC as collateral for the aircraft lease. GECC will retain $0.7 million in Repair Collateral subject to GECC s completion of repairs, tests, inspections, and corrections to the aircraft, which GECC has estimated will cost $0.6 million. The remaining amount of the Repair Collateral, if any, will be returned to us. $0.7 million of Repair Collateral is included in the table above. As a result of our real estate lease commitments, we have $0.4 million of letters of credit outstanding.

Impact of Recently Issued Accounting Standards

In February 2006, the FASB issued SFAS No. 155, Accounting for Certain Hybrid Financial Instruments (SFAS 155) which amends SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133) and SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities (SFAS 140). Specifically, SFAS 155 amends SFAS 133 to permit fair value remeasurement for any hybrid financial instrument with an embedded derivative that otherwise would require bifurcation, provided the whole instrument is accounted for on a fair value basis. Additionally, SFAS 155 amends SFAS 140 to allow a qualifying special purpose entity to hold a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. SFAS 155 applies to all financial instruments acquired or issued after the beginning of an entity s first fiscal year that begins after September 15, 2006, with early application allowed. The adoption of SFAS 155 is not expected to have a material impact on the Company s results of operations or financial position.

In March 2006, the FASB issued SFAS No. 156, Accounting for Servicing of Financial Assets (SFAS 156), to simplify accounting for separately recognized servicing assets and servicing liabilities. SFAS 156 amends SFAS 140. Additionally, SFAS 156 applies to all separately recognized servicing assets and liabilities acquired or issued after the beginning of an entity s fiscal year that begins after September 15, 2006, although early adoption is permitted. The adoption of SFAS 156 is not expected to have a material impact on our results of operations or financial position.

In July 2006, the FASB issued FASB Interpretation 48, Accounting for Uncertainty in Income Taxes (FIN 48) an interpretation of FASB Statement No. 109, Accounting for Income Taxes (FASB 109). FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the financial statements tax positions taken or expected to be taken on a tax return, including decisions on whether or not to file in a particular jurisdiction. FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB 109, Accounting for Income Taxes. The provisions of FIN 48 are to be applied to all tax positions upon initial adoption of this standard. Only tax positions that meet a more-likely-than-not recognition threshold at the effective date may be recognized or continue to be recognized upon adoption of FIN 48. The cumulative effect of applying the provisions of FIN 48 are reported as an adjustment to the opening balance of retained earnings.

We adopted FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, we reduced our deferred tax assets reported as of December 31, 2006 by $13.9 million. The reduction was fully offset by a valuation allowance and therefore, did not have an impact to our financial statements. In addition, we did not recognize any adjustment to the liability for uncertain tax positions nor did we have any unrecognized tax benefits and therefore did not record any adjustment to the beginning balance of retained earnings on the balance sheet.

We file income tax returns in the U.S. federal jurisdiction, in the state of California, in various other states in the United States and in various foreign jurisdictions in which we have an office or physical location.

We have elected to record interest and penalties recognized in accordance with FIN 48 in the financial statements as a component of income tax expense. Any subsequent change in classification of interest and penalties will be treated as a change in accounting principle subject to the requirements of SFAS No. 154, Accounting Changes and Error Corrections.

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements (SFAS 157), which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. Earlier adoption is permitted, provided the company has not yet issued financial statements, including for interim periods, for that fiscal year. We are currently evaluating the impact of SFAS 157, but do not expect adoption to have a material impact on our consolidated financial position, results of operations or cash flows.

In September 2006, the Commission released Staff Accounting Bulletin (SAB) No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108). SAB 108 provides guidance on how the effects of prior-year uncorrected financial statement misstatements should be considered in quantifying a current year misstatement. SAB 108 requires registrants to quantify misstatements using both an income statement (rollover) and balance sheet (iron curtain) approach and evaluate whether either approach results in a misstatement that, when all relevant quantitative and qualitative factors are considered, is material. If prior year errors that had been previously considered immaterial are now considered material based on either approach, no restatement is required as long as management properly applied its previous approach and all relevant facts and circumstances were considered. If prior years are not restated, the cumulative effect adjustment is recorded in opening retained earnings as of the beginning of the fiscal year of adoption. SAB 108 is effective for fiscal years ending on or after November 15, 2006. The adoption of SAB 108 did not have a material impact on our financial statements.

