

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

**FORM 10-Q**

(Mark One)

☒ **Quarterly Report Pursuant to Section 13 or 15(D) of the Securities Exchange Act of 1934**  
For the quarterly period ended December 26, 2003

OR

☐ **Transition Report Pursuant to Section 13 or 15(D) of the Securities Exchange Act of 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_ .

Commission File Number 0-15323

**NETWORK EQUIPMENT TECHNOLOGIES, INC.**  
(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

**94-2904044**  
(I.R.S. Employer  
Identification Number)

**6900 Paseo Padre Parkway**  
**Fremont, CA 94555-3660**  
**(510) 713-7300**  
(Address, including zip code, and telephone number  
including area code, of 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 ☐ No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act): ☒ Yes ☐ No

The number of shares outstanding of the registrant's Common Stock, par value \$.01, as of February 3, 2004 was 23,982,479.

# NETWORK EQUIPMENT TECHNOLOGIES, INC.

## INDEX

	<u>Page Number</u>
PART I. FINANCIAL INFORMATION	
<a href="#"><u>Item 1. Financial Statements</u></a> .....	3
<a href="#"><u>Condensed Consolidated Balance Sheets at December 26, 2003 and March 28, 2003</u></a> .....	3
<a href="#"><u>Condensed Consolidated Statements of Operations and Comprehensive Income (Loss) - Quarter and Nine Months ended December 26, 2003 and December 27, 2002</u></a> .....	4
<a href="#"><u>Condensed Consolidated Statements of Cash Flows - Nine Months ended December 26, 2003 and December 27, 2002</u></a> .....	6
<a href="#"><u>Notes to Condensed Consolidated Financial Statements</u></a> .....	7
<a href="#"><u>Item 2. Management's Discussion and Analysis of Results of Operations and Financial Condition</u></a> .....	10
<a href="#"><u>Item 3. Quantitative and Qualitative Disclosures about Market Risk</u></a> .....	24
<a href="#"><u>Item 4. Disclosure Controls and Procedures</u></a> .....	24
PART II. OTHER INFORMATION	
<a href="#"><u>Item 6. Exhibits and Reports on Form 8-K</u></a> .....	25
<a href="#"><u>SIGNATURES</u></a> .....	25

## PART I - FINANCIAL INFORMATION

### ITEM 1. FINANCIAL STATEMENTS

#### NETWORK EQUIPMENT TECHNOLOGIES, INC. Condensed Consolidated Balance Sheets (Unaudited -- in thousands, except par value)

	<u>December 26, 2003</u>	<u>March 28, 2003</u>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 10,876	\$ 20,593
Restricted cash	1,363	1,361
Short-term investments	83,091	72,614
Accounts receivable, net of allowance for doubtful accounts and sale returns of \$613 at December 26, 2003 and \$846 at March 28, 2003	25,703	14,574
Inventories	12,282	14,569
Prepaid expenses and other assets	3,493	4,110
	<hr/>	<hr/>
Total current assets	136,808	127,821
Property and equipment, net	32,226	34,486
Software production costs, net	-	5
Other assets	3,584	2,506
	<hr/>	<hr/>
Total assets	\$ 172,618	\$ 164,818
	<hr/>	<hr/>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 6,575	\$ 5,427
Accrued liabilities	17,252	18,081
	<hr/>	<hr/>
Total current liabilities	23,827	23,508
Long-term liabilities:		
7 1/4% redeemable convertible subordinated debentures	24,706	24,706
Other long-term liabilities	1,890	1,770
	<hr/>	<hr/>
Total long-term liabilities	26,596	26,476
Stockholders' equity:		
Preferred stock (\$0.01 par value; 5,000 shares authorized; none outstanding)	-	-
Common stock (\$0.01 par value; 50,000 shares authorized; 23,513 and 22,663 shares outstanding at December 26, 2003 and March 28, 2003, respectively)	235	226
Additional paid-in capital	188,473	184,122
Treasury stock	(3,408)	(3,408)
Accumulated other comprehensive loss	(95)	(198)
Accumulated deficit	(63,010)	(65,908)
	<hr/>	<hr/>
Total stockholders' equity	122,195	114,834
	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$ 172,618	\$ 164,818
	<hr/>	<hr/>

See accompanying notes to condensed consolidated financial statements

**NETWORK EQUIPMENT TECHNOLOGIES, INC.**  
**Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)**  
(Unaudited -- in thousands, except per share amounts)

	<u>Quarter Ended</u>		<u>Nine Months Ended</u>	
	<u>December</u>	<u>December</u>	<u>December</u>	<u>December</u>
	<u>26, 2003</u>	<u>27, 2002</u>	<u>26, 2003</u>	<u>27, 2002</u>
<b>Revenue:</b>				
Product	\$ 28,438	\$ 27,991	\$ 85,511	\$ 73,087
Service and other	5,433	5,014	14,401	15,212
Total revenue	33,871	33,005	99,912	88,299
<b>Costs of sales:</b>				
Cost of product revenue	11,033	14,195	34,400	39,295
Cost of service and other revenue	4,394	4,582	11,959	14,315
Total cost of sales	15,427	18,777	46,359	53,610
<b>Gross margin</b>	18,444	14,228	53,553	34,689
<b>Operating expenses:</b>				
Sales and marketing	8,202	7,880	23,320	24,279
Research and development	6,939	6,366	20,728	19,533
General and administrative	2,349	2,707	7,539	8,479
Restructure costs	-	689	266	1,861
Total operating expenses	17,490	17,642	51,853	54,152
<b>Income (loss) from operations</b>	954	(3,414)	1,700	(19,463)
Interest income	383	566	1,127	1,929
Interest expense	(500)	(491)	(1,534)	(1,504)
Gain on sale of Federal Services Business	-	-	1,500	5,000
Other income	69	167	88	2,348
<b>Income (loss) before taxes</b>	906	(3,172)	2,881	(11,690)
Income tax provision (benefit)	(3)	32	(18)	(2,297)
<b>Income (loss) before accounting change</b>	909	(3,204)	2,899	(9,393)
Cumulative effect of change in accounting principle relating to goodwill	-	-	-	(9,592)
<b>Net income (loss)</b>	<u>\$ 909</u>	<u>\$ (3,204)</u>	<u>\$ 2,899</u>	<u>\$ (18,985)</u>
<b>Per share data:</b>				
Income (loss) before accounting change:				
Basic	\$0.04	\$(0.14)	\$0.13	\$(0.42)
Diluted	\$0.04	\$(0.14)	\$0.12	\$(0.42)
Cumulative effect of change in accounting principle relating to goodwill – basic and diluted	\$ -	\$ -	\$ -	\$(0.43)
Net income (loss):				
Basic	\$0.04	\$(0.14)	\$0.13	\$(0.85)
Diluted	\$0.04	\$(0.14)	\$0.12	\$(0.85)
<b>Common and common equivalent shares:</b>				
Basic	23,395	22,476	23,091	22,383
Diluted	24,884	22,476	24,385	22,383

**NETWORK EQUIPMENT TECHNOLOGIES, INC.**  
**Condensed Consolidated Statements of Operations and Comprehensive Income (Loss)**, continued  
(Unaudited -- in thousands, except per share amounts)

	<u>Quarter Ended</u>		<u>Nine Months Ended</u>	
	<u>December</u> <u>26, 2003</u>	<u>December</u> <u>27, 2002</u>	<u>December</u> <u>26, 2003</u>	<u>December</u> <u>27, 2002</u>
<b>Consolidated Statements of Comprehensive Income (Loss)</b>				
Net income (loss)	\$ 909	\$ (3,204)	\$ 2,899	\$ (18,985)
Other comprehensive income, net of tax:				
Cumulative translation adjustments	267	(7)	340	47
Net unrealized gain (loss) on securities	(95)	14	(240)	588
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Comprehensive income (loss)	\$ 1,081	\$ (3,197)	\$ 2,999	\$ (18,350)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

See accompanying notes to condensed consolidated financial statements

**NETWORK EQUIPMENT TECHNOLOGIES, INC.**  
**Condensed Consolidated Statements of Cash Flows**  
(Unaudited -- in thousands)

	<b>Nine Months Ended</b>	
	<b>December 26, 2003</b>	<b>December 27, 2002</b>
Cash and cash equivalents at beginning of period	\$ 20,593	\$ 15,879
Cash flows from operating activities:		
Net income (loss)	2,899	(18,985)
Adjustments required to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	6,571	7,027
Gain on sale of Federal Services Business	(1,500)	(5,000)
Loss on disposition of property and equipment	95	7
Gain on insurance settlement	-	(2,380)
Proceeds from insurance settlement	-	3,451
Cumulative effect of change in accounting principle relating to goodwill	-	9,592
Changes in assets and liabilities:		
Accounts receivable	(11,129)	455
Inventories	2,183	(1,532)
Prepaid expenses and other assets	618	1,709
Accounts payable	1,103	(844)
Accrued liabilities	(825)	(1,905)
Net cash provided by (used in) operating activities	15	(8,405)
Cash flows from investing activities:		
Purchases of short-term investments	(181,011)	(45,032)
Proceeds from maturities of short-term investments	170,294	49,340
Purchases of property and equipment	(4,247)	(4,659)
Proceeds from sale of Federal Services Business	1,500	5,000
Change in restricted cash	(1,453)	1,891
Other, net	360	30
Net cash provided by (used in) investing activities	(14,557)	6,570
Cash flows from financing activities:		
Issuance of common stock	4,362	958
Net cash provided by financing activities	4,362	958
Effect of exchange rate changes on cash	463	(9)
Net decrease in cash and cash equivalents	(9,717)	(886)
Cash and cash equivalents at end of period	\$ 10,876	\$ 14,993
Other cash flow information:		
Cash paid (refunded) during the year for:		
Interest	\$ 1,927	\$ 1,930
Income taxes	\$ 28	\$ (1,067)
Non-cash investing and financing activities:		
Unrealized gain (loss) on available-for-sale securities	\$ (240)	\$ 588

