

UTSTARCOM INC  
Form 10-Q  
October 17, 2007

**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 March 31, 2007**

**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 000-29661**

**UTSTARCOM, INC.**

(Exact name of registrant as specified in its charter)

**DELAWARE**

(State of Incorporation)

**52-1782500**

(I.R.S. Employer Identification No.)

**1275 HARBOR BAY PARKWAY**

**ALAMEDA, CALIFORNIA**

(Address of principal executive offices)

**94502**

(zip code)

Registrant's telephone number, including area code: **(510) 864-8800**

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 a large accelerated filer, an accelerated filer, or non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

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As of September 30, 2007 there were 121,294,645 shares of the registrant's common stock outstanding, par value \$0.00125.

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TABLE OF CONTENTS

<u>PART I FINANCIAL INFORMATION</u>	<u>12</u>
<u>ITEM 1 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS</u>	<u>12</u>
<u>ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	<u>48</u>
<u>ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS</u>	<u>74</u>
<u>ITEM 4 CONTROLS AND PROCEDURES</u>	<u>76</u>
<u>PART II OTHER INFORMATION</u>	<u>81</u>
<u>ITEM 1 LEGAL PROCEEDINGS</u>	<u>81</u>
<u>ITEM 1A RISK FACTORS</u>	<u>84</u>
<u>ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	<u>102</u>
<u>ITEM 3 DEFAULTS UPON SENIOR SECURITIES</u>	<u>102</u>
<u>ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS</u>	<u>103</u>
<u>ITEM 5 OTHER INFORMATION</u>	<u>103</u>
<u>ITEM 6 EXHIBITS</u>	<u>103</u>
<u>SIGNATURES</u>	<u>105</u>

**EXPLANATORY NOTE**

**The Company was unable to file timely its Form 10-Q for the quarterly period ended March 31, 2007 because we had commenced a voluntary review of historical stock option practices and the results of that review were not known at the date the Form 10-Q filing was due. Subsequent to that time, the Audit Committee engaged independent counsel to conduct an investigation of sales in China. Information contained herein about the restatements of previously issued financial statements has been taken from the 2006 Annual Report on Form 10-K that was filed with the Securities and Exchange Commission on October 10, 2007. The 2006 Annual Report contains additional information about the restatements which is not included herein.**

Our consolidated financial statements and related financial information included in this Quarterly Report on Form 10-Q for accounting periods prior to the third quarter of 2006 have been restated, as described below.

***Summary***

In July 2007, the Company announced the Audit Committee of the Board of Directors (the Audit Committee) was conducting an independent investigation of historical sales with certain customers in China and stated that it could not rule out the possibility that the outcome of the investigation could impact revenue recognized for certain of such contracts as recorded in previously issued financial statements. In September 2007, the Company announced the investigative phase of the Audit Committee's investigation had been completed. After consultation with and upon the recommendation of management, the Audit Committee determined revenue in the Company's Western Region of China was recognized earlier than it should have been and that the financial statements for the affected periods should be restated. The Company also announced that its previously issued financial statements for each of the fiscal years ended December 31 in the period 2000 through 2005, the financial statements for the interim periods contained in the Quarterly Reports on Form 10-Q filed with respect to each of these years, and the quarterly reports on Form 10-Q filed with respect to each of the quarterly periods ended March 31 and June 30, 2006 should not be relied upon. In this Quarterly Report we have corrected for the effects of net sales and related costs of net sales that were recorded earlier than they should have been and have restated the financial statements for the three months ended March 31, 2006. The net effect for the three months ended March 31, 2006 was to recognize previously deferred revenue and gross profit of \$5.4 million and \$1.4 million, respectively.

We also conducted a voluntary review of historical stock option practices under the direction of the Nominating and Corporate Governance Committee of our Board of Directors (Governance Committee). This review considered all option grant awards made in the period from February 29, 2000, shortly before the initial public offering of our Common Stock, through August 2006 for compliance with the various stock-based compensation accounting standards applicable during this period as well as the rules of our stock option plans. We found that in a number of instances we did not use the proper date as the measurement date in determining whether stock options had been issued with exercise prices below the fair value of our common stock. Therefore, we have restated our previously issued financial statements for the years ended December 31, 1998 through 2005 to account for an additional \$25.5 million of stock compensation expense that should have been recognized over the period together with an equal increase in additional paid-in capital to recognize the intrinsic value assigned to these issuances of equity securities. Related adjustments of payroll and income taxes resulted in an additional \$0.5 million of expense being recognized for the 1998 through 2005 period and total stockholders' equity being reduced by a total of \$2.1 million at December 31, 2005. During the first six months of 2006 an additional \$1.2 million of stock compensation expense was recognized, which reduces our previously reported operating results for this period. We have restated the financial statements for the three months ended March 31, 2006, and during that period incremental stock compensation expense totaling \$0.7 million was recognized.

None of these restatements had any effect on any of our cash balances, however cash equivalents were reduced at March 31, 2006 due to the correction in classifications described below.

Additional information about these restatements and their effects on our financial statements is presented below as well as in the Notes to Consolidated Financial Statements.

***China Sales Investigation***

The Audit Committee engaged independent counsel to conduct an investigation of sales in China following a determination by the Internal Audit group that allegations of improper activities in a sales office in the Western Region were credible. The allegations were made by a Company employee using the Company's whistle blower program. The independent counsel engaged the assistance of forensic accountants, and this group is collectively referred to as the Investigating Team in the rest of this discussion.

In conducting its procedures, the Investigating Team found instances where the customer contracts that evidenced the arrangement contained obligations for the Company to deliver software upgrades when and if made available for the equipment sold for no additional consideration and for an unspecified period that could extend over the term of the contract. This additional contract obligation is an element of post contract support. In these cases, the Investigating Team found that the contract documentation for the same transaction submitted by the sales office to the Company's China headquarters for accounting purposes and utilized by the Company in determining the amount of revenue recognized did not include evidence of such post contract support obligations.

Accounting standards governing revenue recognition for system sales require all revenue to be deferred while there are undelivered elements under the arrangement unless the seller has established vendor specific objective evidence (VSOE) of fair value for such contract elements. Because these arrangements included such undelivered elements, revenue should be deferred based on the VSOE of the fair value of the underlying elements. VSOE of fair value represents the price charged when the same element is sold separately. Since the Company does not sell this element separately, it has not established VSOE for such undelivered elements, and as such the revenue from such contracts is required to be deferred and recognized over the period the Company is obligated to provide the post contract support.

The China sales investigation covered each of the seven years in the period ended December 31, 2006 and included: investigating approximately 1,200 contracts in all of our five regions in China; reviews of the electronic files of 45 employees; and formal interviews of 96 employees in China. Additionally, the China sales investigation included reviewing contract files, performing various financial analyses including comparison of payments received per our accounting records to the contract terms, and computer forensic procedures where destruction of electronic documents was suspected. In the aggregate, the Investigating Team expended approximately 25,000 hours in conducting this investigation, which commenced in February 2007 and was completed in September 2007 when the independent counsel and forensic accountants presented their final report to the Audit Committee. In July 2007, we announced the Audit Committee was conducting an independent investigation of historical sales with certain customers in China and we stated that we could not rule out the possibility that the outcome of the investigation could impact revenue recognized for certain of such contracts as recorded in our previously issued financial statements.

Upon completion of the investigative phase of the independent investigation by the Audit Committee, our management:

- conducted follow-up procedures to attempt to locate any additional relevant information to ensure the Company considered all available information and documents;
- evaluated the accounting for identified system sales using the contract template and documentation found in the sales contract files from the Western Region offices. This included calculating the financial statement effects of correcting the accounting for all system sales where the contract template found at our sales offices contained post contract support obligations to recognize revenue and cost of net sales over the estimated period of post contract support;
- concluded that as a result of the existence of this undelivered post contract support obligation our previously issued financial statements should be restated to defer system sales contract revenue and the related cost of net sales over the estimated period of post contract support when a contract contained unspecified software upgrade rights.

The Audit Committee concurred with management's decisions.

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The effect of correcting improperly recognized revenue and cost of net sales was to (reduce) increase previously reported net sales, gross profit and net income by the following amounts (in thousands of dollars):

Year ended December 31,	Net sales	Gross profit	Net income
2000	\$ (12,408 )	\$ (5,294 )	\$ (4,781 )
2001	(17,154 )	(6,330 )	(5,779 )
2002	(64,732 )	(22,924 )	(19,697 )
2003	(21,060 )	(8,014 )	(6,382 )
Totals through December 31, 2003	(115,354 )	(42,562 )	(36,639 )
2004	(104,965 )	(27,241 )	(18,594 )
2005	(58,232 )	(27,863 )	(42,433 )
2000 - 2005 Total	(278,551 )	(97,666 )	(97,666 )
<u>2006 quarter ended</u>			
March 31	5,410	1,360	1,360
June 30	2,380	(371 )	(371 )
Total China Sales Restatement	\$ (270,761 )	\$ (96,677 )	\$ (96,677 )

The cumulative effect of all of the China sales restatement adjustments to our consolidated balance sheet as of December 31, 2003 resulted in a decrease in retained earnings of \$36.6 million, an increase in deferred revenue of \$115.4 million to account for previously recognized sales, an increase in deferred costs of \$72.8 million to account for previously recognized cost of net sales, and an increase in deferred tax assets and prepaid taxes of \$5.9 million. In our consolidated balance sheet at March 31, 2007 the net reduction in previously recognized net sales is accounted for as deferred revenue, of which \$36.5 million is classified as current and \$233.3 million as non-current, and the related net reduction in cost of net sales of \$172.9 million is accounted for as deferred costs. These amounts are being recognized in our consolidated statements of operations over the estimated remaining period of post contract support.

Upon completing its investigation, the Audit Committee concluded that the conditions and practices relating to systems contracts prevalent in the Western Region resulted primarily from the failure to prevent or detect instances of override related to controls in China over customer agreements, lack of proper management oversight, unclear record retention policies and procedures relating to systems contracts, and inadequate employee training. The Investigating Team and the Audit Committee also concluded that with respect to four regions other than the Western Region there was no evidence of fraud or misconduct or reason to suspect such occurred. The Investigating Team and the Audit Committee also concluded that there was no credible evidence of knowledge by senior management in China or the United States of the conditions and practices related to the Western Region of China that were discovered in the investigation. The Audit Committee concluded that local management in several of the sales offices in the Western Region of China did not submit appropriate information to the Company's senior management in China and the United States. Therefore, in prior years, neither the Company's management nor the Company's independent registered accounting firm were able to properly evaluate the effect of that information on revenue recognition. The Audit Committee also concluded that certain members of management in China bear varying degrees of responsibility for inadequate oversight of activities. As a result, certain employees in China have either been terminated or placed on suspension for failure to provide adequate oversight of activities.

We have restructured the management of the Western Region sales organization and are working to identify and implement changes to our policies and procedures and enhance employee training to improve internal control consciousness and lessen the possibility of accounting errors occurring in the future.

### ***Stock Option Accounting***

In November 2006, we announced we had commenced a voluntary review of historical stock option practices under the leadership of the Governance Committee following a preliminary review by management which identified potential deficiencies and discrepancies in the documentation of stock option grants. The review considered all option grant awards made in the period from February 29, 2000, shortly before the initial public offering of our Common Stock, through August 2006 ( Review Period ) for compliance with the various stock-based compensation accounting standards applicable during the Review Period as well as the rules of our stock option plans. The Governance Committee engaged independent outside legal counsel to assist in the review who, in turn, engaged forensic accountants. (Separate law firms and separate forensic



accounting firms were engaged by the Audit Committee and the Governance Committee for the China sales investigation and the stock option accounting review.) In the rest of this discussion, this group collectively is referred to as the Stock Option Review Team and their actions and activities are referred to as the Stock Option Review. The Stock Option Review Team members spent over 11,000 hours in this review, and the Governance Committee met with the Stock Option Review Team on more than a dozen occasions to receive, discuss, and consider the Stock Option Review Team's information and findings.

At the time the review commenced, the Governance Committee consisted of three members of the Board of Directors, all of whom are independent directors. The Committee decided to delegate supervision of the review to Mr. Jeff Clarke, its Chairman, who joined our Board in 2005 and had not served on the Compensation Committee of the Board of Directors ( Compensation Committee ) during the period under review. The Governance Committee also consisted of two other independent directors, Mr. Larry D. Horner and Mr. Thomas Toy, who also serve on the Board's Compensation Committee. Mr. Allen Lenzmeier was appointed to the Governance Committee on April 27, 2007.

Review procedures included:

- interviews of individuals involved with granting, advising, administering, or accounting for stock options, including current and former: management, members of the Board of Directors, employees, and non-employee professionals;
- review of relevant stock administration, human resource, legal, and finance department files and records;
- review of stock option grant information in select employee personnel files;
- review by at least 30 attorneys and 15 forensic accountants of approximately 250,000 potentially relevant e-mails and documents in electronic format selected through electronic discovery techniques from over 1.8 million electronic documents processed;
- review of the electronic database of the Company's stock option activity maintained by a third party along with communications to and from this service provider;
- reconciliation of grant activity from approval documents executed by the Compensation Committee with the electronic database;
- reconciliation of stock option grant, exercise, and cancellation information from SEC filings with select employee personnel files and the electronic database;
- statistical and judgmental pattern analysis;
- follow-up on matters raising questions about the option granting process and its history, conduct of those involved with granting, advising, administering, or accounting for stock options, or the accounting treatment for stock options; and
- follow-up on items or issues requested or identified by management or the Company's independent registered public accounting firm.

The Stock Option Review Team, management, and the Governance Committee decided to group stock option grants into six award categories based on differences in what constituted substantive approval for each category under our stock option granting practices as well as giving consideration to the risk of intentional misstatement of the grant date. Guidance in a September 19, 2006 letter publicly issued by the SEC's Chief Accountant focuses on the concept that a measurement date under Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* ( APB 25 ), the accounting standard governing our stock option accounting through 2005, does not occur until the number of shares an individual employee is entitled to receive and the exercise price is determined with finality (i.e., no longer subject to change). This is the date on which substantive approval occurred, and depending on a company's facts and circumstances the guidance from the SEC discussed above recognizes a company may determine that the measurement date for some stock option grants may occur before all required granting



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actions have occurred such as final approval by the Compensation Committee. This alternative is available only when a review of all facts and circumstances supports a conclusion that substantive approval occurs earlier than when all required granting actions have occurred and there is no evidence of fraudulent or manipulative conduct in the company's option granting practices.

6

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In determining the measurement date to be used, the Stock Option Review Team, management, and the Governance Committee agreed to use the following definitions as constituting the proper measurement date, and generally these dates were used in testing the stated grant dates or establishing corrected measurement dates:

<b>Discretionary Director and Officer Grants</b>	The date of a Compensation Committee meeting where the grant was approved or the date the final Compensation Committee signer approved the grant when approval occurred through unanimous written consent documents ( UWC ).
<b>Automatic Director Grants</b>	The date specified in the relevant stock option plan.
<b>Broadbase</b>	The date the grantee list, including the allocation of shares to individual grantees, was complete. Compensation Committee approval was considered perfunctory due to delegation of authority to management.
<b>Acquisition</b>	The first Compensation Committee meeting following the acquisition, provided grantees had received employment offer letters stating the number of stock options to be granted before such date, because this was the date at which the option exercise price was established. Compensation Committee approval was considered perfunctory due to delegation of authority to management.
<b>New Hire</b>	The first scheduled Compensation Committee meeting following the first day of employment, because this was the date at which the option exercise price was established. The number of options was based on either grant amounts specified in an employment offer letter or, in some cases, on a matrix that assigned grant amounts based on position and level within the Company. Compensation Committee approval was considered perfunctory due to delegation of authority to management.
<b>Other Merit</b>	The date the grantee list, including the allocation of shares to grantees, was substantially complete. Compensation Committee approval was considered perfunctory due to delegation of authority to management.

For 12 tested grant dates where a corrected measurement date was required, the Stock Option Review Team and management were unable to locate sufficient evidence to establish a corrected measurement date using our established criteria for the applicable option grant type. In these situations alternative available evidence was used to establish the corrected measurement date.

During the period covered by the Stock Option Review, we granted stock options on approximately 34 million shares of our Common Stock at 197 grant dates. The review specifically examined the appropriateness of the stated grant date for approximately 90% of the stock options granted, including all stock option grants made to directors and officers, all broadbase grants and all option grants made in connection with business acquisitions.

The findings of this review are summarized as follows:

Grant Type	Number of grants	Grants tested	No change required	Measurement date changed additional compensation expense required	no additional compensation expense required(1)
Discretionary Director & Officer	16	16	8	4	4
Automatic Director	5	5	5		
Broadbase	8	8		6	2
Acquisition	10	10	10		
New Hire	166	48	48		
Other Merit	96	41	4	21	16
Total	301	(2) 128	75	31	22

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(1) Under APB 25 there is no expense adjustment arising from using the corrected measurement date for these grants because the amount the employee would have to pay to exercise these stock option grants exceeded the quoted market price of our Common Stock at the corrected measurement date, and therefore, these stock option grants contained no intrinsic value at the corrected measurement date.

(2) The number of grants exceeds the number of grant dates because on certain grant dates more than one category of stock option grants were approved.

7

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In late January 2007 the Governance Committee reported its interim findings concerning the use of incorrect measurement dates in our stock option accounting under APB 25 to our Board of Directors. On February 1, 2007, the Audit Committee of the Board of Directors then concluded, in consultation with and upon the recommendation of management, that we should correct for errors in previously reported stock-based compensation expense through restatement of our previously issued financial statements and that our previously issued financial statements for all periods should no longer be relied upon. We communicated this decision in a February 1, 2007 public announcement.

A non-cash compensation charge, to be recognized as an expense over a grantee's service period, arises under APB 25 if a stock option has intrinsic value at its measurement date. This intrinsic value is measured by the excess, if any, of the fair value at the date of grant of the underlying common stock over the stock option's exercise price. Our practice has been to grant stock options with exercise prices equal to the closing price of our Common Stock at each grant date, to use the grant date as the measurement date for stock-based compensation purposes, and as such previously we had determined the granted stock options had no intrinsic value at their grant dates and no compensation expense was recognized. However, APB 25 states the measurement date does not occur until all essential actions necessary to grant the option are completed, including the final determination of both the number of shares to be granted to each employee or director and the exercise price, and the option grant is approved by those with requisite authority. This is reinforced by the September 19, 2006 letter issued by the SEC's Chief Accountant which focuses on the need for the number of shares and exercise price of an award to an individual to be finalized to have a measurement date. This letter clarifies the SEC staff's view that if it is possible that those terms could change, a measurement date has not occurred, even if the award's terms are not actually changed.

Based on the available evidence, the review found that the number of shares an individual employee was entitled to receive and/or the exercise price was not determined with finality at the stated grant date on 53 tested grant dates, and we should have used a later date as the measurement date. The principal reasons for the stated grant date not qualifying as the measurement date under APB 25 include:

- certain listings of grantees, below officer level, were incomplete and added to or modified by stock option administration personnel after the grant was approved by the Compensation Committee;
- for certain grants where Compensation Committee approval was not considered perfunctory, the date a UWC document was sent to Compensation Committee members for approval was used as the stated grant date for some discretionary officer and director grants rather than the date the UWC was signed by all Compensation Committee members and therefore became effective;
- the Stock Option Review Team was unable to locate contemporaneous documentation of some director and officer, broadbase, new hire, and other merit grants.

During the review the Company also discovered a stock option grant to a former officer that was modified in 1998 in connection with his termination of employment. This change was never included in the Company's stock option grant records and the additional compensation expense resulting from the change in the option's terms (approximately \$1.2 million) was not recorded previously. This discovery is consistent with the Stock Option Review Team's finding that in certain instances there was a lack of formal documentation in the stock option granting process and/or expected documentation is missing from the stock option administration files. In addition, the Stock Option Review Team found that, in many instances, there was a lack of self-authenticating evidence to corroborate that cash exercises were contemporaneous. As a result, the findings on the issue of backdating of cash exercises were inconclusive.

We restated our consolidated financial statements to recognize additional non-cash stock-based compensation expense arising from using corrected measurement dates for certain stock option grants made during the years 2000 through 2005 and to reflect the modification of the 1998 grant described above. Consistent with our historical accounting policy this additional stock-based compensation expense is being recognized on an accelerated basis by treating each vesting tranche as a separate stock option grant (graded vesting).

Our accounting for stock-based compensation changed to a fair value based method in 2006 when, as required by accounting standards, we ceased accounting for stock-based compensation under the intrinsic value method pursuant to APB 25 and began accounting for stock-based compensation under Statement of Financial Accounting Standards 123(R) *Share-Based Payments* (SFAS 123(R)). Under this method all stock option grants have a fair value determined using an option

pricing model, and such fair value is used to recognize non-cash stock-based compensation expense. We restated our unaudited condensed consolidated financial statement information for the first and second fiscal quarters of 2006, included in Exhibit 99.1 in our Annual Report on Form 10-K for the year ended December 31, 2006 (and as reflected in our results for the three months ended March 31, 2006 included in this Form 10-Q), to recognize changes in non-cash stock-based compensation expense that arose from a re-determination of the fair value of stock options granted in 2005 and prior where the Governance Committee's review resulted in a corrected measurement date. By January 1, 2006, of the 17.9 million options granted in 2000 - 2005 where corrections were made to the measurement dates in the Stock Option Review, 4.4 million options with corrected measurement dates granted in 2000 and 2001 had fully vested. Therefore, the fair values of the outstanding and unvested portion of the remaining 13.5 million stock options granted in 2002-2005 with incorrect measurement dates were recalculated. We also recorded additional non-cash stock-based compensation expense in the first two quarters of 2006 arising from correcting the measurement date for stock option grants to three individuals in this period. We recognize stock compensation expense on a straight-line basis under SFAS 123(R).

Those stock option grants with corrected measurement dates have also been restated using the fair value based measurement principles of Statement of Financial Accounting Standards 123 *Accounting for Stock-Based Compensation* ( SFAS 123 ) to present, in Note 2, Restatement of Financial Statements of Notes to Consolidated Financial Statements contained in Item 8 of the Company's 2006 Annual Report, the pro forma effect on stock-based compensation expense, net income (loss), and earnings (loss) per share amounts in 2004 and 2005 of using the fair value based method to determine stock-based compensation expense rather than using APB 25's intrinsic value method. Such disclosure is required in financial statements for periods prior to the adoption of SFAS 123(R).

In addition to restating the consolidated financial statements in response to the Governance Committee's findings, we recorded additional non-cash adjustments to account for the modification in 1998 of a stock option grant to a former officer in connection with his termination of employment and to record in the first two quarters of 2006 corrections relating to accounting for performance related stock options and restricted stock grants, all of which were previously identified and considered immaterial.

Correcting the measurement date for previously granted stock options in some cases results in additional taxable income to employees on which additional payroll taxes are due from the employees as well as us. We have provided for all additional payroll taxes plus related penalties and interest arising from the restatement of stock-based compensation, including amounts otherwise payable by stock option recipients, and our restated financial statements include an accrual in all affected years of approximately \$1.5 million for all estimated payroll tax related expenses.

The corrections for the stock option restatement were to increase (reduce) previously reported non-cash compensation expense, payroll taxes, income taxes and net income by the following amounts (in thousands of dollars):

Year ended December 31,	Non-cash stock compensation	Payroll taxes	Income taxes	Net income
1998	\$ 1,244	\$	\$ (448)	\$ (796)
1999				
2000	556		(104)	(452)
2001	4,870		(942)	(3,928)
2002	8,110		(1,550)	(6,560)
2003	12,470	900	(2,281)	(11,089)
Totals through December 31, 2003	27,250	900	(5,325)	(22,825)
2004	(410)	541	250	(381)
2005	(1,290)	60	4,083	(2,853)
2000-2005 Total	25,550	1,501	(992)	(26,059)
<u>2006 quarter ended</u>				
March 31	662	9		(671)
June 30	504	6		(510)
	\$ 26,716	\$ 1,516	\$ (992)	\$ (27,240)

The Governance Committee's review found 17.9 million stock options of the 28.8 million options granted on our Common Stock during 2000 through 2005 had incorrect measurement dates. Using the corrected measurement dates, 7.6 million stock options had exercise prices that exceeded the closing price of our Common Stock and therefore had no intrinsic value to be accounted for under APB 25, and 10.3 million stock options had intrinsic value because their exercise prices were below the closing price of our Common Stock. These 10.3 million stock options resulted in an increase in additional non-cash stock-based compensation expense of \$24.3 million, and an additional \$1.5 million of payroll tax related expenses during 2000-2005 partially offset by \$0.5 million of income tax benefit as shown in the above table. Of the 10.3 million stock options resulting in additional non-cash stock-based compensation expense, 2.0 million options were granted to officers and directors and resulted in \$6.1 million of additional non-cash stock-based compensation expense.

The total effect of the stock option restatement and the amounts for 2006, as shown in the above table, have been reflected in the December 31, 2006 financial statements as well as in the March 31, 2006 financial statements. As a result of this restatement, net loss increased by \$0.7 million for the three months ended March 31, 2006.

Upon completing its review, the Governance Committee concluded it found no evidence of intent to manipulate the Company's operating results or financial statements. A key finding of the Governance Committee was that there were deficiencies with the process by which stock options were granted during the period from our initial public offering in 2000 through at least 2005, which resulted in accounting errors. The Governance Committee concluded that certain members of management bear varying degrees of responsibility for the deficiencies in the process by which options were granted. The Governance Committee's review also concluded that none of the current or former employees or directors of the Company engaged in intentional wrongdoing.

In determining the above restatement amounts, management used all reasonably available relevant information to form conclusions it believes are reasonable as to the most likely option granting actions that occurred, the dates when such actions occurred, and the determination of grant dates for financial accounting purposes based on when the requirements of the accounting standards were met. In light of significant judgment used in establishing revised measurement dates, alternative approaches to those used by the Stock Option Review Team and management could have resulted in different compensation charges than those recorded in the restatement. The Stock Option Review Team and management considered various alternatives throughout the course of the review and restatement, and management believes the adjustments to measurement dates used in our review of stock option grant accounting and restatement of our financial statements were reasonable and appropriate in our circumstances.

**Summary of Restatement Amounts**

The following table presents the decrease in net earnings from the restatement for each restated year:

Year ended December 31,	Net income (loss), as previously reported	Restatement adjustments		Total	Net income (loss), as restated
		China Sales (in thousands) (Decrease) Increase	Stock Options		
1998		\$	\$ (796 )	\$ (796 )	
1999					
2000		(4,781 )	(452 )	(5,233 )	
2001		(5,779 )	(3,928 )	(9,707 )	
2002	\$ 107,862	(19,697 )	(6,560 )	(26,257 )	\$ 81,605
2003	\$ 209,856	(6,382 )	(11,089 )	(17,471 )	\$ 192,385
<b>Totals through</b>					
December 31, 2003		(36,639 )	(22,825 )	(59,464 )	
2004	\$ 69,824	(18,594 )	(381 )	(18,975 )	\$ 50,849
2005	\$ (487,359 )	(42,433 )	(2,853 )	(45,286 )	\$ (532,645 )
2000 - 2005 Total		(97,666 )	(26,059 )	(123,725 )	
<b>2006 quarter ended</b>					
March 31	\$ (10,635 )	1,360	(671 )	689	\$ (9,946 )
June 30	\$ (21,443 )	(371 )	(510 )	(881 )	\$ (22,324 )
		\$ (96,677 )	\$ (27,240 )	\$ (123,917 )	

The cumulative effect on stockholders' equity at December 31, 2003 from the above corrections was as follows (in thousands):

<b>Increase (decrease) in paid-in capital and deferred stock compensation:</b>	
Values assigned to stock options	\$ 27,250
Reduction of previously recorded income tax benefits from stock options	(1,278 )
Net increase in paid-in capital and deferred stock compensation	25,972
<b>(Increase) decrease in accumulated deficit:</b>	
Revenue and related cost of sales deferral for China system sales	(36,639 )
Additional non-cash compensation expense from stock options	(27,250 )
Payroll taxes for values assigned to stock options	(900 )
Income tax benefit from additional compensation and payroll tax expense	5,325
Net increase in accumulated deficit	(59,464 )
Net decrease in stockholders' equity at December 31, 2003	\$ (33,492 )

In restating the previously issued financial statements for the investigations discussed above, we also corrected other previously reported amounts. We corrected the reporting of \$8.7 million of net sales to certain third party resellers and \$1.8 million of associated cost of net sales for the three months ended March 31, 2006 to classify these amounts as related party net sales and related party cost of net sales classifications, respectively, because in 2006 we determined that sales to these entities were, in substance, sales to a significant shareholder, SOFTBANK CORP. The classification of the accounts receivable from these sales was similarly changed to include them in accounts receivable from related parties in the March 31, 2006 consolidated balance sheet. We also corrected our reporting of \$6.2 million of time deposits at March 31, 2006 because they did not mature within three months. Formerly the time deposits had been reported in error as cash equivalents, but now these amounts are included in short-term investments in the balance sheet and in the statement of cash flows for the March 2006 reporting period.





## PART I FINANCIAL INFORMATION

## ITEM 1 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

## UTSTARCOM, INC.

## CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands, except share data)

	March 31, 2007	December 31, 2006
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 558,150	\$ 661,623
Short-term investments	14,768	9,546
Accounts receivable, net of allowances for doubtful accounts of \$48,264 and \$53,894 at March 31, 2007 and December 31, 2006, respectively	327,449	373,762
Accounts receivable, related parties, net of allowances for doubtful accounts of \$0 and \$19 at March 31, 2007 and December 31, 2006, respectively	25,487	32,318
Notes receivable	6,161	5,060
Inventories	442,996	440,445
Deferred costs	211,666	195,393
Prepays and other current assets	132,004	101,795
Short-term restricted cash and investments	5,620	16,666
Total current assets	\$ 1,724,301	1,836,608
Property, plant and equipment, net	210,042	213,155
Long-term investments	45,087	47,809
Goodwill	3,063	3,063
Intangible assets	52,397	56,443
Long-term deferred costs	172,895	176,649
Other long-term assets	39,575	40,223
Total assets	\$ 2,247,360	\$ 2,373,950
<b>LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS' EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 265,519	\$ 304,869
Short-term debt	378,416	102,758
Income taxes payable		2,483
Customer advances	312,363	265,812
Deferred revenue	96,874	95,742
Other current liabilities	191,807	271,400
Total current liabilities	1,244,979	1,043,064
Long-term deferred revenue	251,369	261,014
Long-term debt	521	275,161
Other long-term liabilities	21,881	13,858
Total liabilities	1,518,750	1,593,097
Commitments and contingencies (Note 15)		
Minority interest in consolidated subsidiaries	6,029	6,493
Stockholders' equity:		
Common stock: \$0.00125 par value; 750,000,000 authorized shares; 121,299,113 issued and 121,294,645 outstanding at March 31, 2007 and December 31, 2006	152	152
Additional paid-in capital	1,208,349	1,205,592
Accumulated deficit	(549,577)	(494,244)
Accumulated other comprehensive income	63,696	62,899
Treasury stock: 4,468 shares held in treasury at March 31, 2007 and December 31, 2006	(39)	(39)
Total stockholders' equity	722,581	774,360
Total liabilities, minority interest and stockholders' equity	\$ 2,247,360	\$ 2,373,950

See accompanying notes to the condensed consolidated financial statements.