In February 2007, the FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Liabilities (SFAS 159), which includes an amendment to FASB Statement No. 115, Accounting for Certain Investments in Debt and Equity Securities. SFAS 159 provides companies with an irrevocable option to report selected financial assets and liabilities at fair value with changes in fair value reported in earnings. SFAS 159 is effective for fiscal years beginning after November 15, 2007. We are currently evaluating

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the impact of SFAS 159, but do not expect adoption to have a material impact on our consolidated financial position, results of operations or cash flows.

Item 3. *Quantitative and Qualitative Disclosures About Market Risk*

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. The primary objective of our investment activities is to preserve principal while maximizing yields without significantly increasing risk. This is accomplished by investing in widely diversified short-term investments, consisting primarily of investment grade securities, substantially all of which mature within the next twenty-four months. A hypothetical 50 basis point increase in interest rates would not have a material impact on the fair value of our available-for-sale securities.

Foreign Currency Risk. A substantial majority of our revenue, expense and capital purchasing activity are transacted in U.S. dollars. However, we do enter into transactions from Belgium, United Kingdom, Hong Kong and Canada. If foreign currency rates were to fluctuate by 10% from the rates at March 31, 2007, our financial position, results of operations and cash flows would not be materially affected. However, we cannot guarantee that there will not be a material impact in the future.

Item 4. *Controls and Procedures*

Evaluation of Disclosure Controls and Procedures

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

In connection with the preparation of this Form 10-Q for the quarter ended March 31, 2007, management, under the supervision of the CEO and CFO, conducted an evaluation of disclosure controls and procedures. 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. Based on that evaluation, the CEO and CFO concluded that the Company s disclosure controls and procedures were not effective at a reasonable assurance level as of March 31, 2007 because of the material weaknesses in the Company s management report on internal controls over financial reporting included in Item 9A to its Annual Report on Form 10-K for the year ended December 31, 2006, as amended (2006 Form 10-K) and outlined below. As of March 31, 2007, none of the material weaknesses identified in the 2006 Form 10-K have been fully remediated, and each remains ongoing as of the filing date of this Form 10-Q. Because the material weaknesses described below have not been fully remediated as of the filing date of this Form 10-Q, the CEO and CFO continue to conclude that the Company s disclosure controls and procedures are not effective as of the filing date of this Form 10-Q.

As previously disclosed in the Company s Annual Report on Form 10-K for the year ended December 31, 2005 (2005 Form 10-K), in its Quarterly Reports on Form 10-Q for each of the first three quarters of 2006, and its 2006 Form 10-K, the following material weaknesses remained ongoing as of March 31, 2007 and as of the date of this filing:

Communication of Financial Information. The Company had insufficient controls related to the identification, capture and timely communication of financially significant information between certain parts of the organization and the accounting and finance department to enable these departments to account for transactions in a complete and timely manner;

Lack of Technical Accounting Expertise and Qualified Accounting Personnel. The Company did not have sufficient personnel with technical accounting expertise in the accounting and finance department, adequate review and approval procedures, and sufficient analysis and documentation in the analysis of GAAP to prepare external financial statements in accordance with GAAP. The Company did not have adequate personnel in its accounting and finance department, and additionally lacked sufficient qualified accounting and finance personnel to identify and resolve complex accounting issues in accordance with GAAP.

The Use of Estimates. The Company lacked policies and procedures for determining estimates and monitoring and adjusting balances related to certain accruals and provisions, and also lacked support for its conclusions on those estimates. The Company did not have controls in place to accurately estimate the accruals including the adequate review and approval of all significant accruals by management personnel.

Inadequate Controls over Documentation and Record Keeping.

The Company did not have sufficient controls in place to ensure the proper authorization and review of manual journal entries and the associated support documentation.

The Company did not have sufficient controls to address the amendment of sales orders with its customers. Sales orders could be amended through the amendment of the sales orders, purchase orders and agreements. When sales were amended through sales or purchase orders, the person processing the amendments would exercise discretion in inputting the revised terms and conditions and there was no consistent policy requiring the accounting and finance department to approve such amendments or even informing the accounting and finance department of such amendments.

The Company did not keep adequate documentation related to the analysis and reconciliation of certain general ledger accounts.

The Company did not retain certain corporate records in connection with the sale of certain subsidiaries to third parties.

Because of these material weaknesses, the CEO and CFO concluded that the Company did not maintain effective internal control over financial reporting as of March 31, 2007 or at the date of this filing.

Remediation of Previously Disclosed Material Weakness

As disclosed in the Company s 2005 Form 10-K, and in its Quarterly Reports on Form 10-Q for each of the first three quarters of 2006, the Company reported a material weakness in internal control over financial reporting related to revenue recognition. As described in the 2006 Form 10-K, based on the remediation steps detailed below and the subsequent testing of these remediation steps, as of December 31, 2006 and the date of this filing, the Company remediated the previously reported material weakness in internal control over financial reporting related to revenue recognition.

