CRAWFORD & CO
Form 8-K
June 18, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 8-K

CURRENT REPORT

Pursuant to Section 13 or 15(d)

of the Securities Exchange Act of 1934

Date of report (Date of earliest event reported): June 15, 2018

CRAWFORD & COMPANY

(Exact name of registrant as specified in its charter)

Georgia	1-10356	58-0506554
(State or Other Jurisdiction of Incorporation)	(Commission File Number)	(IRS Employer Identification No.)

5335 Triangle Parkway, Peachtree Corners, Georgia	**30092**
(Address of Principal Executive Offices)	**(Zip Code)**

(404) 300-1000

(Registrant s Telephone Number, Including Area Code)

N/A

(Former Name or Former Address, if Changed Since Last Report)

Check the appropriate box below if the Form 8-K filing is intended to simultaneously satisfy the filing obligation of the registrant under any of the following provisions:

Written communications pursuant to Rule 425 under the Securities Act (17 CFR 230.425)

Soliciting material pursuant to Rule 14a-12 under the Exchange Act (17 CFR 240.14a-12)

Pre-commencement communications pursuant to Rule 14d-2(b) under the Exchange Act (17 CFR 240.14d-2(b))

Pre-commencement communications pursuant to Rule 13e-4(c) under the Exchange Act (17 CFR 240.13e-4(c))
Indicate by check mark whether the registrant is an emerging growth company as defined in Rule 405 of the Securities Act of 1933 (§230.405 of this chapter) or Rule 12b-2 of the Securities Exchange Act of 1934 (§240.12b-2 of this chapter).

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Item 1.01. Entry into a Material Definitive Agreement.

On June 15, 2018, Crawford & Company (the Company), Crawford & Company (Canada) Inc., an indirect subsidiary of the Company (Crawford Canada), EPIQ Class Action & Claims Solutions, Inc. (EPIQ) and EPIQ Systems Canada ULC (EPIQ Canada) entered into that certain Membership Interest and Asset Purchase Agreement (the Purchase Agreement), pursuant to which Crawford sold its Garden City Group business (the GCG Business) to EPIQ and EPIQ Canada. The sale of the GCG Business was effected by (i) the sale by the Company of all of the issued and outstanding membership interests of Garden City Group, LLC to EPIQ and (ii) the sale by Crawford Canada of specified assets and certain liabilities used in the GCG Business to EPIQ Canada. In connection with the transaction, Crawford Canada is retaining certain liabilities related to the GCG Business.

The purchase price payable by EPIQ and EPIQ Canada (collectively, the Buyers) to the Company and Crawford Canada for the GCG Business was $42,021,655.05, subject to certain adjustments, including an adjustment for the working capital (as defined in the Purchase Agreement) at the closing. In addition, of this purchase price amount, $185,000 will be held in escrow for a period of time following the closing as a source of recovery for indemnification claims by the Buyers.

The Purchase Agreement contains various representations, warranties and covenants made by the parties. The Purchase Agreement provides for post-closing indemnification, subject to certain limitations, with respect to breaches of representations, warranties and covenants by the parties, as well as indemnification with respect to certain other matters specified in the Purchase Agreement.

The Purchase Agreement provides that the Company and its affiliates will be prohibited from engaging in a competing business (as more specifically described in the Purchase Agreement) anywhere in the United States or Canada for a period of four years following the closing. The Purchase Agreement also provides that the Company will not solicit the employment of employees of Garden City Group, LLC or its subsidiaries for four years following the closing.

The parties entered into transition services agreements at the closing pursuant to which the Company and Crawford Canada will provide certain information technology and back-office transition services to the Buyers through December 31, 2018.

The foregoing summary of the transaction and the terms and conditions of the Purchase Agreement is subject to, and qualified in its entirety by, the full text of the Purchase Agreement, which is attached hereto as Exhibit 2.1 and incorporated herein by reference.

The Purchase Agreement is attached as Exhibit 2.1 in accordance with the rules of the Securities and Exchange Commission. It is not intended to provide any other factual information about the Company. The representations, warranties, and covenants contained in the Purchase Agreement were made solely for purposes of such agreement and as of specific dates, were solely for the benefit of the parties to the Purchase Agreement, may be subject to limitations and contractual risk allocation mechanisms agreed upon by the parties, and may be subject to standards of materiality that differ from those applicable to the Company, and thus should not be relied upon as necessarily reflecting the actual state of facts or conditions.

On June 15, 2018, the Company, its subsidiaries Crawford & Company Risk Services Investments Limited, Crawford & Company (Canada) Inc. and Crawford & Company (Australia) Pty. Ltd. (the Company, together with such subsidiaries, as borrowers (the Borrowers)), the Company s guarantor subsidiaries party thereto, Wells Fargo Bank, National Association, as administrative agent and a lender (Wells Fargo), and the other lenders party thereto (together with Wells Fargo, the Lenders), entered into a Limited Consent and First Amendment to Amended and Restated Credit Agreement (the Amendment) which, among other things, amended that certain Amended and Restated Credit Agreement, dated as of October 17, 2017, by and among the Borrowers and the Lenders. Pursuant to the

Amendment, the Lenders approved and consented to the transactions contemplated under the Purchase Agreement. The foregoing description of the Amendment is qualified in its entirety by reference to the Amendment, a copy of which is filed as Exhibit 10.1 to the Report and is incorporated herein by reference.

Item 2.01, Completion of Acquisition or Disposition of Assets.

On June 15, 2018, the Company completed the sale of all of the GCG Business to the Buyers, which closing occurred concurrently with the execution and delivery of the Purchase Agreement as noted above. The information under Item 1.01 above is incorporated herein by reference.

The unaudited pro forma condensed consolidated financial information of the Company after giving effect to the Company s sale of the GCG Business is attached hereto as Exhibit 99.1 and incorporated herein by reference.

Item 8.01 Other Events.

On June 18, 2018, the Company issued a press release announcing the completion of the sale of the GCG Business to the Buyers. A copy of the press release is filed as Exhibit 99.2 to this Current Report on Form 8-K and incorporated herein by this reference.

Item 9.01 Financial Statements and Exhibits.

(b) Pro Forma Financial Information

Unaudited pro forma condensed consolidated financial information of the Company, after giving effect to the sale of the GCG Business to the Buyers as follows: the unaudited pro forma condensed consolidated balance sheets as of March 31, 2018, and the unaudited pro forma condensed consolidated statements of operations for the three months ended March 31, 2018 and the year ended December 31, 2017. This unaudited pro forma condensed consolidated financial information of the Company is included as Exhibit 99.1 to this Current Report on Form 8-K, and is incorporated herein by this reference.

(d) Exhibits

2.1 Membership Interest and Asset Purchase Agreement, by and among Crawford & Company, Crawford & Company (Canada) Inc., EPIQ Class Action & Claims Solutions, Inc., and EPIQ Systems Canada ULC., dated as of June 15, 2018.*

10.1 Limited Consent and First Amendment to Amended and Restated Credit Agreement, dated as of June 15, 2018, by and among Crawford & Company, Crawford & Company Risk Services Investments Limited, Crawford & Company (Canada) Inc. and Crawford & Company (Australia) Pty. Ltd., and the guarantor subsidiaries party thereto, Wells Fargo Bank, National Association, as administrative agent and a lender (Wells Fargo), and the other lenders party thereto.

99.1 Unaudited pro forma condensed consolidated financial information of the Company, after giving effect to the sale of the GCG Business to the Buyers as follows:

Unaudited pro forma condensed consolidated statements of operations for the three months ended March 31, 2018, and the year ended December 31, 2017.

Unaudited pro forma condensed consolidated balance sheets as of March 31, 2018

Notes to unaudited pro forma condensed combined financial information.

99.2 Press Release issued by the Company dated June 18, 2018

* Schedules and similar attachments omitted pursuant to Item 601(b)(2) of Regulation S-K. The Company agrees to furnish supplementally a copy of such omitted schedules and similar attachments to the Securities and Exchange Commission upon request.

Cautionary Note regarding Forward-Looking Statements

This Current Report on Form 8-K (including the Exhibits hereto) includes information, statements, and assumptions that are or may be considered forward-looking within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements generally can be identified by the use of words such as may, should, will, expect, anticipate, continue, estimate, project, believe, plan or similar expressions. This information has be in reliance on the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The Company cautions that forward-looking statements involve known and unknown risks, uncertainties, and other factors that may cause actual results, performance, or achievements to be materially different from future results, performance, or achievements, including, without limitation, as the result of risks referenced in the Company s Annual Report on Form 10-K for the year ended December 31, 2017, filed on March 7, 2018, and in the Company s other filings with the Securities and Exchange Commission from time to time. The Company undertakes no obligation to update or revise any forward-looking statements.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned hereunto duly authorized.

CRAWFORD & COMPANY

By: /s/ Joseph O. Blanco
Name: Joseph O. Blanco
Title: SVP, General Counsel

Date: June 18, 2018

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Purchases of short-term investments
(54,517) (35,440) (89,957) (243,652) (9,381) (253,033)
Proceeds from sales and maturities of short-term investments
107,931 35,549 143,480 224,154 9,947 234,101
Purchases of property and equipment
(2,698) (2) (2,700) (3,831) 185 (3,646)
Net cash provided by (used in) investing activities
50,716 107 50,823 (23,329) 751 (22,578)
Financing activities:

Principal payments on capital leases
(124) (2) (126) (66) (1,631) (1,697)
Proceeds from issuance of common stock
1,681 1 1,682 3,729 (1) 3,728
Net cash provided by financing activities
1,557 (1) 1,556 3,663 (1,632) 2,031
Effect of foreign currency exchange rate changes
307 307 1,172 1,172
Net (decrease) increase in cash and cash equivalents
13,030 13,030 (86,891) (86,891)
Cash and cash equivalents at beginning of year
30,188 30,188 117,079 117,079
Cash and cash equivalents at end of year
$ 43,218 $ $ 43,218 $ 30,188 $ $ 30,188
Supplemental disclosures of cash flow information:

Cash paid for income taxes
$ 138 $ 37 $ 175 $ 194 $ 194
Cash paid for interest
$ 3,268 $ $ 3,268 $ 3,262 $ 3,262
Deferred compensation relating to common stock issued to non-employees
$ 17 $ $ 17 $ 53 $ $ 53

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Fair Value of Financial Instruments

The amounts reported as cash and cash equivalents approximate fair value due to their short-term maturities. The fair value for the Company s investments in marketable debt and equity securities is estimated based on quoted market prices.

The fair value of short-term and long-term capital lease and debt obligations is estimated based on current interest rates available to the Company for debt instruments with similar terms, degrees of risk and remaining maturities. The carrying values of these obligations, as of each period presented, approximate their respective fair values.

The following estimated fair value amounts have been determined using available market information. However, considerable judgment is required in interpreting market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts that the Company could realize in a current market exchange.

December 31, 2005	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(in thousands)		
Investments maturing in less than 1 year:				
Commercial paper	$ 7,950	$	$ (3)	$ 7,947
Government agency obligations	47,000		(325)	46,675
Subtotal	54,950		(328)	54,622
Investments maturing in 1-2 years:				
Fixed income corporate securities	3,959		(9)	3,950
Government agency obligations	13,998		(136)	13,862
Subtotal	17,957		(145)	17,812
Total	$ 72,907	$	$ (473)	$ 72,434

December 31, 2004	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
		(in thousands)		

Investments maturing in less than 1 year:								
Government agency obligations	$	8,000	$		$	(72)	$	7,928
Investments maturing in 1-2 years:								
Government agency obligations		47,006				(417)		46,589
Total	$	55,006	$		$	(489)	$	54,517

There were no realized gains or losses on short-term investments in either the year ended December 31, 2005 or 2004, respectively.

Note 5. Commitments

Leases

The Company leases its facilities and certain equipment under operating leases. Effective in August 2006, the Company entered into a sub-sublease agreement to sub-sublease its then current principal executive offices located in Santa Clara, California and consisting of approximately 141,000 square feet of office space. The sub-sublease agreement expires on October 31, 2009 which is the same day as the Company s agreement to sublease the premises

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

expires. Concurrently, the Company entered into a lease agreement to lease approximately 63,069 square feet of office space through September 2009 at another location in Santa Clara, California to serve as the Company s new principal executive offices. The facility in Belgium is leased through June 30, 2013 with a right to terminate at the end of each three-year period commencing on July 1, 2004. The Company has a lease in Israel that expires in February 2007. The Company rents the remainder of its facilities on a month-to-month basis. Rent expense was approximately $5.6 million, $6.5 million and $6.8 million, for the years ended December 31, 2005, 2004 and 2003, respectively. Prior to the expiration of certain leases, the Company subleased a portion of its facilities to third parties and currently subleases its former principal executive offices to a third party. See Note 7, Restructuring Charges and Asset Write-offs. The Company s sublease rental income was approximately $2.6 million, $1.9 million and $1.5 million for the years ended December 31, 2005, 2004 and 2003, respectively.

In 2002, the Company entered into an operating lease arrangement to lease a corporate aircraft. This lease arrangement was secured by a $9.0 million letter of credit at December 31, 2002. The letter of credit was reduced to $7.5 million in February 2003. The $7.5 million letter of credit was converted to a cash deposit in 2004. In August 2004, the Company entered into a 28-month aircraft sublease terminating on December 31, 2006. The lease commitment for the aircraft is included in the table below.

Future minimum lease payments under non-cancelable operating leases as of December 31, 2005 are as follows (in thousands):

	Operating Leases
2006	$ 4,898
2007	3,221
2008	3,105
2009	2,578
2010	
Thereafter	
Total minimum payments	$ 13,802

As of December 31, 2005 there are approximately $1.3 million of future minimum sublease payments for the Company s corporate jet and leased facility in Ottawa, Canada to be received under non-cancelable subleases not reflected in the table above.

Purchase Obligations and Special Charges

The Company has purchase obligations to certain of its suppliers that support the Company s ability to manufacture its products. The obligations consist of open purchase orders placed with vendors for goods and services of the vendors products at a specified price. As of December 31, 2005, $12.1 million of purchase obligations were outstanding. As a result of declines in its forecasts, the Company has canceled certain purchase orders with its contract manufacturers

that had existing inventory on hand, or on order in anticipation of the Company s earlier forecasts. Consequently, the Company accrued for vendor cancellation charges in amounts that represented management s estimate of the Company s exposure to vendors for its inventory commitments. At December 31, 2005, accrued vendor cancellation charges were $1.5 million and the remaining $10.6 million was attributable to open purchase orders that are expected to be utilized in the normal course of business and are expected to become payable at various times throughout 2006.

Letters of Credit

As of December 31, 2005, the Company had $0.5 million in available letters of credit primarily required to support operating leases which expire at various dates through 2009.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Royalties

The Company has various royalty arrangements, which require it to pay nominal amounts to various suppliers for usage of licensed property. Royalties are generally calculated on a per-unit basis, and to a lesser extent, as a percentage of sales. The Company s total accrued obligations for royalties at December 31, 2005 and 2004 were $50,000 and $0.4 million, respectively.

The Company has purchased, through its acquisition of Radwiz Ltd. (Radwiz), certain technology that utilized funding provided by the Israeli Chief Scientist of the Ministry of Industry and Trade (Chief Scientist). Additionally, Terayon Communication Systems Ltd. (Terayon Ltd.) received certain funding from the Chief Scientist to develop technology used in one of the products developed by the Company. The Company has committed to pay royalties to the Government of Israel based on proceeds from sales of products using this technology. The Company sold Radwiz to a third party in 2004, which included any future Chief Scientist liabilities related to the sale of technology developed by Radwiz. The Company discontinued the product developed by Terayon Ltd. and does not expect to sell any products using this technology in 2006 or any future periods.

Note 6. Accrued Severance Pay

In June 2004, we entered into separation agreements with two executive officers. One officer resigned in the quarter ended June 30, 2004 and the other officer resigned in the quarter ended September 30, 2004. We recorded a severance provision of $1.7 million related to termination costs for one of the officers in the quarter ended June 30, 2004, along with another executive officer who resigned in the quarter effective July 2003. We recorded a severance provision of $1.4 million in the quarter ended September 30, 2004 for the other executive officer. Most of the severance costs were paid in the quarters ended September 30, 2004 and December 31, 2004 with nominal amounts for employee benefits payable through the quarter ended September 30, 2005.

In August 2004, we entered into an employment agreement with another executive officer. The executive officer resigned effective as of December 31, 2004 with a termination date of February 3, 2005. We recorded a severance provision of $0.4 million related to termination costs for this officer in the quarter ended December 31, 2004. Most of the severance costs related to this officer were paid in the quarter ended March 31, 2005 with nominal amounts for employee benefits payable into the quarter ended December 31, 2005.

This table summarizes the executive severance balance as of December 31, 2005 (in thousands):

	December 31, 2005
Balance at December 31, 2004	$ 431
Charges	14
Cash payments	(444)
Balance at December 31, 2005	$ 1

The 2004 charge for executive severance of $3.5 million is included within restructuring charges, executive severance and asset write-off in the Consolidated Statement of Operations. The $0.4 million in executive severance is accrued on the Consolidated Balance Sheet within accrued restructuring and executive severance at December 31, 2004.

One of the Company s subsidiaries is subject to Israeli law and labor agreements, under which it is required to make severance payments to dismissed employees and employees leaving its employment in certain other circumstances. This subsidiary s severance pay liability to its employees, which is calculated on the basis of the salary of each employee for the last month of the reported year multiplied by the years of such employee s employment, is included in the Company s consolidated balance sheets on the accrual basis, and is partially funded by a purchase of insurance policies in the subsidiary s name. At December 31, 2005 and 2004, $0.4 million and

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

$1.3 million, respectively, for accrued severance pay was included in long-term obligations. In accordance with EITF 88-1, Determination of Vested Benefit Obligation for a Defined Benefit Pension Plan, the Company included $0.2 million and $0.7 million which related to the amounts funded by the purchase of insurance policies for the Israeli severance liabilities in its consolidated balance sheets as current liabilities and other assets at December 31, 2005 and 2004, respectively.

Note 7. Restructuring Charges and Asset Write-offs

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

2004 Restructurings

During the quarter ended March 31, 2004, the Company initiated a restructuring plan to bring operating expenses in line with revenue levels. In the quarter ended March 31, 2004, the Company incurred 2004 restructuring plan charges in the amount of $3.3 million of which $1.0 million related to employee termination costs, $0.9 million related to termination costs for an aircraft lease, and $1.4 million related to costs for excess leased facilities. In the quarter ended June 30, 2004, the Company incurred 2004 restructuring plan charges in the amount of $1.1 million related to additional costs for excess leased facilities. In the quarter ended December 31, 2004, to further conform the Company s expenses to its revenues and to cease investment in the CMTS product line, the Company s Board of Directors approved a restructuring plan with a charge in the amount of $1.3 million related to employee terminations. In the second, third and fourth quarters of 2004, the Company re-evaluated the first and second quarter 2004 restructuring charges for the employee severance, excess facilities and the aircraft lease termination. Based on market conditions, new assumptions provided by its real estate broker, and the terms of the aircraft sublease agreement, which the Company entered into in the quarter ended September 30, 2004, the Company increased the restructuring charge for the aircraft lease by a total of $1.0 million, the facilities accrual was increased by $0.3 million and employee severance accrual was decreased by $0.2 million, for the year ended December 31, 2004.

