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**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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(Mark one)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the quarterly period ended June 27, 2003.

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission File No. 0-25826

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**HARMONIC INC.**

(Exact name of Registrant as specified in its charter)

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Delaware

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(State or other jurisdiction of  
incorporation or organization)

77-0201147

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(I.R.S. Employer  
Identification Number)

549 Baltic Way  
Sunnyvale, CA 94089  
(408) 542-2500

(Address, including zip code, of principal executive offices,  
telephone number, including area code, of agent for service)

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

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  No

As of June 27, 2003, there were 60,462,318 shares of the Registrant's Common Stock outstanding.

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## PART I

## FINANCIAL INFORMATION

## ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

HARMONIC INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands, except par value amounts)	June 27, 2003	December 31, 2002
	(Unaudited)	
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 22,867	\$ 21,542
Short-term investments	13,443	27,616
Accounts receivable, net of allowances of \$4,914 and \$6,641, respectively	34,775	25,380
Inventories	21,644	25,904
Prepaid expenses and other current assets	3,554	5,494
	<u>96,283</u>	<u>105,936</u>
Total current assets	96,283	105,936
Property and equipment, net of accumulated depreciation of \$88,460 and \$82,043, respectively	27,295	32,456
Intangibles and other assets	28,378	35,362
	<u>\$ 151,956</u>	<u>\$ 173,754</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Current portion of long-term debt	\$ 1,581	\$ 1,862
Accounts payable	9,578	7,258
Income taxes payable	7,179	6,900
Accrued liabilities	59,336	58,670
	<u>77,674</u>	<u>74,690</u>
Total current liabilities	77,674	74,690
Long-term debt, less current portion	511	710
Accrued excess facilities costs, long-term	32,407	34,754
Other non-current liabilities	1,501	1,417
	<u>112,093</u>	<u>111,571</u>
Total liabilities	112,093	111,571
Commitments and contingencies (Notes 6, 12, 13)		
Stockholders' equity:		
Preferred Stock, \$.001 par value, 5,000 shares authorized; no shares issued or outstanding	—	—
Common Stock, \$.001 par value, 150,000 shares authorized; 60,462 and 60,064 shares issued and outstanding	60	60
Capital in excess of par value	1,964,120	1,963,234
Accumulated deficit	(1,924,474)	(1,901,125)
Accumulated other comprehensive income	157	14
	<u>39,863</u>	<u>62,183</u>
Total stockholders' equity	39,863	62,183
	<u>\$ 151,956</u>	<u>\$ 173,754</u>

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

**HARMONIC INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(IN THOUSANDS, EXCEPT PER SHARE DATA)**  
**(UNAUDITED)**

	Three Months Ended		Six Months Ended	
	June 27, 2003	June 28, 2002	June 27, 2003	June 28, 2002
Net sales	\$ 41,653	\$ 56,309	\$ 78,694	\$ 110,341
Cost of sales	28,901	37,074	55,195	75,343
Gross profit	12,752	19,235	23,499	34,998
Operating expenses:				
Research and development	8,431	10,795	16,934	21,914
Selling, general and administrative	14,408	17,026	26,471	32,347
Amortization of intangibles	1,933	2,828	3,866	5,656
Total operating expenses	24,772	30,649	47,271	59,917
Loss from operations	(12,020)	(11,414)	(23,772)	(24,919)
Interest and other income	438	290	623	283
Loss before income taxes	(11,582)	(11,124)	(23,149)	(24,636)
Provision for income taxes	100	—	200	500
Net loss	\$ (11,682)	\$ (11,124)	\$ (23,349)	\$ (25,136)
Net loss per share				
Basic and Diluted	\$ (0.19)	\$ (0.19)	\$ (0.39)	\$ (0.42)
Weighted average shares				
Basic and Diluted	60,462	59,552	60,457	59,513

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

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

	Six Months Ended	
	June 27, 2003	June 28, 2002
Cash flows from operating activities:		
Net loss	\$ (23,349)	\$ (25,136)
Adjustments to reconcile net loss to cash provided by (used in) operating activities:		
Amortization of intangibles	6,947	11,700
Depreciation	6,613	8,229
Stock option charge	23	372
Impairment and loss on disposal of fixed assets	62	660
Deferred income taxes	—	155
Changes in assets and liabilities:		
Accounts receivable	(9,336)	(4,072)
Inventories	4,303	3,097
Prepaid expenses and other assets	1,968	3,756
Accounts payable	2,320	696
Income taxes payable	279	3,271
Accrued excess facilities costs	(2,692)	(1,864)
Accrued and other liabilities	1,201	815
Net cash provided by (used in) operating activities	(11,661)	1,679
Cash flows from investing activities:		
Purchases of investments	(3,735)	(9,232)
Proceeds from sale of investments	17,907	8,473
Acquisition of property and equipment	(1,514)	(1,764)
Net cash provided by (used in) investing activities	12,658	(2,523)
Cash flows from financing activities:		
Borrowings under bank line and term loan	310	890
Repayments under bank line and term loan	(790)	(621)
Proceeds from issuance of Common Stock, net	863	2,449
Net cash provided by financing activities	383	2,718
Effect of exchange rate changes on cash and cash equivalents	(55)	(31)
Net increase in cash and cash equivalents	1,325	1,843
Cash and cash equivalents at beginning of period	21,542	36,005
Cash and cash equivalents at end of period	\$ 22,867	\$ 37,848
Supplemental disclosure of cash flow information:		
Interest expense	\$ 91	\$ 176
Income tax payments (refunds), net	\$ 23	\$ (3,045)

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

**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 presentation of the results of operations for the unaudited interim periods covered and the consolidated financial condition of the Company at the date of the balance sheets. The quarterly financial information is unaudited. 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, which was filed with the Securities and Exchange Commission on March 31, 2003. 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, 2003, 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 third quarter of 2003 will end on September 26 in order to better equalize the number of days within each quarter of 2003.

**NOTE 2 — SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Employee Stock Plans*

Harmonic accounts for employee stock option plans in accordance with Accounting Principles Board No. 25 ("APB 25"), "Accounting for Stock Issued to Employees," and has adopted the disclosure requirements under SFAS No. 148, "Accounting for Stock-Based Compensation — Transition and Disclosure," which was issued in December 2002. If charges for Harmonic's stock plans had been determined based on the fair value method at the grant dates, as prescribed in SFAS No. 123, "Accounting for Stock-Based Compensation," the Company's net loss and net loss per share would have been as follows:

In thousands, except per share data (Unaudited)	Three Months Ended		Six Months Ended	
	June 27, 2003	June 28, 2002	June 27, 2003	June 28, 2002
Net loss as reported	\$ (11,682)	\$ (11,124)	\$ (23,349)	\$ (25,136)
Deduct: Stock compensation expense included in net loss, net of related tax effects	—	—	—	372
Add: Total stock compensation expense determined under fair value based method for all awards, net of related tax effects	(3,099)	(2,245)	(5,939)	(7,138)
Pro forma net loss	\$ (14,781)	\$ (13,369)	\$ (29,288)	\$ (31,902)
Basic and Diluted net loss per share:				
As reported	\$ (0.19)	\$ (0.19)	\$ (0.39)	\$ (0.42)
Pro forma	\$ (0.24)	\$ (0.22)	\$ (0.48)	\$ (0.54)

These pro forma amounts may not be representative of the effects for future years as options vest over several years and additional awards are generally made each year.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes multiple option pricing model with the following weighted average assumptions:

	Employee Stock Options			
	Three Months Ended		Six Months Ended	
	June 27, 2003	June 28, 2002	June 27, 2003	June 28, 2002
Dividend yield	0.0%	0.0%	0.0%	0.0%

**Employee Stock Options**

	Three Months Ended		Six Months Ended	
	June 27, 2003	June 28, 2002	June 27, 2003	June 28, 2002
	Volatility	125%	122%	126%
Risk-free interest rate	2.0%	3.1%	2.2%	3.2%
Expected life (years)	3.5	3.2	3.6	3.4

**Employee Stock Purchase Plan**

	Three Months Ended		Six Months Ended	
	June 27, 2003	June 28, 2002	June 27, 2003	June 28, 2002
	Dividend yield	0.0%	0.0%	0.0%
Volatility	136%	140%	136%	140%
Risk-free interest rate	1.8%	3.0%	1.8%	3.0%
Expected life (years)	1.2	1.4	1.2	1.4

In accordance with SFAS No. 123, stock options granted to non-employees are valued using the Black-Scholes option-pricing model and stock expense is recognized as earned. Stock expense is recognized on an accelerated basis using the multiple option method presented in Financial Accounting Standards Board Interpretation No. 28 ("FIN 28"), "Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans." For the three and six month periods ended June 27, 2003, Harmonic recorded \$6 thousand and \$23 thousand, respectively, of non-employee stock expenses. Harmonic did not incur non-employee stock expense for the three and six month periods ended June 28, 2002.

*Recent Accounting Pronouncements*

In June 2002, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 146 ("SFAS 146"), "Accounting for Costs Associated with Exit or Disposal Activities." The standard requires companies to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. Harmonic adopted SFAS 146 effective January 1, 2003, and the adoption had no effect on the Company's financial position, results of operations, or cash flows.

In November 2002, the FASB issued FASB Interpretation No. 45 ("FIN 45"), "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others." FIN 45 requires the guarantor to recognize a liability for the fair value of the obligation undertaken in issuing or modifying guarantees. It also expands the disclosures to be made by a guarantor in its financial statements about its obligations under certain guarantees that it has issued and in regard to product warranties. Harmonic adopted FIN 45 effective January 1, 2003, and the adoption had no effect on the Company's financial position, results of operations, or cash flows.

In November 2002, the Emerging Issues Task Force ("EITF") reached a consensus on Issue No. 00-21, "Revenue Arrangements with Multiple Deliverables." EITF Issue No. 00-21 provides guidance on how to account for arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets. The provisions of EITF Issue No. 00-21 will apply to revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The Company believes that the adoption of EITF Issue No. 00-21 will have no material impact on its financial position, results of operations, or cash flows.

In January 2003, the FASB issued FASB Interpretation No. 46 ("FIN 46"), "Consolidation of Variable Interest Entities," which addresses accounting for the assets, liabilities and activities of another entity. Prior to the issuance of FIN 46, a company generally included another entity in its consolidated financial statements only if it controlled the entity through voting interests. FIN 46 now requires a variable interest entity, as defined in FIN 46, to be consolidated by a company if that company is subject to a majority of the risk of loss from the variable interest entity activities or is entitled to receive a majority of the entity's residual returns or both. FIN 46 also requires disclosures about variable interest entities that the company is not required to consolidate but in which it has a significant variable interest. The consolidation requirements of FIN 46 apply immediately to variable interest entities created after January 31, 2003 and to older entities in the first fiscal year or interim period beginning after June 15, 2003. Certain of the disclosure requirements apply to all financial statements issued after January 31, 2003, regardless of when the variable interest entity was established. The adoption of FIN 46 had no effect on the Company's financial position, results of operations, or cash flows.



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In April 2003, the FASB issued SFAS No. 149, "Amendment of Statement 133 on Derivative Instruments and Hedging activities." SFAS No. 149 amends and clarifies the accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities." SFAS No. 149 is generally effective for contracts entered into or modified after June 30, 2003 and for hedging relationships designated after June 30, 2003. The Company believes that the adoption of this standard will have no material impact on its financial position, results of operations, or cash flows.

In May 2003, the FASB issued SFAS No. 150, "Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity." SFAS No. 150 requires that certain financial instruments, which under previous guidance were accounted for as equity, must now be accounted for as liabilities. The financial instruments affected include mandatorily redeemable stock, certain financial instruments that require or may require the issuer to buy back some of its shares in exchange for cash or other assets and certain obligations that can be settled with shares of stock. SFAS No. 150 is effective for all financial instruments entered into or modified after May 31, 2003 and must be applied to existing instruments for the first interim period beginning after June 15, 2003. The Company believes that the adoption of this standard will have no material impact on its financial position, results of operations, or cash flows.

### NOTE 3 — CASH, CASH EQUIVALENTS AND INVESTMENTS

Cash equivalents are comprised of highly liquid investment-grade securities with original maturities of three months or less at the date of purchase. Harmonic's short-term investments are stated at fair value, which approximate the cost of investments and are comprised principally of corporate debt securities. The Company classifies its investments as available for sale in accordance with SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," and states its investments at estimated fair value, with unrealized gains and losses reported in other comprehensive income. The specific identification method is used to determine the cost of securities disposed of, with realized gains and losses reflected in other income and expense. Investments are anticipated to be used for current operations and are therefore classified as current assets, even though maturities may extend beyond one year. At June 27, 2003 and December 31, 2002, cash, cash equivalents and short-term investments are summarized as follows:

	June 27, 2003	December 31, 2002
In Thousands	(Unaudited)	
Cash and cash equivalents	\$ 22,867	\$ 21,542
Short-term investments:		
Less than one year	13,443	26,116
Due in 1-2 years	—	1,500
Total short-term investments	13,443	27,616
Total cash, cash equivalents and short-term investments	\$ 36,310	\$ 49,158

At June 27, 2003, \$4.5 million of cash is restricted under terms of the Company's credit agreement as disclosed in Note 6.