See accompanying notes to the condensed consolidated financial statements

**NETWORK EQUIPMENT TECHNOLOGIES, INC.**  
**Notes to Condensed Consolidated Financial Statements**

***Note 1. Description of the Company***

Network Equipment Technologies, Inc., doing business as net.com (net.com or the Company), is a global provider of networking technology platforms that are used for mission-critical communications solutions. The Company's multiservice wide area networking products, comprising the Promina product line, use circuit-switched technology to provide an effective platform for developing reliable and secure networks. In response to the growth of next-generation networks using packet-switching technologies and the Internet protocol (IP), the Company developed its SCREAM and SHOUTIP service creation platforms for broadband, IP telephony, and multiservice networks. These platforms allow network service providers to rapidly create and deliver new service offerings that the Company believes can help them to accelerate the return on their network investment, reduce capital and operating expenditures, and achieve greater profits. Network Equipment Technologies, Inc. was founded in 1983 and has been doing business as net.com since 2000.

***Note 2. Summary of Significant Accounting Policies***

*Basis of Presentation.* The condensed consolidated financial statements include the accounts of net.com and its wholly owned subsidiaries. All significant intercompany balances and transactions have been eliminated.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments) considered necessary to present fairly the financial position as of December 26, 2003, the results of operations for the quarters and nine months ended December 26, 2003 and December 27, 2002, and the cash flows for the nine months ended December 26, 2003 and December 27, 2002. These financial statements should be read in conjunction with the March 28, 2003 audited consolidated financial statements and notes thereto. The results of operations for the quarter and nine months ended December 26, 2003 are not necessarily indicative of the results to be expected for the fiscal year ending March 26, 2004.

*Stock-Based Compensation.* net.com accounts for its stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and its related interpretations. Stock-based compensation related to non-employees is based on the fair value of the related stock or options in accordance with Statement of Financial Accounting Standards (SFAS) No. 123, Accounting for Stock Based Compensation. Expense associated with stock-based compensation is amortized on an accelerated basis under Financial Accounting Standards Board Interpretation (FIN) No. 28, Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans, over the vesting period of each individual award. In accordance with SFAS No. 148, Accounting for Stock-Based Compensation--Transition and Disclosures--an amendment to FASB Statement No. 123, the Company is required to disclose the effects on reported net income (loss) and basic and diluted net income (loss) per share as if the fair value based method had been applied to all awards. For the quarter and nine months ended December 26, 2003 and December 27, 2002, had compensation cost been determined based on the fair value method pursuant to SFAS 123, the Company's net income (loss) would have been as follows (in thousands, except per share amounts):

	<u>Quarter Ended</u>		<u>Nine Months Ended</u>	
	<u>December</u>	<u>December</u>	<u>December</u>	<u>December</u>
	<u>26, 2003</u>	<u>27, 2002</u>	<u>26, 2003</u>	<u>27, 2002</u>
Net income (loss) -- as reported	\$ 909	\$ (3,204 )	\$ 2,899	\$ (18,985 )
Less: Stock-based compensation expense determined by the fair value method, net of tax	(971 )	(891 )	(3,128 )	(3,350 )
Net loss -- pro forma	<u>\$ (62 )</u>	<u>\$ (4,095 )</u>	<u>\$ (229 )</u>	<u>\$ (22,335 )</u>
Basic income (loss) per share -- as reported	\$ 0.04	\$ (0.14 )	\$ 0.13	\$ (0.85 )
Diluted income (loss) per share -- as reported	\$ 0.04	\$ (0.14 )	\$ 0.12	\$ (0.85 )
Basic and diluted loss per share -- pro forma	\$ (0.00 )	\$ (0.18 )	\$ (0.01 )	\$ (1.00 )

*Recently Issued Accounting Standards.* In December 2003, the Securities and Exchange Commission (SEC) issued Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. SAB 104 revises or rescinds portions of the interpretive guidance included in Topic 13 of the codification of staff accounting bulletins in order to make this interpretive guidance consistent with current authoritative accounting and auditing guidance and SEC rules and regulations. The adoption of SAB 104 did not have a material effect on the Company's results of operations or financial condition.

**Note 3. Inventories**

Inventories are stated at the lower of cost (first-in, first-out) or market and include material, labor and manufacturing overhead costs. Inventories at December 26, 2003 and March 28, 2003 consisted of the following (in thousands):

	<b>December 26, 2003</b>	<b>March 28, 2003</b>
Purchased components	\$ 2,697	\$ 5,084
Work-in-process	7,625	6,153
Finished goods	1,960	3,332
Total	<u>\$ 12,282</u>	<u>\$ 14,569</u>

**Note 4. Income (Loss) Per Share**

The following table sets forth the computation of the numerator and denominator used in the computation of basic and diluted net income (loss) per share (in thousands):

	<b><u>Quarter Ended</u></b>		<b><u>Nine Months Ended</u></b>	
	<b><u>December 26, 2003</u></b>	<b><u>December 27, 2002</u></b>	<b><u>December 26, 2003</u></b>	<b><u>December 27, 2002</u></b>
Numerator:				
Income (loss) before accounting change	\$ 909	\$ (3,204 )	\$ 2,899	\$ (9,393 )
Cumulative effect of change in accounting principle, relating to goodwill	-	-	-	(9,592 )
Net income (loss)	<u>\$ 909</u>	<u>\$ (3,204 )</u>	<u>\$ 2,899</u>	<u>\$ (18,985 )</u>
Denominator:				
Basic weighted average shares of common stock outstanding	23,395	22,476	23,091	22,383
Diluted effect of options issued to employees	1,489	-	1,294	-
Diluted weighted average shares of common stock outstanding	<u>24,884</u>	<u>22,476</u>	<u>24,385</u>	<u>22,383</u>

Basic income (loss) per share has been computed based upon the weighted average number of common shares outstanding for the periods presented. For diluted income per share, shares used in the per share computation include weighted average common and potentially dilutive shares outstanding. Potentially dilutive shares consist of shares issuable upon the assumed exercise of dilutive stock options. These shares totaled 1,489,000 and 121,000 for the quarters ended December 26, 2003 and December 27, 2002, respectively, and 1,294,000 and 203,000 for the nine months ended December 26, 2003 and December 27, 2002. The dilutive shares for the quarter and nine months ended December 26, 2003 were included in the diluted per share computation. Because the Company reported a net loss for the quarter and nine months ended December 27, 2002, the calculation of diluted net loss per share does not include common stock equivalents as they are anti-dilutive and would result in a reduction of net loss per share. Additionally, there were 784,000 shares of common stock issuable upon conversion of debentures. These shares, and the related effect of the accrued interest on the debentures, were not included in the calculation of diluted income (loss) per share for the quarter and nine months ended December 26, 2003 and December 27, 2002, as their inclusion would have been anti-dilutive.



**Note 5. Restructure Costs**

In the first quarter of fiscal 2004, net.com recorded a restructuring charge of \$266,000. This charge included \$254,000 for lease write-off and \$12,000 for office closure costs. The remaining liability for restructuring charges is \$790,000 at December 26, 2003, as shown in the table below. Components of accrued restructuring charges, which are included in accrued liabilities in the accompanying balance sheets, and changes in accrued amounts related to this restructuring program during the first nine months of fiscal 2004 and as of March 28, 2003 were as follows (in thousands):

	<b><u>Employee Separation Costs</u></b>	<b><u>Lease Write-off</u></b>	<b><u>Office Closure Costs</u></b>	<b><u>Other Restructuring Costs</u></b>	<b><u>Total</u></b>
Balance at March 28, 2003	\$ 160	\$ 614	\$ 36	\$ 94	\$ 904
Provision	-	254	12	-	266
Payments	(25)	(343)	(12)	-	(380)
Balance at December 26, 2003	<u>\$ 135</u>	<u>\$ 525</u>	<u>\$ 36</u>	<u>\$ 94</u>	<u>\$ 790</u>

net.com believes that all costs associated with these restructuring charges will be paid no later than the end of fiscal 2007.

