TERAYON COMMUNICATION SYSTEMS
Form 10-Q
August 14, 2002

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SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTERLY PERIOD ENDED June 30, 2002
OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE TRANSITION PERIOD FROM __________ TO __________ .

TERAYON COMMUNICATION SYSTEMS, INC.

(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

DELAWARE	77-0328533
(STATE OR OTHER JURISDICTION OF INCORPORATION OR ORGANIZATION)	(IRS EMPLOYER IDENTIFICATION NO.)

4988 GREAT AMERICA PARKWAY
SANTA CLARA, CALIFORNIA 95054
(408) 235-5500
(ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING AREA CODE, OF THE REGISTRANT S PRINCIPAL EXECUTIVE OFFICES)

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

As of July 30, 2002, registrant had outstanding 72,776,546 shares of Common Stock.

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SPECIAL NOTE ON FORWARD-LOOKING STATEMENTS

This report on Form 10-Q contains forward-looking statements of Terayon Communication Systems, Inc. within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934 which are subject to the safe harbor created by those sections. The forward-looking statements include, but are not limited to: statements related to industry trends and future growth in the markets for cable modem systems; our strategies for reducing the cost of our products; our product development efforts; the effect of GAAP accounting pronouncements on our recognition of revenues; our future research and development; the timing of our introduction of new products; the timing and extent of deployment of our products by our customers; and future profitability. We usually use words such as may, will, should, expect, plan, anticipate, believe, estimate, predict, future, intend, or certain or the negative of these terms or similar expressions to identify forward-looking statements. Discussions containing such forward-looking statements may be found throughout the document. These forward-looking statements involve certain risks and uncertainties that could cause actual results to differ materially from those in such forward-looking statements. We disclaim any obligation to update these forward-looking statements as a result of subsequent events. The business risks discussed in Part 1, Item 2 of this Report on Form 10-Q, among other things, should be considered in evaluating our prospects and future financial performance.

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

TERAYON COMMUNICATION SYSTEMS, INC.
INDEX TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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TERAYON COMMUNICATION SYSTEMS, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands)

	June 30, 2002	December 31, 2001
	(unaudited)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 76,525	$ 100,274
Short-term investments	194,329	233,614
Accounts receivable, net	27,062	48,386
Accounts receivable from related parties	301	4,006
Other current receivables	9,782	7,476
Inventory	10,578	16,658
Other current assets	11,925	13,462
Total current assets	330,502	423,876
Property and equipment, net	21,628	25,279
Intangibles and other assets, net	18,059	17,491
Total assets	$ 370,189	$ 466,646
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 33,046	$ 42,821
Accrued payroll and related expenses	8,714	9,441
Deferred revenues	2,853	4,169
Accrued warranty	8,477	8,368
Accrued vendor cancellation charges	19,898	17,291
Accrued restructuring	6,400	8,197
Other accrued liabilities	9,781	14,015
Interest payable on long-term debt	2,117	3,273
Current portion of capital lease obligations	169	126
Total current liabilities	91,455	107,701
Long-term obligations	4,348	4,267
Long-term portion of capital lease obligations	102	233
Convertible subordinated notes	100,141	174,141
Commitments and contingencies		
Stockholders equity:		
Common stock	73	73
Additional paid in capital	1,077,549	1,074,203
Accumulated deficit	(900,769)	(892,994)
Deferred compensation	(130)	(458)
Treasury stock, at cost	(773)	(768)
Accumulated other comprehensive (loss) income	(1,807)	248
Total stockholders equity	174,143	180,304
Total liabilities and stockholders equity	$ 370,189	$ 466,646

See accompanying notes.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Revenues:				
Product revenues	$ 22,193	$ 40,119	$ 73,802	$ 84,008
Related party product revenues	214	25,614	5,823	35,709
Total revenues	22,407	65,733	79,625	119,717
Cost of goods sold:				
Cost of product revenues	22,417	35,889	60,451	84,803
Cost of related party product revenues	17	16,871	5,153	22,810
Special charges		28,704	(11,443)	28,704
Total cost of goods sold	22,434	81,464	54,161	136,317
Gross profit (loss)	(27)	(15,731)	25,464	(16,600)
Operating expenses:				
Research and development	14,704	19,152	31,644	41,779
Sales and marketing	10,141	16,334	18,994	31,817
General and administrative	3,552	8,664	7,186	16,611
Goodwill amortization		322		22,804
Restructuring costs and asset write-offs	3,972	2,549	3,972	577,293
Total operating expense	32,369	47,021	61,796	690,304
Loss from operations	(32,396)	(62,752)	(36,332)	(706,904)
Interest income	2,013	4,512	4,110	11,246
Interest expense	(2,177)	(4,304)	(4,357)	(10,048)
Other income (expense)	(4,400)	317	(4,465)	(121)
Gain on early retirement of debt	33,276		33,276	121,494
Loss before tax (expense) benefit	(3,684)	(62,227)	(7,768)	(584,333)
Income tax (expense) benefit	(1)	(277)	(7)	13,629
Net loss	($3,685)	($62,504)	($7,775)	($570,704)
Basic and diluted net loss per share	($0.05)	($0.93)	($0.11)	($8.45)
Shares used in computing basic and diluted net loss per share	72,761	67,493	72,682	67,542

See accompanying notes.

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

	Six Months Ended June 30,	
	2002	2001
Operating activities:		
Net loss	$ (7,775)	$ (570,704)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	5,734	4,903
Write-off and amortization of intangible assets	3,972	611,427
Amortization related to stock options	366	1,892
Compensation expense related to warrant issuance		753
Gain on early retirement of debt	(33,276)	(121,494)
Provision for inventory	4,532	
Impairment of investment	4,500	
Loss on disposal of fixed assets	1,115	
Interest payable	3,198	8,193
Changes in operating assets and liabilities:		
Accounts receivable	21,324	11,495
Accounts receivable from related parties	3,705	1,979
Interest paid	(4,354)	(12,951)
Inventory	4,550	48,365
Other assets	(11,312)	15,300
Accounts payable	(9,775)	(71,669)
Accrued payroll and related expenses	(727)	(250)
Deferred revenues	(1,316)	(601)
Accrued warranty	109	2,519
Accrued restructuring	(1,797)	
Accrued vendor cancellation charges	(753)	
Deferred taxes		(18,110)
Other accrued liabilities	(3,876)	14,716
Other non-current liabilities	81	(15,700)
Net cash used in operating activities	(21,775)	(89,937)
Investing activities:		
Purchases of short-term investments	(204,524)	(171,862)
Proceeds from sales and maturities of short-term investments	243,310	238,502
Purchases of property and equipment	(3,198)	(4,182)
Net cash provided by investing activities	35,588	62,458
Financing activities:		
Principal payments on capital leases	(88)	(34)
Payments on repurchase of common stock	(5)	
Exercise of options to purchase common stock	1,693	453
Proceeds from issuance of common stock through employee stock purchase plan	1,614	
Principal payment on stockholders note receivable		3
Retirement of debt	(39,220)	(68,459)
Net cash used in financing activities	(36,006)	(68,037)

Effect of exchange rate changes	(1,556)	(621)
Net decrease in cash and cash equivalents	(23,749)	(96,137)
Cash and cash equivalents at beginning of period	100,274	347,015
Cash and cash equivalents at end of period	$ 76,525	$ 250,878

See accompanying notes.

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

1. Organization and Summary of Significant Accounting Policies

Description of Business

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

The Company develops, markets and sells equipment to cable television operators, telecom carriers and satellite network operators who use the Company s products to deliver broadband voice, video and data services to residential and business subscribers.

Basis of Presentation

The accompanying condensed consolidated financial statements have been prepared in accordance with generally accepted accounting principles in the United States for interim financial information and in accordance with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring adjustments) necessary for a fair presentation of the financial statements at June 30, 2002 and for the three and six months ended June 30, 2002 and 2001 have been included.

Results for the three and six months ended June 30, 2002 are not necessarily indicative of results for the entire fiscal year or future periods. These financial statements should be read in conjunction with the consolidated financial statements and the accompanying notes included in the Company s Form 10-K dated April 1, 2002, as filed with the U.S. Securities and Exchange Commission. The accompanying balance sheet at December 31, 2001 is derived from audited consolidated financial statements at that date.

Reclassifications

Certain amounts in the 2001 financial statements have been reclassified to conform to the 2002 presentation. See Note 7.

Use of Estimates

The preparation of the condensed consolidated financial statements in conformity with generally accepted accounting principles in the United States requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. See Critical Accounting Policies in Management s Discussion and Analysis of Financial Condition and Results of Operations.

Basis of Consolidation

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

Concentrations of Credit Risk, Customers, Suppliers, and Products

The Company operates in two principal operating segments: Cable Broadband Access Systems (Cable) and Telecom Access Systems (Telecom). The Company sells primarily to customers within the cable and telecommunications industries, including related parties. The Company performs ongoing credit evaluations of its customers and generally requires no collateral. A relatively small number of customers account for a significant percentage of the Company s revenues and accounts receivable. The Company expects that the sale of its products to a limited number of customers and resellers may continue to account for a high percentage of revenues for the foreseeable future.

Currently, the Company relies on single source suppliers of materials and labor for the significant majority of its product inventory but is actively pursuing additional supplier alternatives. As a result, should the Company s current suppliers not produce and deliver inventory for the Company to sell on a timely basis, operating results may be adversely impacted.

A majority of the Company s revenues have been attributable to sales of its Cable products, primarily modems and headend equipment. These products are expected to account for a significant part of the Company s revenues for the foreseeable future. As a result, a decline in demand for or failure to achieve broad market acceptance of the Company s Cable products would adversely affect operating results.

In addition, market acceptance of the Company s products may be affected by the emergence and evolution of industry standards. While the Company expects its products to become compliant with industry standards, its inability to do so may adversely affect operating results.

The Company invests its excess cash in debt instruments of governmental agencies, and corporations with credit ratings of AA/AA- or better or A1/P1 or better, respectively. The Company has established guidelines relative to diversification and maturities that attempt to maintain safety and liquidity. The Company has not experienced any significant losses on its cash equivalents or short-term investments.

Revenue Recognition

The Company sells its products directly to broadband access service providers, system resellers and distributors and recognizes revenue upon shipment to the customer when title is transferred. Revenues related to product sales are generally recognized when: (1) persuasive evidence that an arrangement exists, (2) delivery has occurred or services have been rendered, (3) the seller s price to the buyer is fixed or determinable, and (4) collectibility is reasonably assured. The Company s existing agreements with its system resellers and distributors do not contain price protection provisions and do not grant return rights beyond those provided by the Company s standard warranty.

Warranty Reserves

The Company provides a standard warranty for most of its products, generally lasting one year from the date of purchase. The Company provides for the estimated cost of product warranties at the time revenue is recognized. The Company s warranty obligation is affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Reserve estimates are based on historical experience and expectations of future conditions.

Cash Equivalents and Short-Term Investments

The Company invests its excess cash in money market accounts and debt instruments and considers all highly liquid debt instruments purchased with an original maturity of three months or less to be cash equivalents. Investments with an original maturity at the time of purchase of over three months are classified as short-term investments regardless of maturity date as all investments are classified as available-for-sale and can be readily liquidated to meet current operational needs.

The Company accounts for investments in accordance with Statement of Financial Accounting Standards No. 115, Accounting for Certain Investments in Debt and Equity Securities . Management determines the appropriate classification of debt securities at the time of purchase and reevaluates such designation as of each balance sheet date. The Company s short-term investments, which consist primarily of commercial paper, U.S. government and U.S. government agency obligations and fixed income corporate securities, are classified as available-for- sale and are carried at amortized cost which

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approximates fair market value. Realized gains and losses and declines in value judged to be other-than-temporary on available-for-sale securities are included in interest income. The cost of securities sold is based on the specific identification method. The Company had no investments in equity securities at either June 30, 2002 or December 31, 2001.