While Harmonic's cash balances declined \$12.8 million during the first half of 2003 and the Company expects to report a net loss at least through the third quarter, Harmonic currently believes that its existing liquidity sources, including the bank line of credit and trade receivables facilities, as limited by qualified receivables, will satisfy the Company's requirements for at least the next twelve months, including the final settlement and payment of C-Cube's pre-merger tax liabilities. If its measures to reduce its net loss and cash outflows prove to be inadequate or if its expectations or estimates change or prove inaccurate, Harmonic may need to raise additional funds to take advantage of unanticipated opportunities to strengthen its financial position. Harmonic's ability to raise funds may be adversely affected by a number of factors relating to Harmonic, as well as factors beyond its control, including increased market uncertainty surrounding the ongoing U.S. war on terrorism, as well as conditions in capital markets and the cable and satellite industries.

### NOTE 4 — INVENTORIES

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Inventories consist of:

	June 27, 2003	December 31, 2002
In Thousands	(Unaudited)	
Raw materials	\$ 8,100	\$ 10,944
Work-in-process	1,088	1,404
Finished goods	12,456	13,556
	<u>\$ 21,644</u>	<u>\$ 25,904</u>

NOTE 5 — GOODWILL AND IDENTIFIED INTANGIBLES

Harmonic accounts for goodwill and other intangibles in accordance with SFAS No. 142, "Goodwill and Other Intangible Assets", which requires, among other things, that goodwill and intangible assets with indefinite useful lives no longer be amortized and the testing of existing goodwill and other intangibles for impairment at least annually. Management believes the operating segments, BAN and CS, represent the Company's reporting units, and CS is the only reporting unit with goodwill and intangible assets. For the three months ended June 27, 2003 and June 28, 2002, the Company recorded a total of \$3.5 million and \$5.9 million, respectively, of amortization expense for identified intangibles of which \$1.5 million and \$3.0 million were included in cost of sales, respectively. For the six months ended June 27, 2003 and June 28, 2002, the Company recorded a total of \$7.0 million and \$11.7 million, respectively, of amortization expense for identified intangibles of which \$3.1 million and \$6.0 million were included in cost of sales, respectively. Estimated future amortization expense of identified intangibles, over the remaining useful lives of approximately two years, is \$7.0 million, \$13.9 million and \$4.6 million for the remaining six months of 2003, and the fiscal years 2004 and 2005, respectively. Future amortization expense to be included in cost of sales is estimated to be \$3.1 million for the remainder of 2003, and \$6.2 million and \$2.1 million for the fiscal years 2004 and 2005, respectively.

The following is a summary of goodwill and intangible assets as of June 27, 2003 and December 31, 2002:

In Thousands	June 27, 2003			December 31, 2002		
	Gross Carrying Amount	(Unaudited) Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Identified intangibles:						
Developed core technology	\$29,059	\$ (18,945)	\$10,114	\$29,059	\$ (16,186)	\$12,873
Customer base	33,295	(20,669)	12,626	33,295	(17,226)	16,069
Trademark and tradename	4,076	(2,526)	1,550	4,076	(2,103)	1,973
Supply agreement	3,107	(1,925)	1,182	3,107	(1,603)	1,504
Total of identified intangibles	69,537	(44,065)	25,472	69,537	(37,118)	32,419
Goodwill	1,780	—	1,780	1,780	—	1,780
Total goodwill and other intangibles	<u>\$71,317</u>	<u>\$ (44,065)</u>	<u>\$27,252</u>	<u>\$71,317</u>	<u>\$ (37,118)</u>	<u>\$34,199</u>

NOTE 6 — CREDIT FACILITIES AND LONG-TERM DEBT

Harmonic has a bank line of credit facility with Silicon Valley Bank, which provides for borrowings up to \$13.5 million, including \$3.5 million for equipment under a secured term loan. This facility, which expires in March 2004, contains financial and other covenants including the requirement for Harmonic to maintain on deposit with the bank the greater of 50% of total cash, cash equivalents and short-term investments or \$10.0 million, or satisfy a liquidity covenant in the event cash, cash equivalents and short-term investments are less than \$10.0 million. This provision of the facility causes a restriction on the Company's ability to use cash and cash equivalents. Depending on the level of borrowings, letters of credit and other guarantees outstanding at any point in time, the amount of the restriction on usage will vary. As of June 27, 2003, \$4.5 million of cash and cash equivalents was restricted as to usage. If Harmonic is unable to maintain on deposit with the bank the minimum balance of \$10.0 million, or satisfy the liquidity covenant requirement, Harmonic would be in noncompliance with the facility. In the event of noncompliance by Harmonic with the covenants under the facility, Silicon Valley Bank would be entitled to exercise its remedies under the facility, including in the event amounts are outstanding under the facility, offset rights against amounts Harmonic has maintained on deposit with the bank. At June 27, 2003, Harmonic was in compliance with these covenants. Future borrowings pursuant to the line bear interest at the bank's prime rate plus 0.25%-1.75% (prime rate plus 2%-3.75% for equipment borrowings) depending upon the Company's total cash position. Borrowings are payable monthly and are collateralized by all of Harmonic's assets. The Company has entered into an agreement with another financial institution holding amounts on deposit to allow, in the event of default, Silicon Valley Bank to control these deposits. As of June 27, 2003, \$2.1 million was outstanding under the equipment term loan portion of this facility of which \$0.1 million and \$0.2 million was borrowed during the first and second quarters of 2003, respectively. The term loan is payable monthly, including principal and interest at 6.25% per annum on outstanding borrowings as of June 27, 2003 which mature at various dates through January 2006. Other than standby letters of credit and guarantees (Note 12) there were no other outstanding borrowings or commitments under the line of credit facility as of June 27, 2003.

Harmonic also has a facility with Silicon Valley Bank that provides for the sale of trade receivables on a non-recourse basis up to \$12.5 million and expires in March 2004. Trade receivables sold under the facility are discounted based on the bank's prime rate plus 1.5% for North American customers and at a negotiated rate for all other customers. This facility was not utilized in 2002 or in the first half of 2003.

The Company's ability to utilize both facilities with Silicon Valley Bank depends to a significant extent on having a sufficient amount of qualified receivables, which may fluctuate depending on the level and timing of sales and the aging, customer concentration, international mix and credit quality of receivables. To the extent that the Company does not have sufficient qualified receivables, Harmonic's ability to utilize these facilities could be significantly constrained. Based upon current levels of receivables, the Company believes that it would not be able to utilize a significant portion of these facilities at this time.

NOTE 7 — NET LOSS PER SHARE

The basic net loss per share is computed by dividing the net loss attributable to common stockholders for the period by the weighted average number of common shares outstanding during the period. The diluted net loss per share is the same as the basic net loss per share for the three and six month periods ended June 27, 2003 and June 28, 2002 because common shares issuable upon the exercise of stock options are only considered when their effect would be dilutive. During the three month periods ended June 27, 2003 and June 28, 2002, 6.9 million and 7.4 million of weighted average antidilutive options were excluded from the net loss per share computations, respectively, because their effect was antidilutive. For the six month periods ended June 27, 2003 and June 28, 2002, 6.9 million and 5.5 million of weighted average antidilutive options were excluded from the net loss per share computations, respectively, because their effect was antidilutive.

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NOTE 8 — COMPREHENSIVE LOSS

The Company's total comprehensive loss was as follows:

In Thousands (Unaudited)	Three Months Ended		Six Months Ended	
	June 27, 2003	June 28, 2002	June 27, 2003	June 28, 2002
Net loss	\$ (11,682)	\$ (11,124)	\$ (23,349)	\$ (25,136)
Change in unrealized gain on investments, net	—	19	—	5
Foreign currency translation	37	(29)	143	(31)
Total comprehensive loss	\$ (11,645)	\$ (11,134)	\$ (23,206)	\$ (25,162)

NOTE 9 — RESTRUCTURING AND EXCESS FACILITIES

As a result of uncertain market conditions and lower sales during the second half of 2002, the Company implemented workforce reductions of approximately 120 full-time employees and changed its estimates related to accrued excess facilities with regard to the expected timing and amount of sublease income due to the substantial surplus of vacant commercial space in the San Francisco Bay Area. In connection with these actions, Harmonic recorded \$1.5 million and paid \$1.1 million for severance and other costs and recorded an additional excess facilities charge of \$22.5 million, net of sublease income, to selling, general and administrative expenses during the second half of 2002.

During the six months ended June 27, 2003, Harmonic paid \$259 thousand of severance and other costs, and expects to pay the balance of \$155 thousand during the remainder of 2003. As of June 27, 2003, accrued excess facilities cost totaled \$38.9 million of which \$6.5 million was included in current accrued liabilities and \$32.4 million in other non-current liabilities. The Company incurred cash outlays of \$2.7 million during the first half of 2003, principally for lease payments, property taxes, insurance and other maintenance fees related to vacated facilities. Harmonic expects to pay approximately \$3.0 million of excess facilities lease costs, net of estimated sublease income, for the remainder of 2003 and to pay the remaining \$35.9 million, net of estimated sublease income, over the remaining lease terms through September 2010. Harmonic reassesses the liability quarterly and adjusts as necessary based on changes in the timing and amounts of expected sublease rental income. In the event the Company is unable to achieve expected levels of sublease rental income, Harmonic will need to revise its estimate of the liability, which could materially impact the Company's financial position, liquidity, cash flows and results of operations.

The following table summarizes restructuring activities:

In thousands (Unaudited)	Workforce Reduction	Excess Facilities	Total
Balance at December 31, 2002	\$ 414	\$ 41,594	\$42,008
Cash payments	(259)	(2,692)	(2,951)
Balance at June 27, 2003	\$ 155	\$ 38,902	\$39,057

NOTE 10 — SEGMENT REPORTING

Operating segments are defined as components of an enterprise that engage in business activities for which separate financial information is available and evaluated by the chief operating decision maker. Harmonic is organized as two operating segments, Broadband Access Networks, or BAN, for fiber optic systems, and Convergent Systems, or CS, for digital headend systems. Each segment has its own management team directing its product development, marketing strategies and its customer service requirements. A separate sales force generally supports both divisions with appropriate product and market specialization as required.

The results of the reportable segments are derived directly from Harmonic's management reporting system. These results reported below are based on Harmonic's method of internal reporting and are not necessarily presented in conformity with generally accepted accounting principles. Management measures performance of each segment

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based on several metrics, including revenue, and income or loss from segment operations. These results are used, in part, to evaluate the performance of, and allocate resources to each of the segments. Income (loss) from segment operations excludes intangible amortization expense, corporate expenses, eliminations, and interest and other income. Corporate expenses and eliminations include human resources, legal, finance and other corporate departments and intercompany eliminations. Net income or loss, and assets and liabilities are not internally reported by business segment.

In Thousands (Unaudited)	Three Months Ended		Six Months Ended	
	June 27, 2003	June 28, 2002	June 27, 2003	June 28, 2002
<b>Net sales:</b>				
Broadband Access Networks	\$ 14,547	\$ 23,626	\$ 27,608	\$ 45,438
Convergent Systems	27,106	32,683	51,086	64,903
<b>Total net sales</b>	<b>\$ 41,653</b>	<b>\$ 56,309</b>	<b>\$ 78,694</b>	<b>\$ 110,341</b>
<b>Income (loss) from segment operations:</b>				
Broadband Access Networks	\$ (647)	\$ 1,958	\$ (2,074)	\$ 1,017
Convergent Systems	(1,574)	(1,678)	(5,065)	(4,640)
<b>Income (loss) from segment operations</b>	<b>(2,221)</b>	<b>280</b>	<b>(7,139)</b>	<b>(3,623)</b>
Amortization of intangibles	(3,473)	(5,850)	(6,946)	(11,700)
Interest and other income	438	290	623	283
Corporate expenses and eliminations	(6,326)	(5,844)	(9,687)	(9,596)
<b>Loss before income taxes</b>	<b>\$ (11,582)</b>	<b>\$ (11,124)</b>	<b>\$ (23,149)</b>	<b>\$ (24,636)</b>

**NOTE 11 — RELATED PARTY**

Lewis Solomon, a director of Harmonic since January 2002, is CEO of Broadband Services Inc. (BSI). BSI purchases products from Harmonic in connection with its supply chain management and fulfillment services business. Harmonic did not recognize any revenue from BSI in the second quarter of 2003 and revenue from BSI for the six months ended June 27, 2003 was approximately \$31 thousand. For the three and six month periods ended June 28, 2002, revenues from BSI were \$4.4 million and \$7.2 million, respectively. There was no accounts receivable balance from BSI as of June 27, 2003 and as of December 31, 2002, accounts receivable from BSI was \$0.4 million. Mr. Solomon is also a director of Terayon Communications, with whom the Company has a reseller agreement for certain products. As of June 27, 2003 and December 31, 2002, Harmonic had liabilities to Terayon of \$0.5 million and \$0.5 million, respectively, for inventory purchases.