## UTSTARCOM, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(In thousands, except per share data)

	Three months ended March 31, 2007	2006 (As restated)
Net sales		
Unrelated party	\$ 462,574	\$ 557,037
Related party	13,328	44,944
	475,902	601,981
Cost of net sales		
Unrelated party	390,539	461,585
Related party	10,078	16,605
Gross profit	75,285	123,791
Operating expenses:		
Selling, general and administrative	79,837	83,727
Research and development	43,662	46,402
Amortization of intangible assets	4,046	4,925
Total net operating expenses	127,545	135,054
Operating loss	(52,260 )	(11,263 )
Interest income	4,910	3,532
Interest expense	(6,725 )	(3,500 )
Other income, net	3,970	3,568
Loss before income taxes and minority interest	(50,105 )	(7,663 )
Income tax expense	(4,341 )	(2,839 )
Minority interest in losses of consolidated subsidiaries	464	556
Net loss	\$ (53,982 )	\$ (9,946 )
Loss per share - Basic	\$ (0.45 )	\$ (0.08 )
Loss per share - Diluted	\$ (0.45 )	\$ (0.08 )
Weighted average shares used in per-share calculation:		
- Basic	120,900	120,600
- Diluted	120,900	120,600

See accompanying notes to the condensed consolidated financial statements.

## UTSTARCOM, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)

	Three months ended March 31,	
	2007	2006
	(Unaudited)	(As restated)
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net loss	\$ (53,982 )	\$ (9,946 )
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	14,744	17,476
Net (gain) loss on sale of asset	(2,699 )	4,708
Stock-based compensation expense	2,755	2,425
(Recovery of) provision for doubtful accounts	(5,281 )	892
(Recovery of) provision for deferred costs reserves	(1,504 )	795
Other	266	(578 )
Changes in operating assets and liabilities:		
Accounts receivable	60,296	28,787
Inventories	(2,422 )	(4,337 )
Deferred costs	(5,222 )	3,248
Other assets	(31,433 )	(6,771 )
Accounts payable	(41,324 )	18,077
Income taxes payable	5,969	(2,020 )
Customer advances	44,298	43,097
Deferred revenue	(11,790 )	8,789
Other current liabilities	(79,336 )	(50,970 )
Net cash provided by (used in) operating activities	(106,665 )	53,672
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Additions to property, plant and equipment	(5,221 )	(3,162 )
Proceeds from the disposition of an investment interest	1,800	
Proceeds from the sale of semiconductor design assets		19,965
Change in restricted cash and long-term investments	10,365	(17,037 )
Purchase of short-term investments	(15,576 )	(17,041 )
Proceeds from sale of short-term investments	10,483	13,309
Other	(70 )	499
Net cash provided by (used in) investing activities	1,781	(3,467 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Proceeds from borrowings	64,621	62,370
Payments on borrowings	(64,676 )	(89,948 )
Other	(654 )	(3,184 )
Net cash used in financing activities	(709 )	(30,762 )
Effect of exchange rate changes on cash and cash equivalents	2,120	2,374
Net increase (decrease) in cash and cash equivalents	(103,473 )	21,817
Cash and cash equivalents at beginning of period	661,623	645,571
Cash and cash equivalents at end of period	\$ 558,150	\$ 667,388
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid:		
Interest	\$ 5,388	\$ 2,511
Income taxes	\$ 2,788	\$ 3,801
Non-cash operating activity:		
Accounts receivable transferred to notes receivable	\$ 9,240	\$ 8,977

See accompanying notes to the condensed consolidated financial statements.



UTSTARCOM, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

NOTE 1 - BASIS OF PRESENTATION AND LIQUIDITY

The accompanying unaudited condensed consolidated financial statements include the accounts of UTStarcom, Inc. ( Company ) and its wholly and majority owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in the preparation of the condensed consolidated financial statements. The minority interests in consolidated subsidiaries is shown separately in the condensed consolidated financial statements.

The accompanying unaudited condensed consolidated financial statements as of March 31, 2007 and for the three months ended March 31, 2007 and 2006 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission ( SEC ). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The December 31, 2006 balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. These condensed consolidated financial statements should be read in conjunction with the Company s December 31, 2006 financial statements, including the notes thereto, and the other information set forth in the Company s Annual Report on Form 10-K for the year ended December 31, 2006.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) considered necessary for a fair statement of the Company s financial condition, the results of its operations and its cash flows for the periods indicated. The results of operations for the three months ended March 31, 2007 are not necessarily indicative of the operating results for the full year.

The Company reported net losses in each quarter in the period beginning April 1, 2005 and continuing through March 31, 2007, which has resulted in an accumulated deficit of \$549.6 million and total stockholders equity being reduced to \$722.6 million at March 31, 2007. Additionally, at March 31, 2007, the Company had short-term debt in China under its lines of credit of \$103.6 million maturing in 2007 and convertible subordinated notes, outside of China, with a principal balance of \$274.6 million that matures in March 2008. On January 9, 2007 and July 26, 2007 the Company and the holders of the convertible subordinated notes entered into two agreements to prevent covenant defaults occurring from the Company s inability to timely file required periodic reports containing financial statements with the SEC. As a result of these agreements, convertible subordinated notes accrued interest at a rate of 7.625% per annum as of January 9, 2007 and the interest rate increased to 10.875% effective as of July 26, 2007. On October 15, 2007, the Company received an additional notice of default asserting that a default had occurred under the Indenture (as amended by the First Supplemental Indenture and Second Supplemental Indenture) with respect to the Notes.

The specific defaults referred to in the notice of default were (i) the Company s failure to file with the SEC and provide copies to the Trustee of its Quarterly Reports on Form 10-Q for the fiscal quarter ended March 31, 2007 and June 30, 2007 and (ii) the Company s failure to deliver to the Trustee its officer s certificate of compliance required by the Indenture. The notice of default provides that the Company has 60 consecutive days from October 15, 2007 to cure the defaults before such defaults would constitute an Event of Default under the Indenture. For additional information concerning these agreements, see Note 25.

The Company s cash and short-term investments aggregated \$572.9 million (of which \$414.6 million are held in China) at March 31, 2007.

Credit facilities in China at March 31, 2007 totaled \$692.7 million, with \$353.5 million of this amount available for working capital purposes, of which the Company had drawn \$103.6 million in outstanding borrowings, and \$339.2 million was available for use in support of letters of credit and corporate guarantees. These facilities expire primarily in November and December of 2007, and the Company believes that based upon its recent financial performance and financial position its lenders may reduce the total available credit when it negotiates renewals of these lines. Furthermore, each borrowing under the credit facilities is subject to the bank s current favorable opinion of the credit worthiness of the Company s China subsidiaries, as well as the bank having funds available for lending and other Chinese banking regulations. However, the Company believes the amounts of credit its lenders may make available and the borrowings made under the renewed lines of credit will be sufficient to meet planned uses of these credit facilities.

To meet liquidity needs outside of China, the Company s subsidiaries in China have the ability to transfer cash to the Company under China s current exchange control regulations. The amount of cash available for transfer from the Company s China subsidiaries is limited both by the Company s liquidity needs in China and by Chinese government requirements that the China subsidiaries retain adequate capital levels in China to protect creditors and to have funds available for mandated employee benefits. The Company believed the China subsidiaries could freely transfer at least \$200 million to the Company as of December 31, 2006, and during the nine months ended September 30, 2007 its China subsidiaries have made such transfers totaling \$150 million.

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Although management believes the Company has a sufficient amount of cash resources to finance the Company's anticipated working capital and capital expenditure requirements for the next 12 months, the Company does not have enough

15

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cash outside of China to repay the convertible notes due on March 1, 2008. Management's liquidity plans include a partial or complete refinancing of the convertible notes, renewal of the lines of credit in China, transfers of more cash from its subsidiaries in China to the extent necessary, and, if needed, liquidation of certain investments and/or seeking new financing arrangements. The Company's ability to maintain sufficient liquidity is also dependent on achieving projected sales and operating margin forecasts.

If additional sources of liquidity were needed, the Company would consider new debt or equity offerings or obtaining cash from asset sales, but there is no assurance that such transactions could be consummated on acceptable terms or at all. Failure to raise sufficient capital when needed could have a material adverse effect on the business, results of operations and financial position of the Company.

## NOTE 2 - RESTATEMENT OF FINANCIAL STATEMENTS

The consolidated financial statements for the three months ended March 31, 2006 included herein have been restated. The reasons for the restatement are discussed below.

### *China Sales Investigation*

The Audit Committee of the Company's Board of Directors ( Audit Committee ) engaged independent counsel to conduct an investigation of sales in China following a determination by the Internal Audit group that allegations of improper activities in a sales office in the Western Region were credible. The allegations were made by a Company employee using the Company's whistle blower program. The independent counsel engaged the assistance of forensic accountants, and this group is collectively referred to as the Investigating Team in the rest of this discussion.

In conducting its procedures, the Investigating Team found instances where the customer contracts that evidenced the arrangement contained obligations for the Company to deliver software upgrades when and if made available for the equipment sold for no additional consideration and for an unspecified period that could extend over the term of the contract. This additional contract obligation is an element of post contract support. In these cases, the Investigating Team found that the contract documentation for the same transaction submitted by the sales office to the Company's China headquarters for accounting purposes and utilized by the Company in determining the amount of revenue recognized did not include evidence of such post contract support obligations.

Accounting standards governing revenue recognition for system sales require all revenue to be deferred while there are undelivered elements under the arrangement unless the seller has established vendor specific objective evidence ( VSOE ) of fair value for such contract elements. Because these arrangements included such undelivered elements, revenue should be deferred based on the VSOE of the fair value of the underlying elements. VSOE of fair value represents the price charged when the same element is sold separately. Since the Company does not sell this element separately, it has not established VSOE for such undelivered elements, and as such the revenue from such contracts is required to be deferred and recognized over the period the Company is obligated to provide the post contract support.

Upon completion of the investigative phase of the independent investigation by the Audit Committee, management:

- conducted follow-up procedures to attempt to locate any additional relevant information to ensure the China sales investigation considered all available information and documents;
- evaluated the accounting for identified system sales using the contract template and documentation found in the sales contract files from the Western Region offices. This included calculating the financial statement effects of correcting the accounting for all system sales where the contract template found at the sales offices contained post contract support obligations to recognize revenue and cost of net sales over estimated period of post contract support;
- concluded that as a result of this undelivered post contract support obligation the Company's previously issued financial statements should be restated to defer system sales contract revenue and the related cost of net sales over the estimated period of post contract support when a contract contained unspecified software upgrade rights.

The Audit Committee concurred with management's decisions.





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The effect of correcting improperly recognized revenue and cost of net sales was to (reduce) increase previously reported net sales, gross profit and net income by the following amounts (in thousands of dollars):

Year ended December 31,	Net sales		Gross profit		Net income				
2000	\$	(12,408)	)	\$	(5,294)	)	\$	(4,781)	)
2001		(17,154)	)		(6,330)	)		(5,779)	)
2002		(64,732)	)		(22,924)	)		(19,697)	)
2003		(21,060)	)		(8,014)	)		(6,382)	)
Totals through December 31, 2003		(115,354)	)		(42,562)	)		(36,639)	)
2004		(104,965)	)		(27,241)	)		(18,594)	)
2005		(58,232)	)		(27,863)	)		(42,433)	)
2000 - 2005 Total	\$	(278,551)	)	\$	(97,666)	)	\$	(97,666)	)
<u>2006 quarter ended</u>									
March 31	\$	5,410		\$	1,360		\$	1,360	

In our consolidated balance sheet at March 31, 2007 the net reduction in previously recognized net sales is accounted for as deferred revenue, of which \$36.5 million is classified as current and \$233.3 million as non-current, and the related net reduction in cost of net sales of \$172.9 million is accounted for as deferred costs. These amounts will be recognized in our consolidated statements of operations over the estimated remaining period of post contract support. Due to this restatement, we increased net sales, gross profit, and net income (in thousands) for the three month period ended March 31, 2006 as follows: \$5,410, \$1,360 and \$1,360, respectively.

### *Audit Committee Findings*

Upon completing its investigation, the Audit Committee concluded that the conditions and practices relating to systems contracts prevalent in the Western Region resulted primarily from the failure to prevent or detect instances of override related to controls in China over customer agreements, lack of proper management oversight, unclear record retention policies and procedures relating to systems contracts, and inadequate employee training. The Investigating Team and the Audit Committee also concluded that with respect to four regions other than the Western Region there was no evidence of fraud or misconduct or reason to suspect such occurred. The Investigating Team and the Audit Committee also concluded that there was no credible evidence of knowledge by senior management in China or the United States of the conditions and practices related to the Western Region of China that were discovered in the investigation. The Audit Committee concluded that local management in several of the sales offices in the Western Region of China did not submit appropriate information to the Company's senior management in China and the United States. Therefore, in prior years, neither the Company's management nor the Company's independent registered accounting firm were able to properly evaluate the effect of that information on revenue recognition. The Audit Committee also concluded that certain members of management in China bear varying degrees of responsibility for inadequate oversight of activities. As a result, certain employees in China have either been terminated or placed on suspension for failure to provide adequate oversight of activities.

### *Governance Committee Review of Historical Stock Option Accounting*

In November 2006 the Company announced it had commenced a voluntary review of historical stock option practices under the leadership of the Nominating and Corporate Governance Committee of the Company's Board of Directors ( Governance Committee ) following a preliminary review by management which identified potential deficiencies and discrepancies in the documentation of stock option grants. The review considered all option grant awards made in the period from February 29, 2000, shortly before the initial public offering of the Company's Common Stock, through August 2006 ( Review Period ) for compliance with the various stock-based compensation accounting standards applicable during the Review Period, the rules of the Company's stock option plans, and the guidance on stock option accounting issued by the

SEC in the September 19, 2006 letter which was to be considered applicable to periods prior as well as subsequent to its issuance. At the time the review commenced, the Governance Committee consisted of three members of the Board of Directors, all of whom are independent directors. Mr. Allen Lenzmeier was appointed to the Governance Committee on April 27, 2007. The Governance Committee engaged independent outside legal counsel to assist in the review who, in turn, engaged forensic accounting experts (collectively referred to herein as the Review Team ).

The Review Team, management, and the Governance Committee decided to group stock option grants into six award categories based on differences in what constituted substantive approval for each category under the Company's stock option granting practices as well as giving consideration to the risk of intentional misstatement of the grant date. Guidance in the September 19, 2006 letter on determining the date when substantive approval of a stock option grant occurs recognizes that depending on a company's facts and circumstances a company may determine that the measurement date for some stock option grants may occur before all required granting actions have occurred such as final approval by the Compensation Committee. This alternative is available only when a review of all facts and circumstances supports a conclusion that substantive approval occurs earlier than when all required granting actions have occurred and there is no evidence of fraudulent or manipulative conduct in the company's option granting practices.

In determining the measurement date to be used, the Review Team, management, and the Governance Committee agreed to use the following definitions as constituting the proper measurement date, and generally these dates were used in testing the stated grant dates or establishing corrected measurement dates:

**Discretionary Director and Officer Grants**

The date of a Compensation Committee meeting where the grant was approved or the date the final Compensation Committee signer approved the grant when approval occurred through unanimous written consent documents ( UWC ).

**Automatic Director Grants**

The date specified in the relevant stock option plan.

**Broadbase**

The date the grantee list, including the allocation of shares to individual grantees, was complete. Compensation Committee approval was considered perfunctory due to delegation of authority to management.

**Acquisition**

The first Compensation Committee meeting following the acquisition, provided grantees had received employment offer letters stating the number of stock options to be granted before such date because this was the date at which the option exercise price was established. Compensation Committee approval was considered perfunctory due to delegation of authority to management.

**New Hire**

The first scheduled Compensation Committee meeting following the first day of employment because this was the date at which the option exercise price was established. The number of options was based on either grant amounts specified in an employment offer letter or, in some cases, on a matrix that assigned grant amounts based on position and level within the Company. Compensation Committee approval was considered perfunctory due to delegation of authority to management.

**Other Merit**

The date the grantee list, including the allocation of shares to grantees, was substantially complete. Compensation Committee approval was considered perfunctory due to delegation of authority to management.

During the Review Period, the Company granted stock options on approximately 34 million shares of the Company's common stock at 197 grant dates. The review specifically examined the appropriateness of the stated grant date for approximately 90% of the stock options granted, including all stock option grants made to directors and officers, all broadbase options and all option grants made in connection with business acquisitions. The review included an extensive examination of the Company's historical stock option practices including information from stock option administration, human resource, legal, and accounting department files and records as well as from e-mail communications, an electronic database of the Company's stock option activity maintained by a third party, and information stored in Company hard drives and back-up tapes. The Review Team also conducted interviews of individuals involved with the granting, advising,



administering, or accounting for stock options, including current and former: management, members of the Board of Directors, employees, and non-employee professionals.

The findings of this review are summarized as follows:

Grant Type	Number of grants	Grants tested	No change required	Measurement date changed additional compensation expense required	no additional compensation expense required(1)
Discretionary Director & Officer	16	16	8	4	4
Automatic Director	5	5	5		
Broadbase	8	8		6	2
Acquisition	10	10	10		
New Hire	166	48	48		
Other Merit	96	41	4	21	16
Total	301	(2) 128	75	31	22

(1) Under APB 25 there is no expense adjustment arising from using the corrected measurement date for these grants because the amount the employee would have to pay to exercise these stock option grants exceeded the quoted market price of the Company's Common Stock at the corrected measurement date, and therefore, these stock option grants contained no intrinsic value at the corrected measurement date.

(2) The number of grants exceeds the number of grant dates because on certain grant dates more than one category of stock option grants were approved.

A non-cash compensation charge, to be recognized as an expense over a grantee's service period, arises under Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* ( APB 25 ), the accounting standard governing the Company's stock option accounting through 2005, if a stock option has intrinsic value at its measurement date. This intrinsic value is measured by the excess, if any, of the fair value at the date of grant of the underlying common stock over the stock option's exercise price. The Company's practice has been to grant stock options with exercise prices equal to the closing price of the underlying Company common stock at each grant date, to use the grant date as the measurement date for stock-based compensation purposes, and as such previously the Company had determined the granted stock options had no intrinsic value at their grant dates and no compensation expense was recognized. However, APB 25 states the measurement date does not occur until all essential actions necessary to grant the option are completed, including the final determination of both the number of shares to be granted to each employee or director and the exercise price, and the option grant is approved by those with requisite authority. A September 19, 2006 letter publicly issued by the SEC's Chief Accountant focused companies registered with the SEC on the need for the number of shares and exercise price of an award to an individual to be finalized to have a measurement date. This letter clarifies the SEC staff's view that if it is possible that those terms could change, a measurement date has not occurred, even if the award's terms are not actually changed.

Based on available evidence, the review found that the number of shares an individual employee was entitled to receive and/or the exercise price for stock option grants was not determined with finality at the stated grant date at 53 tested grant dates, and the Company should have used a later date as the measurement date. The principal reasons for the stated grant date not qualifying as the measurement date under APB 25 include:

- certain listings of grantees, below officer level, were incomplete and added to or modified by stock option administration personnel after the grant was approved by the Compensation Committee;
- for certain grants where Compensation Committee approval was not considered perfunctory, the date a UWC document was sent to Compensation Committee members for approval was used as the stated grant date for some discretionary officer and director grants rather than the date the UWC was signed by all Compensation Committee members and therefore became effective;
- the Stock Option Review Team was unable to locate contemporaneous documentation of some director and officer, broadbase, new hire, and other merit grants.

A total of 17.9 million stock options were granted at the 53 tested grant dates during 2000 through 2005 where the Governance Committee's review found the Company used incorrect measurement dates. Using the corrected measurement dates, 10.3 million stock options had intrinsic

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value because their exercise prices were below the closing price of the Company's Common Stock at the corrected measurement date, and 7.6 million stock options had exercise prices that exceeded the closing price of the Company's Common Stock and therefore had no intrinsic value to be accounted for under APB 25. These 10.3 million stock options resulted in an increase in non-cash stock-based compensation expense of \$24.3 million during 2000 to 2005. Of the 10.3 million stock options resulting in additional non-cash stock-based compensations expense, 2.0 million options were granted to officers and directors and resulted in \$6.1 million of additional non-cash stock-based compensation expense.

19

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In some cases, in correcting the measurement date for previously granted stock options additional taxable income to employees arises on which additional payroll taxes are due from the employee as well as the Company. The Company has assumed responsibility for all additional payroll taxes plus related penalties and interest arising from the restatement of stock-based compensation, including amounts otherwise payable by stock option recipients, and the Company's restated financial statements include a \$1.5 million accrual for this estimated expense.

Because the holders of stock options where corrections were made to the measurement dates were not aware that improper measurement dates were used, the Company has taken certain actions and is contemplating taking additional actions to deal with the adverse personal income tax consequences that may be incurred by the holders of stock options with corrected measurement dates. Adverse personal income tax consequences arise from the exercise of stock options vesting after December 31, 2004 where the corrected measurement dates cause them to have an exercise price below the fair market value of Company's common stock at the measurement date (409A Affected Options). Such an exercise would subject the option holder to a penalty tax under IRC Section 409A (and, as applicable, similar penalty taxes under California and other state tax laws). The Company has evaluated its stock option exercises through December 31, 2006 and determined there were no exercises of 409A Affected Options; accordingly, no penalty tax has been incurred by employees exercising stock options through that date.

The Company is considering how to deal with exercises of 409A Affected Options that occur in 2007 and beyond. One alternative would be to offer to amend all 409A Affected Options to change the exercise price to the fair market price of the Company's common stock on the corrected measurement date. These amended options would not be subject to taxation under IRC Section 409A. Under IRS regulations, option amendments had to be completed by December 31, 2006 for anyone who was an executive officer or member of the Board of Directors when he or she received 409A Affected Options. Therefore, prior to December 31, 2006 eight of the Company's current and former executive officers and directors executed an irrevocable Protective Amendment Election Form whereby any of their stock options will be automatically amended to restate the exercise price to the fair market value of the Company's common stock at the corrected measurement date if in the future such stock options would otherwise be determined to be 409A Affected Options. A similar offer to amend all 409A Affected Options held by non-officer employees is currently under consideration, but no decision has been reached and such an offer cannot be made until the Company is current with its SEC reporting obligations.

During the review the Company also discovered a stock option grant to a former officer that was modified in 1998 in connection with his termination of employment that should have resulted in additional compensation expense. This change was never included in the Company's stock option grant records and the additional compensation expense resulting from the change in the option's terms (approximately \$1.2 million) was not recorded previously. This discovery is consistent with the Review Team's finding that in certain instances there was a lack of formal documentation in the stock option granting process and/or expected documentation is missing from the stock option administration files. In addition, the Review Team found that, in many instances, there was a lack of self-authenticating evidence to corroborate that cash exercises were contemporaneous. As a result, the findings on the issue of backdating of cash exercises were inconclusive.

The Company's accounting for stock-based compensation changed to a fair value method in 2006 when, as required by accounting standards, it ceased accounting for stock-based compensation under the intrinsic value method pursuant to APB 25 and began accounting for stock-based compensation pursuant to Statement of Financial Accounting Standards 123(R) Share-Based Payments (SFAS 123(R)). Under this method all stock option grants have a fair value determined using an option pricing model, and such fair value is used to recognize non-cash stock-based compensation expense. The Company recognizes stock compensation expense on a straight-line basis under SFAS 123(R).

The table below shows the effects of correcting the consolidated financial statements for the Governance Committee's findings and the modification in 1998 of a stock option grant to a former officer in connection with his termination of employment. Consistent with its historical accounting policy, this additional stock-based compensation expense is being recognized on an accelerated basis by treating each vesting tranche as a separate stock option grant (graded vesting). Additionally, the table gives effect to corrections of the accounting for performance related stock options and restricted stock grants in the first two quarters of 2006, all of which were previously identified and considered immaterial. The effects of correcting the errors in the Company's previous stock option accounting were to increase (reduce) previously reported non-cash compensation expense, payroll taxes, income taxes and net income by the following amounts (in thousands of dollars):

Year ended December 31,	Reduction (increase) in net income from			
	Non-cash stock compensation	Payroll taxes	Income taxes	Net income
1998	\$ 1,244	\$	\$ (448 )	\$ (796 )
1999				
2000	556		(104 )	(452 )
2001	4,870		(942 )	(3,928 )
2002	8,110		(1,550 )	(6,560 )
2003	12,470	900	(2,281 )	(11,089 )
Totals through December 31, 2003	27,250	900	(5,325 )	(22,825 )
2004	(410 )	541	250	(381 )
2005	(1,290 )	60	4,083	(2,853 )
2000-2005 Total	\$ 25,550	\$ 1,501	\$ (992 )	\$ (26,059 )
<u>2006 quarter ended</u>				
March 31	\$ 662	\$ 9	\$	\$ (671 )

The following table shows the Company's stock-based compensation expense as previously reported and the impact of the restatement (excluding payroll taxes) on stock-based compensation for periods prior to fiscal 2006, net of income tax:

Year ended December 31,	Stock-Based Compensation Expense (Net of Tax)		
	(in thousands)	As Reported	As Restated
1998 (net of income tax benefit/(expense) of \$118, \$448 and \$566, respectively)		\$ 294	\$ 1,090
1999 (net of income tax benefit/(expense) of \$1,596, \$0 and \$1,596, respectively)	3,957		3,957
2000 (net of income tax benefit/(expense) of \$3,323, \$104 and \$3,427, respectively)	8,238	452	8,690
2001 (net of income tax benefit/(expense) of \$1,495, \$942 and \$2,437, respectively)	3,706	3,928	7,634
2002 (net of income tax benefit/(expense) of \$891, \$1,550 and \$2,441, respectively)	2,209	6,560	8,769
2003 (net of income tax benefit/(expense) of \$1,212, \$2,281 and \$3,493, respectively)	3,071	10,189	13,260
2004 (net of income tax benefit/(expense) of \$149, (\$250) and (\$101), respectively)	370	(160 )	210
2005 (net of income tax benefit/(expense) of \$105, (\$4,083) and (\$3,978), respectively)	2,154	2,793	4,947

#### *Governance Committee Findings*

Upon completing its review, the Governance Committee concluded it found no evidence of intent to manipulate the Company's operating results or financial statements. A key finding of the Governance Committee was that there were deficiencies with the process by which stock options were granted during the period from the Company's initial public offering in 2000 through at least 2005, which resulted in accounting errors. The Governance Committee concluded that certain members of management bear varying degrees of responsibility for the deficiencies in the process by which options were granted. The Governance Committee's review also concluded that none of the current or former employees or directors of the Company engaged in intentional wrongdoing.



**Restatement and Impact on Financial Statements**

The following table presents the decrease in net income, by year, as a result of restating for the results of the China sales investigation and the historical stock option accounting review:

Year ended December 31,	Net income (loss), as previously reported	Restatement adjustments		Total	Net income (loss), as restated
		China Sales (Decrease)	Stock Options (in thousands) Increase		
1998		\$	\$ (796 )	\$ (796 )	
1999					
2000		(4,781 )	(452 )	(5,233 )	
2001		(5,779 )	(3,928 )	(9,707 )	
2002	\$ 107,862	(19,697 )	(6,560 )	(26,257 )	\$ 81,605
2003	\$ 209,856	(6,382 )	(11,089 )	(17,471 )	\$ 192,385
Totals through December 31,					
2003		(36,639 )	(22,825 )	(59,464 )	
2004	\$ 69,824	(18,594 )	(381 )	(18,975 )	\$ 50,849
2005	\$ (487,359 )	(42,433 )	(2,853 )	(45,286 )	\$ (532,645 )
2000 - 2005 Total		(97,666 )	(26,059 )	(123,725 )	
<u>2006 quarter ended</u>					
March 31	\$ (10,635 )	1,360	(671 )	689	\$ (9,946 )

The cumulative effect of the restatements at December 31, 2003 was an increase to additional paid-in capital and deferred stock-based compensation of \$26.0 million from \$646.7 million to \$672.7 million, and a decrease in retained earnings of \$59.5 million from \$237.4 million to \$177.9 million, and a decrease in total stockholders' equity of \$33.5 million from \$887.7 million to \$854.2 million.

**Other Changes**

In restating the previously issued financial statements for the investigations discussed above, the Company also corrected other previously reported amounts. It corrected the reporting of \$8.7 million of net sales to certain third party resellers and \$1.8 million of associated cost of net sales for the three months ended March 31, 2006 to classify these amounts as related party net sales and related party cost of net sales classifications, respectively, because in 2006 the Company determined that sales to these entities were, in substance, sales to a significant shareholder, SOFTBANK CORP. The classification of the accounts receivable from these sales was similarly changed to include them in accounts receivable from related parties in the March 31, 2006 consolidated balance sheet. The Company also corrected our reporting of \$6.2 million of time deposits at March 31, 2006 because they did not mature within three months. Formerly the time deposits had been reported in error as cash equivalents, but now these amounts are included in short-term investments in the balance sheet and in the statement of cash flows for the March 2006 reporting period.

**Restated Financial Information**

The following tables summarize the impact of the restatement adjustments on the condensed consolidated statement of operations for the three months ended March 31, 2006 and the condensed consolidated statement of cash flows for the three months ended March 31, 2006:

**UTSTARCOM, INC.****CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)****(In thousands, except per share data)**

	<b>Three months ended March 31, 2006</b>		
	<b>As previously reported</b>	<b>Adjustments</b>	<b>As restated</b>
<b>Net sales</b>			
Unrelated party	\$ 560,361	\$ (3,324 )	\$ 557,037
Related party	36,210	8,734	44,944
	596,571	5,410	601,981
<b>Cost of net sales</b>			
Unrelated party	459,381	2,204	461,585
Related party	14,736	1,869	16,605
Gross profit	122,454	1,337	123,791
<b>Operating expenses:</b>			
Selling, general and administrative	83,172	555	83,727
Research and development	46,309	93	46,402
Amortization of intangible assets	4,925		4,925
Total operating expenses	134,406	648	135,054
<b>Operating loss</b>	(11,952 )	689	(11,263 )
<b>Interest income</b>	3,532		3,532
<b>Interest expense</b>	(3,500 )		(3,500 )
<b>Other income, net</b>	3,568		3,568
<b>Loss before income taxes and minority interest</b>	(8,352 )	689	(7,663 )
<b>Income tax expense</b>	(2,839 )		(2,839 )
<b>Minority interest in losses of consolidated subsidiaries</b>	556		556
<b>Net loss</b>	\$ (10,635 )	\$ 689	\$ (9,946 )
<b>Loss per share - Basic</b>	\$ (0.09 )	\$ 0.01	\$ (0.08 )
<b>Loss per share - Diluted</b>	\$ (0.09 )	\$ 0.01	\$ (0.08 )

## UTSTARCOM, INC.

## CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(in thousands)

	Three Months Ended March 31, 2006		
	As previously reported	Adjustments	As restated
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net loss	\$ (10,635 )	\$ 689	\$ (9,946 )
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:			
Depreciation and amortization	17,476		17,476
Loss on sale of assets	4,708		4,708
Stock-based compensation expense	1,769	656	2,425
Provision for doubtful accounts	892		892
Provision for deferred costs	795		795
Other	(578 )		(578 )
Changes in operating assets and liabilities:			
Accounts receivable	28,787		28,787
Inventories	(4,337 )		(4,337 )
Deferred costs	(810 )	4,058	3,248
Other assets	(6,771 )		(6,771 )
Accounts payable	18,077		18,077
Income taxes payable	(2,020 )		(2,020 )
Customer advances	43,097		43,097
Deferred revenue	14,207	(5,418 )	8,789
Other current liabilities	(50,985 )	15	(50,970 )
Net cash provided by operating activities	53,672		53,672
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Additions to property, plant and equipment	(3,162 )		(3,162 )
Sale of business	19,965		19,965
Change in restricted cash and long-term investments	(17,037 )		(17,037 )
Purchase of short-term investments	(10,819 )	(6,222 )	(17,041 )
Proceeds from sale of short-term investments	13,309		13,309
Other	499		499
Net cash provided by (used in) investing activities	2,755	(6,222 )	(3,467 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Proceeds from borrowings	62,370		62,370
Payments on borrowings	(89,948 )		(89,948 )
Other	(3,184 )		(3,184 )
Net cash used in financing activities	(30,762 )		(30,762 )
Effect of exchange rate changes on cash and cash equivalents	2,389	(15 )	2,374
Net increase in cash and cash equivalents	28,054	(6,237 )	21,817
Cash and cash equivalents at beginning of period	645,571		645,571
Cash and cash equivalents at end of period	\$ 673,625	\$ (6,237 )	\$ 667,388
<b>Supplemental disclosure of cash flow information:</b>			
Cash paid:			
Interest	\$ 2,511		\$ 2,511
Income taxes	\$ 3,801		\$ 3,801
Non-cash operating activities			
Accounts receivable transferred to notes receivable	\$ 8,977		\$ 8,977



**NOTE 3 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES***Use of Estimates*

The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are used for revenue recognition, allowance for doubtful accounts and sales returns, tax valuation allowances, reserves for inventory, deferred costs, accrued product warranty costs, provisions for contract losses, goodwill and other long-lived asset impairments, stock-based compensation, loss contingencies and restructuring expenses among others. Actual results could differ from those estimates.