Inventory

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

	June 30, 2002	December 31, 2001
Finished goods	$ 9,308	$ 6,433
Work-in-process	212	236
Raw materials	1,058	9,989
	$10,578	$16,658

Cost of goods sold for the six months ended June 30, 2002 included a reversal of approximately $11.4 million in special charges taken in 2001 for vendor cancellation charges and inventory previously reserved for as obsolete. The Company was able to reverse the provision as it was able to sell inventory originally considered to be excess. In addition, the Company was able to negotiate downward certain vendor cancellation claims to terms more favorable to the Company. In the second quarter of 2002, the Company recorded an additional inventory reserve of $4.5 million to reduce certain inventories to the lower of cost or market as average selling prices fell below the cost of these products.

Net Loss Per Share

Basic and diluted net loss per share were computed using the weighted average number of common shares outstanding. Options to purchase 18,811,454 and 34,993,219 shares of common stock were outstanding at June 30, 2002 and June 30, 2001, respectively. Warrants to purchase 2,408,300 and 2,684,700 shares of common stock were outstanding at June 30, 2002 and June 30, 2001, respectively. Neither the options nor warrants were included in the computation of diluted net loss per share, since the effect would be antidilutive.

Comprehensive Net Income (Loss)

Accumulated other comprehensive loss presented in the accompanying condensed consolidated balance sheets consists of net unrealized gains or losses on short-term investments and accumulated net foreign currency translation gains or losses.

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

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Net loss	($3,685)	($62,504)	($7,775)	($570,704)
Cumulative translation adjustments	(1,321)	(633)	(1,556)	(621)
Change in unrealized gain (loss) on available-for-sale investments	376	(33)	(499)	349
Total comprehensive net loss	($4,630)	($63,170)	($9,830)	($570,976)

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Impact of Recently Issued Accounting Standards

Statement of Financial Accounting Standards No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS No. 146), requires the Company to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 replaces Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). The provisions of SFAS No. 146 are to be applied prospectively to exit or disposal activities initiated after December 31, 2002. The Company has not yet determined whether the adoption of SFAS No. 146 will have a material impact on its financial position, results of operations, or cash flows.

In April 2002, the Financial Accounting Standards Board (FASB) issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections (SFAS No. 145). SFAS No. 145 allows only those gains and losses on the extinguishment of debt that meet the criteria of extraordinary items to be treated as such in the financial statements. SFAS No. 145 also requires sales-leaseback accounting for certain lease modifications that have economic effects that are similar to lease-back transactions. As permitted, the Company early adopted the provisions of SFAS No. 145 in the second quarter of 2002. The Company determined that the extinguishment of its debt did not meet the criteria of an extraordinary item as set forth in SFAS 145. Accordingly, the Company will now report its gain from retirement of its Convertible Subordinated Notes in operations instead of as an extraordinary item. All prior periods will reflect the adoption of SFAS 145. See Note 7.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-lived Assets (SFAS No. 144). SFAS No. 144 supercedes SFAS No. 121, Accounting for the Impairment of Long-lived Assets and Assets to be Disposed Of and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, Reporting the Results of Operations -Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transaction. SFAS No. 144 also amends Accounting Research Bulletin No. 51, Consolidated Financial Statements, to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. The provisions of SFAS No. 144 were adopted by the Company effective January 1, 2002. See Note 6.

In June 2001, FASB issued SFAS No. 141 (SFAS 141), Business Combinations , SFAS No. 142 (SFAS 142), Goodwill and Other Intangible Assets . SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. SFAS No. 141 also includes guidance on the initial recognition and measurement of goodwill and other intangible assets arising from business combinations completed after June 30, 2001. SFAS No. 142 prohibits the amortization of goodwill and intangible assets with indefinite useful lives. SFAS No. 142 requires that these assets be reviewed for impairment at least annually. Intangible assets with finite lives will continue to be amortized over their estimated useful lives. Additionally, SFAS No. 142 requires that goodwill included in the carrying value of equity method investments no longer be amortized.

The Company adopted SFAS No. 142 on January 1, 2002. The Company reclassified identifiable intangible assets with indefinite lives, as defined by SFAS No. 142, to goodwill at the date of adoption. The Company tests goodwill for impairment using the two-step process prescribed in SFAS No. 142. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any. See Note 5.

The following pro forma information reflects the impact on net loss and net loss per share assuming the adoption of SFAS No. 142 had occurred on January 1, 2001 (in thousands):

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	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
		(Pro forma)		(Pro forma)
Reported net loss	($3,685)	($62,504)	($7,775)	($570,704)
Amortization of goodwill and intangible assets with indefinite lives		2,211		28,231
Pro forma net loss	(3,685)	(60,293)	(7,775)	(542,473)
Basic and diluted net loss per share:				
Reported net loss	($0.05)	($0.93)	($0.11)	($8.45)
Adjustment related to amortization of goodwill and intangible assets with indefinite lives		0.03		0.42
Pro forma net loss per share	($0.05)	($0.90)	($0.11)	($8.03)

2. Commitments and Purchase Obligations

On April 1, 2002, the Company entered into a sublease agreement to lease a facility located in Santa Clara, California. The facility encompasses approximately 141,000 square feet and has become the Company s new headquarters. The sublease agreement expires on October 31, 2009. The Company will be required to make monthly rental payments that escalate to predetermined amounts on an annual basis. The Company also leases its other facilities and certain equipment under operating leases. These operating leases expire at various dates through 2005.

The Company has purchase obligations to certain of its 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. During the first six months of 2001, and for the fiscal year 2001, the Company recorded special charges of $28.7 million and $33.5 million, respectively, relating to vendor cancellation fees as well as inventory obsolescence. During the first quarter of 2002, special charges were reduced by $11.4 million as the Company was able to reverse the provision upon the sale of inventory originally considered to be excess. As of June 30, 2002, the Company had $71.6 million of purchase obligations, of which $19.9 million is included on the balance sheet as accrued vendor cancellation charges. The remaining obligations are expected to become payable at various times through mid 2003.

3. Contingencies

Beginning in April 2000, several plaintiffs filed lawsuits against the Company and certain of its officers and directors in federal court. The plaintiff in the first of these lawsuits purported to represent a class whose members purchased the Company s securities between February 2, 2000 and April 11, 2000. The complaint alleged that the defendants had violated the federal securities laws by issuing materially false and misleading statements and failing to disclose material information regarding the Company s technology. The allegations in the other lawsuits were substantially the same and, on August 24, 2000, all of these lawsuits were consolidated in the United States District Court, Northern District of California. The court hearing the consolidated action has appointed lead plaintiffs and lead plaintiffs counsel pursuant to the Private Securities Litigation Reform Act.

On September 21, 2000, the lead plaintiffs filed a consolidated class action complaint containing factual allegations nearly identical to those in the original lawsuits. The consolidated class action complaint, however, alleged claims on behalf of a class whose members purchased or otherwise acquired our securities between November 15, 1999 and April 11, 2000. On October 30, 2000, defendants moved to dismiss the consolidated class action complaint. On March 14, 2001, after defendants motion had been fully briefed and argued, the court issued an order granting in part defendants motion and giving plaintiffs leave to file an amended complaint. On April 13, 2001, plaintiffs filed their first amended consolidated class action complaint. On June 15, 2001, defendants moved to dismiss this new complaint and oral argument on the motion occurred on December 17, 2001. On March 29, 2002, the court denied the defendants motion to dismiss. The parties are now in the discovery process.

The lawsuit seeks an unspecified amount of damages, in addition to other forms of relief. The Company considers the lawsuits to be without merit and intends to defend vigorously against these allegations. However, the litigation could prove to be costly and time consuming to defend, and there can be no assurances about the eventual outcome.

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 San Luis Obispo County, California. This lawsuit is titled *Bertram v. Terayon Communications Systems, Inc*. (Bertram). The Bertram complaint contains factual allegations similar to those alleged in the federal securities class action lawsuit. The complaint asserts causes of action for unlawful business practices, unfair and fraudulent business practices, and false and misleading advertising. Plaintiffs purport to bring the action on behalf of themselves and as representatives of all persons or entities in the State of California and such other persons or entities outside California that have been and are adversely affected by defendants activity, and as the Court shall determine is not inconsistent with the exercise of the Court s jurisdiction. Plaintiffs seek equitable and injunctive relief. Defendants removed the Bertram case to the United States District Court, Central District of California and, on January 19, 2001, filed a motion to dismiss the complaint. A hearing on defendants motion was held March 26, 2001 and the court granted Defendants motion to dismiss the action and denied Plaintiffs motion requesting remand. On April 5, 2001, Defendants moved for an order requiring further proceedings, if any to take place in the Northern District of California. Plaintiffs did not oppose this motion and eventually entered into a stipulation to go forward in the Northern District. On July 9, 2001, a status conference was held in this case before Judge Patel. Plaintiffs did not appear for the conference, and the court requested that defendants submit an order dismissing the Bertram action with prejudice, which the defendants have submitted to the court. The Company believes that these allegations, as with the allegations in the federal securities case, are without merit and intends to contest the matter vigorously.

On May 7, 2002, a shareholder filed a derivative lawsuit purportedly on behalf of Terayon against five of its current directors, two former directors and two former officers. This lawsuit is titled *Campbell vs. Rakib, et al.*, and is pending in the California Superior Court, Santa Clara County. The Company is a nominal defendant in this lawsuit, which alleges claims relating to essentially the same purportedly misleading statements that are at issue in the pending securities class action. In that litigation, the Company disputes it made any misleading statements. The derivative complaint also alleges claims relating to stock sales by certain of the director and officer defendants. The Company believes that there are many defects in these complaints.

On July 12, 2002, a shareholder filed a derivative lawsuit purportedly on behalf of Terayon against three of its current directors, one former officer and three former investors. This lawsuit is titled *O Brien vs. Rakib, et al.*, and is pending in the California Superior Court, San Francisco County. The Company is a nominal defendant in this lawsuit, which alleges claims relating to essentially the same purportedly misleading statements that are at issue in the pending securities class action. In that litigation, the Company disputes that it made any misleading statements. The derivative complaint also alleges claims relating to stock sales by certain of the director and officer defendants. The Company believes that there are many defects in these complaints.

4. Operating Segment Information

The Chief Executive Officer has been identified as the Chief Operating Decision Maker (CODM) because he has final authority over resource allocation decisions and performance assessment. The CODM allocates resources to each segment based on their business prospects, competitive factors, revenues and operating results.

The Company views its business as having two principal operating segments: Cable Broadband Access Systems (Cable) and Telecom Carrier Access Systems (Telecom). The Cable segment consists primarily of its TeraComm Systems, CherryPicker Digital Video Management Systems, and Multigate

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Telephony and Data Access Systems that are sold primarily to cable operators for the deployment of data, video and voice services over the existing cable infrastructure. The Telecom segment consists primarily of MiniPlex DSL Systems, IPTL Converged Voice and Data Service System and MainSail products, which are sold to providers of broadband services for the deployment of voice and data services over the existing copper wire infrastructure.