The Company anticipates the remaining restructuring accrual related to the aircraft lease to be substantially utilized for servicing operating lease payments through January 2007, and the remaining restructuring accrual related to excess leased facilities to be utilized for servicing operating lease payments through October 2009.

The reserve for the aircraft lease approximates the difference between the Company s current costs for the aircraft lease and the estimated income derived from subleasing.

The amount of net charges accrued under the 2004 restructuring plans assumes that the Company will successfully sublease excess leased facilities. The reserve for the excess leased facilities includes the estimated income derived from subleasing, which is based on information from the Company s real estate brokers, who estimated it based on assumptions relevant to the real estate market conditions as of the date of the Company s implementation of the restructuring plan and the time it would likely take to sub-lease the excess leased facility. The Company sub-subleased its former principal executive offices in August 2006.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

This table summarizes the accrued restructuring balances related to the 2004 restructurings as of December 31, 2005 (in thousands):

	Involuntary Terminations	Excess Leased Facilities	Aircraft Lease Termination	Total
Charges	$ 2,298	$ 2,523	$ 933	$ 5,754
Cash payments	(1,467)	(850)	(1,194)	(3,511)
Changes in estimates	(239)	324	954	1,039
Balance at December 31, 2004	592	1,997	693	3,282
Charges	1,037			1,037
Cash payments	(1,534)	(1,190)	(344)	(3,068)
Changes in estimates	(95)	1,246	149	1,300
Balance at December 31, 2005	$	$ 2,053	$ 498	$ 2,551

2003 Restructuring

During the quarter ended March 31, 2003, the Company initiated a restructuring plan to conform the Company s expenses to its revenue levels and to better position the Company for future growth and eventual profitability. The Company incurred restructuring charges in the amount of $2.7 million related to employee termination costs as part of the 2003 restructuring. As of December 31, 2003, 81 employees were terminated throughout the Company, and the Company paid $2.6 million in termination costs. In the quarter ended June 30, 2003, the Company reversed approximately $0.1 million of previously accrued termination costs due to a change in estimate. At December 31, 2005 and 2004, no restructuring charges remained accrued related to the 2003 restructurings.

2002 Restructuring

During 2002, another restructuring plan (2002 Plan) increased the reserve for excess leased facilities due to the exiting of additional space within the same facility in Israel as in the 2001 Plan. The Company incurred restructuring charges in the amount of $3.6 million for the 2002 Plan. Improving real estate market conditions in Israel in the early part of 2004 gave rise to our improved tenant sublease assumptions thereby creating a change in estimate of $0.1 million in the 2002 Plan, leaving nominal accrued restructuring charges at December 31, 2004.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

This table summarizes the accrued restructuring balances related to the 2002 restructurings as of December 31, 2005 (in thousands):

	Involuntary Terminations	Excess Leased Facilities and Cancelled Contracts	Total
Balance at December 31, 2002	$ 88	$ 1,423	$ 1,511
Cash payments	(88)	(220)	(308)
Changes in estimates		(1,103)	(1,103)
Balance at December 31, 2003		100	100
Charges		20	20
Cash payments		(5)	(5)
Changes in estimates		(100)	(100)
Balance at December 31, 2004		15	15
Changes in estimates		(15)	(15)
Balance at December 31, 2005	$	$	$

2001 Restructurings

As part of the restructuring plan initiated in 2001 (2001 Plan), the Company incurred restructuring charges in the amount of $12.7 million. In 2003, the Company increased the restructuring reserve by $0.8 million primarily related to excess leased facilities that had previously been part of the excess leased facilities reserve in the 2002 restructuring plan. In 2004, the Company decreased the reserve by $0.2 million due to improving real estate market conditions in Israel that gave rise to the Company s improved tenant sublease assumption that resulted in a change of estimate to the 2001 Plan. In 2005, the Company decreased the reserve by $0.3 million to reflect a decrease for improving tenant sublease conditions in Israel that was partially offset by an increase in the reserve for excess leased facilities due to the use of the wrong lease term in its initial estimate. At December 31, 2005, $0.1 million remained accrued for excess leased facilities.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

This table summarizes the accrued restructuring balances related to the 2001 restructurings as of December 31, 2005 (in thousands):

		Excess Leased Facilities and Cancelled Contracts
Balance at December 31, 2002	$	4,066
Charges		
Cash payments		(1,676)
Changes in estimates		813
Balance at December 31, 2003		3,203
Charges		
Cash payments		(1,165)
Changes in estimates		(200)
Balance at December 31, 2004		1,838
Charges		
Cash payments		(1,450)
Changes in estimates		(253)
Balance at December 31, 2005	$	135

Asset Write-offs

As a result of CMTS product line restructuring activities in 2004, the Company wrote down $2.4 million of fixed assets, which were determined to have no remaining useful life or identified by management as being impaired.

As a result of restructuring activities in 2003, the Company wrote off $0.4 million of fixed assets in 2003, which were determined to have no remaining useful life. As a result of restructuring activities in 2002, approximately $1.4 million of fixed assets were determined to have no remaining useful life.

Note 8. Convertible Subordinated Notes

In July 2000, the Company issued $500 million of 5% convertible subordinated notes (Notes) due in August 2007 resulting in net proceeds to the Company of approximately $484 million. The Notes were convertible into shares of the Company s common stock at a conversion price of $84.01 per share at any time on or after October 24, 2000 through maturity, unless previously redeemed or repurchased. Under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities (SFAS 133), the Notes are considered a hybrid instrument since, and as described below, they contained multiple embedded derivatives.

The Notes contained several embedded derivatives. First, the Notes contain a contingent put (Contingent Put) where in the event of any default by the Company, the Trustee or holders of at least 25% of the principal amount of the Notes outstanding may declare all unpaid principal and accrued interest to be due and payable immediately. Second, the Notes contain an investor conversion option (Investor Conversion Option) where the holder of the Notes may convert the debt security into Company common stock at any time after 90 days from original issuance and prior to August 1, 2007. The number of shares of common stock that is issued upon conversion is determined by dividing the principal amount of the security by the specified conversion price in effect on the conversion date. The initial conversion price was $84.01 which was subject to adjustment under certain circumstances described in the Indenture. Third, the Notes contain a liquidated damages provision (Liquidated Damages Provision) that obligated

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

the Company to pay liquidated damages to investors of 50 basis points on the amount of outstanding securities for the first 90 days and 100 basis points thereafter, in the event that the Company did not file an initial shelf registration for the securities within 90 days of the closing date. In the event that the Company filed its initial shelf registration within 90 days but failed to keep it effective for a two year period from the closing date, the Company would pay 50 basis points on the amount of outstanding securities for the first 90 days and 100 basis points thereafter. Fourth, the Notes contain an issuer s call option (Issuer Call Option) that allowed the Company to redeem some or all of the Notes at any time on or after October 24, 2000 and before August 7, 2003 at a redemption price of $1,000 per $1,000 principal amount of the Notes, plus accrued and unpaid interest, if the closing price of the Company s stock exceeded 150% of the conversion price, or $126.01, for at least 20 trading days within a period of 30 consecutive trading days ending on the trading day prior to the date of the mailing of the redemption notice. In addition, if the Company redeemed the Notes, it was also required to make cash payment of $193.55 per $1,000 principal amount of the Notes less the amount of any interest actually paid on the Notes prior to redemption. The Company had the option to redeem the Notes at any time on or after August 7, 2003 at specified prices plus accrued and unpaid interest.

Under SFAS 133, an embedded derivative must be separated from its host contract (i.e., the Notes) and accounted for as a stand-alone derivative if the economic characteristics and risks of the embedded derivative are not considered clearly and closely related to those of the host. An embedded derivative would not be considered clearly and closely related to the host if there was a possible future interest rate scenario (even though it may be remote) in which the embedded derivative would at least double the initial rate of return on the host contract and the effective rate would be twice the current market rate as a contract that had similar terms as the host and was issued by a debtor with similar credit quality. Furthermore, per SFAS 133, the embedded derivative would not be considered clearly and closely related to the host contract if the hybrid instrument could be settled in such a way the investor would not recover substantially all of its initial investment.

During the restatement process, the Company determined under SFAS 133 that both the Issuer Call Option and the Liquidated Damages Provision represented an embedded derivative that was not clearly and closely related to the host contract, and therefore needed to be bifurcated from the Notes and valued separately. As it related to the Liquidated Damages Provision and based on a separate valuation that included Black-Scholes valuation methodologies, the Company assessed a valuation of $0.4 million. Based on the need to amortize the $0.4 million over the 7-year life of the Notes, the impact to the Company s financial results related to the Liquidated Damages Provision was not material.

As it related to the Issuer Call Option and based on a separate valuation that included Black-Scholes valuation methodologies, the Company assessed a valuation of $11.9 million. As a result, at the time the Notes were issued in July 2000, the Company should have created an asset to record the value of the Issuer Call Option for $11.9 million and created a bond premium to the Notes for $11.9 million. In accordance with SFAS 133, the asset value would then be marked to market at the end of each accounting period and the bond premium would be amortized against interest expense at the end of each accounting period. Due to the decrease in the price of the Company s common stock, the value of the Issuer Call Option became effectively zero and the Company should have written off the asset related to the Issuer Call Option in 2000. Additionally, as part of the bond repurchase activity where the Company repurchased $325.9 million and $109.1 million of face value of the Notes (for a total of $435 million) that occurred in 2001 and 2002, the Company should have recognized an additional gain from the retirement of the bond premium associated with the Issuer Call Option of $7.0 million in 2001 and $1.9 million in 2002. The Company determined that the $7.0 million non-cash gain on the early retirement of the premium to be immaterial to 2001 financial results.

In the quarter ended March 31, 2006, the Company paid off the entire principal amount of the outstanding Notes, including all accrued and unpaid interest and related fees, for a total of $65.6 million. In addition, the Company recognized $0.3 million into other income, net representing the remaining unamortized bond premium associated with the Issuer Call Option.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. Contingencies

Litigation

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

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

In 2002, two shareholders filed derivative cases purportedly on behalf of the Company against certain of its current and former directors, officers and investors. (The defendants differed somewhat in the two cases.) Since the cases were filed, the investor defendants have been dismissed without prejudice, and the lawsuits have been consolidated as *Campbell v. Rakib* in the Superior Court of California, County of Santa Clara. The Company is a nominal defendant in these lawsuits, which allege claims relating to essentially the same purportedly misleading statements that are at issue in the securities class action filed in April 2000. In that securities class action, the Company disputed making any misleading statements. The derivative complaints also allege claims relating to stock sales by certain of the director and officer defendants. On September 15, 2006, the Company entered into a Stipulation of Settlement of Derivative Claims. On September 18, 2006, the Superior Court of California, County of Santa Clara approved the final settlement of the derivative litigation entitled *In re Terayon Communication Systems, Inc. Derivative Litigation* (Case No. CV

807650). In connection with the settlement, the Company paid $1.0 million in attorney s fees and expenses to the derivative plaintiffs counsel and agreed to adopt certain corporate governance practices. As a result, the Company accrued $1.0 million to litigation settlement expense in the fourth quarter of 2005.

On June 23, 2006, a putative class action lawsuit was filed against the Company in the United States District Court for the Northern District of California by I.B.L. Investments Ltd. purportedly on behalf of all persons who

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

purchased the Company s common stock between October 28, 2004 and March 1, 2006. Zaki Rakib, Jerry D. Chase, Mark Richman and Edward Lopez are named as individual defendants. The lawsuit focuses on the Company s March 1, 2006 announcement of the restatement of the Company s financial statements for the year ended December 31, 2004, and for the four quarters of 2004 and the first two quarters of 2005. The plaintiffs are seeking damages, interest, costs and any other relief deemed proper by the court. An unfavorable ruling in this legal matter could materially and adversely impact the Company s results of operations.

In January 2005, Adelphia Communications Corporation (Adelphia) sued the Company in the District Court of the City and County of Denver, Colorado. Adelphia s complaint alleged, among other things, breach of contract and misrepresentation in connection with the Company s sale of cable modem termination systems (CMTS) products to Adelphia and the Company s announcement to cease future investment in the CMTS market. Adelphia sought damages in excess of $25.0 million and declaratory relief. The Company moved to dismiss the complaint seeking an order blocking the case from going forward at a preliminary stage. The court denied the Company s motion to dismiss the complaint, thereby permitting the case and discovery to go forward. The Company filed a response to Adelphia s complaint and discovery began. On October 21, 2005, the parties settled the litigation in exchange for (i) full mutual releases of the other party for claims related to the CMTS and customer premise equipment products and (ii) a payment to Adelphia consisting of $3.0 million in cash, $0.8 million of DM 6400 products at list price and $0.8 million of modems at a price of $33.50 each. On December 1, 2005, the United States Bankruptcy Court of the Southern District of New York approved the settlement. On December 15, 2005, the court dismissed the case with prejudice.

On April 22, 2005, the Company filed a lawsuit in the Superior Court of California, County of Santa Clara against Adam S. Tom (Tom) and Edward A. Krause (Krause) and a company founded by Tom and Krause, RGB Networks, Inc. (RGB). The Company sued Tom and Krause for breach of contract and RGB for intentional interference with contractual relations based on breaches of the Noncompetition Agreements entered into between the Company and Tom and Krause, respectively. On May 24, 2006, RGB, Tom and Krause filed a Notice of Motion and Motion For Leave To File a Cross-Complaint, in which the defendants stated that they intended to file counter-claims against the Company for misappropriation of trade secrets, unfair competition, tortious interference with contractual relations and tortious interference with prospective economic advantage. On July 6, 2006, the court granted the defendants motion, and on July 20, defendants filed a cross-complaint for misappropriation of trade secrets, unfair competition, tortious interference with contractual relations and tortious interference with prospective economic advantage. On August 21, 2006, the Company filed a demurrer to certain of those claims. The court granted the Company s demurrer as to RGB s request for declaratory judgment. On November 9, 2006, the Company filed the Company s answer to RGB s complaint. Damages in this matter are not capable of determination at this time and the case may be lengthy and expensive to litigate.

On September 13, 2005, a case was filed by Hybrid Patents, Inc. (Hybrid) against Charter Communications, Inc. (Charter) in the United States District Court for the Eastern District of Texas for patent infringement related to Charter s use of equipment (cable modems, CMTS and embedded multimedia terminal adapters (eMTAs)) meeting the Data Over Cable System Interface Specification (DOCSIS) standards and certain video equipment. Hybrid has alleged that the use of such products violates its patent rights. Charter has requested that the Company and others supplying it with equipment indemnify Charter for these claims. The Company and others have agreed to contribute to the payment of the legal costs and expenses related to this case. On May 4, 2006, Charter filed a cross-complaint asserting its indemnity rights against the Company and a number of companies that supplied Charter with cable modems, and to date, this cross-complaint has not been dismissed. Trial is scheduled on Hybrid s claims for July 2, 2007. At this point,

the outcome is uncertain and the Company cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Hybrid is successful in its claim against Charter and then elects to pursue other cable operators that use the allegedly infringing products.

On July 14, 2006, a case was filed by Hybrid against Time Warner Cable (TWC), Cox Communications Inc. (Cox), Comcast Corporation (Comcast), and Comcast of Dallas, LP (together, the MSOs) in the United States

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

District Court for the Eastern District of Texas for patent infringement related to the MSOs use of data transmission systems and certain video equipment. Hybrid has alleged that the use of such products violate its patent rights. No trial date is known yet. To date, the Company has not been named as a party to the action. The MSOs have requested that the Company and others supplying them with cable modems and equipment indemnify the MSOs for these claims. The Company and others have agreed to contribute to the payment of legal costs and expenses related to this case. At this point, the outcome is uncertain and the Company cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Hybrid is successful in its claim against the MSOs and then elects to pursue other cable operators that use the allegedly infringing products.

On September 16, 2005, a case was filed by Rembrandt Technologies, LP (Rembrandt) against Comcast in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, Rembrandt alleged that products and services sold by Comcast infringe certain patents related to cable modem, voice-over internet, and video technology and applications. To date, the Company has not been named as a party in the action, but the Company has received a subpoena for documents and a deposition related to the products the Company sold to Comcast. The Company continues to comply with this subpoena. Comcast requested that the Company and others supplying them with products for indemnity related to the products that the Company sold to them. The Company and others have agreed to contribute to the payment of legal costs and expenses related to this case. Trial is scheduled on Rembrandt s claims for August 6, 2007. At this point, the outcome is uncertain and the Company cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Rembrandt is successful in its claim against Comcast and then elects to pursue other cable operators that use the allegedly infringing products.

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

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

On September 13, 2006, a second case was filed by Rembrandt against TWC in the United States District Court for the Eastern District of Texas alleging patent infringement. In this matter, Rembrandt alleged that products and services sold by TWC infringe certain patents related to the DOCSIS standard. To date, the Company has not been named as a party in the action, but TWC has made a request for indemnity related to the products that the Company and others have sold to them. The Company and others have agreed to contribute to the payment of legal costs and expenses related to this case. Trial date of this matter is not known at this time. At this point, the outcome

TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

is uncertain and the Company cannot assess damages. However, the case may be expensive to defend and there may be substantial monetary exposure if Rembrandt is successful in its claim against TWC and then elects to pursue other cable operators that use the allegedly infringing products.

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

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

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

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

In December 2005, the Commission issued a formal order of investigation in connection with the Company s accounting review of a certain customer transaction. These matters were previously the subject of an informal Commission inquiry. We have been cooperating fully with the Commission and will continue to do so in order to bring the investigation to a conclusion as promptly as possible.

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

above legal proceedings could change in the future.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10. Stockholders Equity

Common Stock Warrants

In conjunction with a 1998 preferred stock financing, the Company issued Shaw Communications Inc. (Shaw) a warrant (Anti-Dilution Warrant) to purchase an indeterminate number of shares of common stock. The Anti-Dilution Warrant was exercisable at the option of Shaw during the period that Shaw owned equity in the Company and in the event the Company issued new equity securities at below the current market price defined in the Anti-Dilution Warrant. The aggregate exercise price was $0.50. The Company issued certain equity securities that, as of December 31, 2003 and 2002, respectively, required the Company to issue an additional 37,283 and 17,293 shares of common stock under the Anti-Dilution Warrant. The Company recorded expenses of approximately $45,000 and $26,000 relating to the issuance of warrants pursuant to the Anti-Dilution Warrant in 2003 and 2002, respectively. The expense was calculated by multiplying the annualized fair market value of the Company s stock by the share dilution attributable to the Anti-Dilution Warrant. As of May 31, 2003, Shaw transferred all of its outstanding shares of common stock to a third party and consequently, the Anti-Dilution Warrant expired unexercised.

In October 1999, a customer of the Company entered into an agreement with Telegate Ltd., an Israeli company (Telegate), which was negotiating with the Company to be acquired by the Company, whereby the customer committed to an investment in Telegate in connection with the acquisition of all the outstanding shares of Telegate by the Company. The customer committed to provide this investment in the event that the acquisition of Telegate by the Company did not close. In January 2000, the Company issued the customer a warrant to purchase 2,000,000 shares of the Company s common stock at a price of $30.75 per share, the closing price of the Company s common stock on the date the warrant was issued. The warrant was fully vested, non-forfeitable, and immediately exercisable and had a term of three years. The fair value of the warrant, determined as approximately $34.6 million using the Black-Scholes method, was included in the Telegate purchase price and was associated with the value of the customer relationship. The value of the warrant resulted in a non-cash charge to cost of goods sold to be amortized over the three-year term of the warrant. For the year ended December 2003, the Company incurred no amortization expense related to the warrant. The Telegate warrant expired unexercised in January 2003.