**Note 6. Sale of N.E.T. Federal, Inc.'s Professional Services Business**

On December 1, 2000, net.com sold the assets of its federal services business to CACI International Inc. (CACI) for cash consideration of \$40.0 million. The assets sold were comprised mainly of federal government service contracts, accounts receivable, spares inventory and fixed assets. The cash received from CACI to date is \$38.5 million. The remaining \$1.5 million is payable during the first quarter of fiscal 2005. During the quarter ended June 27, 2003, net.com received payment and recorded a gain of \$1.5 million related to the sale. The total net gain on the sale to date is \$26.4 million. In addition, under an ongoing agreement with CACI, net.com will continue to receive royalties on maintenance revenue.

**Note 7. Goodwill and other intangible assets**

In July 2001, the FASB issued SFAS No. 142, Goodwill and Other Intangible Assets, which establishes financial accounting and reporting for acquired goodwill and other intangible assets and supercedes APB Opinion No.17, Intangible Assets. The Company adopted SFAS 142 on March 30, 2002. SFAS 142 requires that goodwill and intangible assets that have indefinite useful lives not be amortized but, instead, tested at least annually for impairment. Accordingly, net.com ceased amortization of all goodwill on March 30, 2002. Intangible assets that have finite useful lives, consisting primarily of patents, continue to be amortized over their estimated useful lives. Any impairment loss was measured as of the date of adoption and recognized as a cumulative effect of a change in accounting principle.

The standard also requires that goodwill be tested for impairment annually. In the year of adoption, the standard required a transitional goodwill impairment evaluation, which was a two-step process. The first step of the goodwill impairment test, used to identify potential impairment, compares the fair value of a reporting unit with its carrying amount, including goodwill. If the fair value of a reporting unit exceeds its carrying amount, goodwill of the reporting unit is considered not impaired, thus the second step of the impairment test is unnecessary. If the carrying amount of a reporting unit exceeds its fair value, the second step of the goodwill impairment test shall be performed to measure the amount of impairment loss. During the quarter ended June 28, 2002, net.com completed this first step, which indicated that the goodwill could be impaired.

The second step of the goodwill impairment test used to measure the amount of impairment loss compares the implied fair value of goodwill with the carrying amount of the goodwill. If the carrying amount of the goodwill exceeds the implied fair value of the goodwill, an impairment loss shall be recognized in an amount equal to that excess. As of June 28, 2002, net.com completed this second step and measured and recognized a transitional impairment loss of \$9.6 million (which represented the write off of the entire goodwill balance) as a cumulative effect of change in accounting principle in its statement of operations.

**Note 8. Warranty accruals**

Components of the warranty accrual, which are included in accrued liabilities in the accompanying condensed consolidated balance sheets, during the first nine months of fiscal 2004 were as follows (in thousands):

	<b>Warranty Accrual</b>
Balance at March 28, 2003	\$ 204
Charges to cost of goods sold	196
Charges to warranty accrual	(197)
Other adjustments (1)	(77)
	<hr/>
Balance at December 26, 2003	\$ 126
	<hr/>

(1) Adjustment resulted from a change in warranty cost estimates primarily from lower hourly costs of labor to repair products and reduced frequency of warranty claims.

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

This discussion and analysis should be read in conjunction with Part II of our Form 10-K for the fiscal year ended March 28, 2003. Statements contained in this Form 10-Q, which are not historical facts are forward-looking statements, including statements that relate to products, customers, operations and contingent payments. A forward-looking statement may contain words such as "plans," "hopes," "believes," "estimates," "will continue to be," "will be," "continue to," "expect to," "anticipate that," "to be," or "can impact." Forward-looking statements are based upon management expectations and involve risks and uncertainties that may cause actual results to differ materially from those anticipated in the forward-looking statements. Many factors may cause actual results to vary including, but not limited to, the factors discussed in this Form 10-Q. net.com expressly disclaims any obligation or undertaking to revise or publicly release any updates or revisions to any forward-looking statement contained in this Form 10-Q. Investors should carefully review the risk factors described in this Form 10-Q along with other documents net.com files from time to time with the Securities and Exchange Commission (SEC).

**Significant Accounting Policy Judgments and Estimates**

The preparation of financial statements in accordance with accounting principles generally accepted in the United States requires that we make estimates and judgments, which affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosures of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to sales returns, bad debts, inventories, investments, intangible assets, income taxes, warranty obligations, restructuring charges, contingencies, such as litigation, and contract terms that have multiple elements and other complexities typical in the telecommunications equipment industry. We base our estimates on historical experience and other assumptions that we believe are reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect the more significant judgments and estimates used in the preparation of our financial statements.

*Revenue Recognition:* We enter into agreements to sell products and services and other arrangements (multiple element arrangements) that include combinations of products and services. We recognize product revenue generally upon shipment, when all four of the following criteria are met:

- 1) we have a contract with our customer,
- 2) when delivery has occurred and risk of loss passes to the customer,
- 3) when our price is fixed or determinable, and
- 4) when collection of the receivable is reasonably assured.

For transactions where we have not yet obtained customer acceptance, revenue is generally deferred until the terms of acceptance are satisfied. Revenue for installation or other services is recognized upon completion of the service. Maintenance contracts are typically recognized ratably over the period of the contracts. When arrangements include multiple elements, such as products and services, we allocate revenue among the elements using objective evidence of fair value of each element, to the extent such objective evidence is available, and then recognize revenue for each element when the criteria for revenue recognition have been met. This allocation requires judgment as to whether

vendor-specific objective evidence of fair value exists for the various elements. If fair value cannot be determined for some elements of the arrangement, such as support services, a portion of product revenue is deferred and recognized when the other elements of the arrangement have been delivered and accepted. Many of the conditions discussed above are inherently subjective and are frequently dependent on individual facts and circumstances. Therefore, we cannot always accurately determine in advance when some components of revenue will be recognizable. Deferral of substantial revenue due to any of these conditions could adversely affect our revenue in a given period.

*Allowance for Sales Returns:* A reserve for sales returns is established based on historical trends in product returns. If the actual future returns differ from historical levels, our revenue could be adversely affected.

*Allowance for Doubtful Accounts:* The allowance for doubtful accounts receivable is based on our assessment of the collectibility of specific customer accounts and the aging of accounts receivable. If there is a deterioration of a major customer's credit worthiness or actual defaults are higher than our historical experience, we may have to increase our allowance for doubtful accounts receivable, and our operating expenses could be adversely affected.

*Inventory Provisions:* Inventory purchases and commitments are based upon future demand forecasts. If there is a significant decrease in demand for our products or there is a higher risk of inventory obsolescence because of rapidly changing technology and customer requirements, we may be required to make adjustments to write down our inventory to the lower of cost or market, and our gross margin could be adversely affected.

*Warranty Accruals:* We generally provide a warranty for hardware product sales for twelve months and a warranty for software sales for three months. We accrue warranty expense based on historical expense trends calculated as a percentage of new product sales. Actual expenses are charged against the accrual in the period they are incurred. On a quarterly basis, the warranty accrual is analyzed for adequacy based on actual trends and subsequent adjustments are made to the liability balance.

*Stock-Based Compensation:* We account for stock-based awards to employees using the intrinsic value method in accordance with Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and its related interpretations. Accordingly, no charges were taken in the first nine months of fiscal 2004 and 2003 as all stock options were granted at market price.

*Deferred Taxes:* We have incurred tax losses in the last four fiscal years and, at December 26, 2003, we have an estimated \$91.5 million of federal net operating loss carryforwards and \$18.0 million of state operating loss carryforwards available expiring in the years 2020 through 2024. We have provided a full valuation allowance against our tax assets, given the uncertainty as to their realization. In future years, these benefits are available to reduce or eliminate taxes on future taxable income. Current federal and state tax laws include provisions that could limit the annual use of our net operating loss carryforwards in the event of certain defined changes in stock ownership. Our issuances of common and preferred stock could result in such a change. Accordingly, the annual use of our net operating loss carryforwards may be limited by these provisions, and this limitation may result in the loss of carryforward benefits to the extent the above-limit portion expires before it can be used. Management has not yet determined the extent of the limitation, if any.