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Information on reportable segments for the three and six months ended June 30, 2002 and 2001 is as follows (in thousands):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Cable Broadband Access Segment:				
Revenues	$ 19,203	$ 57,931	$ 73,829	$ 102,297
Operating loss	$ (29,240)	$ (44,602)	$ (29,897)	$ (429,800)
Telecom Broadband Access Segment:				
Revenues	$ 3,204	$ 7,802	$ 5,796	$ 17,420
Operating loss	$ (3,156)	$ (18,150)	$ (6,435)	$ (277,104)
Operating loss:				
Operating loss by reportable segments	$ (32,396)	$ (62,752)	$ (36,332)	$ (706,904)
Unallocated amounts:				
Interest and other income, net	(4,564)	525	(4,712)	1,077
Gain on early retirement of debt	33,276		33,276	121,494
Income tax (expense) benefit	(1)	(277)	(7)	13,629
Net loss	($3,685)	($62,504)	($7,775)	($570,704)
Geographic areas:				
Revenues:				
United States	$ 7,246	$ 13,644	$ 16,891	$ 33,229
Canada	2,896	24,827	10,008	36,070
Europe and Israel	4,535	8,506	12,574	17,700
Asia	7,730	18,268	39,716	32,188
South America		488	436	530
Total	$ 22,407	$ 65,733	$ 79,625	$ 119,717

	June 30, 2002	December 31, 2001
Assets:		
Cable Broadband Access Segment	$ 365,348	$ 455,836
Telecom Broadband Access Segment	4,841	10,810
Total assets	$ 370,189	$ 466,646
Long-lived assets:		
United States	$ 32,889	$ 36,106
Canada	333	256
Europe and Israel	3,345	4,145
Asia	201	243
South America	2,919	2,020
Total Long-lived assets	39,687	42,770
Total current assets	330,502	423,876
Total Assets	$ 370,189	$ 466,646

Three customers accounted for 10% or more of total revenues (28%, 11% and 10%) for the three months ended June 30, 2002. Two customers accounted for 10% or more of total revenues (37% and 19%) for the three months ended June 30, 2001. One customer accounted for 10% or more of total revenues (34%) for the six months ended June 30, 2002. Two customers accounted for 10% or more of total

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revenues (26% and 16%) for the six months ended June 30, 2001. No other customer accounted for more than 10% of revenues during these periods.

5. Restructuring Charges and Asset Write-offs

During 2001, the Company s Board of Directors approved a restructuring plan to streamline the Company s organizational structure worldwide. The Company incurred restructuring charges in the amount of $4.0 million in the first six months of 2001 and $12.7 million in fiscal year 2001. Of the total restructuring charges recorded during fiscal year 2001, $3.2 million related to employee termination costs and the remaining $9.5 million related primarily to costs for excess leased facilities. At June 30, 2002, restructuring charges of $6.4 million remain accrued, primarily related to excess facility costs. The Company anticipates utilizing the remaining restructuring accrual, which relates to servicing operating lease payments or negotiated buyout of operating lease commitments, through 2005. As a result of these headcount reductions, the Company expects reductions in overall operating expenses.

In the second quarter of 2002, the Company reclassified $1.0 million, which had originally been accrued for as employee termination costs to accrued excess lease facility costs due to a revision in estimate. Remaining employee termination costs of $0.1 million are expected to be paid during fiscal 2002.

Restructuring liabilities are summarized below (in millions):

	Involuntary Terminations	Excess Leased Facilities and Cancelled Contracts	Total
Balance at December 31, 2001	$ 1.2	$ 7.0	$ 8.2
Additions			
Cash Payments	(0.1)	(1.7)	(1.8)
Reclassification	(1.0)	1.0	
Balance at June 30, 2002	$ 0.1	$ 6.3	$ 6.4

During the six months ended June 30, 2001, $1.6 million related to fixed assets acquired from ANE were determined to have no remaining useful life and were written-off.

In March 2001, the Company evaluated the carrying value of certain long-lived assets and acquired intangibles, consisting primarily of goodwill recorded on its balance sheet. Pursuant to accounting rules, the majority of the goodwill was recorded based on stock prices at the time acquisition agreements were executed and announced. Prior to the adoption of SFAS No. 142, goodwill and other long-lived assets were reviewed for impairment whenever events such as product discontinuance, plant closures, product dispositions or other changes in circumstances indicate that the carrying amount may not be recoverable. When such events occur, the Company compares the carrying amount of the assets to undiscounted expected future cash flows. If this comparison indicates that there is an impairment, the amount of the impairment is based on the fair value of the assets, typically calculated using discounted expected future cash flows. The discount rate applied to these cash flows is based on the Company s weighted average cost of capital, which represents the blended costs of debt and equity.

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Downturns in the broadband services and telecommunications markets created unique circumstances with regard to the assessment of goodwill and other intangible assets for recoverability. As a result of the Company s decision to suspend certain product lines and product development efforts during the first six months of 2001, intangible assets totaling $165.8 million relating to certain acquisitions were deemed to be impaired with no future value and were written-off. Further, the aforementioned downturns in the principal markets in which the Company continues to operate, have negatively impacted the forecasted revenues and cash flows from certain other companies acquired during fiscal 1999 and 2000. In accordance with the Company s policy, the comparison of the discounted expected future cash flows to the carrying amount of the related intangible assets resulted in a write-down of these assets related to both the Cable and Telecom segments of $405.9 million in the first six months of 2001.

As discussed in Note 1, the company adopted SFAS 142 on January 1, 2002. The Company reclassified identifiable intangible assets with indefinite lives, as defined by SFAS No. 142, to goodwill at the date of adoption. The Company tested goodwill for impairment using the two-step process prescribed in SFAS No. 142. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any. The first step was completed during the three months ended March 31, 2002 and did not result in an impairment charge based on the determination of fair value at January 1, 2002.

Due to a difficult economic environment and heightened price competition in the modem and telecom businesses during the three months ended June 30, 2002, the Company experienced a significant drop in its market capitalization, and therefore proceeded to perform an interim test to measure goodwill and intangible assets for impairment at June 30, 2002. The outcome of this test resulted in a non-cash charge of $4.0 million to write off goodwill in both the Cable and Telecom segments.

6. Impairment of Long-Term Investment

The Company s long-lived assets include long-term equity investments. During the three months ended June 30, 2002, the Company determined that one such equity investment in a privately-held company, classified as a cable asset, was impaired and recorded an impairment charge of $4.5 million. In the second quarter of 2002, the investee s forecasts were not met and market conditions significantly deteriorated. The Company s estimate of the fair value of the long-term investment was dependent on the performance of the investment, as well as the volatility inherent in the external markets for this investment.

7. Convertible Subordinated Notes

In the first six months of 2001, the Company repurchased approximately $195.6 million of its Convertible Subordinated Notes (Notes) for $68.5 million in cash, resulting in a gain of approximately $121.5 million, net of related unamortized issuance costs of $5.6 million. In April 2002, the Company adopted SFAS No. 145 and determined that the extinguishment of its debt did not meet the criteria of an extraordinary item as set forth in SFAS No. 145. Accordingly, the Company will now report its gain from retirement of its Notes in its results of operations. All prior periods will reflect the adoption of SFAS No. 145. In the first six months of 2002, the Company repurchased approximately $74 million of its Notes for $39.2 million in cash, resulting in a gain included in operations of approximately $33.3 million net of related unamortized issuance costs of $1.5 million.

8. Related Party Transaction

Lewis Solomon, a member of the Company s Board of Directors and chairman of the Company s Audit Committee is also a member of the Board of Directors of Harmonic, Inc. (Harmonic). In June 2002, the Company entered a reseller agreement with Harmonic to sell certain of the Company s products. For the quarter ended June 30, 2002, there was approximately $70,000 in revenues generated from this reseller agreement.

9. Subsequent Event

In August 2002, the Company repurchased approximately $35.1 million of its Notes for $18.4 million in cash, resulting in a gain to be included in operations in the third quarter of fiscal 2002 of approximately $15.8 million, net of related unamortized issuance costs of $0.9 million.

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

The following discussion and analysis should be read in conjunction with our condensed consolidated financial statements and notes thereto.

Overview

We develop, market and sell equipment to cable television operators, telecom carriers and satellite network operators, who use our products to deliver broadband voice, video and data services to residential and business subscribers. We strive to deliver innovative broadband data, video and voice solutions that enable service providers to accelerate the deployment of revenue-generating services today and tomorrow.

We sell our products to cable operators and other providers of broadband services through direct sales forces in North America, South America, Europe and Asia. We also distribute our products through resellers and system integrators. We are structured around, and our sales are derived from, the following operating segments: Cable Broadband Access Systems (Cable) and Telecom Carrier Systems (Telecom). The products sold in Cable consist primarily of our TeraComm System products which are based on our proprietary S-CDMA technology, our CherryPicker digital video management system and the Multigate telephony and data access system, which are sold primarily to cable operators for the deployment of data, video and voice services over the existing cable infrastructure. The products sold in Telecom consist primarily of our MiniPlex DSL Systems, our IPTL Converged Voice and Data Service System and our MainSail products, which are sold to broadband service providers for the deployment of voice and data services over the existing copper wire infrastructure. We sell directly to providers of broadband access services and to distributors and resellers throughout the world.

We sustained a net loss of $7.8 million for the six months ended June 30, 2002. We had an accumulated deficit of $900.8 million as of June 30, 2002. Our operating expenses are based in part on our expectations of future sales, and we expect that a significant portion of our expenses will be committed in advance of sales. We anticipate that we will spend approximately $6 million to $10 million on capital expenditures and approximately $60 million to $65 million on research and development during the year ending December 31, 2002. Anticipated capital expenditures consist of purchases of computer hardware, furniture and leasehold improvements for our facilities, and software and equipment for newly hired employees.

Critical Accounting Policies

We consider certain accounting policies related to revenue recognition, bad debt reserves, inventory valuation, impairment of long-lived assets, warranty returns and contingencies to be critical policies due to the estimation processes involved in each.

Use of Estimates. The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires that we make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Revenue Recognition. We recognize revenue in accordance with SEC Staff Accounting Bulletin No. 101, *Revenue Recognition in Financial Statements* (SAB 101), as amended by SAB 101A and 101B. SAB 101 requires that four basic criteria must be met before revenue can be recognized: (1) persuasive evidence of an arrangement exists; (2) delivery has occurred or services rendered; (3) the selling price is fixed and determinable; and (4) collectibility is reasonably assured. Determination of criteria (4) is based on management s judgments regarding the collectibility of the selling price.

Bad Debt Reserves. We evaluate our trade receivables based upon a combination of factors. When we become aware of a customer s inability to pay, such as in the case of bankruptcy or a decline in the customer s operating results or financial position, we record a specific reserve for bad debt to reduce the related receivable to an amount we reasonably believe is collectible. We also record reserves for bad debt for customers based upon other factors including the length of time the receivables are past due and historical experience. If circumstances related to a specific customer change, our estimates of the recoverability of receivables could be further reduced.

Inventory Valuation. We perform a detailed assessment of inventory at each balance sheet date, which includes a review of, among other factors, demand requirements, product lifecycle and product development plans. Based on this analysis, we record adjustments, when appropriate, to reflect inventory at lower of cost or market.

We have adjusted our reserves significantly in recent periods due to changes in strategic direction, such as discontinuances of product lines as well as fluctuations in market conditions due to changes in demand requirements. If future demand is less favorable than we have projected, additional inventory write-downs may be required.

Warranty Reserves. We provide a standard warranty for most of our products, generally lasting one year from the date of purchase. We provide for the estimated cost of product warranties at the time revenue is recognized. Our warranty obligations are affected by product failure rates, material usage and service delivery costs incurred in correcting a product failure. Our estimate of costs to service our warranty obligations is based on historical experience and expectation of future conditions. Should actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability would be required, resulting in decreased gross profits.