In February 2001, the Company issued a warrant to purchase 200,000 shares of the Company s common stock at a price of $5.4375 per share, the closing price of the Company s common stock on the date the warrant was issued, in connection with the December 2000 acquisition of TrueChat, Inc. (TrueChat). Under the terms of the warrant, 100,000 shares were vested and exercisable immediately and the remaining 100,000 shares vested and became exercisable at the rate of 1/24th per month, beginning January 31, 2001. The fair value of the warrant of approximately $0.7 million was calculated using the Black-Scholes method and was recorded as additional consideration relating to the purchase of TrueChat. As of December 31, 2003, the TrueChat warrant was exercisable for an aggregate of 200,000 shares of the Company s common stock. The TrueChat warrant expired unexercised in February 2004.

Stockholder Rights Plan

In February 2001, the Company s Board of Directors approved the adoption of a Stockholder Rights Plan under which all stockholders of record as of February 20, 2001 received rights to purchase shares of a new series of preferred stock. The rights were distributed as a non-taxable dividend and will expire in ten years from the record date. The rights will

be exercisable only if a person or group acquires 15% or more of the Company s common stock or announces a tender offer for 15% or more of the Company s common stock. If a person or group acquires 15% or more of the Company s common stock, all rights holders except the buyer will be entitled to acquire the Company s common stock at a discount. The Board of Directors may terminate the Stockholder Rights Plan at any time or redeem the rights prior to the time a person or group acquires more than 15% of the Company s common stock.

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Common Stock Reserved

Common stock reserved for issuance is as follows:

	December 31, 2005
Common stock options	18,392,821
Employee stock purchase plan	600,371
Total	18,993,192

Stock Option and Stock Purchase Plans

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

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

The Company s 1999 Non-Officer Equity Incentive Plan (1999 Plan) provides for nonqualified stock options to be issued to non-officer employees and consultants of the Company. Prices for nonqualified stock options may not be less than 85% of the fair market value of the common stock at the date of the grant. Options generally vest and become exercisable over a period not to exceed five years from the date of grant. Unexercised options expire ten years after date of grant. The 1999 Plan also provides for the sale of restricted shares of common stock to employees, directors and consultants and the Company has provided such awards in prior years and may provide such awards in the future.

As of December 31, 2005, and from inception, the Company had authorized an aggregate of 2,643,442, 16,796,362, 800,000 and 7,208,501 shares of common stock for issuance under the 1995 Plan, the 1997 Plan, the 1998 Plan and

the 1999 Plan, respectively. As of December 31, 2005, a total of 4,518 shares, 3,980,642 shares, 79,967 shares, and 1,305,392 shares were available for issuance under the 1995 Plan, the 1997 Plan, the 1998 Plan and the 1999 Plan, respectively.

During the year ended December 31, 2002, the Company recorded aggregate deferred compensation of approximately $38,000 representing the difference between the grant price and the deemed fair value of the Company s common stock options granted during the period. During the years ended December 31, 2004 and 2003, the Company did not record any additional deferred compensation. The amortization of deferred compensation is being charged to operations and is being amortized over the vesting period of the options, which is typically five years. In each subsequent reporting period (through the vesting period) the remaining deferred compensation will be re-measured. For the years ended December 31, 2005, 2004 and 2003 the amortization expense was approximately $0.1 million, $17,000 and $0.1 million, respectively.

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The following is a summary of additional information with respect to the 1995 Plan, the 1997 Plan, the 1998 Plan, the 1999 Plan, Mainsail Equity Incentive Plan, TrueChat Equity Incentive Plan, other outside equity plans and outstanding options assumed by the Company in conjunction with its business acquisitions and option grants made outside the plans:

	Options	Options Outstanding	
	Available for Grant	Number of Shares	Weighted Average Exercise Price
Balance at December 31, 2002	28,991,401	14,619,825	$ 8.02
Options authorized	(17,000,000)		
Options granted	(7,153,320)	7,153,320	3.05
Options exercised		(602,272)	4.20
Options canceled	3,706,914	(3,706,914)	7.61
Balance at December 31, 2003	8,544,995	17,463,959	$ 6.20
Options authorized	3,000,000		
Options granted	(4,738,944)	4,738,944	1.96
Options exercised		(225,645)	2.19
Options canceled	5,174,420	(5,174,420)	5.19
Balance at December 31, 2004	11,980,471	16,802,838	$ 5.37
Options authorized	(8,500,000)		
Options granted	(2,911,675)	2,911,675	3.01
Options exercised		(1,341,112)	2.28
Options canceled	5,341,415	(5,341,415)	6.31
Shares expired	(379,286)		
Balance at December 31, 2005	5,530,925	13,031,986	$ 4.78

In addition, the following table summarizes information about stock options that were outstanding and exercisable at December 31, 2005:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Shares Outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Exercisable Options	Weighted Average Exercise Price

$0.00 - $1.99	2,692,641	8.59	$ 1.76	1,078,710	$ 1.74
$2.01 - $2.95	2,606,963	7.62	2.52	2,154,490	2.47
$2.97 - $3.49	2,612,493	5.50	3.04	437,250	3.04
$3.50 - $6.52	1,250,704	6.13	5.53	973,743	5.58
$6.81 - $66.37	3,869,185	5.00	9.33	3,858,293	9.33
Total	13,031,986	6.48	$ 4.78	8,502,486	$ 5.88

At December 31, 2005, there were no shares of the Company s common stock subject to repurchase by the Company.

Employee Stock Purchase Plan

In June 1998, the Board of Directors approved, and the Company adopted, the 1998 Employee Stock Purchase Plan (ESPP), which is designed to allow eligible employees of the Company to purchase shares of common stock at

TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

semi-annual intervals through periodic payroll deductions. An aggregate of 4,400,000 shares of common stock are reserved for the ESPP, and 3,799,629 shares had been issued through December 31, 2005. The ESPP is implemented in a series of successive offering periods, each with a maximum duration of 24 months. Eligible employees can have up to 15% of their base salary deducted to purchase shares of the common stock on specific dates determined by the Board of Directors (up to a maximum of $25,000 per year based upon the fair market value of the shares at the beginning date of the offering). The price of common stock purchased under the ESPP will be equal to 85% of the lower of the fair market value of the common stock on the commencement date of each offering period or the specified purchase date. In November 2002 the Company s Board of Directors suspended the ESPP after the final offering period expired on July 31, 2004.

The Company has elected to follow APB 25 and related interpretations in accounting for its employee stock plans because, as discussed below, the alternative fair value accounting provided for under SFAS 123 requires the use of valuation models that were not developed for use in valuing employee stock instruments. Under APB 25, when the exercise price of the Company s employee stock options equals the market price of the underlying stock on the date of grant, no compensation expense is recognized.

Pro forma information regarding net loss is required under SFAS 123 and is calculated as if the Company had accounted for its employee stock options and for its ESPP shares to be issued under the fair value method of SFAS 123. The fair value for employee stock options granted and ESPP shares was estimated at the date of grant based on the Black-Scholes method using the following weighted average assumptions:

	Risk-free Interest Rates	Expected Volatility	Expected Life (in years)	Dividend Yield
2003				
Stock option plans	2.67%	0.87	5.0	0.0%
Employee stock purchase plan	1.27%	1.54	0.5	0.0%
2004				
Stock option plans	3.47%	0.78	5.0	0.0%
Employee stock purchase plan	1.16%	0.80	0.5	0.0%
2005				
Stock option plans	3.93%	0.58	2.1	0.0%

As discussed above, the valuation models used under SFAS 123 were developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, valuation models require the input of highly subjective assumptions, including the expected life of the option. Because the Company s employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management s opinion, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock instruments.

The options weighted average grant date fair value, which is the value assigned to the options under SFAS 123, was $1.42, $1.28 and $2.14, for options granted during 2005, 2004 and 2003, respectively. The weighted average grant date fair value of ESPP shares to be issued was $0.99 and $0.99 for the years ended December 31, 2004 and 2003, respectively. There were no ESPP shares issued in 2005.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11. Income Taxes

The benefit (expense) for income taxes consists of (in thousands):

	Year Ended December 31,		
	2005	2004 (as restated)(1)	2003 (as restated)(1)
Current:			
Federal	$	$	$
State		(40)	
Foreign	(149)	116	(316)
Total current	(149)	76	(316)
Deferred:			
Federal			
State			
Foreign			
Total deferred			
	$ (149)	$ 76	$ (316)

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

The reconciliation of income tax benefit attributable to net loss applicable to common stockholders computed at the U.S. federal statutory rates to income tax benefit (expense) (in thousands):

	Year Ended December 31,		
	2005	2004 (as restated)(1)	2003 (as restated)(1)
Tax benefit at U.S. statutory rate	$ 9,418	$ 16,513	$ 19,568
Loss for which no tax benefit is currently recognizable	(9,418)	(16,513)	(19,568)
Other, net	(149)	76	(316)
	$ (149)	$ 76	$ (316)

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

components of the Company s deferred tax assets and liabilities as of December 31, 2005 and 2004 are as follows (in thousands):

	Year Ended December 31, 2005		2004 (as restated)(1)
Deferred tax assets:			
Net operating loss carryforwards	$	156,229	$ 156,608
Tax credit carryforwards		13,607	13,336
Reserves and accruals		9,469	10,533
Capitalized research and development		2,270	2,959
Intangible asset amortization		24,929	27,482
Deferred revenue		14,239	4,738
Other, net		9,078	10,904
Gross deferred tax assets		229,821	226,560
Valuation allowance		(229,821)	(226,560)
Net deferred tax assets	$		$

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

Realization of deferred tax assets is dependent on future earnings, if any, the timing and the amount of which are uncertain. Accordingly, a valuation allowance has been established to reflect these uncertainties as of December 31, 2005 and 2004. The valuation allowance increased $3.3 million for the year ended December 31, 2005 as compared to 2004. Approximately $44.3 million of the valuation allowance at December 31, 2005 related to stock options benefits to be credited to equity when realized.

As of December 31, 2005 and 2004, the Company had federal and California net operating loss carryforwards of approximately $391.7 million and $312.8 million, respectively. The Company also had federal and California tax credit carryforwards of approximately $8.8 million and $11.2 million, respectively, as of December 31, 2005. The federal and California net operating loss and credit carryforwards will expire at various dates beginning in the years 2006 through 2025, if not utilized. The federal research credits expire at various dates beginning in the years 2009 through 2022, if not utilized. The California research credits have no expiration date.

Utilization of net operating loss and tax credit carryforwards may be subject to a substantial annual limitation due to the ownership change limitations provided by the Internal Revenue Code of 1986, as amended, and similar state provisions. The annual limitation may result in the expiration of net operating loss and tax credit carry-forwards before full utilization.

Note 12. Defined Contribution Plan

During 1995, the Company adopted a 401(k) Profit Sharing Plan and Trust that allows eligible employees to make contributions subject to certain limitations. The Company may make discretionary contributions based on profitability as determined by the Board of Directors. No amount was contributed by the Company to the plan during the years ended December 31, 2005, 2004 and 2003.

Note 13. Segment Information

In late 2000, the worldwide telecom and satellite industries experienced severe downturns that resulted in significantly reduced purchases of equipment. Because of that decrease in demand, the Company refocused its efforts on sales of its data products to the cable industry and its digital video products to the cable and satellite

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

industry, and significantly reduced and then ultimately eliminated its telecom and satellite businesses. Consequently, beginning in 2003, the Company s previously reported telecom segment no longer meets the quantitative threshold for disclosure and the Company now operates as one business segment.

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

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

	Year Ended December 31,		
	2005	**2004 (as restated)(1)**	**2003 (as restated)(1)**
Geographic areas:			
Revenues:			
United States	$ 52,838	$ 72,838	$ 71,945
Americas, excluding United States	1,871	4,930	3,081
Europe, Middle East and Africa (EMEA), excluding Israel	15,314	17,640	9,450
Israel	7,645	16,645	15,274
Asia excluding Japan	11,544	15,259	9,094
Japan	1,452	9,172	21,343
Total	$ 90,664	$ 136,484	$ 130,187

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Year Ended December 31, 2005	2004 (as restated)(1)
Long-lived assets:		
United States	$ 3,701	$ 4,517
Americas, excluding United States	5	402
Europe, Middle East and Africa (EMEA), excluding Israel	65	132
Israel	16	687
Asia	128	116
Total	$ 3,915	$ 5,854

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

Three customers, Harmonic, Inc. (Harmonic), Thomson Broadcast, and Comcast Corporation (Comcast) each accounted for 10% or more of total revenues for the year ended December 31, 2005 (12%, 11% and 10%, respectively). Two customers, Adelphia Communications Corporation (Adelphia) and Comcast accounted for more than 10% each of total revenues for the year ended December 31, 2004 (20% and 13%, respectively). Three customers, Adelphia, Cross Beam Networks and Comcast each accounted for more than 10% of total revenues for the year ended December 31, 2003 (21%, 16% and 13%, respectively). Four customers, Comcast, HOT Telecom, Wharf T&T Limited and CSC Holdings, each accounted for 10% or more of total accounts receivable as of December 31, 2005 (16%, 11%, 11%, and 11%, respectively). Two customers, Comcast and Harmonic, each accounted for 10% or more of total accounts receivable as of December 31, 2004 (17% and 15%, respectively).

Note 14. Related Party Transactions

Aleksander Krstajic, a member of the Company s Board of Directors until June 19, 2006, was the Senior Vice President of Interactive Services, Sales and Product Development for Rogers Communications, Inc. (Rogers) until January 2003. Effective in April 2003, Rogers was no longer a related party to the Company. Revenues attributable to Rogers are only classified as related party revenues in the first and second quarters of 2003, which were not material. The Company recognized revenues of $1.5 million from sales to Rogers during the combined periods of the first and second quarters of 2003.

Note 15. Product Warranty

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

the liability for product warranties is as follows (in thousands):

	Year Ended December 31, 2005	2004 (as restated)(1)
Balance at beginning of period	$ 4,670	$ 5,229
Additions (reductions) charged to costs and expenses	(166)	3,075
Settlements	(1,617)	(3,634)
Balance at end of period	$ 2,887	$ 4,670

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Guarantees, Including Indirect Guarantees of Indebtedness of Others

In addition to product warranties, the Company, from time to time, in the normal course of business, indemnifies other parties with whom it enters into contractual relationships, including customers, lessors, and parties to other transactions with the Company, with respect to certain matters. These obligations primarily relate to certain agreements with the Company s officers, directors and employees, under which the Company may be required to indemnify such persons for liabilities arising out of their employment relationship. The Company has agreed to hold the other party harmless against specified losses, such as those arising from a breach of representations or covenants, third party claims that the Company s products when used for their intended purpose(s) infringe the intellectual property rights of such third party, or other claims made against certain parties. It is not possible to determine the maximum potential amount of liability under these indemnification obligations due to the limited history of prior indemnification claims and the unique facts and circumstances that are likely to be involved in each particular claim. Historically, payments made by the Company under these obligations were not material and no liabilities have been recorded for these obligations on the balance sheets as of December 31, 2005 and 2004.

Note 16. Sale of Certain Assets

In July 2003, the Company entered into an agreement with Verilink Corporation (Verilink) to sell certain assets to Verilink for up to a maximum of $0.9 million. The Company received $0.6 million 2003. During 2004, the Company received an additional $0.1 million toward the asset sale. The assets were originally acquired through the Company s acquisition of Access Network Electronics (ANE) in February 2000. Additionally, Verilink agreed to purchase at least $2.1 million of related inventory from the Company on or before December 31, 2004. During 2005 and 2004, Verilink had purchased $0.5 million and $0.6 million, respectively, of this inventory. As of December 2005, Verilink owed the Company approximately $0.3 million as part of its purchase of inventory, which Verilink did not pay to the Company. All inventories purchased by Verilink had been fully reserved as excess and obsolete in prior periods.

As part of this agreement, Verilink also agreed to assume all warranty obligations related to ANE products sold prior to, on, or after July 2003. The Company agreed to reimburse Verilink for up to $2.4 million of certain warranty obligations for ANE products sold prior to July 2003. Further, Verilink assumed the obligation for one of the Company s operating leases.

In May 2005, Verilink attempted to make a claim under the agreement for the Company to reimburse Verilink for certain warranty obligations provided by Verilink to its customers. The Company denied Verilink s claim. In April 2006, Verilink filed for bankruptcy. In August 2006, the Company and Verilink entered into a settlement agreement, which was approved by the bankruptcy court, whereby both the Company and Verilink waived any and all claims against the other party. The Company waived its rights to claims of approximately $0.3 million owed to it, and Verilink waived any and all current or future claims for reimbursement of warranty expenses.

On April 2, 2004, the Company sold all of its ownership interests in Radwiz, Ltd., Ultracom Communications Holdings Ltd. and Combox Ltd. to a third party for a cash payment of $0.2 million. In connection with this disposition, the acquirer received obsolete inventories with no book value, $0.2 million of selected net assets, and assumed $1.4 million of net liabilities related to these subsidiaries. The Company recorded a net gain of $1.1 million, which is included as a component of other income (expense) in the accompanying condensed consolidated statement of operations.

On March 9, 2005, the Company sold certain of its cable modem semiconductor assets to ATI Technologies, Inc. (ATI). Under the agreement, ATI acquired the Company s cable modem silicon intellectual property and related software, entered into a sublease and hired approximately 25 employees from the Company s design team. Under the terms of the agreement, ATI was required to pay the Company $7.0 million at the closing, with a balance of $7.0 million subject to its achieving milestones for certain conditions, services and deliverables up to June 9, 2006. Upon closing, the Company received $8.6 million in cash, which was comprised of the $7.0 million for the initial

TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

payment and $1.9 million for having met the first milestone, minus $0.3 million to pay for Company funded retention bonuses for employees that accepted employment with ATI. In June 2005, ATI paid the Company $2.5 million for delivering certain documentation and validation deliverables. On September 9, 2005, the Company forfeited $0.8 million for failing to obtain vendor author status for ATI with CableLabs. In June 2006, ATI paid the Company $1.1 million from the amount that was released from escrow and the Company forfeited $0.8 million, the amount that was held in escrow, for failing to obtain vendor author status for ATI with CableLabs by June 9, 2006. Additionally, in June 2006, the Company and ATI amended the agreement to (i) transfer assets related to the manufacture of the semiconductors to ATI and (ii) engage ATI to provide technical assistance to the Company. The Company s maximum liability is set at $14.0 million for breaches of representations and warranties made by the Company and obligations assumed by the Company. In June 2006, the Company recognized a $9.9 million gain from the sale of assets to ATI, which represented the purchase price of $12.5 million, less transaction related costs of $2.6 million. Despite receiving cash payments for the sale of assets to ATI, the Company did not recognize the gain on the ATI transaction until the quarter ended June 30, 2006, based upon the completion of milestones and the termination of the supply arrangement between the Company and ATI.