## **Results of Operations**

The following table depicts selected data derived from our consolidated condensed statements of operations expressed as a percentage of revenue for the periods presented:

<u>Percent of revenue</u>	<u>Quarter Ended</u>		<u>Nine Months Ended</u>	
	<u>December</u> <u>26, 2003</u>	<u>December</u> <u>27, 2002</u>	<u>December</u> <u>26, 2003</u>	<u>December</u> <u>27, 2002</u>
Product revenue	84.0%	84.8%	85.6%	82.8%
Service and other revenue	16.0	15.2	14.4	17.2
Total revenue	100.0	100.0	100.0	100.0
Product revenue gross margin	61.2	49.3	59.8	46.2
Service and other revenue gross margin	19.1	8.6	17.0	5.9
Total gross margin	54.5	43.1	53.6	39.3
Sales and marketing	24.2	23.9	23.4	27.5
Research and development	20.5	19.3	20.7	22.1
General and administrative	6.9	8.2	7.5	9.6
Restructure costs	-	2.1	0.3	2.1
Total operating costs	51.6	53.5	51.9	61.3
Income (loss) from operations	2.8	(10.4)	1.7	(22.0)
Other income, net	0.2	0.5	1.6	8.3
Interest income (expense), net	(0.3)	0.3	(0.4)	0.5
Income (loss) before taxes	2.7	(9.6)	2.9	(13.2)
Income tax provision (benefit)	-	0.1	-	(2.6)
Income (loss) before accounting change	2.7	(9.7)	2.9	(10.6)
Cumulative effect of change in accounting principle relating to goodwill	-	-	-	(10.9)
Net income (loss)	2.7%	(9.7)%	2.9%	(21.5)%

### *Overview and Highlights*

- *We are focused on achieving consistent profitability.* With the quarter ended December 26, 2003, we achieved a third straight quarter of operating profitability and a fourth consecutive quarter of net income, with net income of \$909,000 or \$0.04 per share for the quarter ended December 26, 2003.
- *The primary driver for profitability is growing our revenue base.* Total revenue for the quarter ended December 26, 2003 increased 2.6% from the third quarter of the prior year and increased 6.0% from the second quarter of fiscal 2004, due to increases in both product and service revenue.
- *In order to grow revenue, we must develop and successfully introduce new products.* During the third quarter we announced a number of product developments to be introduced early in calendar 2004, including: the addition of Cisco's IOS software to our SCREAM platform; enhancements for secure voice on our SHOUTIP platform; new versions of a number of cards for our Promina platform with enhanced functionality as well as production cost savings; and our new network management system, "netMS." Revenue from our new products was under 10% of total product revenue for both the quarter and nine months ended December 26, 2003.
- *Until our new products achieve broad market acceptance, we are dependent on revenue from existing products.* To date, we have been successful in extending the lifecycle of our circuit-switched products by continually expanding their functionality, and we have developed a migration path to broadband technology through the SCREAMlink program. The SCREAMlink program, which facilitates the connection of our circuit-switched Promina products to our broadband SCREAM products, has helped stimulate demand for both product lines. The Promina product line continues to provide the substantial majority of our revenue, and in the third quarter of fiscal 2004 we received substantial new orders for Promina products, particularly from defense agencies, including a large order comprised of Promina, SCREAMlink and SCREAM gear for integrated voice, routing, and data transport capabilities over a variety of transport protocols.

- *Our new products are targeted primarily at telecommunications carriers, and also at new applications within our existing customer base.* The environment for sales of new equipment to telecommunications carriers remains challenging, but we believe that some carriers are beginning to resume investment in new equipment, which will hopefully result in increased sales opportunities for our new products. In the third quarter of fiscal 2004, we deployed the SCREAM Service Creation Manager platform in a number of carriers' testing labs. We also installed a new SHOUTIP network for an existing customer to deliver voice services over Internet protocol (VoIP), and we tested SHOUTIP for a defense customer requiring secure voice over IP.
- *We strive to maintain a strong cash position for stability and flexibility in managing our business.* Total cash, cash equivalents, restricted cash and short term investments rose to \$96.8 million, including \$1.5 million in long term restricted cash related to a performance bond on a contract, at December 26, 2003, from \$94.4 million at September 26, 2003. The increase in cash resulted from operating activities and proceeds from the sale of common stock upon the exercise of employee stock options.

#### Revenue

	<u>Quarter Ended</u>			<u>Nine Months Ended</u>		
	<u>December</u> <u>26, 2003</u>	<u>December</u> <u>27, 2002</u>	<u>Change</u>	<u>December</u> <u>26, 2003</u>	<u>December</u> <u>27, 2002</u>	<u>Change</u>
Product revenue	\$ 28,438	\$ 27,991	1.6%	\$ 85,511	\$ 73,087	17.0%
Service and other revenue	5,433	5,014	8.4	14,401	15,212	(5.3)
Total revenue	<u>\$ 33,871</u>	<u>\$ 33,005</u>	2.6%	<u>\$ 99,912</u>	<u>\$ 88,299</u>	13.2%

The increase in total revenue in the quarter ended December 26, 2003 compared to the quarter ended December 27, 2002 is due to increases in both product and service revenue. The increase in total revenue in the nine months ended December 26, 2003 compared to the nine months ended December 27, 2002 is due to the increase in product revenue.

The increases in product revenue in the quarter and nine months ended December 26, 2003 compared to the prior-year periods are due to strong sales in the government sales channel. Government sales in the third quarter of fiscal 2004 increased \$848,000 from the prior year's comparative quarter and increased \$14.5 million on a fiscal year to date basis, due largely to government defense initiatives and purchases of our new products by the government. This increase was offset by declines in international commercial sales of \$649,000 in the quarter ended December 26, 2003 and \$2.2 million in the nine months ended December 26, 2003 compared to the prior year periods, partly as a result of a general decline in the commercial market for circuit-switched products, along with smaller declines in commercial sales in North America. Product revenue is generated primarily from our circuit switched product line, Promina, which accounts for the majority of our product sales worldwide. We caution that factors such as new constraints on government spending, the uncertainty of future U.S. action internationally, or continued slowdown in our international business could cause our revenue to decrease in the near term. Additionally, the recognition of revenue from some recent large deals will depend on customer deployment schedules and the timing of contractual acceptance provisions being met, which could cause significant fluctuations in our revenue in the near term. We have developed new service creation products, SCREAM and SHOUTIP, for the broadband equipment and IP telephony markets. The product revenue from these products in the third quarter of fiscal 2004 was \$1.7 million, or 5.8% of product revenue, and year to date revenue from these products was less than 10%. We expect the level of revenue from these new products, which are in the early stage of customer adoption with prolonged sales cycles, to fluctuate in the near term until we establish a broad customer base.

The increase in service and other revenue is primarily the result of some federal customers that have begun entering into service contracts with us rather than directly with our third-party service provider, as well as early sales of our new broadband products that include related service offerings. These increases are partially offset by a general decline in the installed base of equipment held by non-Federal customers requiring ongoing service support. In addition, a number of customers have been lowering their levels of service support in efforts to reduce their operating costs, which is enabled in part by the reliability of our Promina products. Over the remainder of fiscal 2004, we expect our service revenue to remain flat compared to the levels experienced in the first nine months of the fiscal year.

## Gross Margin

	<u>Quarter Ended</u>		<u>Nine Months Ended</u>	
	<u>December 26, 2003</u>	<u>December 27, 2002</u>	<u>December 26, 2003</u>	<u>December 27, 2002</u>
Product revenue gross margin	61.2%	49.3%	59.8%	46.2%
Service and other revenue gross margin	19.1	8.6	17.0	5.9
Total gross margin	54.5%	43.1%	53.6%	39.3%

Total gross margin improved in the quarter and nine months ended December 26, 2003 compared to the prior-year periods primarily due to higher product and service revenue and our ongoing cost reduction initiatives.

The increase in product revenue gross margin in the quarter and nine months ended December 26, 2003 compared to the quarter and nine months ended December 27, 2002, respectively, is due primarily to:

- supply chain initiatives begun in the quarter ended June 26, 2003, which have yielded significant reductions in materials cost, contributing several points to the product revenue gross margin;
- increases in product revenue, allowing fixed costs to be spread over a greater revenue base;
- a change in the mix of products, including a decrease of more than 50% from prior periods in “original equipment manufacturer” (OEM) product sales, which have lower gross margins;
- for the nine-month comparison, a one-time refund in the amount of \$600,000 for third party royalty fees paid in prior years that was received in the first quarter of fiscal 2004.

Additionally, product revenue gross margins in the quarter and nine months ended December 27, 2002 were negatively affected by inventory reserve charges of \$345,000 and \$2.2 million, respectively.

We expect product revenue gross margin to remain relatively flat through the remainder of fiscal 2004, depending on the level of product revenue, the mix of products, and our ability to control materials cost, which is affected by factors such as order lead times.

The increase in service and other revenue gross margin in the quarter and nine months ended December 26, 2003 compared to the quarter and nine months ended December 27, 2002, respectively, is due to:

- increases in service revenue, allowing the relatively fixed costs of service support to be spread over a greater revenue base,
- reductions in compensation and related costs of \$440,000 and \$2.0 million, respectively, and
- decreases in third party service costs of \$244,000 and \$1.1 million, respectively.

We expect service and other revenue gross margin to remain relatively flat through the remainder of fiscal 2004.

Gross margins may be adversely affected in the future due to increases in material and labor costs, increases in subcontractor charges, changes in the mix of products and services we sell, increased sales through resellers, increased warranty costs, or pressure on pricing and margins due to competition. Our newer product lines, SCREAM and SHOUTIP, currently have lower gross margins than our Promina product line, as a result of customary discounting for early customers and higher per-unit costs associated with low purchase volumes of components.

## Operating Expenses

	<u>Quarter Ended</u>			<u>Nine Months Ended</u>		
	<u>December</u> <u>26, 2003</u>	<u>December</u> <u>27, 2002</u>	<u>Change</u>	<u>December</u> <u>26, 2003</u>	<u>December</u> <u>27, 2002</u>	<u>Change</u>
Sales and marketing	\$ 8,202	\$ 7,880	4.1%	\$ 23,320	\$ 24,279	(3.9)%
Research and development	6,939	6,366	9.0	20,728	19,533	6.1
General and administrative	2,349	2,707	(13.2)	7,539	8,479	(11.1)
Restructure costs	-	689	(100.0)	266	1,861	(85.7)
Total operating expenses	<u>\$ 17,490</u>	<u>\$ 17,642</u>	<u>(0.9)%</u>	<u>\$ 51,853</u>	<u>\$ 54,152</u>	<u>(4.2)%</u>

The reductions in total operating expenses are primarily a result of tightly managed expenses across all functions of the Company.