*Revenue Recognition*

Revenues from sales of telecommunications equipment and handsets are recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable and collectibility is probable. If the payment due from the customer is not fixed or determinable due to extended payment terms, revenue is recognized as payments become due and payable by the customer, assuming all other criteria for revenue recognition are met. Any payments received prior to revenue recognition are recorded as customer advances. Normal payment terms differ for various reasons amongst different customer regions, depending upon common business practices for customers within a region. Billing to customers for shipping and handling are recorded as revenues and the associated costs are recorded as costs of revenues. Any expected losses on contracts are recognized when identified on an individual basis in accordance with the prevailing accounting guidance for the respective contract.

Sales may be generated from complex contractual arrangements that require significant revenue recognition judgments, particularly in the area of contracts with multiple deliverable elements (multiple element arrangements). Where multiple elements exist in an arrangement, the contract price is allocated to the different elements based upon and in proportion to verifiable objective evidence of the fair value of the various elements, as governed under Emerging Issues Task Force Issue ( EITF ) No. 00-21, Accounting for Revenue Arrangements with Multiple Deliverables and SEC Staff Accounting Bulletin No. 104 Revenue Recognition. Multiple element arrangements primarily involve the sale of equipment, installation, training and post-contract support. Revenue is recognized as each element is earned, namely upon installation and acceptance of equipment or delivery of handsets, provided that the fair value of the undelivered element(s) has been determined, the delivered element(s) has stand-alone value, there is no right of return on delivered element(s), and the Company is in control of the undelivered element(s). For arrangements that include service elements, including promotional support and installation, for which verifiable objective evidence of the fair value does not exist, revenue is deferred until such services are deemed complete, or until the time the Company can establish verifiable objective evidence of the fair value.

Final acceptance is required for revenue recognition when installation services are not considered perfunctory. Final acceptance indicates that the customer has fully accepted delivery of equipment and the Company is entitled to the full payment. The Company does not recognize revenue before final acceptance is granted by the customer if acceptance is considered substantive to the transaction.

Where multiple elements exist in an arrangement that includes software, and the software is considered more than incidental to the equipment or services in the arrangement, software and software related elements are recognized under the provisions of Statement of Position 97-2 Software Revenue Recognition, as amended, and EITF No. 03-05, Applicability of SOP 97-2 to Non-Software Deliverables Containing More Than Incidental Software. The Company allocates revenues to each element of software arrangements based on vendor specific objective evidence ( VSOE ) of fair value. VSOE of fair value of each element is based on the price charged when the same element is sold separately. The Company uses the residual method to recognize revenue when an arrangement includes one or more elements to be delivered at a future date and VSOE of the fair value of all the undelivered elements exists. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the contract price is recognized as revenue when all other revenue recognition criteria are met. If VSOE of fair value of one or more undelivered elements does not exist, all revenue for delivered and undelivered elements is deferred until delivery of all elements occurs or when VSOE of fair value of the undelivered elements can be established. In some cases the Company has agreed to give software upgrade rights on a when and if made available basis for equipment sold for no additional consideration and for an unspecified period which could extend over the term of the contract. This additional contract obligation is an element of post contract support. The Company has not established VSOE for such contract element. Accordingly, the revenues from such contracts are recognized ratably over the period during which the post contract support is



expected to be provided. The expected period of support is generally the term of the contract. In some cases where there is no stated contractual term, revenue is recognized ratably over the estimated period of support. The Company reviews assumptions regarding the estimated post contract support periods on a regular basis. If the Company determines that it is necessary to revise the Company's estimates of the support periods, the amount of revenue recognized over the life of the contract would not be affected. However, to the extent the new assumptions regarding the post contract support periods were different than original assumptions, the contract revenues would be recognized over the remaining expected period of support.

Contract accounting is utilized for contracts that include a requirement for significant software modification or customization; when utilized the Company generally accounts for such contracts using the completed contract method of accounting, whereby no revenue is recognized prior to the completion of the project, because for contracts involving unique requirements the Company is unable to make reasonably dependable estimates of its progress towards meeting contractual requirements. In the event estimated total project costs exceed estimated total project revenues, the entire estimated loss is charged to operations in the period in which the loss becomes probable and can be reasonably estimated. The complexity of the estimation process and judgments about internal and external factors including labor utilization, changes to specifications and testing requirements, time required for performance and resulting incurrence of contract penalties, and the performance of subcontractors affect the estimation process.

The Company recognizes revenue for system integration, installation and training upon completion of performance and if all other revenue recognition criteria are met. Other service revenue, principally related to maintenance and support contracts, is recognized ratably over the maintenance term. Revenues from services were less than 10% of revenues for all periods present.

The Company also sells products through resellers. Revenue is generally recognized when the standard price protection period, which ranges from 30 to 90 days, has lapsed. If collectibility cannot be reasonably assured in a reseller arrangement, revenue is recognized upon sell through to the end customer and receipt of cash. There may be additional obligations in reseller arrangements such as inventory rotation, or stock exchange rights on the product. As such, revenue is recognized in accordance with Statement of Financial Accounting Standards (SFAS) No. 48, Revenue Recognition When Right of Return Exists. In most cases, the Company has developed reasonable estimates for stock exchanges based on historical experience with similar types of sales of similar products.

The Company has sales agreements with certain wireless customers that provide for a rebate of the selling price to such customers if the particular product is subsequently sold at a lower price to such customers or to a different customer. The rebate period extends for a relatively short period of time. Historically, the amounts of such rebates paid to customers have not been material. The Company estimates the amount of the rebate based upon the terms of each individual arrangement, historical experience and future expectations of price reductions and then records its estimate of the rebate amount at the time of the sale. The Company also enters into sales incentive programs, such as co-marketing arrangements, with certain wireless and handset customers. The Company records the incurred incentive as a reduction of revenue when the sales revenue is recognized.

The assessment of collectibility is also a factor in determining whether revenue should be recognized. The Company assesses collectibility based on a number of factors, including payment history and the credit-worthiness of the customer. The Company does not request collateral from its customers. In international sales, the Company may require letters of credit from its customers that can be drawn on demand if the customer defaults on its payment. If the Company determines that collection of a payment is not reasonably assured, the Company defers revenue recognition until collection becomes reasonably assured, which is generally upon receipt of cash.

Occasionally, the Company enters into revenue sharing arrangements. Under these arrangements, the Company collects payment only after its customer, the telecommunications service provider, collects service revenues. When the Company enters a revenue sharing arrangement, the Company does not recognize revenue until collection is reasonably assured.

Because of the nature of doing business in China and other emerging markets, the Company's billings and/or customer payments may not correlate with the contractual payment terms and the Company generally does not enforce contractual payment terms prior to final acceptance. Accordingly, accounts receivable are not recorded until the Company recognizes the related customer revenue. Advances from customers are recognized when the Company has collected cash from the customer, prior to recognizing revenue. The Company had current deferred revenue of \$96.9 million and \$95.7 million, and long-term deferred revenue of \$251.4 million and \$261.0 million, at March 31, 2007 and December 31, 2006, respectively.

### *Inventories*

Inventories consist of product held at the Company's manufacturing facility and warehouses, as well as finished goods at customer sites for which the customer has taken possession, but based on specific contractual terms, title has not yet passed to the customer. The Company may ship inventory to existing customers that require additional equipment to expand their existing networks prior to the signing of an expansion contract. Inventories are stated at the lower of cost or market value, net of write-downs for excess, slow moving and obsolete inventory. With the exception of the handset inventory for our Personal Communications Division (PCD), which is based on weighted average cost, inventory cost is computed using standard cost, which approximates actual cost on a first-in, first-out basis. Inventory is written down for estimated obsolescence or unmarketable inventory equal to the difference between inventory cost and the estimated market value.

### *Deferred costs*

Deferred costs consist of product shipped to the customer for which the rights and obligations of ownership have passed to the customer but revenue has not yet been recognized. All deferred costs are stated at cost. Management periodically assesses the recoverability of deferred costs and provides reserves against deferred cost balances when recovery of deferred costs is not probable. Recoverability is evaluated based on various factors including the length of time the product has been held at the customer site, the viability of payment, including assessment of product demand if a revenue sharing arrangement exists and/or the evaluation if a related transaction will result in a gross margin loss. In a loss situation for a transaction, the deferred cost balance is adjusted for an impairment equal to the value of the excess of cost over the amount of revenue that will be eventually recognized for the transaction. Revenue and cost of sales are recorded when final acceptance is received from the customer. With greater concentration of product at customer sites with specific or individual customer, the financial conditions of any specific or individual customer may result in increased concentration risk exposure for the Company's inventory.

For any post contract support services where the revenue is deferred, the entire related deferred direct costs are classified as a noncurrent asset, consistent with the definition of a current asset per Accounting Research Bulletin No. 43, Working Capital: Current Assets and Current Liabilities.

### *Stock-Based Compensation*

Prior to January 1, 2006, the Company accounted for share-based payment awards under Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees (APB 25), and provided the required pro forma disclosures under SFAS No. 123, Accounting for Stock-Based Compensation (SFAS 123). In accordance with APB 25, non-cash compensation expense was recognized for any options for which the exercise price was below the market price on the actual grant date, based on the difference between the exercise price and the market price. The expense was recognized ratably over the associated service period, which was generally the option vesting term.

On January 1, 2006, the Company adopted SFAS No. 123 (revised 2004), Share-Based Payment (SFAS 123(R)), using the modified prospective transition method. Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest. Stock-based compensation expense recognized in the consolidated statement of operations for the year ended December 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). The Company used the Black-Scholes option-pricing model (Black-Scholes model) method of valuation for share-based awards granted on or prior to December 31, 2005, and continues to use the Black-Scholes model for subsequent share-based payment awards. On November 10, 2005, the Financial Accounting Standards Board (FASB) issued FASB Staff Position No. FAS 123(R)-3, Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards. The Company adopted the alternative transition method provided in the FASB Staff Position for calculating the tax effects of stock-based compensation pursuant to SFAS 123(R). The alternative transition method includes simplified methods for establishing the beginning balance of the additional paid-in-capital pool (APIC pool) related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and consolidated statements of cash flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R). The Company accounts for utilization of windfall tax benefits based on tax law ordering and considered only the direct effects of stock-based compensation for purposes of measuring the windfall at settlement of an award.



*Income Taxes*

The Company accounts for income taxes under the liability method, and deferred income taxes are recognized for the differences between the tax bases of assets and liabilities and their financial statement amounts based on enacted tax rates. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. The Company is required to adjust its deferred tax asset and liabilities in the period when tax rates or the provisions of the income tax laws change.

In 2006, due to recent developments in its business, the Company determined that earnings from certain subsidiaries were not permanently reinvested outside the United States. The Company provides U.S. taxes on foreign undistributed earnings that are not considered to be permanently reinvested outside the United States. Under APB 23 Accounting for Income Taxes Special Areas, deferred income taxes must be provided on the unremitted earnings of foreign subsidiaries unless such earnings could be deemed to be permanently reinvested outside the United States. Prior to 2006, the Company had not provided for U.S. tax on any foreign unremitted earnings because the Company did not intend to repatriate such earnings.

As described in Note 21, effective January 1, 2007, the Company adopted FASB Interpretation No. 48 ( FIN 48 ), Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109.

**NOTE 4 - STOCK-BASED COMPENSATION**

The Company grants restricted stock awards to its employees under the 1997 and 2006 Plans. Such awards generally vest over a period of one to four years from the date of grant. The restricted stock awards have the voting rights of common stock and the shares underlying the restricted stock awards are considered issued and outstanding. On February 28, 2006, the Company granted rights to purchase 301,133 shares of restricted stock to executive officers of the Company which were allowed to lapse unexercised in March 2006. In their place, on February 1, 2007, the Compensation Committee of the Board of Directors of the Company ( the Committee ) determined that certain executive officers, based on their level of performance during the Company s 2006 fiscal year, were eligible to receive 203,000 shares of common stock in the aggregate ( the Performance Stock ). The Committee s determination is subject to compliance with applicable law, and the Committee will issue the Performance Stock after the Company is in compliance with all SEC reporting requirements. The Performance Stock is included in the Company s computation of stock-based compensation expense and was \$0.2 million for both of the three months ended March 31, 2007 and 2006.

In addition, on February 28, 2006, the Committee granted 602,267 performance options under the 1997 and 2006 Plans. On February 1, 2007, the Committee determined, based on each executive officer s level of performance during the Company s 2006 fiscal year, that 406,000 shares underlying the previously granted performance options were earned as of February 28, 2007. Each performance option has an exercise price of \$6.25 per share, which equals the closing price of the Company s common stock on the NASDAQ Stock Market on the date of grant, February 28, 2006. The 196,267 performance options not declared earned by the Committee were cancelled and returned to the Company. The performance options are included in the Company s computation of stock-based compensation expense and were \$0.5 million and \$0.2 million for the three months ended March 31, 2007 and 2006, respectively.

The total stock-based compensation cost recognized in the condensed consolidated statement of operations was as follows:

	<b>Three months ended March 31, 2007</b>	<b>2006 (As restated)</b>
	<b>(in thousands)</b>	
Stock-based compensation expense by type of award:		
Employee stock options and stock purchase plans	\$ 1,619	\$ 4,043
Restricted stock	1,136	775
Forfeitures related to disposal of a component of a business		(2,393)
Total	\$ 2,755	\$ 2,425

For additional information regarding the Company s stock-based compensation plans, see the Company s Annual Report on Form 10-K for the year ended December 31, 2006.



**NOTE 5 - LOSS PER SHARE**

Basic earnings per share ( EPS ) is computed by dividing net loss available to common stockholders by the weighted average number of shares of the Company's common stock outstanding during the period, which excludes unvested restricted shares. Diluted EPS presents the amount of net loss available to each share of common stock outstanding during the period plus each share of common stock that would have been outstanding assuming the Company had issued shares of common stock for all dilutive potential common shares outstanding during the period. The Company's potential common shares include employee stock options, unvested restricted shares, a written call option, warrants, convertible subordinated notes and vested acquisition-related stock options.

The following is a summary of the calculation of basic and diluted EPS:

	<b>Three months ended March 31, 2007</b>	<b>2006 (As restated)</b>
	<b>(in thousands except per share data)</b>	
<b>Numerator:</b>		
Net loss for basic EPS computation	\$ (53,982 )	\$ (9,946 )
Effect of dilutive securities - convertible subordinated notes		
Net loss adjusted for dilutive securities	\$ (53,982 )	\$ (9,946 )
<b>Denominator:</b>		
Shares used to compute basic EPS	120,900	120,600
Dilutive common stock equivalent shares		
Shares used to compute diluted EPS	120,900	120,600
Loss per share - basic and diluted	\$ (0.45 )	\$ (0.08 )

For the three months ended March 31, 2007 and 2006, no potential common shares were dilutive because of the net loss in each of these periods, and basic and dilutive EPS are the same. The following table summarizes the total potential shares of common stock that were excluded from the diluted per share calculation, because to include them would have been anti-dilutive for the period.

	<b>Three months ended March 31, 2007</b>	<b>2006 (As restated)</b>
	<b>(in thousands)</b>	
Stock options	19,344	22,848
Conversion of convertible subordinated notes	11,543	11,543
Unvested restricted shares	635	582
	31,522	34,973

**NOTE 6 - COMPREHENSIVE LOSS**

The reconciliation of net loss to comprehensive loss for the three months ended March 31, 2007 and 2006 is as follows:

	<b>Three months ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	<b>(As restated)</b>
Net loss	\$ (53,982 )	\$ (9,946 )
Unrealized gain (loss) on investments	(3,869 )	23
Foreign currency translation	4,666	1,764
Total comprehensive loss	\$ (53,185 )	\$ (8,159 )

**NOTE 7 - CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS**

Cash and cash equivalents consist of instruments with maturities of three months or less at the date of purchase. There were no available-for-sale securities included in cash and cash equivalents at March 31, 2007 or December 31, 2006. Short-term investments, consisting entirely of available-for-sale securities, were \$14.8 million and \$9.5 million at March 31, 2007 and December 31, 2006, respectively. The available-for-sale securities currently consist of bank time deposits, but can consist of government-backed notes, commercial paper, floating rate corporate bonds and fixed income corporate bonds. These investments are recorded at fair value. Any unrealized holding gains or losses are reported as a component of other comprehensive income. Realized gains and losses are reported in earnings.

The Company accepts bank notes receivable with maturity dates of between three and six months from its customers in China in the normal course of business. The Company may discount these bank notes with banking institutions in China. A sale of these notes is reflected as a reduction of cash and cash equivalents or short-term investments and the proceeds of the settlement of these notes are included in cash flows from operating activities in the consolidated statement of cash flows. There were no bank notes sold during the three months ended March 31, 2007 and 2006.

**NOTE 8 - RESTRICTED CASH AND INVESTMENTS**

At March 31, 2007 the Company had short-term restricted cash and investments of \$5.6 million and long-term restricted cash of \$17.2 million included in other long-term assets. At December 31, 2006 the Company had short-term restricted cash and investments of \$16.7 million and long-term restricted cash of \$16.5 million included in other long-term assets. These amounts primarily collateralize the Company's issuances of standby and commercial letters of credit.

**NOTE 9 - ACCOUNTS AND NOTES RECEIVABLE**

The Company accepts bank notes and commercial notes receivable from its customers in China in the normal course of business. The notes are typically non-interest bearing, with maturity dates between three and six months. Bank notes are included in short-term investments. Commercial notes receivable available for sale were \$6.2 million and \$5.1 million at March 31, 2007 and December 31, 2006, respectively. The Company may discount these notes with banking institutions in China. A sale of these notes is reflected as a reduction of notes receivable and the proceeds of the settlement of these notes are included in cash flows from operating activities in the consolidated statement of cash flows. Any notes that have been sold are not included in the Company's consolidated balance sheets as the criteria for sale treatment established by SFAS No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities* (SFAS 140), have been met. Under SFAS 140, upon a transfer, the transferor or entity must de-recognize financial assets when control has been surrendered and the transferee obtains control over the assets. In addition, the transferred assets have been isolated from the transferor, beyond the reach of its creditors, and the transferee has the right, without conditions or constraints, to pledge or exchange the assets it has received. There were no notes receivable sold during the three months ended March 31, 2007 and 2006.

In August 2005, the Company entered into a Committed Receivables Purchase Agreement (Agreement) with a commercial bank, whereby the Company may sell up to \$100.0 million of its eligible accounts receivable, as defined in the Agreement. The Agreement contains provisions customary in transactions of this nature including certain commitment fees. During the three months ended March 31, 2007, no receivables have been sold pursuant to provisions of the Agreement, and the Company recorded commitment fees of \$0.1 million. In March 2007, the Agreement was amended and restated to reflect that the purchase of trade receivables shall be at the sole discretion of the commercial bank, with no associated commitment fees.



**NOTE 10 - INVENTORIES**

As of March 31, 2007 and December 31, 2006, total inventories consisted of the following:

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
	<b>(in thousands)</b>	
Raw materials	\$ 60,375	\$ 72,230
Work-in-process	48,613	43,542
Finished goods	334,008	324,673
Total Inventories	\$ 442,996	\$ 440,445

**NOTE 11 - GOODWILL AND INTANGIBLE ASSETS**

As of March 31, 2007 and December 31, 2006, goodwill was \$3.1 million, the entire amount of which was allocated to the services operating segment. As of March 31, 2007 and December 31, 2006, intangible assets consisted of the following:

	<b>March 31, 2007</b>			<b>December 31, 2006</b>		
	<b>(in thousands)</b>					
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Amount</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Amount</b>
Amortized intangible assets:						
Existing technology	\$ 39,530	\$ (29,329 )	\$ 10,201	\$ 39,530	\$ (27,824 )	\$ 11,706
Customer relationships	57,220	(20,077 )	37,143	57,220	(18,544 )	38,676
Trade names	4,940	(4,162 )	778	4,940	(3,829 )	1,111
Non-compete agreement	10,800	(6,525 )	4,275	10,800	(5,850 )	4,950
	\$ 112,490	\$ (60,093 )	\$ 52,397	\$ 112,490	\$ (56,047 )	\$ 56,443

Amortization expense was \$4.0 million and \$4.9 million for the three months ended March 31, 2007 and 2006, respectively. The estimated aggregate amortization expense for intangibles for the remainder of 2007 and each of the next four years and thereafter is as follows:

	<b>March 31, 2007</b>
	<b>(in thousands)</b>
Remainder of 2007	\$ 11,915
2008	12,745
2009	6,874
2010	5,132
2011	5,132
Thereafter	10,599
	\$ 52,397

**NOTE 12 - LONG-TERM INVESTMENTS**

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
	<b>(in thousands)</b>	
Gemdale	\$ 29,061	\$ 32,781
Global Asia Partners L.P.	1,700	1,700
Fiberxon Ltd.	3,000	3,000
ImmenStar		2,000
Cortina	3,013	
GCT SemiConductor	3,000	3,000
Xalted Networks	3,302	3,302
Infinera	1,902	1,902
Others	109	124
Total	\$ 45,087	\$ 47,809

*Gemdale*

The negotiable Gemdale shares are traded on the Shanghai Stock Exchange. The 13.8 million negotiable shares are subject to a transfer restriction through August 2007. As of March 31, 2007 the Company had a 2% ownership interest in Gemdale. The investment is classified as equity securities available-for-sale and recorded at fair value. An unrealized gain on the investment and related receivable totaling \$27.8 million was recorded in accumulated other comprehensive income as of March 31, 2007.

*Cortina Systems / ImmenStar*

In September 2004, the Company invested \$2.0 million in Series A preferred stock of ImmenStar, Inc. ( ImmenStar ). ImmenStar is a development stage company that was designing a chip that can be used in the Company's product. This investment was accounted for under the cost method. In February 2007, ImmenStar was acquired by Cortina Systems, Inc., a privately owned company. In exchange for the Company's investment in ImmenStar, the Company received 3.6 million shares of Series D Preferred Stock of Cortina Systems, Inc., \$1.8 million cash in March 2007 and is entitled to receive an additional 0.4 million shares of Series D Preferred Stock and \$0.2 million cash currently in escrow. As a result of the acquisition, the Company recorded a gain on investment of \$2.8 million, in other income, net, and owns 1.3% interest of Cortina Systems, Inc. on a fully diluted basis. The Company accounts for its investment in Cortina Systems, Inc. using the cost method.

**NOTE 13 - DEBT**

The following represents the outstanding borrowings at March 31, 2007 and December 31, 2006:

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
	<b>(in thousands)</b>	
Bank loans	\$ 103,584	\$ 102,510
Capital lease obligations, at 4.7%-10.0%, due through 2011	753	809
Convertible subordinated notes, due March 1, 2008	274,600	274,600
Total Debt	\$ 378,937	\$ 377,919
Long-term debt	521	275,161
Short-term debt	\$ 378,416	\$ 102,758

At March 31, 2007, the Company had loans with various banks totaling \$103.6 million with interest rates ranging from 5.51 % to 5.57 % per annum. These bank loans that are denominated in Chinese Renminbi mature during 2007 and the first quarter of 2008 and are included in short-term debt. There are no significant covenants associated with these loans.

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The Company also had available credit facilities in China at March 31, 2007 totaling \$692.7 million, of which \$353.5 million was available for working capital purposes. The Company had drawn \$103.6 million in outstanding borrowings as of March 31, 2007, and \$339.2 million was available for use in support of letters of credit and corporate guarantees. These facilities expire primarily in 2007.

On March 12, 2003, the Company completed an offering of \$402.5 million of 7/8% convertible subordinated notes due March 1, 2008 to qualified buyers pursuant to Rule 144A under the Securities Act of 1933. The notes are convertible into the Company's common stock at a conversion price of \$23.79 per share and are subordinated to all present and future senior debt of the Company. Holders of the notes may convert their notes only if: (i) the price of the Company's common stock issuable upon conversion of a note reaches a specified threshold, (ii) specified corporate transactions occur, or (iii) the trading price for the notes falls below certain thresholds. At the initial conversion price, each \$1,000 principal amount of notes will be convertible into 42.0345 shares of common stock. Expenses associated with the convertible subordinated notes issuance were \$11.7 million and have been recorded in other long-term assets and are being amortized over the life of the notes.

The Company has entered into a convertible bond hedge and a call option transaction. The convertible bond hedge allows the Company to purchase 11.5 million shares of its common stock at \$23.79 per share from the other party to the agreement. The written call option allows the holder to purchase 11.5 million shares of the Company's common stock from the Company at \$32.025 per share. Both the bond hedge and call option transactions may be settled at the Company's option either in cash or net shares and expire on March 1, 2008.

The Company recorded these instruments at cost, and their carrying value at March 31, 2007 equaled their original cost as adjusted for amendments related to the early extinguishment of debt. The convertible bond hedge and call option transactions are expected to reduce the potential dilution from conversion of the notes. The options have been included in stockholders' equity in accordance with the guidance in EITF No. 00-19, Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock.

On November 15, 2006, the Company received a notice asserting that its failure to timely file its Quarterly Report on Form 10-Q for the period ended September 30, 2006 had caused a default under the provisions of the indenture governing the convertible subordinated notes, which if not cured within 60 days, would cause an event of default. The Company solicited and obtained the requisite consents from holders of the convertible subordinated notes due March 2008 to a waiver effective January 9, 2007 of any default which may have occurred prior to such date due to the delay in filing and non-compliance with certain covenants, and the Company and the Trustee entered into a First Supplemental Indenture, dated January 9, 2007, providing that any failure by the Company to comply with certain covenants of the original indenture would not result in a default or an event of default through May 31, 2007. The First Supplemental Indenture provided for additional interest at a rate of 6.75% per annum in special interest on the notes from and after January 9, 2007 to the March 1, 2008 maturity date of the notes, unless the notes are earlier repurchased or converted. Payments of the special interest were to be made in addition to and at the same time and in the same manner as regularly scheduled payments of interest to holders entitled to such regularly scheduled payments of interest. As a result of the First Supplemental Indenture, the convertible subordinated notes accrued interest at a rate of 7.625% per annum as of January 9, 2007. For information regarding the subsequent solicitation of consents from the holders of the notes and the related amendments to the indenture governing the notes, see Note 25 entitled "Subsequent Events" below.

### **NOTE 14 - WARRANTY OBLIGATIONS AND OTHER GUARANTEES**

The Company provides a warranty on its equipment and handset sales for a period generally ranging from one to three years from the time of final acceptance. Very rarely, the Company has entered into arrangements to provide limited warranty services for periods longer than three years. The longest of such warranty periods is ten years. The Company provides for the expected cost of product warranties at the time that revenue is recognized based on an assessment of past warranty experience.



Warranty obligations, included in other current liabilities, are as follows:

	<b>Three months ended March 31, 2007</b>	<b>2006 as restated</b>
	<b>(in thousands)</b>	
Beginning of period	\$ 63,900	\$ 76,719
Accruals for warranties issued during the period	3,297	8,949
Settlements made during the period	(9,886 )	(16,966 )
Balance at end of period	\$ 57,311	\$ 68,702

During 2005, the Company recorded a special warranty charge for equipment sold to Softbank during 2003 and 2004. Since the agreement to repair these parts exceeds the Company's normal warranty terms the Company recorded additional special warranty charges of \$11.7 million for certain asynchronous digital subscriber line ( ADSL ) products, \$4.0 million primarily for NetRing equipment and \$14.9 million for Gigabit Ethernet Passive Optical Network ( GEAPON ) equipment. The special warranty balance was \$15.2 million and \$20.9 million at March 31, 2007 and 2006, respectively, and is included in the above amounts. These products are in the Company's Broadband Infrastructure segment.

Certain of the Company's sales contracts include provisions under which customers would be indemnified by the Company in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to the Company's products. There are no limitations on the maximum potential future payments under these guarantees. The Company has not accrued any amount in relation to these provisions as no such claims have been made and the Company believes it has valid, enforceable rights to the intellectual property embedded in its products.

#### **NOTE 15 - COMMITMENTS AND CONTINGENCIES**

##### *Leases*

The Company leases certain facilities under non-cancelable operating leases that expire at various dates through 2013. The minimum future lease payments under the leases at March 31, 2007 were as follows:

	<b>March 31, 2007 (in thousands)</b>
1 year	\$ 14,189
2 year	9,917
3 year	6,686
4 year	1,624
5 year and after	1,447
Total minimum lease payments	\$ 33,863

Rent expense for the quarters ending March 31, 2007 and 2006 was \$4.8 million and \$5.6 million, respectively.

*Contractual obligations and commercial commitments:*

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As of March 31, 2007 the Company's obligations under contractual obligations and commercial commitments are as follows:

	Payments due by period			
	Total (in thousands)	Less than 1 year	1-3 years	3-5 years
Bank loans	\$ 103,584	\$ 103,584	\$	\$
Convertible subordinated notes	\$ 274,600	\$ 274,600	\$	\$
Interest payable on debt	\$ 26,166	\$ 26,166	\$	\$
Letters of credit	\$ 45,965	\$ 28,813	\$ 17,152	\$
Long-term purchase obligations	\$ 6,182	\$ 602	\$ 5,580	\$

### *Letters of credit*

The Company issues standby letters of credit primarily to support international sales activities outside of China. When the Company submits a bid for a sale, often the potential customer will require that the Company issue a bid bond or a standby letter of credit to demonstrate its commitment through the bid process. In addition, the Company may be required to issue standby letters of credit as guarantees for advance customer payments upon contract signing or performance guarantees. The standby letters of credit usually expire without being drawn by the beneficiary thereof. Finally, the Company may issue commercial letters of credit in support of purchase commitments.