**NOTE 12 — GUARANTEES AND INDEMNIFICATIONS**

*Warranties.* The Company accrues for estimated warranty costs at the time of product shipment. Management periodically reviews the estimated fair value of its warranty liability and adjusts based on the terms of warranties provided to customers, historical and anticipated warranty claims experience, and estimates of the timing and cost of specified warranty claims. Activity for the Company's warranty accrual, which is included in accrued liabilities, is summarized below (in thousands):

Balance as of December 31, 2002	\$ 5,866
Accrual for warranties	1,859
Warranty costs incurred	(2,930)
<b>Balance as of June 27, 2003</b>	<b>\$ 4,795</b>

*Standby Letters of Credit.* As of June 27, 2003 the Company's financial guarantees consisted of standby letters of credit outstanding, which were related to customs bond requirements and corporate purchase cards. The maximum amount of potential future payments under these arrangements was \$1.0 million.

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*Guarantees.* As of June 27, 2003, Harmonic had a no outstanding guarantees.

*Indemnifications.* Harmonic indemnifies the members of its Board of Directors and its officers pursuant to the requirements of its bylaws and indemnification agreements with such individuals, and some of its suppliers and customers for specified intellectual property rights pursuant to certain parameters and restrictions. The scope of these indemnities varies, but in some instances, includes indemnification for damages and expenses (including reasonable attorneys' fees). No amounts have been accrued in respect of the indemnifications provisions at June 27, 2003.

### NOTE 13 — LEGAL PROCEEDINGS

Between June 28 and August 25, 2000, several actions alleging violations of the federal securities laws by Harmonic and certain of its officers and directors (some of whom are no longer with Harmonic) were filed in or removed to the United States District Court for the Northern District of California. The actions subsequently were consolidated.

A consolidated complaint, filed on December 7, 2000, was brought on behalf of a purported class of persons who purchased Harmonic's publicly traded securities between January 19 and June 26, 2000. The complaint also alleged claims on behalf of a purported subclass of persons who purchased C-Cube securities between January 19 and May 3, 2000. In addition to Harmonic and certain of its officers and directors, the complaint also named C-Cube Microsystems Inc. and several of its officers and directors as defendants. The complaint alleged that, by making false or misleading statements regarding Harmonic's prospects and customers and its acquisition of C-Cube, certain defendants violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The complaint also alleged that certain defendants violated section 14(a) of the Exchange Act and sections 11, 12(a)(2), and 15 of the Securities Act of 1933 by filing a false or misleading registration statement, prospectus, and joint proxy in connection with the C-Cube acquisition.

On July 3, 2001, the Court dismissed the consolidated complaint with leave to amend. An amended complaint alleging the same claims against the same defendants was filed on August 13, 2001. Defendants moved to dismiss the amended complaint on September 24, 2001. On November 13, 2002, the Court issued an opinion granting the motions to dismiss the amended complaint without leave to amend. Judgment for defendants was entered on December 2, 2002. On December 12, 2002, plaintiffs filed a motion to amend the judgment and for leave to file an amended complaint pursuant to Rules 59(e) and 15(a) of the Federal Rules of Civil Procedure. On June 6, 2003, the Court denied plaintiffs' motion to amend the judgment and for leave to file an amended complaint.

Plaintiffs filed a notice of appeal on July 1, 2003. According to the scheduling order issued by the Court on July 3, 2003, plaintiffs' opening brief is due on October 17, 2003. No hearing date has been scheduled.

A derivative action purporting to be on behalf of Harmonic was filed against its then-current directors in the Superior Court for the County of Santa Clara on September 5, 2000. Harmonic also was named as a nominal defendant. The complaint is based on allegations similar to those found in the securities class action and claims that the defendants breached their fiduciary duties by, among other things, causing Harmonic to violate federal securities laws. The derivative action was removed to the United States District Court for the Northern District of California on September 20, 2000. All deadlines in this action were stayed pending resolution of the motions to dismiss the securities class action. On July 29, 2003, the Court approved the parties' stipulation to dismiss this derivative action without prejudice and to toll the applicable limitations period. The limitations period is tolled until fourteen days after (1) defendants provide plaintiff with a copy of the mandate issued by the Ninth Circuit in the securities action or (2) either party provides written notice of termination of the tolling period, whichever occurs first.

A second derivative action purporting to be on behalf of Harmonic was filed in the Superior Court for the County of Santa Clara on May 15, 2003. It alleges facts similar to those previously alleged in the securities class action and the federal derivative action. The complaint names as defendants former and current Harmonic officers and directors, along with former officers and directors of C-Cube Microsystems, Inc., who were named in the securities class action. The complaint also names Harmonic as a nominal defendant. The complaint alleges claims for abuse of control, gross mismanagement, and waste of corporate assets against the Harmonic defendants, and claims for breach of fiduciary duty, unjust enrichment, and negligent misrepresentation against all defendants. The action has

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been stayed pending resolution of the appeal in the securities class action. The parties have agreed in principle to a dismissal without prejudice and a tolling of the statute of limitations period on similar terms as in the federal derivative action.

Based on its review of the complaints filed in the securities class action, Harmonic believes that it has meritorious defenses and intends to defend itself vigorously. There can be no assurance, however, that Harmonic will prevail. No estimate can be made of the possible range of loss associated with the resolution of this contingency and accordingly, the Company has not recorded a liability. An unfavorable outcome of this litigation could have a material adverse effect on Harmonic's business, operating results, financial position and cash flows.

Harmonic announced on July 17, 2003 a settlement of its litigation with Power and Telephone Supply (P&T) in Federal court in Tennessee. Under the terms of the settlement agreement, Harmonic agreed to pay \$2.8 million to P&T in release of all outstanding claims. The settlement followed summary judgment against Harmonic on certain of the claims made by P&T under a Tennessee statute relating to retailers and suppliers. These claims arose from the cancellation of purchase orders on P&T by one of its end-customers in 2000. Harmonic's operating results for the second quarter and first half of 2003 include a charge to general and administrative expense of approximately \$2.7 million related to the settlement with P&T. The settlement charge is after accounting for the value of products to be returned and other costs. Harmonic paid \$1.0 million of the settlement on July 24, 2003 and is obligated to pay the balance of \$1.8 million on January 15, 2004. The settlement payments are secured by a standby letter of credit.

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of Harmonic's products infringe U.S. Patent No. 4,859,016. This patent expires in September 2003. The complaint seeks injunctive relief, royalties and damages. Harmonic has not been served in the case. Harmonic is currently evaluating its position with respect to this patent and has engaged in discussions with the plaintiff regarding potential settlement of the matter. At this time, Harmonic is unable to determine whether Harmonic will be able to settle this matter on reasonable terms or at all, nor can Harmonic predict the impact of an adverse outcome of this matter if Harmonic elects to defend against it. No estimate can be made of the possible range of loss associated with the resolution of this contingency and accordingly, the Company has not recorded a liability associated with the outcome of a negotiated settlement or an unfavorable verdict in litigation. An unfavorable outcome of this matter could have a material adverse effect on Harmonic's business, operating results, financial position and cash flows.

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding future operating results, industry capital spending and market conditions, future capital expenditures, future cash flows, future cost reduction actions, future interest income, future tax provisions and liabilities, future borrowing capability and future liquidity. These statements involve risks and uncertainties as well as assumptions that, if they were to never materialize or prove incorrect, could cause actual results to differ materially from those projected, expressed or implied in the forward-looking statements. These risks and uncertainties include those set forth under "Factors That May Affect Future Results of Operations" below and elsewhere in this Form 10-Q and that are otherwise described from time to time in Harmonic's filings with the Securities and Exchange Commission.

### Overview

Harmonic designs, manufactures and sells a variety of broadband solutions that allow communications service providers around the world to deliver video, voice and data to their subscribers. Harmonic's fiber optic, digital video and data delivery systems enable network operators to provide a range of interactive and advanced digital services that include digital video, high-speed Internet access, telephony, HDTV, video and audio streaming, and video-on-demand.

Historically, almost all of our sales were derived directly or indirectly from sales of fiber optic transmission systems to cable television operators. With the introduction of digital headend products beginning in 1997, we broadened our product offering to enable delivery of digital video, voice and data over satellite and wireless networks and cable systems.

In order to further expand our digital systems capability, Harmonic acquired C-Cube Microsystems Inc. in May 2000, pursuant to the terms of a merger agreement dated October 27, 1999. Under the terms of the merger agreement, C-Cube spun off its semiconductor business as a separate publicly traded company, which was subsequently acquired by LSI Logic in June 2001. C-Cube merged into Harmonic and Harmonic therefore acquired C-Cube's DiviCom business, which provides encoding products and systems for digital television. The merger was structured as a tax-free exchange of stock and has been accounted for under the purchase method of accounting. The purchase price, including merger-related costs, was approximately \$1.8 billion. As of December 31, 2000, the Company determined that there was an impairment and recorded an impairment charge of \$1.4 billion, eliminating goodwill and reducing identified intangibles acquired to \$79.3 million. The merged company has been organized into two operating divisions, Broadband Access Networks, or BAN, for fiber optic systems and Convergent Systems, or CS, for digital headend systems.

Harmonic's net sales decreased 26% in the second quarter of 2003 compared to the second quarter of 2002, and decreased 29% in the first half of 2003 compared to the first half of 2002. The decreased net sales reflected a more cautious capital spending environment worldwide, which adversely impacted sales of each division. BAN division and CS division sales decreased 38% and 17% in the second quarter of 2003, respectively, compared to the second quarter of 2002. For the first half of 2003, BAN and CS sales decreased 39% and 21%, respectively.

Since the middle of 2000, Harmonic's sales have been well below levels achieved by Harmonic and DiviCom in 1999 and early 2000 as industry capital spending has been and generally remains weak. In addition, certain of our domestic and international customers have accumulated significant levels of debt and have announced during the past two years reorganizations and financial restructurings, including bankruptcy filings. In particular, Adelphia Communications declared bankruptcy in June 2002, and as a result, we have recorded reduced revenue from Adelphia since the first quarter of 2002 and established a \$2.9 million provision in the second quarter of 2002 for probable losses on receivables and deferred costs of sales determined to no longer be recoverable. Adelphia accounted for approximately 5% of our net sales in the first quarter of 2002 and approximately 2% of our net sales for the full year in 2002 and the first half of 2003. The stock prices of other domestic cable companies came under pressure following the Adelphia Communications bankruptcy due to concerns about debt levels and capital expenditure requirements for new and expanded services. These issues may further restrict our customers' access to capital and increase the cost of capital.



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We believe that these capital market concerns about the cable industry and the associated pressures on capital spending contributed to our lower sales during the second quarter and first half of 2003 and we expect capital spending by domestic cable customers to remain at reduced levels at least through the third quarter of 2003. In addition, while spending by Harmonic's international customers increased sequentially in the second quarter of 2003, international sales generally remained weak. We believe that this was due in part to financial restructurings and regulatory issues in Europe.

Operating results for the second quarter and first half of 2003 include a charge to general and administrative expense of approximately \$2.7 million related to the settlement of litigation with Power and Telephone Supply (P&T) in Federal court in Tennessee. Under the terms of the settlement agreement announced on July 17, 2003, Harmonic agreed to pay \$2.8 million to P&T in release of all outstanding claims. The settlement followed summary judgment against Harmonic on certain of the claims made by P&T under a Tennessee statute relating to retailers and suppliers. These claims arose from the cancellation of purchase orders on P&T by one of its end-customers in 2000. The settlement charge is after accounting for the value of products to be returned and other costs. Harmonic paid \$1.0 million of the settlement on July 24, 2003 and is obligated to pay the balance of \$1.8 million on January 15, 2004. The settlement payments are secured by a standby letter of credit.

As a result of uncertain market conditions and lower sales during the second half of 2002, the Company implemented a series of cost control measures that included workforce reductions totaling approximately 120 employees during the second half of 2002. Harmonic recorded severance charges of \$1.5 million during the second half of 2002 related to the work force reductions. This followed a workforce reduction of approximately 30% during 2001 for which the Company recorded severance and other costs of \$2.5 million at the time. These actions coupled with normal turnover reduced headcount from over 1000 at the end of 2000 to 559 at the end of June 2003.

