AETHER SYSTEMS INC
Form 10-Q
May 15, 2002

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

ý **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Period Ended March 31, 2002

or

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File Number: 000-27707

AETHER SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware (State or other jurisdiction of incorporation or organization)	**52-2186634** (IRS Employer Identification Number)
11460 Cronridge Dr., Owings Mills, MD (Address of principal executive offices)	**21117** (Zip Code)

(Registrant's telephone number, including area code): **(410) 654-6400**

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 $.01
Convertible Subordinated Notes Due 2005

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

The aggregate market value of the voting stock held by nonaffiliates of the registrant as of May 10, 2002 was $167,298,206.

As of May 10, 2002, 42,140,606 shares of the Registrant's common stock, $.01 par value per share, were outstanding.

AETHER SYSTEMS, INC.

QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED MARCH 31, 2002

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PART I FINANCIAL INFORMATION

ITEM I: FINANCIAL STATEMENTS

AETHER SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS, EXCEPT SHARE DATA)

	March 31, 2002	December 31, 2001
	(Unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 469,777	$ 522,177
Restricted cash	5,268	5,253
Short-term investments	2,444	2,490
Trade accounts receivable	23,206	24,802
Inventory	27,994	27,178
Prepaid expenses and other current assets	18,140	19,521
Total current assets	546,829	601,421
Property and equipment, net	57,608	61,304
Investments	23,108	32,350
Intangibles, net	236,080	226,774
Other noncurrent assets, net	27,761	27,571
	$ 891,386	$ 949,420
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Current portion of notes payable	$ 27,243	$ 15,493
Accounts payable	3,541	8,560
Accrued expenses	26,965	27,666
Accrued employee compensation and benefits	10,739	9,983
Deferred revenue	17,031	15,145
Current portion of restructuring reserve	20,740	15,452
Accrued interest payable	1,081	5,249
Total current liabilities	107,340	97,548
Convertible subordinated notes payable and other notes payable, less current portion	275,643	290,645
Deferred revenue, less current portion	4,761	6,380
Restructuring reserve, less current portion	16,230	12,365
Total liabilities	403,974	406,938
Minority interest in net assets of a subsidiary	(1,568)	(45)
Stockholders' equity:		
Preferred stock, $0.01 par value; 1,000,000 shares authorized; 0 shares issued and outstanding at March 31, 2002 and December 31, 2001		
Common stock, $0.01 par value;1,000,000,000 shares authorized; 42,047,110 and 41,864,646 shares issued and outstanding at March 31, 2002 and December 31, 2001, respectively	420	419
Additional paid-in capital	2,582,952	2,579,445
Accumulated deficit	(2,095,043)	(2,039,409)
Foreign currency translation adjustment	569	487
Unrealized gain on investments available for sale	82	1,585

	March 31, 2002		December 31, 2001	
Total stockholders' equity		488,980		542,527
Commitments and Contingencies				
Total liabilities and stockholders' equity	$	891,386	$	949,420

See accompanying notes to condensed consolidated financial statements.

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AETHER SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS
(IN THOUSANDS, EXCEPT PER SHARE DATA)
(unaudited)

	Three Months Ended March 31,			
	2002		2001	
Subscriber revenue	$	12,309	$	10,400
Engineering services revenue		1,623		2,363
Software and related services revenue		6,022		11,797
Device sales		3,718		6,099
Total revenue		23,672		30,659
Cost of subscriber revenue		7,354		6,234
Cost of engineering services revenue		803		1,300
Cost of software and related services revenue		2,176		4,082
Cost of device sales		3,431		8,217
Total cost of revenue		13,764		19,833
Gross profit		9,908		10,826
Operating expenses:				
Research and development (exclusive of option and warrant expense)		8,626		17,171
General and administrative (exclusive of option and warrant expense)		17,375		25,804
Selling and marketing (exclusive of option and warrant expense)		10,154		20,216
Depreciation and amortization		10,994		91,795
Option and warrant expense:				
Research and development		1,258		2,475
General and administrative		587		972
Selling and marketing		376		1,133
Impairment of intangibles and other assets		2,377		959,369

