HARMONIC INC
Form 10-Q
May 10, 2006

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

FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the Quarterly Period Ended March 31, 2006

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
Commission File No. 0-25826
HARMONIC INC.
(Exact name of Registrant as specified in its charter)

Delaware	**77-0201147**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

549 Baltic Way
Sunnyvale, CA 94089
(408) 542-2500
(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)
Securities registered pursuant to section 12(b) of the Act:
None
Securities registered pursuant to section 12(g) of the Act:
Common Stock, par value $.001 per share
Preferred Share Purchase Rights

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 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 (as defined in Rule 12b-2 of the Exchange Act). (Check one):

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

The number of shares outstanding of the Registrant s Common Stock, $.001 par value, was 74,168,674 on April 28, 2006.

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PART I

FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HARMONIC INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(In thousands, except par value amounts)	March 31, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 41,123	$ 37,818
Short-term investments	67,435	73,010
Accounts receivable, net of allowances of $3,153 and $3,230	43,329	43,433
Inventories	31,208	38,552
Prepaid expenses and other current assets	8,220	8,335
Total current assets	191,315	201,148
Property and equipment, net	16,463	17,040
Intangibles and other assets	7,384	8,109
Total assets	$ 215,162	$ 226,297
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 751	$ 812
Accounts payable	16,445	19,378
Income taxes payable	6,586	6,480
Deferred revenue	17,241	19,687
Accrued liabilities	34,407	37,438
Total current liabilities	75,430	83,795
Long-term debt, less current portion	301	460
Accrued excess facilities costs, long-term	17,717	18,357
Other non-current liabilities	10,064	10,703
Total liabilities	103,512	113,315
Commitments and contingencies (Notes 15 and 16)		
Stockholders equity:		
Preferred stock, $0.001 par value, 5,000 shares authorized; no shares issued or outstanding		
Common stock, $0.001 par value, 150,000 shares authorized; 74,150 and 73,636 shares issued and outstanding	74	74
Capital in excess of par value	2,051,834	2,048,090
Accumulated deficit	(1,939,863)	(1,934,715)

Accumulated other comprehensive loss		(395)		(467)
Total stockholders equity		111,650		112,982
Total liabilities and stockholders equity	$	215,162	$	226,297

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

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HARMONIC INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

(In thousands, except per share data)	**Three Months Ended March 31, 2006**	**Three Months Ended April 1, 2005**
Net sales	$ 56,221	$ 72,915
Cost of sales	36,341	45,868
Gross profit	19,880	27,047
Operating expenses:		
Research and development	9,948	9,459
Selling, general and administrative	15,713	15,325
Amortization of intangibles	91	958
Total operating expenses	25,752	25,742
Income (loss) from operations	(5,872)	1,305
Interest income, net	992	522
Other income (expense), net	(92)	(49)
Income (loss) before income taxes	(4,972)	1,778
Provision for income taxes	175	72
Net income (loss)	$ (5,147)	$ 1,706
Net income (loss) per share:		
Basic	$ (0.07)	$ 0.02
Diluted	$ (0.07)	$ 0.02
Weighted average shares:		
Basic	74,102	72,839
Diluted	74,102	74,375

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

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HARMONIC INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(In thousands)	Three Months Ended March 31, 2006	Three Months Ended April 1, 2005
Cash flows from operating activities:		
Net income (loss)	$ (5,147)	$ 1,706
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Amortization of intangibles	250	1,730
Depreciation	2,170	2,080
Stock-based compensation	1,627	5
Loss on disposal of fixed assets		89
Changes in assets and liabilities, net of effect of acquisition:		
Accounts receivable	(186)	9,148
Inventories	7,324	(171)
Prepaid expenses and other assets	183	2,419
Accounts payable	(2,933)	1,109
Deferred revenue	(3,144)	8,106
Income taxes payable	77	(566)
Accrued excess facilities costs	(1,193)	(1,147)
Accrued and other liabilities	(1,575)	(16,605)
Net cash provided by (used in) operating activities	(2,547)	7,903
Cash flows provided by (used in) investing activities:		
Purchases of investments	(18,609)	(19,787)
Proceeds from sales of investments	24,259	20,747
Acquisition of property and equipment	(1,593)	(1,815)
Acquisition of BTL, net of cash received		(5,955)
Net cash provided by (used in) investing activities	4,057	(6,810)
Cash flows from financing activities:		
Proceeds from issuance of common stock, net	2,073	4,243
Repayments under bank line and term loan	(220)	(386)
Repayments of capital lease obligations	(20)	(32)
Net cash provided by financing activities	1,833	3,825
Effect of exchange rate changes on cash and cash equivalents	(38)	140
Net increase in cash and cash equivalents	3,305	5,058
Cash and cash equivalents at beginning of period	37,818	26,603
Cash and cash equivalents at end of period	$ 41,123	$ 31,661

Supplemental disclosure of cash flow information:				
Income tax payments, net	$	103	$	51
Interest paid during the period	$	36	$	127
Non-cash investing and financing activities:				
Issuance of restricted common stock from BTL acquisition	$		$	1,831

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

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HARMONIC INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include all adjustments (consisting only of normal recurring adjustments) which Harmonic Inc. (the Company) considers necessary for a fair statement of the results of operations for the interim periods covered and the consolidated financial condition of the Company at the date of the balance sheets. This Quarterly Report on Form 10-Q should be read in conjunction with the Company s audited consolidated financial statements contained in the Company s Annual Report on Form 10-K and Form 10-K/A, which were filed with the Securities and Exchange Commission on March 14, 2006 and April 26, 2006, respectively. The interim results presented herein are not necessarily indicative of the results of operations that may be expected for the full fiscal year ending December 31, 2006, or any other future period. The Company s fiscal quarters end on the Friday nearest the calendar quarter end, except for the fourth quarter which ends on December 31.