In light of the Company's reduced headcount, difficult business conditions, and a weak local commercial real estate market, we reassessed our accrual for the costs of excess facilities and recorded a charge of \$22.5 million during the third quarter of 2002. We changed our estimates with regard to the expected timing and amount of sublease income due to the substantial surplus of vacant space in the San Francisco Bay Area. The excess facilities charge recorded during the third quarter of 2002 was for facilities that we no longer occupied, do not intend to occupy, or plan to sublease. The 2002 charges followed \$30.1 million recorded for excess facilities in 2001 when the initial accruals were established.

Due to lower than expected sales in several quarters during 2000 and 2001, the third quarter of 2002, and the first quarter of 2003, Harmonic failed to meet the expectations of securities analysts, and the price of our common stock declined, in some cases significantly. See "Factors That May Affect Results of Future Operations — Our Operating Results Are Likely To Fluctuate Significantly And May Fail To Meet Or Exceed The Expectations Of Securities Analysts Or Investors, Causing Our Stock Price To Decline."

## **Results of Operations**

### *Net Sales*

Harmonic's net sales decreased 26% from \$56.3 million in the second quarter of 2002 to \$41.7 million in the second quarter of 2003. For the six month periods, net sales decreased 29% from \$110.3 million in the first half of 2002 to \$78.7 million in the first half of 2003. The sales decreases in both periods reflected significantly lower sales in each division. BAN division sales decreased 38% in the second quarter of 2003 compared to the second quarter of 2002, and decreased 39% in the first six months of 2003 compared to the first six months of 2002. The BAN sales decrease was principally due to cautious capital spending by cable operators, in particular Charter Communications. We believe this cautious spending was caused by current conditions in financial markets and capital market concerns about the cable industry in the aftermath of the Adelphia bankruptcy filing in the first half of 2002. CS division sales decreased 17% in the second quarter of 2003 compared to the second quarter of 2002, and decreased 21% in the first six months of 2003 compared to the first six months of 2002. The CS sales decrease was attributable to lower sales to domestic cable and satellite customers due in part to competitive pricing pressures, partially offset by volume increases, in certain product lines. Harmonic's domestic sales represented 73% of net sales in the second quarter of 2003 compared to 77% of net sales in the second quarter of 2002.

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### *Gross Profit*

Gross profit decreased from \$19.2 million (34% of net sales) in the second quarter of 2002 to a gross profit of \$12.8 million (31% of net sales) in the second quarter of 2003. For the six month periods, gross profit decreased from of \$35.0 million (32% of net sales) in the first six months of 2002 to \$23.5 million (30% of net sales) in the first six months of 2003. The decreases in gross profit for both periods of 2003 were primarily due to lower overall sales volume and heightened competitive pricing pressures for certain products, particularly in the CS division. These factors were partially offset by a higher proportion of CS division sales in both periods of 2003, which historically carry higher margins, and cost control measures implemented during the second half of 2002. The cost control measures included a reduction in headcount to streamline operations in the factory and technical service and support organizations.

Gross profit includes amortization of intangibles of \$3.0 million and \$6.0 million for the second quarter and first half of 2002, respectively, compared to \$1.5 million and \$3.0 million for the second quarter and first half of 2003, respectively. In addition, gross profit includes credits related to products sold for which the cost basis had been written down in prior years of \$2.9 million for the second quarter and first half of 2002 compared to \$1.0 million and \$2.1 million for the second quarter and first half of 2003, respectively.

Harmonic anticipates that gross margins may fluctuate in future periods due to a number of factors including sales volume, pricing, product mix, factory and service organization spending levels and the timing and amount of sales of previously written down products.

### *Research and Development*

Research and development expenses decreased from \$10.8 million (19% of net sales) in the second quarter of 2002 to \$8.4 million (20% of net sales) in the second quarter of 2003. For the six month periods, research and development expenses decreased from \$21.9 million (20% of net sales) in 2002 to \$16.9 million (22% of net sales) in 2003. The decreases in absolute dollars were primarily due to lower headcount associated with the workforce reductions during the second half of 2002 and ongoing cost control measures. The increases in research and development expenses as a percentage of sales were attributable to decreased net sales.

### *Selling, General and Administrative*

Selling, general and administrative expenses decreased from \$17.0 million (30% of net sales) in the second quarter of 2002 to \$14.4 million (35% of net sales) in the second quarter of 2003. For the six month periods, selling, general and administrative expenses decreased from \$32.3 million (29% of net sales) in 2002 to \$26.5 million (34% of net sales) in 2003. The decreases in absolute dollars were principally due to a reduction in headcount associated with the work force reductions implemented during the second half of 2002. The increases in selling, general and administrative expenses as a percentage of sales were attributable to decreased net sales and the \$2.7 million charge described below.

Selling, general and administrative expenses for the second quarter and first half of 2002 included a \$2.7 million charge to provide for probable losses on receivables in connection with the Adelphia bankruptcy filing. In addition, selling, general and administrative expenses for the second quarter and first half of 2003 included a charge of \$2.7 million related to the settlement of litigation with Power and Telephone Supply in Federal court in Tennessee.

### *Amortization of Intangibles*

The Company recorded amortization of \$2.8 million and \$5.7 million in the second quarter and first half of 2002, respectively. Amortization expense decreased to \$1.9 million and \$3.9 million in the second quarter and first half of 2003 due to cessation of amortization associated with the acquisition of Cogent Technology.

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### *Interest and Other Income (Expense), Net*

Interest and other income (expense), net, increased from \$0.3 million in the second quarter of 2002 to \$0.4 million in the second quarter of 2003, and increased from \$0.3 million in the first half of 2002 to \$0.6 million in the first half of 2003. The increases were principally due to foreign currency translation gains in both periods of 2003 compared to foreign currency translation losses in both periods of 2002, partially offset by lower interest income and higher interest expense in each period of 2003.

### *Income Taxes*

Provisions for income tax expense of \$0.1 million and \$0.2 million were recorded for the second quarter and first half of 2003 compared to no provision in the second quarter of 2002 and a provision of \$0.5 million for the first half of 2002. The lower provision in the first half of 2003 compared to the first half of 2002 was due to the expectation of lower foreign income taxes in 2003 than in 2002.

### *Segments*

Harmonic's management uses income or loss from segment operations as its measure of segment profitability. Income or loss from segment operations excludes intangible amortization expense, corporate expenses, including excess facilities charges, and interest and other income. See Note 10 of Notes to Condensed Consolidated Financial Statements for further detail regarding segment operations.

Fluctuations in net sales by operating segments are discussed more extensively in the section above entitled *Net Sales*. With regard to losses from segment operations, the CS division had a loss from segment operations of \$1.7 million in the second quarter of 2002 compared to a loss of \$1.6 million in the second quarter of 2003. For the six month periods CS had a loss from segment operations of \$4.6 million for the 2002 period compared to \$5.1 million for the 2003 period. The increased CS losses in both periods of 2003 compared to 2002 were due to lower sales and lower gross margins offset in part by lower operating expenses resulting from lower headcount. CS results for the second quarter and first half of 2003 included credits of \$0.1 million and \$0.3 million, respectively, related to products sold for which the cost basis had been written down in prior years, compared to \$0.3 million for the second quarter and first half of 2002.

The BAN division had income from segment operations of \$2.0 million in the second quarter of 2002 compared to a loss from segment operations of \$0.6 million in the second quarter of 2003. For the six month periods, BAN had income from segment operations of \$1.0 million in the 2002 period compared to a loss from segment operations of \$2.1 million in the 2003 period. The BAN losses in both periods of 2003 compared to income in both periods of 2002 were due to lower sales and lower gross margins, partially offset by lower operating expenses associated with lower headcount. BAN results for the second quarter and first half of 2003 include credits of \$0.9 million and \$1.8 million, respectively, related to products sold for which the cost basis had been written down in prior years, compared to \$2.6 million for the second quarter and first half of 2002.

### **Liquidity and Capital Resources**

As of June 27, 2003, cash and cash equivalents and short term investments totaled \$36.3 million compared to \$49.2 million as of December 31, 2002. Cash used in operations was \$11.7 million in the first half of 2003, compared to cash provided by operations of \$1.7 million in the first half of 2002. The use of cash in operations in the first six months of 2003 compared to cash provided by operations in 2002 was primarily due to a lower net loss in 2003 which was more than offset by significantly lower non-cash charges for depreciation and amortization of intangibles in 2003, and a more significant increase in accounts receivable in 2003 than in 2002. The more significant increase in accounts receivable in the first six months of 2003 than the comparable period of 2002 was due to recognition of a more substantial portion of our revenue in the last month of the second quarter of 2003 than in the last month of the second quarter of 2002. In addition, the change in cash from operations was due to a federal income tax refund in the first half of 2002 related to a net operating loss carryback claim.

Under the terms of the merger agreement with C-Cube, Harmonic is generally liable for C-Cube's pre-merger tax liabilities. Approximately \$20.8 million of pre-merger tax liabilities remain outstanding and are included in accrued

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liabilities. We are working with LSI Logic, which acquired C-Cube's spun-off semiconductor business in June 2001 and assumed its obligations, to develop an approach to settle these obligations, a process which has been underway since the merger in 2000. These liabilities represent estimates of C-Cube's pre-merger tax obligations to various tax authorities in 13 countries. We are currently in discussions with tax authorities in 2 of these countries, but none of these estimates has yet been finalized. Harmonic is unable to predict when any or all of these tax obligations will be paid, or in what amount. The full amount of the estimated obligation has been classified as a current liability. To the extent that these obligations are finally settled for less than the amounts provided, Harmonic is required, under the terms of the merger agreement, to refund the difference to LSI Logic. Conversely, if the settlements are more than the \$20.8 million pre-merger tax liability, LSI is obligated to reimburse Harmonic.

Additions to property, plant and equipment were \$1.8 million and \$1.5 million in the first half of 2002 and 2003, respectively. Harmonic currently expects capital expenditures to be less than \$5 million during 2003.

In March 2003, Harmonic entered into a new bank line of credit facility with Silicon Valley Bank, which provides for borrowings up to \$13.5 million, including \$3.5 million for equipment under a secured term loan. This new facility, which expires in March 2004, contains financial and other covenants including the requirement for Harmonic to maintain on deposit with the bank the greater of 50% of total cash, cash equivalents and short-term investments or \$10.0 million, or satisfy a liquidity covenant in the event cash, cash equivalents and short-term investments are less than \$10.0 million. This provision of the facility causes a restriction on the Company's ability to use cash and cash equivalents. Depending on the level of borrowings, letters of credit and other guarantees outstanding at any point in time, the amount of the restriction on usage will vary. As of June 27, 2003 \$4.5 million of cash and cash equivalents were restricted as to usage. If Harmonic is unable to maintain on deposit with the bank the minimum balance of \$10.0 million, or satisfy the liquidity covenant requirement, Harmonic would be in noncompliance with the facility. In the event of noncompliance by Harmonic with the covenants under the facility, Silicon Valley Bank would be entitled to exercise its remedies under the facility, including in the event amounts are outstanding under the facility, offset rights against the amounts Harmonic has maintained on deposit with the bank. At June 27, 2003, Harmonic was in compliance with these covenants. Future borrowings pursuant to the line bear interest at the bank's prime rate plus 0.25%-1.75% (prime rate plus 2%-3.75% for equipment borrowings) depending upon the Company's total cash position. Borrowings are payable monthly and are collateralized by all of Harmonic's assets. The Company has entered into an agreement with another financial institution holding amounts on deposit to allow, in the event of default, Silicon Valley Bank to control these deposits. As of June 27, 2003, \$2.1 million was outstanding under the equipment term loan portion of this facility. The term loan was payable monthly, including principal and interest at rates of 6.25% per annum on outstanding borrowings as of June 27, 2003 and matures at various dates through January 2006. Other than standby letters of credit and guarantees there were no other outstanding borrowings or commitments under the line of credit facility as of June 27, 2003. See Note 12 of "Notes to Condensed Consolidated Financial Statements" for further detail regarding these obligations.

In March 2003, Harmonic also renewed a facility with Silicon Valley Bank that provides for the sale of trade receivables on a non-recourse basis up to \$12.5 million and expires in March 2004. Trade receivables sold under the facility are discounted based on the bank's prime rate plus 1.5% for North American customers and at a negotiated rate for all other customers. This facility was not utilized in 2002 or in the first half of 2003.

The Company's ability to utilize both facilities with Silicon Valley Bank depends to a significant extent on having a sufficient amount of qualified receivables, which may fluctuate depending on the level and timing of sales and the aging, customer concentration, international mix and credit quality of receivables. To the extent that the Company does not have sufficient qualified receivables, Harmonic's ability to utilize these facilities could be significantly constrained. Based upon current levels of receivables, the Company believes that it would not be able to utilize a significant portion of these facilities at this time.