### *Long-term purchase obligations*

At March 31, 2007, long-term purchase obligations include non-cancelable agreements to purchase components, primarily in connection with last time buy agreements. As of March 31, 2007, total commitments under these agreements were approximately \$6.2 million. Additionally, the Company has agreed to purchase global data services from Verizon Communications, Inc. ( *Verizon* ). At March 31, 2007, the remaining commitment to Verizon under this agreement is approximately \$0.9 million. In connection with the sale of assets to Marvell Technology Group Ltd. ( *Marvell* ), the Company has agreed to purchase from Marvell certain chipsets that will be included in the Company's Personal Access Service and IP-based Personal Access Service (collectively *PAS* ) handsets through 2011. These chipsets will be included in certain handset products designed and manufactured by the Company.

### *Intellectual property*

Certain sales contracts include provisions under which customers would be indemnified by the Company in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to the Company's products. There are no limitations on the maximum potential future payments under these guarantees. The Company has not accrued any amounts in relation to these provisions as no such claims have been made and the Company believes it has valid enforceable rights to the intellectual property embedded in its products.

### *Litigation*

#### *Securities Class Action Litigation*

Beginning in October 2004, several shareholder class actions alleging federal securities violations were filed against the Company and various officers and directors of the Company. The actions have been consolidated in United States District Court for the Northern District of California under the caption *In re UTStarcom, Inc. Securities Litigation*, Master File No. C-04-4908-JW(PVT). The lead plaintiffs in the case filed a First Amended Consolidated Complaint on July 26, 2005. The First Amended Complaint alleged violations of the Securities Exchange Act of 1934, and was brought on behalf of a putative class of shareholders who purchased our stock after April 16, 2003 and before September 20, 2004. On April 13, 2006, the lead plaintiffs filed a Second Amended Complaint adding new allegations and extending the end of the class period to October 6, 2005. In addition to the Company defendants, the plaintiffs are also suing Softbank. Plaintiffs' complaint seeks recovery of damages in an unspecified amount.

On June 2, 2006, the Company and the individual defendants filed a motion to dismiss the Second Amended Complaint. On March 21, 2007, the Court granted defendants' motion and dismissed plaintiffs' Second Amended Complaint. The Court granted plaintiffs leave to file a Third Amended Complaint, which plaintiffs filed on May 25, 2007. On July 13, 2007, the Company and the individual defendants filed a motion to dismiss and a motion to strike the Third Amended Complaint.

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On September 4, 2007, a second shareholder class action complaint captioned *Peter Rudolph v. UTStarcom, et al.*, Case No. C-07-4578 SI, was filed in the United States District Court for the Northern District of California against the

35

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Company and some of the Company's current and former directors and officers. The complaint alleges violations of the Securities Exchange Act of 1934 through undisclosed improper accounting practices concerning the Company's historical equity award grants. Plaintiff seeks unspecified damages on behalf of a purported class of purchasers of the Company's common stock between July 24, 2002 and September 4, 2007.

Due to the preliminary status of these lawsuits and uncertainties related to litigation, the Company is unable to evaluate the likelihood of either a favorable or unfavorable outcome. Accordingly, the Company is unable at this time to estimate the effects of these complaints on the Company's financial position, results of operations, or cash flows.

#### *Governmental Investigations*

The Company has received notice of a formal inquiry by the staff of the Securities & Exchange Commission (SEC) into certain aspects of the Company's financial disclosures during prior reporting periods and certain other issues. In addition, in December 2005, the U.S. Embassy in Mongolia informed the Company that it had forwarded to the Department of Justice (DOJ) allegations that an agent of the Company's Mongolia joint venture had offered payments to a Mongolian government official in possible violation of the Foreign Corrupt Practices Act (the FCPA). The Company through our Audit Committee, authorized an independent investigation into possible violations of the FCPA, and the Company has been in contact with the DOJ and SEC regarding the investigation. The investigation has identified possible FCPA violations in Mongolia, Southeast Asia, India, and China, as well as possible violations of U.S. immigration laws. The DOJ has requested that the Company voluntarily produce documents related to the investigation and the SEC has subpoenaed the Company for documents. The Company has executed tolling agreements extending the statute of limitations for the FCPA issues under investigation by the SEC and DOJ and the immigration issues under investigation by the DOJ. At this time, the Company cannot predict when any inquiry will be completed or what the outcome of any inquiry will be.

#### *Shareholder Litigation*

On November 17, 2006, a shareholder derivative complaint captioned *Ernesto Espinoza v. Ying Wu et al.*, Case No. RG06298775, was filed against certain of the Company's current and former officers and directors in the Superior Court of the County of Alameda, California. The complaint alleges that the individual defendants, among other things, breached their duties, were unjustly enriched, and violated the California Corporations Code in connection with the timing of stock option grants. The complaint names the Company as a nominal defendant and seeks unspecified monetary damages against the individual defendants and various forms of injunctive relief. On February 2, 2007, the Company and the individual defendants filed demurrers against the complaint. On April 11, 2007, the Court sustained the individual defendants' demurrer, overruled the Company's demurrer, ordered the plaintiff to file an amended complaint, and ordered the Company to answer the original complaint. The plaintiff filed an amended complaint and the Company has filed an answer to the amended complaint. On August 21, 2007, the individual defendants filed demurrers against the amended complaint. The Court sustained the individual defendants' demurrers and ordered the plaintiff to file a second amended complaint.

Due to the preliminary status of this complaint and uncertainties related to litigation, the Company is unable to evaluate the likelihood of either a favorable or unfavorable outcome. Accordingly, the Company is unable at this time to estimate the effects of this complaint on the Company's financial position, results of operations, or cash flows.

#### *IPO Allocation*

On October 31, 2001, a complaint was filed in United States District Court for the Southern District of New York against the Company, some of the Company's directors and officers and various underwriters for the Company's initial public offering. Substantially similar actions were filed concerning the initial public offerings for more than 300 different issuers, and the cases were coordinated as *In re Initial Public Offering Securities Litigation*, 21 MC 92 for pretrial purposes. In April 2002, a consolidated amended complaint was filed in the matter against the Company, captioned *In re UTStarcom, Initial Public Offering Securities Litigation*, Civil Action No. 01-CV-9604. Plaintiffs allege violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 through undisclosed improper underwriting practices concerning the allocation of IPO shares in exchange for excessive brokerage commissions, agreements to purchase shares at higher prices in the aftermarket and misleading analyst reports. Plaintiffs seek unspecified damages on behalf of a purported class of purchasers of the Company's common stock between March 2, 2000 and December 6, 2000. The Company's directors and officers have been dismissed without prejudice pursuant to a stipulation. On February 19, 2003, the Court granted in part and denied in part a motion to dismiss brought by defendants including the Company. The order dismissed all claims against the Company except for a claim brought under Section 11 of the Securities Act of 1933, which alleges that the registration statement filed in accordance with the IPO was misleading. In June 2004, a stipulation of settlement and release of claims against the issuer defendants, including the Company, was submitted to the court for approval. The terms of the settlement, if approved, would have dismissed and released



all claims against the participating defendants (including the Company). In August 2005, the Court preliminarily approved the settlement. In December 2006, the Court of Appeals for the Second Circuit reversed the Court's October 2004 order certifying a class in six test cases that were selected by the underwriter defendants and plaintiffs in the coordinated proceedings. The Company's case is not one of the test cases. Because class certification was a condition of the settlement, it was unlikely that the settlement would receive final Court approval. On June 25, 2007, the Court entered an order terminating the proposed settlement based on a stipulation among the parties to the settlement. Plaintiffs have filed amended master allegations and amended complaints in the six test cases. It is unclear whether there will be any revised or future settlement. If the litigation proceeds, the Company believes that the Company has meritorious defenses and intend to defend the action vigorously. The total amount of the loss associated with the above litigation is not determinable at this time. Therefore, the Company is unable to currently estimate the loss, if any, associated with the litigation.

#### *Passave Litigation*

In November 2005, the Company filed suit in the Superior Court of California, County of Santa Clara, against Passave, Inc. ( Passave ) for breaches of contract and warranties in connection with a semiconductor device sold by Passave, Ltd. (Passave's wholly-owned subsidiary) to the Company. The Company's complaint alleges that the Passave device, known as the PAS5001M3 chip, has exhibited certain operational malfunctions within some of our Fiber-to-the-Home product line, and has thereby caused damage to the Company. The parties entered into a settlement agreement, in favor of the Company dated August 7, 2007, and have since dismissed all claims with prejudice.

#### *UTStarcom, Inc. v. Starent Patent Infringement Litigations*

On February 16, 2005, the Company filed a suit against Starent for patent infringement in the U.S. District Court for the Northern District of California. In the Complaint, the Company asserts that Starent infringes UTStarcom patent U.S. Reg. No. 6,829,473 ( the 473 patent ) through Starent's development and testing of a software upgrade for its customer's installed ST-16 Intelligent Mobile Gateways. The Company seeks declaratory and injunctive relief. Starent subsequently filed its answer and counterclaims, denying the Company's allegations and seeking a declaration that the patent-in-suit is not infringed, is invalid, and is unenforceable. On June 16, 2005, the Company filed a motion to strike Starent's affirmative defense and dismiss Starent's counterclaim alleging inequitable conduct. On July 19, 2005, the parties stipulated that Starent would file an amended answer and counterclaim by July 27, 2005 and that the Company would withdraw the Company's motion to strike. On August 10, 2005, the Company responded to Starent's amended counterclaim filed on July 27, 2005. In early December 2006, the Company filed a reissue application for the 473 patent with the United States Patent and Trademark Office. Starent has also filed for reexamination of the 473 patent. The reexamination and reissue are currently pending. The litigation is still in a preliminary stage and its outcome cannot be predicted, although the Company believes the litigation has merit. Nonetheless, the Company believes that any adverse judgment on Starent's counterclaims will not have a material adverse effect on the Company's business, financial condition, or results of operations.

On May 8, 2007, the Company filed an additional suit against Starent and sixteen individual defendants (who were all former employees of 3Com's CommWorks division which the Company acquired certain assets of in May of 2003) in the Northern District of Illinois. The causes of action include claims for patent infringement, misappropriation of trade secrets, intentional interference with business relations and prospective economic advantage and declarations of ownership of certain patent rights. In its Complaint, the Company asserts that Starent infringes UTStarcom patents U. S. Reg. Nos. 7,173,905; 6,978,128; 6,963,582; 6,975,900; and 6,684,256 through the manufacture, use, offer, for sale, and sale of Starent's ST16 Intelligent Mobile Gateway and ST40 multimedia code platform, that the individual Defendants and Starent have misappropriated valuable Company trade secrets by improperly taking and using the Company's confidential and proprietary information for the benefit of Starent, that the individual defendants and Starent have interfered with the Company's business relations and prospective economic advantage by using the misappropriated information to obtain and enhance sales of Starent's products, and that several of Starent's patent applications and one issued patent are based on information obtained by the former employees while at the Company (CommWorks) and on that basis belong to UTStarcom. The Company seeks compensatory damages, punitive damages and injunctive relief. After the court denied the defendants motion to dismiss the misappropriation of trade secrets claims, on August 30, 2007, Starent answered the Company's complaint, denying the Company's allegations and asserting a number of affirmative defenses and counterclaims, including non-infringement of the subject patents and alleged tortious interference with prospective economic advantage. The Company has filed a motion to dismiss most of the counterclaims and the court has ordered appointment of a special master to handle discovery, which is just beginning. The Company believes that any adverse judgment on Starent's counterclaims will not have a material adverse effect on the Company's business, financial condition or results of operations.



*Telemetrix, Inc. Arbitration*

On October 19, 2006, Telemetrix, Inc. ( Telemetrix ) filed a formal Request for Arbitration against the Company to the World Intellectual Property Organization ( WIPO ) in Geneva, Switzerland. The Request for Arbitration sought unspecified damages arising from a contract between Telemetrix and Telos Technology, Inc., dated October 22, 2003. The Company assumed Telos rights and obligations under this contract pursuant to the Company s purchase of Telos assets on May 19, 2004. Telemetrix alleged nine causes of action, including breach of contract, fraud, negligent misrepresentation, interference with contractual relations, and interference with prospective economic advantage. In December 2006, the Company filed a formal response to the Request for Arbitration, denying all material factual allegations asserted by Telemetrix. An arbitrator was selected by the parties, and, on August 2, 2007, the arbitrator granted a pleading motion in favor of the Company due to Telemetrix s failure to allege sufficient facts in support of a majority of its causes of action. On August 17, 2007, Telemetrix filed an Amended Statement of Claim, alleging six causes of action, including breach of contract, fraud, interference with contractual relations and interference with prospective economic advantage. The previous hearing date of December 11-13 has been vacated. No hearing date has been rescheduled. Discovery has begun.

*Telos Technology, Inc. Litigation*

On November 22, 2005, plaintiffs Telos Technology, Inc., Telos Technology (Canada), Inc., Telos Technology (Bermuda) Ltd., and Telos Engineering Limited (collectively, the Telos Plaintiffs ) filed a Complaint against the Company in the Superior Court of California, County of Santa Clara. The Complaint alleges five causes of action, including breach of contract, breach of the implied covenant of good faith and fair dealing, fraudulent inducement, intentional misrepresentation and negligent misrepresentation, all of which arise from the Asset Purchase Agreement between the parties dated April 21, 2004. The Telos Plaintiffs assert that the Company breached the express and implied terms of the Asset Purchase Agreement and made representations to the Telos Plaintiffs during negotiations that it never intended to fulfill. The Telos Plaintiffs sought at least \$19 million in damages, unspecified punitive damages and attorneys fees. The parties executed a settlement agreement in the amount of \$4.5 million on August 20, 2007 and the case was dismissed on September 26, 2007 with prejudice.

*Other Litigation*

The Company is a party to other litigation matters and claims that are normal in the course of operations, and while the results of such litigation matters and claims cannot be predicted with certainty, the Company believes that the final outcome of such matters will not have a material adverse impact on the Company s financial position, results of operations or cash flows.

**NOTE 16 - SEGMENT REPORTING**

The Company has organized its business in a manner consistent with the chief operating decision makers view and management of the business. The Company offers products and services through four operating units, (i) Network Solutions, (ii) PCD, (iii) Handsets and (iv) Services. The Network Solutions operating unit provides its products and services through two reporting segments; Broadband Infrastructure and Wireless Infrastructure. Each reporting segment and operating unit is responsible for managing its own performance.

The Company currently evaluates operating performance of and allocates resources to the reporting segments based on segment gross profit. Cost of sales and direct expenses in relation to production are assigned to the reporting segments. The accounting policies used in measuring segment assets and operating performance are the same as those used by corporate and are consistently applied across all segments.

Summarized below are the Company s segment sales revenue and gross profit for the three months ended March 31, 2007 and 2006, respectively.



	Three months ended March 31,					
	2007	% of net sales	2006	(As restated)	% of net sales	
<i>(in thousands)</i>						
<b>Net Sales by Segment</b>						
Broadband Infrastructure	\$ 31,222	6 %	\$ 57,251		10 %	
Wireless Infrastructure	69,879	15 %	105,733		18 %	
Network Solutions	101,101	21 %	162,984		28 %	
PCD	288,330	61 %	322,995		54 %	
Handsets	69,719	15 %	99,034		16 %	
Services	16,752	3 %	16,968		2 %	
	\$ 475,902	100 %	\$ 601,981		100 %	

	Three months ended March 31,					
	2007	Gross profit %	2006	(As restated)	Gross profit %	
<i>(in thousands)</i>						
<b>Gross profit by Segment</b>						
Broadband Infrastructure	\$ 5,001	16 %	\$ 23,086		40 %	
Wireless Infrastructure	24,266	35 %	50,761		48 %	
Network Solutions	29,267	29 %	73,847		45 %	
PCD	16,845	6 %	14,389		4 %	
Handsets	25,048	36 %	31,613		32 %	
Services	4,125	25 %	3,942		23 %	
	\$ 75,285	16 %	\$ 123,791		21 %	

Assets by segment are as follows:

	March 31, 2007	December 31, 2006
<i>(in thousands)</i>		
<b>Long-lived assets</b>		
Broadband Infrastructure	\$ 42,554	\$ 43,157
Wireless Infrastructure	78,578	79,691
Network solutions	121,132	122,848
PCD	2,208	2,377
Handsets	42,987	43,596
Services	43,715	44,334
	\$ 210,042	\$ 213,155

	March 31, 2007 (in thousands)	December 31, 2006
<b>Total assets</b>		
Broadband Infrastructure	\$ 457,985	\$ 438,190
Wireless Infrastructure	838,072	909,450
Network solutions	1,296,057	1,347,640
PCD	354,221	414,295
Handsets	506,678	505,693
Services	90,404	106,322
	\$ 2,247,360	\$ 2,373,950

Net sales are attributed to a geographical area based upon the location of the customer. Sales data by geographical area are as follows:

	Three months ended March 31,				
	2007	% of net sales			
(in thousands)					
<b>Net Sales by region</b>					
United States	\$ 293,169	62 %		\$ 329,763	55 %
China	136,734	29 %		199,810	33 %
Japan	14,315	3 %		47,660	8 %
Other	31,684	6 %		24,748	4 %
Net sales	\$ 475,902	100 %		\$ 601,981	100 %

Long-lived assets, consisting of property, plant and equipment by geographical area are as follows:

	March 31, 2007 (in thousands)	December 31, 2006
<b>Long-lived assets by region</b>		
U.S.	\$ 14,161	\$ 14,354
China	188,593	191,517
Other	7,288	7,284
Total long-lived assets	\$ 210,042	\$ 213,155

#### NOTE 17 - TRANSACTIONS WITH RELATED PARTIES AND CERTAIN INVESTEEES

The following is a summary of the Company's transactions with related parties and certain investees:

	Three months ended March 31,	
	2007	2006 (As restated)
(in thousands)		
<b>Net sales</b>		
Softbank	\$ 11,535	\$ 43,027
Japan Telecom, Ltd	1,581	1,790
Total Softbank and affiliates	13,116	44,817
ORG, Inc.	212	127
Total	\$ 13,328	\$ 44,944



	Accounts receivable		Accounts payable	
	March 31, 2007	December 31, 2006	March 31, 2007	December 31, 2006
	(in thousands)			
Softbank and affiliates	\$ 24,451	\$ 29,941	\$ 591	\$ 535
MDC Holding, Ltd.	962	1,300		
Fiberxon, Ltd.	55	44	151	368
ORG, Inc.	2	1,025		
GCT Semiconductor, Inc.			339	1,051
Acoustek Int'l, Inc.			51	51
Cortina/Immenstar				345
Other	17	8	11	50
Total	\$ 25,487	\$ 32,318	\$ 1,143	\$ 2,400

	Purchases March 31, 2007	March 31, 2006 (As restated)
	(in thousands)	
Softbank and affiliates	\$ 484	\$
Fiberxon, Ltd.	1,803	1,661
GCT Semiconductor, Inc.	1,177	2,285
Cortina/Immenstar	13	2,017
Total	\$ 3,477	\$ 5,963

#### *Softbank and affiliates*

The Company recognized revenue with respect to sales of telecommunications equipment to affiliates of Softbank, a significant stockholder of the Company. Softbank offers ADSL coverage throughout Japan, which is marketed under the name YAHOO! BB. The Company supports Softbank's fiber-to-the-home service through sales of its carrier class GEAPON product as well as its multi-service optical transport product (NetRing™). In addition, the Company supports Softbank's new internet protocol television (IPTV), through sales of its RollingStream™ product. Included in revenue for the three months ended March 31, 2006 is a fee of \$17.0 million charged for the cancellation of orders for broadband products.

Sales to Softbank include a three year service period and a penalty clause if product failure rates exceed a certain level over a seven year period. As of March 31, 2007, the Company's customer advance balance related to Softbank agreements was \$0.5 million compared to no balance as of December 31, 2006. The current deferred revenue balance related to Softbank was \$9.3 million and \$11.6 million as of March 31, 2007 and December 31, 2006, respectively. As of March 31, 2007, the Company's noncurrent deferred revenue balance related to Softbank was \$11.7 million compared to \$11.5 million as of December 31, 2006.

During August 2004, the Company entered into several agreements with Japan Telecom Co., Ltd (JT), a wholly owned subsidiary of Softbank. These agreements relate to the sale of iAN-8000 equipment with specified value and delivery dates, as well as an oral agreement which subsequently converted into specific service contracts to manage a sales promotional program for JT. The Company has determined that the service activities revenue should be recorded net of expected promotional spending.

On July 17, 2003, the Company entered into a Mezzanine Loan Agreement with BB Modem Rental PLC (BB Modem), an affiliate of Softbank. Under the terms of the agreement, the Company loaned BB Modem \$10.1 million at an effective interest rate of 12.01% per annum, for the purpose of investing in a portfolio of ADSL modems and associated modem rental agreements, from Softbank. Softbank will continue to service such modems and modem rental agreements. The Company's loan was subordinated to certain senior lenders of BB Modem, and repayments were paid to the Company over a 42-month period through January 31, 2007, with a substantial portion of the principal amount of the loan schedule repaid during the last 16 months of this period. During the three months ended March 31, 2007 and 2006, the Company recorded an immaterial



amount and \$0.2 million, respectively, in interest income with respect to this loan. The loan receivable was fully settled at March 31, 2007 compared to a balance of approximately \$1.0 million as of December 31, 2006 which was included in prepaid and other current assets.

As of March 31, 2007, Softbank beneficially owned approximately 12% of the Company's outstanding stock.

*ORG, Inc.*

As of March 31, 2007, the Company has a 49% ownership in Global Asia Partners L.P. which in turn is a significant shareholder in ORG, Inc., a reseller of infrastructure equipment for broadband access. In January 2005, the Company entered into a reseller agreement with ORG, Inc., which was terminated in August 2006; however an immaterial amount of revenue for pre-August 2006 deliveries was recognized in the three months ended March 31, 2007.

*MDC Holding, Ltd.*

The Company has an outstanding accounts receivable balance with MDC Holding, Ltd. ( MDC ) related to a PAS system purchase. Certain employees of the Company were shareholders of MDC as of March 31, 2007. MDC is in the business of providing value-added services, such as short message, voicemail or ring-tone services for PAS telecom networks.

*Fiberxon, Ltd.*

The Company has an outstanding purchase commitment of an immaterial amount with Fiberxon, Ltd., in which the Company has a 7% ownership interest, to purchase component parts for optical networking products. The Company paid \$0.1 million to Fiberxon, Ltd. for each of the three months ended March 31, 2007 and 2006.

*GCT Semiconductor, Inc.*

The Company has a 2% ownership interest in GCT Semiconductor, Inc., which designs, develops and markets integrated cost circuit products for the wireless communications industry.

*Acoustek International, Inc.*

The Company has obtained consulting services from Acoustek International Inc. ( Acoustek ), which employed Minnie Huang, spouse of William Huang, the Company's former Senior Vice President and Chief Technology Officer. Mr. Huang's employment with the Company terminated on December 31, 2006. The Company made no payments during the three months ended March 31, 2007 compared to \$0.1 million for the same period in 2006 to Acoustek for consulting services.

*Cortina / Immenstar*

The Company has an outstanding purchase commitment of approximately \$1.8 million with Cortina Systems, Inc. in which the Company has a 1.3% ownership interest on a fully diluted basis, to purchase chips that are used in the Company's product

*Xalted Networks, Inc.*

The Company has received purchase orders from Xalted Networks ( Xalted ) totaling approximately \$1.3 million in 2005 for telecommunications equipment that is for product not typically sold by the Company to other customers. The Company is charging a ten percent procurement fee to Xalted for obtaining and reselling these products. The equipment was delivered during 2005 but revenue has not been recognized as the revenue recognition process had not been completed. As of March 31, 2007, the Company's customer advance balance related to Xalted was \$1.3 million compared to no balance as of December 31, 2006.

**NOTE 18 - RESTRUCTURING COSTS**

As of March 31, 2007 and December 31, 2006, the restructuring accrual, included within accrued liabilities in the condensed consolidated balance sheet, was approximately \$70,000 and \$122,000, respectively. The balance of the liability relates to non-cancelable lease payments for the New Jersey facility. The Company expects the remaining accrual to be paid by the third quarter of 2007.



**NOTE 19 - OTHER INCOME**

Net other income was \$4.0 million and \$3.6 million for the three months ended March 31, 2007 and 2006, respectively. The balances were comprised of the following:

	<b>Three months ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
Foreign exchange gains	\$ 1,058	\$ 2,814
Gain on sale of Immenstar investment	2,813	
Chinese government financial subsidy	354	536
Other	(255 )	218
<b>Total</b>	<b>\$ 3,970</b>	<b>\$ 3,568</b>

**NOTE 20 - CREDIT RISK AND CONCENTRATION**

The table below outlines the Company's sales to, and the accounts receivable balances from its largest customers:

	<b>For the three</b>			
	<b>months ended</b>		<b>March 31,</b>	
	<b>March 31,</b>		<b>March 31,</b>	
	<b>% of net</b>		<b>% of</b>	
	<b>sales</b>		<b>accounts</b>	
	<b>receivable</b>		<b>receivable</b>	
<b>2007</b>				
Verizon Wireless	15	%	1	%
T-Mobile USA, Inc.	13	%	13	%
Sprint Spectrum	11	%	5	%
<b>2006</b>				
Verizon Wireless	16	%	1	%
Sprint Spectrum	13	%	7	%

Approximately 18% and 33% of the Company's net sales during the three months ended March 31, 2007 and 2006, respectively, were to entities affiliated with the government of China. Accounts receivable balances from these China government affiliated entities or state owned enterprises were \$202.7 million and \$170.4 million, respectively, as of March 31, 2007 and December 31, 2006. The Company extends credit to its customers in China generally without requiring collateral. In global sales outside of China, the Company often requires letters of credit from its customers. The Company monitors its exposure for credit losses and maintains allowances for doubtful accounts.

Approximately 27% and 33% of the Company's sales for the three months ended March 31, 2007 and 2006, respectively, were made in China. Accordingly, the political, economic and legal environment, as well as the general state of China's economy may influence the Company's business, financial condition and results of operations. The Company's operations in China are subject to special considerations and significant risks not typically associated with companies in the United States. These include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company's results may be adversely affected by, among other things, changes in the political, economic and social conditions in China, and by changes in governmental policies with respect to laws and regulations, changes in China's telecommunications industry and regulatory rules and policies, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation.

**NOTE 21 - INCOME TAX ASSETS AND LIABILITIES**

In June 2006, the FASB issued FIN 48. The interpretation contains a two-step approach to recognizing and measuring uncertain tax positions accounted for in accordance with SFAS No. 109, Accounting for Income Taxes. The first step is to evaluate the tax position for recognition by determining if the weight of available evidence indicates that it is more likely



than not that the position will be sustained on audit, including resolution of related appeals or litigation processes, if any. The second step is to measure the tax benefit as the largest amount which is more than 50% likely of being realized upon ultimate settlement.

The Company adopted the provisions of FIN 48 effective January 1, 2007. As a result of the adoption of FIN 48, the Company recognized a \$1.4 million increase in the liability for unrecognized tax benefits which, as required, was accounted for as a reduction to the January 1, 2007 balance of retained earnings. As of January 1, 2007, the Company had \$69.9 million of liabilities for unrecognized tax benefits. If recognized, the portion of liabilities for unrecognized tax benefits that would decrease the provision for income taxes and increase the Company's net income is \$6.4 million. The impact on net income reflects the liabilities for unrecognized tax benefits net of certain deferred tax assets and the federal benefit of state income tax items totaling \$63.5 million. The adoption resulted in a reclassification of tax liabilities totaling \$6.4 million from current to non-current. As of March 31, 2007, the Company's liabilities for unrecognized tax benefits totaled \$71.9 million and are included in other long-term liabilities, net of non-current deferred tax assets and the federal tax benefit of state income tax items. If recognized, the portion of liabilities for unrecognized tax benefits that would decrease the provision for income taxes and increase the Company's net income is \$6.7 million. The total liabilities for unrecognized tax benefits, and increases for the current period of these liabilities, relate primarily to the allocations of revenue and costs among our global operations.

The Company recognizes interest expense and penalties related to the above unrecognized tax benefits within income tax expense. The Company had accrued interest and penalties of approximately \$2.2 million as of January 1, 2007 and approximately \$2.4 million as of March 31, 2007.

The Company is subject to taxation in the U.S. federal jurisdiction and various U.S. state and foreign jurisdictions. The Company's income tax returns for the 2003, 2004, and 2005 tax years are currently under audit by the United States Internal Revenue Service. The Company is also under audit by the taxing authorities in China on a recurring basis. The material jurisdictions that the Company is subject to examination are in the United States and China.

In establishing its deferred income tax assets and liabilities, the Company makes judgments and interpretations based on the enacted tax laws and published tax guidance applicable to its operations as well as the amount and jurisdiction of future taxable income. The Company records deferred tax assets and liabilities and evaluates the need for valuation allowances to reduce the deferred tax assets to realizable amounts. The Company will maintain a full valuation allowance on its net deferred tax assets in China, the United States, and other countries until an appropriate level of profitability that generates taxable income is sustained or until the Company is able to develop tax strategies that would enable it to conclude that it is more likely than not that a portion of its deferred tax assets will be realizable. Any reversal of valuation allowances will favorably impact our results of operations in the period of the reversal.

Income tax expense was \$4.3 million and \$2.8 million for the three months ended March 31, 2007 and 2006, respectively. There are two primary reasons why the Company has tax expense while the Company has pretax losses. First, the Company has not provided any tax benefit on the forecasted current year losses incurred and tax credits generated in the United States and other countries, because management believes that it is more likely than not that the tax benefit associated with these losses will not be realized. Second, the Company continues to accrue tax expense in jurisdictions where the Company has been historically profitable. Estimates of the annual effective tax rate at the end of the interim periods are based on evaluations of possible future events and transactions and may be subject to subsequent refinement or revision.

#### **NOTE 22 - RECENT ACCOUNTING PRONOUNCEMENTS**

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements, ( SFAS 157 ). SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. The provisions of this standard apply to current accounting pronouncements that require or permit fair value measurements. SFAS 157 becomes effective for the Company on January 1, 2008. Upon adoption, the provisions of SFAS 157 are to be applied prospectively with limited exceptions. The Company is currently evaluating the effects of SFAS 157 on its consolidated financial statements.

In February 2007, The FASB issued SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities ( SFAS 159 ). This statement permits, but does not require, companies to report at fair value the majority of recognized financial assets, financial liabilities and firm commitments. Under this standard, unrealized gains and losses on items for which the fair value option is elected are reported in earnings at each subsequent reporting date. SFAS 159 becomes

effective for the Company on January 1, 2008. The Company is currently evaluating the effects of SFAS 159 on its consolidated financial statements.

#### **NOTE 23 - VARIABLE INTEREST ENTITY**

The FASB issued FASB Interpretation No. 46, Consolidation of Variable Interest Entities ( FIN 46 ). FIN 46 requires that if an entity is the primary beneficiary of a variable interest entity ( VIE ), the assets, liabilities, and results of operations of the VIE should be included in the consolidated financial statements of the entity.