	Three Months Ended March 31,	
Restructuring charge	12,556	
Total operating expenses	64,303	1,118,935
Operating loss	(54,395)	(1,108,109)
Other income (expense):		
Interest income	2,502	11,101
Interest expense	(4,518)	(4,695)
Equity in losses of investments	(2,773)	(14,516)
Investment losses, including impairments, net	(4,235)	(94,744)
Minority interest	1,523	3,664
Loss before income taxes, extraordinary item and cumulative effect of change in accounting principle	(61,896)	(1,207,299)
Income tax benefit		435
Loss before extraordinary item and cumulative effect of change in accounting principle	(61,896)	(1,206,864)
Extraordinary item (early extinguishment of debt)	6,262	
Loss before cumulative effect of change in accounting principle	(55,634)	(1,206,864)
Cumulative effect of change in accounting principle relating to adoption of SFAS No. 133		6,564
Net loss	$ (55,634)	$ (1,200,300)
Other comprehensive loss:		
Unrealized holding losses on investments available for sale	(1,503)	(21,091)
Foreign currency translation adjustment	82	(354)
Comprehensive loss	$ (57,055)	$ (1,221,745)
Net loss per share-basic and diluted before extraordinary item and cumulative effect of change in accounting principle	$ (1.47)	$ (29.83)
Extraordinary item (early extinguishment of debt)	0.15	
Cumulative effect of change in accounting principle relating to adoption of SFAS No. 133		0.16
Net loss per share-basic and diluted	$ (1.32)	$ (29.67)
Weighted average shares outstanding basic and diluted	41,993	40,452

See accompanying notes to condensed consolidated financial statements.

AETHER SYSTEMS, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(DOLLARS IN THOUSANDS)
(unaudited)

	Three Months Ended March 31, 2002	Three Months Ended March 31, 2001
Cash flows from operating activities:		
Net loss	$ (55,634)	(1,200,300)
Adjustments to reconcile net loss to net cash used by operating activities:		
Depreciation and amortization	10,994	91,795
Provision for doubtful accounts	1,063	3,949
Provision for inventory obsolescence		1,895
Equity in losses of investments	2,773	14,516
Option and warrant expense	2,221	4,580
Minority interest	(1,523)	(3,664)
Deferred income tax benefit		(435)
Extraordinary item	(6,262)	
Cumulative effect of change in accounting principle		(6,564)
Impairment of intangibles	2,377	959,369
Investment losses, including impairments	4,235	94,744
Changes in assets and liabilities, net of acquired assets and liabilities:		
Decrease (increase) in trade accounts receivable	533	(5,773)
Decrease (increase) in inventory	8	(15,096)
Decrease (increase) in prepaid expenses and other assets	1,599	(3,784)
(Decrease) increase in accounts payable	(5,019)	4,174
Decrease in accrued expenses, accrued employee compensation and benefits, interest payable and acquisitions payable	(5,751)	(4,026)
Increase in restructuring reserve	9,520	
Increase in deferred revenue	267	2,461
Net cash used in operating activities	(38,599)	(62,159)
Cash flows from investing activities:		
Sales and maturities of short-term investments		3,286
Purchases of short-term investments		(3,411)
Acquisitions, net of cash acquired	(3,486)	(31,041)
Purchases of property and equipment	(2,342)	(15,366)
Purchase of long-term investments	(473)	(22,243)
Sale of long-term investments	1,235	
Increase in other intangible assets	(50)	(704)
Decrease in other assets		2,032
Net cash used in investing activities	(5,116)	(67,447)
Cash flows from financing activities:		
Proceeds from issuance of common stock	415	
Repayment of notes payable including buyback of convertible debt	(8,848)	

	Three Months Ended March 31,	
Repayments on notes payable/credit facility	(252)	(540)
Decrease in restricted cash		635
Exercise of options and warrants		409
Net cash (used in) provided by financing activities	(8,685)	504
Net decrease in cash and cash equivalents	(52,400)	(129,102)
Cash and cash equivalents, at beginning of period	522,177	856,391
Cash and cash equivalents, at end of period	$ 469,777	$ 727,289
Supplemental disclosure of cash flow information:		
Cash paid during the year for interest	$ 8,704	$ 9,315

Supplemental disclosure of non-cash investing and financing activities:

For the three months ended March 31, 2002 and 2001, the Company incurred unrealized holding losses associated with its investments available for sale totaling $1,503 and $21,091, respectively. These amounts have been reported as decreases in members' capital and stockholders' equity.