While our cash balances declined \$12.8 million during the first half of 2003 and we expect to report a net loss at least through the third quarter of 2003, we currently believe that our existing liquidity sources, including our bank line of credit and trade receivables facilities, as limited by qualified receivables, will satisfy our cash requirements for at least the next twelve months, including the final settlement and payment of C-Cube's pre-merger tax liabilities. We have taken measures, and may take additional measures, to reduce our net loss and cash outflows. However, if these measures prove to be inadequate or if our expectations or estimates change or prove inaccurate, we would very likely need to raise additional funds to take advantage of unanticipated opportunities or to strengthen our financial position. Because our stock is currently trading near historically low levels, any financing at these

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levels could be significantly dilutive to existing shareholders. On March 18, 2002, Harmonic filed a registration statement on Form S-3 with the Securities and Exchange Commission, or SEC. This shelf registration statement, which was declared effective by the SEC in April 2002, will allow Harmonic to issue various types of securities, including common stock, preferred stock, debt securities and warrants to purchase common stock from time to time, up to an aggregate of \$150 million, subject to market conditions and our capital needs.

In addition, from time to time, we review potential acquisitions that would complement our existing product offerings, enhance our technical capabilities or expand our marketing and sales presence. Any future transaction of this nature could require potentially significant amounts of capital to finance the acquisition and related expenses as well as to integrate operations following a transaction, and could require us to issue our stock and dilute existing stockholders. If adequate funds are not available, or are not available on acceptable terms, we may not be able to take advantage of market opportunities, to develop new products or to otherwise respond to competitive pressures.

Our ability to raise funds may be adversely affected by a number of factors relating to Harmonic, as well as factors beyond our control, including increased market uncertainty surrounding the ongoing U.S. war on terrorism and conditions in capital markets and the cable and satellite industries. There can be no assurance that any financing will be available on terms acceptable to us, if at all. See "Factors That May Affect Future Results of Operations — We May Need Additional Capital In The Future And May Not Be Able To Secure Adequate Funds On Terms Acceptable To Us."

### **FACTORS THAT MAY AFFECT FUTURE RESULTS OF OPERATIONS**

*We Depend On Cable And Satellite Industry Capital Spending For A Substantial Portion Of Our Revenue And Any Decrease Or Delay In Capital Spending In These Industries Would Negatively Impact Our Resources, Operating Results And Financial Condition and Cash Flows.*

Prior to the merger with C-Cube in May 2000, almost all of Harmonic's historic sales had been derived from sales to cable television operators and we expect these sales to constitute a significant portion of net sales for the foreseeable future. Almost all of the DiviCom business' historic sales had been derived from sales to satellite operators, telephone companies and cable operators. Demand for our products will depend on the magnitude and timing of capital spending by cable television operators, satellite operators, broadcasters and telephone companies for constructing and upgrading of their systems.

These capital spending patterns are dependent on a variety of factors, including:

- access to financing;
- annual budget cycles;
- the impact of industry consolidation;
- the status of federal, local and foreign government regulation of telecommunications and television broadcasting;
- overall demand for communication services and the acceptance of new video, voice and data services;
- evolving industry standards and network architectures;
- competitive pressures, including pricing pressures
- discretionary customer spending patterns; and
- general economic conditions.

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In the past, specific factors contributing to reduced capital spending have included:

- uncertainty related to development of digital video and cable modem industry standards;
- delays associated with the evaluation of new services and system architectures by many cable television operators;
- emphasis on generating revenue from existing customers by cable television operators instead of new construction or network upgrades;
- proposed business combinations by our customers and regulatory review thereof;
- economic and financial conditions in domestic and international markets; and
- bankruptcies and financial restructuring of major customers.

Developments in capital markets over the past several years have reduced access to funding for new and existing customers, causing delays in the timing and scale of deployments of our equipment, as well as the postponement or cancellation of certain projects by our customers. Our business has been negatively impacted by the prolonged economic recession. During this same period Harmonic and other vendors received notification from several customers that they were canceling new projects, or delaying new orders to allow them to reduce inventory levels which were in excess of their current deployment requirements.

Certain of our customers have accumulated significant levels of debt and have announced during the past two years, reorganizations and financial restructurings, including bankruptcy filings. For example, two of our major domestic customers, Adelphia Communications and Winfirst, declared bankruptcy during the first half of 2002, while NTL, a major international customer, has recently emerged from bankruptcy. Even if these restructurings are completed, we cannot assure you that these customers will be in a position to purchase new equipment at levels we have seen in the past. Our business has been negatively impacted by the prolonged economic recession and the bankruptcy of Adelphia Communications has further heightened concerns in the financial markets about the domestic cable industry. These concerns, coupled with the current uncertain and volatile capital markets, have further pressured the market values of domestic cable operators and may further restrict their access to capital. BAN division sales have decreased significantly from the third quarter of 2000 due in particular to reduced spending by AT&T Broadband, which was acquired by Comcast in November 2002, and RCN, and more recently have decreased due to reduced spending by Charter Communications. While BAN sales increased 3% in 2002, sales declined 39% in the first half of 2003 compared to the first half of 2002 and generally remain weak.

CS division sales increased significantly from the first quarter of 2001 through the second quarter of 2002 due principally to demand for our next-generation digital systems such as the Narrowcast Services Gateway, or NSG, for video-on-demand deployments, and the MV50 encoder. CS sales of the MV50 encoder benefited during this period from the expansion of local channel offerings and compliance with FCC "must carry" regulations by domestic direct broadcast satellite, or DBS, operators. However, CS sales have decreased significantly since the first half of 2002 due principally to lower sales to cable, operators, other than Comcast, as a result of lower NSG shipments. In addition, during the second half of 2002 the decrease in CS sales was also attributable to lower sales to satellite customers. We believe the decrease in sales to satellite customers was the result, in part, of the prolonged regulatory review of the proposed acquisition of DIRECTV by Echostar, as most major domestic cable operators focused on initial VOD service launches rather than new VOD deployments, and reduced cable industry spending in the aftermath of the Adelphia bankruptcy filing.

Due to more challenging market conditions since the first half of 2002, and uncertainty about the current capital spending plans of certain of our domestic and international cable and satellite customers, it is difficult to estimate growth in the markets in which we participate. For example, capital spending remained slow worldwide and some of our major domestic cable customers moved even more cautiously than we expected during the first half of 2003. Accordingly, Harmonic expects sales to remain at reduced levels compared to the first half of 2002 at least through the third quarter of 2003.

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*Our Customer Base Is Concentrated And The Loss Of One Or More Of Our Key Customers Would Harm Our Business. The Loss Of Any Key Customer Would Have A Negative Effect On Our Business.*

Historically, a majority of our sales have been to relatively few customers, and due in part to the consolidation of ownership of cable television and direct broadcast satellite systems, we expect this customer concentration to continue in the foreseeable future. Sales to our ten largest customers in 2001, 2002, and the first half of 2003 accounted for approximately 49%, 61% and 69% of net sales, respectively. Although we are attempting to broaden our customer base by penetrating new markets such as the telco and broadcast markets, we expect to see continuing industry consolidation and customer concentration due in part to the significant capital costs of constructing broadband networks. For example, Comcast acquired AT&T Broadband in November 2002, thereby creating the largest U.S. cable operator, reaching approximately 21 million subscribers. In the DBS segment, News Corp. Ltd. recently announced its plan to acquire a controlling interest in Hughes Electronics, the parent company of DIRECTV, subject to certain regulatory and shareholder approvals. This transaction follows regulatory opposition to the proposed acquisition of DIRECTV by EchoStar. Consummation of this transaction would result in additional industry concentration. In addition, financial restructurings of companies such as Adelphia Communications and several European operators may lead to further industry consolidation. In the second quarter of 2003, sales to Comcast accounted for 37% of net sales compared to 16% in the second quarter of 2002. In the second quarter of 2002, sales to Charter Communications accounted for 20% of net sales. For the first six months of 2003, Comcast, DirecTV and Echostar accounted for 29%, 13% and 11% of net sales, respectively, compared to net sales of less than 10% for each of these customers in the first six months of 2002. For the first six months of 2002, Charter Communications represented 18% of net sales. The loss of Comcast, DIRECTV, Echostar, or any other significant customer or any reduction in orders by Comcast, DIRECTV, Echostar, or any significant customer, or our failure to qualify our products with a significant customer could adversely affect our business, operating results and liquidity. In this regard sales to Charter Communications are expected to continue to be significantly lower in 2003 than in 2002, both in absolute dollars and as a percentage of revenue, as they are now in the latter stages of their network upgrade program and they have significantly reduced capital spending as a result of capital market concerns about the cable industry and Charter in the aftermath of the Adelphia Communications bankruptcy filing in June 2002. The loss of, or any reduction in orders from, a significant customer would harm our business.

*We May Need Additional Capital In The Future And May Not Be Able To Secure Adequate Funds On Terms Acceptable To Us.*

While Harmonic's cash balances declined \$12.8 million during the first half of 2003 and the Company expects to report a net loss at least through the third quarter of 2003, we currently believe that our existing liquidity sources, including our bank line of credit and trade receivables facilities, as limited by qualified receivables, will satisfy our cash requirements for at least the next twelve months, including the final settlement and payment of C-Cube's pre-merger tax liabilities. We have taken measures, and may take additional measures, to reduce our net loss and cash outflows. However, if these measures prove to be inadequate or if our expectations or estimates change or prove inaccurate, we would very likely need to raise additional funds to take advantage of unanticipated opportunities or to strengthen our financial position. Because our stock is currently trading at near historically low levels, any financing at these levels could be significantly dilutive to existing shareholders. On March 18, 2002, Harmonic filed a registration statement on Form S-3 with the Securities and Exchange Commission, or SEC. This shelf registration statement, which was declared effective by the SEC in April 2002, will allow Harmonic to issue various types of securities, including common stock, preferred stock, debt securities and warrants to purchase common stock from time to time, up to an aggregate of \$150 million, subject to market conditions and our capital needs. Our ability to raise funds may be adversely affected by a number of factors relating to Harmonic, as well as factors beyond our control, including increased market uncertainty surrounding the ongoing U.S. war on terrorism as well as conditions in capital markets. There can be no assurance that such financing will be available on terms acceptable to us, if at all.

In addition, from time to time, we review potential acquisitions that would complement our existing product offerings, enhance our technical capabilities or expand our marketing and sales presence. Any future transaction of this nature could require potentially significant amounts of capital to finance the acquisition and related expenses as well as to integrate operations following a transaction, and could require us to issue our stock and dilute existing stockholders. If adequate funds are not available, or are not available on acceptable terms, we may not be able to take advantage of market opportunities, to develop new products or to otherwise respond to competitive pressures.



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*Our Operating Results Are Likely To Fluctuate Significantly And May Fail To Meet Or Exceed The Expectations Of Securities Analysts Or Investors, Causing Our Stock Price To Decline.*

Our operating results have fluctuated in the past and are likely to continue to fluctuate in the future, on an annual and a quarterly basis, as a result of several factors, many of which are outside of our control. Some of the factors that may cause these fluctuations include:

- the level and timing of capital spending of our customers, both in the U.S. and in foreign markets;
- changes in market demand;
- the timing and amount of orders, especially from significant customers;
- the timing of revenue from systems contracts which may span several quarters;
- competitive market conditions, including pricing actions by our competitors;
- seasonality, with fewer construction and upgrade projects typically occurring in winter months and otherwise being affected by inclement weather;
- our unpredictable sales cycles;
- new product introductions by our competitors or by us;
- changes in domestic and international regulatory environments;
- market acceptance of new or existing products;
- the cost and availability of components, subassemblies and modules;
- the mix of our customer base and sales channels;
- the mix of our products sold;
- our development of custom products and software;
- the level of international sales; and
- economic and financial conditions specific to the cable and satellite industries, and general economic conditions.

For example, the timing of deployment of our equipment can be subject to a number of other risks, including the availability of skilled engineering and technical personnel, the availability of other equipment such as digital set top boxes, and the need for local franchise and licensing approvals. We believe that changes in our customers' deployment plans have in recent quarters delayed, and may in the future delay, the receipt of new orders or the release of existing backlog.

In addition, we often recognize a substantial portion of our revenues in the last month of the quarter. We establish our expenditure levels for product development and other operating expenses based on projected sales levels, and expenses are relatively fixed in the short term. Accordingly, variations in timing of sales can cause significant fluctuations in operating results. As a result of all these factors, our operating results in one or more future periods may fail to meet or exceed the expectations of securities analysts or investors. In that event, the trading price of our common stock would likely decline. In this regard, due to lower than expected sales in several quarters during 2000 and 2001, and during the third quarter of 2002 and the first quarter of 2003, we failed to meet our internal



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expectations, as well as the expectations of securities analysts and investors, and the price of our common stock declined, in some cases significantly.