During the fourth quarter of 2005, the Company provided an interest free, \$12.4 million loan to a party in China as seed capital for a venture organized to participate in providing technical service, networking technology, and equipment to the emerging market for IPTV products in China. The loan is partially secured by an indirect ownership interest in the venture, is payable in 10 years and may be called early without penalty. As a result of the foregoing, and the fact that the venture's continuing viability is heavily dependent on the further provision of network and terminal equipment by the Company, the Company has determined that the venture is a VIE and that the Company is the primary beneficiary of the venture. Therefore, this venture is consolidated into the Company's results as of March 31, 2007. This VIE had insignificant revenue during the three months ended March 31, 2007 and March 31, 2006, and had a net loss of \$1.5 million and \$0.7 million, respectively during the same period. The consolidation of this VIE represented \$16.7 million and \$17.2 million of the total assets of the Company as of March 31, 2007 and December 31, 2006. The liabilities of the VIE consolidated by the Company do not represent additional claims on the Company's general assets; rather they represent claims against the specific assets of the VIE. Likewise, the assets of the VIE consolidated by the Company do not represent additional assets available to satisfy claims against the Company's general assets. The creditors of the VIE do not have recourse to the Company thereby limiting the liability risks associated with the Company's variable interests in the VIE.

In the first quarter of 2005, the Company invested in an additional entity, which is considered a VIE where the Company is the primary beneficiary and does not hold a majority voting interest. The company was established to install, develop and operate a PAS network in Mongolia. The creditors of this VIE have no recourse to the Company. In December 2005, the U.S. Embassy in Mongolia informed the Company that it had forwarded to the Department of Justice allegations that an agent of the joint venture had offered payments to a Mongolian government official, in possible violation of the Foreign Corrupt Practices Act. The Audit Committee authorized an independent investigation into the matter. As a result of the investigation, the Company wrote off \$1.2 million of intangibles and established a \$2.6 million value added tax ( VAT ) liability at December 31, 2005. The investigation is still ongoing. The consolidation of this entity resulted in a \$6.0 million increase in both total assets and total liabilities and equity as of December 31, 2005. In the first quarter of 2006, the Company decided to terminate the joint venture arrangement and wrote off the remaining net assets, of approximately \$4.7 million. In November 2006, the Board of Directors of the VIE approved dissolution of the joint venture. As a result, the Company ceased to be the primary beneficiary of this VIE and the asset and the liabilities of the VIE were not consolidated as of December 31, 2006. The \$2.6 million VAT liability was reversed accordingly as management concluded that it is remote that the Company would be required to pay such tax for the joint venture.

#### **NOTE 24 SALE OF ASSETS**

*Marvell Technology Group Ltd.*

In February 2006, the Company sold substantially all of the assets and selected liabilities of its semiconductor design business division to Marvell Technology Group Ltd. ( Marvell ). The Company received \$35.4 million in cash, net of \$0.6 million of transaction costs, and an additional \$4.3 million in cash was paid by Marvell to the Company in August 2007. Included in the cash received was \$16.0 million earned by the Company as a result of achieving certain defined milestones. The Company received payment of this \$16.0 million in October 2006. The assets sold include the assets related to the prior acquisition of Advanced Communications Devices Corporation in 2001, and other system-on-chip semiconductors. In connection with the sale of assets, the Company has entered into a supply agreement with Marvell.

In connection with the sale of assets, the Company has entered into a supply agreement with Marvell to purchase chipsets for the Company's handset products over the next five years. The value allocated to the supply agreement of \$20.2 million is included in other current and long-term liabilities, and is being amortized in proportion to the quantities of chipsets purchased under the supply agreement over the next five years. For the three months ended March 31, 2007, approximately \$0.5 million has been amortized against cost of sales.

## NOTE 25 - SUBSEQUENT EVENTS

### *Notice of Default and Second Supplemental Indenture*

On May 31, 2007, the Company received a notice of default for the convertible subordinated notes asserting that a default had occurred under the indenture, as amended by the First Supplemental Indenture (the Indenture) with respect to the Company's convertible subordinated notes due in March 2008. The specific purported defaults referred to in the notice of default were (1) the Company's failure to file its Quarterly Report on Form 10-Q for the fiscal quarter ended September 30, 2006, its annual report on Form 10-K for the year ended December 31, 2006 and its Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2007 and (2) the Company's failure to deliver to the Trustee the officer's certificate of compliance of the Company required by the Indenture.

Subsequently, the Company solicited and obtained the requisite consents from the holders of the notes to a waiver, effective July 26, 2007, of any default which may have occurred prior to such date due to the delay in filing and non-compliance with certain covenants, and the Company entered into a Second Supplemental Indenture with the Trustee, dated July 26, 2007, after receiving consent from holders of more than 50% of the outstanding aggregate principal amount of the convertible subordinated notes in connection with the Company's consent solicitation announced July 19, 2007. The Second Supplemental Indenture provided that the convertible subordinated notes accrue additional interest at a rate of (a) 6.75% per annum in special interest from and after January 9, 2007 to and including July 25, 2007, and (b) 10% per annum in special interest from and after July 26, 2007 to the date the notes are paid, prepaid, redeemed converted or otherwise cease to be outstanding. The special interest rate provided by the Second Supplemental Indenture represented an increase of 3.25% per annum over the special interest rate of 6.75% provided by the First Supplemental Indenture. As a result of the Second Supplemental Indenture, the convertible subordinated notes now bear a stated interest rate of 10.875%. Payments of special interest will be made in addition to, and at the same time and in the same manner as, regularly scheduled payments of interest to holders entitled to such regularly scheduled payments of interest.

The Second Supplemental Indenture also provided that (i) during the period from and including July 26, 2007 to and including October 15, 2007 (Covenant Reversion Date), any failure by the Company to comply with the covenants contained in the original agreement related to the filing of reports required to be filed with the SEC, and the furnishing of copies of the SEC reports and certain compliance certificates to the Trustee, will not constitute a default, and that (ii) if, but for the Second Supplemental Indenture, a default would be deemed to have occurred as a result of a failure to comply with such covenants and such default remains uncured and is continuing as of the Covenant Reversion Date, such default will be deemed to have occurred on the Covenant Reversion Date.

The Company filed its 2006 Annual Report on Form 10-K and its Form 10-Q for the quarterly period ended September 30, 2006 with the Securities and Exchange Commission on October 10, 2007.

On October 15, 2007, the Company received an additional notice of default asserting that a default had occurred under the Indenture (as amended by the First Supplemental Indenture and the Second Supplemental Indenture) with respect to the Notes. The specific purported defaults referred to in the notice of default were (i) the Company's failure to file with the SEC and provide copies to the Trustee of its Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2007 and its Quarterly Report on Form 10-Q for the fiscal quarter ended June 30, 2007 and (ii) the Company's failure to deliver to the Trustee the officer's certificate of compliance of the Company required by the Indenture. The notice of default provides that the Company has 60 consecutive days from October 15, 2007 (the Demand Date) to cure the purported defaults before such defaults would constitute an Event of Default under the Indenture. The occurrence of an Event of Default under the Indenture would afford the Trustee or holders of not less than 25% in aggregate principal amount of outstanding Notes the right to declare the full principal amount of all outstanding Notes to be immediately due and payable.

### *Liquidation of Assets*

In the fourth quarter of 2006, the Company recorded a \$13.5 million other-than-temporary impairment charge to write down the Company's investment in Cellon, and further recorded a write down of a prepaid royalty balance of \$3.0 million related to Cellon. Based on the deterioration of Cellon's financial condition, the Company determined that the carrying value of the investment was at an amount above the fair value of the investment, and the decline was other-than-temporary. On June 18, 2007, a meeting of Cellon's shareholders was held where a resolution was passed to place Cellon in voluntary liquidation.

### *Infinera Initial Public Offering*

On June 7, 2007, Infinera Corporation (Infinera) closed on its initial public offering of 14,000,000 shares of common stock at a price of \$13.00 per share. Infinera also announced that the underwriters of the offering exercised in full their option to purchase an additional 2,100,000 shares of Infinera common stock, bringing the total initial public offering size to \$209.3 million. After the initial public offering, the Company is entitled to convert its 669,643 shares of Series D and 2,500,000 shares of Series E Preferred Stock into 792,410 shares of Infinera's common

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stock; subject to Rule 144 trading restrictions and 180 days lock up period starting June 2007 through December 2007.

As a result of the initial public offering, the value of the Infinera shares owned by the Company became readily determinable and the investment will be classified as an equity security available-for-sale in accordance with SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, in the balance sheet for the quarter ended June 30, 2007. The closing price per share of Infinera common stock on June 29, 2007 was \$24.92 and the value of the Company's investment was \$19.7 million. In the second quarter of 2007, the Company recorded an unrealized gain of \$17.8 million, in

46

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other comprehensive income, representing the difference between the fair value of the investment on June 29, 2007 and the initial investment amount of \$1.9 million.

*Fiberxon merger with MRV Communications*

On July 1, 2007, Fiberxon, an investment in which the Company has a 7% ownership interest, completed a merger with MRV Communications ( MRV ). In exchange for the Company's investment in Fiberxon, the Company will receive approximately \$1.5 million in cash, 1.5 million shares of MRV common stock and deferred consideration of approximately \$2.7 million. The deferred consideration becomes payable upon the completion of certain milestones and may be reduced by legitimate claims of MRV for certain matters related to the merger.

47

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**ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS****FORWARD-LOOKING STATEMENTS**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws. These statements are based on information that is currently available to management. We intend such forward-looking statements to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, and we are including this statement for purposes of complying with those provisions. The forward-looking statements include, without limitation, those concerning the following: our expectations regarding our compliance with SEC reporting requirements and NASDAQ listing requirements; our expectations as to the nature of possible market trends; our expectations regarding continued growth in our business and operations; our expectations regarding fluctuations in gross profit; our plans regarding payment of cash dividends; our expectations regarding recognition of certain compensation costs; our plans regarding legal proceedings; our expectations regarding the effect of legal proceedings and government inquiries; our expectations regarding the functionality, performance and features of our products; our expectation regarding Softbank's continued service of certain modems and modem rental agreements; our expectations regarding possible transition in our management; our plans and expectations regarding relationships with vendors and suppliers, including Marvell and Cellon; our expectations regarding the future source and costs of chipsets; our plan to fulfill the purchase commitment under various orders from our suppliers; our expectations regarding the exchange rate risks with respect to accountable receivables and payables in Renminbi, Japanese Yen and Euros; our plans regarding the use of financial instruments to hedge against certain foreign currency exchange rate risks; our plans regarding the use of derivative financial instruments for speculative trading purposes; our plans regarding the discounting of certain bank notes and commercial notes; our expectations regarding our ability to raise funds, including the impact of late filing of our reports with the SEC on our ability to raise funds; our expectations regarding the availability of funding under the account receivable financing program with Citibank, N.A. and our plan to continue service the account receivable; our expectations regarding our investment in Global Asia Partners L.P.; our expectations regarding our right to intellectual property embedded in our products; our expectations regarding our ability to protect our intellectual property; our expectations regarding the effect of market risks on our operating results; our plans to implement measures to remediate material weaknesses; our expectations regarding the effectiveness of remediation measures; our plans to continue to review internal controls; our expectations regarding competition and the competitive advantages of our competitors; our expectations regarding consolidation of the telecommunications industry; our expectations regarding the development and introduction of new and more advanced products; our expectations regarding deployment of our products; our plans to reinvest cost savings derived from and expectations regarding our workforce restructurings; our expectations regarding future workforce restructurings; our expectation regarding the adoption of environmental, health and safety laws by countries world-wide; our expectations regarding the effect of the Sarbanes-Oxley Act on our corporate governance and disclosure practices; our expectation regarding the expenses associated with compliance with the Sarbanes-Oxley Act; our expectations regarding the impact of the restatement of our consolidated financial statements; our expectations regarding the maturation of the PAS market and corresponding decrease in PAS subscriber growth; our expectations regarding the long-term demand for our PAS products; our expectations regarding our ability to offset the decline in PAS sales through pursuing other products; our expectations regarding PAS system spending; our plan to pursue opportunities for our wireless infrastructure products in multiple markets; our expectations regarding our investment in and development of the IPTV market; our expectations regarding product margins; our expectations regarding the impact of our initiatives on our revenue plan; our expectations regarding our annual effective tax rate; our expectations regarding the likelihood to realize the tax benefits in the U.S. and other countries; our expectations regarding the effect of the China Corporate Income Tax Law on our future tax expenses; our expectations regarding valuation allowance on our net deferred tax assets and its impact; our expectations regarding the reporting of net losses throughout 2007; our expectations regarding our level of capital expenditures in China; our plans to maintain adequate liquidity levels through at least the next 12 months; our expectations regarding the availability and sufficiency of credit lines from our existing lenders; our plans to issue new debt instruments, sell investments and assets; our expectations regarding refinancing of the convertible notes and access to cash in our China subsidiaries to meet our liquidity requirements outside of China; our expectations regarding interest rates; our expectations regarding sufficiency of cash resources; our expectations regarding our ability to receive licenses for our products; our expectation that our business, financial condition and results of operations will continue to be significantly influenced by the political, economic, legal and social environment in China and other international markets, including Japan, India and Europe; our expectations regarding the nature of political, economic and legal reform in China; our expectations regarding the continued importance of the Chinese market for our technologies and development and the importance of sales in China to our operating results; our expectations regarding future sales generated from China as a percentage of total sales; our expectations regarding the impact of our receiving the license to sell GSM and CDMA handsets in China on our ability to meet future market demands; our expectations regarding subscriber growth in China; our expectations regarding global expansion of sales outside of China; our plan to extend our supplier base by introducing more models of our own design and expanding relationships with more

manufacturers; our plans to pursue opportunities to divest additional non-core assets; our expectation that research and development expenses will be stable; our expectations regarding future amortization expenses; our expectations regarding the impact of product defects or performance quality issues; our expectations regarding the impact of international expansion on our management, operational, financial and other resources; our expectations regarding the impact of legislation that restricts or prohibits the use of wireless handsets while driving on our future sales; our expectations regarding improvement to shorten days sales outstanding; our plans regarding improvement of our internal supply chain and inventory management processes; our expectations regarding the reliability of stock-based compensation valuation models and the impact of SFAS 123R; and our expectations regarding our ability to implement and enhance our administrative infrastructure. Additional forward-looking statements may be identified by the words anticipate, expect, believe, intend, will, may, and similar expressions, as they relate to us or our management, or by the words designed, intended and similar expressions, as they relate to our products and services. Investors are cautioned that these forward-looking statements are inherently uncertain. These statements are subject to risks and uncertainties that may cause actual results and events to differ materially. For a detailed discussion of these risks and uncertainties, see Part II, Item 1A Risk Factors of this Form 10-Q. We do not guarantee future results and undertake no obligation to update the forward-looking statements to reflect events or circumstances occurring after the date of this Form 10-Q.

## **RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS**

Our consolidated financial statements and related financial information included in this Quarterly Report on Form 10-Q for accounting periods prior to the third quarter of 2006 have been restated, as described below.

### ***Summary***

In July 2007, the Company announced the Audit Committee of the our Board of Directors ( Audit Committee ) was conducting an independent investigation of historical sales with certain customers in China and stated that it could not rule out the possibility that the outcome of the investigation could impact revenue recognized for certain of such contracts as recorded in previously issued financial statements. In September 2007, the Company announced the investigative phase of the Audit Committee s investigation had been completed. After consultation with and upon the recommendation of management, the Audit Committee determined revenue in the Company s Western Region of China was recognized earlier than it should have been and that the financial statements for the affected periods should be restated. The Company also announced that its previously issued financial statements for each of the fiscal years ended December 31 in the period 2000 through 2005, the financial statements for the interim periods contained in the Quarterly Reports on Form 10-Q filed with respect to each of these years, and the quarterly reports on Form 10-Q filed with respect to each of the quarterly periods ended March 31 and June 30, 2006 should not be relied upon. In this Annual Report we have corrected for the effects of net sales and related costs of net sales that were recorded earlier than they should have been and have restated the financial statements for the three months ended March 31, 2006.. The net effect for the three months ended March 31, 2006 was to recognize previously deferred revenue and gross profit of \$5.4 million and \$1.4 million, respectively.

We also conducted a voluntary review of historical stock option practices under the direction of the Nominating and Corporate Governance Committee of our Board of Directors ( Governance Committee ). This review considered all option grant awards made in the period from February 29, 2000, shortly before the initial public offering of our Common Stock, through August 2006 for compliance with the various stock-based compensation accounting standards applicable during this period as well as the rules of our stock option plans. We found that in a number of instances we did not use the proper date as the measurement date in determining whether stock options had been issued with exercise prices below the fair value of our common stock. Therefore, we have restated our previously issued financial statements for the years ended December 31, 1998 through 2005 to account for an additional \$25.5 million of stock compensation expense that should have been recognized over the period together with an equal increase in additional paid-in capital to recognize the intrinsic value assigned to these issuances of equity securities. Related adjustments of payroll and income taxes resulted in an additional \$0.5 million of expense being recognized for the 1998 through 2005 period and total stockholders equity being reduced by a total of \$2.1 million at December 31, 2005. During the first six months of 2006 an additional \$1.2 million of stock compensation expense was recognized, which reduced our previously reported operating results for this period. We have restated the financial statements for the three months ended March 31, 2006, and during that period incremental stock compensation expense totaling \$0.7 million was recognized.

None of these restatements had any effect on any of our cash balances, however cash equivalents were reduced at March 31, 2006 due to the correction in classifications described below.





Additional information about these restatements and their effects on our financial statements is presented below as well as in the Notes to Condensed Consolidated Financial Statements.

### *China Sales Investigation*

The Audit Committee engaged independent counsel to conduct an investigation of sales in China following a determination by the Internal Audit group that allegations of improper activities in a sales office in the Western Region were credible. The allegations were made by a Company employee using the Company's whistle blower program. The independent counsel engaged the assistance of forensic accountants, and this group is collectively referred to as the Investigating Team in the rest of this discussion.

In conducting its procedures, the Investigating Team found instances where the customer contracts that evidenced the arrangement contained obligations for the Company to deliver software upgrades when and if made available for the equipment sold for no additional consideration and for an unspecified period that could extend over the term of the contract. This additional contract obligation is an element of post contract support. In these cases, the Investigating Team found that the contract documentation for the same transaction submitted by the sales office to the Company's China headquarters for accounting purposes and utilized by the Company in determining the amount of revenue recognized did not include evidence of such post contract support obligations.

Accounting standards governing revenue recognition for system sales require all revenue to be deferred while there are undelivered elements under the arrangement unless the seller has established vendor specific objective evidence ( VSOE ) of fair value for such contract elements. Because these arrangements included such undelivered elements, revenue should be deferred based on the VSOE of the fair value of the underlying elements. VSOE of fair value represents the price charged when the same element is sold separately. Since the Company does not sell this element separately, it has not established VSOE for such undelivered elements, and as such the revenue from such contracts is required to be deferred and recognized over the period the Company is obligated to provide the post contract support.

The China sales investigation covered each of the seven years in the period ended December 31, 2006 and included: investigating approximately 1,200 contracts in all of our five regions in China; reviews of the electronic files of 45 employees; and formal interviews of 96 employees in China. Additionally, the China sales investigation included reviewing contract files, performing various financial analyses including comparison of payments received per our accounting records to the contract terms, and computer forensic procedures where destruction of electronic documents was suspected. In the aggregate, the Investigating Team expended approximately 25,000 hours in conducting this investigation, which commenced in February 2007 and was completed in September 2007 when the independent counsel and forensic accountants presented their final report to the Audit Committee. In July 2007, we announced the Audit Committee was conducting an independent investigation of historical sales with certain customers in China and we stated that we could not rule out the possibility that the outcome of the investigation could impact revenue recognized for certain of such contracts as recorded in our previously issued financial statements.

Upon completion of the investigative phase of the independent investigation by the Audit Committee, our management:

- conducted follow-up procedures to attempt to locate any additional relevant information to ensure the China sales investigation considered all available information and documents;
- evaluated the accounting for identified system sales using the contract template and documentation found in the sales contract files from the Western Region offices. This included calculating the financial statement effects of correcting the accounting for all system sales where the contract template found at our sales offices contained post contract support obligations to recognize revenue and cost of net sales over estimated period of post contract support;
- concluded that as a result of the existence of this undelivered post contract support obligation our previously issued financial statements should be restated to defer system sales contract revenue and the related cost of net sales over the estimated period of post contract support when a contract contained unspecified software upgrade rights.

The Audit Committee concurred with management's decisions.



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The effect of correcting improperly recognized revenue and cost of net sales was to (reduce) increase previously reported net sales, gross profit and net income by the following amounts (in thousands of dollars):

Year ended December 31,		Net sales		Gross profit		Net income
	2000	\$ (12,408	)	\$ (5,294	)	\$ (4,781
	2001	(17,154	)	(6,330	)	(5,779
	2002	(64,732	)	(22,924	)	(19,697
	2003	(21,060	)	(8,014	)	(6,382
	Totals through December 31, 2003	(115,354	)	(42,562	)	(36,639
	2004	(104,965	)	(27,241	)	(18,594
	2005	(58,232	)	(27,863	)	(42,433
	2000 - 2005 Total	(278,551	)	(97,666	)	(97,666
	<u>2006 quarter ended</u>					
	March 31	5,410		1,360		1,360
	June 30	2,380		(371	)	(371
	Total China Sales Restatement	\$ (270,761	)	\$ (96,677	)	\$ (96,677

The cumulative effect of all of the China sales restatement adjustments to our consolidated balance sheet as of December 31, 2003 resulted in a decrease in retained earnings of \$36.6 million, an increase in deferred revenue of \$115.4 million to account for previously recognized sales, an increase in deferred costs of \$72.8 million to account for previously recognized cost of net sales, and an increase in deferred tax assets and prepaid taxes of \$5.9 million. In our consolidated balance sheet at December 31, 2006, deferred revenue is \$275.7 million, of which \$35.6 million is classified as current and \$240.1 million as non-current, and the deferred costs balance is \$176.6 million. These amounts will be recognized in our consolidated statements of operations over the estimated remaining period of post contract support.

Due to this restatement, we increased net sales, gross profit, and net income (in thousands) for the three month period ended March 31, 2006 as follows: \$5,410, \$1,360 and \$1,360, respectively. In our consolidated balance sheet at March 31, 2007 the net reduction in previously recognized net sales is accounted for as deferred revenue, of which \$36.5 million is classified as current and \$233.3 million as non-current, and the related net reduction in cost of net sales of \$172.9 million is accounted for as deferred costs. These amounts are being recognized in our consolidated statements of operations over the estimated remaining period of post contract support.

Upon completing its investigation, the Audit Committee concluded that the conditions and practices relating to systems contracts prevalent in the Western Region resulted primarily from the failure to prevent or detect instances of override related to controls in China over customer agreements, lack of proper management oversight, unclear record retention policies and procedures relating to systems contracts, and inadequate employee training. The Investigating Team and the Audit Committee also concluded that with respect to four regions other than the Western Region there was no evidence of fraud or misconduct or reason to suspect such occurred. The Investigating Team and the Audit Committee also concluded that there was no credible evidence of knowledge by senior management in China or the United States of the conditions and practices related to the Western Region of China that were discovered in the investigation. The Audit Committee concluded that local management in several of the sales offices in the Western Region of China did not submit appropriate information to the Company's senior management in China and the United States. Therefore, in prior years, neither the Company's management nor the Company's independent registered accounting firm were able to properly evaluate the effect of that information on revenue recognition. The Audit Committee also concluded that certain members of management in China bear varying degrees of responsibility for inadequate oversight of activities. As a result, certain employees in China have either been terminated or placed on suspension for failure to provide adequate oversight of activities.

We have restructured the management of the Western Region sales organization and are working to identify and implement changes to our policies and procedures and enhance employee training to improve internal control consciousness and lessen the possibility of accounting errors occurring in the future.

### *Stock Option Accounting*

In November 2006, we announced we had commenced a voluntary review of historical stock option practices under the leadership of the Governance Committee following a preliminary review by management which identified potential deficiencies and discrepancies in the documentation of stock option grants. The review considered all option grant awards made in the period from February 29, 2000, shortly before the initial public offering of our Common Stock, through August 2006 ( Review Period ) for compliance with the various stock-based compensation accounting standards applicable during the Review Period as well as the rules of our stock option plans. The Governance Committee engaged independent outside legal counsel to assist in the review who, in turn, engaged forensic accountants. (Separate law firms and separate forensic accounting firms were engaged by the Audit Committee and the Governance Committee for the China sales investigation and the stock option accounting review.) In the rest of this discussion, this group collectively is referred to as the Stock Option Review Team and their actions and activities are referred to as the Stock Option Review. The Stock Option Review Team members spent over 11,000 hours in this review, and the Governance Committee met with the Stock Option Review Team on more than a dozen occasions to receive, discuss, and consider the Stock Option Review Team's information and findings.

At the time the review commenced, the Governance Committee consisted of three members of the Board of Directors, all of whom are independent directors. The Committee decided to delegate supervision of the review to Mr. Jeff Clarke, its Chairman, who joined our Board in 2005 and had not served on the Compensation Committee of the Board of Directors ( Compensation Committee ) during the period under review. The Governance Committee also consisted of two other independent directors, Mr. Larry D. Horner and Mr. Thomas Toy, who also serve on the Board's Compensation Committee. Mr. Allen Lenzmeier was appointed to the Governance Committee on April 27, 2007.

Review procedures included:

- interviews of individuals involved with granting, advising, administering, or accounting for stock options, including current and former: management, members of the Board of Directors, employees, and non-employee professionals;
- review of relevant stock administration, human resource, legal, and finance department files and records;
- review of stock option grant information in select employee personnel files;
- review by at least 30 attorneys and 15 forensic accountants of approximately 250,000 potentially relevant e-mails and documents in electronic format selected through electronic discovery techniques from over 1.8 million electronic documents processed;
- review of the electronic database of the Company's stock option activity maintained by a third party along with communications to and from this service provider;
- reconciliation of grant activity from approval documents executed by the Compensation Committee with the electronic database;
- reconciliation of stock option grant, exercise, and cancellation information from SEC filings with select employee personnel files and the electronic database;
- statistical and judgmental pattern analysis;
- follow-up on matters raising questions about the option granting process and its history, conduct of those involved with granting, advising, administering, or accounting for stock options, or the accounting treatment for stock options; and
- follow-up on items or issues requested or identified by management or the Company's independent registered public accounting firm.

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The Stock Option Review Team, management, and the Governance Committee decided to group stock option grants into six award categories based on differences in what constituted substantive approval for each category under our stock option granting practices as well as giving consideration to the risk of intentional misstatement of the grant date. Guidance in a September 19, 2006 letter publicly issued by the SEC's Chief Accountant focuses on the concept that a measurement date under Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* ( APB 25 ), the accounting standard governing our stock option accounting through 2005, does not occur until the number of shares an individual employee is entitled to receive and the exercise price is determined with finality (i.e., no longer subject to change). This is the date on which substantive approval occurred, and depending on a company's facts and circumstances the guidance from the SEC discussed above recognizes a company may determine that the measurement date for some stock option grants may

52

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occur before all required granting actions have occurred such as final approval by the Compensation Committee. This alternative is available only when a review of all facts and circumstances supports a conclusion that substantive approval occurs earlier than when all required granting actions have occurred and there is no evidence of fraudulent or manipulative conduct in the company's option granting practices.

In determining the measurement date to be used, the Stock Option Review Team, management, and the Governance Committee agreed to use the following definitions as constituting the proper measurement date, and generally these dates were used in testing the stated grant dates or establishing corrected measurement dates:

<b>Discretionary Director and Officer Grants</b>	The date of a Compensation Committee meeting where the grant was approved or the date the final Compensation Committee signer approved the grant when approval occurred through unanimous written consent documents ( UWC ).
<b>Automatic Director Grants</b>	The date specified in the relevant stock option plan.
<b>Broadbase</b>	The date the grantee list, including the allocation of shares to individual grantees, was complete. Compensation Committee approval was considered perfunctory due to delegation of authority to management.
<b>Acquisition</b>	The first Compensation Committee meeting following the acquisition, provided grantees had received employment offer letters stating the number of stock options to be granted before such date, because this was the date at which the option exercise price was established. Compensation Committee approval was considered perfunctory due to delegation of authority to management.
<b>New Hire</b>	The first scheduled Compensation Committee meeting following the first day of employment, because this was the date at which the option exercise price was established. The number of options was based on either grant amounts specified in an employment offer letter or, in some cases, on a matrix that assigned grant amounts based on position and level within the Company. Compensation Committee approval was considered perfunctory due to delegation of authority to management.
<b>Other Merit</b>	The date the grantee list, including the allocation of shares to grantees, was substantially complete. Compensation Committee approval was considered perfunctory due to delegation of authority to management.

For 12 tested grant dates where a corrected measurement date was required, the Stock Option Review Team and management were unable to locate sufficient evidence to establish a corrected measurement date using our established criteria for the applicable option grant type. In these situations alternative available evidence was used to establish the corrected measurement date.

During the period covered by the Stock Option Review, we granted stock options on approximately 34 million shares of our Common Stock at 197 grant dates. The review specifically examined the appropriateness of the stated grant date for approximately 90% of the stock options granted, including all stock option grants made to directors and officers, all broadbase grants and all option grants made in connection with business acquisitions.

The findings of this review are summarized as follows:

Grant Type	Number of grants	Grants tested	No change required	Measurement date changed additional compensation expense required	no additional compensation expense required(1)
Discretionary Director & Officer	16	16	8	4	4
Automatic Director	5	5	5		
Broadbase	8	8		6	2
Acquisition	10	10	10		
New Hire	166	48	48		
Other Merit	96	41	4	21	16
Total	301	(2) 128	75	31	22

(1) Under APB 25 there is no expense adjustment arising from using the corrected measurement date for these grants because the amount the employee would have to pay to exercise these stock option grants exceeded the quoted market price of our Common Stock at the corrected measurement date, and therefore, these stock option grants contained no intrinsic value at the corrected measurement date.

(2) The number of grants exceeds the number of grant dates because on certain grant dates more than one category of stock option grants were approved.

In late January 2007 the Governance Committee reported its interim findings concerning the use of incorrect measurement dates in our stock option accounting under APB 25 to our Board of Directors. On February 1, 2007, the Audit Committee of the Board of Directors then concluded, in consultation with and upon the recommendation of management, that we should correct for errors in previously reported stock-based compensation expense through restatement of our previously issued financial statements and that our previously issued financial statements for all periods should no longer be relied upon. We communicated this decision in a February 1, 2007 public announcement.

A non-cash compensation charge, to be recognized as an expense over a grantee's service period, arises under APB 25 if a stock option has intrinsic value at its measurement date. This intrinsic value is measured by the excess, if any, of the fair value at the date of grant of the underlying common stock over the stock option's exercise price. Our practice has been to grant stock options with exercise prices equal to the closing price of our Common Stock at each grant date, to use the grant date as the measurement date for stock-based compensation purposes, and as such previously we had determined the granted stock options had no intrinsic value at their grant dates and no compensation expense was recognized. However, APB 25 states the measurement date does not occur until all essential actions necessary to grant the option are completed, including the final determination of both the number of shares to be granted to each employee or director and the exercise price, and the option grant is approved by those with requisite authority. This is reinforced by the September 19, 2006 letter issued by the SEC's Chief Accountant which focuses on the need for the number of shares and exercise price of an award to an individual to be finalized to have a measurement date. This letter clarifies the SEC staff's view that if it is possible that those terms could change, a measurement date has not occurred, even if the award's terms are not actually changed.