The condensed consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

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

Note 2: Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board, FASB, issued Statement of Financial Accounting Standard, SFAS , No. 151, *Inventory Costs*, to amend the guidance in Chapter 4, *Inventory Pricing*, of FASB Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*. SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) and requires these costs be treated as current period charges. Additionally, SFAS No. 151 requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. The provisions of SFAS No. 151 are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 did not have a significant impact on the Company s financial condition or results of operations.

In May 2005, FASB issued SFAS No. 154, *Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3*. SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle, and applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. This statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting change made in fiscal years beginning after December 15, 2005. The adoption of this standard did not have an impact on our results of operations or financial condition.

Note 3: Stock-based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), 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

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stock purchases related to our Employee Stock Purchase Plan (ESPP) based upon the grant-date fair value of those awards. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations, and provided the required pro forma disclosures prescribed by Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, (SFAS 123) as amended. In addition, we have applied the provisions of Staff Accounting Bulletin No. 107 (SAB 107), issued by the Securities and Exchange Commission, in our adoption of SFAS No. 123(R).

The Company adopted SFAS 123(R) using the modified-prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company s fiscal year 2006. The Company s Condensed Consolidated Financial Statements as of and for the three months ended March 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s Condensed Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the three months ended March 31, 2006 was $1.6 million which consisted of stock-based compensation expense related to employee equity awards and employee stock purchases. There was no stock-based compensation expense related to employee equity awards and employee stock purchases recognized during the three months ended April 1, 2005.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service period in the Company s Condensed Consolidated Statement of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for employee equity awards and employee stock purchases using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123. Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company s Condensed Consolidated Statement of Operations because the exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s Condensed Consolidated Statement of Operations for the three months ended March 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company changed its method of attributing the value of stock-based compensation costs to expense from the accelerated multiple-option method to the straight-line single-option method. Compensation expense for all share-based payment awards granted on or prior to December 31, 2005 will continue to be recognized using the accelerated approach while compensation expense for all share-based payment awards related to stock options and employee stock purchase rights granted subsequent to December 31, 2005 are recognized using the straight-line method.

As stock-based compensation expense recognized in our results for the first quarter of fiscal year 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to fiscal year 2006, we accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

The fair value of share-based payment awards is estimated at grant date using a Black-Scholes-Merton option pricing model. The Company s determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as the assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors.

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Harmonic currently does not expect to receive any tax benefits in fiscal 2006 for any expense deductions resulting from expensing of stock options or shares issued under its ESPP plan. Harmonic currently provides a valuation allowance for most of its deferred tax assets, and a valuation allowance has also been provided for any tax effects of stock-based compensation expense pursuant to SFAS 123(R).

Note 4: BTL Acquisition

On February 25, 2005, Harmonic purchased all of the issued and outstanding shares of Broadcast Technology Limited, or BTL, a private UK company, for a purchase consideration of £4.0 million, or approximately $7.6 million. The purchase consideration consisted of a payment of £3.0 million in cash and the issuance of 169,112 shares of Harmonic common stock. In addition, Harmonic paid approximately $0.3 million in transaction costs for a total transaction price of approximately $7.9 million. The addition of BTL has expanded Harmonic s product line to include professional video/audio receivers and decoders. This enabled us to expand the scope of solutions we provide for existing and emerging cable, satellite, terrestrial broadcast and telecom applications. These factors contributed to a purchase price exceeding the fair value of BTL s net tangible and intangible assets acquired; as a result, we have recorded goodwill in connection with this transaction.

The BTL acquisition was accounted for under SFAS No. 141 and certain specified provisions of SFAS No. 142. The results of operations of BTL are included in Harmonic s Condensed Consolidated Statements of Operations from February 25, 2005, the date of acquisition. The following table summarizes the allocation of the purchase price based on the estimated fair value of the tangible assets acquired and the liabilities assumed at the date of acquisition (in thousands):

Cash acquired	$ 149
Other tangible assets acquired	2,508
Amortizable intangible assets:	
Existing technology	2,050
Customer relationships	540
Tradenames/trademarks	320
Order backlog	60
Goodwill	3,745
Total assets acquired	9,372
Liabilities assumed	(568)
Deferred tax liability for acquired intangibles	(891)
Net assets acquired	$ 7,913

Identified intangible assets, including existing technology and customer relationships are being amortized over their useful lives of three years; tradename/trademarks are being amortized over their useful lives of two years; and order backlog is being amortized over its useful life of three months.