Revenue Recognition.

The Company previously did not properly recognize revenue on its video products in accordance with GAAP, specifically SOP 97-2, SAB 104 and EITF 00-21, and previously did not properly account for deferred revenue and related cost of goods sold. The Company previously acquired its video products as part of acquisitions completed by the Company in 1999 and 2000, and at that time determined that the products would be accounted for under SAB 101, as amended by SAB 104. The Company did not sufficiently evaluate its video products and continued to account for its video products in accordance with SAB 104 when revenue on the video products should have been accounted for in accordance with the software revenue recognition principles under SOP 97-2, SAB 104 and EITF 00-21. Additionally, the Company previously sold maintenance support contracts that included software upgrades with its video products and did not establish vendor specific objective evidence (VSOE) of fair value on the pricing of such maintenance contracts in accordance with SOP 97-2, SAB 104 and EITF 00-21. Because the Company continued to account for the video products and maintenance sold with the video products under SAB 104, the Company did not take the steps necessary to establish VSOE of fair value on the pricing of its maintenance products and revenue was recognized during incorrect periods.

The Company previously incorrectly recorded deferred revenue and cost of goods sold on the balance sheet for certain transactions. As a result of the Company s focus on revenue recognition described above, the Company identified invoices for which deferred revenue for these sales had been recognized but the criteria for revenue recognition had not been met. Accordingly, the Company corrected these errors in deferred revenue, deferred cost of goods sold, inventory and accounts receivable accounts and recognized revenue when title transferred or customer payments were reasonably assured and all criteria for revenue recognition were met. The Company has implemented the following remediation steps:

Remediation Steps:

The Company engaged the services of experienced accounting consultants to review the Company s books and close procedures on a monthly basis to assist management in ensuring that the Company s financial

statements are being recorded in accordance with GAAP.

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During the quarter ended September 30, 2006, the Company established a process where all significant accruals must be reviewed and approved by the Corporate Controller.

During the first three quarters of 2006, the Company s accounting and finance department, with the assistance of outside consultants, implemented procedures to recognize sales of its video products under the software accounting rules under SOP 97-2 in accordance with GAAP.

In 2006, the Company established pricing guidelines and internal procedures to ensure consistent pricing to allow for the establishment of VSOE of fair value for sales made with multiple element arrangements.

During the second and third quarters of 2005, the accounting and finance department established procedures surrounding the month-end close process to ensure that the information and estimates necessary for recognizing revenue in accordance with SOP 97-2 were available.

The Company provided its accounting staff with training on revenue recognition, including software accounting and project accounting, and GAAP, including attending seminars and conferences. Additional training will be provided on a regular and periodic basis and updated as considered necessary.

During the quarter ended March 31, 2006, the Company hired an experienced revenue accountant to review all revenue transactions and to ensure that revenues, cost of goods sold, deferred revenue and deferred cost of goods sold are properly accounted for in accordance with GAAP and the Company s policies.

Remediation Steps to Address Continuing Material Weaknesses

As described in the 2006 Form 10-K, in an effort to remediate the Company s identified continuing material weaknesses, management is in the process of implementing the following steps. While these continuing material weaknesses did not result in adjustments to the Company s consolidated financial statements for the quarter ended March 31, 2007, it is reasonably possible that, if not remediated, these material weaknesses could result in a material misstatement of the Company s financial statement accounts that might result in a material misstatement to a future annual or interim period. Management does not anticipate that the continuing material weaknesses will be remediated until the second half of the year ended December 31, 2007.

Communication of Financial Information.

During the quarter ended June 30, 2005, the Company established procedures to document the review of press releases to account for transactions in a complete and timely manner.

During the quarter ended June 30, 2005, the Company also improved the internal process of drafting and reviewing periodic reports by implementing additional management and external legal counsel review prior to their submission to the Company s independent registered public accounting firm.

Continue to monitor the communication channels between the Company s senior management and the Company s accounting and finance department and take prompt action, as necessary, to further strengthen these communication channels;

Implement training procedures for new employees and/or consultants in the accounting and finance department on the Company s disclosure procedures and controls, the Company and the Company s actions in previous reporting periods; and

Take steps to ensure that the Company senior management has timely access to all material financial and non-financial information concerning our business.

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Use of Estimates.