Based on the available evidence, the review found that the number of shares an individual employee was entitled to receive and/or the exercise price was not determined with finality at the stated grant date on 53 tested grant dates, and we should have used a later date as the measurement date. The principal reasons for the stated grant date not qualifying as the measurement date under APB 25 include:

- certain listings of grantees, below officer level, were incomplete and added to or modified by stock option administration personnel after the grant was approved by the Compensation Committee;
- for certain grants where Compensation Committee approval was not considered perfunctory, the date a UWC document was sent to Compensation Committee members for approval was used as the stated grant date for some discretionary officer and director grants rather than the date the UWC was signed by all Compensation Committee members and therefore became effective;

- the Stock Option Review Team was unable to locate contemporaneous documentation of some director and officer, broadbase, new hire, and other merit grants.

During the review the Company also discovered a stock option grant to a former officer that was modified in 1998 in connection with his termination of employment. This change was never included in the Company's stock option grant records and the additional compensation expense resulting from the change in the option's terms (approximately \$1.2 million) was not recorded previously. This discovery is consistent with the Stock Option Review Team's finding that in certain instances there was a lack of formal documentation in the stock option granting process and/or expected documentation is missing from the stock option administration files. In addition, the Stock Option Review Team found that, in many instances, there was a lack of self-authenticating evidence to corroborate that cash exercises were contemporaneous. As a result, the findings on the issue of backdating of cash exercises were inconclusive.



We restated our consolidated financial statements to recognize additional non-cash stock-based compensation expense arising from using corrected measurement dates for certain stock option grants made during the years 2000 through 2005 and to reflect the modification of the 1998 grant described above. Consistent with our historical accounting policy this additional stock-based compensation expense is being recognized on an accelerated basis by treating each vesting tranche as a separate stock option grant (graded vesting).

Our accounting for stock-based compensation changed to a fair value based method in 2006 when, as required by accounting standards, we ceased accounting for stock-based compensation under the intrinsic value method pursuant to APB 25 and began accounting for stock-based compensation under Statement of Financial Accounting Standards 123(R) *Share-Based Payments* ( SFAS 123(R) ). Under this method all stock option grants have a fair value determined using an option pricing model, and such fair value is used to recognize non-cash stock-based compensation expense. We restated our unaudited condensed consolidated financial statement information for the first and second fiscal quarters of 2006, included in Exhibit 99.1 in our Annual Report on Form 10-K for the year ended December 31, 2006 (and as reflected in our results for the three months ended March 31, 2006 included in this Form 10-Q), to recognize changes in non-cash stock-based compensation expense that arose from a re-determination of the fair value of stock options granted in 2005 and prior where the Governance Committee's review resulted in a corrected measurement date. By January 1, 2006, of the 17.9 million options granted in 2000-2005 where corrections were made to the measurement dates in the Stock Option Review, 4.4 million options with corrected measurement dates granted in 2000 and 2001 had fully vested. Therefore, the fair values of the outstanding and unvested portion of the remaining 13.5 million stock options granted in 2002-2005 with incorrect measurement dates were recalculated. We also recorded additional non-cash stock-based compensation expense in the first two quarters of 2006 arising from correcting the measurement date for stock option grants to three individuals in this period. We recognize stock compensation expense on a straight-line basis under SFAS 123(R).

Those stock option grants with corrected measurement dates have also been restated using the fair value based measurement principles of Statement of Financial Accounting Standards 123 *Accounting for Stock-Based Compensation* ( SFAS 123 ) to present, in Note 2, *Restatement of Financial Statements of Notes to Consolidated Financial Statements* contained in Item 8 of this Annual Report, the pro forma effect on stock-based compensation expense, net income (loss), and earnings (loss) per share amounts in 2004 and 2005 of using the fair value based method to determine stock-based compensation expense rather than using APB 25's intrinsic value method. Such disclosure is required in financial statements for periods prior to the adoption of SFAS 123(R).

In addition to restating the consolidated financial statements in response to the Governance Committee's findings, we recorded additional non-cash adjustments to account for the modification in 1998 of a stock option grant to a former officer in connection with his termination of employment and to record in the first two quarters of 2006 corrections relating to accounting for performance related stock options and restricted stock grants, all of which were previously identified and considered immaterial.

Correcting the measurement date for previously granted stock options in some cases results in additional taxable income to employees on which additional payroll taxes are due from the employees as well as us. We have provided for all additional payroll taxes plus related penalties and interest arising from the restatement of stock-based compensation, including amounts otherwise payable by stock option recipients, and our restated financial statements include an accrual in all affected years of approximately \$1.5 million for all estimated payroll tax related expenses.

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The corrections for the stock option restatement were to increase (reduce) previously reported non-cash compensation expense, payroll taxes, income taxes and net income by the following amounts (in thousands of dollars):

Year ended December 31,	Reduction (increase) in net income from			
	Non-cash stock compensation	Payroll taxes	Income taxes	Net income
1998	\$ 1,244	\$	\$ (448)	\$ (796)
1999				
2000	556		(104)	(452)
2001	4,870		(942)	(3,928)
2002	8,110		(1,550)	(6,560)
2003	12,470	900	(2,281)	(11,089)
Totals through December 31, 2003	27,250	900	(5,325)	(22,825)
2004	(410)	541	250	(381)
2005	(1,290)	60	4,083	(2,853)
2000 -2005 Total	\$ 25,550	\$ 1,501	\$ (992)	\$ (26,059)
<u>2006 quarter ended</u>				
March 31	662	9		(671)
June 30	504	6		(510)
	\$ 26,716	\$ 1,516	\$ (992)	\$ (27,240)

The Governance Committee's review found 17.9 million stock options of the 28.8 million options granted on our Common Stock during 2000 through 2005 had incorrect measurement dates. Using the corrected measurement dates, 7.6 million stock options had exercise prices that exceeded the closing price of our Common Stock and therefore had no intrinsic value to be accounted for under APB 25, and 10.3 million stock options had intrinsic value because their exercise prices were below the closing price of our Common Stock. These 10.3 million stock options resulted in an increase in additional non-cash stock-based compensation expense of \$24.3 million, and an additional \$1.5 million of payroll tax related expenses during 2000-2005 partially offset by \$0.5 million of income tax benefit as shown in the above table. Of the 10.3 million stock options resulting in additional non-cash stock-based compensation expense, 2.0 million options were granted to officers and directors and resulted in \$6.1 million of additional non-cash stock-based compensation expense.

The total effect of the stock option restatement and the amounts for 2006, as shown in the above table, have been reflected in the December 31, 2006 financial statements, as well as in the March 31, 2006 financial statements. As a result of this restatement, net loss increased by \$0.7 million for the three months ended March 31, 2006.

Upon completing its review, the Governance Committee concluded it found no evidence of intent to manipulate the Company's operating results or financial statements. A key finding of the Governance Committee was that there were deficiencies with the process by which stock options were granted during the period from our initial public offering in 2000 through at least 2005, which resulted in accounting errors. The Governance Committee concluded that certain members of management bear varying degrees of responsibility for the deficiencies in the process by which options were granted. The Governance Committee's review also concluded that none of the current or former employees or directors of the Company engaged in intentional wrongdoing.

In determining the above restatement amounts, management used all reasonably available relevant information to form conclusions it believes are reasonable as to the most likely option granting actions that occurred, the dates when such actions occurred, and the determination of grant dates for financial accounting purposes based on when the requirements of the accounting standards were met. In light of significant judgment used in establishing revised measurement dates, alternative approaches to those used by the Stock Option Review Team and management could have resulted in different compensation charges than those recorded in the restatement. The Stock Option Review Team and management considered various alternatives throughout the course of the review and restatement, and management believes the approaches used were the most appropriate in the circumstances, and the choices of measurement dates used in our review of stock option grant accounting and restatement of our financial statements were reasonable and appropriate in our circumstances.

**Summary of Restatement Amounts**

The following table presents the decrease in net earnings from the restatement for each restated year:

Year ended December 31,	Net income (loss), as previously reported	Restatement adjustments		Total	Net income (loss), as restated
		China Sales (in thousands) (Decrease) Increase	Stock Options		
1998		\$	\$ (796)	\$ (796)	
1999					
2000		(4,781	) (452	) (5,233	)
2001		(5,779	) (3,928	) (9,707	)
2002	\$ 107,862	(19,697	) (6,560	) (26,257	) \$ 81,605
2003	\$ 209,856	(6,382	) (11,089	) (17,471	) \$ 192,385
Totals through December 31, 2003		(36,639	) (22,825	) (59,464	)
2004	\$ 69,824	(18,594	) (381	) (18,975	) \$ 50,849
2005	\$ (487,359	) (42,433	) (2,853	) (45,286	) \$ (532,645
2000 - 2005 Total		(97,666	) (26,059	) (123,725	)
<u>2006 quarter ended</u>					
March 31	\$ (10,635	) 1,360	(671	) 689	\$ (9,946
June 30	\$ (21,443	) (371	) (510	) (881	) \$ (22,324
		\$ (96,677	) \$ (27,240	) \$ (123,917	)

The cumulative effect on stockholders' equity at December 31, 2003 from the above corrections was as follows (in thousands):

**Increase (decrease) in paid-in capital and deferred stock compensation:**

Values assigned to stock options	\$ 27,250
Reduction of previously recorded income tax benefits from stock options	(1,278)
Net increase in paid-in capital and deferred stock compensation	25,972
(Increase) decrease in accumulated deficit:	
Revenue and related cost of sales deferral for China system sales	(36,639)
Additional non-cash compensation expense from stock options	(27,250)
Payroll taxes for values assigned to stock options	(900)
Income tax benefit from additional compensation and payroll tax expense	5,325
Net increase in accumulated deficit	(59,464)
Net decrease in stockholders' equity at December 31, 2003	\$ (33,492)

In restating the previously issued financial statements for the investigations discussed above, we also corrected other previously reported amounts. We corrected the reporting of \$8.7 million of net sales to certain third party resellers and \$1.8 million of associated cost of net sales for the three months ended March 31, 2006 to classify these amounts as related party net sales and related party cost of net sales classifications, respectively, because in 2006 we determined that sales to these entities

were, in substance, sales to a significant shareholder, SOFTBANK CORP. The classification of the accounts receivable from these sales was similarly changed to include them in accounts receivable from related parties in the March 31, 2006 consolidated balance sheet. We also corrected our reporting of \$6.2 million of time deposits at March 31, 2006 because they did not mature within three months. Formerly the time deposits had been reported in error as cash equivalents, but now these amounts are included in short-term investments in the balance sheet and in the statement of cash flows for the March 2006 reporting period.

**ALL AMOUNTS IN THE FOLLOWING SECTIONS OF THIS MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS, EXCEPT THOSE IDENTIFIED AS PREVIOUSLY REPORTED IN TABLES WITHIN THE QUARTERLY DATA (UNAUDITED), AS RESTATED CAPTION, REFLECT THE EFFECTS OF THE RESTATEMENT OF OUR FINANCIAL STATEMENTS TO CORRECT OUR REVENUE RECOGNITION FOR CERTAIN SALES CONTRACTS IN CHINA AND OUR HISTORICAL STOCK OPTION ACCOUNTING, AND THE CORRECTION OF THE CLASSIFICATION OF A TIME DEPOSIT FROM CASH TO SHORT-TERM INVESTMENTS IN THE FIRST TWO QUARTERS OF 2006.**

#### **Late SEC Filings and NASDAQ Delisting Proceedings**

As a result of the Nominating and Corporate Governance's Committee's review of our historical stock option accounting and the resulting restatements, we did not timely file our Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 ( Q3 2006 Form 10-Q ), our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 ( 2006 Form 10-K ), and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2007 ( Q1 2007 Form 10-Q ) with the Securities and Exchange Commission. In addition, as a result of the Audit Committee's review of certain historical sales contracts in China, we did not timely file our Quarterly Report on Form 10-Q for the quarter ended June 30, 2007 ( Q2 2007 Form 10-Q ) with the Securities and Exchange Commission.

In connection with our failure to timely file our periodic reports, we received four NASDAQ Staff Determination letters, dated November 15, 2006, March 7, 2007, May 16, 2007 and August 13, 2007, respectively, stating that, as a result of each of these non-timely filings, we were not in compliance with the requirements of Marketplace Rule 4310(c)(14) and, therefore, our stock was subject to delisting from the NASDAQ Stock Market. We appealed the November 15, 2006 determination to the NASDAQ Listing Qualifications Panel (the Panel ) and were granted a conditional extension to our request for continued listing until April 16, 2007. On April 17, 2007, the Panel extended the deadline for filing our Q3 2006 Form 10-Q to May 14, 2007. The Panel also extended the deadline for filing our 2006 Form 10-K until July 16, 2007.

On May 2, 2007, we asked the NASDAQ Listing and Hearing Review Council ( Listing Council ) to review the April 17, 2007 decision of the Panel. On May 14, 2007, the Listing Council called the Panel's decision for review and requested that we provide an update on our efforts to file our delinquent filings. We have continued and continue to comply with that request. In addition, the Listing Council stayed the Panel's decision that required us to file our Quarterly Report on Form 10-Q for the third quarter of 2006 Form 10-Q by May 14, 2007, and to file our Annual Report Form 10-K for 2006 by July 16, 2007. On August 23, 2007, the Listing Council granted the Company an extension until October 22, 2007 to file our delinquent periodic reports and restatements. On October 10, 2007, we filed our Quarterly Report on Form 10-Q for the third quarter of 2006 and our Annual Report on Form 10-K for 2006. As of the date of the filing of this Quarterly Report on Form 10-Q for the first quarter of 2007, we will have one periodic report still outstanding, our Quarterly Report on Form 10-Q for the second quarter of 2007. We expect to be able to complete the filing of this outstanding report as soon as practicable.

#### **EXECUTIVE SUMMARY**

We design, manufacture and sell telecommunications infrastructure, handsets and customer premise equipment and provide services associated with their installation, operation, and maintenance. Our products are sold primarily to telecommunications service providers or operators. We sell an extensive range of products that are designed to enable voice, data and video services for our operator customers and consumers around the world. While historically the vast majority of our sales have been to service providers in China, we have expanded our focus to build a global presence and currently sell our products in several other established and emerging growth markets, which include North America, Japan, India, Central and Latin America, Europe, the Middle East, Africa and Southeast and North Asia.

We differentiate ourselves with products designed to reduce network complexity, integrate high performance capabilities and allow a simple transition to next generation networks. We design our products to facilitate cost-effective and efficient deployment, maintenance and upgrades.

As of March 31, 2007, the Company was structured across four key operating units:

1. **Network Solutions:** Our Network Solutions operating unit provides its products and services through two reporting segments; Wireless Infrastructure and Broadband Infrastructure. Our Wireless Infrastructure segment designs, builds and sells software and hardware products that enable end users, or subscribers, to send and receive voice and data communication in either a fixed or mobile environment by using wireless devices. Our Broadband Infrastructure segment designs, builds and sells software and hardware products that enable end users to access high-speed, cost effective fixed data, voice and media communication;
2. **Personal Communications Division:** Our Personal Communications Division ( PCD ) markets, sells and supports handsets other than PAS handsets for markets other than China. Most of our handset sales prior to 2006 were designed and built by other manufacturers, but beginning in 2006 and beyond future sales will include more products built by our Handsets segment;
3. **Handsets:** Our Handsets segment designs, builds and sells consumer devices that allow customers to access wireless services. Revenues from worldwide PAS handsets and all handset revenues within China are included in this segment; and
4. **Services:** Our Services segment provides service and support for Wireless Infrastructure and Broadband Infrastructure customers in the areas of planning, deployment, operations and ongoing maintenance.

Our products within each of these categories, excluding services, include multiple hardware and software subsystems that can be offered in various combinations to suit individual carrier needs. Our system products are based on widely adopted global communications standards and are designed to allow service providers to quickly and cost-efficiently integrate our systems into their existing networks and deploy our systems in new broadband, Internet Protocol and wireless network rollouts. Our products are also designed for quick and cost-effective transition to future network technologies, enabling our customers to make the best use of their existing infrastructure.

We monitor our key business indicators on a regular basis, including net new bookings, collections, revenues, gross margins, operating expenses, inventory and inventory turns, days sales outstanding, cash flow from operations and cash balances. The inventory turns and days sales outstanding for the handsets and PCD segments are different from the Network Solutions operating unit and tend to fluctuate because of seasonality effects. Net new bookings and booking margins are good indicators of the health of the business and the aging distribution of accounts receivable indicates how well we are performing on our cash collections.

Our largest market for the three months ended March 31, 2007 and the year ended December 31, 2006 was the United States of America, representing 62% and 55% of sales, respectively. Prior to 2005, the majority of our sales were to service providers in China. This shift in market concentration and revenue is due to the combination of China's continued slow-down in its economy since the fourth quarter of 2004 and our ability to capture growth opportunities internationally as well as the incremental sales contributed by PCD subsequent to its acquisition in November 2004.

Our gross profit as a percentage of sales in both our PCD and handset product lines have improved despite the decline in sales prices as a result of improved product cost management. However, we expect gross profit as a percentage of sales to decline during the remainder of the year as cost reduction measures are not likely to keep pace with price reductions. We strive to develop products with more advanced features and to enhance the features of our existing products, which, we believe, will enable us to offer our customers more advanced products at higher average selling prices than otherwise would be possible in the future.

China has been one of our largest markets and we believe that it will continue to be an important market for our current and future technologies and development for the foreseeable future. However, we have also experienced a maturation of our PAS market in China resulting in our need to have a more diversified product and customer base. The number of competitors for communications access and switching systems and handsets in China has grown in line with China's telecommunications market expansion. This growth has led to competitive pricing pressure, causing average selling prices to decrease during the three months ended March 31, 2007 relative to those in the comparative period in 2006.



We strive to develop products with more advanced features and to enhance the features of our existing products, which, we believe, will enable us to offer our customers more advanced products at higher average selling prices than otherwise would be possible in the future.

Over the past few years, we have undertaken a significant globalization program and we intend to continue to expand our global sales outside of China in the current year. As we expand, we will continue to improve our internal supply chain and inventory management processes to ensure timely deliveries. We use subscriber growth statistics to gauge future inventory purchasing requirements as well as forecast our anticipated revenue growth. We will also continue to implement and enhance our administrative infrastructure to assist with our growth and globalization transformation.

On October 2, 2007, our Board of Directors approved a restructuring plan (the Plan) to reduce operating costs, which includes a worldwide reduction in force of approximately 11% of the Company's headcount, or approximately 700 employees. The workforce reduction will be based primarily in the United States and China and, to a lesser degree, other international locations. Management expects the Plan to be completed in the fourth quarter of fiscal year 2007. We expect to incur a restructuring charge in connection with the Plan of approximately \$10 million, comprised largely of cash payments associated with one-time severance benefits, with the majority of the charge to be taken in the fourth quarter of 2007. In addition, we expect to realize cost savings in salary and compensation related expenses of approximately \$21 million on an annualized basis.

We will continue our efforts to evaluate certain operations and will actively pursue opportunities to divest additional non-core assets and may incur additional costs associated with future actions to further align our business operations and streamline our business processes.

## **KEY TRANSACTIONS**

### ***Marvell Technology Group Ltd.***

In February 2006, we sold substantially all of the assets and selected liabilities of our semiconductor design business division, including the assets related to the prior acquisition of Advanced Communications Devices Corporation, to Marvell. We received \$20.0 million in cash in February 2006 and an additional \$4.3 million in cash in August 2007. We received an additional payment of \$16.0 million from Marvell in October 2006 as a result of achieving certain defined milestones.

In connection with the sale of assets, we have entered into a supply agreement with Marvell to purchase chipsets for our handset products over the next five years. The value allocated to the supply agreement of \$20.2 million is included in other current and long-term liabilities, and is being amortized in proportion to the quantities of chipsets purchased under the supply agreement over the next five years. For the three months ended March 31, 2007, approximately \$0.5 million amortized against cost of sales.

**TRANSACTIONS WITH RELATED PARTIES AND OTHER INFORMATION**

The following is a summary of the Company's transactions with related parties and other information:

	<b>Three months ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(As restated)</b>	
<b>Net sales</b>	<b>(in thousands)</b>	
Softbank	\$ 11,535	\$ 43,027
Japan Telecom, Ltd	1,581	1,790
Total Softbank and affiliates	13,116	44,817
ORG, Inc.	212	127
Total	\$ 13,328	\$ 44,944

	<b>Accounts receivable</b>		<b>Accounts payable</b>	
	<b>March 31,</b>	<b>December 31,</b>	<b>March 31,</b>	<b>December 31,</b>
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>			
Softbank and affiliates	\$ 24,451	\$ 29,941	\$ 591	\$ 535
MDC Holding, Ltd.	962	1,300		
Fiberxon, Ltd.	55	44	151	368
ORG, Inc.	2	1,025		
GCT Semiconductor, Inc.			339	1,051
Acoustek Int'l, Inc.			51	51
Cortina/Immenstar				345
Other	17	8	11	50
Total	\$ 25,487	\$ 32,318	\$ 1,143	\$ 2,400

	<b>March 31,</b>	<b>March 31,</b>
	<b>2007</b>	<b>2006</b>
	<b>(As restated)</b>	
	<b>(in thousands)</b>	
Softbank and affiliates	\$ 484	\$
Fiberxon, Ltd.	1,803	1,661
GCT Semiconductor, Inc.	1,177	2,285
Cortina/Immenstar	13	2,017
Total	\$ 3,477	\$ 5,963

***Softbank and affiliates***

We recognize revenue with respect to sales of telecommunications equipment to affiliates of SOFTBANK CORP. ( Softbank ), a significant stockholder of the Company. Softbank offers asynchronous digital subscriber line ( ADSL ) coverage throughout Japan, which is marketed under the name YAHOO! BB. We support Softbank's fiber-to-the-home service through sales of our carrier class Gigabit Ethernet Passive Optical Network ( GEAPON ) product as well as our multi-service optical transport product ( NetRing ). In addition, we support Softbank's new IPTV, through sales of our RollingStream product. Included in revenue for the three months ended March 31, 2006 is a fee of \$17.0 million charged for the cancellation of orders for broadband products.

Sales to Softbank include a three-year service period and a penalty clause if product failure rates exceed a certain level over a seven-year period. As of March 31, 2007, our customer advance balance related to Softbank agreements was \$0.5 million compared to no balance as of December 31, 2006. The current deferred revenue balance related to Softbank was \$9.3 million and \$11.6 million as of March 31, 2007 and December 31, 2006, respectively. As of March 31, 2007, our noncurrent deferred revenue balance related to Softbank was \$11.7 million compared to \$11.5 million as of December 31, 2006.



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During August 2004, we entered into several agreements with Japan Telecom Co., Ltd ( JT ), a wholly owned subsidiary of Softbank. These agreements relate to the sale of *iAN-8000* equipment with specified value and delivery dates, as well as an oral agreement which subsequently converted into specific service contracts to manage a sales promotional program for JT. We have determined that the service activities revenue should be recorded net of expected promotional spending.

On July 17, 2003, we entered into a Mezzanine Loan Agreement with BB Modem Rental PLC ( BB Modem ), an affiliate of Softbank. Under the terms of the agreement, we loaned BB Modem \$10.1 million at an effective interest rate of 12.01% per annum, for the purpose of investing in a portfolio of ADSL modems and associated modem rental agreements, from Softbank. Softbank will continue to service such modems and modem rental agreements. Our loan was subordinated to certain senior lenders of BB Modem, and repayments were paid to us over a 42-month period through January 31, 2007, with a substantial portion of the principal amount of the loan schedule repaid during the last 16 months of this period. During the three months ended March 31, 2007 and 2006, we recorded an immaterial amount and \$0.2 million, respectively, in interest income with respect to this loan. The loan receivable was fully settled at March 31, 2007 compared to a balance of approximately \$1.0 million as of December 31, 2006 which was included in prepaid and other current assets.

61

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As of March 31, 2007, Softbank beneficially owned approximately 12% of our outstanding stock.

***ORG, Inc.***

We have a 49% ownership in Global Asia Partners L.P. which in turn is a significant shareholder in ORG, Inc., a reseller of infrastructure equipment for broadband access. In January 2005, we entered into a reseller agreement with ORG, Inc., which was terminated in August 2006; however an immaterial amount of revenue for pre-August 2006 deliveries were recognized in the three months ended March 31, 2007.

***MDC Holding, Ltd.***

We have an outstanding accounts receivable balance with MDC Holding, Inc. ( MDC ) related to a PAS system purchase, in which certain of our employees were shareholders of MDC. MDC is in the business of providing value-added services, such as short message, voicemail or ring-tone services for PAS telecom networks.

***Fiberxon, Ltd.***

We have an outstanding purchase commitment of an immaterial amount with Fiberxon, Ltd., in which we have a 7% ownership interest, to purchase component parts for optical networking products. We paid \$0.1 million to Fiberxon, Ltd. for each of the three months ended March 31, 2007 and 2006.

***GCT Semiconductor, Inc.***

We have a 2% ownership interest in GCT Semiconductor, Inc., which designs, develops and markets integrated cost circuit products for the wireless communications industry.

***Acoustek Int l, Inc.***

We have obtained consulting services from Acoustek Int l Inc. ( Acoustek ), which employed Minnie Huang, spouse of William Huang, our former Senior Vice President and Chief Technology Officer. Mr. Huang s employment with the Company terminated on December 31, 2006. We made no payments during the three months ended March 31, 2007 compared to \$0.1 million for the same period in 2006 to Acoustek for consulting services.

***Cortina / Immenstar***

We have an outstanding purchase commitment with Cortina Systems, Inc, in which the Company has a 1.3% ownership interest on a fully diluted basis, to purchase chips that are used in our product.

***Xalted Networks, Inc.***

We received purchase orders from Xalted Networks (Xalted ) totaling approximately \$1.3 million in 2005 for telecommunications equipment that is for product not typically sold by us to other customers. We are charging a ten percent procurement fee to Xalted for obtaining and reselling these products. The equipment was delivered during 2005 but revenue has not been recognized as the revenue recognition process had not been completed. As of March 31, 2007, our customer advance balance related to Xalted was \$1.3 million compared to no balance as of December 31, 2006.

**RESULTS OF OPERATIONS**

As mentioned in the Executive Summary, we manage our business based principally upon product families of four operating units, (i) Network Solutions, which includes the Broadband Infrastructure and Wireless Infrastructure reporting segments, (ii) PCD, (iii) Handsets, and (iv) Services. A summary of the financial results of each of the segments are as follows:

*Net sales*

	Three months ended March 31,			2006	
	2007	% of net sales		as restated	% of net sales
<i>Net Sales by Segment</i>					
	(in thousands)				
Broadband Infrastructure	\$ 31,222	6 %	\$ 57,251	10 %	
Wireless Infrastructure	69,879	15 %	105,733	18 %	
Network Solutions	101,101	21 %	162,984	28 %	
PCD	288,330	61 %	322,995	54 %	
Handsets	69,719	15 %	99,034	16 %	
Services	16,752	3 %	16,968	2 %	
Net sales	\$ 475,902	100 %	\$ 601,981	100 %	

	Three months ended March 31,			2006	
	2007	% of net sales		(As restated)	% of net sales
<i>Net Sales by region</i>					
	(in thousands)				
United States	\$ 293,169	62 %	\$ 329,763	55 %	
China	136,734	29 %	199,810	33 %	
Japan	14,315	3 %	47,660	8 %	
Other	31,684	6 %	24,748	4 %	
Net sales	\$ 475,902	100 %	\$ 601,981	100 %	

*Three months ended March 31, 2007 and 2006*

Net sales decreased by 21% to \$475.9 million during the quarter ended March 31, 2007 compared to the same period in 2006. The decrease is primarily due to a decrease in sales in the Wireless Infrastructure and Broadband Infrastructure segments by 38% for the three months ended March 31, 2007 compared to the three months ended March 31, 2006. Broadband Infrastructure net sales decreased by \$26.0 million, or 45%, for the three months ended March 31, 2007 compared to the same period in 2006. Higher Broadband Infrastructure segment sales during the three months ended March 31, 2006 included order cancellation fees of \$22.6 million, primarily for the GEAPON and Netring products. In addition, due to the customer concentration in this segment, revenues fluctuate based upon the magnitude and timing of revenue recognition on certain contracts. Wireless Infrastructure net sales decreased by \$35.9 million, or 34%, for the three months ended March 31, 2007 compared to the same period in 2006, mainly due to the continued weakening demand for our PAS products. Handset sales declined by \$29.3 million, or 30%, in the first quarter of 2007 due to both price and volume declines when compared to the first quarter of 2006. As we have been experiencing in recent quarters, increased competition and lower net subscriber growth of PAS have resulted in lower demand and average selling price for our handsets.

Net sales of PCD decreased during the three months ended March 31, 2007 as compared to the same period in 2006, primarily due to a decline in the overall average selling price. Net sales for our Services segment remained relatively stable during the first three months of 2007. For additional discussion see Segment Reporting section of this Item 2.

**Gross profit**

	Three months ended March 31,			Gross profit %		
	2007			2006		
	(in thousands)			(As restated)		
<b>Gross profit by Segment</b>						
Broadband Infrastructure	\$ 5,001	16	%	\$ 23,086	40	%
Wireless Infrastructure	24,266	35	%	50,761	48	%
Network Solutions	29,267	29	%	73,847	45	%
PCD	16,845	6	%	14,389	4	%
Handsets	25,048	36	%	31,613	32	%
Services	4,125	25	%	3,942	23	%
Gross Profit	\$ 75,285	16	%	\$ 123,791	21	%

Cost of sales consists primarily of material and labor costs, including stock-based compensation, associated with manufacturing, assembly and testing of products, costs associated with installation and customer training, warranty costs, fees to agents, inventory provision and overhead. Cost of sales also includes import taxes and tariffs on components and assemblies. Some components and materials used in our products are purchased from a single supplier or a limited group of suppliers and, in some cases, are subject to obtaining Chinese import permits and approvals. We also rely on third party manufacturers to manufacture and assemble most of our CDMA handsets.

Our gross profit has been affected by average selling prices, material costs, product mix, the impact of warranty charges and contract loss provisions as well as inventory reserves and release of deferred revenues and related cost pertaining to prior years. Our gross profit, as a percentage of net sales, varies among our product families. We expect that our overall gross profit, as a percentage of net sales, will fluctuate from period to period as a result of shifts in product mix, stage of product life cycle, anticipated decreases in average selling prices and our ability to reduce cost of sales.

*Three months ended March 31, 2007 and 2006*

Gross profit was \$75.3 million, or 16% of net sales, in the three months ended March 31, 2007, compared to \$123.8 million, or 21% of net sales, in the corresponding quarter of 2006. The overall gross profit decrease is due to a decline in sales and lower gross profit as a percentage of sales in the Wireless Infrastructure and Broadband Infrastructure segments. Gross profit percentages improved in the PCD, Handset and Services segments, primarily due to a change in the product mix to higher gross margin products. For additional discussion see Segment Reporting section of this Item 2.