On August 31, 2005, the Company sold all of its ownership in Terayon Communication Systems Ltd. (formerly known as Telegate Ltd. (Telegate)) to a third party for a cash payment of NIS 1. In connection with this disposition, the acquirer received obsolete inventory with no book value, $1.6 million of selected net assets, and assumed $1.9 million of net liabilities related to this subsidiary. Additionally, the third party agreed to assume all warranty and service obligations related to the Telegate product. The Company recognized a net gain of $0.7 million which is included as a component of other income (expense) net in the accompanying condensed consolidated statement of operations. The $0.7 million gain includes a $0.3 million gain due to the recognition of cumulative translation adjustment related to Telegate previously included in accumulated other comprehensive loss component of total shareholders equity.

Note 17. Subsequent Events

Events Related to the Company Accounting Review and the Restatement

On November 7, 2005, the Company announced that it initiated a review of revenue recognition after determining that certain revenues recognized in the second half of the year ended December 31, 2004 from a customer may have been recorded in incorrect periods. The review included the Company s revenue recognition policies and practices for current and past periods and its internal control over financial reporting as it related to those items. Additionally, the Audit Committee of the Board of Directors conducted an independent inquiry into the circumstances related to the accounting treatment of certain of the transactions at issue and retained independent legal counsel to assist with the inquiry.

On March 1, 2006, the Company announced that the Audit Committee had completed its independent inquiry and that the Company would restate its consolidated financial statements for the year ended December 31, 2004 and for the four quarters for 2004 and the first two quarters of 2005.

On November 8, 2006, the Company announced that the Audit Committee, upon the recommendation of management, had concluded that the Company s consolidated financial statements for the years ended December 31, 2003, 2002 and 2000 and for the quarters of 2003, 2002 and 2000 should no longer be relied upon. The restatement of financial

statements for 2003 would correct errors primarily relating to revenue recognition, cost of goods sold and estimates of reserves. The restatement of financial statements for 2000 and 2002 would correct errors primarily relating to the need to separately value and account for an embedded derivative option associated with the Company s 5% convertible subordinated notes issued in July 2000, and other estimates. While no determination was made that the financial statements for 2001 could not be relied upon, adjustments would be made to 2001 that would be reflected in the financial statements to be included in its periodic reports to be filed with the Commission.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The Company s previous auditors resigned effective as of September 21, 2005 and on that date, the Audit Committee engaged Stonefield Josephson, Inc. (Stonefield) as the Company s new independent registered public accounting firm. On May 26, 2006, the Company announced that it had engaged Stonefield to re-audit the Company s consolidated financial statements for the year ended December 31, 2004 and, if necessary, to re-audit the Company s consolidated financial statements for the year ended December 31, 2003. On November 8, 2006, the Company announced that it had engaged Stonefield to re-audit the Company s consolidated financial statements for the year ended December 31, 2003. The Company, through outside counsel, retained FTI Consulting, Inc. to provide an independent accounting perspective in connection with the accounting issues under review.

In connection with the Company s accounting review of the customer contract referred to above, the Commission initiated a formal investigation. This matter was previously the subject of an informal Commission inquiry. The Company has been cooperating fully with the Commission and will continue to do so in order to bring the investigation to a conclusion as promptly as possible.

Repayment in full of 5% Convertible Subordinated Notes due 2007

On November 7, 2005, the Company announced that the filing of its periodic report on Form 10-Q for the quarter ending on September 30, 2005 would be delayed pending completion of the accounting review. The Company was required under its Indenture, dated July 26, 2000 (Indenture), to file with the Commission and the trustee of the Company s Notes all reports, information and other documents required pursuant to Section 13 or 15(d) of the Exchange Act. On January 12, 2006, holders of more than 25% of the aggregate principal amount of the Notes, in accordance with the terms of the Indenture, provided written notice to the Company that it was in default under the Indenture based on the Company s failure to file its Form 10-Q for the quarter ending September 30, 2005. The Company was unable to cure the default within 60 days of the written notice, March 13, 2006, which triggered an Event of Default under the Indenture. The Event of Default enabled the holders of at least 25% in aggregate principal amount of Notes outstanding to accelerate the maturity of the Notes by written notice and declare the entire principal amount of the Notes, together with all accrued and unpaid interest thereon, to be due and payable immediately. On March 16, 2006, the Company received a notice of acceleration from holders of more than 25% of the aggregate principal amount of the Notes. On March 21, 2006, the Company paid in full the entire principal amount of the outstanding Notes, including all accrued and unpaid interest thereon and related fees, for a total of $65.6 million.

De-listing by The NASDAQ Stock Market

The Company received a letter from The NASDAQ Stock Market (NASDAQ), dated November 17, 2005, notifying the Company that its common stock was subject to delisting based on its failure to file its Form 10-Q for the quarter ending September 30, 2005 as required by NASDAQ Marketplace Rule 4310(c)(14). On November 25, 2005, the Company requested a hearing before a NASDAQ Listing Qualifications Panel to request an extension to comply with the periodic filing requirements. NASDAQ stayed the delisting process and a hearing was held on December 15, 2005. The Company received a second letter from NASDAQ on January 4, 2006, notifying the Company that its common stock was subject to delisting based on its failure to satisfy NASDAQ Marketplace Rules 4350(e) and 4350(g), which required the Company to solicit proxies and hold an annual meeting of shareholders before December 31, 2005. The Company held its 2004 annual shareholder meeting in December 2004 and the Company s 2005 annual shareholder meeting was originally planned for December 2005, but the Company was unable to hold its 2005 annual shareholder meeting due in part to its ongoing accounting review. On January 17, 2006, The NASDAQ Listing Qualifications Panel (Panel) granted the Company s request for continued listing subject to certain conditions.

On March 28, 2006, the Company announced it had concluded that the restatement will not be completed by the March 31, 2006 deadline, and had communicated this information to the Panel.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

On March 31, 2006, the Company received a letter from The NASDAQ Stock Market notifying the Company that the Panel had determined to de-list the Company s securities from The NASDAQ National Market effective as of the opening of business on Tuesday, April 4, 2006. Upon de-listing, the quotations for the Company s common stock appeared in the Pink Sheets, a centralized quotation service that collects and publishes market maker quotes for over-the-counter securities in real time, under the trading symbol TERN.PK.

Settlement of Securities Class Action Lawsuit

On March 17, 2006, the Company entered into a Memorandum of Understanding (MOU) providing for the settlement of the securities class action entitled *In re Terayon Communication Systems, Inc. Securities Litigation*, Case No. C-00-1967-MHP, pending in the United States District Court for the Northern District of California. As previously disclosed, the amended complaint alleged that the Company and certain of its officers and directors (collectively, Defendants) violated the federal securities laws by issuing materially false and misleading statements and failing to disclose material information regarding the Company s technology. The class action included claims for damages on behalf of those who purchased or otherwise acquired the Company s securities (Affected Securities) during the class period of November 15, 1999 to April 11, 2000 (Plaintiff Class).

In accordance with the settlement outlined in the MOU, the Defendants agreed to pay to the Plaintiff Class $15.0 million with the Company contributing approximately $2.2 million of this amount, and its insurance carriers paying the remaining amount. As a result, the Company accrued $2.2 million to litigation settlement expense in the fourth quarter of 2005. The Court held a hearing to review the settlement of the shareholder litigation on September 25, 2006. To date, the Court has not approved the settlement.

In consideration of the payment of the settlement funds described above, the Plaintiff Class agreed, upon final court approval, to dismiss the class action with prejudice and release all known and unknown claims arising out of or relating to, or in connection with the purchase or acquisition of the Affected Securities during the class period which have been or could have been asserted by any member of the Plaintiff Class.

Settlement of Derivative Lawsuit

On September 15, 2006, the Company entered into a Stipulation of Settlement of Derivative Claims with respect to the derivative litigation entitled *In re Terayon Communication Systems, Inc. Derivative Litigation*, Case No. CV 807650, pending in the Superior Court of California, County of Santa Clara. As previously reported, the Company is a nominal defendant in the derivative litigation and the claims are the same as those that were in the securities class action, essentially that the Company made certain misleading statements. On September 18, 2006, the court approved the final settlement of the derivative litigation. In connection with the settlement, the Company paid $1.0 million in attorney s fees and expenses to the derivative plaintiffs counsel and agreed to adopt certain corporate governance practices. As a result, the Company accrued $1.0 million to litigation settlement expense in the fourth quarter of 2005.

Costs of Restatement and Legal Activities

The Company has incurred substantial expenses for legal, accounting, tax and other professional services in connection with the internal review of its historical financial statements, the audit of the Company s historical financial statements for the years ended December 31, 2004 and 2003 and the review of the four quarters of 2004 and 2005, the preparation of the restated financial statements, the Commission investigation and inquiries from other government

agencies, the related class action litigation and the repayment in full of the Notes. Excluding the $65.6 million that the Company was required to pay to the holders of the Notes, which consisted of the face value of the Notes, the accrued and unpaid interest and related costs, the Company estimates these expenses to date to be in excess of $7.5 million in aggregate through the quarter ended September 30, 2006. The Company expects to continue to incur significant expenses in connection with these matters until these matters are completed.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Asset Sales

In June 2006, the Company and ATI amended the agreement to (i) transfer assets related to the manufacture of the semiconductors to ATI and (ii) engage ATI to provide technical assistance to the Company. Additionally, in June 2006, ATI paid the Company $1.1 million from the amount that was released from escrow and the Company forfeited $0.8 million of the amount that was held in escrow, for failing to obtain vendor author status for ATI with CableLabs by June 9, 2006. In June 2006, the Company recognized a $9.9 million gain from the sale of assets to ATI, which represented the purchase price of $12.5 million, less transaction related costs of $2.6 million.

Reliance Settlement

In 2001, the insurer of the second layer of the Company s directors and officers insurance, Reliance Insurance Company (Reliance), filed for liquidation under the laws of the Commonwealth of Pennsylvania. Because of Reliance s filing for liquidation, the Company self-insured the Reliance layer of $2.5 million and paid the $2.5 million as part of the securities class action lawsuit filed against the Company and certain of its officers and directors in 2000. The Company filed a claim for $2.5 million against Reliance with its liquidator. In April 2005, the liquidator for Reliance provided the Company with a notice of determination that allowed its claim against Reliance. In June 2006, the Company sold its claim against Reliance to Prime Shares World Market LLC for $1.0 million.

Discontinued Products

In January 2006 the Company reviewed its operational effectiveness and determined that it would discontinue its modem and eMTA products in order to focus the Company s strategy solely on its digital video applications and reduce its overall cost structure. As part of this decision, the Company implemented a global reduction in headcount, with a resulting expense of $0.6 million.

Commitments and Obligations

Effective in August 2006, the Company entered into an agreement to sub-sublease its then current principal executive offices located in Santa Clara, California consisting of approximately 141,000 square feet of office space. The sublease agreement expires on the same day as the Company s agreement to sub-sublease the premises, which is in October 2009. Concurrently, the Company entered into a lease agreement to lease approximately 63,069 square feet of office space through September 2009 at another location in Santa Clara, California to serve as the Company s new principal executive offices. In addition, in the third quarter of 2006, the Company recorded an impairment of leasehold improvements of $1.0 million relating to the Company s former headquarters.

Changes in Membership and Reduction in Size of the Board of Directors

On June 19, 2006, the Company announced that two members of the Board of Directors resigned, and that the Board of Directors approved a reduction in size from nine to seven members. Mark Slaven, Chair of the Audit Committee and member of the Board of Directors of the Company, resigned effective August 2, 2006 as a result of the increased demands on his time from his duties as Senior Vice President, Chief Financial Officer and Treasurer of Cross Match Technologies Inc. in Palm Beach Garden, Florida, and not as a result of any matter concerning the Company. Aleksander Krstajic resigned, effective June 19, 2006, as a result of the increased travel and demands on his time from his duties as President and Chief Executive Officer of Bell Vanguard Inc., and not as a result of any matter concerning

the Company. The Company appointed Lewis Solomon, currently a member of the Board of Directors, to be a member of the Audit Committee effective August 2, 2006. With four independent directors on the seven member board, the Board of Directors is currently comprised of a majority of independent directors.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 18. 2005 and 2004 Unaudited Condensed Consolidated Quarterly Information

The Company did not file its periodic quarterly report on Form 10-Q for the third quarter 2005. The Company did not timely file its periodic report for the year ended December 31, 2005 and is currently filing the information required in this Form 10-K for the fiscal year ended December 31, 2005. The Company is including the unaudited results of the third and fourth quarter 2005 and management discussion and analysis on the third quarter 2005 in this Note 18.

Summarized quarterly financial data for 2005 and 2004 is as follows (in thousands, except per share data):

	(unaudited)			
Year Ended December 31, 2005	**First Quarter (as restated)(1)**	**Second Quarter (as restated)(1)**	**Third Quarter**	**Fourth Quarter**
Revenues	$ 17,813	$ 18,925	$ 23,440	$ 30,486
Cost of goods sold	11,263	11,578	16,999	15,795
Gross profit	6,550	7,347	6,441	14,691
Operating expenses:				
Research and development	5,234	4,254	3,555	4,607
Sales and marketing	5,674	5,610	6,326	4,924
General and administrative	3,419	3,601	5,570	7,766
Restructuring charges, executive severance and asset write-offs	1,282	282	235	458
Total operating expenses	15,609	13,747	15,686	17,755
Loss from operations	(9,059)	(6,400)	(9,245)	(3,064)
Interest income (expense), net	(190)	(86)	21	66
Other income (expense), net	66	(51)	1,180	(40)
Loss before income tax benefit (expense)	(9,183)	(6,537)	(8,044)	(3,038)
Income tax benefit (expense)	(50)	50	(76)	(73)
Net loss	(9,233)	(6,487)	(8,120)	(3,111)
Basic and diluted net loss per share	$ (0.12)	$ (0.08)	$ (0.11)	$ (0.04)
Shares used in computing basic and diluted net loss per share	76,645	76,444	76,445	76,381

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

Loss per share is computed independently for each of the quarters presented. The sum of the quarterly loss per share in 2005 and 2004 does not necessarily equal the total computed for the year due to changes in shares outstanding and rounding.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	(unaudited)			
Year Ended December 31, 2004	**First Quarter (as restated)(1)**	**Second Quarter (as restated)(1)**	**Third Quarter (as restated)(1)**	**Fourth Quarter (as restated)(1)**
Revenues	$ 40,069	$ 41,355	$ 30,560	$ 24,500
Cost of goods sold	27,487	25,039	30,393	18,968
Gross profit	12,582	16,316	167	5,532
Operating expenses:				
Research and development	9,129	8,136	8,304	7,630
Sales and marketing	7,221	5,411	6,222	5,291
General and administrative	3,124	3,542	2,384	2,989
Restructuring charges, executive severance and asset write-offs	3,367	3,579	1,463	3,927
Total operating expenses	22,841	20,668	18,373	19,837
Loss from operations	(10,259)	(4,352)	(18,206)	(14,305)
Interest expense, net	(310)	(310)	(232)	(238)
Other income (expense), net	141	1,071	(45)	(136)
Loss before income tax benefit (expense)	(10,428)	(3,591)	(18,483)	(14,679)
Income tax benefit (expense)	(67)	(79)	(83)	305
Net loss	(10,495)	(3,670)	(18,566)	(14,374)
Basic and diluted net loss per share	$ (0.14)	$ (0.05)	$ (0.24)	$ (0.19)
Shares used in computing basic and diluted net loss per share	75,305	74,884	75,275	74,897

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

Loss per share is computed independently for each of the quarters presented. The sum of the quarterly loss per share in 2005 and 2004 does not necessarily equal the total computed for the year due to changes in shares outstanding and rounding.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following unaudited quarterly financial information is presented for the quarter ended September 30, 2005.

CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	September 30, 2005 (unaudited)	December 31, 2004 (as restated)(1)
ASSETS		
Current assets:		
Cash and cash equivalents	$ 37,547	$ 43,218
Short-term investments	72,322	54,517
Accounts receivable, net allowance for doubtful accounts	11,610	18,559
Other current receivables	1,438	1,044
Inventory	9,751	17,666
Other current assets	8,225	3,516
Total current assets	140,893	138,520
Property and equipment, net	4,093	5,854
Restricted cash	317	1,241
Other assets, net	11,901	11,366
Total assets	$ 157,204	$ 156,981
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 5,989	$ 7,846
Accrued payroll and related expenses	1,819	4,493
Deferred revenues	23,992	4,965
Deferred gain on asset sale	8,631	
Accrued warranty expenses	2,655	4,670
Accrued restructuring and executive severance	1,212	3,744
Accrued vendor cancellation charges	248	521
Accrued other liabilities	6,340	3,873
Interest payable	542	1,356
Current portion of convertible subordinated notes	65,422	
Total current liabilities	116,850	31,468
Long-term obligations	1,583	2,076
Accrued restructuring and executive severance	1,554	1,822

Long-term Deferred revenues		13,783		11,084
Convertible subordinated notes				65,588
Total liabilities		133,770		112,038
Stockholders equity:				
Preferred stock				
Common stock		78		76
Additional paid-in capital		1,086,623		1,083,709
Accumulated deficit		(1,059,327)		(1,035,487)
Treasury stock, at cost		(773)		(773)
Accumulated other comprehensive loss		(3,167)		(2,582)
Total stockholders equity		23,434		44,943
Total liabilities and stockholders equity	$	157,204	$	156,981

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(in thousands, except per share data)
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004 (as restated)(1)	2005	2004 (as restated)(1)
Revenues	$ 23,440	$ 30,560	$ 60,178	$ 111,984
Cost of goods sold	16,999	30,393	39,840	82,919
Gross profit	6,441	167	20,338	29,065
Operating expenses:				
Research and development	3,555	8,304	13,043	25,569
Sales and marketing	6,326	6,222	17,611	18,854
General and administrative	5,570	2,384	12,589	9,050
Restructuring charges, executive severance and asset write-offs	235	1,463	1,799	8,408
Total operating expenses	15,686	18,373	45,042	61,881
Loss from operations	(9,245)	(18,206)	(24,704)	(32,816)
Interest income (expense), net	21	(232)	(255)	(853)
Other income (expense), net	1,180	(45)	1,195	1,167
Loss before income tax expense	(8,044)	(18,483)	(23,764)	(32,502)
Income tax expense	(76)	(83)	(76)	(229)
Net loss	$ (8,120)	$ (18,566)	$ (23,840)	$ (32,731)
Net loss per share, basic and diluted	$ (0.11)	$ (0.25)	$ (0.31)	$ (0.43)
Shares used in computing, basic and diluted net loss per share	76,445	75,275	76,998	75,604

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Management Discussion and Analysis of Financial Condition and Results of Operations for the three months and nine months ended September 30, 2005 and 2004, respectively.