The Company has engaged the services of experienced accounting consultants to review the Company s books and close procedures on a monthly basis to assist management in ensuring that the Company s financial statements are being recorded in accordance with GAAP.

The Company continues to engage the services of an outside tax accounting firm to assist with the calculation of the Company s tax liabilities.

During the quarter ended September 30, 2006, the Company established a process where all significant accruals must be reviewed and approved by the Corporate Controller.

During the quarter ended June 30, 2006, the Company implemented a process to obtain and assess accruals for legal costs and expenses owed to third party vendors whereby the Company s legal department obtains monthly estimates from the third party vendors and reviews the amount reported by third party vendors for accuracy.

Lack of Technical Accounting Expertise and Qualified Accounting Personnel.

During the quarter ended June 30, 2006, the Company engaged experienced accounting consultants to act as the VP Finance, Corporate Controller and Revenue Recognition Accountant.

During the second, third and fourth quarters of 2006, the Company engaged expert accounting consultants to assist the Company s accounting and finance department with the management and implementation of controls surrounding revenue recognition, the administration of existing controls and procedures, the preparation of the Company s periodic reports and the documentation of complex accounting transactions.

The Company is increasing staffing in the accounting and finance department, and re-allocating duties to persons within the accounting and finance organization to maximize their skills and experience.

The Company continues to take steps to recruit additional qualified senior accounting personnel, including certified public accountants personnel with recent public accounting firm experience. The Company is looking to hire an accountant with SEC reporting experience.

Inadequate Controls over Documentation and Record Keeping.

During the quarter ended March 31, 2007, the Company s employees involved in order entry received training regarding the controls and procedures surrounding the amendment of sales orders. Additional training will be provided on a regular and periodic basis and updated as necessary to reflect any changes in the Company s or its customers business practices or activities.

The Company has established policies and procedures for the review and approvals of all manual journal entries.

The Company has adopted a policy requiring it to retain a copy of all corporate records in connection with dispositions of assets to third parties.

Improve the review process that occurs prior to providing the initial draft of the periodic report to our independent auditors for review.

The Company has developed monthly close schedules which include the timeline for completion and approval of reconciliations by the Corporate Controller.

During the quarter ended June 30, 2006, the Company entered into agreements with third parties that purchased assets from the Company in Israel. These agreements provide the Company with access to the corporate records and require the third parties to retain documents in accordance with Israeli law.

Subsequent Changes in Internal Control over Financial Reporting

Except for the changes in connection with the remediation efforts performed in regard to the material weaknesses described above, there were no changes in the Company s internal control over financial reporting that occurred during the quarter ended March 31, 2007 that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. ***Legal Proceedings***

Beginning in April 2000, several plaintiffs filed class action lawsuits in federal court against us and certain of our officers and directors. Later that year, the cases were consolidated in the United States District Court for the Northern District of California (Court) as *In re Terayon Communication Systems, Inc. Securities Litigation.* The Court then appointed lead plaintiffs who filed an amended complaint. In 2001, the Court granted in part and denied in part defendants motion to dismiss, and plaintiffs filed a new complaint. In 2002, the Court denied defendants motion to dismiss that complaint, which, like the earlier complaints, alleged that the defendants violated the federal securities laws by issuing materially false and misleading statements and failing to disclose material information regarding our technology. On February 24, 2003, the Court certified a plaintiff class consisting of those who purchased or otherwise acquired our securities between November 15, 1999 and April 11, 2000. On September 8, 2003, the Court heard defendants motion to disqualify two of the lead plaintiffs and to modify the definition of the plaintiff class. On September 10, 2003, the Court issued an order vacating the hearing date for the parties summary judgment motions, and, on September 22, 2003, the Court issued another order staying all discovery until further notice and vacating the trial date, which had been scheduled for November 4, 2003. On February 23, 2004, the Court issued an order disqualifying two of the lead plaintiffs and ordered discovery, which was conducted. In February 2006, we mediated the case with plaintiffs counsel. As part of the mediation, we reached a settlement of $15.0 million. After this mediation, our insurance carriers agreed to tender their remaining limits of coverage, and we contributed approximately $2.2 million to the settlement. On March 17, 2006, we, along with plaintiffs counsel, submitted the settlement to the Court and the shareholder class for approval. The Court held a hearing to review the settlement of the shareholder litigation on September 25, 2006. To date, the Court has not approved the settlement.