In connection with the acquisition of certain assets of @Track Communications, Inc. on March 18, 2002, the Company issued a note payable for $12.0 million. Such amount has been allocated to the fair value of the assets purchased.

See accompanying notes to condensed consolidated financial statements.

AETHER SYSTEMS, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE (1) ORGANIZATION, DESCRIPTION OF THE BUSINESS AND BASIS OF PRESENTATION

(a) ORGANIZATION AND DESCRIPTION OF THE BUSINESS

Aether Systems, Inc. ("the Company") was originally formed as Aeros, L.L.C. in January 1996. The Company changed its name to Aether Technologies International, L.L.C. effective August 1996 and to Aether Systems L.L.C. effective September 1999. Immediately prior to the completion of its initial public offering of common stock on October 26, 1999, the limited liability company was converted into a Delaware corporation and the Company's name was changed to Aether Systems, Inc.

The Company provides the services, software and support necessary for businesses to extend existing and future applications from the desktop to almost all currently available personal digital assistant (PDA) operating systems and their respective wireless devices. Through the Aether Fusion(TM) approach, the Company develops, deploys and manages wireless solutions built on industry standard technology and backed by the Company's expertise in wireless hosting, software and services.

The Company is focused on several growth areas including enterprise services, mobile government and transportation and logistics.

In the first quarter of 2002, the Company expanded its products, services, and customer base in the transportation and logistics market through the acquisition of certain assets and licenses from @Track Communications, Inc. ("@Track"). @Track is a leading provider of wireless-based vehicle fleet management and intelligent mobile-asset-tracking solutions.

(b) BASIS OF PRESENTATION

The condensed consolidated financial statements include the accounts of Aether Systems, Inc. and its subsidiaries. The condensed consolidated balance sheet as of March 31, 2002, the condensed consolidated statements of operations and other comprehensive loss for the three months ended March 31, 2002 and 2001, and the condensed consolidated statements of cash flows for the three months ended March 31, 2002 and 2001 have been prepared by the Company, without audit. In the opinion of management, all adjustments have been made, which include normal recurring adjustments necessary to present fairly the condensed consolidated financial statements. Operating results for the three months ended March 31, 2002 are not necessarily indicative of the operating results for the full year. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The Company believes that the disclosures provided are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company's Annual Report for the year ended December 31, 2001 on Form 10-K.

NOTE (2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) USE OF ESTIMATES

The preparation of consolidated financial statements in conformity with generally accepted accounting principles 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 dates of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates. Estimates are used in accounting for, among other things, long-term contracts, allowances for uncollectible receivables, inventory obsolescence, recoverability of long-lived assets and investments, depreciation and amortization,

employee benefits, restructuring accruals, taxes and contingencies. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary.

(b) RECENT ACCOUNTING PRONOUNCEMENTS

(i) SFAS No. 142

In June 2001, the FASB issued SFAS No. 142, "Goodwill and Other Intangible Assets", which is effective for fiscal years beginning after December 15, 2001. SFAS No. 142 requires, among other things, the discontinuance of goodwill amortization. In addition, the standard includes provisions, upon adoption, for the reclassification of certain existing and recognized intangibles as goodwill, reassessment of the useful lives of existing recognized intangibles, reclassification of certain intangibles out of previously reported goodwill and testing for impairment of existing goodwill and other intangibles. Upon adoption of SFAS No. 142 on January 1, 2002, the Company ceased to amortize approximately $161.1 million of goodwill and $9.9 million of assembled workforce which was combined with goodwill since the intangible asset no longer met the criteria to be separable from goodwill. The Company recorded approximately $78.4 million of amortization on these amounts during the first quarter of 2001 and would have recorded approximately $13.3 million of amortization during the first quarter of 2002. In lieu of amortization, the Company was required to begin an impairment review of its goodwill balance upon the initial adoption of SFAS No. 142. The impairment review involves a two-step process as follows:

Step 1 The Company will compare the fair value of its reporting units to the carrying value, including goodwill of each of those units. For each reporting unit where the carrying value, including goodwill, exceeds the unit's fair value, the Company will move on to step 2. If a unit's fair value exceeds the carrying value, no further work is performed and no impairment charge is necessary.