Revenues

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

	Three Months Ended				Nine Months Ended			
	Sept. 30, 2005	Sept. 30, 2004 (as restated)(1)	Variance in Dollars	Variance in Percent	Sept. 30, 2005	Sept. 30, 2004 (as restated)(1)	Variance in Dollars	Variance in Percent
Revenues by product:								
DVS	$ 10,293	$ 5,168	$ 5,125	99.2%	$ 21,601	$ 16,544	5,057	30.6%
HAS	10,116	19,915	(9,799)	(49.2)%	32,448	68,231	(35,783)	(52.4)%
CMTS	3,031	5,477	(2,446)	(44.7)%	6,129	27,105	(20,976)	(77.4)%
Other						104	(104)	(100.0)%
Total	$ 23,440	$ 30,560	$ (7,120)	(23.3)%	$ 60,178	$ 111,984	$ (51,806)	(46.3)%

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

The Company s revenues decreased 23% from $30.6 million to $23.4 million for the quarter ended September 30, 2005 compared to the quarter ended September 30, 2004, and decreased 46% from $112.0 million to $60.2 million for the nine months ended September 30, 2005 compared to the nine months ended September 30, 2004. While sales of DVS products increased, HAS and CMTS products declined significantly driven by the discontinuation of the CMTS product line in October 2005, and a decrease in the sale of HAS products that resulted from the lack of widespread adoption of the eMTA modems. With the decision to cease investment in CMTS products, the Company has limited revenue opportunities for this product as it attempts to sell existing inventory levels. In addition, modem revenues were increasingly being driven by voice enabled eMTA products. The Company was also relatively late in developing and qualifying an eMTA product for the North American market.

The Company s revenue was impacted by its adoption of SOP 97-2 for DVS products. In 2003, 2004 and 2005, the Company was unable to establish VSOE of fair value for sales of DVS products that contained PCS as part of a multiple element arrangement, which required the Company to recognize revenue for the hardware and PCS ratably over the period of the PCS. This resulted in significant levels of deferred revenue in 2004 and 2005, including in the third quarter of 2005. For the three months ended September 30, 2005, $10.3 million of recognized DVS product

revenue consisted of $12.5 million of DVS product revenue invoiced during the period of which $8.8 million was deferred and will be recognized in future periods, and $6.6 million of DVS product revenue recognized in the current period that was invoiced in prior periods. For the nine months ended September 30, 2005, $21.6 million of recognized DVS product revenue consisted of $44.4 million of DVS product revenue invoiced during the period of which $28.7 million was deferred and will be recognized in future periods, and $5.9 million of DVS product revenue recognized in the current period that was invoiced in prior periods.

The Company expects shipments of DVS product in 2006 to decrease as a result of the slowdown in purchases by major MSOs due to their completion of a substantial portion of the build out of their all-digital simulcast networks. However, reported revenue will increase as a result of the recognition of revenue previously deferred in prior periods.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended				Nine Months Ended			
	Sept. 30, 2005	Sept. 30, 2004 (as restated)(1)	Variance in Dollars	Variance in Percent	Sept. 30, 2005	Sept. 30, 2004 (as restated)(1)	Variance in Dollars	Variance in Percent
Revenues:								
United States	$ 14,173	$ 19,050	$ (4,877)	(25.6)%	$ 32,146	$ 58,446	$ (26,300)	(45.0)%
Americas, excluding United States	418	603	(185)	(30.7)%	1,235	4,209	(2,974)	(70.7)%
Europe, Middle East and Africa (EMEA), excluding Israel	3,481	2,678	803	30.0%	10,393	13,348	(2,955)	(22.1)%
Israel	1,441	1,807	(366)	(20.3)%	5,525	14,858	(9,333)	(62.8)%
Asia, excluding Japan	3,546	3,055	491	16.1%	9,814	12,069	(2,255)	(18.7)%
Japan	381	3,367	(2,986)	(88.7)%	1,065	9,054	(7,989)	(88.2)%
Total	$ 23,440	$ 30,560	$ (7,120)	(23.3)%	$ 60,178	$ 111,984	$ (51,806)	(46.3)%

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

Revenues in the United States as a percentage of overall sales in the three and nine months ended September 30, 2005 was relatively constant compared to the same periods in 2004. Revenues in EMEA and Asia increased in the three months ended September 30, 2005 compared to 2004 due to increased sales of eMTA modems in Eastern Europe, as well as sales of existing inventory of CMTS in Eastern Europe and to a reseller in Asia. Revenues in EMEA, Israel and Asia decreased in the three months ended September 30, 2005, primarily due to a reduction in HAS sales. Revenues in EMEA, Asia and Israel decreased in the nine months ended September 30, 2005 compared to 2004 due to decreased sales of CMTS and traditional modem products. During the third quarter of 2005, the Company continued to emphasize sales to the United States, EMEA and Israel customers while placing a lower emphasis on other locations such as Canada, South America and Asia. For the remainder of 2005, the Company expects revenue to remain constant or slightly decrease in the U.S. and EMEA markets.

Two customers, Harmonic, Inc. (Harmonic), and Cox Communications, Inc. (Cox) each accounted for 10% or more of total revenues (16% and 10%, respectively) for the three months ended September 30, 2005. One customer, Harmonic, accounted for 10% or more of total revenues (13%) for the nine months ended September 30, 2005. Three customers, Comcast, Cross Beam Networks and Adelphia Communications Corporation (Adelphia), each accounted for 10% or more of total revenues (24%, 11% and 18%, respectively) for the three months ended September 30, 2004. Two customers, Adelphia and Comcast, each accounted for 10% or more of total revenues (21% and 11%, respectively) for the nine months ended September 30, 2004.

Adelphia ceased purchasing product from the Company in the fourth quarter of 2004 when the Company ceased investment in its CMTS products. The Company expects that sales to customers located in the United States will increase in 2006 as a percentage of sales to customers, since the Company expects DVS product sales to become a larger percentage of total products sold, HAS sales to decrease and CMTS sales to cease. DVS product sales have historically been concentrated in the United States and the Company expects that trend to continue.

Cost of Goods Sold and Gross Profit

Cost of goods sold consists of direct product costs as well as the cost of manufacturing operations. The cost of manufacturing includes contract manufacturing, test and quality assurance for products, warranty costs and associated costs of personnel and equipment. In the three and nine months ended September 30, 2005, cost of goods

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

sold was approximately 73% and 66% of revenues, respectively, compared to 99% and 74% of revenues, respectively, in the same periods in 2004.

Gross profit decreased in the three and nine months ended September 30, 2005 compared to the same period in 2004. The decrease in gross profit was due to the decrease in revenues from HAS and CMTS products. The gross margin percentage was 27% and 34% for the three and nine months ended September 30, 2005, respectively, compared to 1% and 26% for the comparable periods in 2004. The improvement in gross margin percentage is due to the larger percentage of revenues derived from higher margin DVS products, as well as higher excess and obsolete reserves that were expensed in 2004 primarily attributable to the winding down of the CMTS product line.

During 2005, the Company continued to focus on improving sales of higher margin DVS products and reducing product manufacturing costs, and expects gross profit as a percentage of revenues to increase. In January 2006, the Company announced that it would focus solely on its DVS products. Consequently, its revenue mix will consist of higher margin DVS product as the sales of CMTS and HAS products decline.

Operating Expenses

The following summarizes expenses for research and development, sales and marketing and general and administrative and restructuring charges (in thousands, except percentages) (unaudited):

	Three Months Ended				Nine Months Ended			
	Sept. 30, 2005	Sept. 30, 2004 (as restated)(1)	Variance in Dollars	Variance in Percent	Sept. 30, 2005	Sept. 30, 2004 (as restated)(1)	Variance in Dollars	Variance in Percent
Research and development	$ 3,555	$ 8,304	$ (4,749)	(57.2)%	$ 13,043	$ 25,569	$ (12,526)	(49.0)%
Sales and marketing	6,326	6,222	104	1.7%	17,611	18,854	(1,243)	(6.6)%
General and administrative	5,570	2,384	3,186	133.6%	12,589	9,050	3,539	39.1%
Restructuring charges, executive severance and asset write-offs	235	1,463	(1,228)	(83.9)%	1,799	8,408	(6,609)	(78.6)%

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

Research and Development

Research and development expenses consist primarily of personnel costs, internally designed prototype material expenditures, and expenditures for outside engineering consultants, equipment and supplies required in developing and enhancing products. In the three months ended September 30, 2005, research and development expenses were $3.6 million, or 15% of revenues. This is a $4.7 million decrease from research and development expenses for the three months ended September 30, 2004, in which expenses were $8.3 million, or 27% of revenues.

The decrease in research and development expenses was attributable to the reduction in employee expenses related to the decision to cease investment in the CMTS product line as announced in the third quarter of 2004 and CMTS related employees being terminated in the fourth quarter 2004 and first quarter 2005; reduction in employee expenses from the semiconductor division after the sale of certain assets to ATI Technologies, Inc. (ATI) in the first quarter 2005; decrease in allocations of facility and overhead related support costs to research and development; and reduction of other expenses, partially offset by an increase in utilization of outside engineering consultants. The increase in utilization of outside engineering consultants is related to the transfer of sustaining engineering efforts of the CMTS, eMTA modems and DVS products to Infosys, an engineering consulting company in India. The Company believes that it is critical to continue to make significant investments in research and development in digital video products to create innovative technologies and products that meet the current and

TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

future requirements of customers. Accordingly, the Company intends to increase its investment in research and development in its digital video products in 2006.

Sales and Marketing

Sales and marketing expenses consist primarily of personnel costs, including salaries and commissions for sales personnel and salaries for marketing and support personnel, costs related to marketing communications, consulting and travel. Sales and marketing expenses remained consistent year over year at $6.3 million, or 27% of revenues for the three months ended September 30, 2005 compared to $6.2 million, or 20% of revenues for the comparable period in 2004. For the nine months ended September 30, 2005, sales and marketing expenses were $17.6 million, or 29% of revenues. This is a $1.2 million decrease from sales and marketing expenses for the nine months ended September 30, 2004, in which expenses were $18.9 million or 17% of revenues. The Company expects expenses for sales and marketing to decline in 2006 as a result of headcount reductions, shifting its distribution model to rely more on distribution partners for international sales, and reducing advertising expenditures.

General and Administrative

General and administrative expenses consist primarily of salary and benefits for administrative officers and support personnel, travel expenses and legal, accounting and consulting fees. In the three months ended September 30, 2005, general and administrative expenses were $5.6 million or 24% of revenues. This is an increase of $3.2 million from general and administrative expenses for the three months ended September 30, 2004, in which expenses were $2.4 million or 8% of revenues. The increase was primarily attributable to a $2.6 million net expense for the settlement of the litigation with Adelphia in the third quarter of 2005. In the nine months ended September 30, 2005, general and administrative expenses were $12.6 million or 21% of revenues. This is a $3.5 million increase from general and administrative expenses for the nine months ended September 30, 2004, in which expenses were $9.1 million or 8% of revenues. The Company currently expects general and administrative expenses to increase significantly in 2006 when compared to 2005 because of increased audit, consulting and legal costs associated with the restatement.

Restructuring Costs

During 2005, the Company continued restructuring activities related to its decision to cease investment in its CMTS product line. In the quarters ended March 31, 2005 and June 30, 2005, the Company incurred net restructuring charges of $0.7 million and $0.3 million, respectively, related to employee termination costs.

In the first three quarters of 2005, the Company re-evaluated the charges for excess leased facilities accrued as part of the 2001 and 2004 restructuring plans. During the three quarters ended September 30, 2005, the Company decreased accrual by $0.3 million for the 2001 restructuring plan and increased the accrual by $0.9 million for the 2004 restructuring plan.

Net charges for restructuring that occurred in 2005 totaled $2.2 million, comprised of $1.0 million for employee terminations, $1.1 million for excess leased facilities and $0.1 million related to the aircraft lease.

The Company anticipates the remaining restructuring accrual related to the aircraft lease, net of the sublease income related to the aircraft, to be substantially utilized for servicing operating lease payments through January 2007, and the

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

The reserve for leased facilities, net of sublease income, approximates the difference between the Company s current costs for the excess leased facilities, which is its former principal executive offices located in Santa Clara, California, and the estimated income derived from subleasing the facilities, which was based on information derived by brokers that estimated real estate market conditions as of the date of the implementation of the

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

restructuring plan and the time it would likely take to fully sublease the excess leased facilities. The Company sub-subleased the Santa Clara facility effective as of August 2006, with the sub-sublease commencing on October 1, 2006.

Executive Severance

In August 2004, the Company entered into an employment agreement with an executive officer who resigned effective December 31, 2004 with a termination date of February 3, 2005. The Company recorded a severance provision of $0.4 million related to termination costs for this officer in the quarter ended December 31, 2004. Most of the severance costs related to this officer were paid in the quarter ended March 31, 2005 with nominal amounts for employee benefits payable through the quarter ended March 31, 2006.

Asset Write-offs

There were no material asset write-offs in 2005. As a result of CMTS product line restructuring activities in 2004, the Company recognized a fixed asset impairment charge of $2.4 million. The impairment charge reflected a write-down of the assets carrying value to a fair value based on a third party valuation.

Non-operating Expenses

The following summarizes interest income (expense), net and other income (expense), net for the three and nine months ended September 30, 2005 and 2004 (in thousands, except percentages) (unaudited):

	Three Months Ended				Nine Months Ended			
	Sept. 30, 2005	Sept. 30, 2004 (as restated)(1)	Variance in Dollars (as restated)(1)	Variance in Percent (as restated)(1)	Sept. 30, 2005	Sept. 30, 2004 (as restated)(1)	Variance in Dollars (as restated)(1)	Variance in Percent (as restated)(1)
Interest income (expense), net	$ 21	$ (232)	$ 253	(109.1)%	$ (255)	$ (853)	$ 598	(70.1)%
Other income (expense), net	1,180	(45)	1,225	(2,722.2)%	1,195	1,167	28	2.4%

(1) See Note 3, Restatement of Consolidated Financial Statements, to Consolidated Financial Statements.

Interest Income. Interest income increased in the three and nine months ended September 30, 2005 compared to the same periods in 2004. The increase in interest income was primarily due to slightly higher interest rates.

Interest Expense. Interest expense, which related primarily to interest payment of the Notes, remained constant in the three and nine months ended September 30, 2005 compared to the same periods in 2004.

Other Income. Other income is generally comprised of realization of foreign currency gains and losses, realized gains or losses on investments, and non-operational gains and losses. In the third quarter of 2005, the Company sold all of its ownership in Terayon Communication Systems Ltd. (formerly known as Telegate Ltd. (Telegate)) to a third party for a cash payment of NIS 1. In connection with this disposition, the acquirer received obsolete inventory with no book value, $1.6 million of selected net assets, and assumed $1.9 million of net liabilities related to this subsidiary. Additionally, the third party agreed to assume all warranty and service obligations related to the Telegate product. The Company recognized a net gain of $0.7 million, which is included as a component of other income (expense), net.

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TERAYON COMMUNICATION SYSTEMS, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Contractual Obligations

The following summarizes the Company s contractual obligations at September 30, 2005, and the effect such obligations are expected to have on the Company s liquidity and cash flows in future periods (in millions) (unaudited):

		Payments Due by Period			
	Total	Less Than 1 Year	1 - 3 Years	4 - 5 Years	After 5 Years
Unconditional purchase obligations	$ 15.4	$ 15.3	$ 0.1	$	$
Long-term debt	65.1		65.1		
Operating lease obligations	12.9	3.4	6.2	3.3	
Aircraft lease obligation	1.9	1.5	0.4		
Total	$ 95.3	$ 20.2	$ 71.8	$ 3.3	$

The Company has unconditional purchase obligations to certain of suppliers that support the Company s ability to manufacture its products. The obligations require the Company to purchase minimum quantities of the suppliers products at a specified price. As of September 30, 2005, the Company had approximately $15.4 million of purchase obligations, of which $0.2 million is included in the Condensed Consolidated Balance Sheet as accrued vendor cancellation charges, and the remaining $15.2 million is attributable to open purchase orders. The remaining obligations are expected to become payable at various times through 2005. However, in March 2006, the Company paid off the principal amount of the Outstanding Notes, which was $65.1 million.

Other commercial commitments, primarily required to support operating leases, are as follows (in millions) (unaudited):

		Amount of Commitment Expiration per Period			
	Total	Less Than 1 Year	1 - 3 Years	4 - 5 Years	After 5 Years
Deposits	$ 8.2	$ 0.7	$ 7.5	$	$
Standby letters of credit	0.5	0.2		0.3	
Total	$ 8.7	$ 0.9	$ 7.5	$ 0.3	$

In 2002, the Company entered into an operating lease arrangement to lease a corporate aircraft. This lease arrangement was secured by a $9.0 million letter of credit. The letter of credit was reduced to $7.5 million in February

2003. During 2004 the $7.5 million letter of credit was converted to a cash deposit. This lease commitment is included in the table above. In March 2004, in connection with the worldwide restructuring, the Company notified the lessor of its intentions to locate a purchaser for its remaining obligations under this lease. In August 2004, the Company entered into an agreement with a third party to sublease the corporate aircraft through December 31, 2006.

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Item 9. ***Changes in and Disagreements with Accountants on Accounting and Financial Disclosure***

Information regarding the change in accountants is incorporated herein by reference to Forms 8-K and 8-K/A filed on September 27, 2005 and October 17, 2005, respectively.

Item 9A. ***Controls and Procedures***

Evaluation of Disclosure Controls and Procedures

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

In connection with the preparation of this Form 10-K for the year ended December 31, 2005, management, under the supervision of the CEO and CFO, conducted an evaluation of disclosure controls and procedures. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control systems are met. Based on that evaluation, the CEO and CFO concluded that the Company s disclosure controls and procedures were not effective at a reasonable assurance level as of December 31, 2005 due to the material weaknesses discussed below. Because the material weaknesses described below have not been remediated as of the filing date of this Form 10-K, the CEO and CFO continue to conclude that the Company s disclosure controls and procedures are not effective as of the filing date of this Form 10-K.

Management s Report on Internal Control over Financial Reporting

Management is responsible for establishing and maintaining adequate internal control structure and procedures over financial reporting (as defined in Rules 13a-15(e) and 15d-15(e)) under the Exchange Act. Management conducted an assessment of the effectiveness of the Company s internal control over financial reporting as of December 31, 2005 based on the framework set forth in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Internal control over financial reporting cannot provide absolute assurance of achieving financial reporting objectives because of its inherent limitations. Internal control over financial reporting is a process that involves human diligence and compliance and is subject to lapses in judgment and breakdowns resulting from human failures. Because of such limitations, there is a risk that material misstatements may not be prevented or detected on a timely basis by internal control over financial reporting. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate. Management engaged experienced consultants to assist management with the Company s assessment of the effectiveness of internal control over financial reporting.

A material weakness in internal control over financial reporting is defined by the Public Company Accounting Oversight Board s Audit Standard No. 2 as being a significant deficiency, or combination of significant deficiencies, that results in more than a remote likelihood that a material misstatement of the financial statements would not be prevented or detected. A significant deficiency is a control deficiency, or combination of control deficiencies, that adversely affects the Company s ability to initiate, authorize, record, process or report external financial data reliably in accordance with generally accepted accounting principles (GAAP) such that there is more than a remote likelihood

that a misstatement of the Company s annual or interim financial statements that is more than inconsequential will not be prevented or detected.

Based on the results of management s assessment and evaluation of the remediation steps listed below, the CEO and CFO concluded that the remediation initiatives undertaken in response to material weaknesses identified in 2004 (failure to prepare the Company s periodic reports in accordance with GAAP due to the lack of sufficient accounting and finance personnel with technical accounting expertise and inadequate review and approval procedures and the inadequacy of communication of financially significant information between certain parts

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of the Company s organization and the accounting and finance organization) did not result in the remediation of the material weaknesses.