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

On June 23, 2006, a putative class action lawsuit was filed against us in the United States District Court for the Northern District of California by I.B.L. Investments Ltd. purportedly on behalf of all persons who purchased our common stock between October 28, 2004 and March 1, 2006. Zaki Rakib, Jerry D. Chase, Mark Richman and Edward Lopez are named as individual defendants. The lawsuit focuses on our March 1, 2006 announcement of the restatement of financial statements for the year ended December 31, 2004, and for the four quarters of 2004 and the first two quarters of 2005. On November 8, 2006, Adrian G. Mongeli was appointed lead plaintiff in the case, replacing I.B.L. Investments Ltd. On January 8, 2007, Mongeli filed an amended complaint, purportedly on behalf of all persons who purchased our common stock between June 28, 2001 and March 1, 2006. The amended complaint adds Ray Fritz, Carol Lustenader, Matthew Miller, Shlomo Rakib, Doug Sabella, Christopher Schaepe, Mark Slaven, Lewis Solomon, Howard W. Speaks, Arthur T. Taylor and David Woodrow as individual defendants, and also names Ernst & Young as a defendant. The amended complaint incorporates the prior allegations and includes new allegations relating to the restatement of our consolidated historical financial statements as reported in our Form 10-K filed on December 29, 2006. The plaintiffs are seeking damages, interest, costs and any other relief deemed proper by the court. An unfavorable ruling in this legal matter could materially and adversely impact our results of operations. On March 9, 2007, Terayon and the individual defendants filed a motion to dismiss the amended complaint. On March 23, 2007, Ernst & Young filed a motion to dismiss the amended complaint. Both motions are scheduled to be heard on July 24, 2007.

On April 22, 2005, we filed a lawsuit in the Superior Court of California, County of Santa Clara against Adam S. Tom (Tom) and Edward A. Krause (Krause) and a company founded by Tom and Krause, RGB Networks, Inc. (RGB). We sued Tom and Krause for breach of contract and RGB for intentional interference with contractual relations based on breaches of the Noncompetition Agreements entered into between us and Tom and Krause,

respectively. On May 24, 2006, RGB, Tom, and Krause filed a Notice of Motion and Motion For Leave To File a Cross-Complaint, in which the defendants stated that they intended to file counter-claims against us for misappropriation of trade secrets, unfair competition, tortious interference with contractual relations, and tortious interference with prospective economic advantage. On July 6, 2006, the court granted the defendants motion, and on July 20, defendants filed a cross-complaint for misappropriation of trade secrets, unfair competition, tortious interference with contractual relations, and tortious interference with prospective economic advantage. On August 21, 2006, we filed a demurrer to certain of those claims. The court granted our demurrer as to RGB s request for declaratory judgment. On November 9, 2006, we filed our answer to RGB s complaint. On March 26, 2007, we entered into a stipulation for settlement with RGB amicably resolving all outstanding litigation between the parties. On April 10, 2007 we entered into a formal settlement agreement with RGB, Tom, and Krause. The Company recorded the settlement as of March 31, 2007 and the settlement amount is included in other income and expense.

On September 13, 2005, a case was filed by Hybrid Patents, Inc. (Hybrid) against Charter Communications, Inc. (Charter) in the United States District Court for the Eastern District of Texas for patent infringement related to Charter s use of equipment (cable modems, cable modem termination systems (CMTS) and embedded multimedia terminal adapters (eMTAs)) meeting the Data Over Cable System Interface Specification (DOCSIS) standard and certain video equipment. Hybrid has alleged that the use of such products violates its patent rights. Charter has requested that we and others supplying it with equipment indemnify Charter for these claims. We and others have agreed to contribute to the payment of the legal costs and expenses related to this case and we have entered into a joint defense and cost sharing agreement with all named defendants in the suit. On May 4, 2006, Charter filed a cross-complaint asserting its indemnity rights against us and a number of companies that supplied Charter with cable modems. To date, this cross-complaint has not been dismissed. Trial is scheduled on Hybrid s claims for July 3, 2007. At this point, the outcome is uncertain and we cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Hybrid is successful in its claim against Charter and then elects to pursue other cable operators that use the allegedly infringing products.

On July 14, 2006, a case was filed by Hybrid against Time Warner Cable (TWC), Cox Communications Inc. (Cox), Comcast Corporation (Comcast), and Comcast of Dallas, LP (together, the MSOs) in the United States District Court for the Eastern District of Texas for patent infringement related to the MSOs use of data transmission systems and certain video equipment. Hybrid has alleged that the use of such products violates its patent rights. To date, we have not been named as a party to the action. The MSOs have requested that we and others supplying them with cable modems and equipment indemnify the MSOs for these claims. We and others have agreed to contribute to the payment of legal costs and expenses related to this case and we have entered into a joint defense and cost sharing agreement with all named defendants in the suit. Trial is scheduled on Hybrid s claims for July 3, 2007. At this point, the outcome is uncertain and we cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Hybrid is successful in its claim against the MSOs and then elects to pursue other cable operators that use the allegedly infringing products.