Contingencies. We are subject to proceedings, lawsuits and other claims related to labor, acquisition and other matters. We are required to assess the likelihood of any adverse judgments or outcomes to these matters as well as potential ranges of probable losses. A determination of the amount of reserves required, if any, for these contingencies are made after careful analysis of each individual issue. The required reserves may change in the future due to new developments in each matter or changes in approach such as a change in settlement strategy in dealing with these matters, resulting in higher net loss.

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Results of Operations

Three Months and Six Months Ended June 30, 2002 and 2001

Revenues. We sell our products directly to broadband service providers, and to a lesser extent, resellers and integrators. Revenues related to product sales are generally recognized when: (1) persuasive evidence that an arrangement exists, (2) delivery has occurred or services rendered, (3) the selling price is fixed or determinable, and (4) collectibility is reasonably assured. A provision is made for estimated product returns as product shipments are made. Our existing agreements typically do not grant return rights beyond those provided by the warranty.

Revenues consist primarily of sales of products to new and existing customers providing broadband services. Our revenues decreased 66% to $22.4 million for the three months ended June 30, 2002 from $65.7 million in 2001 and decreased 33% to $79.6 million for the six months ended June 30, 2002 from $119.7 million in 2001. Revenues from Cable were $73.8 million in the first six months of 2002, down 28% from $102.3 million in 2001 and $19.2 million during the three months ended June 30, 2002, down 67% from $57.9 for the same period in 2001. Our decrease in Cable revenues reflects the challenge of transitioning from our proprietary-based products to standards-based products during a period of difficult market conditions including significant declines in the Average Selling Price (ASPs) of our proprietary-based modems.

The intensely competitive nature of the market for broadband products has resulted in significant price erosion over time. We have experienced and expect to continue to experience downward pressure on our unit ASPs. A key component of our strategy is to decrease the cost of manufacturing our products to offset the decline in ASPs. We intend to continue to implement cost reduction efforts, including design changes and manufacturing efficiencies. However, there can be no assurance that we will be able to successfully achieve cost reductions and efficiencies necessary to offset the decline in ASPs.

Revenues from Telecom were $5.8 million in the first six months of 2002, down 67% from $17.4 million in 2001 and $3.2 million during the three months ended June 30, 2002, down 59% from $7.8 for the same period in 2001. Our telecom business revenues in the second quarter continue to reflect the lower capital expenditures in the telecom industry due to weak demand and over-capacity in existing networks.

Cost of Goods Sold. Cost of goods sold consists of direct product costs as well as the cost of our manufacturing. The cost of the manufacturing includes contract manufacturing, test and quality assurance for products, warranty costs and associated costs of personnel and equipment. In the three months ended June 30, 2002, cost of goods sold decreased by 72% to $22.4 million compared to $81.5 million in 2001. The decrease in cost of goods sold is primarily due to the decrease in revenues and to special charges of $28.7 million and approximately $0.7 million of amortization of acquired intangible assets recorded in the second quarter of 2001. In the second quarter of 2002, we recorded additional inventory reserves of $4.5 million to reduce certain inventories to the lower of cost or market.

In the six months ended June 30, 2002, cost of goods sold decreased by 60% to $54.2 million compared to $136.3 million in 2001. Cost of goods sold for the six months ended June 30, 2002 included a reversal of approximately $11.4 million in special charges taken in 2001 for vendor cancellation charges and inventory previously reserved for obsolescence. We reversed the provision as we were able to sell inventory originally considered to be in excess. In addition, we were able to negotiate downward certain vendor cancellation claims to terms more favorable to us. Cost of goods sold for the six months ended June 30, 2001 also included special charges of $28.7 million and approximately $12.5 million of amortization of acquired intangible assets. There was no amortization of acquired intangible assets in 2002.

Excluding the effects of special charges in 2002 and 2001 and the amortization of acquired intangible assets in 2001, our cost of goods sold for the six months ended June 30, 2002, increased as a percentage of sales due to certain fixed indirect product costs which are allocated to a smaller revenue base, and a write-down of a prepaid license agreement which no longer has future value to us.

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Gross Profit (loss). We incurred a gross loss of $27,000 of sales for the three months ended June 30, 2002 compared to a gross loss of $15.7 million for the three months ended June 30, 2001. The decrease in gross loss in the three months ended June 30, 2002 compared to the three months ended June 30, 2001 is primarily related to the $28.7 million special charge in 2001.

For the six months ended June 30, 2002, we achieved a gross profit of $25.5 million or 32% of sales, compared to a gross loss of $16.6 million for the six months ended June 30, 2001. The increase in gross profit is primarily related to an $11.4 million reversal of special charges in 2002, the special charges and amortization of acquired intangible assets in 2001 which were not recorded in 2002, and the change in our product mix which included higher-margin headend equipment. Excluding the reversal of special charges, gross profit for the six months ended June 30, 2002 was 18% of sales. Excluding special charges and amortization costs, gross profit for the six months ended June 30, 2001 was 21% of sales. We anticipate further decreases in our ASPs and continued pressure on margins unless and until we can produce lower cost products and increase sales of our higher-margin headend products. These ASP decreases, without a corresponding decrease in our product costs, will likely have an adverse impact on our operating results through at least 2002.

Research and Development. Research and development expenses consist primarily of personnel costs, as well as prototype materials, equipment and supplies required to develop and to enhance our products. Research and development expenses decreased 23% to $14.7 million in the three months ended June 30, 2002 and 24% to $31.6 million in the six months ended June 30, 2002, compared to $19.2 million in three months ended June 30, 2001 and $41.8 million in the six months ended June 30, 2001. The decrease in research and development expenses was primarily related to overall reductions in research and development spending, particularly in prototype development, during 2002. Additionally, in 2001, we recorded amortization of acquired intangible assets of $1.1 million and $3.2 million in the three and six months ended June 30, 2001, respectively. There was no amortization in 2002. We intend to continue our investment in research and development.

Sales and Marketing. Sales and marketing expenses consist primarily of salaries and commissions for sales personnel, marketing and support personnel, and costs related to trade shows, consulting and travel. Sales and marketing expenses decreased 38% to $10.1 million in the three months ended June 30, 2002 and 40% to $19.0 million in the six months ended June 30, 2002, compared to $16.3 million in the three months ended June 30, 2001 and $31.8 million in the six months ended June 30, 2001. The decrease in sales and marketing expenses was due to lower headcount due to reductions in force during late 2001. Additionally, in 2001, we recorded amortization of acquired intangible assets of $0.5 million and $1.8 million in first three and six months of 2001, respectively. There was no amortization in 2002. We expect sales and marketing expenses to continue to decrease in the second half of 2002.

General and Administrative. General and administrative expenses primarily consist of salary and benefits for administrative officers and support personnel, travel expenses, legal, accounting and consulting fees. General and administrative expenses decreased 59% to $3.6 million for the three months ended June 30, 2002 and 57% to $7.2 million in the six months ended June 30, 2002, compared to $8.7 million in the first three months of 2001 and $16.6 million in the first six months of 2001. General and administrative expenses in the first three and six months of 2001 include $1.1 million and $2.4 million, respectively, of amortization of acquired intangible assets. There was no amortization in 2002. In addition, general and administrative expenses decreased due to lower headcount and reduced legal and information technology expenditures in 2002. We expect general and administrative expenses to remain flat or continue to decrease in the second half of 2002.

Goodwill Amortization. On January 1, 2002, we adopted SFAS No. 142, *Goodwill and Other Intangible Assets*. Statement 142 prohibits the amortization of goodwill and intangible assets with indefinite useful lives and requires that these assets be reviewed for impairment at least annually. Intangible assets with finite lives will continue to be amortized over their estimated useful lives. As of June 30, 2002, we have no further goodwill and intangible assets. No amortization expense was recorded during the six months ended June 30, 2002. Unallocated goodwill arising from acquisitions accounted for $0.3 million in amortization in the three months ended June 30, 2001 and $22.8 million in amortization in the six months ended June 30, 2001.

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Restructuring Costs and Asset Write-offs. In March 2001, we evaluated the carrying value of certain long-lived assets and acquired intangibles, consisting primarily of goodwill recorded on the balance sheet. Pursuant to accounting rules, the majority of the goodwill was recorded based on stock prices at the time acquisition agreements were executed and announced. Prior to the adoption of FAS 142, goodwill and other long-lived assets were reviewed for impairment whenever events such as product discontinuance, plant closures, product dispositions or other changes in circumstances indicate that the carrying amount may not be recoverable. When such events occur, we compare the carrying amount of the assets to undiscounted expected future cash flows. If this comparison indicates that there is an impairment, the amount of the impairment is based on the fair value of the assets, typically calculated using discounted expected future cash flows. The discount rate applied to these cash flows is based on our weighted average cost of capital, which represents the blended costs of debt and equity.

Downturns in the broadband services and telecommunications markets created unique circumstances with regard to the assessment of goodwill and other intangible assets for recoverability. As a result of our decision to suspend certain product lines and product development efforts during the first quarter of 2001, intangible assets totaling $165.8 million relating to certain acquisitions were deemed to be impaired with no future value and were written off. Further, the aforementioned downturns in the principal markets in which we continue to operate, have negatively impacted the forecasted revenues and cash flows from certain other companies acquired during fiscal 1999 and 2000. In accordance with our policy, the comparison of the discounted expected future cash flows to the carrying amount of the related intangible assets resulted in a write-down of these assets related to both our Cable and Telecom segments of $405.9 million during the first quarter 2001.

We incurred restructuring charges in the amount of $4.0 million in the first six months of 2001 and $12.7 million in fiscal year 2001. Of the total restructuring charges recorded during fiscal year 2001, $3.2 million related to employee termination costs and the remaining $9.5 million relates primarily to costs for excess leased facilities. During the first six months of 2002, we made cash payments of $1.8 million against the restructuring accrual. At June 30, 2002, restructuring charges of $6.4 million remain accrued, primarily related to excess facility costs. We anticipate utilizing the remaining restructuring accrual, which relates to servicing operating lease payments or negotiated buyout of operating lease commitments, through 2005. Remaining employee termination costs of $0.1 million are expected to be paid during fiscal 2002. We recorded a charge of $1.6 million in the six months ended June 30, 2001, resulting from the write-down of impaired assets.

In January 1, 2002, we adopted SFAS No. 142. We tested goodwill for impairment using the two-step process prescribed in SFAS No. 142. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any. The first step was completed during the three months ended March 31, 2002 and did not result in an impairment charge based on the determination of fair value at January 1, 2002.

Due to a difficult economic environment and heightened price competition in the modem and telecom businesses during the three months ended June 30, 2002, we experienced a significant drop in our market capitalization, and we proceeded to perform an interim step to measure goodwill and intangible assets for impairment. The outcome of this test resulted in a non-cash charge of $4.0 million in the six months ended June 30, 2002 to write off goodwill in both the Cable and Telecom segments.

Gain on early retirement of debt. In the first six months of 2001, we repurchased approximately $195.6 million of our Convertible Subordinated Notes (Notes) for $68.5 million in cash, resulting in a gain of approximately $121.5 million, net of related unamortized issuance costs. In April 2002, we adopted SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections (SFAS No. 145). Accordingly, we will now report our gain from retirement of our Notes in operations. All prior periods will reflect the adoption of SFAS No. 145. In the first six months of 2002, we repurchased approximately $74 million of our Notes for $39.2 million in cash, resulting in a gain of approximately $33.3 million net of related unamortized issue costs.