The increase in sales and marketing expenses in the quarter ended December 26, 2003 compared to the quarter ended December 27, 2002 is primarily the result of a \$244,000 increase in marketing communications including advertising, promotions, tradeshow and other sales meeting events, and a \$209,000 increase in compensation and related costs including commissions. In the third quarter of fiscal 2004, we participated in the ITU Telecom World trade show in Geneva, Switzerland which involved significant expense. The decrease in spending in the nine months ended December 26, 2003 compared to the nine months ended December 27, 2002 is primarily the result of a \$277,000 decrease in facility, information technology and corporate services related costs, a \$313,000 decrease in rental costs, and a \$149,000 decrease in depreciation and amortization. We expect sales and marketing expenses to remain relatively constant compared to the first nine months of fiscal 2004 as we balance the priority of cost control and the importance of new business development.

The increase in research and development spending in the quarter ended December 26, 2003 compared to the quarter ended December 27, 2002 is primarily the result of a \$224,000 increase in compensation and benefits, a \$227,000 increase for the use of outside consultants, a \$136,000 increase in facilities, information technology and corporate services related costs, and a \$134,000 increase in depreciation and amortization, offset in part by a \$119,000 decrease in engineering related expenses. The increase in spending in the nine months ended December 26, 2003 compared to the nine months ended December 27, 2002 is primarily the result of a \$512,000 increase for the use of outside consultants, a \$435,000 increase in facilities, information technology and corporate services related costs, and a \$272,000 increase in depreciation and amortization. We expect research and development spending in future periods to remain relatively constant compared to the first nine months of fiscal 2004 as we balance the priority of cost control and the importance of development for the new broadband products.

The decrease in general and administrative expenses in the quarter ended December 26, 2003 compared to the quarter ended December 27, 2002 is primarily the result of a \$324,000 decrease in outside legal fees and a \$144,000 decrease in the use of outside consultants. The decrease in spending in the nine months ended December 26, 2003 compared to the nine months ended December 27, 2002 is primarily the result of a \$708,000 decrease in outside legal fees, a \$243,000 decrease in facility and information technology related costs, a \$166,000 decrease in the use of consultants, and a \$130,000 decrease in recruiting and relocation fees, offset in part by a \$321,000 increase in the use of outside services. We expect general and administrative expenses in future periods to remain relatively constant as compared to the third quarter of fiscal 2004.

Restructuring charges in the third quarter and first nine months of fiscal 2004 were zero and \$266,000, respectively. The charge consisted of \$254,000 for lease write-off and \$12,000 for office closure costs. Restructuring charges in the third quarter and first nine months of fiscal 2003 were \$689,000 and \$1.9 million, respectively, and related to employee separation costs. The remaining liability for restructuring charges is \$790,000 at December 26, 2003, as shown in the table below. Components of accrued restructuring charges, which are included in accrued liabilities in the accompanying balance sheets, and changes in accrued amounts related to this restructuring program during the first nine months of fiscal 2004 and as of March 28, 2003 were as follows (in thousands):

	<b><u>Employee Separation Costs</u></b>	<b><u>Lease Write-off</u></b>	<b><u>Office Closure Costs</u></b>	<b><u>Other Restructuring Costs</u></b>	<b><u>Total</u></b>
Balance at March 28, 2003	\$ 160	\$ 614	\$ 36	\$ 94	\$ 904
Provision	-	254	12	-	266
Payments	(25)	(343)	(12)	-	(380)
Balance at December 26, 2003	<u>\$ 135</u>	<u>\$ 525</u>	<u>\$ 36</u>	<u>\$ 94</u>	<u>\$ 790</u>

We believe that all costs associated with these restructuring charges will be paid no later than the end of fiscal 2007.

#### *Non-Operating Items*

	<b><u>Quarter Ended</u></b>			<b><u>Nine Months Ended</u></b>		
	<b><u>December 26, 2003</u></b>	<b><u>December 27, 2002</u></b>	<b><u>Change</u></b>	<b><u>December 26, 2003</u></b>	<b><u>December 27, 2002</u></b>	<b><u>Change</u></b>
Interest income	\$ 383	\$ 566	(32.3)%	\$ 1,127	\$ 1,929	(41.6)%
Interest expense	(500)	(491)	1.8	(1,534)	(1,504)	2.0
Gain on sale of Federal Services Business	-	-	-	1,500	5,000	(70.0)
Other income	69	167	(58.7)	88	2,348	(96.3)

The decrease in interest income, primarily relating to short term investments, is the result of a declining yield from our investment portfolio.

Interest expense was due primarily to the interest on our 7 1/4% convertible subordinated debentures. Also included in interest expense is interest related to our \$2.0 million note payable to our landlord for building repairs related to our former headquarters. The note bears interest at 10% and is payable in monthly installments over 10 years.

In the first quarters of fiscal 2004 and 2003, we recorded gains on the sale of our Federal Services Business of \$1.5 million and \$5.0 million, respectively. These gains resulted from certain milestones being met as part of the sale of the Federal Services Business to CACI International Inc. (CACI).

Other income in the first quarter of fiscal 2003 resulted primarily from non-recurring gains of \$2.2 million in proceeds from an insurance settlement related to our former headquarters campus, used for construction costs associated with our new corporate headquarters.

#### *Income Tax Expense (Benefit)*

Income tax expense (benefit) was a benefit of \$3,000 and an expense of \$32,000 in the third quarters of fiscal 2004 and 2003, respectively, due to our net operating loss carryforwards, which have offset our taxable income. Income tax benefit was \$18,000 and \$2.3 million in the first nine months of fiscal 2004 and 2003, respectively. In the second quarter of fiscal 2003, we received a non-recurring tax benefit of \$2.3 million comprised primarily of the release of \$1.4 million of state deferred income taxes and \$1.0 million of refunds of domestic and international taxes paid in prior years.

#### *Cumulative Effect of Change in Accounting Principle Relating to Goodwill*

In the first quarter of fiscal 2003, we recorded a charge of \$9.6 million for the impairment of goodwill as a result of the implementation of Statement of Financial Accounting Standard ("SFAS") No. 142, Goodwill and Other Intangible Assets. This charge was recorded as a cumulative effect of a change in accounting principle in our condensed consolidated financial statements.



## Liquidity and Capital Resources

As of December 26, 2003, we had cash and cash equivalents of \$10.9 million, restricted cash of \$1.4 million, short-term investments of \$83.1 million and long term restricted cash included in other assets on our balance sheet of \$1.5 million related to a performance bond on a contract, for a total of \$96.8 million as compared to \$94.6 million at the end of fiscal 2003.

The Company benefited in the first nine months of fiscal 2004 from the following:

- a \$227,000 refund of county property taxes in the second quarter of fiscal 2004,
- a \$1.5 million payment received in the first quarter of fiscal 2004 from CACI as part of the sale of our Federal Services Business,
- a \$600,000 refund from royalties previously paid, and
- \$4.4 million in proceeds from issuance of common stock upon the exercise of employee stock options.

### *Net Cash Provided by (Used in) Operating Activities*

Net cash provided by operating activities for the nine months ended December 26, 2003 was \$15,000 compared to net cash used in operating activities of \$8.4 million for the nine months ended December 27, 2002. Non cash adjustments to reconcile net income to net cash provided by investing activities for the nine months ended December 26, 2003 were due primarily to depreciation and amortization of \$6.6 million offset by a \$1.5 million gain on the sale of our Federal Services Business. Non cash adjustments to reconcile net loss to net cash used in investing activities for the nine months ended December 27, 2002 were due primarily to depreciation and amortization of \$7.0 million, \$3.5 million of insurance settlement proceeds related to our former headquarters campus, and \$9.6 million from the cumulative effect of an accounting change relating to goodwill from the implementation of SFAS 142, offset by a \$5.0 million gain on the sale of our Federal Services Business and a \$2.4 million gain related to the insurance settlement. We expect to continue to incur charges for depreciation and amortization and are expecting to record gains from the sale of our Federal Services business in the first quarter of fiscal 2005, when the last payment is due, but are not expecting the other items to affect our cash flows going forward as they are non-recurring in nature. The other items that affect our cash flow from operations are changes in our assets and liabilities accounts, including accounts receivable, inventories, prepaid expenses and other assets, accounts payable, and accrued liabilities. The increase in accounts receivable was \$11.1 million for the nine months ended December 26, 2003 due to the timing of orders shipped in the quarter. Days sales outstanding (DSO) for the quarter ended December 26, 2003 was 69 days as compared to 53 days for the quarter ended December 27, 2002.