During the quarter ended June 30, 2005 and through the date of the filing of this Form 10-K, and in response to the material weaknesses identified as of December 31, 2004 and March 31, 2005, the Company implemented the following steps to remediate the deficiencies in disclosure controls and procedures and material weaknesses in internal control over financial reporting:

established procedures to document the review of press releases to account for transactions in a complete and timely manner;

engaged the former Assistant Controller, who had significant SEC reporting experience, to serve as the Company s Controller and to supervise the Company s financial reporting to ensure compliance with SEC requirements. During the quarter ended June 30, 2006, the Controller left the Company, and the Company then engaged experienced accounting consultants to act as the VP Finance, Corporate Controller and Revenue Recognition Accountant; and

improved the internal process of drafting and reviewing periodic reports by implementing additional management and external legal counsel review prior to their submission to the Company s independent registered public accounting firm.

Because management was not able to fully execute the remediation plans that were established to address the material weaknesses identified in 2004, these material weaknesses were unremediated and remained ongoing as of December 31, 2005 and as of the date of this filing. Management s process for assessing internal control over financial reporting, as of December 31, 2005, was delayed as a result of the restatement of the Company s prior years consolidated financial statements, which did not conclude until December 2006. Additional material weaknesses were identified during the restatement process. Management identified the following material weaknesses as of December 31, 2005 and during the restatement process relating to the Company s internal control over financial reporting:

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

lack of sufficient personnel with technical accounting expertise in the accounting and finance department and inadequate review and approval procedures to prepare external financial statements in accordance with GAAP;

failure in identifying the proper recognition of revenue in accordance with GAAP, including revenue recognized in accordance with Statement of Position (SOP) 97-2, Software Revenue Recognition (SOP 97-2), Staff Accounting Bulletin (SAB) No. 101, Revenue Recognition (SAB 101), as amended by SAB No. 104 (SAB 104), SOP 81-1, Accounting for Performance of Construction-Type and Certain Production-Type Contracts (SOP 81-1), Financial Accounting Standards Board, Emerging Issues Task Force (EITF) 00-21, Accounting for Revenue Arrangements with Multiple Deliverables (EITF 00-21);

the use of estimates, including monitoring and adjusting balances related to certain accruals and reserves, including allowance for doubtful accounts, legal charges, license fees, restructuring charges, taxes, warranty obligations and fixed assets;

lack of sufficient analysis and documentation of the application of GAAP; and

ineffective controls over the documentation, authorization and review of manual journal entries and ineffective controls to ensure the accuracy and completeness of certain general ledger account reconciliations conducted in connection with period end financial reporting.

Because of the material weaknesses, the CEO and CFO concluded that the Company did not maintain effective internal control over financial reporting at a reasonable assurance level as of December 31, 2005 or at the date of this filing.

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The Company s independent registered public accounting firm, Stonefield Josephson, Inc. (Stonefield), has issued an attestation report on management s assessment and the effectiveness of the Company s internal control over financial reporting. The attestation report is included in the Report of Stonefield and appears under Item 8 Financial Statements and Supplementary Data.

Changes in Internal Control over Financial Reporting

As disclosed in the Quarterly Report on Form 10-Q for the quarter ended June 30, 2005, in connection with the preparation of that report and in consultation with Ernst & Young LLP, the Company s former independent registered public accountants, the Company determined that, due to deficiencies in communication of financially significant information between certain parts of the Company s organization and the accounting and finance organization (in particular the sales organization and the accounting and finance department), its disclosure controls and procedures and internal control over financial reporting were not effective. As previously disclosed, under the direction of the Company s Audit Committee and with the participation of senior management, the Company took steps designed to ensure that organizations within it would communicate with one another to further strengthen the Company s internal controls. These steps include increasing the scope of executive staff meetings held on a weekly basis, quarterly disclosure committee meetings, which include the heads of operational groups (including sales, accounting and finance), the completion of disclosure committee procedures by each member of the disclosure committee, training provided to employees on the procedures followed for reporting transactions to finance and emphasizing the importance of promptly communicating with the accounting and finance organization, and additional training provided to the sales organization on prompt communication and appropriate documentation.

In addition, in connection with our review of our disclosure controls and procedures as of December 31, 2004, we determined that procedures related to controls over the preparation and review of the 2004 Annual Report on Form 10-K were not effective. The insufficient controls included a lack of sufficient personnel with technical accounting expertise in the accounting and finance department and inadequate review and approval procedures to prepare external financial statements in accordance with GAAP.

In connection with the review of disclosure controls and procedures as of December 31, 2005, the Company determined that its revised communication procedures lacked sufficient documentation to permit verification of the operation of this control. Since the Company was not reporting its financial information, this lack of documentation resulted from the suspension of regular meetings of the disclosure committee. Additionally, the Company did not complete the disclosure procedures required by disclosure committee members on a quarterly basis during the period that the Company was preparing the restatement of its financials, as well as a lack of documentation related to the training of the sales organization. In addition, the Company has been relying on experienced accounting consultants to provide the technical accounting expertise and has not yet hired permanent personnel with this expertise. As a result, as discussed above in Management s Report of Internal Controls over Financial Reporting, the Company concluded that it failed to remediate the previously identified material weaknesses; therefore, the following material weaknesses constitute ongoing material weaknesses in internal control over financial reporting as of December 31, 2005 and at the date of this filing:

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

- lack of sufficient personnel with technical accounting expertise in the accounting and finance department and inadequate review and approval procedures to prepare external financial statements in accordance with GAAP.

Detailed Discussion of Material Weaknesses

In addition to the two ongoing material weaknesses described above, management identified four additional material weaknesses as of December 31, 2005 and during the restatement process.

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Revenue Recognition. The Company did not properly recognize revenue on its video products in accordance with GAAP, specifically SOP 97-2, SAB 104 and EITF 00-21. The Company also did not properly account for a product development project in accordance with SOP 81-1 and did not properly account for deferred revenue and related cost of goods sold.

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

The Company did not properly account for a significant transaction whereby it developed a broadcast platform based on its DM 6400 product to sell to its customer Thomson Broadcast (Thomson) in accordance with project accounting under SOP 81-1, SAB 104 and EITF 00-21. The Company entered into an agreement with Thomson in December 2003 where it agreed to develop a statistical remultiplexing product that would include certain features and functionality (BP 5100) agreed upon by the parties, as well as maintenance of the products purchased by Thomson for a period of one year. In September 2004, Thomson accepted the BP 5100 and the Company recognized revenue on the products sold through September 2004 and the maintenance provided through September 2004. In December 2004, the Company recognized revenue on the BP 5100s sold to Thomson and the maintenance provided to Thomson in the quarter ended December 31, 2004. In December 2004, the Company extended its agreement with Thomson by agreeing to develop an additional software release containing additional features and functionality that were not developed under the original agreement and providing product maintenance for an additional period of one year. The Company should have accounted for the transaction as a multiple element arrangement under SOP 97-2 and adopted the completed contract recognition criteria under SOP 81-1, which would have required the Company to delay recognizing revenue under its agreement with Thomson until December 2005 when the Company completed its deliverables under the agreement.

The Company incorrectly recorded deferred revenue and cost of goods sold on the balance sheet for certain transactions. As a result of the Company s focus on revenue recognition more generally as described above, the Company identified specific invoices for which deferred revenue for these sales had been recognized but the criteria for revenue recognition had not been met, including the criteria that delivery or performance had occurred, the fees were fixed or determinable or that collectibility was reasonably assured. Accordingly, the Company corrected these errors in deferred revenue, deferred cost of goods sold, inventory and accounts receivable accounts and recognized revenue when title transferred or customer payments were reasonably assured and all criteria for revenue recognition were met.

The Use of Estimates. The Company lacked policies and procedures for determining estimates and monitoring and adjusting balances related to certain accruals and provisions, and also lacked support for its conclusions on those estimates.

The Company did not effectively monitor and adjust reserves related to its restructuring charges. In 2001, the Company restructured a portion of its leased facilities in Israel. The Company did not sufficiently review its

restructuring charges to account for its rental of the restructured facilities such that at one point, the restructuring reserve exceeded the amount of rent due under the lease.

The Company over accrued reserves related to the payment of legal fees, taxes and other liabilities owed to third party vendors. The Company did not have controls in place to accurately estimate the accruals.

The Company used the wrong methodology to account for a prepaid license fee associated with the research and development of one of its product lines. The Company prepaid a license fee of $2.0 million to license technology to incorporate into the semiconductor chip used in its cable modem and eMTA products. Additionally, as part of the license agreement, the Company was required to pay a royalty of $1.00 per semiconductor chip sold to a third party. When the Company selected the method of amortization to be applied to the $2.0 million license fee, the Company opted to amortize $1.00 per chip for each chip utilized in the modem and eMTA products based on the third party rate established in the license agreement. However, the Company amortized the $2.0 million over the production of the semiconductor chips and not the sale of the modem and eMTA products containing the semiconductor chips. In hindsight, the Company should have used the useful life method, which resulted in quarterly adjustments as the royalty of $1.00 was overstated.

The Company did not properly account for warranty obligations related to the sale of certain assets. In July 2003, the Company sold certain assets related to one of its products to a third party. Under the terms of the sale, the Company agreed to assume up to $1.0 million warranty obligation on the product related to the complaint of one customer. The Company recorded the $1.0 million as an accrued warranty liability. The Company amortized $0.8 million of the $1.0 million obligation during 2004. However, during the course of the restatement, the Company determined that the obligation should not have been relieved unless either there was other actual expenses incurred in connection with the obligation or upon the actual expiration of the warranty. Since the Company did not incur any expenses in connection with this obligation, the Company corrected this error by increasing the accrual $0.2 million in each quarter of 2004. Accordingly, the warranty obligation of $1.0 million was relieved at March 31, 2005 at the expiration of the warranty term.

Qualified Accounting Personnel. The Company did not have adequate personnel in its accounting and finance department, and additionally lacked sufficient qualified accounting and finance personnel to identify and resolve complex accounting issues in accordance with GAAP.

Inadequate Controls over Documentation and Record Keeping.

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

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

The Company did not have sufficient controls in place to ensure the proper authorization and review of manual journal entries and the associated support documentation. Additionally, the Company did not keep adequate documentation related to the reconciliation of certain general ledger accounts.

Remediation Steps to Address Material Weaknesses

In an effort to remediate the identified material weaknesses, management is in the process of implementing the following steps. As of the date of the filing of this Form 10-K, the material weaknesses identified by management (and discussed above) have not been remediated. Management does not anticipate that the material weaknesses will be remediated until the second half of the year ended December 31, 2007.

Communication of Financial Information.

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

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

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

Increase staffing in the accounting and finance department;

Re-allocate duties to persons within the accounting and finance organization to maximize their skills and experience;

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

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

Revenue Recognition.

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

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

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

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

During the quarter ended March 31, 2006, the Company hired an experienced revenue accountant to review all revenue transactions and to ensure that revenues, cost of goods sold, deferred revenue and deferred cost of goods sold are properly accounted for in accordance with GAAP and the Company s policies. This accountant will leave the Company following the completion of the restatement, and the Company intends to hire a replacement.

Use of Estimates.

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

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

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

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

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Accounting Personnel.

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

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

The Company continues to take steps to recruit additional qualified senior accounting personnel, including certified public accountants personnel with recent public accounting firm experience.

Record Keeping and Documentation.

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

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

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

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

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

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

Subsequent Changes in Internal Control over Financial Reporting

Except for the changes in connection with the remediation subsequent to December 31, 2005 of the material weaknesses described above, there were no changes in the Company s internal control over financial reporting that occurred during the year ended December 31, 2005 that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.

Report of Independent Registered Public Accounting Firm

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The Board of Directors and
Shareholders of Terayon Communication Systems, Inc.

We have audited management s assessment, included in Management s Report on Internal Control Over Financial Reporting in Item 9A, that Terayon Communication Systems, Inc. (Terayon) did not maintain effective internal control over financial reporting as of December 31, 2005 because of the effect of the material weaknesses described in management s assessment, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). Terayon s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an

opinion on management s assessment and an opinion on the effectiveness of the company s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

A material weakness is a control deficiency, or combination of control deficiencies, that results in more than a remote likelihood that a material misstatement of the annual or interim financial statements will not be prevented or detected. The following material weaknesses have been identified and included in management s assessment:

Management identified a material weakness due to insufficient controls related to the identification, capture, and timely communication of financially significant information between certain parts of the organization and the accounting and finance department to enable these departments to account for transactions in a complete and timely manner

Management also identified a material weakness due to the lack of sufficient personnel with technical accounting expertise in the accounting and finance department and inadequate review and approval procedures to prepare external financial statements in accordance with generally accepted accounting principles (GAAP).

Management identified a material weakness due to its failure in identifying proper revenue recognition in accordance with GAAP, including revenue recognized on long term construction and production type contracts, accounting for revenue arrangements with multiple deliverables and software revenue recognition.

Management identified a material weakness in the use of estimates, including monitoring and adjusting balances related to certain accruals and reserves, including allowance for doubtful accounts, legal charges, license fees, restructuring charges, taxes, warranty obligations and fixed assets.

Management identified a material weakness in the lack of sufficient analysis and documentation of the application of GAAP.

Management identified a material weakness in its ineffective controls over the documentation, authorization and review of manual journal entries and ineffective controls to ensure the accuracy and completeness of certain general ledger account reconciliations conducted in connection with period end financial reporting.

As a result of these material weaknesses, management restated its financial statements for certain prior periods and made substantial revisions to its 2005 consolidated financial statements and footnote disclosures before they

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were issued, including: recording numerous adjustments and restatements to certain accruals and reserves, including the provision for bad debts, deferred revenues and cost of revenues, legal and professional charges, license fees, and fixed assets warranty obligations, restructuring charges, bond issue costs and identification of embedded derivatives; and making adjustments for revenue recognition and related cost of goods sold.

These material weaknesses were considered in determining the nature, timing, and extent of audit tests applied in our audit of the 2005 consolidated financial statements, and this report does not affect our report dated December 6, 2006 on those financial statements.

In our opinion, management s assessment that Terayon Communication Systems, Inc. did not maintain effective internal control over financial reporting as of December 31, 2005 is fairly stated, in all material respects, based on the COSO control criteria. Also, in our opinion, because of the effect of the material weaknesses described above on the achievement of the objectives of the control criteria, Terayon Communication Systems, Inc. has not maintained effective internal control over financial reporting as of December 31, 2005, based on the COSO control criteria.

We have also audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Terayon Communication Systems, Inc. as of December 31, 2005 and 2004 and the related consolidated statements of operations, stockholders equity and cash flows for each of the three years in the period ended December 31, 2005, and our report dated December 6, 2006, expressed an unqualified opinion on those consolidated financial statements.

/s/ Stonefield Josephson, Inc.
San Francisco, California
December 6, 2006

Item 9B. ***Other Information***

Not applicable.

PART III

Item 10. ***Directors and Executive Officers of the Registrant***

Certain information regarding the Company s directors and executive officers as of December 1, 2006, is set forth below.

Name	Age	Position
Jerry D. Chase	47	Chief Executive Officer and Director
Mark A. Richman	46	Chief Financial Officer and Senior Vice President, Finance and Administration
Matthew J. Aden	50	Senior Vice President, Global Sales and Customer Support
Zaki Rakib	48	Chairman of the Board and Director
Matthew Miller(2)	59	Director
Shlomo Rakib	49	Director
Lewis Solomon(1)(2)(3)	73	Director
Howard W. Speaks, Jr.(1)(2)	58	Director

David Woodrow(1)(3)	60	Director

(1) Member of Audit Committee

(2) Member of Compensation Committee

(3) Member of Nominating and Governance Committee

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Jerry D. Chase has served as Chief Executive Officer and a director of the Company since September 2004. He was the Chairman and Chief Executive Officer of Thales Broadcast & Multimedia (TBM), a telecom and test equipment supplier, from 2001 to August 2004, and was President and Chief Executive Officer of the U.S. subsidiary of TBM from 1998 to 2001. During Mr. Chase s tenure, TBM took a leading market position in providing systems solutions for MPEG and IP video over DSL networks and won two Technical Emmy Awards. Mr. Chase is a former United States Marine Corps Officer and a recipient of the American Legion Aviator s Valor Award. He holds a Bachelor of Science degree in Business Administration from East Carolina University and an MBA from Harvard University.

Mark A. Richman has served as Chief Financial Officer and Senior Vice President, Finance and Administration of the Company since November 2004. Prior to joining the Company, Mr. Richman served as Senior Vice President and Chief Financial Officer of Covad Communication Systems, Inc. (Covad), a broadband communications provider, beginning in September 2001 and became Executive Vice President and Chief Financial Officer of Covad in May 2002. Mr. Richman was appointed Chief Financial Officer of Covad after it filed for Chapter 11 bankruptcy protection. Prior to joining Covad, Mr. Richman served as Vice President and Chief Financial Officer of Main Street Networks from June 2000 to August 2001. From October 1996 to June 2000, Mr. Richman served as Vice President and Corporate Treasurer of Adecco S.A. and as Vice President of Finance and Administration for its subsidiary, Adecco U.S. From February 1994 to October 1996, he was Director of Finance for Merisel, Inc. Mr. Richman holds a B.S. degree in Managerial Economics from the University of California, Davis and an MBA from the University of California, Los Angeles.

Mathew J. Aden joined the Company in July 2005 as Senior Vice President, Global Sales and Customer Support. Prior to joining the Company, Mr. Aden served at Motorola Connected Home Solutions, a division of Motorola, Inc. At Motorola Connected Home Solutions, Mr. Aden served as Senior Vice President, Sales and Customer Operations from July 2002 to 2004, Senior Vice President and General Manager of the Digital Media Group from January 2002 to June 2002, and Corporate Vice President, Director Worldwide Sales and Support from January 2000 to December 2001. Mr. Aden holds a Bachelors Degree in Business Administration from the University of Nebraska.

Dr. Zaki Rakib co-founded the Company in 1993 and serves as the Chairman of the Board of Directors and the Secretary of the Company. From January 1993 to September 2004, Dr. Rakib served as the Chief Executive Officer of the Company and from January 1993 to July 1998, Dr. Rakib also served as Chief Financial Officer of the Company. Currently, Dr. Rakib is the Chief Executive Officer of Novafora, Inc., a privately held semiconductor company, and owns and is the Chairman of Zaki Enterprises, a corporation engaged in developing new businesses and venture opportunities in various industries. Prior to co-founding the Company, Dr. Rakib served as Director of Engineering for Cadence Design Systems (Cadence), an electronic design automation software company, from 1990 to 1994, when he joined the Company. Prior to joining Cadence, Dr. Rakib was Vice President of Engineering at Helios Software, which was acquired by Cadence in 1990. Dr. Rakib is also a director of a privately held company. Dr. Rakib holds B.S., M.S. and Ph.D. degrees in engineering from Ben-Gurion University in Israel. Dr. Rakib is the brother of Shlomo Rakib, a director of the Company.

Dr. Matthew Miller has served as a director of the Company since July 2004. Since February 2004, Dr. Miller has been the President and Chief Executive Officer of Multispectral Imaging, Inc., a venture-financed company developing applications for night vision and thermal imaging. Dr. Miller served as Chief Executive Officer of NxtWave Communications, a leading supplier of semiconductor chips for emerging digital television markets worldwide, from 1997 until its acquisition in 2002 by ATI Technologies, Inc. Prior to NxtWave, Dr. Miller was Vice President of Technology at General Instrument Corporation from 1988 to 1994, where he made major contributions to the development of digital television, optical communications for cable television and cable modems. Dr. Miller also serves on the board of a privately held company. Dr. Miller holds a bachelor s degree from Harvard University and a Ph.D. from Princeton University.