Interest Income and Expense. Interest income decreased 55% to $2.0 million for the three months ended June 30, 2002 and 63% to $4.1 million in the six months ended June 30, 2002, compared to $4.5 million and $11.2 million in the comparable periods of 2001. Interest expense, which relates primarily to interest on our Notes due in 2007, decreased 49% to $2.2 million for the three months ended June 30, 2002 and 57% to $4.4 million in the six months ended June 30, 2002, compared to $4.3 million and $10.0 million in the comparable periods of 2001. The decrease in both interest income and interest expense was due to the use of cash to repurchase of $325.9 million of the Notes in 2001 and $74 million of the Notes in the first half of 2002 and to the use of cash for operations.

Other income and expense. During the three months ended June 30, 2002, we wrote down $4.5 million of long-term investments which were included in our Cable Segment (as defined by SFAS No. 131) and were charged due to impairment to other expense. We estimated the fair value of the long-term investment based on the performance of the investment, as well as the volatility inherent in the external markets for this investment.

Income Taxes. We recorded a provision for income taxes of $1,000 during the three months ended June 30, 2002 and a provision for income taxes of $7,000 during the six months ended June 30, 2002. During the three and six months ended June 30, 2001 we had a provision for income taxes of $0.3 million and a benefit for income taxes of $13.6 million, respectively. During the first three months of 2001 we recorded a benefit of $13.9 million, which consisted of a reduction of deferred tax liabilities related to the Telegate, Radwiz, Ultracom, and Combox acquisitions and a $485,000 provision for foreign taxes.

Litigation

Beginning in April 2000, several plaintiffs filed lawsuits against us and certain of our officers and directors in federal court. The plaintiff in the first of these lawsuits purported to represent a class whose members purchased our securities between February 2, 2000 and April 11, 2000. The complaint alleged that the defendants had violated the federal securities laws by issuing materially false and misleading statements and failing to disclose material information regarding our technology. The allegations in the other lawsuits were substantially the same and, on August 24, 2000, all of these lawsuits were consolidated in the United States District Court, Northern District of California. The consolidated lawsuit is named In *re Terayon Communication Systems, Inc. Securities Litigation*, Case No. C 00-1967-MHP. The court hearing the consolidated action has appointed lead plaintiffs and lead plaintiffs counsel pursuant to the Private Securities Litigation Reform Act.

On September 21, 2000, the lead plaintiffs filed a consolidated class action complaint containing factual allegations nearly identical to those in the original lawsuits. The consolidated class action complaint, however, alleged claims on behalf of a class whose members purchased or otherwise acquired our securities between November 15, 1999 and April 11, 2000. On October 30, 2000, defendants moved to dismiss the consolidated class action complaint. On March 14, 2001, after defendants motion had been fully briefed and argued, the court issued an order granting in part defendants motion and giving plaintiffs leave to file an amended complaint. On April 13, 2001, plaintiffs filed their first amended consolidated class action complaint. On June 15, 2001, defendants moved to dismiss this new complaint and oral argument on the motion occurred on December 17, 2001. On March 29, 2002, the court denied the defendants motion to dismiss. The parties are now in the discovery process.

The lawsuit seeks an unspecified amount of damages, in addition to other forms of relief. We consider the lawsuits to be without merit and we intend to defend vigorously against these allegations. However, the litigation could prove to be costly and time consuming to defend, and there can be no assurances about the eventual outcome.

On October 16, 2000, a lawsuit was filed against us and the individual defendants (Zaki Rakib, Selim Rakib and Raymond Fritz) in the superior court of San Luis Obispo County, California. This lawsuit is titled *Bertram v. Terayon Communications Systems, Inc*., Case No. CV 000900 (Bertram). The Bertram complaint contains factual allegations similar to those alleged in the federal securities class action lawsuit. The complaint asserts causes of action under California Business & Professions Code Sections 17200 et seq. and 17500 et seq. for unlawful business practices, unfair and fraudulent business practices, and false and misleading advertising. Plaintiffs purport to bring the action on behalf of themselves and as representatives of all persons or entities in the State of California and such other persons or entities outside California that have been and are adversely affected by defendants activity, and as the Court shall determine is not inconsistent with the exercise of the Court s jurisdiction. Plaintiffs seek equitable and injunctive relief. Defendants removed the Bertram case to the United States District Court, Central District of California and, on January 19, 2001, filed a motion to dismiss the complaint. A hearing on defendants motion was held March 26, 2001 and the court granted Defendants motion to dismiss the action and denied Plaintiffs motion requesting remand. On April 5, 2001, Defendants moved for an order requiring further proceedings, if any to take place in the Northern District of California. Plaintiffs did not oppose this motion and eventually entered into a stipulation to go forward in the Northern District. On July 9, 2001, a status conference was held in this case before Judge Patel. Plaintiffs did not appear for the conference, and the court requested that defendants submit an order dismissing the Bertram action with prejudice, which the defendants have submitted to the court. We believe that these allegations, as with the allegations in the federal securities case, are without merit and intend to contest the matter vigorously.

On May 7, 2002, a shareholder filed a derivative lawsuit purportedly on our behalf against five of our current directors, two former directors and two former officers. This lawsuit is titled *Campbell vs. Rakib, et al.* (No. CV807650), and is pending in the California Superior Court, Santa Clara County. We are a nominal defendant in this lawsuit, which alleges claims relating to essentially the same purportedly misleading statements that are at issue in the pending securities class action. In that litigation, we dispute we made any misleading statements. The derivative complaint also alleges claims relating to stock sales by certain of the director and officer defendants. We believe that there are many defects in these complaints.

On July 12, 2002, a shareholder filed a derivative lawsuit purportedly on our behalf against three of our current directors, one former officer and three former investors. This lawsuit is titled *O Brien vs. Rakib, et al.* (No. 410201), and is pending in the California Superior Court, San Francisco County. We are a nominal defendant in this lawsuit, which alleges claims relating to essentially the same purportedly misleading statements that are at issue in the pending securities class action. In that litigation, we dispute that we made any misleading statements. The derivative complaint also alleges claims relating to stock sales by certain of the director and officer defendants. We believe that there are many defects in these complaints.

Liquidity and Capital Resources

Cash used in operating activities for the six months ended June 30, 2002 was $21.8 million compared to $89.9 million used in 2001. In the six months ended June 30, 2002, cash used by operating activities included $7.8 million net loss, and an $11.3 million decrease in other assets relating primarily to cash which was restricted due to certain operating lease commitments and is now classified in other assets. In the six months ended June 30, 2001, cash used by operating activities was primarily related to decreases in accounts payable, deferred taxes and other non-current liabilities partially offset by an increase in inventory.

Cash used in investing activities during the six months ended June 30, 2002 was $35.6 million, compared to cash provided by investing activities of $62.5 million in 2001. Investing activities consisted primarily of the purchase and sale of short-term investments.

Cash used by financing activities was $36.0 million in the first six months of 2002, compared to cash used in financing activities of $68.0 million in 2001. Financing activities typically consist of cash received through the exercise of stock options and shares issued through stock purchase plans, which are offset by interest payments on outstanding debt. In the first half of 2001, we repurchased Notes for $68.5 million in cash. In the first half of 2002, we repurchased Notes for $39.2 million in cash.

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As of June 30, 2002, we had a standby letter of credit outstanding for $9.0 million in support of certain operating lease commitments and another $0.7 million in letters of credit in support of purchase obligations.

We have unconditional purchase obligations to certain of our suppliers that support our ability to manufacture our products. The obligations require us to purchase minimum quantities of the suppliers products at a specified price. As of June 30, 2002, we had approximately $71.6 million of purchase obligations, of which $19.9 million is included on the balance sheet as accrued vendor cancellation charges. The remaining obligations are expected to become payable at various times through mid-2003.

We believe that our current cash balances will be sufficient to satisfy our cash requirements for at least the next 12 months. This estimate is a forward-looking statement that involves risks and uncertainties, and actual results may vary as a result of a number of factors, including those discussed under the risk factor Our Operating Results May Fluctuate below and elsewhere. We may need to raise additional funds in order to support more rapid expansion, develop new or enhanced services, respond to competitive pressures, acquire complementary businesses or technologies or respond to unanticipated requirements. We may seek to raise additional funds through private or public sales of securities, strategic relationships, bank debt, financing under leasing arrangements or otherwise. If additional funds are raised through the issuance of equity securities, the percentage ownership of our stockholders will be reduced, stockholders may experience additional dilution or such equity securities may have rights, preferences or privileges senior to those of the holders of our common stock. There can be no assurance that additional financing will be available on acceptable terms, if at all. If adequate funds are not available or are not available on acceptable terms, we may be unable to develop our products, take advantage of future opportunities or respond to competitive pressures or unanticipated requirements, which could have a material adverse effect on our business, financial condition and operating results.

Impact of Recently Issued Accounting Standards

In July 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 146, Accounting for Costs Associated with Exit or Disposal Activities (SFAS No. 146), which requires us to recognize costs associated with exit or disposal activities when they are incurred rather than at the date of a commitment to an exit or disposal plan. SFAS No. 146 replaces Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). The provisions of SFAS No. 146 are to be applied prospectively to exit or disposal activities initiated after December 31, 2002. We have not yet determined whether adoption of SFAS No. 146 will have a material impact on our financial statements.

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44 and 64, Amendment of FASB Statement No. 13, and Technical Corrections (SFAS No. 145). SFAS No. 145 allows only those gains and losses on the extinguishment of debt that meet the criteria of extraordinary items to be treated as such in the financial statements. SFAS No. 145 also requires sales-leaseback accounting for certain lease modifications that have economic effects that are similar to lease-back transactions. We adopted the provisions of SFAS No. 145 in the second quarter of 2002. In accordance with its adoption of SFAS No. 145, all prior periods will reflect the adoption of SFAS No. 145 in our condensed consolidated financial statements.

In August 2001, the FASB issued SFAS No. 144, Accounting for the Impairment or Disposal of Long-lived Assets (SFAS No. 144). SFAS No. 144 supercedes SFAS No. 121, Accounting for the Impairment of Long-lived Assets and Assets to be Disposed of and the accounting and reporting provisions of Accounting Principles Board Opinion No. 30, Reporting the Results of Operations -Reporting the Effects of Disposal of a Segment of a Business, and Extraordinary, Unusual and Infrequently Occurring Events and Transactions. SFAS No. 144 also amends Accounting Research Bulletin No. 51, Consolidated Financial Statements, to eliminate the exception to consolidation for a subsidiary for which control is likely to be temporary. The provisions of SFAS No. 144 were adopted by us effective January 1, 2002.

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In June 2001, the FASB issued SFAS No. 141, Business Combinations, and No. 142, Goodwill and Other Intangible Assets (SFAS No. 141 and SFAS No. 142). SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated after June 30, 2001. SFAS No. 141 also includes guidance on the initial recognition and measurement of goodwill and other intangible assets arising from business combinations completed after June 30, 2001. SFAS No. 142 prohibits the amortization of goodwill and intangible assets with indefinite useful lives. SFAS No. 142 requires that these assets be reviewed for impairment at least annually. Intangible assets with finite lives will continue to be amortized over their estimated useful lives. Additionally, SFAS No. 142 requires that goodwill included in the carrying value of equity method investments no longer be amortized.

We adopted SFAS No. 142 on January 1, 2002. We reclassified identifiable intangible assets with indefinite lives, as defined by SFAS No. 142, to goodwill at the date of adoption. We test goodwill for impairment using the two-step process prescribed in SFAS No. 142. The first step is a screen for potential impairment, while the second step measures the amount of the impairment, if any. See Note 5 in Note to Condensed Consolidated Financial Statements.

RISK FACTORS

You should carefully consider the risks described below before making an investment decision. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations. If any of the following risks actually occur, our business could be harmed. In such case, the trading price of our common stock could decline, and you may lose all or part of your investment.