On September 16, 2005, a case was filed by Rembrandt Technologies, LP (Rembrandt) against Comcast in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, Rembrandt alleged that products and services sold by Comcast infringe certain patents related to cable modem, voice-over internet, and video technology and applications. To date, we have not been named as a party in the action, but we have received a subpoena for documents and a deposition related to the products we sold to Comcast. We continue to comply with this subpoena. Comcast has made a request for indemnity related to the products that we and others sold to them. We and others have agreed to contribute to the payment of legal costs and expenses related to this case and we have entered into a joint defense and cost sharing agreement with all named defendants in the suit. On February 1, 2007, the Court entered an order disqualifying Rembrandt s counsel and vacated all scheduled dates pending Rembrandt obtaining new counsel. At this point, the outcome is uncertain and we cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Rembrandt is successful in its claim against Comcast and then elects to pursue other cable operators that use the allegedly infringing products.

On June 1, 2006, a case was filed by Rembrandt against Charter, Cox, CSC Holdings, Inc. (CSC), and Cablevision Systems Corp. (Cablevision) in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, Rembrandt alleged that products and services sold by Charter infringe certain patents related to cable modem, voice-over internet, and video technology applications. To date, we have not been named as a party in the action, but Charter has made a request for indemnity related to the products that we and others have sold to them. We have not received an indemnity request from Cox, CSC and Cablevision but we expect that such request will be forthcoming shortly. To date, we and others have not agreed to contribute to the payment of legal costs and expenses related to this case. A trial date is not set at this time. At this point, the outcome is uncertain and we cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Rembrandt is successful in its claim against Charter and then elects to pursue other cable operators that use the allegedly infringing products.

On June 1, 2006, a case was filed by Rembrandt against TWC in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, Rembrandt alleged that products and services sold by

TWC infringe certain patents related to cable modem, voice-over internet, and video technology applications. To date, we have not been named as a party in the action, but TWC has made a request for indemnity related to the products that we and others have sold to them. We and others have agreed to contribute to the payment of legal costs and expenses related to this case. A trial date is not set at this time. At this point, the outcome is uncertain and we cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Rembrandt is successful in its claim against TWC and then elects to pursue other cable operators that use the allegedly infringing products.

On September 13, 2006, a second case was filed by Rembrandt against TWC in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, Rembrandt alleged that products and services sold by TWC infringe certain patents related to the DOCSIS standard. To date, we have not been named as a party in the action, but TWC has made a request for indemnity related to the products that we and others have sold to them. We and others have agreed to contribute to the payment of legal costs and expenses related to this case. A trial date is not set at this time. At this point, the outcome is uncertain and we cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Rembrandt is successful in its claim against TWC and then elects to pursue other cable operators that use the allegedly infringing products.

On January 31, 2007, a complaint was filed by GPNE Corp. (GPNE) against Time Warner Inc. (TWI), Comcast and Charter in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, GPNE alleged that products and services sold by TWI, Comcast and Charter infringe certain patents related to the DOCSIS standard (data transmission). To date, we have not been named as a party in the action, but TWC has made a request for indemnity related to the products that we and others have sold to them. We believe that Comcast and Charter will also make indemnity requests. We and others have agreed to contribute to the payment of legal costs and expenses related to this case. Trial date of this matter is not known at this time. On February 2, 2007, TWC filed a lawsuit against GPNE in the United States District Court for the District of Delaware requesting a declaratory judgment of non-infringement. At this point, the outcome is uncertain and we cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if GPNE is successful in its claim against TWI, Comcast and Charter and then elects to pursue other cable operators that use the allegedly infringing products.

On May 9, 2007, we entered into a settlement agreement with Dolby Laboratories Licensing Corporation (Dolby) for $0.3 million to settle our past infringement of certain Dolby patents and copyrighted works. Additionally, Dolby and us are entering into a license agreement to license such patents and copyrighted works beginning January 1, 2007.