The residual purchase price of $3.7 million has been recorded as goodwill. The goodwill as a result of this acquisition is not expected to be deductible for tax purposes. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill relating to the acquisition of BTL is not being amortized and will be tested for impairment annually or whenever events indicate that an impairment may have occurred.

Supplemental pro forma information is not provided because the acquisition of BTL was not material to the Company s financial statements for all periods presented.

Note 5: Cash, Cash Equivalents and Investments

At March 31, 2006 and December 31, 2005, cash, cash equivalents and short-term investments are summarized as follows (in thousands):

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	March 31, 2006	December 31, 2005
Cash and cash equivalents	$ 41,123	$ 37,818
Short-term investments:		
Less than one year	61,696	56,605
Due in 1-2 years	5,739	16,405
Total short-term investments	67,435	73,010
Total cash, cash equivalents and short-term investments	$ 108,558	$ 110,828

The following is a summary of available-for-sale securities (in thousands).

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
March 31, 2006				
U.S. government debt securities	$ 28,131	$ ¾	$ (152)	$ 27,979
Corporate debt securities	30,531	¾	(125)	30,406
Other debt securities	9,050	¾	¾	9,050
Total	$ 67,712	$ ¾	$ (277)	$ 67,435
December 31, 2005				
U.S. government debt securities	$ 20,264	$ ¾	$ (146)	$ 20,118
Corporate debt securities	46,873	3	(209)	46,667
Other debt securities	6,225	¾	¾	6,225
Total	$ 73,362	$ 3	$ (355)	$ 73,010

Impairment of Investments

We monitor our investment portfolio for impairment on a periodic basis. In the event that the carrying value of an investment exceeds its fair value and the decline in value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis for the investment is established. In order to determine whether a decline in value is other-than-temporary, we evaluate, among other factors: the duration and extent to which the fair value has been less than the carrying value; our financial condition and business outlook, including key operational and cash flow metrics, current market conditions and future trends in the company s industry; our relative competitive position within the industry; and our intent and ability to retain the investment for a period of time sufficient to allow any anticipated recovery in fair value.

In accordance with FASB Staff Position Nos. 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1), the following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of March 31, 2006 (in thousands):

	Less than 12 months		Greater than 12 months		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government debt securities	$ 11,399	$ (74)	$ 16,564	$ (78)	$ 27,963	$ (152)
Corporate debt securities	13,758	(74)	15,969	(51)	29,727	(125)
Total	$ 25,157	$ (148)	$ 32,533	$ (129)	$ 57,690	$ (277)

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The decline in the estimated fair value of these investments relative to amortized cost is primarily related to changes in interest rates and is considered to be temporary in nature.

Note 6: Inventories

(In thousands)	March 31, 2006	December 31, 2005
Raw materials	$ 12,687	$ 14,392
Work-in-process	1,955	4,131
Finished goods	16,566	20,029
	$ 31,208	$ 38,552

Note 7: Goodwill and Identified Intangibles

The following is a summary of goodwill and intangible assets as of March 31, 2006 and December 31, 2005 (in thousands):

	March 31, 2006			December 31, 2005		
	Gross Carrying Amount *	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Identified intangibles:						
Developed core technology	$ 29,684	$ (28,478)	$ 1,206	$ 29,663	$ (28,315)	$ 1,348
Customer base	31,904	(31,904)		31,904	(31,904)	
Trademark and tradename	4,194	(4,194)		4,190	(4,142)	48
Supply agreement	3,469	(3,151)	318	3,464	(3,109)	355
Subtotal of identified intangibles	69,251	(67,727)	1,524	69,221	(67,470)	1,751
Goodwill	4,399		4,399	4,896		4,896
Total goodwill and other intangibles	$ 73,650	$ (67,727)	$ 5,923	$ 74,117	$ (67,470)	$ 6,647

* Foreign currency translation adjustments, reflecting movement in the currencies of the underlying

entities, totaled approximately $0.2 and $0.3 million for intangible assets and approximately $0.3 and $0.3 million for goodwill as of March 31, 2006 and December 31, 2005, respectively.

The acquisition of BTL resulted in an increase in goodwill and intangible assets of $3.5 million and $2.7 million, respectively, during 2005. In addition, intangible assets decreased by $3.0 million in 2005 from the reversal of a reserve for a DiviCom pre-acquisition uncertain tax provision.

The changes in the carrying amount of goodwill for the three months ended March 31, 2006 are as follows (in thousands):

	Goodwill
Balance as of January 1, 2006	$ 4,896
Deferred taxes related to BTL acquisition	(531)
Foreign currency translation adjustments	34
Balance as of March 31, 2006	$ 4,399

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For the three months ended March 31, 2006, the Company recorded a total of $0.3 million of amortization expense for identified intangibles, of which $0.2 million was included in cost of sales. For the three months ended April 1, 2005, the Company recorded a total of $1.7 million of amortization expense for identified intangibles, of which $0.8 million was included in cost of sales. The estimated future amortization expense of purchased intangible assets with definite lives for the next three years is as follows (in thousands):