We Have a History of Losses.

It is difficult to predict our future operating results. We began shipping products commercially in June 1997, and we have been shipping products in volume since the first quarter of 1998. As of June 30, 2002, we had an accumulated deficit of $900.8 million. We believe that we will continue to experience net losses for the foreseeable future. We generally are unable to reduce our expenses significantly in the short term to compensate for any unexpected delay or decrease in anticipated revenues. In addition, significant delays in our commercialization of new products will adversely affect our business. Moreover, even though we have experienced significant revenue growth since our inception, the profit potential of our business remains unproven.

Our Operating Results May Fluctuate.

Our quarterly revenues are likely to fluctuate significantly in the future due to a number of factors, many of which are outside our control.

Factors that could affect our revenues include, among others, the following:

- variations in the timing of orders and shipments of our products;
- variations in the size of the orders by our customers;
- new product introductions by competitors;

delays in our introduction of new products;

delays in our receipt of and cancellation of orders forecasted by customers;

delays by our customers in the completion of upgrades to their cable infrastructures;

variations in capital spending budgets of broadband service providers; and

adoption of industry standards and the inclusion in or compatibility of our technology with any such standards.

A variety of factors affecting our gross margin include, among others, the following:

the sales mix of our products;

the volume of products manufactured;

the type of distribution channel through which we sell our products;

the ASPs of our products; and

the costs of manufacturing our products and the effectiveness of our cost reduction measures.

We anticipate that unit ASPs of our products will continue to decline in the future. This could cause a decrease in the gross margins for these products. In addition, the gross margins we realize from the sale of our products are affected by the mix of product sales between higher margin, lower volume headend equipment, such as CMTSs, and lower margin, higher volume CPE, such as modems. We typically sell more headend equipment in connection with new deployments of our systems. As deployments mature, we tend to sell more CPE into the deployments compared to headend equipment. Sales of our CPE have constituted, and we expect will continue to constitute, a significant portion of our revenues.

Our expenses generally vary from quarter to quarter depending on the level of actual and anticipated business activities. Moreover, our research and development expenses increase as we develop new products and our development programs move to wafer fabrication and prototype development.

We Are Dependent on a Small Number of Customers.

A substantial majority of our revenues have been and will continue to be derived from sales to a relatively small number of customers. Three customers (one of which is a related party) accounted for approximately 49% of our revenues for the six months ended June 30, 2002. The loss of any one of these customers could have a material adverse effect on our results of operations. In addition, sales to our customers are and will continue to be focused on a limited number of projects.

The markets we serve are undergoing significant consolidation in both North America and internationally, as a limited number of service providers control an increasing number of systems. Currently, ten cable operators in the United States own and operate facilities passing approximately 82% of total homes passed. In addition, the North American DSL market is concentrated with the major ILECs constituting a significant percentage of the market. As a result, our sales have been and will continue to be dependent upon product acceptance by the leading broadband service providers.

The timing and size of each customer s order is critical to our operating results. Our major customers have significant negotiating leverage and sometimes attempt to change the terms, including pricing, upon which we do business with them. These customers may decide to purchase competitive products from other vendors at any time and can reschedule or cancel purchase orders on short notice. When purchasing product from us, these customers are requiring longer payment terms than in the past, which requires us to maintain additional capital to meet our working capital needs. Reduced spending in the cable and telecom industries has had and may continue to have a negative impact on our operations.

Acquisitions Could Result In Dilution, Operating Difficulties and Other Adverse Consequences.

We acquired ten companies from September 1999 through December 2000. We may acquire additional companies in the future. As a result of our decision to suspend certain product lines and product development efforts and downturns in the broadband services and telecommunications industries, in general, we wrote-down intangible assets relating to these acquisitions of approximately $572.8 million in 2001, and $4.0 million during the first six months of 2002. The process of integrating any such acquired company into our business and operations may be risky and may create unforeseen operating difficulties and expenditures going forward.

Future acquisitions could result in potentially dilutive issuances of equity securities, the incurrence of additional debt, contingent liabilities or amortization expenses related to goodwill and other intangible assets, any of which could harm our business. Future acquisitions also could require us to obtain additional equity or debt financing, which may not be available on favorable terms or at all. Even if available, this financing may be dilutive.

The Sales Cycle for Our Products Is Lengthy.

The sales cycle for our products typically is lengthy, often lasting six months to more than a year. Our customers typically conduct significant technical evaluations of competing technologies prior to making a purchasing decision. In addition, purchasing decisions may be delayed because of our customers internal budget approval procedures. Sales also generally are subject to customer trials, which typically last more than three months. Because of the lengthy sales cycle and the large size of customer orders, if orders forecasted for a specific customer for a particular quarter do not occur in that quarter, our revenues and operating results could suffer.

There Are Many Risks Associated with Our Participation in DOCSIS.

In January 2002, CableLabs announced that it had finished specifications for an advanced generation of cable modems called DOCSIS 2.0. DOCSIS 2.0 incorporates two advanced physical layer modulation techniques, S-CDMA and A-TDMA that four companies, including us, had helped to develop.

In connection with the finalization of the DOCSIS 2.0 specification, we have contributed some aspects of our current proprietary S-CDMA technology to a royalty-free intellectual property pool established by CableLabs to the extent that the technology is included in the DOCSIS 2.0 specification. This royalty-free pool facilitates the participation of as many vendors as possible in providing equipment that is compatible with the DOCSIS specification. As a result, any of our competitors who join the DOCSIS intellectual property pool would have access to these aspects of our technology and would not be required to pay us any royalties or other compensation for the use of our technology. If a competitor is able to duplicate the functionality and capabilities of our technology, we could lose some or all of the time-to-market advantage we might otherwise have due to our familiarity with S-CDMA. This may adversely affect our future revenues and operating results.

We believe the addition of advanced upstream physical layer (PHY) capabilities to DOCSIS in the DOCSIS 2.0 specification could increase the overall market for DOCSIS-compatible products and, as such, could result in increased competition in the cable modem market. This competition could come from existing competitors or from new competitors who enter the market. This increased competition is likely to result in lower ASPs of cable products and could harm revenues and gross margins. Because our competitors will be able to incorporate some aspects of our technology into their products, our current customers may choose alternate suppliers or choose to purchase DOCSIS-compliant cable products with advanced PHY capabilities from multiple suppliers. We may be unable to produce DOCSIS compliant cable products with advanced PHY capabilities more quickly or at lower cost than our competitors. As a result of the inclusion of S-CDMA technology in the DOCSIS 2.0 specification, competition for the services of our existing employees who have experience with S-CDMA could increase. The loss of these employees to one or more competitors could harm our business.

DOCSIS standards have not yet been accepted in Europe and Asia. An alternate specification for cable products, called the Euro-DOCSIS specification, has been formalized, and some European cable system operators have embraced it. We intend to develop and sell products that comply with the Euro-DOCSIS specification and to pursue having portions of our S-CDMA technology included in a future version of the Euro-DOCSIS specification. We may be unsuccessful in these efforts.

We Need to Develop New Products in Order to Remain Competitive.

Our future success depends on our ability to develop, market and sell new products in a timely manner. We also must respond to competitive pressures, evolving industry standards and technological advances. We are developing products that include both S-CDMA and A-TDMA, the two modulation techniques required by the DOCSIS 2.0 specification. There is no guarantee that our products will pass testing to be DOCSIS certified or qualified. If we are unable to certify or qualify our products as DOCSIS compliant in a timely manner, we may lose some or all of the time to market advantage we might otherwise have had, and our future operating results may be adversely affected.

Although we sell DOCSIS systems, the majority of our sales are derived from our proprietary S-CDMA products, which are not DOCSIS compliant. There have been instances where our customers and potential customers delayed or canceled purchases of our proprietary products in order to purchase products that comply with the DOCSIS specification. In addition, there have been instances where our existing customers and potential new customers purchased DOCSIS-compliant products from one or more of our competitors rather than purchasing our products. We believe that this may be an increasing trend in the future as service providers look to purchase DOCSIS certified or qualified products. As a result, we have reduced our prices and continue to experience customer demand to further reduce our prices in order to promote sales of our current products. This has had and may continue to have an adverse impact on our operating results and gross margin.

Average Selling Prices of Broadband Access Equipment Typically Decrease.

The broadband access market has been characterized by erosion of ASPs. We expect this to continue. This erosion is due to a number of factors, including competition, rapid technological change and price performance enhancements. The ASPs for our products may be lower than expected as a result of competitive pricing pressures, promotional programs and customers who negotiate price reductions in exchange for longer term purchase commitments. We anticipate that ASPs and gross margins for our products will decrease over their life cycles. In addition, we believe that the widespread adoption of industry standards is further eroding ASPs, particularly for cable modems and other similar CPE. It is likely that widespread adoption of industry standards will result in increased retail distribution of cable modems and other similar CPE, which could put further price pressure on our products. Decreasing ASPs could result in decreased revenues even if the number of units sold increases. As a result, we may experience substantial period-to-period fluctuations in future revenue and operating results due to ASP erosion. Therefore, we must continue to develop and introduce on a timely basis next-generation products with enhanced functionalities that can be sold at higher gross margins. Our failure to do this could cause our revenues and gross margin to decline.

We Must Achieve Cost Reductions.

Certain of our competitors currently offer products at prices lower than ours. Market acceptance of our products will depend in part on reductions in the unit cost of our products. We expect that as CMTS

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equipment becomes more widely deployed, the price of cable modems and other similar CPE will decline. In particular, we believe that the widespread adoption of industry standards such as DOCSIS will cause increased price competition for CPE. However, we may be unable to reduce the cost of our products sufficiently to enable us to compete with other equipment manufacturers. Even if we achieve certain cost reductions, it is not certain that these efforts will allow us to keep pace with competitive pricing pressures or lead to gross margin improvement.

Some of our competitors are larger and manufacture products in significantly greater quantities than we currently intend to manufacture for the foreseeable future. Consequently, these competitors have more leverage in obtaining favorable pricing from suppliers and manufacturers. In order to remain competitive, we must significantly reduce the cost of manufacturing our products through design and engineering changes. We may not be successful in redesigning our products. Even if we are successful, our redesign may be delayed or may contain significant errors and product defects. In addition, any redesign may not result in sufficient cost reductions to allow us to reduce significantly the list price of our products or improve our gross margin. Reductions in our manufacturing costs will require us to use more highly integrated components in future products and may require us to enter into high volume or long-term purchase or manufacturing agreements. Volume purchase or manufacturing agreements may not be available on acceptable terms. We could incur expenses without related revenues if we enter into a high volume or long-term purchase or manufacturing agreements and then decide that we cannot use the products or services offered by the agreement. We have incurred cancellation charges in the past and may incur such charges in the future.

We Must Keep Pace with Rapid Technological Change to Remain Competitive.

The markets for our products are characterized by rapid technological change, evolving industry standards, changes in end-user requirements and frequent new product introductions and enhancements. Our future success will depend upon our ability to enhance our existing products and to develop and introduce new products that achieve market acceptance. Service providers may adopt alternative technologies or may deploy alternative services that are incompatible with our products.

In January 2002, CableLabs announced that it had finished specifications for an advanced generation of cable products called DOCSIS 2.0. DOCSIS 2.0 incorporates two advanced physical layer modulation techniques, S-CDMA and A-TDMA. We believe that, as DOCSIS 2.0 gains acceptance among cable operators, our future success depends on our ability to manufacture, market and sell cable products certified and qualified as meeting the DOCSIS 2.0 specification. Our inability to produce DOCSIS 2.0 compliant cable products more quickly or at lower cost than our competitors may adversely affect our future results of operations.