We have received letters and other communications claiming that our technology infringes the intellectual property rights of others. We have consulted with our patent counsel and reviewed the allegations made by such third parties. If these allegations were submitted to a court, the court could find that our products infringe third party intellectual property rights. If we are found to have infringed third party rights, we could be subject to substantial damages and/or an injunction preventing us from conducting our business. In addition, other third parties may assert infringement claims against us in the future. A claim of infringement, whether meritorious or not, could be time-consuming, result in costly litigation, divert our management s resources, cause product shipment delays or require us to enter into royalty or licensing arrangements. These royalty or licensing arrangements may not be available on terms acceptable to us, if at all.

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

We may, in the future, take legal action to enforce our patents and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could negatively affect our business, results of operations and financial condition.

In December 2005, the Commission issued a formal order of investigation in connection with our accounting review of a series of contractual arrangements with Thomson Broadcast. These matters were previously the subject of an informal Commission inquiry. We cooperated fully with the Commission in order to bring the investigation to a conclusion as promptly as possible. On April 2, 2007, we received written notification from the staff of the

Commission that the Commission s investigation has been terminated and no enforcement action has been recommended at this time. The decision of the Commission to terminate the investigation is not a finding or judgment regarding the matters investigated, and should not be construed that we have been exonerated or that no action may ultimately result from the Commission s investigation of the matter.

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

Item 1A. *Risk Factors*

The reader should carefully consider, in connection with the other information in this report, the factors discussed in Part I, Item 1A Risk Factors on pages 12 through 37 of our Annual Report on Form 10-K for the year ended December 31, 2006, as amended (2006 Form 10-K). These factors could cause our actual results to differ materially from those stated in forward-looking statements contained in this document and elsewhere. In addition to the factors included in the 2006 Form 10-K, the reader should also consider the following risk factors:

Risks Related to the Proposed Acquisition by Motorola, Inc.

Our business and results of operations are likely to be affected by our announced acquisition by Motorola, Inc. (Motorola).

On April 21, 2007, we entered into an Agreement and Plan of Merger (Merger Agreement) with Motorola, and Motorola GTG Subsidiary VI Corporation, a wholly-owned subsidiary of Motorola (Merger Sub), pursuant to which Merger Sub will be merged with and into the Company, with the Company continuing as the surviving corporation and as a wholly-owned subsidiary of Motorola.

The uncertainty about the effect of the proposed acquisition may have an adverse effect on us. These uncertainties may impair our ability to retain and motivate key personnel until the acquisition is completed, and could cause customers and others that deal with us to defer purchases or other decisions concerning us, or to seek to change existing business relationships with us. Although we are attempting to mitigate this risk through communications with our customers, current and prospective customers could be reluctant to purchase our products or services due to uncertainty about the direction of the combined company s product offerings and its support and service of existing products. To the extent that our announcement of the acquisition creates uncertainty among customers such that one or more customers delay purchase decisions pending consummation of the planned acquisition, our results of operations could be negatively affected and could fall below the expectations of market analysts, which could cause a decline in our stock price. Finally, activities relating to the acquisition and related uncertainties could divert our management s and our employees attention from our day-to-day business, cause disruptions among our relationships with customers and business partners, and detract us from our ability to generate revenue and control costs. In addition, the Merger Agreement restricts us from taking certain specified actions without the consent of Motorola until the acquisition is completed. These restrictions may prevent us from pursuing attractive business opportunities that may arise prior to the completion of the acquisition.

Employee retention and recruitment may be particularly challenging during the pendency of the proposed acquisition, as employees and prospective employees may experience uncertainty about their future roles with Motorola. The departure of existing key employees or the failure of potential key employees to accept employment with us, despite our retention and recruiting efforts, could have a material adverse impact on our business, financial condition and operating results.

If the conditions to the proposed acquisition by Motorola set forth in the Merger Agreement are not met, the acquisition may not occur.

The obligation of Motorola and Merger Sub to consummate the merger is subject to a number of conditions described in the Merger Agreement, including, among others, the receipt of antitrust approval under the Hart-Scott-Rodino Antitrust Improvement Act of 1976, as amended. Approval of the merger by holders of a majority of our outstanding shares is required. The closing of the merger is also subject to closing conditions. These conditions are set forth in detail in the Merger Agreement, which we have previously filed with the Commission. We cannot assure you that each of the conditions will be satisfied. If the conditions are not satisfied or waived, the proposed

merger will not occur or will be delayed, and the market price of our common stock could decline.

Failure to complete the proposed acquisition by Motorola would negatively affect our business, financial condition, stock price and operating results.