*The Terrorist Attacks Of 2001 And The Ongoing Threat Of Terrorism Have Created Great Uncertainty And May Continue To Harm Our Business.*

Current conditions in the U.S. and global economies are uncertain. The terrorist attacks in 2001 created many economic and political uncertainties that have severely impacted the global economy. We experienced a further decline in demand for our products after the attacks. The long-term effects of the attacks, the situation in Iraq and the ongoing war on terrorism on our business and on the global economy remain unknown. Moreover, the potential for future terrorist attacks has created additional uncertainty and makes it difficult to estimate how quickly the U.S. and other economies will recover and our business will improve.

*We Depend On Our International Sales And Are Subject To The Risks Associated With International Operations, Which May Negatively Affect Our Operating Results.*

Sales to customers outside of the United States in 2001, 2002 and the first half of 2003 represented 40%, 29% and 27%, of net sales, respectively, and we expect that international sales will continue to represent a substantial portion of our net sales for the foreseeable future. Part of our revenue growth strategy is to increase our presence in the international markets. Our international operations, and our efforts to increase sales in international markets, are subject to a number of risks, including:

- changes in foreign government regulations and telecommunications standards;
- import and export license requirements, tariffs, taxes and other trade barriers;
- fluctuations in currency exchange rates;
- difficulty in collecting accounts receivable;
- the burden of complying with a wide variety of foreign laws, treaties and technical standards;
- difficulty in staffing and managing foreign operations; and
- political and economic instability.

Certain of our international customers have accumulated significant levels of debt and have announced during the past two years, reorganizations and financial restructurings, including bankruptcy filings. Even if these restructurings are completed, we cannot assure you that these customers will be in a position to purchase new equipment at levels we have seen in the past.

While our international sales and operations have typically been denominated in U.S. dollars, fluctuations in currency exchange rates could cause our products to become relatively more expensive to customers in a particular country, leading to a reduction in sales or profitability in that country.

Following implementation of the Euro in January 2002, a higher portion of our European business is denominated in Euros, which may subject us to increased foreign currency risk. Gains and losses on the conversion to U.S. dollars of accounts receivable, accounts payable and other monetary assets and liabilities arising from international operations may contribute to fluctuations in operating results. Furthermore, payment cycles for international customers are typically longer than those for customers in the United States. Unpredictable sales cycles could cause us to fail to meet or exceed the expectations of security analysts and investors for any given period. In addition, foreign markets may not develop in the future.

*If Sales Forecasted For A Particular Period Are Not Realized In That Period Due To The Unpredictable Sales Cycles Of Our Products, Our Operating Results For That Period Will Be Harmed.*

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The sales cycles of many of our products, particularly our newer products and products sold internationally, are typically unpredictable and usually involve:

- a significant technical evaluation;
- a commitment of capital and other resources by cable, satellite, and other network operators;
- time required to engineer the deployment of new technologies or new broadband services;
- testing and acceptance of new technologies that affect key operations; and
- test marketing of new services with subscribers.

For these and other reasons, our sales cycles generally last three to six months, but can last up to 12 months. If orders forecasted for a specific customer for a particular quarter do not occur in that quarter, our operating results for that quarter could be substantially lower than anticipated.

As a result of the merger with C-Cube, a significant portion of our revenue is derived from solution contracts that include a combination of product sales as well as design, installation and integration services. Revenue forecasts for solution contracts are based on the estimated timing of the design, installation and integration of projects. Because the solution contracts generally span several quarters and revenue recognition is based on progress under the contract, the timing of revenue is difficult to predict and could result in lower than expected revenue in any particular quarter.

### *We Face Risks Associated With Having Important Facilities And Resources Located In Israel.*

Harmonic maintains a facility in Caesarea in the State of Israel with a total of approximately 60 employees, or 10% of our workforce. The employees at this facility consist principally of research and development personnel involved in development of certain products for the CS division. In addition, we have pilot production capabilities at this facility consisting of procurement of subassemblies and modules from Israeli subcontractors and final assembly and test operations. Accordingly, we are directly influenced by the political, economic and military conditions affecting Israel, and any major hostilities involving Israel or the interruption or curtailment of trade between Israel and its trading partners could significantly harm our business. The September 2001 terrorist attacks, the ongoing U.S. war on terrorism and the escalation of terrorist attacks and hostilities within Israel have heightened these risks. We cannot assure you that the protraction or escalation of current tensions in the Middle East will not adversely affect our business and results of operations.

In addition, most of our employees in Israel are currently obligated to perform annual reserve duty in the Israel Defense Forces and several have been called for active military duty recently. We cannot predict the effect of these obligations on Harmonic in the future.

### *Pending Business Combinations And Other Financial And Regulatory Issues Among Our Customers Could Adversely Affect Our Business.*

The telecommunications industry has been particularly impacted by the prolonged economic recession, adverse conditions in capital markets and financial difficulties in both the service and equipment sectors, including bankruptcies. Although large telecommunications service providers such as WorldCom (now MCI) and troubled data and voice-oriented start-ups have not been traditional customers of Harmonic, the cable, satellite and broadcast sectors have experienced significant financial problems. Many of our domestic and international customers have accumulated significant levels of debt and have announced reorganizations and financial restructurings during the past two years, including bankruptcy filings. In particular, Adelphia Communications, a major domestic cable operator, declared bankruptcy in June 2002. The stock prices of other domestic cable companies came under pressure following the Adelphia bankruptcy due to concerns about debt levels and capital expenditure requirements for new and expanded services, thereby making the raising of capital more difficult and expensive. New competitors, such as RCN and WinFirst, also had difficulty in accessing capital markets. WinFirst subsequently filed for bankruptcy. In Europe, rapid consolidation of the cable industry through acquisition also led to significant levels

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of debt at the major MSOs, and companies such as NTL and UPC commenced bankruptcy proceedings. European digital broadcasters, such as ITV Digital, Kirsch and Quiero, have also filed for protection from creditors.

While the capital market concerns about the domestic cable industry have eased somewhat since the summer of 2002, market conditions remain difficult and capital spending plans are generally constrained. It is likely that further industry restructuring will take place via mergers or spin-offs, such as the recent Comcast/AT&T Broadband transaction and the proposed spin-off of Time-Warner Cable from AOL Time-Warner. For instance, News Corp. Ltd. recently announced its plan to acquire a controlling interest in Hughes Electronics, the parent company of DIRECTV, subject to certain regulatory and shareholder approvals. This transaction follows regulatory opposition to the proposed acquisition of DIRECTV by EchoStar. We cannot currently predict the impact of the announcement by News Corp. Ltd. to acquire control of DIRECTV, and the related industry uncertainty, on our future sales. We believe that uncertainty during 2002 regarding the proposed DIRECTV and EchoStar merger adversely affected capital spending by both of these parties as well as other customers. If the announcement by News Corp. Ltd. to acquire control of DIRECTV has a similar effect on industry capital spending, our sales will be adversely affected. In addition, further business combinations may occur in the satellite industry, and these further combinations could adversely affect our business. Regulatory issues, financial concerns and business combinations among our customers are likely to significantly affect the industry, its capital spending plans, and our levels of business for the foreseeable future.

### *We Must Be Able To Manage Expenses And Inventory Risks Associated With Meeting The Demand Of Our Customers.*

From time to time, we receive indications from our customers as to their future plans and requirements to ensure that we will be prepared to meet their demand for our products. If actual orders differ materially from these indications, our ability to manage inventory and expenses may be affected. In addition, if we fail to meet customers' supply expectations, we may lose business from such customers. If we enter into purchase commitments to acquire materials, or expend resources to manufacture products and such products are not purchased by our customers, our business and operating results could suffer. In this regard, our gross margins and operating results for the fourth quarter of 2000 and in 2001 were adversely affected by provisions for excess and obsolete inventories of approximately \$49 million.

### *The Markets In Which We Operate Are Intensely Competitive And Many Of Our Competitors Are Larger And More Established.*

The markets for cable television fiber optics systems and digital video broadcasting systems are extremely competitive and have been characterized by rapid technological change and declining average selling prices. Pressure on average selling prices has been particularly severe during the recent economic downturn as equipment suppliers compete aggressively for customers' reduced capital spending. Harmonic's competitors in the cable television fiber optics systems business include corporations such as C-Cor.net (which recently acquired Philips' fiber optics systems business), Motorola, and Scientific-Atlanta. In the digital and video broadcasting systems business, we compete broadly with vertically integrated system suppliers including Motorola, Scientific-Atlanta, Tandberg Television and Thomson Multimedia, and in certain product lines with Cisco and a number of smaller companies.

Many of our competitors are substantially larger and have greater financial, technical, marketing and other resources than Harmonic. Many of these large organizations are in a better position to withstand any significant reduction in capital spending by customers in these markets. They often have broader product lines and market focus and may not be as susceptible to downturns in a particular market. In addition, many of our competitors have been in operation longer than we have and therefore have more long standing and established relationships with domestic and foreign customers. We may not be able to compete successfully in the future which may harm our business.

If any of our competitors' products or technologies were to become the industry standard, our business could be seriously harmed. For example, U.S. cable operators have to date mostly purchased proprietary digital systems from Motorola and Scientific-Atlanta. While certain operators have made limited purchases of the "open" systems provided by Harmonic, we cannot assure you that our digital products will find broad market acceptance with U.S. cable operators. In addition, companies that have historically not had a large presence in the broadband

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communications equipment market have begun recently to expand their market share through mergers and acquisitions. The continued consolidation of our competitors could have a significant negative impact on us. Further, our competitors, particularly competitors of our digital and video broadcasting systems' business, may bundle their products or incorporate functionality into existing products in a manner that discourages users from purchasing our products or which may require us to lower our selling prices resulting in lower gross margins.

### *Broadband Communications Markets Are Characterized By Rapid Technological Change.*

Broadband communications markets are relatively immature, making it difficult to accurately predict the markets' future growth rates, sizes or technological directions. In view of the evolving nature of these markets, it is possible that cable television operators, telephone companies or other suppliers of broadband wireless and satellite services will decide to adopt alternative architectures or technologies that are incompatible with our current or future products. If we are unable to design, develop, manufacture and sell products that incorporate or are compatible with these new architectures or technologies, our business will suffer.

### *We Need To Develop And Introduce New And Enhanced Products In A Timely Manner To Remain Competitive.*

Broadband communications markets are characterized by continuing technological advancement, changes in customer requirements and evolving industry standards. To compete successfully, we must design, develop, manufacture and sell new or enhanced products that provide increasingly higher levels of performance and reliability. However, we may not be able to successfully develop or introduce these products, if our products:

- are not cost effective;
- are not brought to market in a timely manner;
- are not in accordance with evolving industry standards and architectures; or
- fail to achieve market acceptance, or are ahead of the market.

Also, to successfully develop and market certain of our planned products for digital applications, we may be required to enter into technology development or licensing agreements with third parties. We cannot assure you that we will be able to enter into any necessary technology development or licensing agreement on terms acceptable to us, or at all. The failure to enter into technology development or licensing agreements when necessary could limit our ability to develop and market new products and, accordingly, could materially and adversely affect our business and operating results.

### *We Need To Effectively Manage Our Operations And The Cyclical Nature Of Our Business.*

The cyclical nature of our business has placed, and is expected to continue to place, a significant strain on our personnel, management and other resources. This strain has been exacerbated by the acquisition of DiviCom and the subsequent loss of numerous employees, including senior management. In addition, we reduced our work force by approximately 44% since the beginning of 2001 due to reduced industry spending and demand for our products. Our ability to manage our business effectively in the future, including any future growth, will require us to train, motivate and manage our employees successfully, to attract and integrate new employees into our overall operations, to retain key employees and to continue to improve our operational, financial and management systems.

### *We Are Incurring Additional Costs And Devoting More Management Resources to Comply With Increasing Regulation of Corporate Governance And Disclosure.*

We are spending an increased amount of management time and external resources to understand and comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, new SEC regulations and Nasdaq Stock Market rules. Devoting the necessary resources to comply with evolving corporate governance and public disclosure standards may result

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in increased general and administrative expenses and a diversion of management time and attention to compliance activities.

### *Competition For Qualified Personnel Can Be Intense, And We May Not Be Successful In Attracting And Retaining Personnel.*

Our future success will depend, to a significant extent, on the ability of our management to operate effectively, both individually and as a group. We are dependent on our ability to retain and motivate high caliber personnel, in addition to attracting new personnel. In spite of the current worldwide economic slowdown, competition for qualified technical and other personnel can be intense, and we may not be successful in attracting and retaining such personnel. Competitors and others have in the past and may in the future attempt to recruit our employees. While our employees are required to sign standard agreements concerning confidentiality and ownership of inventions, we generally do not have employment contracts or non-competition agreements with any of our personnel. The loss of the services of any of our key personnel, the inability to attract or retain qualified personnel in the future or delays in hiring required personnel, particularly engineers and other technical personnel, could negatively affect our business.