Shlomo Rakib co-founded the Company in 1993 and currently serves as a director. Mr. Rakib served as Chairman of the Board of the Company from January 1993 until September 2004 and as Chief Technical Officer and President from February 1995 until October 2004. Currently, Mr. Rakib is the Chief Technology Officer of Novafora, Inc., a privately held semiconductor company. Prior to co-founding the Company, Mr. Rakib served as

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Chief Engineer at PhaseCom, Inc., a communications products company, from 1981 to 1993, where he pioneered the development of data and telephony applications over cable. Mr. Rakib is the inventor of several patented technologies in the area of data and telephony applications over cable. Mr. Rakib is a director of several privately held companies. Mr. Rakib holds a B.S.E.E. degree from Technion University in Israel. Mr. Rakib is the brother of Zaki Rakib, the Company s Chairman of the Board and Secretary.

Lewis Solomon has served as a director of the Company since March 1995. Mr. Solomon has been a principal of G&L Investments, a consulting firm, since 1989. From 1983 to 1988, Mr. Solomon served as Executive Vice President at Alan Patricof Associates, a venture capital firm focused on high technology, biotechnology and communications industries. Prior to that, Mr. Solomon served in various capacities with General Instrument Corporation, most recently as Senior Vice President. From April 1986 to January 1997, he served as Chairman of the Board of Cybernetic Services, Inc., a LED systems manufacturer, which commenced a Chapter 7 bankruptcy proceeding in April 1997. From October 1999 until July 2004, Mr. Solomon was Chief Executive Officer of Broadband Services, Inc., which commenced a Chapter 7 bankruptcy proceeding in July 2004. Mr. Solomon serves on the boards of Anadigics, Inc., a manufacturer of integrated circuits, and Harmonic, Inc., a company that designs, manufacturer and markets digital and fiberoptic systems. Mr. Solomon also serves on the board of a privately held company. Mr. Solomon holds a Bachelor of Science degree in Physics from St. Joseph s College.

Howard W. Speaks, Jr. has served as a director of the Company since May 2004. Mr. Speaks has been the Chief Executive Officer of Rosum Corporation, a maker of global positioning system products, since August 2003. Previously, Mr. Speaks was President and Chief Executive Officer of Kyocera Wireless Corporation, a developer and manufacturer of wireless phones and accessories, from August 2001 to August 2003; President and Chief Executive Officer of Triton Network Systems, Inc., a wireless communications equipment company, from September 1999 to August 2001; Executive Vice President and General Manager, Network Operators Group of Ericsson, Inc. from 1998 to 1999; Executive Vice President and General Manager, Wireless Division of Ericsson, Inc. from 1997 to 1998; and Vice President, Western Region of Ericsson, Inc. from 1995 to 1997. Mr. Speaks is a director of Glenayre Technologies, a supplier of wireless data infrastructure and a manufacturer and distributor of pre-recorded entertainment products. Mr. Speaks also serves on the board of a privately held company. Mr. Speaks holds a Bachelor of Science degree in Civil Engineering from West Virginia Institute of Technology.

David Woodrow has served as a director of the Company since June 2002. From September 2000 until March 2002, Mr. Woodrow served as the Chief Executive Officer and President of Qwest Digital Media LLC, a production and digital media management company. From 1982 until September 2000, Mr. Woodrow held a number of senior management positions, most recently serving as the Executive Vice President, Broadband Services, with Cox Communications, Inc., a major cable operator in the United States. Mr. Woodrow is a director of several privately held companies. Mr. Woodrow holds B.S. and M.S. degrees in mechanical engineering from Purdue University and an M.B.A. from the University of Connecticut.

Board Committees and Meetings

Audit Committee

The Audit Committee of the Board of Directors oversees the Company s financial reporting process. For this purpose, the Audit Committee reviews auditing, accounting, financial reporting and internal control functions and selects and engages the Company s independent auditors. In discharging its duties, the Audit Committee reviews and approves the scope of the annual audit, non-audit services to be performed by the independent auditors and the independent auditors audit and non-audit fees; recommends to the Board of Directors that the audited financial statements be included in the Annual Report on Form 10-K for filing with the Commission; meets independently with the Company s independent auditors and senior management; and reviews the general scope of the Company s accounting, financial

reporting, annual audit and matters relating to internal control systems, as well as the results of the annual audit and interim financial statements, auditor independence issues and the adequacy of the Audit Committee charter. The Audit Committee monitors the Company s compliance with laws and regulations and standards of business conduct. The Audit Committee has also established procedures for (a) the receipt, retention and treatment of complaints received by the Company regarding accounting, internal accounting controls or

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auditing matters, and (b) the confidential, anonymous submission by the Company s employees of concerns regarding questionable accounting or auditing matters.

The current members of the Audit Committee are Messrs. Solomon, Speaks and Woodrow. Mr. Slaven, who formerly served as the Chair of the Audit Committee, resigned as of August 2, 2006. After considering transactions and relationships between each member of the Audit Committee or his immediate family and the Company and its subsidiaries and reviewing the qualifications of the members of the Audit Committee, the Board of Directors has determined that all current members of the Audit Committee are: (1) independent as that term is defined in Section 10A of the Securities and Exchange Act; (2) independent as that term is defined in Rule 4200 of the listing standards of The NASDAQ Stock Market; and (3) financially literate and have the requisite financial sophistication as required by the NASDAQ rules applicable to issuers listed on The NASDAQ Stock Market.

The Audit Committee operates under a written charter adopted by the Board of Directors. The Board of Directors adopted a new Audit Committee Charter on August 2, 2006, which is included herein as Exhibit 99.1.

Audit Committee Financial Expert

The Board of Directors has determined that the Audit Committee does not have a member who is an audit committee financial expert as such term is defined by the rules and regulations of the Commission. While the Board of Directors recognizes that no individual Board member meets the qualifications required of an audit committee financial expert, the Board of Directors believes that the level of financial knowledge and experience of the current members of the Audit Committee is cumulatively sufficient to discharge adequately the Audit Committee s responsibilities.

Compensation Committee

The Compensation Committee makes recommendations concerning salaries and incentive compensation, awards stock options to employees and consultants pursuant to the Company s stock option plans and performs other functions regarding compensation as the Board of Directors may delegate.

The current members of the Compensation Committee are Messrs. Solomon and Speaks, and Dr. Miller. The current Chair of the Compensation Committee is Mr. Solomon. The Board of Directors has determined that all current members of the Compensation Committee are independent as that term is defined in Rule 4200 of the listing standards of The NASDAQ Stock Market.

The Compensation Committee operates under a written charter adopted by the Board of Directors. The Board of Directors adopted a new Compensation Committee Charter on August 2, 2006, which is included herein as Exhibit 99.2.

Nominating and Governance Committee

The Nominating and Governance Committee was established in February 2003 and was reconstituted as the Nominating and Governance Committee in May 2004. The committee recommends director nominees to stand for election at the Company s annual meeting of stockholders, monitors the Board of Director s composition and reviews corporate governance issues. The Nominating and Governance Committee has the authority under its charter to hire and approve fees paid to consultants or search firms to assist in the process of identifying and evaluating potential director candidates.

The current members of the Nominating and Governance Committee are Messrs. Solomon and Woodrow. The current Chair of the Nominating and Governance Committee is Mr. Woodrow. The Board of Directors has determined that all

current members of the Nominating and Governance Committee are independent as that term is defined in Rule 4200 of the listing standards of The NASDAQ Stock Market.

The Nominating and Governance Committee operates under a written charter adopted by the Board of Directors. The Board of Directors adopted a new Nominating and Governance Committee Charter on August 2, 2006, which is included herein as Exhibit 99.3.

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Legal Committee

The Legal Committee reviews the Company s compliance with applicable laws and regulations, significant pending litigation or regulatory actions, as well as oversees the development of the Company s compliance policies and procedures. The current members of the Legal Committee are Messrs. Solomon and Woodrow, and Dr. Rakib. The Chair of the Legal Committee is Mr. Woodrow.

Section 16(a) Beneficial Ownership Reporting Compliance

Section 16(a) of the Exchange Act requires the Company s directors and executive officers, as well as persons who own more than ten percent of a registered class of the Company s equity securities, to file with the Commission initial reports of ownership and report of changes in ownership of common stock and other equity securities of the Company. Officers, directors and ten percent beneficial owners are required by Commission regulation to furnish the Company with copies of all Section 16(a) forms they file.

To the Company s knowledge, based solely on review of the copies of such reports provided to the Company and written representations that no other reports were required, during the year ended December 31, 2005, all Section 16(a) filing requirements applicable to the Company s directors, officers and greater than ten percent beneficial owners were complied with, and all applicable Section 16(a) reports were filed on a timely basis.

Code of Ethics

The Board of Directors adopted a Code of Business Conduct on January 14, 2004, and amended the Code of Business Conduct on November 10, 2006. The Code of Business Conduct is applicable to all members of the Board of Directors, executive officers and employees, including the Company s chief executive officer, chief financial officer and principal accounting officer. The Code of Business Conduct is available on the Company s Investor Relations website (www.terayon.com/investor) under Corporate Governance. The Code of Business Conduct satisfies the requirements under the Sarbanes-Oxley Act of 2002, as well as NASDAQ rules applicable to issuers listed on The NASDAQ Stock Market. The Code of Business Conduct addresses, among other things, issues relating to conflicts of interests, including internal reporting of violations and disclosures, and compliance with applicable laws, rules and regulations. The purpose of the Code of Business Conduct is to deter wrongdoing and to promote, among other things, honest and ethical conduct and to ensure to the greatest possible extent that the Company s business is conducted in a legal and ethical manner. The Company intends to promptly disclose (1) the nature of any amendment to the Company s code of ethics that applies to executive officers and (2) the nature of any waiver, including an implicit waiver, from a provision of the Company s Code of Business Conduct that is granted to one of these specified officers, the name of such person who is granted the waiver and the date of the waiver on the Company s website in the future.

Item 11. ***Executive Compensation***

Summary Compensation Table

The following table shows for the years ended December 31, 2005 and 2004, compensation awarded or paid to, or earned by, the Company s Chief Executive Officer and each of the other two executive officers who were serving

as executive officers as of December 31, 2005 (Named Executive Officers). None of the Named Executive Officers served as executive officers during the year ended December 31, 2003.

Name and Principal Position in Fiscal 2005	Year	Annual Compensation Salary ($)	Annual Compensation Bonus ($)	Long-Term Compensation Securities Underlying Options/ SARs (#)	All Other Compensation ($)
Jerry D. Chase(1)	2004	125,897		800,000	52,656(4)
Chief Executive Officer	2005	400,000			450(5)
Mark A. Richman(2)	2004	26,154		500,000	38(5)
Chief Financial Officer and Senior Vice President, Finance and Administration	2005	300,000			450(5)
Matthew J. Aden(3) Senior Vice President, Global Sales and Customer Support	2005	139,167	42,066	500,000	206(5)

(1) Mr. Chase was appointed the Chief Executive Officer the Company effective September 2004.

(2) Mr. Richman was appointed the Chief Financial Officer and Senior Vice President, Finance and Administration of the Company effective November 2004.

(3) Mr. Aden was appointed Senior Vice President, Global Sales and Customer Support of the Company effective July 2005.

(4) Represents $52,544 moving expenses paid to Mr. Chase in connection with the commencement of his employment and $112 in taxable insurance premiums.

(5) Represents taxable insurance premiums.

The following tables show for the year ended December 31, 2005, certain information regarding options granted to, and held at year-end by, the Named Executive Officers. No options were exercised by the Named Executive Officers during the year ended December 31, 2005. In accordance with the rules of the Commission, also shown in the below table is the potential realizable value over the term of the option (the period from the grant date to the expiration date) based on assumed rates of stock appreciation of 5% and 10%, compounded annually. These amounts are based on certain assumed rates of appreciation specified by the Commission and do not represent the Company s estimate of future stock price. Actual gains, if any, on stock option exercises will be dependent on the future performance of the Company s common stock.

Option Grants in Last Fiscal Year

Individual Grants Number of	Potential Realizable Value at Assumed Annual

Name	Securities Underlying Options Granted (#)	Percentage of Total Options Granted to Employees in Fiscal Year	Exercise or Base Price ($/Sh)	Expiration Date	Rates of Stock Price Appreciation for Option Term 5% ($)	10% ($)
Jerry D. Chase						
Mark A. Richman						
Matthew J. Aden	500,000	17.2%	3.17	7/31/2015	996,798	2,526,082

The exercise price of the option granted to Mr. Aden is the closing selling price per share of the Company s common stock on The NASDAQ Stock Market on August 1, 2005. The option will vest over a four year period, twenty-five percent of which vested on July 27, 2006, and the remainder vesting on a monthly basis thereafter. The grant was made pursuant to the Company s 1997 Equity Incentive Plan. The shares subject to the option granted will immediately vest in full in the event Mr. Aden s employment is terminated following certain changes in control of the Company.

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Aggregated Option Exercises in Last Fiscal Year and Fiscal Year-End Option Values

The Named Executive Officers did not exercise options to purchase common stock of the Company in the fiscal year ended December 31, 2005. No stock appreciation rights are held by the Named Executive Officers.

Name	Number of Securities Underlying Unexercised Options at Fiscal Year-End (#) Exercisable/Unexercisable	Value of Unexercised In-the-Money Options at Fiscal Year-End ($) Exercisable/Unexercisable(1)
Jerry D. Chase	250,000/550,000	160,000/352,000
Mark A. Richman	135,416/364,584	43,333/116,667
Matthew J. Aden	0/500,000	/

(1) Calculated on the basis of the closing price of the Company s common stock as reported on The NASDAQ Stock Market on December 30, 2005, $2.31, minus the exercise price.

Compensation of Directors

Members of the Board of Directors who are not employees of the Company, whom the Company will refer to as outside directors, are entitled to receive cash compensation and are granted stock options for their services on the Board of Directors, as described below. All directors with the exception of Mr. Chase are outside directors.

Cash Compensation

Cash compensation for the Company s outside directors is as follows:

a monthly retainer of $2,000;

a per meeting attendance fee of $1,000 for each Board of Directors or committee meeting attended; and

for the chairs of the Audit Committee, the Compensation Committee and the Nominating and Governance Committee, an additional $500 for each committee meeting attended.

The outside directors are eligible for reimbursement for their expenses incurred in connection with attendance at Board of Directors and committee meetings in accordance with Company policy.

Equity Compensation

None of the Company s outside directors was granted stock options during the year ended December 31, 2005.

In 2006, the Company amended its 1997 Equity Incentive Plan to provide for a non-employee director equity compensation policy, which the Company will refer to as the Company s director equity policy. The outside directors will be automatically granted the following stock options on a non-discretionary basis under the Company s director equity policy:

for each outside director, an option to purchase 60,000 shares of common stock on the date of such director s initial election or appointment;

an annual grant of options to purchase 25,000 shares of common stock on the date of each annual meeting of stockholders, prorated for the 12-month period prior to the annual meeting of stockholders if the director has not continuously served as director during such period; and

for each outside director who is then serving as a member of a committee of the Company s Board of Directors, an option to purchase 6,000 shares of common stock for service on each such committee on the date of each annual meeting of stockholders, prorated for the 12-month period prior to the annual meeting of stockholders if the director has not continuously served as a committee member during such 12-month period.

The exercise price of stock options granted under the Company s director equity policy will be equal to the fair market value of the common stock on the date of grant. These non-discretionary options vest and become exercisable as to 33% of the underlying shares on the first anniversary of the date of grant and as to 1/36th of the underlying shares on a monthly basis thereafter. An outside director whose service relationship with the Company or any affiliate (whether as a non-employee director or subsequently as an employee, director or consultant of either the Company or an affiliate) ceases for any reason may exercise vested options during the post-termination exercise period provided in the option agreement (three months generally, 12 months in the event of disability and 18 months in the event of death). In the event of certain changes in control of the Company, the vesting and exercisability of all outstanding options granted under the director equity policy will accelerate automatically to the extent they are not assumed or substituted for by the surviving entity.

Employment and Severance Agreements with Named Executive Officers

Jerry D. Chase and Mark A. Richman

On July 22, 2005, Mr. Chase and Mr. Richman entered into employment agreements with the Company, which superseded their previous agreements governing their employment and severance arrangements with the Company, providing for, in the case of Mr. Chase, his employment as the Chief Executive Officer of the Company, and in the case of Mr. Richman, his employment as Chief Financial Officer and Senior Vice President, Finance and Administration of the Company. Pursuant to their respective agreements, Mr. Chase and Mr. Richman receive an annual salary of $400,000 and $300,000, respectively. The executive officers also are eligible to receive an annual bonus in an amount of up to seventy-five percent of their respective base salaries to the extent bonus arrangements are established for the executive officers, the payment of which is based on the achievement of specified goals to be defined by the Board of Directors or the Compensation Committee.

In the event the Company terminates the executive officers employment for any reason other than for cause, permanent disability (as these terms are defined in their agreement) or the executive officer s death, or if the executive resigns his employment within 30 days following the occurrence of specified events detailed in the executive s agreement, including, a material reduction in the executive s title, authority or responsibility, a material reduction in the executive s base salary or a relocation of the executive s work place beyond a specified distance, the executive would be entitled to the following severance benefits:

a lump sum cash payment equal to 12 months of the executive s then base salary;

a lump sum cash payment equal to the greater of (1) the executive s annual performance bonus for the most recent completed calendar year or (2) the executive s target performance bonus in effect for the year of the termination; and

payment for the cost of COBRA continuation premiums for the medical, dental and vision care benefits for the executive officer and his dependents for a period of up to 12 months.

In the event the executive s employment is terminated under the circumstances described in the preceding paragraph within twelve months following a change in control (as this term is defined in his agreement) of the Company, the executive officer would be entitled to the following severance benefits:

a lump sum cash payment equal to, in the case of Mr. Chase, 2.5 times, and in the case or Mr. Richman, 2 times, the sum of (1) the executive officer s then base salary and (2) an amount that is equal to the greater of (a) the executive s annual performance bonus for the most recent completed calendar year or (b) the executive s

target performance bonus in effect for the year of the termination;

payment for the cost of COBRA continuation premiums for the medical, dental and vision care benefits for the executive officer and his dependents for a period of up to 30 months in the case of Mr. Chase, and 24 months in the case of Mr. Richman; and

full vesting of all of the executive officer s unvested stock options.

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To the extent any payments made to the executive officer are subject to the excise tax imposed by Section 4999 of the Internal Revenue Code (pursuant to Section 280G of the Internal Revenue Code), then the executive will receive a gross-up payment for the amount exceeding the first $200,000 in excise taxes (and all other taxes resulting from the excise tax and the gross-up payment) imposed on the executive officer.

Any severance benefits provided to the executive in connection with an employment termination will be offset and reduced by the value of any severance benefits that the executive receives pursuant to a federal or state statute. The payment of the severance benefits is subject to, among other requirements, the executive s execution and delivery of an effective general release against the Company.