Broadband Access Services Have Not Achieved Widespread Market Acceptance, and Many Competing Technologies Exist.

Our success will depend upon the widespread acceptance of broadband services by providers and end users. The markets for these services are not fully developed. We cannot accurately predict the future growth rate or the ultimate size of the market for broadband services. Potential users of our products may have concerns regarding the security, reliability, cost, ease of installation and use and capability of broadband services in general.

The markets for our products may be impacted by the development of other technologies that enable the provisioning of broadband services and the deployment of services over other media. Widespread acceptance of other technologies or deployment of services over media not supported by our products could materially limit acceptance of our products. Broadband services based on our products and technology may fail to gain widespread commercial acceptance by service providers and end users. We may not be successful in marketing and selling these products.

We Need to Develop Additional Distribution Channels.

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We presently market our products to service providers. With changes in the industry, we may need to establish new, additional distribution channels. For example, we believe that much of the North American market for CPE may shift to a retail distribution model. Accordingly, we may need to redirect our future marketing efforts to sell our CPE directly to retail distributors and end users. This shift would require us to establish new distribution channels for these products.

We face many challenges in establishing these new distribution channels. These challenges include, among others, the following:

- our inability to hire additional personnel necessary to establish and enhance these new distribution channels;
- to the extent that large consumer electronics companies enter the cable modem market, their well-established retail distribution capabilities would provide them with a significant competitive advantage;
- our potential customers are likely to prefer purchasing products from established manufacturing companies that can demonstrate the capability to supply large volumes of products on short notice; and
- many of our potential customers may be reluctant to adopt technologies that have not gained acceptance among other providers of similar services. This reluctance could result in lengthy product testing and acceptance cycles for our products. Consequently, the impediments to our initial sales may be even greater than those to later sales.

The vast majority of our sales are to larger, more established service providers that are critical to our business. We do not have access to smaller or geographically diverse service providers. Although we intend to establish strategic relationships with leading distributors worldwide to access these customers, we may not succeed in establishing these relationships. Even if we do establish these relationships, the distributors may not succeed in marketing our products to their customers. Some of our competitors have already established, long-standing relationships with these service providers that may limit our and our distributors ability to sell our products to those customers. Even if we were to sell our products to those customers, it would likely not be based on long-term commitments, and those customers would be able to terminate their relationships with us at any time.

We Are Dependent on Service Providers Choosing to Offer Additional Services to Their Customers.

We depend on service providers to purchase our products. Service providers have a limited amount of available bandwidth over which they can offer new services, such as high speed Internet access and telephony. They may choose not to provide these new services to their customers. When service providers choose to provide these new services, we depend upon them to market these services to their customers, to install our equipment and to provide support to end-users. In addition, we depend on these service providers to continue to maintain their infrastructures in a manner that allows us to provide consistently high performance and reliable services.

Sales of Our Cable Products Are Dependent on the Cable Industry Upgrading to Two-Way Cable Infrastructure.

Demand for our cable products will depend, to a significant degree, upon the magnitude and timing of capital spending by cable operators for implementation of access systems for data transmission over cable networks. This involves the enabling of two-way transmission over existing coaxial cable networks and the eventual upgrade to hybrid fiber coaxial (HFC) in areas of higher penetration of data services. If cable operators fail to complete these upgrades of their cable infrastructures in a timely and satisfactory manner, the market for our products could be limited. In addition, few businesses in the United States currently have cable access. Cable operators may not choose to upgrade existing residential cable systems or to install new cable systems to serve business locations.

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The success and future growth of our cable business will be subject to economic and other factors affecting the cable television industry generally, particularly its ability to finance substantial capital expenditures. Capital spending levels in the cable industry in the United States and internationally have fluctuated significantly in the past, and we believe that such fluctuations will occur in the future. We are currently experiencing reduced levels of spending in the cable industry. The capital spending patterns of cable operators are dependent on a variety of factors, including the following:

- the availability of financing;
- annual budget cycles, as well as the typical reduction in upgrade projects during the winter months;
- the status of federal, local and foreign government regulation and deregulation of the telecommunications industry;
- overall demand for broadband services;
- competitive pressures (including the availability of alternative data transmission and access technologies);
- discretionary consumer spending patterns; and
- general economic conditions.

In recent years, the cable market has been characterized by the acquisition of smaller and independent cable operators by larger operators. We cannot predict the effect, if any, that such consolidation will have on overall capital spending patterns by cable operators. The effect on our business of further industry consolidation also is uncertain.

Supply of Our Products Depends On Our Ability to Forecast Demand Accurately.

The emerging nature of the broadband services market makes it difficult for us to accurately forecast demand for our products. Our inability to forecast accurately the actual demand for our products may result in too much or too little supply of product or an over/under capacity of manufacturing or testing resources at any given point in time. The existence of any one or more of these situations could have a negative impact on our business, operating results or financial condition. We had purchase obligations of approximately $71.6 million as of June 30, 2002, primarily to purchase minimum quantities of materials and components used to manufacture our products. We must fulfill these obligations even if demand for our products is lower than we anticipate.

Our Business May Be Affected By Conditions In Israel.

Our operations may be affected by conditions in Israel because of our significant operations there. Since the establishment of the State of Israel in 1948, a number of armed conflicts have taken place between Israel and its Arab neighbors and a state of hostility, varying in degree and intensity, has led to security and economic problems for Israel. Hostilities within Israel have continued to escalate over the past year, which could disrupt some of our operations. We could be adversely affected by any major hostilities involving Israel. As a result of the hostilities and unrest presently occurring within Israel, the future of the peace efforts between Israel and its Arab neighbors is uncertain. A number of our employees based in Israel are currently obligated to perform annual military reserve duty and are subject to being called to active duty at any time under emergency circumstances. We cannot assess the full impact of these requirements and the hostilities on our workforce, business or operations if conditions should change, and we cannot predict the effect of any expansion or reduction of these obligations or the hostilities.

We May Have Financial Exposure to Litigation Against Our Directors and Officers.

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We and/or our directors and officers are defendants in a number of lawsuits, including securities litigation lawsuits. As a result, we may have financial exposure to litigation as a defendant and because we are obligated to indemnify our officers and members of our Board of Directors for certain actions taken by our officers and directors on our behalf. In order to limit financial exposure arising from litigation and/or our obligation to indemnify our officers and directors, we purchase insurance.

In October 2001, Reliance Insurance Co. (Reliance) was placed into liquidation by the state of Pennsylvania. Reliance was the underwriter for one excess layer of our directors and officers insurance for the period covering the claims made against the company and its officers in the pending securities litigation. Because Reliance is in liquidation, we may have to pay the amount insured under the Reliance policy ($2.5 million).

We Are Dependent on Key Third-Party Suppliers.

We manufacture all of our products using components or subassemblies procured from third-party suppliers. Some of these components are available from a sole source and others are available from limited sources. A majority of our sales are from products containing one or more components that are available only from sole source suppliers.

In addition, some of our components are custom parts produced to our specifications. For example, we have relied and will continue to rely on sole source semiconductor manufacturers to supply us with custom ASICs for use in our products. Additional components, such as the radio frequency tuner and some surface acoustic wave filters, are also procured from sole source suppliers. Any interruption in the operations of vendors of sole source parts could adversely affect our ability to meet our scheduled product deliveries to customers. We are dependent on semiconductor manufacturers and are affected by worldwide conditions in the semiconductor market. If we are unable to obtain a sufficient supply of components from our current sources, we could experience difficulties in obtaining alternative sources or in altering product designs to use alternative components. Resulting delays or reductions in product shipments could damage customer relationships. Further, a significant increase in the price of one or more of these components could harm our gross margin or operating results.

We May Be Unable to Migrate to New Semiconductor Process Technologies Successfully or on a Timely Basis.

Our future success will depend in part upon our ability to develop products that utilize new semiconductor process technologies. These technologies change rapidly and require us to spend significant amounts on research and development. We continuously evaluate the benefits of redesigning our integrated circuits using smaller geometry process technologies to improve performance and reduce costs. The transition of our products to integrated circuits with increasingly smaller geometries will be important to our competitive position. Other companies have experienced difficulty in migrating to new semiconductor processes and, consequently, have suffered reduced yields, delays in product deliveries and increased expense levels. Moreover, we depend on our relationship with our third-party manufacturers to migrate to smaller geometry processes successfully.

Our Ability to Directly Control Product Delivery Schedules and Product Quality Is Dependent on Third-Party Contract Manufacturers.

Most of our products are assembled and tested by contract manufacturers using testing equipment that we provide. As a result of our dependence on these contract manufacturers for assembly and testing of our products, we do not directly control product delivery schedules or product quality. Any product shortages or quality assurance problems could increase the costs of manufacture, assembly or testing of our products. In addition, as manufacturing volume increases, we will need to procure and assemble additional testing equipment and provide it to our contract manufacturers. The production and assembly of testing equipment typically requires significant lead times. We could experience significant delays in the shipment of our products if we are unable to provide this testing equipment to our contract manufacturers in a timely manner.

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There Are Many Risks Associated with International Operations.

We expect sales to customers outside of the United States to continue to represent a significant percentage of our revenues for the foreseeable future.

International sales are subject to a number of risks, including the following:

- changes in foreign government regulations and communications standards;
- export license requirements, tariffs and taxes;
- trade barriers;
- difficulty in protecting intellectual property;
- difficulty in collecting accounts receivable;
- difficulty in managing foreign operations; and
- political and economic instability.

If our customers are affected by currency devaluations or general economic crises, such as the recent economic crises affecting many Asian and Latin American economies, their ability to purchase our products could be reduced significantly. Payment cycles for international customers typically are longer than those for customers in North America. Foreign countries may decide to prohibit, terminate or delay the construction of new broadband services infrastructures for a variety of reasons. These reasons include environmental issues, economic downturns, availability of favorable pricing for other communications services or the availability and cost of related equipment. Any action like this by foreign countries would reduce the market for our products.

While we generally invoice our foreign sales in U.S. dollars, we do invoice our sales into Brazil in reals and certain sales in Europe in euros. We currently do not engage in foreign currency hedging transactions. As we expand our international operations, payments to us in foreign currencies and our exposure to losses as the result of foreign currency fluctuations may increase. We may choose to limit our exposure by the purchase of forward foreign exchange contracts or through similar hedging strategies. No currency hedging strategy can fully protect against exchange-related losses. In addition, if the relative value of the U.S. dollar in comparison to the currency of our foreign customers should increase, the resulting effective price increase of our products to those foreign customers could result in decreased sales.

We May Be Unable to Provide Adequate Customer Support.

Our ability to achieve our planned sales growth and retain current and future customers will depend in part upon the quality of our customer support operations. Our customers generally require significant support and training with respect to our broadband products, particularly in the initial deployment and implementation stages. To date, our sales have been concentrated in a small number of customers. We have limited experience with widespread deployment of our products to a diverse customer base. We may not have adequate personnel to provide the levels of support that our customers may require during initial product deployment or on an ongoing basis. Our inability to provide sufficient support to our customers could delay or prevent the successful deployment of our products. In addition, our failure to provide adequate support could harm our reputation and relationships with our customers and could prevent us from gaining new customers.

Our Industry Is Highly Competitive with Many Established Competitors.