**Operating expenses**

The following table summarizes our operating expenses:

	Three months ended March 31,			% of net sales		
	2007			2006		
	(in thousands)			(As restated)		
Selling, general and administrative	\$ 79,837	17	%	\$ 83,727	14	%
Research and development	43,662	9	%	46,402	8	%
Amortization of intangible assets	4,046	1	%	4,925	1	%
Total operating expenses	\$ 127,545	27	%	\$ 135,054	23	%

Selling, general and administrative expenses ( SG&A ) include compensation and benefits, professional fees, sales commissions, provision for doubtful accounts receivable and travel and entertainment costs. Research and development ( R&D ) expenses consist primarily of compensation and benefits of employees engaged in research, design and development activities, costs of parts for prototypes, equipment depreciation and third party development expenses. We believe that continued and prudent investment in research and development is critical to our long-term success, and we will aggressively evaluate appropriate investment levels. A portion of our costs are fixed and are difficult to quickly reduce in periods of lower sales.



Selling, general and administrative

*Three months ended March 31, 2007 and 2006*

SG&A expenses decreased \$3.9 million but increased by 3 percentage points as a percentage of net sales during the three months ended March 31, 2007 compared to the same period in 2006. The decrease in SG&A expenses was primarily due to a \$6.1 million decrease in our provision for doubtful accounts compared to the same period in 2006. Days sales outstanding was 67 days at March 31, 2007 as compared to 74 days at March 31, 2006. The shorter days sales outstanding and resultant decrease in provision for doubtful accounts is the result of improved cash collections in the first quarter of 2007 relative to the comparable period in 2006. This was offset by higher labor related expenses as well as external accounting and legal expenses.

In the first quarter of 2006, the Company decided to terminate the Mongolian joint venture arrangement and wrote off the remaining net assets, of approximately \$4.7 million. SG&A expense for the three months ended March 31, 2006 included one-time charges related to the write off of these assets.

Research and development

*Three months ended March 31, 2007 and 2006*

R&D expenses decreased by \$2.7 million but increased by 1 percentage points as a percentage of net sales during the three months ended March 31, 2007 compared to the same period in 2006. The absolute decrease in R&D expenses is mainly attributed to a \$2.3 million decrease in consulting expenses.

Amortization of intangible assets

*Three months ended March 31, 2007 and 2006*

Amortization of intangible assets decreased by \$0.9 million in the three months ended March 31, 2007 compared to the same quarter last year. Amortization of intangible assets declined as several intangible assets became fully amortized during the preceding twelve months.

**Interest income**

*Three months ended March 31, 2007 and 2006*

Interest income was \$4.9 million and \$3.5 million for the three months ended March 31, 2007 and 2006, respectively. Interest income increased primarily due to a change in our investment mix which was more heavily weighted toward short-term and long-term investments during the three months ended March 31, 2007 as compared to the same period in 2006.

**Interest expense**

*Three months ended March 31, 2007 and 2006*

Interest expense was \$6.7 million and \$3.5 million for the three months ended March 31, 2007 and 2006, respectively. The increase in interest expense for the three months ended March 31, 2007 compared to the same period in 2006 was primarily attributable to the incremental interest expense of \$4.2 million resulting from the First Supplemental Indenture. As a result of the First Supplemental Indenture, our convertible subordinated notes stated interest rate increased to 7.625% per annum after January 9, 2007 to the March 1, 2008 maturity date. Prior to January 9, 2007, our convertible subordinated notes accrued interest at 7/8% per annum.

**Other income**

*Three months ended March 31, 2007 and 2006*

Net other income was \$4.0 million and \$3.6 million for the three months ended March 31, 2007 and 2006, respectively. Net other income for the three months ended March 31, 2007 was primarily due to a \$2.8 million gain on the sale of the Immenstar investment and a \$1.1 million gain on foreign currency revaluation. Net other income for the three months ended March 31, 2006 was primarily due to a \$2.8 million gain on foreign currency revaluation and a \$0.5 million financial subsidy from the local Chinese government.



**Income tax expense**

Income tax expense is based upon a blended effective tax rate based upon our expectation of the amount of income to be earned in each tax jurisdiction and is accounted under the liability method. Deferred income taxes are recognized for the differences between the tax bases of assets and liabilities and their financial statement amounts based on enacted tax rates. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. We will maintain a full valuation allowance on our net deferred tax assets in China, the United States, and other countries until an appropriate level of profitability that generates taxable income is sustained or until we are able to develop tax strategies that would enable us to conclude that it is more likely than not that a portion of our deferred tax assets will be realizable. Any reversal of valuation allowances will favorably impact our results of operations in the period of the reversal.

*Three months ended March 31, 2007 and 2006*

Income tax expense was \$4.3 million and \$2.8 million for the three months ended March 31, 2007 and 2006, respectively. There are two primary reasons why the Company has tax expense while the Company has pretax losses. First, we have not provided any tax benefit on the forecasted current year losses incurred and tax credits generated in the United States and other countries, because management believes that it is more likely than not that the tax benefit associated with these losses will not be realized. Second, we continue to accrue tax expense in jurisdictions where we have been historically profitable. Estimates of the annual effective tax rate at the end of the interim periods are based on evaluations of possible future events and transactions and may be subject to subsequent refinement or revision.

We adopted the provisions of Financial Accounting Standards Board ( FASB ) Interpretation No. 48, Accounting for Uncertainty in Income Taxes-an interpretation of FASB Statement No. 109 ( FIN 48 ) on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized a \$1.4 million increase in the liability for unrecognized tax benefits which, as required, was accounted for as a reduction to the January 1, 2007 balance of retained earnings. FIN 48 established criteria for recognizing or continuing to recognize only more-likely-than tax positions, which may result in income tax expense volatility in future periods. While we believe that we have adequately provided for all tax positions, amounts asserted by taxing authorities could be greater than our accrued position. Accordingly, additional provisions on income tax related matters could be recorded in the future as revised estimates are made or the underlying matters are settled or otherwise resolved.

**SEGMENT REPORTING**

We offer products and services through four operating units, namely Network Solutions, PCD, Handsets and Services. The Network Solutions operating unit provides its products and services through two reporting segments; Broadband Infrastructure and Wireless Infrastructure. Each reporting segment and operating unit is responsible for managing its own performance.

We currently evaluate operating performance of and allocate resources to the reporting segments based on segment gross profit. Cost of sales and direct expenses in relation to production are assigned to the reporting segments. The accounting policies used in measuring segment assets and operating performance are the same as those used by corporate and are consistently applied across all segments.

Summarized below are our segment sales revenue and gross profit for the three months ended March 31, 2007 and 2006, respectively.

*Network Solutions*Broadband Infrastructure

	<b>Three months ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
		<b>as restated</b>
Sales	\$ 31,222	\$ 57,251
Gross profit	\$ 5,001	\$ 23,086
Gross profit as a percentage of sales	16	40
	%	%



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Our largest Broadband Infrastructure customer is Softbank in Japan, representing approximately 30% and 74% of total broadband sales during the three months ended March 31, 2007 and 2006, respectively. Due to the customer concentration in this segment, revenues fluctuate based upon the magnitude and timing of revenue recognition on certain contracts.

Gross profit decreased in the first quarter of 2007 when compared to the same period in 2006, primarily due to revenue recorded for the cancellation compensation fees in 2006 of \$22.6 million; this revenue had no associated cost of sales related to it. This caused a one-time increase in both sales and gross profit in the first three months of 2006, when compared to the same period in 2007. The overall reduction in gross profit during 2007 was partially offset by \$4.8 million of RollingStream revenue which has a higher gross profit margin.

We currently offer and have initial market acceptance of our RollingStream IPTV products in China, Japan and other geographic regions. We believe that the IPTV market presents a meaningful growth opportunity in these regions as well as other regions we have targeted to expand our IPTV offerings, including India.

### Wireless Infrastructure

	<b>Three months ended March 31,</b>			
	<b>2007</b>		<b>2006</b>	
	<b>(in thousands)</b>		<b>as restated</b>	
Sales	\$	69,879	\$	105,733
Gross profit	\$	24,266	\$	50,761
Gross profit as a percentage of sales		35	%	48
			%	%

During the three months ended March 31, 2007, PAS systems sales declined 41% and now comprise approximately 79% of our Wireless Infrastructure sales compared to 88% during the same period in 2006. Wireless sales declined in China by 40%, and were offset by marginal increases in other regions. The decrease in PAS systems sales is primarily a result of our customers in China transitioning from new system installations to system expansions as PAS systems reach product maturity and China readies for 3G launch.

The gross profit as a percentage of sales decreased by 13 percentage points in the three months ended March 31, 2007, as compared to the corresponding quarter in 2006 due to a number of factors, including: (i) decrease of PAS infrastructure margin, and (ii) lower voice and data networks software sales which have higher margin.

We expect future PAS infrastructure spending to decline further as China readies for 3G launch. We plan to aggressively pursue opportunities for our Packet PAS products (for broadband wireless data market based on PAS technology), high end PAS products including dual mode, CDMA products and Softswitch products in multiple markets; though we do not anticipate that these sales will fully offset the decline in PAS sales.

### PCD

	<b>Three months ended March 31,</b>			
	<b>2007</b>		<b>2006</b>	
	<b>(in thousands)</b>		<b>as restated</b>	
Sales	\$	288,330	\$	322,995
Gross profit	\$	16,845	\$	14,389
Gross profit as a percentage of sales		6	%	4
			%	%

Revenue for the PCD segment decreased 11% during the three months ended March 31, 2007 as compared to the same period in 2006. Although the number of units sold during the first three months of 2007 increased by 256,000 units, the decline in the overall average selling price of 22% resulted in a \$34.7 million decrease to revenue for the three months ended March 31, 2007 as compared to the same period in 2006.

Historically, PCD has relied upon a limited number of manufacturers to supply its handset products. During the three months ended March 31, 2007, sales of UTStarcom branded devices accounted for 51% of the total units sold, compared to 16%



of the total units sold for the three months ended March 31, 2006. We have focused on increasing our sales of UTStarcom branded devices as we earn a higher gross margin on these handsets.

Gross profit as a percentage of sales increased to 6% for the three months ended March 31, 2007 compared to 4% for the three months ended March 31, 2006. The increase in gross profit is mainly attributable to the product mix including more UTStarcom products with higher gross margins. As the percentage of UTStarcom designed and manufactured products increases, we expect the PCD margin to increase in the future.

#### **Handsets**

	<b>Three months ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
		<b>as restated</b>
Sales	\$ 69,719	\$ 99,034
Gross profit	\$ 25,048	\$ 31,613
Gross profit as a percentage of sales	36 %	32 %

Net sales declined 30% for the three months ended March 31, 2007 compared to the same period in 2006. Nearly all our handset sales are in China, where we have experienced a decline in volume and price for our PAS handsets. The PAS handset units sold declined to 1.3 million compared to 2.0 million in the comparable period last year. The 35% volume decline was primarily attributed to lower demand for our PAS handsets resulting from slower subscriber growth as service providers reduced the marketing efforts for PAS handsets in anticipation for next generation technology networks.

The average selling price per unit in the PAS products declined 5% due to competitive pricing pressures. We have also experienced continuing pricing pressure in the China telecommunications market since the latter part 2003, which has driven average unit selling prices lower. We expect to see cumulative PAS subscriber growth at lower rates in future periods.

Gross profit as a percentage of sales for our handsets segment increased from 32% to 36% in the three months ended March 31, 2007, as compared to the corresponding period in 2006. The improvement in the gross profit percentage primarily relates to shifting most of our products to the use of chip-sets with greater functionality in PAS handsets that reduce the overall component costs of each unit.

#### **Services**

	<b>Three months ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
	<b>(in thousands)</b>	
		<b>as restated</b>
Sales	\$ 16,752	\$ 16,968
Gross profit	\$ 4,125	\$ 3,942
Gross profit as a percentage of sales	25 %	23 %

Our Services segment's revenue from external customers remained relatively stable in the three months ended March 31, 2007 as compared to the corresponding quarter last year.

During the first quarter of 2007, revenues of \$1.4 million from Wireless Infrastructure and \$0.2 million from Broadband Infrastructure in China were allocated to the Services segment. The allocation was made on certain completed contracts for which the service element was not separately priced. The allocated amount for the three months ended March 31, 2006 was \$2.6 million from Wireless Infrastructure and \$0.1 million from Broadband Infrastructure. The lower allocated amount of \$1.1 million in the first three months of 2007, when compared to the same period in 2006, was due to a renewal delay of certain service contracts and a net loss in our China Services segment.



## LIQUIDITY AND CAPITAL RESOURCES

### *Operating Activities*

#### 2007

Net cash used in operating activities for the three months ended March 31, 2007 was \$106.7 million. Operating cash was negatively affected by the net loss of \$54.0 million and changes in other assets, inventories, payables and other current liabilities offset by changes in accounts receivable and customer advances, as discussed below.

During the first three months of 2007, inventories increased \$2.4 million primarily due to inventory purchases related to a large infrastructure deployment contract that we entered into in the fourth quarter of 2006, and increases in other assets of \$31.4 million primarily due to advances to our suppliers and the prepayment of taxes and insurance. In addition, accounts payable decreased \$41.3 million, due to our decision to change the timing of payments to vendors in the first quarter of 2007 to comply with shorter vendor payment terms. Other current liabilities decreased \$79.3 million in the first three months of 2007, due primarily to payments of bonuses and commissions earned in the prior year and warranty settlements.

The cash used in operating activities was partially offset by a reduction in accounts receivable of \$60.3 million as a result of strong cash collections and the high percentage of revenue in the first quarter of 2007 from our PCD segment which generally has experienced a shorter collection period on related receivables.

Customer advances increased by \$44.3 million at March 31, 2007. Customer advances represents cash deposits we have received from our customers for orders that have not yet received final acceptance. Upon subsequent receipt of final acceptances and revenue recognition, customer advances are reduced and revenue and cost of sales is recorded.

#### 2006

Net cash provided by operating activities for the three months ended March 31, 2006 was \$53.7 million. Operating cash was affected by changes in deferred costs, customer advances, accounts receivable, and accounts payable and offset by the net loss as well as changes in other current liabilities and inventory.

Customer advances increased by \$43.1 million for the three months ended March 31, 2006. Customer advances represent cash deposits we have received from our customers for orders that have not yet received final acceptance. Upon subsequent receipt of final acceptances and revenue recognition, customer advances are reduced and revenue and cost of sales is recorded. Deferred costs decreased by \$3.2 million from December 31, 2005 to March 31, 2006 due to a net increase in cost of sales recognition resulting from customer acceptances during this three month timeframe..

The \$28.8 million decrease in accounts receivable was attributable to a decline in sales preceding the end of the March 31, 2006 quarter as compared to sales in the preceding quarter. Partially offsetting this is a lengthening of days sales outstanding to 74 days at March 31, 2006 as compared to 66 days at December 31, 2005.

Accounts payable increased by \$18.1 million and inventory increased by \$4.3 million primarily due to handset unit inventory purchases in China partially offset by lower inventory purchases by PCD. Other current liabilities decreased by \$51.0 million, primarily as a result of a decrease in taxes payable of approximately \$14.2 million, a decrease in compensation related costs of approximately \$8.8 million, a decrease in accrued expenses, such as warranty, royalty and legal, of approximately \$13.9 million, and a decrease of approximately \$14.1 million in other liabilities.

### *Investing Activities*

#### 2007

Net cash provided by investing activities for the three months ended March 31, 2007 totaled \$1.8 million. Cash of \$12.3 million was received from the disposition of an investment interest and proceeds from the sale of short-term investments, and \$10.4 million was the result of a decrease in restricted cash. Cash outflows from investing activities included \$15.6 million for the purchase of short-term investments as well as \$5.2 million for the purchase of property, plant and equipment.

#### 2006

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Net cash used in investing activities for the three months ended March 31, 2006 totaled \$3.5 million. Cash outflows from investing activities included an increase in restricted cash of \$17.0 million as well as \$17.0 million used to purchase short-term investments. Cash of \$20.0 million was received from the sale of the semiconductor design assets to Marvell, and \$13.3 million was received from the net sale of short-term investments.

69

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### *Financing Activities*

#### 2007

Net cash used in financing activities was \$0.7 million, primarily consisting of a change in cash overdrafts for the three months ended March 31, 2007.

#### 2006

Net cash used in financing activities was \$30.8 million, primarily consisting of a net repayment of short-term borrowings in excess of new borrowing of \$27.6 million for the three months ended March 31, 2006.

### *Liquidity*

We reported net losses in each quarter in the period beginning April 1, 2005 and continuing through March 31, 2007, which have resulted in an accumulated deficit of \$549.6 million and total stockholders' equity being reduced to \$722.6 million at March 31, 2007. Additionally, at March 31, 2007, we had short-term debt in China under lines of credit to our China subsidiaries of \$103.6 million maturing in 2007 and the first quarter of 2008, and short-term debt outside of China in the form of 7/8% convertible subordinated notes with a principal balance of \$274.6 million that matures in March 2008.

Our working capital was \$479.3 million and \$855.0 million at March 31, 2007 and 2006, respectively, and included cash on hand of \$558.1 million and \$667.4 million and short term investments of \$14.8 million in and \$17.1 million, respectively in 2007 and 2006. Planned capital expenditures include an increase in the level of our capital expenditures in China in 2007 by approximately \$40 million to support wire line telephone carriers in China who utilize our products and services to provide television service to their customers using the IPTV protocol.

Credit facilities in China at March 31, 2007 totaled \$692.7 million, with \$353.5 million of this amount available for working capital purposes, of which we had drawn \$103.6 million in outstanding borrowings, with interest rates ranging from 5.51% to 5.57%, and \$339.2 million was available for use in support of letters of credit and corporate guarantees. These facilities expire primarily in November and December of 2007. We believe that based upon our recent financial performance and financial position our lenders may reduce the total available credit when it negotiates renewals of these lines. Furthermore, each borrowing under the credit facilities is subject to the bank's current favorable opinion of the credit worthiness of the Company's China subsidiaries, as well as the bank having funds available for lending and other Chinese banking regulations. However, we believe the amounts of credit our lenders may make available and the borrowings made under the renewed lines of credit will be sufficient to meet planned uses of these credit facilities.

As of September 30, 2007 our outstanding borrowings under the credit facilities in China totaled \$140.1 million, with interest rates of up to 6.67%, with varying maturity dates through September 2008. The Company's practice in China is to draw new loans under the credit facilities prior to either the maturity of our borrowings or expiration of our facilities to ensure we maintain adequate liquidity to re-pay the existing borrowings at maturity, or to effectively lengthen the credit facility period to the latest maturity date of the underlying borrowings.

Of our total cash and short-term investments at March 31, 2007 of \$572.9 million, a total of \$414.6 million was held in China. To meet liquidity needs outside of China, our subsidiaries in China have the ability to transfer cash to the Company in the United States under China's current exchange control regulations. The amount of cash available for transfer from the China subsidiaries is limited both by liquidity needs of the subsidiaries in China and by Chinese government requirements that the China subsidiaries retain adequate capital levels in China to protect creditors and to have funds available for mandated employee benefits. During the nine months ended September 30, 2007 our China subsidiaries have made such transfers of funds out of China to the Company totaling \$150 million.

Although management believes we now have a sufficient amount of cash resources to finance our anticipated working capital and capital expenditure requirements for the next 12 months, we do not have enough cash outside of China to repay the convertible notes due on March 1, 2008. Management's liquidity plans include a partial or complete refinancing of the convertible notes, renewal of the lines of credit in China, transfers of more cash from its subsidiaries in China to the extent necessary, and, if needed, liquidation of certain investments and/or seeking new financing arrangements. Our ability to maintain sufficient liquidity is also dependent on achieving projected sales and operating margin forecasts.





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The convertible notes were issued in March 2003 when we completed an offering of \$402.5 million of 7/8% convertible subordinated notes due March 1, 2008 to qualified institutional buyers. The notes are convertible into our common stock at a conversion price of \$23.79 per share and are subordinated to all of our present and future senior debt. Concurrent with the issuance of the convertible notes, we entered into a convertible bond hedge and a call option transaction with respect to our common stock. Both the bond hedge and call option transactions may be settled at our option either in cash or net shares and expire on March 1, 2008. During 2005, we completed exchanges of approximately 5.0 million shares of our common stock and approximately \$57.1 million in cash for \$127.9 million aggregate principal amount of outstanding notes. As a result of the early extinguishment, we also amended the convertible bond hedge and call option transactions to reflect the change in principal amount of the underlying notes.

If an event of default were to occur and be continuing, the Trustee or the holders of at least 25% in aggregate principal amount of the notes then outstanding could declare all unpaid principal and accrued interest on the Notes then outstanding to be immediately due and payable. Therefore as a result of our inability to timely file our Quarterly Report on Form 10-Q for the period ended September 30, 2006, because the independent review by the Governance Committee of the Company's historic stock option accounting was not completed, after receiving a purported notice of default from the trustee for the notes (the Trustee) asserting that the delay in filing and a failure to comply with certain covenants had caused a default under the indenture, we solicited and received the requisite consents from the holders of the notes to a waiver of any defaults which may have occurred to and including January 9, 2007, caused by a delay in filing certain reports required to be filed pursuant to the Exchange Act (the SEC Reports) with the Securities and Exchange Commission (the SEC) and entered into a First Supplemental Indenture with the Trustee, dated January 9, 2007, which provided that any failure by us to comply with certain provisions of the original agreement will not result in a default or an event of default through May 31, 2007. After receiving a notice of default from the Trustee asserting that our inability to timely file SEC Reports and comply with certain covenants as of May 31, 2007 had caused a default under the indenture, we solicited and received the requisite consents from the holders of the notes to a waiver of any defaults which may have occurred to and including July 26, 2007 and entered into a Second Supplemental Indenture with the Trustee, after receiving consent from holders of more than 50% of the outstanding aggregate principal amount of the convertible subordinated notes in connection with our consent solicitation announced July 19, 2007. The Second Supplemental Indenture provides that (i) during the period from and including July 26, 2007 to and including October 15, 2007 (Covenant Reversion Date), any failure by us to comply with the covenants contained in the original indenture agreement related to the required filing of reports with the SEC, and the furnishing of copies of the SEC reports and certain compliance certificates to the Trustee, will not constitute a default, and that (ii) if, but for the Second Supplemental Indenture, a default would be deemed to have occurred as a result of a failure to comply with such covenants and such default remains uncured and is continuing as of the Covenant Reversion Date, such default will be deemed to have occurred on the Covenant Reversion Date. On October 15, 2007, we received an additional notice of default from the Trustee asserting that a default had occurred under the Indenture (as amended by the First Supplemental Indenture and the Second Supplemental Indenture) with respect to the Notes. The specific purported defaults referred to in the notice of default were (i) our failure to file with the SEC and provide copies to the Trustee of our Quarterly Report on Form 10-Q for the fiscal quarter ending March 31, 2007 and our Quarterly Report on Form 10-Q for the fiscal quarter ending June 30, 2007 and (ii) our failure to deliver to the Trustee our officer's certificate of compliance required by the Indenture. The notice of default provides that we have 60 consecutive days from October 15, 2007 to cure the purported defaults before such defaults would constitute an Event of Default under the Indenture. The occurrence of an Event of Default under the Indenture would afford the Trustee or holders of not less than 25% in aggregate principal amount of the Notes the right to declare the full principal amount of all outstanding Notes to be immediately due and payable. We cannot be certain that we will be able to file all required reports with the SEC by the Demand Date. Furthermore, we cannot be certain that consents from holders of the Notes necessary for an additional waiver of its obligations to comply with the Indenture covenants within the required period can be obtained on reasonable terms or at all.

Under the Second Supplemental Indenture, the convertible subordinated notes accrue an additional 6.75% per annum in special interest from and after January 9, 2007 to and including July 25, 2007, and an additional 10% per annum in special interest from and after July 26, 2007 to the date the notes are paid, prepaid, redeemed, converted or otherwise cease to be outstanding. The special interest rate accruing on the notes after July 26, 2007 represents an increase of 3.25% per annum over the previous special interest rate of 6.75% per annum provided by the First Supplemental Indenture. As a result of the Second Supplemental Indenture, the convertible subordinated notes now bear a stated interest rate of 10.875%. Accordingly, we will have \$22.0 million of additional annual interest expense in 2007 while the convertible subordinated notes are outstanding. Payments of special interest will be made in addition to, and at the same time and in the same manner as, regularly scheduled payments of interest to holders entitled to such regularly scheduled payments of interest.

If additional sources of liquidity were needed, the Company would consider new debt or equity offerings or obtaining cash from asset sales, but there is no assurance that such transactions could be consummated on acceptable terms or at all. Failure to raise sufficient capital when needed could have a material adverse effect on the business, results of operations and financial position of the Company.

Our China sales are generally denominated in local currency, and we accept commercial notes receivable with maturity dates of between three and six months from our customers in China in the normal course of business. Notes receivable available for sale was \$6.2 million and \$5.1 million at March 31, 2007 and December 31, 2006, respectively. We may discount these notes with banking institutions in China. Any notes that have been sold are not included in our consolidated balance sheets as the criteria for sale treatment established by Statement of Financial Accounting Standards No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities (SFAS 140) have been met.



Due to the limitations on converting Renminbi, we are limited in our ability to engage in foreign currency hedging activities in China. We cannot guarantee that fluctuations in foreign currency exchange rates in the future will not have a material adverse effect on revenues from international sales and, correspondingly, on our business, financial condition, results of operations and cash flows. We have contracts negotiated in Japanese Yen and we maintain bank accounts in Japanese Yen for purchasing portions of our inventories and supplies. The balance of these Japanese Yen accounts at March 31, 2007 was approximately \$15.4 million.

On August 1, 2005, we entered into a 364-day \$100.0 million committed receivables purchase facility with a financial institution. In March 2007, the agreement was amended and restated to reflect that the purchase of trade receivables shall be at the sole discretion of the financial institution. The agreement was also extended to the earlier of (i) March 28, 2008 or (ii) upon 90 days written notice by the financial institution. Pursuant to the terms of the receivable purchase facility, we may sell certain receivables arising from the sale of telecommunications equipment to this financial institution. No receivables had been sold pursuant to this arrangement.

We have not guaranteed any debt that is not included in the consolidated balance sheet.

### ***Income taxes***

Certain subsidiaries and joint ventures located in China enjoy tax benefits in China which are generally available to foreign investment enterprises, including full exemption from national enterprise income tax for two years starting from the first profit-making year and/or a 50% reduction in national income tax rate for the following three years. In addition, local enterprise income tax is often waived or reduced during this tax holiday/incentive period. Under current regulations in China, foreign investment enterprises that have been accredited as technologically advanced enterprises are entitled to additional tax incentives. These tax incentives vary in different locales and could include preferential national enterprise income tax treatment at 50% of the usual rates for different periods of time. The tax holidays discussed above are applicable or potentially applicable to UTStarcom Chongqing Telecom Co. Ltd. ( CUTS ), UTStarcom Telecom Co., Ltd. ( HUTS ), Hangzhou UTStarcom Telecom Co., Ltd. ( HSTC ) and UTStarcom China Co., Ltd. ( UTSC ), our active subsidiaries in China, as those entities may qualify as accredited technologically advanced enterprises.

On March 16, 2007, China's top legislature, the National People's Congress, passed the China Corporate Income Tax Law ( CIT Law ). CIT Law will be effective on January 1, 2008. Under the CIT Law, China's dual tax system for domestic enterprises and foreign investment enterprises ( FIEs ) would be effectively replaced by a unified system. The new law establishes a tax rate of 25% for most enterprises and a reduced tax rate of 15% for certain qualified high technology enterprises.

Prior to this change in tax law, certain subsidiaries and joint ventures located in China enjoy tax benefits in China which are generally available to FIEs. The tax holidays/incentives for FIEs were applicable or potentially applicable to CUTS, HUTS, HSTC and UTSC, our active subsidiaries in China, as those entities may qualify as accredited technologically advanced enterprises.

CIT Law targets certain industries for the reduced 15% tax rate for certain qualified high technology enterprises. For FIEs established before the promulgation of the new law who currently enjoy lower tax rates, any increase in their tax rates would be gradually phased in over five years. Significant regulations regarding the interpretation and implementation of the new tax law are still pending. There is potential risk that our subsidiaries may not qualify for the reduced 15% tax rate. Therefore, the new law may have an adverse impact on our future tax expense in China.

Moreover, the Chinese central government may review and audit tax benefits granted by local or provincial authorities and could determine to disallow such benefits. Certain of our subsidiaries and joint ventures located in China enjoy tax benefits in China that are generally available to foreign investment enterprises. If these tax benefits are reduced, disallowed or repealed due to changes in tax laws or determination by the Chinese government, our business could suffer.

We adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized a \$1.4 million increase in the liability for unrecognized tax benefits which, as required, was accounted for as a reduction to the January 1, 2007 balance of retained earnings. FIN 48 provides a comprehensive model for the recognition, measurement and disclosure in financial statements of uncertain income tax positions that a company has taken or expects to take on a tax return. Under FIN 48, a company can recognize the benefit of an income tax position only if it is more likely than not (greater than 50%) that the tax position will be sustained upon tax examination, based solely on the technical merits of the tax position. Otherwise, no benefit can be recognized. The tax benefits recognized are measured based on the largest benefit that has a greater than fifty percent likelihood of being realized upon ultimate settlement. Additionally, companies are



required to accrue interest and related penalties, if applicable, on all tax exposures for which reserves have been established consistent with jurisdictional tax laws. While we believe that we have adequately provided for all tax positions, amounts asserted by taxing authorities could be greater than our accrued position. Accordingly, additional provisions on income tax related matters could be recorded in the future as revised estimates are made or the underlying matters are settled or otherwise resolved.

#### *Off-balance sheet arrangements*

On August 1, 2005, we entered into a 364-day committed receivables purchase facility with Citibank, N.A., which provides for the sale of up to \$100.0 million of trade accounts receivable of our PCD segment. On March 30, 2007, the agreement was amended and restated to reflect that the purchase of trade receivables shall be at the sole discretion of Citibank, N.A. Sales of the accounts receivables to Citibank, N.A. under this program will result in a reduction of total accounts receivable in our consolidated balance sheet. The remaining accounts receivables not sold to Citibank, N.A. will be carried at their net realizable value, including an allowance for doubtful accounts. We have not sold any receivables pursuant to this facility during 2006 or the first three months of 2007. We believe that available funding under our accounts receivable financing program provides us increased flexibility to manage working capital requirements, and that there are sufficient trade accounts receivable to support the U.S. financing programs. Under the program, we will continue to service the accounts receivable.

At March 31, 2007, we have no other off balance sheet arrangements.

#### *Contractual obligations and other commitments*

Our obligations under contractual obligations and commercial commitments at March 31, 2007 were as follows:

	Payments due by period			
	Total (in thousands)	Less than 1 year	1-3 years	3-5 years
<b>Contractual Obligations</b>				
Bank loans	\$ 103,584	\$ 103,584	\$	\$
Convertible subordinated notes	\$ 274,600	\$ 274,600	\$	\$
Interest payable on debt	\$ 26,166	\$ 26,166	\$	\$
Lease obligations	\$ 33,863	\$ 14,189	\$ 16,603	\$ 3,071
<b>Other Commercial Commitments</b>				
Letters of credit	\$ 45,965	\$ 28,813	\$ 17,152	\$
Purchase commitments	\$ 106,469	\$ 100,889	\$ 5,580	\$

#### Bank loans

At March 31, 2007, we had loans with various banks totaling \$103.6 million with interest rates ranging from 5.51% to 5.57 % per annum. These bank loans mature during the fourth quarter of 2007 and the first quarter of 2008, and are included in short-term debt.