Matthew J. Aden

On July 27, 2005, Mr. Aden entered into an employment agreement with the Company providing for his employment as Senior Vice President, Global Sales and Customer Support of the Company. Pursuant to the agreement, Mr. Aden receives an annual salary of $325,000. Mr. Aden is also eligible to participate in the Company s sales commission plan with a target incentive payout equal to 100% of his base salary, the payment of which will be based on the achievement of sales goals to be defined by the Chief Executive Officer and approved by the Board of Directors. In the event the Company terminates Mr. Aden s employment for any reason other than for cause or permanent disability (as these terms are defined in his agreement) or his death, or if Mr. Aden resigns from his employment within 30 days following the occurrence of specified events detailed in his agreement, including a material reduction in his title, authority or responsibility, a material reduction in his base salary or a relocation of his work place beyond a specified distance, Mr. Aden would be entitled to the following severance benefits:

- a lump sum cash payment equal to 12 months of his then base salary and

- payment for the cost of COBRA continuation premiums for the medical, dental and vision care benefits for Mr. Aden and his dependents for a period of up to 12 months.

In the event Mr. Aden s employment with the Company is terminated under the circumstances described in the preceding paragraph within twelve months of a change in control (as this term is defined in his agreement) of the Company, Mr. Aden would be entitled to the following severance benefits:

- a lump sum cash payment equal to 2 times his then base salary;

- a lump sum cash payment equal to 2 times the greater of (1) Mr. Aden s sales commission payments for the most recent completed calendar year or (2) Mr. Aden s target sales commission payment in effect for the year of the termination;

- payment for the cost of COBRA continuation premiums for the medical, dental and vision care benefits for Mr. Aden and his dependents for a period of up to 24 months; and

- full vesting of all of his unvested stock options.

Any severance benefits paid to Mr. Aden will be offset and reduced by the value of any severance benefits that Mr. Aden may be entitled to receive pursuant to federal or state statute. The payment of the severance benefits is subject to, among other requirements, Mr. Aden s execution and delivery of an effective general release against the Company.

Compensation Committee Interlocks and Insider Participation

During the year ended December 31, 2005, the Compensation Committee consisted of Messrs. Solomon and Speaks and Dr. Miller, and Mr. Solomon served as Chair of the Compensation Committee. Messrs. Solomon and Speaks and Dr. Miller are not, and have never been, officers or employees of the Company. No executive officer of the Company served on the Board of Directors or compensation committee of any other entity that has one or more executive officers serving as a member of the Company s Board of Directors or Compensation Committee. Each of the Company s directors holds securities of the Company.

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Item 12. ***Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters***

The following table sets forth certain information regarding the ownership of the Company s common stock as of November 30, 2006 by: (i) each director; (ii) each Named Executive Officer; (iii) all Named Executive Officers and directors of the Company as a group; and (iv) all those known by the Company to be beneficial owners of more than five percent of its common stock. All shares of the Company s common stock subject to options currently exercisable or exercisable within 60 days of November 30, 2006, are deemed to be outstanding for the purpose of computing the percentage of ownership of the person holding such options, but are not deemed to be outstanding for computing the percentage of ownership of any other person. This table is based upon information supplied by officers, directors and principal stockholders and Schedules 13D and 13G filed with the Commission. Unless otherwise indicated in the footnotes to this table and subject to community property laws where applicable, the Company believes that each of the stockholders named in this table has sole voting and investment power with respect to the shares indicated as beneficially owned. Applicable percentages are based on 77,637,177 shares outstanding on November 30, 2006, adjusted as required by rules promulgated by the Commission. Unless otherwise indicated in the table, the address of each party listed in the table is 2450 Walsh Avenue, Santa Clara, California 95051.

	Beneficial Ownership	
Beneficial Owner	**Number of Shares**	**Percentage Ownership**
Kern Capital Management, LLC(1) 114 West 47th Street, Suite 1926 New York, New York 10036	11,080,800	14.3%
Zaki Rakib(2)	4,302,040	5.5%
Shlomo Rakib(3)	4,302,040	5.5%
Jerry D. Chase(4)	466,666	*
Lewis Solomon(5)	352,692	*
Mark A. Richman(6)	260,416	*
Matthew J. Aden(7)	187,500	*
David M. Woodrow(8)	128,302	*
Howard W. Speaks, Jr.(9)	67,593	*
Matthew Miller(10)	57,183	*
All executive officers and directors as a group (9 persons)(11)	10,124,432	13.0%

(1) Kern Capital Management, LLC filed an amendment to Schedule 13G, dated as of February 14, 2006, with the Commission. Kern Capital Management, LLC reported beneficial ownership of 11,080,800 shares.

(2) Shares beneficially owned by Dr. Zaki Rakib include 240,000 shares of common stock held by the Shlomo Rakib Children s Trust of which Dr. and Mrs. Rakib are trustees, and 1,300,000 shares of common stock underlying stock options, which are exercisable within 60 days of November 30, 2006. Dr. Rakib disclaims beneficial ownership of these shares held by the Zaki Rakib Children s Trust and stock and stock options held by Dr. Rakib s family members, totaling 4,302,040 shares.

(3) Shares beneficially owned by Shlomo Rakib include 240,000 shares of common stock held by the Zaki Rakib Children s Trust of which Mr. And Mrs. Rakib are trustees, and 1,300,000 shares of common stock underlying

stock options which are exercisable within 60 days of November 30, 2006. Mr. Rakib disclaims beneficial ownership of these shares held by the Shlomo Rakib Children s Trust and stock and stock options held by Mr. Rakib s family members, totaling 4,302,040 shares.

(4) Shares beneficially owned include 466,666 shares of common stock underlying stock options that are exercisable within 60 days of November 30, 2006.

(5) Shares beneficially owned include 292,692 shares of common stock underlying stock options that are exercisable within 60 days of November 30, 2006, as well as 60,000 shares of common stock.

(6) Shares beneficially owned include 260,416 shares of common stock underlying stock options that are exercisable within 60 days of November 30, 2006.

(7) Shares beneficially owned include 187,500 shares of common stock underlying stock options that are exercisable within 60 days of November 30, 2006.

(8) Shares beneficially owned include 128,302 shares of common stock underlying stock options that are exercisable within 60 days of November 30, 2006.

(9) Shares beneficially owned include 67,593 shares of common stock underlying stock options that are exercisable within 60 days of November 30, 2006.

(10) Shares beneficially owned include 57,183 shares of common stock underlying stock options that are exercisable within 60 days of November 30, 2006.

(11) Shares beneficially owned by the Company s current directors and executive officers as a group include 4,060,352 shares of common stock underlying stock options that are exercisable within 60 days of November 30, 2006.

Item 13. ***Certain Relationships and Related Transactions***

The Company has entered into indemnity agreements with all directors and executive officers of the Company. The indemnity agreement provides, among other things, that the Company will indemnify such officer or director, under the circumstances and to the extent provided for therein, for expenses, damages, judgments, fines and settlements he may be required to pay in actions or proceedings which he or she is or may be made a party by reason of his position as a director, officer or other agent of the Company, and otherwise to the fullest extent permitted under Delaware law and the Company s Bylaws.

Item 14. ***Principal Accountant Fees and Services***

On September 21, 2005, the Company appointed Stonefield Josephson, Inc. (Stonefield) as its independent registered public accounting firm to replace Ernst & Young LLP, which resigned effective as of that date. The aggregate fees billed by Stonefield for professional services rendered in 2005 are summarized in the following table (in thousands):

	2005
Audit fees(1)	$ 637
Audit-related fees(2)	
Tax fees(3)	
All other fees	
	$ 637

(1) Audit fees consist of fees for professional services rendered for the audit of the Company s consolidated annual financial statements and review of the interim consolidated financial statements included in quarterly reports and services that are normally provided in connection with statutory and regulatory filings or engagements. In 2005,

audit fees include fees for professional services rendered for the audits of (i) management s assessment of the effectiveness of internal control over financial reporting and (ii) the effectiveness of internal control over financial reporting.

(2) Audit-related fees consist of fees billed for professional services that are reasonably related to the performance of the audit or review of the Company s consolidated financial statements but are not reported under Audit Fees. Such fees include, among other things, employee benefit plan audits and certain consultations concerning financial accounting and reporting standards.

(3) Tax fees consist of fees for professional services rendered for assistance with federal, state and international tax compliance.

In considering the nature of the services provided by Stonefield, the Audit Committee determined that such services are compatible with the provision of independent audit services. The Audit Committee discussed these

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services with Stonefield and Company management to determine that they are permitted under the rules and regulation concerning auditor independence promulgated by the Commission to implement the Sarbanes-Oxley Act of 2002, as well as the American Institute of Certified Public Accountants.

The services performed by Stonefield in 2005 were pre-approved in accordance with the requirements of the Audit Committee Charter.

Except as stated above, there were no other fees billed by Stonefield for 2005. The Audit Committee considers the provision of these services to be compatible with maintaining the independence of the Company s independent auditors. None of the fees paid to the independent auditors under the categories Audit-Related Fees and Tax Fees described above were approved by the Audit Committee after services were rendered pursuant to the *de minimus* exception established by the Commission.

PART IV

Item 15. *Exhibits, Financial Statement Schedules*

(a) (1) The following documents are included as part of this Form 10-K.

Reference is made to the Index to Consolidated Financial Statements of Terayon Communication Systems, Inc. under Item 8 in Part II of this Form 10-K.

(2) Financial Statement Schedules:

Schedules not included herein have been omitted because they are not applicable or the required information is in the consolidated financial statements or notes thereto.

(3) The following exhibits are filed as a part of this Form 10-K and this list includes the Exhibit Index.

Exhibit Number	Exhibit Description
3.1	Amended and Restated Certificate of Incorporation of Terayon Communication Systems, Inc.(11)
3.2	Bylaws of Terayon Communication Systems, Inc.(11)
3.3	Certificate of Amendment to Amended and Restated Certificate of Incorporation of Terayon Communication Systems, Inc.(11)
3.4	Certificate of Designation of Series A Junior Participating Preferred Stock.(4)
4.1	Specimen Common Stock Certificate.(2)
4.2	Amended and Restated Information and Registration Rights Agreement, dated April 6, 1998.(1)
4.3	Form of Security for Terayon Communication Systems, Inc. s 5% Convertible Subordinated Notes due August 1, 2007.(3)
4.4	Registration Rights Agreement, dated July 26, 2000, among Terayon Communication Systems, Inc. and Deutsche Bank Securities, Inc. and Lehman Brothers, Inc.(3)
4.5	Indenture, dated July 26, 2000, between Terayon Communication Systems, Inc. and State Street Bank and Trust Company of California, N.A.(3)
4.6	Rights Agreement, dated February 6, 2001, between Terayon Communication Systems, Inc. and Fleet National Bank.(4)
10.1	

	Form of Indemnification Agreement between Terayon Communication Systems, Inc. and each of its directors and officers.(16)
10.2	1995 Stock Option Plan, as amended.(1)
10.3	1997 Equity Incentive Plan, as amended.(6)
10.4	1998 Employee Stock Purchase Plan, as amended.(9)
10.5	1998 Non-Employee Directors Stock Option Plan, as amended.(9)
10.6	1998 Employee Stock Purchase Plan Offering for Foreign Employees.(5)
10.7	1999 Non-Officer Equity Incentive Plan, as amended.(10)

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Exhibit Number	Exhibit Description
10.8	Azrieli Center Offices Lease Agreement, dated January 23, 2000, between Canit HaShalom Investments Ltd. and Terayon Communication Systems, Inc.(6)
10.9	Azrieli Center Agreement to Transfer Lease Rights, dated January 23, 2000.(8)
10.10	Data Over Cable Service Interface Specifications License Agreement, dated December 21, 2001, between Terayon Communication Systems, Inc. and Cable Television Laboratories, Inc.(6)
10.11	Amendment to DOCSIS IPR Agreement to cover DOCSIS 2.0, dated December 21, 2002, between Terayon Communication Systems, Inc. and Cable Television Laboratories, Inc.(6)
10.12	Lease Agreement, dated September 18, 1996, between Sobrato Interests III and VeriFone.(7)
10.13	Triple Net Sublease, dated April 1, 2002, by and between Terayon Communication Systems, Inc. and Hewlett-Packard Company.(7)
10.14	Aircraft Lease Agreement, dated February 8, 2002, between Terayon Communication Systems, Inc. and General Electric Capital Corporation.(8)
10.15	Letter of Credit Agreement, dated February 8, 2002, between Terayon Communication Systems, Inc. and General Electric Capital Corporation.(8)
10.16	Agreement, dated January 23, 2004, between Terayon Communication Systems, Inc. and YAS Corporation.(12)
10.17	First Amendment to Aircraft Lease Agreement, dated December 31, 2003, between Terayon Communication Systems, Inc. and General Electric Capital Corporation.(14)
10.18	Code of Business Conduct.
10.19	Notification Letter of Intent to Terminate or Sublease the Aircraft Lease Agreement, dated March 12, 2004.(14)
10.20	Employment Agreement, dated July 22, 2005, between Terayon Communication Systems, Inc. and Jerry Chase.(17)
10.21	Proprietary Information and Inventions Agreement, dated July 22, 2004, between Terayon Communication Systems, Inc. and Jerry Chase.(13)
10.22	Aircraft Sublease Agreement, dated August 24, 2004, between Terayon Communication Systems, Inc. and United Furniture Equipment Rental, Inc.(13)
10.23	Employment Agreement, dated July 22, 2005, between Terayon Communication Systems, Inc. and Mark Richman. (17)
10.24	Proprietary Information and Inventions Agreement, dated November 10, 2004, between Terayon Communication Systems, Inc. and Mark Richman.(16)
10.25	Form of Option Agreement for the Terayon Communication Systems, Inc. 1997 Equity Incentive Plan.(15)
10.26	Form of Option Agreement for the Terayon Communication Systems, Inc. 1998 Non-Employee Directors Stock Option Plan.(16)
10.27	Lease, dated August 9, 2006 between Sobrato Development Companies #871 and Terayon Communication Systems, Inc.
10.28	Triple Net Sub-Sublease Agreement, effective as of August 9, 2006, as amended, between Terayon Communication Systems, Inc. and Citrix Systems, Inc.
10.29	Employment Agreement, dated July 27, 2005, between Terayon Communication Systems, Inc. and Matt Aden. (17)
10.30	Proprietary Information and Inventions Agreement, dated July 27, 2005, between Terayon Communication Systems, Inc. and Matthew J. Aden.(17)
10.31	Amendment No. 1 to the Terayon Communication Systems, Inc. 1997 Equity Incentive Plan.
10.32	Non-Employee Director Equity Compensation Policy.

10.33 Non-Employee Director Equity Compensation Policy Nonstatutory Stock Option Agreement.
10.34 2006 Executive Sales Commission Plan.
10.35 2006 Section 16 Executive Officer Bonus Plan.

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Exhibit Number	Exhibit Description
21.1	List of Subsidiaries.
24.1	Power of Attorney (see signatures of this Form 10-K).
31.1	Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
99.1	Audit Committee Charter of Terayon Communication Systems, Inc.
99.2	Compensation Committee Charter of Terayon Communication Systems, Inc.
99.3	Nominating and Governance Committee Charter of Terayon Communication Systems, Inc.

(1) Incorporated by reference to exhibits to our Registration Statement on Form S-1 filed on June 16, 1998 (File No. 333-56911).

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

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

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

(5) Incorporated by reference to our Report on Form 10-K filed on April 2, 2001.

(6) Incorporated by reference to our Report on Form 10-K filed on April 1, 2002.

(7) Incorporated by reference to our Report on Form 10-Q filed on May 15, 2002.

(8) Incorporated by reference to our Report on Form 10-K filed on March 27, 2003.

(9) Incorporated by reference to our Report on Registration Statement on Form S-8 filed on August 30, 2002.

(10) Incorporated by reference to our Report on Form 10-Q filed on August 14, 2003.

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

(12) Incorporated by reference to our Report on Form 10-Q filed on July 27, 2004.

(13) Incorporated by reference to our Report on Form 10-Q filed on November 9, 2004.

(14) Incorporated by reference to our Report on Form 10-K filed on March 15, 2004.

(15) Incorporated by reference to our Report on Form 8-K filed on September 14, 2004.

(16) Incorporated by reference to our Report on Form 10-K filed on March 15, 2005.

(17) Incorporated by reference to our Report on Form 10-Q filed on August 9, 2005.

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(4)(d) Financial Statement Schedules

Schedules not included herein have been omitted because they are not applicable or the required information is in the consolidated financial statements or notes thereto.

Schedule II Valuation and Qualifying Accounts (in thousands):

		Balance at Beginning of Period	Charges	Deductions	Balance at End of Period
December 31, 2005:					
Allowance for doubtful accounts	U.S.	$ 2,254	$ 5,036	$ (4,481)	$ 2,809
Allowance for doubtful accounts	International				
Total Allowance for doubtful accounts		2,254	5,036	$ (4,481)	2,809
Reserve for inventory valuation		12,267	2,732	(7,146)	7,853
Valuation allowance on deferred tax assets		226,560	3,261		229,821
December 31, 2004 (as restated):					
Allowance for doubtful accounts	U.S.	$ 6,037	$ 4,014	$ (7,797)	$ 2,254
Allowance for doubtful accounts	International	473		(473)	
Total Allowance for doubtful accounts		6,510	4,014	(8,270)	2,254
Reserve for inventory valuation		12,291	11,550	(11,574)	12,267
Valuation allowance on deferred tax assets		227,978		(1,418)	226,560
December 31, 2003 (as restated):					
Allowance for doubtful accounts	U.S.	$ 201	$ 6,131	$ (295)	$ 6,037
Allowance for doubtful accounts	International	1,576		(1,103)	473
Total Allowance for doubtful accounts		1,777	6,131	(1,398)	6,510
Reserve for inventory valuation		25,473	4,025	(17,207)	12,291
Valuation allowance on deferred tax assets		244,803		(16,825)	227,978

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto due authorized, in County of Santa Clara, State of California, on the 29 day of December, 2006.

TERAYON COMMUNICATION SYSTEMS, INC.

/s/ Jerry D. Chase

Jerry D. Chase
Chief Executive Officer

Each person whose signature appears below constitutes Jerry D. Chase his true and lawful attorney-in-fact and agent, each acting alone, with full power of substitution and re-substitution, for him and in his name, place and stead, in any and all capacities, to sign any or all amendments to this Form 10-K, and to file the same, with all exhibits thereto, and all documents in connection therewith, with the Commission, granting unto said attorney-in- fact and agent, full power and authority to do and perform each and every act and thing requisite and necessary to be done in and about the premises, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorney-in-fact and agent, each acting alone, or his or her substitutes, may lawfully do or cause to be done by virtue hereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signature	Title	Date
/s/ Jerry D. Chase Jerry D. Chase	Chief Executive Officer and Director	December 29, 2006
/s/ Mark A. Richman Mark A. Richman	Chief Financial Officer (Principal Financial Officer, Principal Accounting Officer)	December 29, 2006
/s/ Zaki Rakib Dr. Zaki Rakib	Chairman of the Board of Directors	December 29, 2006
/s/ Shlomo Rakib Shlomo Rakib	Director	December 29, 2006
/s/ Lewis Solomon Lewis Solomon	Director	December 29, 2006

/s/ David Woodrow	Director	December 29, 2006
David Woodrow		
/s/ Matthew Miller	Director	December 29, 2006
Dr. Matthew Miller		
/s/ Howard W. Speaks	Director	December 29, 2006
Howard W. Speaks, Jr.		

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