### *We Are Liable For C-Cube's Pre-Merger Tax Liabilities, Including Tax Liabilities Resulting From The Spin-Off Of Its Semiconductor Business.*

Under the terms of the merger agreement with C-Cube, Harmonic is generally liable for C-Cube's pre-merger tax liabilities. Approximately \$20.8 million of pre-merger tax liabilities remain outstanding and are included in accrued liabilities. We are working with LSI Logic, which acquired C-Cube's spun-off semiconductor business in June 2001 and assumed its obligations, to develop an approach to settle these obligations, a process which has been underway since the merger in 2000. These liabilities represent estimates of C-Cube's pre-merger tax obligations to various tax authorities in 13 countries. We are currently in discussions with tax authorities in 2 of these countries, but none of these estimates has yet been finalized. Harmonic is unable to predict when any or all of these tax obligations will be paid, or in what amount. The full amount of the estimated obligation has been classified as a current liability. To the extent that these obligations are finally settled for less than the amounts provided, Harmonic is required, under the terms of the merger agreement, to refund the difference to LSI Logic. Conversely, if the settlements are more than the \$20.8 million pre-merger tax liability, LSI is obligated to reimburse Harmonic.

The merger agreement stipulates that Harmonic will be indemnified by the spun-off semiconductor business if the cash reserves are not sufficient to satisfy all of C-Cube's tax liabilities for periods prior to the merger. If for any reason, the spun-off semiconductor business does not have sufficient cash to pay such taxes, or if there are additional taxes due with respect to the non-semiconductor business and Harmonic cannot be indemnified by C-Cube, Harmonic generally will remain liable, and such liability could have a material adverse effect on our financial condition, liquidity and results of operations.

### *We May Be Subject To Risks Associated With Other Acquisitions.*

We have made and may make investments in complementary companies, products or technologies. If we make acquisitions, we could have difficulty assimilating or retaining the acquired companies' key personnel and operations or integrating the acquired technology or products into ours. We also may face challenges in achieving the strategic objectives, cost savings or other benefits from a proposed acquisition and difficulties in expanding our management information systems to accommodate the acquired business. These difficulties could disrupt our ongoing business, distract our management and employees and significantly increase our expenses. Moreover, our operating results may suffer because of acquisition-related expenses, amortization of intangible assets and impairment of acquired goodwill or intangible assets. Furthermore, we may have to incur debt or issue equity securities to pay for any future acquisitions, or to provide for additional working capital requirements, the issuance of which could be dilutive to our existing shareholders. If we are unable to successfully address any of these risks, our business, financial condition and operating results could be harmed.

### *Cessation Of The Development And Production Of Video Encoding Chips By C-Cube's Spun-off Semiconductor Business May Adversely Impact Us.*

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The DiviCom business and C-Cube semiconductor business collaborated on the production and development of two video encoding microelectronic chips prior to the merger. In connection with the merger, Harmonic and the spun-off semiconductor business entered into a contractual relationship under which Harmonic will have access to certain of the spun-off semiconductor business technologies and products which the DiviCom business previously depended for its product and service offerings. The spun-off semiconductor business is the sole supplier of these chips to Harmonic. Several of these products continue to be important to our business, and we have incorporated these chips into additional products that we have developed.

However, under the contractual relationships between Harmonic and the spun-off semiconductor business, which was acquired by LSI Logic in June 2001, the semiconductor business does not have a firm commitment to continue the development of video encoding microelectronic chips. As a result, the semiconductor business may choose not to continue future development of the chips for any reason. The semiconductor business may also encounter in the future technological difficulties in the production and development of the chips. If the spun-off semiconductor business is not able to or does not sustain its development and production efforts in this area our business, financial condition, liquidity and results of operations could be harmed. Also, this agreement expires in October 2004. See "Supply, License and Development Agreement" at page 60 of the joint proxy statement filed with the SEC on March 23, 2000, for further details of Harmonic's business relationship with the spun-off semiconductor business after the merger.

*We Purchase Several Key Components, Subassemblies And Modules Used In The Manufacture Or Integration Of Our Products From Sole Or Limited Sources, And We Are Increasingly Dependent On Contract Manufacturers.*

Many components, subassemblies and modules necessary for the manufacture or integration of our products are obtained from a sole supplier or a limited group of suppliers. Our reliance on sole or limited suppliers, particularly foreign suppliers, and our increased reliance on subcontractors since the merger with C-Cube involves several risks, including a potential inability to obtain an adequate supply of required components, subassemblies or modules and reduced control over pricing, quality and timely delivery of components, subassemblies or modules. In particular, certain optical components have in the past been in short supply and are available only from a small number of suppliers, including sole source suppliers. While we expend considerable efforts to qualify additional optical component sources, consolidation of suppliers in the industry and the small number of viable alternatives have limited the results of these efforts. We do not generally maintain long-term agreements with any of our suppliers or subcontractors. An inability to obtain adequate deliveries or any other circumstance that would require us to seek alternative sources of supply could affect our ability to ship our products on a timely basis, which could damage relationships with current and prospective customers and harm our business. We attempt to limit this risk by maintaining safety stocks of these components, subassemblies and modules. As a result of this investment in inventories, we have in the past and in the future may be subject to risk of excess and obsolete inventories, which could harm our business, operating results, financial position and liquidity. In this regard, our gross margins and operating results from the fourth quarter of 2000 through the third quarter of 2001 were adversely affected by excess and obsolete inventory charges of approximately \$49 million.

*Our Failure To Adequately Protect Our Proprietary Rights May Adversely Affect Us.*

We currently hold 44 issued United States patents and 10 issued foreign patents, and have a number of patent applications pending. Although we attempt to protect our intellectual property rights through patents, trademarks, copyrights, licensing arrangements, maintaining certain technology as trade secrets and other measures, we cannot assure you that any patent, trademark, copyright or other intellectual property rights owned by us will not be invalidated, circumvented or challenged, that such intellectual property rights will provide competitive advantages to us or that any of our pending or future patent applications will be issued with the scope of the claims sought by us, if at all. We cannot assure you that others will not develop technologies that are similar or superior to our technology, duplicate our technology or design around the patents that we own. In addition, effective patent, copyright and trade secret protection may be unavailable or limited in certain foreign countries in which we do business or may do business in the future.

We believe that the future success of our business will depend on our ability to translate the technological expertise and innovation of our personnel into new and enhanced products. We generally enter into confidentiality or license agreements with our employees, consultants, vendors and customers as needed, and generally limit access to and

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distribution of our proprietary information. Nevertheless, we cannot assure you that the steps taken by us will prevent misappropriation of our technology. In addition, we have taken in the past, and may take in the future, 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, operating results, financial position and liquidity.

In order to successfully develop and market certain of our planned products for digital applications, we may be required to enter into technology development or licensing agreements with third parties. Although many companies are often willing to enter into technology development or licensing agreements, we cannot assure you that such agreements will be negotiated on terms acceptable to us, or at all. The failure to enter into technology development or licensing agreements, when necessary, could limit our ability to develop and market new products and could cause our business to suffer.

### *We or Our Customers May Face Intellectual Property Infringement Claims From Third Parties.*

Harmonic's industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In particular, leading companies in the telecommunications industry have extensive patent portfolios. From time to time, third parties, including these leading companies, have asserted and may assert exclusive patent, copyright, trademark and other intellectual property rights against us or our customers. Indeed, a number of third parties, including leading companies, have asserted patent rights to technologies that are important to us. On July 3, 2003, we were sued by Litton Systems and Stanford University for alleged infringement of a U.S. patent. See "Legal Proceedings" in Part II Item 1.

Our suppliers and customers may receive similar claims. We have agreed to indemnify some of our suppliers and customers for alleged patent infringement. The scope of this indemnity varies, but, in some instances, includes indemnification for damages and expenses (including reasonable attorney's fees). In this regard, since December 2000, we have been in communication with several of Harmonic's customers who have been contacted by one of these leading companies that believes certain of our products require a license under a number of their patents. We currently are reviewing the identified patents to examine whether we consider a license necessary. While it is our understanding that the third party is willing to grant our customers a non-exclusive license under the identified patents, there can be no assurance that the terms of any offered license would be acceptable to our customers or that failure to obtain a license or the costs associated with any license would not cause our operating results to be materially adversely affected.

### *We Are The Subject Of Securities Class Action Claims And Other Litigation Which, If Adversely Determined, Could Harm Our Business And Operating Results.*

Between June 28 and August 25, 2000, several actions alleging violations of the federal securities laws by Harmonic and certain of its officers and directors (some of whom are no longer with Harmonic) were filed in or removed to the United States District Court for the Northern District of California. The actions subsequently were consolidated.

A consolidated complaint, filed on December 7, 2000, was brought on behalf of a purported class of persons who purchased Harmonic's publicly traded securities between January 19 and June 26, 2000. The complaint also alleged claims on behalf of a purported subclass of persons who purchased C-Cube securities between January 19 and May 3, 2000. In addition to Harmonic and certain of its officers and directors, the complaint also named C-Cube Microsystems Inc. and several of its officers and directors as defendants. The complaint alleged that, by making false or misleading statements regarding Harmonic's prospects and customers and its acquisition of C-Cube, certain defendants violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The complaint also alleged that certain defendants violated section 14(a) of the Exchange Act and sections 11, 12(a)(2), and 15 of the Securities Act of 1933 by filing a false or misleading registration statement, prospectus, and joint proxy in connection with the C-Cube acquisition.

On July 3, 2001, the Court dismissed the consolidated complaint with leave to amend. An amended complaint alleging the same claims against the same defendants was filed on August 13, 2001. Defendants moved to dismiss the amended complaint on September 24, 2001. On November 13, 2002, the Court issued an opinion granting the



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motions to dismiss the amended complaint without leave to amend. Judgment for defendants was entered on December 2, 2002. On December 12, 2002, plaintiffs filed a motion to amend the judgment and for leave to file an amended complaint pursuant to Rules 59(e) and 15(a) of the Federal Rules of Civil Procedure. On June 6, 2003, the Court denied plaintiffs' motion to amend the judgment and for leave to file an amended complaint.

Plaintiffs filed a notice of appeal on July 1, 2003. According to the scheduling order issued by the Court on July 3, 2003, plaintiffs' opening brief is due on October 17, 2003. No hearing date has been scheduled.

A derivative action purporting to be on behalf of Harmonic was filed against its then-current directors in the Superior Court for the County of Santa Clara on September 5, 2000. Harmonic also was named as a nominal defendant. The complaint is based on allegations similar to those found in the securities class action and claims that the defendants breached their fiduciary duties by, among other things, causing Harmonic to violate federal securities laws. The derivative action was removed to the United States District Court for the Northern District of California on September 20, 2000. All deadlines in this action were stayed pending resolution of the motions to dismiss the securities class action. On July 29, 2003, the Court approved the parties' stipulation to dismiss this derivative action without prejudice and to toll the applicable limitations period. The limitations period is tolled until fourteen days after (1) defendants provide plaintiff with a copy of the mandate issued by the Ninth Circuit in the securities action or (2) either party provides written notice of termination of the tolling period, whichever occurs first.

A second derivative action purporting to be on behalf of Harmonic was filed in the Superior Court for the County of Santa Clara on May 15, 2003. It alleges facts similar to those previously alleged in the securities class action and the federal derivative action. The complaint names as defendants former and current Harmonic officers and directors, along with former officers and directors of C-Cube Microsystems, Inc., who were named in the securities class action. The complaint also names Harmonic as a nominal defendant. The complaint alleges claims for abuse of control, gross mismanagement, and waste of corporate assets against the Harmonic defendants, and claims for breach of fiduciary duty, unjust enrichment, and negligent misrepresentation against all defendants. The action has been stayed pending resolution of the appeal in the securities class action. The parties have agreed in principle to a dismissal without prejudice and a tolling of the statute of limitations period on similar terms as in the federal derivative action.

Based on its review of the complaints filed in the securities class action, Harmonic believes that it has meritorious defenses and intends to defend itself vigorously. There can be no assurance, however, that Harmonic will prevail. An unfavorable outcome of this litigation could have a material adverse effect on Harmonic's business, operating results, financial position and cash flows.

Harmonic announced on July 17, 2003 a settlement of its litigation with Power and Telephone Supply (P&T) in Federal court in Tennessee. Under the terms of the settlement agreement, Harmonic agreed to pay \$2.8 million to P&T in release of all outstanding claims. The settlement followed summary judgment against Harmonic on certain of the claims made by P&T under a Tennessee statute relating to retailers and suppliers. These claims arose from the cancellation of purchase orders on P&T by one its end-customers in 2000. Harmonic's operating results for the second quarter and first half of 2003 include a charge to general and administrative expense of approximately \$2.7 million related to the settlement with P&T. The settlement charge is after accounting for the value of products to be returned and other costs. Harmonic paid \$1.0 million of the settlement on July 24, 2003 and is obligated to pay the balance of \$1.8 million on January 15, 2004. The settlement payments are secured by a standby letter of credit.