### *Net Cash Provided by (Used in) Investing Activities*

Net cash used in investing activities for the nine months ended December 26, 2003 was \$14.6 million compared to net cash provided by investing activities of \$6.6 million for the nine months ended December 27, 2002. Purchases of short-term investments exceeded proceeds from maturities of short-term investments by \$10.7 million in the nine months ended December 27, 2003 as compared to proceeds from maturities of short-term investments exceeding purchases of short-term investments by \$4.3 million in the nine months ended December 27, 2002. This change resulted from turning short-term investments more quickly in an effort to maximize the returns on our short-term investments to offset the declines in the yields we have experienced over the past year. Investments in property, plant and equipment remained fairly consistent at approximately \$4.2 million and \$4.7 million in the nine months ended December 26, 2003 and December 27, 2002, respectively. In the nine months ended December 26, 2003 and December 27, 2002, net cash provided by (used in) investing activities included \$1.5 million and \$5.0 million, respectively, in proceeds from the sale of our Federal Services Business.

### *Net Cash Provided by Financing Activities*

Net cash provided by financing activities for the nine months ended December 26, 2003 was \$4.4 million compared to \$958,000 for the nine months ended December 27, 2002, due to the issuance of common stock upon the exercise of employee stock options. Our stock price has increased from \$6.02 at March 28, 2003 to \$10.57 at December 26, 2003. If our stock price continues to rise, we would expect more employees to exercise their stock options resulting in increased proceeds to us from the issuance of common stock upon exercise of the options.

### *Summary Disclosures About Contractual Obligations and Commercial Commitments*

The following table provides a summary of our contractual obligations and other commercial commitments as of December 26, 2003:

	<u><b>Total</b></u>	<u><b>Less than 1 year</b></u>	<u><b>1 – 3 years</b></u>	<u><b>4 – 5 years</b></u>	<u><b>After 5 years</b></u>
Contractual obligations					
Long-term debt	\$ 24,706	\$ -	\$ -	\$ -	\$ 24,706
Interest on long-term debt	17,912	1,791	3,582	3,582	8,957
Operating leases	34,084	5,377	8,694	8,098	11,915
Total contractual obligations \$	<u>76,702</u>	<u>\$ 7,168</u>	<u>\$ 12,276</u>	<u>\$ 11,680</u>	<u>\$ 45,578</u>

In the normal course of business, we enter into contractual commitments to purchase materials and components from suppliers in exchange for favorable pricing or more beneficial terms. As of December 26, 2003, there were no such outstanding commitments.

We believe that our existing current cash and cash equivalents, short-term investments and cash flows from operations will be sufficient to fund operations, purchases of capital equipment, and research and development programs currently planned, at least through the next 12 months.

### **Recently Issued Accounting Standards**

In December 2003, the SEC issued Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition. SAB 104 revises or rescinds portions of the interpretive guidance included in Topic 13 of the codification of staff accounting bulletins in order to make this interpretive guidance consistent with current authoritative accounting and auditing guidance and SEC rules and regulations. The adoption of SAB 104 did not have a material effect on our results of operations or financial condition.

### **BUSINESS ENVIRONMENT AND RISK FACTORS**

Our business is subject to the risks and uncertainties described below. Although we have tried to identify the material risks to our business, this is not an all-inclusive list. There may be additional risks that have not yet been identified and risks that are not material now but could become material. Any one of these risks could hurt our business, results of operations or financial condition.

#### ***We have incurred net losses in the recent past and may incur losses again in the future.***

For each of the past five fiscal years, we have incurred net losses. Although the Company has reduced operating expenses over the past few years, and was profitable in the first nine months of fiscal 2004, we will need revenue to continue to grow in order to achieve ongoing profitability. Our circuit-switched product line, Promina, currently provides the bulk of our revenue, but revenue from that product line may decline within the next few years. Our newer broadband and IP-telephony product lines, SCREAM and SHOUTIP, have not yet achieved market acceptance or broad commercial sales, and we are incurring substantial product development and marketing expenses for those product lines. Accordingly, we will not likely be profitable on an ongoing basis unless our newer product lines achieve commercial success that outpaces the anticipated decline of our Promina product line. In addition, we must contain our operating expenses, many of which are fixed in the short term making it difficult to reduce expenses rapidly in response to shortfalls in revenue.

#### ***Our operating results may continue to fluctuate.***

Our operating results vary significantly from quarter to quarter. These fluctuations may result from a number of factors, including:

- the volume and timing of orders from and shipments to our customers;
- the timing of the introduction of, and market acceptance for, new products and services;
- variations in the mix of products and services we sell;
- the timing and level of certain expenses, such as marketing activities, prototype costs, or write-offs of obsolete inventory;
- the timing of revenue recognition, which depends on numerous factors and can be affected by changes to accounting rules;
- the adoption of new accounting standards, such as the potential requirement to record expenses for employee stock option grants;
- the timing and size of Federal Government budget approvals; and

- economic conditions in the telecommunications industry, including the overall capital expenditures of our customers.

Due to the foregoing factors, we believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. Any shortfall in revenue may adversely affect our business, results of operations and financial condition. Investors should not rely on our results or growth for one quarter as any indication of our future performance.

***Our stock price is volatile and could decline substantially.***

The market price of our common stock has fluctuated significantly in the past, will likely continue to fluctuate in the future and may decline. Fluctuations or a decline in our stock price may occur regardless of our performance. Among the factors that could affect our stock price, in addition to our performance, are:

- variations between our operating results and the published expectations of securities analysts;
- changes in financial estimates or investment recommendations by securities analysts following our business;
- announcements by us or our competitors of significant contracts, new products or services, acquisitions, or other significant transactions;
- sale of our common stock or other securities in the future;
- the inclusion or exclusion of our stock in various indices or investment categories, especially as compared to the investment profiles of our stockholders at a given time;
- changes in the stock prices of other telecommunications equipment companies, to the extent that some investors tend to buy or sell our stock based on segment trends; and
- the trading volume of our common stock.

***We are dependent on revenue from the Promina product line.***

Currently, we derive the majority of our product revenue from our Promina product line, a circuit-based narrowband technology. The market for our Promina product is expected to decline as networks are expected to increasingly employ packet-based broadband technology. This technology migration has already resulted in a significant drop in sales of our Promina products in the commercial markets over the last three years. If this decline extends into our government markets in a similar fashion before we gain traction on our newer packet-based broadband product lines, our revenue will decrease, and our business and results of operations will suffer.

***A significant portion of our revenue is generated from sales to governmental agencies.***

A significant portion of our total revenue from product sales comes from contracts with governmental agencies, most of which do not include long-term purchase commitments. Historically, the government has been slower to adopt new technology, such as packet-based technology, which has had the effect of extending the product life of our Promina product. While the government has purchased and is evaluating some of our new products for broader deployment, this new business may not be sufficient to offset expected declines in sales of our Promina product. Furthermore, if the government accelerated adoption of new technology, and replaced the Promina product line in their networks with products other than ours, our product revenue would decline sharply. We anticipate that our past experience will result in future contracts with the Federal Government; however, we face significant competition in this endeavor. If we fail in renewing a significant number of Federal Government contracts or if sales to the Federal Government decline sharply, our revenue may not increase to profitable levels.

***Continued declines in purchases by our commercial customers and the overall decline of product sales in the service provider market could negatively affect our operations and financial results.***

Over the last three years, the financial health of many of our commercial customers, particularly telecommunications service providers, has deteriorated, resulting in a decreased demand for telecommunications products. In addition, the timing and volume of purchases by service providers can be unpredictable due to their need to generate new revenue with sharply reduced capital budgets while reducing operating expenses. Further, our ability to recognize revenue on sales to these customers will depend on our meeting various acceptance criteria imposed on the company in connection with these products by our early adopter customers, and on the relative financial condition of these customers and whether receivables balances from them are deemed to be collectible. Also, the selling cycle of our SCREAM and SHOUTip product lines could be extended if our service provider customers continue to reduce their capital budgets. Declines in revenue as a result of any of these factors could cause a material adverse effect on our business, operating results and financial condition.

***Our success depends on our ability to develop new products and product enhancements that will achieve market acceptance.***

Our operating results will depend on the successful design, development, testing, introduction, marketing, and broad commercial distribution of our newer packet-based products, the SCREAM and SHOUTIP product lines. The success of these and other new products is dependent on several factors, including proper product definition, competitive pricing, timely completion and introduction to the market, differentiation from competitors' products, and broad market acceptance. The markets for our products are characterized by rapidly changing technology, evolving industry standards, frequent new product introductions and evolving methods of building and operating networks. Our SCREAM product line is targeted at long-established incumbent carriers, such as BellSouth, SBC Communications, Sprint, Verizon, British Telecom and France Telecom, who typically have stringent product requirements and who are reluctant to purchase products from vendors lacking substantial revenue and assets. Our SHOUTIP product line is largely targeted at start-up telecommunications companies who demand highly competitive pricing and, more recently, to government agencies that require secure voice communications over limited bandwidth. We may not successfully identify new product opportunities, develop and bring new products to market in a timely manner, or achieve market acceptance of our products. Products and technologies developed by others may render our products or technologies obsolete or non-competitive, which in turn could adversely affect our ability to achieve profitability.