Step 2 The Company will perform an allocation of the fair value of the reporting unit to its identifiable tangible and non-goodwill intangible assets and liabilities. This will derive an implied fair value for the reporting unit's goodwill. The Company will then compare the implied fair value of the reporting unit's goodwill with the carrying amount of reporting unit's goodwill. If the carrying amount of the reporting unit's goodwill is greater than the implied fair value of its goodwill, an impairment loss must be recognized for the excess.

The Company is not yet required by the SFAS to complete, and has not yet completed, step 1 or step 2 of the impairment review. The Company must complete Step 1 of the impairment review during the second quarter of 2002 and must complete Step 2 prior to December 31, 2002. During the first quarter of 2002, the Company determined its reporting units and assigned its assets and liabilities to the respective reporting units. The Company also evaluated the estimated useful lives and separability of its identifiable intangible assets. The Company has no intangible assets with an indefinite useful life. Since year end, the Company's business has continued to be impacted by significant negative industry and economic trends. Additionally, the Company's stock price has continued to decline since December 31, 2001 and the Company's market capitalization is below the Company's book value. Accordingly, the Company may be required to record an impairment charge upon completing the impairment review required by SFAS No. 142, but is as yet unable to determine the effect this may have on its financial position or results of operations.

(ii) SFAS No. 144

In October 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 addresses significant issues relating to the implementation of SFAS No. 121 and develops a single accounting method under which long-lived assets that are to be disposed of by sale are measured at the lower of book value or fair value less cost to sell. Additionally, SFAS

No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and its provisions are to be applied prospectively. The Company's adoption of SFAS No. 144 on January 1, 2002 did not have a significant impact on its financial position or results of operations.

NOTE (3) ASSET PURCHASE CONSIDERATION

On March 18, 2002, the Company expanded its products, services, and customer base in the transportation and logistics market through the acquisition of certain assets and licenses from @Track. @Track is a leading provider of wireless-based vehicle fleet management and intelligent mobile-asset-tracking solutions. The purchase consideration (excluding approximately $486,000 of purchase related expenses) was $15.0 million consisting of $3.0 million in cash and a $12.0 million note payable. The note bears interest at 5.75% and is payable in equal monthly installments through June 2002 in either i) cash or ii) convertible preferred stock. This acquisition has been accounted for under the purchase method of accounting and, accordingly, the assets acquired and liabilities assumed have been recorded at their estimated fair value as of the acquisition date. The preliminary allocation of the total purchase price for this acquisition (subject to change upon finalization of the valuation) is summarized as follows:

	(Amounts in Thousands)
Current assets	$ 824
Property and equipment	702
Identifiable intangibles	2,815
Goodwill	11,145
Total consideration	$ 15,486

NOTE (4) RESTRUCTURING CHARGES

During each of the last three quarters in 2001, the Company had restructuring charges. The Company implemented an expense reduction plan as part of the Company's integration strategy focused on improving operational efficiencies and the implementation of other measures intended to reduce planned expenses. These efforts have resulted in the consolidation of excess facilities and a reduction in the Company's work force. The charge related mainly to a workforce reduction of over 480 positions and the closing or consolidation of twelve facilities. Employee separation benefits under the restructuring plan include severance, medical, and other benefits. Facility closure costs included expected losses on subleases, brokerage commissions, asset impairment charges, contract termination costs and other costs.

During the first quarter of 2002, the Company continued its expense reduction plan focused on improving operational efficiencies and the implementation of other measures in order to reduce planned expenses. These efforts have resulted in the further consolidation of excess facilities and elimination of positions. As a result of this restructuring plan, the Company recorded a charge to earnings in the first quarter of $12.6 million (including adjustments of approximately $2.4 million). The charge related mainly to a workforce reduction of over 225 positions and the closing or consolidation of three facilities. Employee separation benefits of $3.6 million under the restructuring plan include severance, medical, and other benefits. Facility closure and other costs of $8.9 million include expected losses on subleases, brokerage commissions, asset impairment charges, and other costs. As of March 31, 2002, the accrued liability balance related to the restructuring was $37.0 million.

Calculation of the restructuring accrual related to expected losses on subleases requires the Company to make estimates concerning: (1) the expected length of time to sublease the facility; (2) the expected rental rates on subleases; and, (3) estimated brokerage expenses associated with executing the sublease. The Company used the assistance of independent real estate brokerage firms in developing these estimates and the Company's estimates may be impacted by future economic trends. The expected losses on subleases have not been discounted. If the actual results differ from the Company's estimates, the Company may be required to adjust its restructuring accrual related to expected losses on subleases, including recording additional losses.