If the merger is not completed, we could suffer a number of consequences that may adversely affect our business, financial condition, stock price and operating results, including the following:

- Activities relating to the acquisition and related uncertainties may lead to a loss of revenue and market position that we may not be able to regain if the acquisition does not occur;

- The price of our common stock may decline to the extent that the current market price of the common stock reflects an assumption that the acquisition will be completed;

- We could be required to pay Motorola a termination fee of $5.25 million under the circumstances described in the Merger Agreement;

- We would remain liable for our costs related to the acquisition, such as legal, accounting, investment banking fees and related expenses in connection with the merger;

- We may not be able to take advantage of alternative business opportunities or effectively respond to competitive pressures;

- Our management and employees attention would have been diverted for which they will have received little or no benefit;

- We may not be able to retain key employees;

- We may not be able to maintain effective internal control over financial reporting due to employee departures; and

- We would continue to be exposed to the general competitive pressures and risks discussed in Item 1A. Risk Factors of our 2006 Form 10-K, which pressures and risks may be increased if the acquisition is not completed.

Further, if the Merger Agreement is terminated and our Board of Directors determines to seek another merger or business combination, it may not be able to find a partner willing to pay an equivalent or more attractive price than that which would have been paid in the merger with Motorola.

Item 2. ***Unregistered Sales of Equity Securities and Use of Proceeds***

Not applicable.

Item 3. ***Defaults Upon Senior Securities***

Not applicable.

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

Not applicable.

Item 5. ***Other Information***

Not applicable.

Item 6. ***Exhibits***

Exhibit Number	Exhibit Description
2.1	Agreement and Plan of Merger, dated as of April 21, 2007 among Terayon Communication Systems, Inc., Motorola, Inc., and Motorola GTG Subsidiary VI Corp.(7)
3.1	Amended and Restated Certificate of Incorporation of Terayon Communication Systems, Inc.(5)
3.2	Bylaws of Terayon Communication Systems, Inc.(5)
3.3	Certificate of Amendment to Amended and Restated Certificate of Incorporation of Terayon Communication Systems, Inc.(5)
3.4	Certificate of Designation of Series A Junior Participating Preferred Stock.(4)
4.1	Specimen Common Stock Certificate.(2)
4.2	Amended and Restated Information and Registration Rights Agreement, dated April 6, 1998.(1)
4.3	Form of Security for Terayon Communication Systems, Inc. s 5% Convertible Subordinated Notes due August 1, 2007.(3)
4.4	Registration Rights Agreement, dated July 26, 2000, among Terayon Communication Systems, Inc. and Deutsche Bank Securities, Inc. and Lehman Brothers, Inc.(3)
4.5	Indenture, dated July 26, 2000, between Terayon Communication Systems, Inc. and State Street Bank and Trust Company of California, N.A.(3)
4.6	Rights Agreement, dated February 6, 2001, between Terayon Communication Systems, Inc. and Fleet National Bank.(4)
4.7	Rights Agreement Amendment, dated April 21, 2007 between Terayon Communication Systems, Inc. and Computershare Trust Company, N.A. (as successor in interest to Fleet National Bank).(7)
10.31	Termination Agreement, effective as of March 22, 2007, between Terayon Communications Systems, Inc. and General Electric Capital Corporation.(6)
10.32	2007 Executive Sales Commission Plan.
10.33	Amendment to Employment Agreement, dated May 10, 2007, between Terayon Communication Systems, Inc. and Matthew Aden.
10.34	Amendment to Employment Agreement, dated May 10, 2007, between Terayon Communication Systems, Inc. and Jerry Chase.
10.35	Amendment to Employment Agreement, dated May 10, 2007, between Terayon Communication Systems, Inc. and Mark Richman.

31.1	Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
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(1) Incorporated by reference to exhibits to our Registration Statement on Form S-1 filed on June 16, 1998 (File No. 333-56911).

(2) Incorporated by reference to exhibits to our Registration Statement on Form S-1/A filed on July 31, 1998 (File No. 333-56911).

(3) Incorporated by reference to our Registration Statement on Form S-3 filed on October 24, 2000 (File No. 333-48536).

(4) Incorporated by reference to our Report on Form 8-K filed on February 9, 2001.

(5) Incorporated by reference to our Report on Form 8-K filed on November 21, 2003.

(6) Incorporated by reference to our Report on Form 10-K filed on April 2, 2007.

(7) Incorporated by reference to our Report on Form 8-K filed on April 23, 2007.

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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.

TERAYON COMMUNICATION SYSTEMS, INC.

By: /s/ Mark A. Richman
Mark A. Richman
Chief Financial Officer

Date: May 10, 2007

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