***The success of our SCREAM product line depends largely on it being chosen by service providers as a platform for the delivery of new services.***

Since the second quarter of our fiscal year 2000, we have spent the majority of our research and development and marketing resources to position ourselves, and our SCREAM family of products, as the next generation of telecommunications equipment that will enable carriers to optimize the delivery of differentiated services. The future success of the SCREAM product line will depend in large measure on service providers choosing to invest in products, such as SCREAM, that can be used to deliver new services such as quality-of-service guarantees, class-of-service subscriptions, or bandwidth-on-demand, to increase their revenue and lower their operating expenses. If service providers do not meaningfully invest in such new technologies, or do not choose the SCREAM product line for such investment, our revenues from SCREAM will be negatively affected, which will in turn have a negative effect on our business and operating results.

***We need partnerships to accelerate the acceptance of our new products by service providers.***

Building relationships with partners, such as software application partners, system integrators, OEMs or resellers can accelerate the sales of new products. The importance of the software application partners is that they provide functions, such as billing, mediation, provisioning and configuration that are needed to create a total solution for our customers. We need product OEM or resale partners to supplement and enhance our sales force both in the United States and overseas. Service providers rely on systems integrators to incorporate new equipment or services into their network. These integrators are important in the large incumbent carrier networks and could facilitate our entry into those networks. While we have begun the process of identifying and signing software application, system integrator and OEM or resale partners, more partners may be necessary in all these areas for us to be successful. We may need to pursue strategic partnerships with vendors who have broader technology or product offerings in order to compete with the end-to-end solution providers, as well as to bolster our co-marketing efforts. Failure to sign up these new strategic partners could affect our ability to grow overall revenue.

***Gross margins could decline over future periods.***

Gross margins may be adversely affected in the future due to increases in material and labor costs, increases in subcontractor charges, changes in the mix of products and services we sell, increased sales through resellers, increased warranty costs, or pressure on pricing and margins due to competition. Our newer product lines, SCREAM and SHOUTIP, currently have lower gross margins than our Promina product line, as a result of customary discounting for early customers and higher per-unit costs associated with low purchase volumes of components. A decline in our gross margins could have a material adverse effect on our business, results of operations and financial condition.

***Factors beyond our control could affect our ability to sell into international markets.***

We conduct significant sales and customer support operations in countries outside of the United States and depend on non-US operations of our subsidiaries and distribution partners. In addition, we also maintain a satellite research and development facility in Ottawa, Province of Ontario, Canada and, on a case-by-case basis, we outsource research and development activities to third parties here in the US and abroad. As a general rule, international sales tend to have risks that are difficult to foresee and plan for, including political and economic stability, regulatory

changes, currency exchange rates, changes in tax rates and structures, and collection of accounts receivable. Further, our international markets are served primarily by non-exclusive resellers who themselves may be severely affected by economic or market changes within a particular country or region. Our future results could be materially adversely affected by a variety of uncontrollable and changing factors that could affect these activities. Unforeseen or unpredictable changes in international markets could have a material adverse effect on our business, results of operations and financial condition.

***The divestiture of our federal services business has reduced our ability to control the quality of service provided to our Federal Government customers.***

On December 1, 2000, we closed the sale of our federal service business to CACI, which subsequently provides maintenance and other services to our Federal Government customers. We continue to sell net.com products directly to the Federal Government and we rely on CACI to perform various services for them. Additionally, we have a strategic alliance with CACI to jointly market each other's products and services. As a result of these arrangements, we are dependent on CACI to provide the level of service to which our customers have become accustomed. If CACI experiences difficulties in providing those services, or for any other reason leaves our mutual customers unsatisfied, it could adversely affect purchasing decisions for our products and cause our Federal Government customers to seek products from other vendors.

***The market for our products is highly competitive and many of our competitors have greater resources than us.***

The market for telecommunication equipment is highly competitive, dynamic and characterized by rapid changes to and the convergence of technologies, and a worldwide migration from existing circuit technology to the new packet-based technologies. We compete directly, internationally and domestically with many different companies, some of which are large, established suppliers of end-to-end solutions, such as Alcatel, Cisco, Lucent, Nortel, Juniper and Siemens. In addition, there are a number of other smaller companies that are targeting the same market, including CoSine, Nuera, Copper Mountain, Advanced Fiber Communications, Redback and others. Some of our larger competitors have significantly greater financial, marketing and technical resources than we have and offer a wider range of networking products than we offer. They are often able to devote greater resources to the development, marketing and sale of their products and to use their equity or significant cash reserves to acquire other companies with technology and/or products that compete directly with ours. They often can compete favorably on price because their large product selection allows them to bundle multiple solutions together without significantly affecting their overall product margins. The smaller companies have more ability than net.com to focus their resources on a particular product development unencumbered by the requirements to support an existing product line. As a result of the flexibility of their market strategies, our competitors may be able to obtain strategic advantages that may adversely affect our business, financial condition or results of operations.

In addition, the networking equipment market has seen the constant introduction of new technologies that has reduced the value of older technology solutions. This has created pricing pressure on older products while increasing the performance expectations of newer networking equipment. Moreover, broadband technology standards are constantly evolving and alternative technologies or technologies with greater capability are constantly introduced and sought by our customers. It is possible that the introduction of other technologies will either supplant our current technologies and technologies we have in development or will require us to significantly lower our prices in order to remain competitive. To remain competitive, we must continue to evolve our SCREAM and SHOUTIP product lines to meet the ever-changing technology needs of the networking market while ensuring that they can be sold at a competitive price. We also must enhance our Promina product line to provide needed features that increase their overall value for the customer while keeping the price competitive. Due to the competitive nature of the market and the relative age of our Promina product offerings as well as the competitive pressure being exerted on our SCREAM and SHOUTIP technologies, we may not be able to maintain prices for them at levels that will sustain profitability.

***If we are unable to sign competitive resale partners, our future product and service revenue will be adversely affected.***

Our international sales are made almost entirely through indirect channels that include distributors and resellers worldwide, and our business strategy includes leveraging resale partners in the United States as well. Our reseller agreements do not have minimum purchase requirements that they must meet. Our distributors and resellers often also resell product lines from other companies, including our competitors, some of whom have strong market position relative to net.com. Because of existing relationships that many of our competitors have with distributors and resellers, it is often difficult for us to find a distributor or reseller who is willing and contractually able to resell our products. If we cannot develop relationships with distributors and resellers that can effectively market and sell our products and services, we may not be able to meet our forecasted revenue in future quarters.

***Our products have long sales cycles, making it difficult to predict when a customer will place an order and when to forecast revenue from the related sale.***

Our products are very complex and represent a significant capital expenditure to our customers. The purchase of our products can have a significant impact on how a customer designs its network and provides services either within its own organization or to an external customer. Consequently, our customers often engage in extensive testing and evaluation of products before purchase. There are also numerous financial and budget considerations and approvals that the customer often must obtain before it will issue a purchase order. As a result, the length of our sales cycle can be quite long, extending beyond twelve months in some cases. In addition, our customers, including resellers, often have the contractual right to delay scheduled order delivery dates with minimal penalties and to cancel orders within specified time frames without penalty, which makes it difficult to predict whether or not an order may actually ship. We often must incur substantial sales and marketing expense to ensure a purchase order is placed. If the order is not placed in the quarter forecasted, our sales may not meet forecast and revenue may be insufficient to meet expenses.

***Because it is difficult for us to accurately forecast sales, particularly within a given time frame, we face a risk of carrying too much or too little inventory.***

Typically, the majority of our revenue in each quarter has resulted from orders received and shipped in that quarter. While we do not believe that backlog is necessarily indicative of future revenue levels, our customers' ordering patterns and the possible absence of backlogged orders create a significant risk that we could carry too much or too little inventory if orders do not match forecasts. Rather than base forecasts on orders received, we have been forced to schedule production and commit to certain expenses based more upon forecasts of future sales, which are difficult to predict in the telecommunications industry. Furthermore, if large orders do not close when forecasted or if near-term demand weakens for the products we have available to ship, our operating results for that quarter or subsequent quarters would be materially adversely affected.

***If we are unable to retain existing employees and attract, recruit and retain key personnel, then we may not be able to successfully manage our business.***

Our success continues to be dependent on our being able to attract and retain highly skilled engineers, managers and other key employees. Despite the economic slowdown, we must continue to compete for the most qualified personnel for new positions and to replace departing employees. Any restrictions on our ability to use stock options as a key component of employee compensation, such as changes in accounting treatment, stockholder actions, or changes in corporate regulations, could severely impair our ability to recruit and retain personnel. If we are not able to continue to attract, recruit and retain key personnel, particularly in engineering, sales and marketing positions, we may be unable to meet important company objectives such as product delivery deadlines and sales targets.

***We rely on a number of sole source suppliers for our component parts and third party products which could affect our ability to ship our products in a timely manner.***

We purchase key components from single source suppliers, in particular, our back planes, integrated circuits, and power supplies. If we or our sole source suppliers fail to obtain components in sufficient quantities when required, delivery of our products could be delayed resulting in decreased revenues. In addition, if one of these suppliers were no longer able to supply a required component, we may have to significantly reengineer the affected product. Further, variability in demand and cyclical shortages of capacity in the semiconductor industry have caused lead times for ordering parts to increase from time to time. If we encounter shortages or delays in receiving ordered components or if we are not able to accurately forecast our ordering requirements, we may be unable to ship ordered products in a timely manner.