The market for our products is extremely competitive and is characterized by rapid technological change. Our direct competitors in the cable arena include Cisco Systems, ADC, Arris, Juniper Networks, Com21, Motorola, Nortel Networks, Thomson Consumer Electronics (which markets products under the brand name RCA), Samsung, Scientific-Atlanta and Toshiba. We also compete with companies that develop integrated circuits for broadband products, such as Broadcom, Conexant and Texas Instruments. In addition, we compete with companies in the DSL arena such as Alcatel, Siemens, Lucent, Nortel Networks, Efficient Networks, Zhone, Marconi, Charles Industries, Accelerated Networks and Integral Access. The principal competitive factors in our market include the following:

- product performance, features and reliability;
- price;
- size and stability of operations;
- breadth of product line;
- sales and distribution capabilities;
- technical support and service;
- relationships with providers of service providers; and
- compliance with industry standards.

Some of these factors are outside of our control. The existing conditions in the market for broadband services could change rapidly and significantly as a result of technological advancements. The development and market acceptance of alternative technologies could decrease the demand for our products or render them obsolete. Our competitors may introduce products that are less costly, provide superior performance or achieve greater market acceptance than our products.

Many of our current and potential competitors have greater financial, technical, marketing, distribution, customer support and other resources, as well as better name recognition and access to customers than we do. The widespread adoption of DOCSIS and other industry standards is likely to cause increased worldwide price competition, particularly in the North American market. We believe that the adoption of these standards have resulted in and are likely to continue to result in lower sales of our proprietary S-CDMA products. Any increased price competition or reduction in sales of our products, particularly our higher margin headend products, would result in downward pressure on our gross margin. These competitive pressures have and are likely to continue to adversely impact our business.

Our Business Is Dependent on the Internet and the Development of Internet Infrastructure.

Our success depends on increased demand for high-speed Internet services for commercial use. Critical issues concerning the commercial use of the Internet remain largely unresolved and are likely to affect the development of the market for our products. These issues include security, reliability, cost, ease of access and quality of service. Our success also will depend on the growth of the use of the Internet by businesses for multimedia applications that require high bandwidth. The recent growth in the use of the Internet has caused frequent periods of performance degradation. This has required the upgrade of routers, telecommunications links and other components forming the infrastructure of the Internet by service providers and other organizations with links to the Internet. Any perceived degradation in the performance of the Internet as a whole could undermine the benefits of our products.

We Are Dependent on Key Personnel.

Due to the specialized nature of our business, we are highly dependent on the continued service of, and on the ability to attract and retain, qualified engineering, sales, marketing and senior management personnel. The competition for some of these personnel is intense. The loss of any of these individuals may harm our business. In addition, if we are unable to hire qualified personnel as needed, we may be unable to adequately manage and grow our business.

Highly skilled employees with the education and training that we require, especially employees with significant experience and expertise in both data networking and radio frequency design, are in high demand. We may be unable to continue to attract and retain qualified personnel necessary for the development of our business. We do not have key person insurance coverage for the loss of any of our employees. Any officer or employee can terminate his or her relationship with us at any time. Our employees are not bound by non-competition agreements with us.

Our Business Is Subject to the Risks of Product Returns, Product Liability and Product Defects.

Products like ours are very complex and frequently contain undetected errors or failures, especially when first introduced or when new versions are released. Despite testing, errors may occur. The occurrence of errors could result in product returns and other losses to us and/or our customers. This occurrence could result in the loss of or delay in market acceptance of our products. We have limitation of liability provisions in our standard terms and conditions of sale. However, these terms and conditions may not be effective as a result of federal, state or local laws or ordinances or unfavorable judicial decisions in the United States or other countries. The sale and support of our products entails the risk of product liability claims. In addition, any failure by our products to properly perform could result in claims against us by our customers. We maintain insurance to protect against certain claims associated with the use of our products, but our insurance coverage may not adequately cover any claim asserted against us. In addition, even claims that ultimately are unsuccessful could result in our expenditure of funds in litigation and management time and resources.

We May Be Unable to Adequately Protect or Enforce Our Intellectual PropertyRights.

We rely on a combination of patent, trade secret, copyright and trademark laws and contractual restrictions to establish and protect proprietary rights in our products. Even though we seek to establish and protect proprietary rights in our products, there are risks. Our pending patent applications may not be granted. Even if they are granted, the claims covered by the patent may be reduced from those included in our applications. Any patent might be subject to challenge in court and, whether or not challenged, might not be broad enough to prevent third parties from developing equivalent technologies or products without a license from us.

We have entered into confidentiality and invention assignment agreements with our employees, and we enter into non-disclosure agreements with many of our suppliers, distributors and appropriate customers so as to limit access to and disclosure of our proprietary information. These contractual arrangements, as well as statutory protections, may not prove sufficient to prevent misappropriation of our technology or deter independent third-party development of similar technologies. In addition, the laws of some foreign countries may not protect our intellectual property rights to the same extent as do the laws of the United States.

CableLabs DOCSIS 2.0 specification includes two modulation techniques, S-CDMA and A-TDMA. In connection with the development of the DOCSIS 2.0 specification by CableLabs, we entered into an agreement with CableLabs whereby we licensed to CableLabs any of our intellectual property rights to the extent that such rights may be asserted against a party desiring to design, manufacture or sell DOCSIS based products, including DOCSIS 2.0 based products. This license agreement grants to CableLabs the right to sublicense our intellectual property, including our intellectual property rights in our S-CDMA patents, to manufacturers that compete with us in the marketplace for DOCSIS based products.

We pursue the registration of our trademarks in the United States and have applications pending to register several of our trademarks throughout the world. However, the laws of certain foreign countries might not protect our products or intellectual property rights to the same extent as the laws of the United

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States. Effective trademark, copyright, trade secret and patent protection may not be available in every country in which our products may be manufactured, marketed or sold.

Our Business And Our Customers Are Subject to Regulation.

Our business and customers are subject to varying degrees of regulation by regulatory bodies in the United States and foreign countries. Although these regulations have not materially restricted our operations to date or the operations of our customers, future regulations applicable to our business or customers could be adopted. The adoption of future regulations may adversely affect our customers, our ability to sell our products and therefore our operating results.

Our Products Are Subject to Approvals and Certifications.

In the United States, our products are required to meet certain safety requirements. For example, we are required to have our products certified by Underwriters Laboratory in order to meet federal requirements relating to electrical appliances to be used inside the home. Outside the United States, our products are subject to the regulatory requirements of each country in which the products are manufactured or sold. These requirements are likely to vary widely. We may be unable to obtain on a timely basis or at all the regulatory approvals that may be required for the manufacture, marketing and sale of our products. In addition to regulatory compliance, some cable operators require that our products be certified or qualified as having met DOCSIS or Euro-DOCSIS specifications.

We Are Vulnerable to Earthquakes, Power Outages and Other Unexpected Events.

Our corporate headquarters, as well as the majority of our research and development activities and some manufacturing operations are located in California, an area known for seismic activity. In addition, the operations of some of our key suppliers are also located in this area and in other areas known for seismic activity, such as Taiwan. An earthquake, or other significant natural disaster, could result in an interruption in our business or the operations of one or more of our key suppliers. Such an interruption could harm our operating results. We may not carry sufficient business interruption insurance to compensate for any losses that we may sustain as a result of any natural disasters or other unexpected events.

Our Indebtedness Could Adversely Affect our Financial Condition; We May Incur Substantially More Debt.

As of June 30, 2002, we had approximately $100.4 million of indebtedness outstanding. This high level of indebtedness may adversely affect our stockholders by:

- making it more difficult for us to satisfy our obligations with respect to our indebtedness;
- increasing our vulnerability to general adverse economic and industry conditions;
- limiting our ability to obtain additional financing;
- requiring the dedication of a substantial portion of our cash flow from operations to the payment of principal of, and interest on, our indebtedness, thereby reducing the availability of our cash flow to fund our growth strategy, working capital, capital expenditures and other general corporate purposes;
- limiting our flexibility in planning for, or reacting to, changes in our business and the industry; and

placing us at a competitive disadvantage relative to our competitors with less debt.

We may incur substantial additional debt in the future. The terms of our outstanding debt do not fully prohibit us from doing so. If new debt is added to our current levels, the related risks described above could intensify.

Our Stock Price Has Been and Is Likely to Continue To Be Highly Volatile.

The trading price of our common stock has been and is likely to continue to be highly volatile. Our stock price could be subject to extreme fluctuations in response to a variety of factors, including the following:

- actual or anticipated variations in quarterly operating results;
- announcements of technological innovations;
- new products or services offered by us or our competitors;
- changes in financial estimates by securities analysts;
- conditions or trends in the broadband services industry;
- changes in the economic performance and/or market valuations of Internet, online service or broadband service industries;
- our announcement of significant acquisitions, strategic partnerships, joint ventures or capital commitments;
- adoption of industry standards and the inclusion or compatibility of our technology with such standards;
- adverse or unfavorable publicity regarding us or our products;
- additions or departures of key personnel;
- sales of common stock; and
- other events or factors that may be beyond our control.

In addition, the stock markets in general, and the Nasdaq National Market and the market for broadband services and technology companies in particular, have experienced extreme price and volume volatility and a significant cumulative decline over the last two years. This volatility and decline has affected many companies irrespective of or disproportionately to the operating performance of these companies. Additionally, industry factors may materially adversely affect the market price of our common stock, regardless of our actual operating performance.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Risk.

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. The primary objective of our investment activities is to preserve principal while maximizing yields without significantly increasing risk. This is accomplished by investing in widely diversified short-term investments, consisting primarily of investment grade securities, substantially all of which mature

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within the next twenty-four months. A hypothetical 50 basis point increase in interest rates would result in an approximate $854,000 decline (less than 0.4%) in the fair value of our available-for-sale securities.

Foreign Currency Risk.

A substantial majority of our revenue, expense and capital purchasing activity are transacted in U.S. dollars. However, we do enter into transactions in Belgium, United Kingdom, Hong Kong, Korea, Canada and Israel. An adverse change of 10% in exchange rates would result in a decline in income before taxes of approximately $160,000.

All of the potential changes noted above are based on sensitivity analyses performed as of June 30, 2002. Actual results may differ materially

PART II. OTHER INFORMATION

ITEM 3. LEGAL PROCEEDINGS

See Litigation under Part I, Item 2, Management s Discussion and Analysis of Financial Condition and Results of Operations

ITEM 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

None

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None

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

(a) The registrant s Annual Meeting of Stockholders was held on May 22, 2002.

(b) The meeting involved the election of two officers: Aleksander Krstajic and Lewis Solomon. The following directors terms continued after the meeting: Shlomo Rakib, Zaki Rakib and Christopher Schaepe.

(c) There were four matters voted on at the Meeting. A brief description of each of these matters, and the results of the votes thereon, are as follows:

1. Election of Directors

Nominee	For	Withheld
Aleksander Krstajic	58,004,446	1,121,509
Lewis Solomon	58,023,105	1,102,850

2. Amendment to the 1998 Non-Employee Directors Plan to increase the aggregate number of common stock authorized for issuance under the plan by 400,000 shares

For	Against	Abstain
46,354,850	12,639,675	131,430

3. Amendment to the 1998 Employee Stock Purchase Plan to increase the aggregate number of common stock authorized for issuance under the plan by 3,000,000 shares

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For	Against	Abstain
56,431,564	2,590,465	103,926

4. Ratification of the appointment of Ernst & Young LLP as the registrant s auditors for the fiscal year ending December 31, 2002

For	Against	Abstain
58,446,244	620,123	59,589

ITEM 5. OTHER INFORMATION

None

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) EXHIBITS

None

(b) REPORTS ON FORM 8-K

The Company filed no reports on Form 8-K during the quarter ended June 30, 2002.

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SIGNATURES

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

Date: August 14, 2002

TERAYON COMMUNICATION SYSTEMS, INC.

By /s/ Carol Lustenader

Carol Lustenader
Chief Financial Officer