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of Harmonic's products infringe U.S. Patent No. 4,859,016. This patent expires in September, 2003. The complaint seeks injunctive relief, royalties and damages. Harmonic has not been served in the case. Harmonic is currently evaluating its position with respect to this patent and has engaged in discussions with the plaintiff regarding potential settlement of the matter. At this time, Harmonic is unable to determine whether Harmonic will be able to settle this matter on reasonable terms or at all, nor can Harmonic predict the impact of an adverse outcome of this matter if Harmonic elects to defend against it. Consequently, Harmonic has made no provision in its financial statements for the outcome of a negotiated settlement or an unfavorable verdict in litigation. An unfavorable outcome of this matter could have a material adverse effect on Harmonic's business, operating results, financial position and cash flows.



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### *Our Stock Price May Be Volatile.*

The market price of our common stock has fluctuated significantly in the past, particularly in recent years, and is likely to fluctuate in the future. In addition, the securities markets have experienced significant price and volume fluctuations and the market prices of the securities of technology companies have been especially volatile. Investors may be unable to resell their shares of our common stock at or above their purchase price. In the past, companies that have experienced volatility in the market price of their stock have been the object of securities class action litigation.

### *We Rely On A Continuous Power Supply To Conduct Our Operations, And Any Electrical And Natural Gas Crisis Could Disrupt Our Operations And Increase Our Expenses.*

We rely on a continuous power supply for manufacturing and to conduct our business operations. Interruptions in electrical power supplies in California in the early part of 2001 could recur in the future. In addition, the cost of electricity and natural gas has risen significantly. Power outages could disrupt our manufacturing and business operations and those of many of our suppliers, and could cause us to fail to meet production schedules and commitments to customers and other third parties. Any disruption to our operations or those of our suppliers could result in damage to our current and prospective business relationships and could result in lost revenue and additional expenses, thereby harming our business and operating results.

### *Some Anti-Takeover Provisions Contained in Our Certificate of Incorporation, Bylaws and Stockholder Rights Plan, as well as Provisions of Delaware Law, Could Impair a Takeover Attempt.*

Harmonic has provisions in its certificate of incorporation and bylaws, each of which could have the effect of rendering more difficult or discouraging an acquisition deemed undesirable by the Harmonic Board of Directors. These include provisions:

- authorizing blank check preferred stock, which could be issued with voting, liquidation, dividend and other rights superior to Harmonic common stock;
- limiting the liability of, and providing indemnification to, directors and officers;
- limiting the ability of Harmonic stockholders to call and bring business before special meetings;
- requiring advance notice of stockholder proposals for business to be conducted at meetings of Harmonic stockholders and for nominations of candidates for election to the Harmonic Board of Directors;
- controlling the procedures for conduct and scheduling of Board and stockholder meetings; and
- providing the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

These provisions, alone or together, could delay hostile takeovers and changes in control or management of Harmonic.

In addition, Harmonic has adopted a stockholder rights plan. The rights are not intended to prevent a takeover of Harmonic, and we believe these rights will help Harmonic's negotiations with any potential acquirers. However, if the Board of Directors believes that a particular acquisition is undesirable, the rights may have the effect of rendering more difficult or discouraging that acquisition. The rights would cause substantial dilution to a person or group that attempts to acquire Harmonic on terms or in a manner not approved by the Harmonic Board of Directors, except pursuant to an offer conditioned upon redemption of the rights.

As a Delaware corporation, Harmonic also is subject to provisions of Delaware law, including Section 203 of the Delaware General Corporation law, which prevents some stockholders holding more than 15% of our outstanding common stock from engaging in certain business combinations without approval of the holders of substantially all of our outstanding common stock.

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Any provision of our certificate of incorporation or bylaws, our stockholder rights plan or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for Harmonic stockholders to receive a premium for their shares of Harmonic common stock, and could also affect the price that some investors are willing to pay for Harmonic common stock.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Market risk represents the risk of loss that may impact the operating results, financial position or liquidity of Harmonic due to adverse changes in market prices and rates. Harmonic is exposed to market risk because of changes in interest rates and foreign currency exchange rates as measured against the U.S. Dollar and currencies of Harmonic's subsidiaries.

*Foreign Currency Exchange Risk*

Harmonic has a number of international subsidiaries each of whose sales and results of operations are generally denominated in U.S. dollars. Following implementation of the Euro in January 2002, a higher proportion of our European business is denominated in Euros, which may subject us to increased foreign currency exchange risk. In addition, the Company has various international branch offices, which provide sales support and systems integration services. While Harmonic does not anticipate that near-term changes in exchange rates will have a material impact on future operating results, financial position and liquidity, Harmonic cannot assure you that a sudden and significant change in the value of local currencies would not harm Harmonic's operating results, financial position and liquidity.

*Interest Rate Risk*

Exposure to market risk for changes in interest rates relate primarily to Harmonic's investment portfolio of marketable debt securities of various issuers, types and maturities, and to Harmonic's borrowings under its bank line of credit facility. Harmonic does not use derivative instruments in its investment portfolio, and its investment portfolio only includes highly liquid instruments with an original maturity of less than two years. These investments are classified as available for sale and are carried at estimated fair value, with material unrealized gains and losses reported in other comprehensive income. There is risk that losses could be incurred if the Company were to sell any of its securities prior to stated maturity. A 10% change in interest rates would not have a material impact on financial conditions, results of operations and cash flows.

**ITEM 4. CONTROLS AND PROCEDURES**

*Evaluation of disclosure controls and procedures.*

Our chief executive officer and our chief financial officer, after evaluating our "disclosure controls and procedures" (as defined in Securities Exchange Act of 1934 (the "Exchange Act") Rules 13a-14(c) and 15-d-14(c)) as of a date (the "Evaluation Date") within 90 days before the filing date of this Quarterly Report on Form 10-Q, have concluded that as of the Evaluation Date, our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

*Changes in internal controls.*

Subsequent to the Evaluation Date, there were no significant changes in our internal controls or in other factors that could significantly affect our disclosure controls and procedures, nor were there any significant deficiencies or material weaknesses in our internal controls. As a result, no corrective actions were required or undertaken.

## PART II

### OTHER INFORMATION

#### ITEM 1. LEGAL PROCEEDINGS

Between June 28 and August 25, 2000, several actions alleging violations of the federal securities laws by Harmonic and certain of its officers and directors (some of whom are no longer with Harmonic) were filed in or removed to the United States District Court for the Northern District of California. The actions subsequently were consolidated.

A consolidated complaint, filed on December 7, 2000, was brought on behalf of a purported class of persons who purchased Harmonic's publicly traded securities between January 19 and June 26, 2000. The complaint also alleged claims on behalf of a purported subclass of persons who purchased C-Cube securities between January 19 and May 3, 2000. In addition to Harmonic and certain of its officers and directors, the complaint also named C-Cube Microsystems Inc. and several of its officers and directors as defendants. The complaint alleged that, by making false or misleading statements regarding Harmonic's prospects and customers and its acquisition of C-Cube, certain defendants violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934. The complaint also alleged that certain defendants violated section 14(a) of the Exchange Act and sections 11, 12(a)(2), and 15 of the Securities Act of 1933 by filing a false or misleading registration statement, prospectus, and joint proxy in connection with the C-Cube acquisition.

On July 3, 2001, the Court dismissed the consolidated complaint with leave to amend. An amended complaint alleging the same claims against the same defendants was filed on August 13, 2001. Defendants moved to dismiss the amended complaint on September 24, 2001. On November 13, 2002, the Court issued an opinion granting the motions to dismiss the amended complaint without leave to amend. Judgment for defendants was entered on December 2, 2002. On December 12, 2002, plaintiffs filed a motion to amend the judgment and for leave to file an amended complaint pursuant to Rules 59(e) and 15(a) of the Federal Rules of Civil Procedure. On June 6, 2003, the Court denied plaintiffs' motion to amend the judgment and for leave to file an amended complaint.

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Based on its review of the complaints filed in the securities class action, Harmonic believes that it has meritorious defenses and intends to defend itself vigorously. There can be no assurance, however, that Harmonic will prevail. An unfavorable outcome of this litigation could have a material adverse effect on Harmonic's business, operating results, financial position and cash flows.

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#### **ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

At the Annual Meeting of Stockholders of the Company, held on May 22, 2003, the following matters were acted upon by the stockholders of the Company:

1. The election of Anthony J. Ley, E. Floyd Kvamme, William F. Reddersen, Lewis Solomon, Michel L. Vaillaud, and David Van Valkenburg as directors of the Company, each to hold office for a one-year term or until a successor for each such director is elected and qualified. No additional directors continued as members of Harmonic's Board of Directors after the meeting.
2. The ratification of the appointment of PricewaterhouseCoopers LLP as independent auditors of the Company for the fiscal year ending December 31, 2003.

The number of shares of Common Stock outstanding and entitled to vote at the Annual Meeting was 60,462,318 and 57,084,596 shares were represented in person or by proxy. The results of the voting on each of the matters presented to stockholders at the Annual Meeting are set forth below:

	VOTES FOR	WITHHELD
1. Election of Directors		
a. Anthony J. Ley	53,440,318	3,644,278
b. E. Floyd Kvamme	52,168,583	4,916,013
c. William F. Reddersen	53,261,647	3,822,949
d. Lewis Solomon	44,835,770	12,248,826
e. Michel L. Vaillaud	53,393,785	3,690,811
f. David R. Van Valkenburg	52,614,390	4,470,206

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	VOTES FOR	VOTES AGAINST	ABSTENTIONS	BROKER NON-VOTE
2. Ratification of Independent Accountants	55,884,869	1,142,440	57,287	0

**ITEM 5. OTHER INFORMATION**

*Audit Committee Approval of Non-Audit Services*

As required by Section 202 Sarbanes-Oxley Act of 2002, the Company's Audit Committee of the Board of Directors of the Company has pre-approved certain non-audit services to be provided by PricewaterhouseCoopers LLP, the Company's independent accountants. These services relate to consultation, advice and other services in connection with tax planning and compliance, SEC registration statements, potential acquisitions and other transactions, application of generally accepted accounting principles and the provision of statutory audit services in foreign jurisdictions.

**ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K**

a. *Exhibits.*

- 99.1 Certificate of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
- 99.2 Certificate of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

b. *Reports on Form 8-K.*

- April 24, 2003 On April 24, 2003, the Registrant issued a press release announcing results for the quarter ended March 28, 2003 and furnished its press release on Form 8-K.
- June 5, 2003 The Registrant amended its current report on Form 8-K filed with the Securities and Exchange Commission on March 18, 2002 solely to add as an exhibit to such Form 8-K the consent of Deloitte & Touche LLP, independent public accountants.

**SIGNATURE**

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.

Dated: August 11, 2003

HARMONIC INC.  
(Registrant)  
By: /s/ Robin N. Dickson

\_\_\_\_\_  
Robin N. Dickson  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO  
SECTION 302 (a) OF  
THE SARBANES-OXLEY ACT OF 2002

I, Anthony J. Ley, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Harmonic Inc.:
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.
6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: August 11, 2003

By: /s/ Anthony J. Ley

\_\_\_\_\_  
Anthony J. Ley  
Chairman, President and Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER  
PURSUANT TO  
SECTION 302 (a) OF  
THE SARBANES-OXLEY ACT OF 2002

I, Robin N. Dickson, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Harmonic Inc.:
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - d) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - e) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.
6. The registrant's other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: August 11, 2003

By: /s/ Robin N. Dickson

Robin N. Dickson  
Chief Financial Officer



**INDEX TO EXHIBITS**

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CERTIFICATION OF CHIEF EXECUTIVE OFFICER  
PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Anthony J. Ley, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Harmonic Inc. on Form 10-Q for the fiscal quarter ended June 27, 2003 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of Harmonic Inc.

By: /s/ Anthony J. Ley

-----  
Name: Anthony J. Ley  
Title: Chairman, President and Chief Executive Officer

CERTIFICATION OF CHIEF FINANCIAL OFFICER  
PURSUANT TO  
18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Robin N. Dickson, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Harmonic Inc. on Form 10-Q for the fiscal quarter ended June 27, 2003 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934 and that information contained in such Quarterly Report on Form 10-Q fairly presents in all material respects the financial condition and results of operations of Harmonic Inc.

By: /s/ Robin N. Dickson

-----  
Name: Robin N. Dickson  
Title: Chief Financial Officer