***We single source our manufacturing processes; a failure or delay by a contract-manufacturing vendor could affect our ability to ship our products timely.***

We currently subcontract some product testing and all product manufacturing to third parties, with generally only a single source for manufacturing of each product line. Final test and assembly is generally performed at our Fremont, California facility, although we intend to have third parties also perform more of those functions. While subcontracting creates substantial cost efficiencies in the manufacturing process, it also exposes us to delays in product shipments should the contract manufacturer be unable to perform. We have agreed to compensate our contract manufacturers in the event of termination or cancellation of orders, discontinuance of product, or excess material created by an engineering change. Also, should a contract manufacturer in some future period decide not to renew our contract with them, it would be difficult for us to quickly transfer our manufacturing requirements to another vendor, likely causing substantial delays in customer product shipments and affecting our revenue and results of operations. We have recently transitioned some of our product manufacturing to a new vendor, but the

transition is limited to specific products and has not materially diversified the outsourcing risk. Also, the transition itself and the lack of experience with the new vendor could cause delays in customer product shipments or otherwise negatively affect our results of operations.

***Our intellectual property rights may not be adequate to protect our business.***

Our future success depends in part upon our proprietary technology. Although we attempt to establish and maintain rights in proprietary technology and products through patents, copyrights, and trade secrets laws, we cannot predict whether such protection will be adequate, or whether our competitors can develop similar technology independently without violating our proprietary rights. As competition in the communications equipment industry increases and the functionality of the products in this industry further overlap, we believe that companies in the communications equipment industry may become increasingly subject to infringement claims. We have received and may continue to receive notice from third parties, including some of our competitors, claiming that we are infringing their patents or their other proprietary rights. We cannot predict whether we will prevail in any litigation over third-party claims, or that we will be able to license any valid and infringed patents on commercially reasonable terms. Any of these claims, whether with or without merit, could result in costly litigation, divert our management's time, attention and resources, delay our product shipments or require us to enter into royalty or licensing agreements. In addition, a third-party may not be willing to enter into a royalty or licensing agreement on acceptable terms, if at all. If a claim of product infringement against us is successful and we fail to obtain a license or develop or license non-infringing technology, we may be unable to market the affected product.

***We rely on technologies licensed from third parties.***

For our Promina, SCREAM and SHOUTiP products, we license some of our technology from third parties. These licenses are generally limited in duration or by the volume of shipments of the licensed technology. In addition, some of these licenses contain limitations on distribution of the licensed technology or provide for expiration upon certain events, such as a change in control of the company. If the relevant licensing agreement expires or is terminated without our being able to renew that license on commercially reasonable terms, or if we cannot obtain a license for our products or enhancements on our existing products we may be unable to market the affected products.

For many of these technologies, we rely on the third-party provider to update and maintain the technology, fixing errors and adding new features. If the third-party provider does not adequately update and maintain these technologies, whether due to changes in their product direction, their own financial difficulties, or other reasons, we would need to seek alternative means to fulfill the ongoing requirements for our products that incorporate the third-party technology. If we are unable to find alternative means of fulfilling the ongoing requirements, we may be unable to market the affected products.

***We face risks associated with changes in telecommunications regulations and tariffs, including regulation of the Internet.***

Changes in domestic and international telecommunications requirements could affect the sales of our products. In the United States, our products must comply with various Federal Communication Commission (FCC) requirements and regulations. In countries outside of the United States, our products must meet various requirements of local telecommunications authorities. Changes in tariffs or failure by us to obtain timely approval of products could impact our ability to market the affected product.

The demand for our broadband products could also be affected by rulings of the FCC regarding services offered by service providers to their customers, such as differentiated broadband services. If rulings or regulations of the FCC diminish the attractiveness of offering such services, then service providers would likely have less need for our products.

In addition, there are currently few laws or regulations that govern access or commerce on the Internet. If individual countries, or groups of countries, acting in concert, began to impose regulations or standards on Internet access or commerce including IP telephony, our ability to sell our new SCREAM and SHOUTiP products or other new products would be adversely impacted if the regulations or standards resulted in decreased demand or increased costs for our products.

New restrictions on trade, such as in response to transfers of jobs from the United States to lower-cost foreign locations, could limit our ability to purchase components from, or outsource functions to, foreign entities, which would likely make it more difficult to maintain competitiveness in the global market. As a result of our current concentration of business to the Federal government, we are more sensitive to these trade restrictions, whether tariffs, incentives, or government purchasing requirements such as the "Buy American Act," than it would be with a more diversified customer base.

In North America, the former Regional Bell Operating Companies (RBOCs) recommend that Telcordia Technologies, Inc. certify telecommunications equipment under its Operations Systems Modifications for the Integration of Network Elements (OSMINE) program in order to ensure interoperability with other network elements and operational support systems. The OSMINE certification process is expensive and lengthy, and we have not completed it for our product lines. Failure to attain certification could have a material adverse impact on our business, operating results, and financial condition.

***We are exposed to fluctuations in the exchange rates of foreign currency.***

As a global concern, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve and could have a material adverse impact on our financial results. In fiscal 2003, we commenced using foreign exchange contracts to hedge significant accounts receivable and intercompany account balances denominated in foreign currencies. Although we have established foreign exchange contracts for non-dollar denominated sales and operating expenses in the United Kingdom, France, Germany and Japan, exposures remain for non-dollar denominated operating expenses in Latin America, Canada, and Asia. We will continue to monitor our exposure and may hedge against these or any other emerging market currencies as necessary. Market value gains and losses on hedge contracts are substantially offset by fluctuations in the underlying balances being hedged.

***The location of our facilities subjects us to the risk of earthquake and floods.***

Our corporate headquarters, including most of our research and development operations and our manufacturing facilities, are located in the Silicon Valley area of Northern California, a region known for seismic activity. These facilities are located near the San Francisco Bay where the water table is quite close to the surface and where tenants have experienced water intrusion problems in the facilities nearby. In particular, unknown defects in the construction of our new facilities combined with the proximity to water may result in future water infiltration problems for net.com. A significant natural disaster, such as an earthquake or flood, could have a material adverse impact on our business, operating results, and financial condition.

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

In the first quarter of fiscal 2003 we began using foreign exchange contracts to hedge significant accounts receivable and intercompany account balances denominated in foreign currencies. Market value gains and losses on these hedged contracts are substantially offset by fluctuations in the underlying balances being hedged. The net financial impact of foreign exchange gains and losses has not been material. A 10% increase or decrease in the foreign currency rates would not have a significant effect on our business, operating results and financial condition. Our policy is to not use hedges or other derivative financial instruments for speculative purposes.

A portion of our investment portfolio is composed of income securities. These securities are subject to interest rate risk and will fall in value if market interest rates increase. A sensitivity analysis assuming a hypothetical increase or decrease of 10% from levels at December 26, 2003 and March 28, 2003 indicated the fair value of the portfolio would change by an immaterial amount. At December 26, 2003, the fair value of the short-term investments was \$83.1 million compared to \$72.6 million at March 28, 2003.

### **ITEM 4. DISCLOSURE CONTROLS AND PROCEDURES**

In accordance with Section 302 of the Sarbanes-Oxley Act of 2002 and the Securities Exchange Act of 1934, we implemented disclosure controls and procedures pursuant to which management under the supervision and with the participation of the chief executive officer (CEO) and chief financial officer (CFO) carried out a review and evaluation of the effectiveness of these controls and procedures as of December 26, 2003. Based on this review, our CEO and CFO have concluded that our disclosure controls and procedures are effective in timely alerting them to material changes in information required to be included in our periodic Securities and Exchange Commission filings.

We intend to review and evaluate the design and effectiveness of our disclosure controls and procedures on an ongoing basis and to improve our controls and procedures over time and to correct any deficiencies that we may discover in the future. Our goal is to ensure that our senior management has timely access to all material financial and non-financial information concerning our business. While we believe the present design of our disclosure controls and procedures is effective to achieve our goal, future events affecting our business may cause us to significantly modify our disclosure controls and procedures.



## **PART II -- OTHER INFORMATION**

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

#### **(a) Exhibits**

31. Rule 13a-14(a) Certifications

32. Section 1350 Certification

#### **(b) Report on Form 8-K**

The Company filed one Current Report on Form 8-K in the quarter ended December 26, 2003. The report, dated October 15, 2003, furnished the Company's press release announcing its financial results for the quarter ended September 26, 2003.

## **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.

### **NETWORK EQUIPMENT TECHNOLOGIES, INC.**

Dated: February 4, 2004

/s/ Hubert A.J. Whyte

Hubert A.J. Whyte

President and Chief Executive Officer

/s/ John F. McGrath, Jr.

John F. McGrath, Jr.

Vice President and Chief Financial Officer

(Principal Financial and Accounting Officer)