A rollforward of the restructuring accrual is as follows:

2001 Restructuring:	**Employee Separation Benefits**	**Facility Closure Costs and Other**	**Total**
Second quarter	4,870	10,989	15,859
Third quarter	4,070	14,528	18,598
Third quarter adjustments	(147)	(220)	(367)
Fourth quarter	1,435	6,386	7,821
Fourth quarter adjustments		3,095	3,095
Total restructuring charge	10,228	34,778	45,006
Second quarter reclassification from acquisition accounts		1,643	1,643
Cash payments	(8,626)	(10,206)	(18,832)
Restructuring liability as of December 31, 2001	1,602	26,215	27,817
2002 Restructuring:			
First quarter	3,631	6,490	10,121
First quarter adjustments		2,434	2,434
Total restructuring charge for period ending March 31, 2002	3,631	8,924	12,555
Cash payments	(1,160)	(2,242)	(3,402)
Total restructuring liability as of March 31, 2002	4,073	32,897	36,970

NOTE (5) OTHER RELATED PARTY TRANSACTIONS

RELATED PARTY REVENUE AND RECEIVABLES

In the ordinary course of business, the Company has entered into sales arrangements with entities in which the Company has equity interests or entities that have an equity interest in the Company. For the three months ended March 31, 2002 and 2001, the Company recorded revenue from these related parties aggregating approximately $731,000 and $5.1 million, respectively. Of the $731,000 in revenue for the period ended March 31, 2002, the Company recognized approximately $585,000 related to engineering work the Company is performing for AOL given our current percentage completion projections. Percentage completion projections are estimates made by the Company. If the Company made different judgments or utilized different estimates of the total amount of work it expects to be required to complete the project, the timing of its revenue recognition from period to period, and its margins on the project in this reporting period, may have differed materially from that reported. As of March 31, 2002 and 2001, the Company had accounts receivable from these related entities aggregating approximately, $613,000 and $7.6 million, respectively.

NOTE (6) COMMITMENTS AND CONTINGENCIES

LEGAL PROCEEDINGS

Aether and certain of its officers and directors are among the defendants named in nine purported class action lawsuits. These actions were filed on behalf of persons and entities who acquired the Company's common stock after its initial public offering in October 21, 1999. The suits seek damages on account of alleged violations of securities laws. Among other things, the complaints claim that prospectuses, dated October 21, 1999 and September 27, 2000 and issued by the Company in connection with the public offerings of common stock, allegedly contained untrue statements of material fact or omissions of material fact in violation of securities laws because the prospectuses allegedly failed to disclose that the offerings' underwriters had solicited and received additional and excessive fees, commissions and benefits beyond those listed in the arrangements with certain of their customers which were designed to maintain, distort and/or inflate the market price of Aether's common stock in the aftermarket. The actions seek unspecified monetary damages and rescission. The Company believes the claims are without merit and plans to vigorously contest these actions.

The Company is also a party to other legal proceedings in the normal course of business. Based on evaluation of these matters and discussions with counsel, the Company believes that liabilities arising from these matters will not have a material adverse effect on the consolidated results of its operations or financial position.

NOTE (7) SEGMENT INFORMATION

The Company's operating segments include Vertical Markets and European Operations. The Vertical Markets segment provides wireless data services software and engineering services to develop applications for the financial services, mobile government, transportation and logistics, real estate, automobile and insurance industries. The European Operations Segment consists of Sila, the Company's European joint venture with Reuters and has the majority of its customers in the European financial services industry. Corporate and Other consists mainly of corporate assets and selling general and administrative expenses.

The Company began to report its financial results by segment as of the first quarter of 2000. During 2001, the Company's reportable segments changed, and the Company expects them to continue to change, as its operating structure, business and the market in which it operates evolves.

Segment detail is summarized as follows:

	Vertical Markets	European Operations	Corporate and Other	Total
THREE MONTHS ENDED MARCH 31, 2002				
Revenue	$ 21,647	$ 2,072	$ (47)	$ 23,672
Gross Profit (loss)	$ 8,902	$ 1,058	$ (52)	$ 9,908
Total Assets	$ 313,419	$ 15,840	$ 562,127	$