#### Convertible subordinated notes

Our convertible subordinated notes, due March 1, 2008, are convertible into our common stock at a conversion price of \$23.79 per share and are subordinated to all our present and future senior debt. The principal is due only at maturity of the notes.

Effective January 9, 2007, the Company and the holders of the remaining \$274.6 million of convertible subordinated notes entered into a First Supplemental Indenture, providing that any failure by us to comply with certain provisions of the original agreement will not result in a default or an event of default thru May 31, 2007. The convertible subordinated notes accrue an additional 6.75% per annum in special interest from and after January 9, 2007 to the March 1, 2008 maturity date of the notes, unless the notes are earlier repurchased or converted. On July 26, 2007, we entered into a Second Supplemental Indenture providing that the convertible subordinated notes will accrue an additional 10% per annum in special interest from and after July 26, 2007 to the March 31, 2008 maturity date of the notes unless the notes are earlier repurchased or converted. The special interest rate represents an increase of 3.25% per annum over the previous special interest rate of 6.75% per



annum in the First Supplemental Indenture. As a result of the Second Supplemental Indenture, the convertible subordinated notes now bear a stated interest rate of 10.875%. Interest is payable semiannually on March 1 and September 1, and payments of the special interest are made in addition to and at the same time and in the same manner as regularly scheduled payments of interest to holders entitled to such regularly scheduled payments of interest. For more information regarding the notice of default on May 31, 2007, the Company's Second Supplemental Indenture and the notice of default on October 15, 2007, see the Liquidity section of this Item 2.

#### Operating leases

We lease certain facilities under non-cancelable operating leases that expire at various dates through 2013.

#### Letters of credit

We issue standby letters of credit primarily to support international sales activities outside of China. When we submit a bid for a sale, often the potential customer will require that we issue a bid bond or a standby letter of credit to demonstrate our commitment through the bid process. In addition, we may be required to issue standby letters of credit as guarantees for advance customer payments upon contract signing or performance guarantees. The standby letters of credit usually expire six to twelve months from date of issuance without being drawn by the beneficiary thereof.

#### Purchase commitments

We are obligated to purchase raw materials and work-in-process inventory under various orders from various suppliers, all of which should be fulfilled without adverse consequences material to our operations or financial condition. Purchase commitments exclude agreements that are cancelable without penalty. As of March 31, 2007 total open commitments under these purchase orders extending beyond one year were approximately \$5.6 million. Additionally, we have agreed to purchase from Marvell certain chip-sets that will be included in 50% to 100% of our PAS handsets, through 2011.

#### Intellectual property

Certain sales contracts include provisions under which customers would be indemnified by us in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to our products. There are no limitations on the maximum potential future payments under these guarantees. We have not accrued any amounts in relation to these provisions as no such claims have been made and we believe we have valid enforceable rights to the intellectual property embedded in our products.

#### Income Tax Obligations

Effective January 1, 2007, the Company adopted the provisions of FIN 48. As of March 31, 2007, the liability for uncertain tax positions, net of federal impacts on state tax issues, was \$71.9 million, of which none is expected to be paid within one year. Included in the \$71.9 million is approximately \$6.7 million which has not yet reduced income tax payments, and, therefore, has been netted against non-current deferred tax assets. For the remaining liability, the Company is unable to make a reasonably reliable estimate when cash settlement with a taxing authority may occur.

### **RECENT ACCOUNTING PRONOUNCEMENTS**

See Note 22, Recent Accounting Pronouncements, in the Notes to Condensed Consolidated Financial Statements in Item 1 of this Quarterly Report for a full description of recent accounting pronouncements, including the expected dates of adoption and estimated effects on results of operations and financial condition, which is incorporated herein by reference.

### **ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS**

We are exposed to the impact of interest rate changes, changes in foreign currency exchange rates and changes in the stock market.

#### ***Interest Rate Risk***

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. The fair value of our investment portfolio would not be significantly affected by either a 10% increase or decrease in interest rates due mainly to the short-term nature of most of our investment portfolio. However, our interest income can be sensitive to changes in the general level of U.S. interest rates since the majority of

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our funds are invested in instruments with maturities less than one year. Our policy is to ensure the safety of invested funds by generally attempting to limit market risk. Funds in excess of current operating requirements are mostly invested in government-backed notes, commercial paper, floating rate corporate bonds, fixed income corporate bonds and tax-exempt instruments. In accordance with our investment policy, all short-term investments are invested in investment grade rated securities with minimum A or better ratings. Currently, most of our short-term investments have AA or better ratings.

74

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The table below represents carrying amounts and related weighted-average interest rates of our investment portfolio at March 31, 2007:

	(in thousands, except interest rates)	
Cash and cash equivalents	\$	558,150
Average interest rate	2.18	%
Restricted cash - short-term	\$	5,620
Average interest rate	4.52	%
Short-term investments	\$	14,768
Average interest rate	1.73	%
Restricted cash - long-term	\$	17,152
Average interest rate	4.95	%
Total investment securities	\$	595,690
Average interest rate	2.27	%

#### ***Equity Investment Risk***

Our investment portfolio includes equity investments in publicly traded companies, the values of which are subject to market price volatility. Economic events could adversely affect the public equities market and general economic conditions may worsen. Should the fair value of our publicly traded equity investments decline below their cost basis in a manner deemed to be other-than-temporary, our earnings may be adversely affected. We have also invested in several privately held companies as well as investment funds which invest primarily in privately held companies, many of which can still be considered in the start-up or development stages. These investments are inherently risky, as the market for the technologies or products they have under development are typically in the early stages and may never materialize.

#### ***Foreign Exchange Rate Risk***

We are exposed to foreign currency exchange rate risk because most of our sales in China are denominated in Renminbi and portions of our accounts receivable and payable are denominated in Japanese Yen. Due to the limitations on converting Renminbi, we are limited in our ability to engage in foreign currency hedging activities in China. Although the impact of currency fluctuations of Renminbi to date has been slight, fluctuations in currency exchange rates in the future may have a material adverse effect on our results of operations. The balance of cash and short-term investment balance held in China was \$414.6 million at March 31, 2007. In July 2005, China uncoupled the Renminbi from the U.S. dollar and let it float in a narrow band against a basket of foreign currencies. The move revalued the Renminbi by 2.1% against the U.S. dollar. Additionally, during 2006 and the first three months of 2007 we made significant sales in both Japanese Yen and in Euros. We maintain Japanese Yen bank accounts for purchasing portions of our inventories and supplies.

Our revenues, earnings and cash flows are subject to fluctuations due to changes in foreign currency exchange rates. We may hedge currency exposures associated with certain assets and liabilities denominated in nonfunctional currencies and certain anticipated nonfunctional currency transactions using forward foreign currency exchange rate contracts. We have not hedged any such transactions, and due to the limitations on converting Renminbi, we are limited in our ability to engage in currency hedging activities in China. As a global concern, we face exposure to adverse movements in foreign currency exchange rates.

We have performed a sensitivity analysis as of March 31, 2007, using a modeling technique that measures the change in the fair values arising from a hypothetical 10% positive or adverse movement in the levels of foreign currency exchange rates relative to the U.S. Dollar, with all other variables held constant. The analysis covers all of our foreign currency contracts offset by the underlying exposures. The foreign currency exchange rates used were based on market rates in effect at March 31, 2007. The sensitivity analysis indicated that a hypothetical 10% movement in foreign currency exchange rates would result in a gain or loss in the fair values of our foreign exchange financial instruments of \$3.5 million at March 31, 2007.

## ITEM 4 CONTROLS AND PROCEDURES

### Evaluation of Disclosure Controls and Procedures

UTStarcom, Inc. ( UTStarcom or the Company ) maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports the Company files or submits under the Securities Exchange Act of 1934, as amended ( Exchange Act ), is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's ( SEC ) rules and forms, and that such information is accumulated and communicated to the Company's management, including its chief executive officer ( CEO ) and chief financial officer ( CFO ), as appropriate, to allow timely decisions regarding required financial disclosure.

In connection with the preparation of this Quarterly Report on Form 10-Q ( Form 10-Q ), the Company carried out an evaluation as of March 31, 2007 under the supervision and with the participation of the Company's management, including the CEO and CFO, of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. Based upon this evaluation, management concluded that as of March 31, 2007 the Company's disclosure controls and procedures were not effective because of the material weaknesses described in Management's Annual Report on Internal Control over Financial Reporting, included in ITEM 9A CONTROLS AND PROCEDURES in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2006 (the Item 9A in the 2006 Annual Report ), which have not yet been fully remediated. Investors are directed to Item 9A in the 2006 Annual Report for the description of these weaknesses.

A material weakness is a control deficiency in internal control over financial reporting, or a combination of deficiencies in internal control over financial reporting, that results in more than a remote likelihood that a material misstatement of the annual or interim consolidated financial statements will not be prevented or detected. To address these material weaknesses in internal control over financial reporting noted above, the Company performed additional analyses and other procedures (as further described below under Management's Planned Remediation Initiatives and Interim Measures ) to ensure that the Company's consolidated financial statements are prepared in accordance with generally accepted accounting principles in the United States ( GAAP ). Accordingly, the Company's management believes that the consolidated financial statements included in this Form 10-Q fairly present in all material respects the Company's financial condition, results of operations and cash flows for the periods presented and that this Form 10-Q does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the periods covered by this report.

### Management's Planned Remediation Initiatives and Interim Measures

The Company plans to make necessary changes and improvements to the overall design of its control environment to address the material weaknesses in internal control over financial reporting described in Item 9A in the 2006 Annual Report. In particular, the Company has implemented during 2006 and the first quarter of 2007, and plans to continue to implement during 2007, the specific measures described below. In addition, in connection with the March 31, 2007 quarter-end reporting process, the Company has undertaken additional measures described under the subheading Interim Measures below to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's consolidated financial statements included in this Form 10-Q and to ensure that material information relating to the Company and its consolidated subsidiaries was made known to management in connection with the preparation of this Form 10-Q.

#### Remediation Initiatives

1. To remediate the material weakness described in Item 9A in the 2006 Annual Report, in 1. *The Company did not maintain an effective control environment*, the Company has implemented or plans to implement the measures described below, and will continue to evaluate and may in the future implement additional measures. These measures include the following:

a) *Effective financial reporting process, including policies and procedures* In the fourth quarter of 2006, the Company's finance department commenced an initiative to update its finance and accounting policies and procedures. Through this initiative, which was ongoing through the first nine months of 2007 and will be ongoing through the rest of 2007, the Company's financial policies and procedures will be reviewed for completeness, accuracy and adequacy, updated and brought current, and standardized globally as necessary and appropriate. A communication plan will also be developed to ensure updated policies and procedures are publicized and understood, and appropriate employees are trained in their application, as necessary. The Company expects this initiative will form the foundation for the process to maintain and keep current its finance and accounting policies and procedures on a go-forward basis. In addition,

starting in the fourth quarter of 2006, the Company commenced internal audits of, and in the remainder of 2007 and 2008 plans to continue to expand and increase the scope of its efforts to monitor, controls at the Company's decentralized and remote operations globally, through reviews and audits of employee compliance with applicable policies and procedures at business units, subsidiaries and other locations.

76

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b) *Non-compliance with established policies and procedures intended to ensure compliance with laws and regulations* During the second quarter of 2006, the Company launched a formal investigation at the direction of the Audit Committee of the Company's Board of Directors ( Audit Committee ) to review alleged violations of the FCPA; refer to *Governmental Investigations* under ITEM 3 LEGAL PROCEEDINGS for additional information. Throughout the course of this investigation, the Company took and plans to continue to take all appropriate actions including changes to its training, processes and procedures related to its code of business conduct and ethics, its payment controls particularly in outlying regions, and its due diligence evaluation of business partnerships. Upon conclusion of this investigation, the Company will review and, as necessary, further enhance its procedures to reduce the risk of ongoing control deficiencies in this area. In addition, in the third and fourth quarters of 2006 and 2007 to date, the Company provided training to personnel in offices in various regions including North America, Europe, and China and, in the remainder of 2007 and in 2008, plans to continue to provide training and expand its coverage of personnel employed in other regions and countries. In addition, the Company's internal audit staff commenced audits and plans to continue to expand and increase the scope of the Company's efforts to monitor controls at Company operations globally, through reviews and audits of employee compliance with applicable policies and procedures at business units, subsidiaries and other locations.

c) In addition to the specific measures described above to address this material weakness in the control environment, the Company's planned remediation measures include the following:

i. In November, 2006, the Company hired an assistant controller and a shared services manager at its U.S. headquarters whose responsibilities include overseeing the corporate accounting and SEC external financial reporting functions. In the first quarter of 2007, the Company hired a vice president of financial operations and a vice president of financial planning and analysis to provide additional finance personnel at its U.S. headquarters. These personnel have appropriate qualifications, considerable technical experience and training in areas including accounting and SEC reporting, and in the utilization of the Oracle financial system modules. The Company believes the addition of these personnel improves and strengthens the capabilities of this function.

ii. In April 2007, the Company created the position of and hired a new chief ethics officer, to provide focused executive leadership in the area of corporate ethics and integrity.

iii. The Company retained and intends to continue to retain the services of outside consultants with relevant accounting experience, skills and knowledge in the application of GAAP, working under the supervision and direction of the Company's management, to supplement the Company's existing corporate accounting and external financial reporting personnel.

iv. The Company will continue to hire, and has allocated resources to hire, additional finance personnel as needs arise and to replace departures, in the areas of compliance, corporate accounting, external financial reporting, internal audit, revenue accounting and tax, with relevant accounting experience, skills and knowledge in the application of GAAP.

v. In the first quarter of 2007, the Company implemented a new management by objectives system which is being used globally to capture corporate and executive management goals and articulate them throughout the organization, and to cascade and align each employee's goals to support corporate objectives. The goal setting, monitoring and evaluation process will incorporate capturing employee's training and development requirements, including training to stay current with the application of GAAP and the Company's code of business conduct and ethics.

vi. During 2007 to date, the Company's CFO, with assistance from senior financial staff and outside consultants, reviewed and in the remainder of 2007 will continue to review and adapt the overall design of the Company's financial

reporting organization and structure, including the roles and responsibilities of each functional group within the Company.

2. In addition to the remediation measures described above, the Company has implemented or plans to implement the measures described below, and will continue to evaluate and may in the future implement additional measures.

a) To remediate the material weaknesses described in Item 9A in the 2006 Annual Report in section 2. a) over *instances of override related to controls in China over customer agreements*, the Company's planned remediation measures are intended to address material weakness in China that has the potential of misstating these balances in the financial statements in future financial periods. These measures include the following:

77

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- i. In the period from January to May 2007, the Company effected personnel changes in the sales force in China's western sales region, as well as certain associated sales offices. The Company believes that these changes will enable effective management of the China western sales region's sales operations and enhance compliance with the Company's policies and procedures, including the Company's Code of Business Conduct and Ethics.
  - ii. The Company plans to revise its policies and procedures related to entering into sales contracts, document retention, as well as the Code of Business Conduct and Ethics to provide for details around the standards for entering into sales agreements and breaches to the Code of Business Conduct and Ethics.
  - iii. The Company plans to implement mandatory training to employees in China's sales organization around control consciousness and ongoing training to Sales, Contract Management and Finance in China around the Company's policies and procedures, including revenue recognition.
  - iv. The Company plans to review and make improvements to the sales databases to capture relevant contract information and current status information.
  - v. The Company plans to establish a process around organizing visits by business operations and the regional sales managers to the various sales offices in China to enhance the awareness and compliance with the Company's policies and procedures.
- b) To remediate the material weaknesses described in Item 9A in the 2006 Annual Report in section 2. b) over *inventory, including finished goods at customer sites, inventory reserves and deferred costs accounts and associated cost of sales*, section 2. c) over *inventory reserves for losses on customer contracts and associated cost of sales*, and section 2. d) over *accounting for warranty reserves and associated cost of sales*, the Company's planned remediation measures are intended to address material weaknesses at its U.S. headquarters that have the potential of misstating these balances in the financial statements in future financial periods. These measures include the following:
- i. In November 2006, the Company hired an assistant controller and a shared services manager at its U.S. headquarters whose responsibilities include overseeing the international cost accounting function. These personnel have considerable experience and training in cost accounting and utilization of the relevant Oracle financial system modules. The Company believes the addition of these personnel improves and strengthens the capabilities for the manual analyses and management review required of this function.
  - ii. The Company plans in the remainder of 2007, to enhance its processes and procedures related to properly tracking and confirming inventory movements to ensure the proper classification of inventory, including finished goods at customer sites, and deferred costs (and associated accounts such as purchase price variances), and to ensure the completeness and accuracy of the recording of the cost of sales when revenue is recognized. The revised processes will include involving and obtaining detailed and timely input from business unit, operations and sales operations personnel to enhance the information available for finance to analyze these accounts. New reports have been developed and reports and procedures will continue to be enhanced as necessary to facilitate the accuracy of accounting for these processes. In addition, finance management has placed increased attention on reviewing in detail the accounting in this area.
- c) To remediate the material weaknesses described in Item 9A in the 2006 Annual Report in section 2. e) over *accounting for and disclosure of stock-based compensation expense*, the Company's planned remediation measures are intended to address material weaknesses that have the potential of misstating these balances in the financial statements in future financial periods. These measures include the following:

- i. In November 2006, the Company announced a voluntary review of its historical equity award grant practices under the direction of the nominating and corporate governance committee of the board of directors. Upon this announcement, the Company immediately suspended granting of equity awards and no new equity awards have been granted through the date of filing of this Form 10-Q.
- ii. Further, in November 2006, the Company migrated to a new vendor's system for stock options and equity awards administration, selected in part for its improved processes, systems and controls.
- iii. In April 2007, the Company's compensation committee of the board of directors approved an equity award grant policy and procedures ( Awards Policy ). Under this Awards Policy, the Company has adopted the following equity awards grant processes:

78

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- Equity awards will be made only on grant dates pre-determined in accordance with the Awards Policy.
  - The awards committee (a committee as defined in the Awards Policy consisting of human resources, legal and finance personnel, duly formed and authorized by the compensation committee, with specific, limited authority to approve certain grants of equity awards) will ensure completeness and accuracy of the final equity awards grant list.
  - All equity awards will be approved monthly, at a meeting of the awards committee, the compensation committee or the board of directors, as applicable.
  - Internal audit will conduct periodic review of the accounting records and equity awards grant process.
- iv. Relevant personnel at the Company will be provided training in the equity awards granting and accounting process.
- v. In April 2007, the Company created the position of and hired a new chief ethics officer, to provide focused executive leadership in the area of corporate ethics and integrity.
- vi. During the remainder of 2007, the Company will update its record retention policy to specify retention of equity award records.
- d) To remediate the material weaknesses described in Item 9A in the 2006 Annual Report in section 2. f) over *its process to ensure the complete, accurate and timely preparation and review of its consolidated financial statements in accordance with GAAP*, the Company's planned remediation measures are intended to address material weaknesses at its U.S. headquarters that have the potential of preventing the complete, accurate and timely preparation and review of the Company's consolidated financial statements in future financial periods. In addition to the measures described above, these measures include the following:
- i. During the fourth quarter of 2006 and 2007 to date, the Company implemented and in the remainder of 2007 and in 2008, the Company plans to continue to enhance and improve month and quarter-end closing procedures within its corporate accounting function to standardize its processes for financial review to ensure that reviewers at its U.S. headquarters analyze and monitor financial information in a consistent and thorough manner. In addition, the Company implemented and plans to continue to improve new and enhanced procedures within its corporate accounting function to ensure that non-routine transactions are identified and escalated to senior financial management during the close process to help ensure proper accounting treatment.
- ii. During the fourth quarter of 2006 and 2007 to date, the Company implemented and in the remainder of 2007 and in 2008, the Company plans to continue to enhance and improve the documentation and review of required information associated with the preparation of its quarterly and annual filings under the Exchange Act.

#### ***Interim Measures***

Management has not yet implemented and/or tested all of the measures described above under the heading *Remediation Initiatives*. Nevertheless, management believes the measures identified above (to the extent these have been implemented), together with other measures undertaken by the Company in connection with preparation of the consolidated financial statements included in this Form 10-Q and described below, address the material weaknesses in internal control over financial reporting described in Item 9A in the 2006 Annual Report and that remain material weaknesses as of March 31, 2007. These other measures include the following:

1. The Company retained on an interim basis outside consultants with relevant accounting experience, skills and knowledge, working under the supervision and direction of the Company's management, to assist with its review in a number of areas including inventory and reserves, equity award pricing and accounting, and SEC external financial



reporting.

2. The Company implemented and performed a number of additional detailed procedures and a comprehensive review of its accounting in various areas, including:

- a) Inventory cycle counts at a majority of its International inventory locations.
- b) Reconciliation of inventories at customer sites to outstanding customer contracts as of quarter end and consideration and analysis of this inventory for recoverability and potential impairment.

79

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- c) Review of contract analysis reports and consolidated revenue schedules from the first quarter of 2007 to determine the proper recording and classification of inventory and deferred costs and the related cost of goods sold (including associated accounts such as purchase price variance).
- d) Analysis of the backlog report, gross margin report and contract analysis report, enhanced discussions with business unit, operations and sales and services personnel to enhance the information available for finance to analyze, and thorough review of related sales and cost information to determine the reserves for losses on customer contracts and associated cost of sales.
- e) Analysis of actual cost reports associated with specific warranty reserves, and discussions with business unit, operations and sales and services personnel to enhance the information available for finance to analyze and determine the adequacy of liability reserves for warranty and associated cost of sales.
- f) A variety of manual review procedures, such as an extensive review of journal entry postings into the Oracle system, a thorough review of account reconciliations, and a detailed review at its U.S. headquarters of trial balances including those issued from decentralized locations, to ensure the completeness and accuracy of the underlying financial information used to generate the consolidated financial statements included in this Form 10-Q.

3. As part of the investigation of historical sales in China, the Audit Committee retained independent outside counsel and forensic accountants to conduct an investigation of sales in China. The investigation was expanded to consider sales contracts entered into in the period 2000 to 2006 in China, beyond the Western Region in order to provide adequate coverage percentage of the value of sales contracts entered into during the period. The investigation encompassed different procedures depending on the contract type, date and region in which the contracts were executed. In addition, the accounting and reporting process for the consolidated financial statements for the quarter ended March 31, 2007 was extended, thereby allowing the Company time to conduct additional procedures and analyses, to assess the adequacy and accuracy of the related balances, and to make additional adjustments and disclosures as necessary to ensure the accuracy of financial reporting. Additionally, the Company conducted a review of a portion of contracts recognized in revenue during the quarter ended March 31, 2007, from the Western Region in China, for compliance with revenue recognition criteria. As part of this review, the Company matched the contract copies at the China headquarters, regional office and the relevant sales office, and analyzed them for terms that might affect revenue recognition.

#### ***Management's Conclusion***

Management believes the remediation measures described under *Management's Planned Remediation Initiatives and Interim Measures* above will strengthen the Company's internal control over financial reporting and remediate the material weaknesses identified in *Management's Annual Report on Internal Control over Financial Reporting*. However, management has not yet implemented all of these measures and/or tested them. Management believes that the interim measures described under *Management's Planned Remediation Initiatives and Interim Measures* above provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements included in this Form 10-Q and has discussed this with the Company's Audit Committee.

The Company is committed to continuing to improve its internal control processes and will continue to diligently and vigorously review its disclosure controls and procedures and its internal control over financial reporting in order to ensure compliance with the requirements of Section 404 of the Sarbanes-Oxley Act of 2002. However, any control system, regardless of how well designed, operated and evaluated, can provide only reasonable, not absolute, assurance that its objectives will be met. As management continues to evaluate and work to improve the Company's internal control over financial reporting, it may determine to take additional or alternate measures to address control deficiencies, and it may determine not to complete certain of the measures described under *Management's Planned Remediation Initiatives and Interim Measures* above.

#### **Changes in Internal Control over Financial Reporting**

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The discussion above under Management's Planned Remediation Initiatives and Interim Measures includes a description of the material changes to the Company's internal control over financial reporting during the first quarter of 2007 and subsequent to March 31, 2007 that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

80

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## PART II OTHER INFORMATION

### ITEM 1 LEGAL PROCEEDINGS

#### *Securities Class Action Litigation*

Beginning in October 2004, several shareholder class actions alleging federal securities violations were filed against us and various officers and directors of our Company. The actions have been consolidated in United States District Court for the Northern District of California under the caption *In re UTStarcom, Inc. Securities Litigation*, Master File No. C-04-4908-JW(PVT). The lead plaintiffs in the case filed a First Amended Consolidated Complaint on July 26, 2005. The First Amended Complaint alleged violations of the Securities Exchange Act of 1934, and was brought on behalf of a putative class of shareholders who purchased our stock after April 16, 2003 and before September 20, 2004. On April 13, 2006, the lead plaintiffs filed a Second Amended Complaint adding new allegations and extending the end of the class period to October 6, 2005. In addition to the Company defendants, the plaintiffs are also suing Softbank. Plaintiffs' complaint seeks recovery of damages in an unspecified amount.

On June 2, 2006, we and the individual defendants filed a motion to dismiss the Second Amended Complaint. On March 21, 2007, the Court granted defendants' motion and dismissed plaintiffs' Second Amended Complaint. The Court granted plaintiffs leave to file a Third Amended Complaint, which plaintiffs filed on May 25, 2007. On July 13, 2007, we and the individual defendants filed a motion to dismiss and a motion to strike the Third Amended Complaint.

On September 4, 2007, a second shareholder class action complaint captioned *Peter Rudolph v. UTStarcom, et al.*, Case No. C-07-4578 SI, was filed in the United States District Court for the Northern District of California against us and some of our current and former directors and officers. The complaint alleges violations of the Securities Exchange Act of 1934 through undisclosed improper accounting practices concerning our historical equity award grants. Plaintiff seeks unspecified damages on behalf of a purported class of purchasers of our common stock between July 24, 2002 and September 4, 2007.

Due to the preliminary status of these lawsuits and uncertainties related to litigation, we are unable to evaluate the likelihood of either a favorable or unfavorable outcome. Accordingly, we are unable at this time to estimate the effects of these complaints on our financial position, results of operations, or cash flows.

#### *Governmental Investigations*

In September 2005, we have received notice of a formal inquiry by the staff of the Securities & Exchange Commission ( SEC ) into certain aspects of our financial disclosures during prior reporting periods and certain other issues. In addition, in December 2005, the U.S. Embassy in Mongolia informed us that it had forwarded to the Department of Justice ( DOJ ) allegations that an agent of our Mongolia joint venture had offered payments to a Mongolian government official in possible violation of the Foreign Corrupt Practices Act (the FCPA ). We, through our Audit Committee, authorized an independent investigation into possible violations of the FCPA, and we have been in contact with the DOJ and SEC regarding the investigation. The investigation has identified possible FCPA violations in Mongolia, Southeast Asia, India, and China, as well as possible violations of U.S. immigration laws. The DOJ has requested that we voluntarily produce documents related to the investigation and the SEC has subpoenaed us for documents. We have executed tolling agreements extending the statute of limitations for the FCPA issues under investigation by the SEC and DOJ and the immigration issues under investigation by the DOJ. At this time, we cannot predict when any inquiry will be completed or what the outcome of any inquiry will be.

#### *Shareholder Litigation*

On November 17, 2006, a shareholder derivative complaint captioned *Ernesto Espinoza v. Ying Wu et al.*, Case No. RG06298775, was filed against certain of our current and former officers and directors in the Superior Court of the County of Alameda, California. The complaint alleges that the individual defendants, among other things, breached their duties, were unjustly enriched, and violated the California Corporations Code in connection with the timing of stock option grants. The complaint names us as a nominal defendant and seeks unspecified monetary damages against the individual defendants and various forms of injunctive relief. On February 2, 2007, we and the individual

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defendants filed demurrers against the complaint. On April 11, 2007, the Court sustained the individual defendants' demurrer, overruled our demurrer, ordered the plaintiff to file an amended complaint, and ordered us to answer the original complaint. The plaintiff filed an amended complaint and we have filed an answer to the amended complaint. On August 21, 2007, the individual defendants filed demurrers against the amended complaint. The Court sustained the individual defendants' demurrers and ordered the plaintiff to file a second amended complaint.

Due to the preliminary status of this complaint and uncertainties related to litigation, we are unable to evaluate the likelihood of either a favorable or unfavorable outcome. Accordingly, we are unable at this time to estimate the effects of this complaint on our financial position, results of operations, or cash flows.

81

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*IPO Allocation*

On October 31, 2001, a complaint was filed in United States District Court for the Southern District of New York against us, some of our directors and officers and various underwriters for our initial public offering. Substantially similar actions were filed concerning the initial public offerings for more than 300 different issuers, and the cases were coordinated as *In re Initial Public Offering Securities Litigation*, 21 MC 92 for pretrial purposes. In April 2002, a consolidated amended complaint was filed in the matter against us, captioned *In re UTStarcom, Initial Public Offering Securities Litigation*, Civil Action No. 01-CV-9604. Plaintiffs allege violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 through undisclosed improper underwriting practices concerning the allocation of IPO shares in exchange for excessive brokerage commissions, agreements to purchase shares at higher prices in the aftermarket and misleading analyst reports. Plaintiffs seek unspecified damages on behalf of a purported class of purchasers of our common stock between March 2, 2000 and December 6, 2000. Our directors and officers have been dismissed without prejudice pursuant to a stipulation. On February 19, 2003, the Court granted in part and denied in part a motion to dismiss brought by defendants including us. The order dismissed all claims against us except for a claim brought under Section 11 of the Securities Act of 1933, which alleges that the registration statement filed in accordance with the IPO was misleading. In June 2004, a stipulation of settlement and release of claims against the issuer defendants, including us, was submitted to the court for approval. The terms of the settlement, if approved, would have dismissed and released all claims against the participating defendants (including us). In August 2005, the Court preliminarily approved the settlement. In December 2006, the Court of Appeals for the Second Circuit reversed the Court's October 2004 order certifying a class in six test cases that were selected by the underwriter defendants and plaintiffs in the coordinated proceedings. Our case is not one of the test cases. Because class certification was a condition of the settlement, it was unlikely that the settlement would receive final Court approval. On June 25, 2007, the Court entered an order terminating the proposed settlement based on a stipulation among the parties to the settlement. Plaintiffs have filed amended master allegations and amended complaints in the six test cases. It is unclear whether there will be any revised or future settlement. If the litigation proceeds, we believe that we have meritorious defenses and intend to defend the action vigorously. The total amount of the loss associated with the above litigation is not determinable at this time. Therefore, we are unable to currently estimate the loss, if any, associated with the litigation.

*Passive Litigation*

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In November 2005, the Company filed suit in the Superior Court of California, County of Santa Clara, against Passave, Inc. ( Passave ) for breaches of contract and warranties in connection with a semiconductor device sold by Passave, Ltd. (Passave s wholly--owned subsidiary) to the Company. The Company s complaint alleges that the Passave device, known as the PAS5001M3 chip, has exhibited certain operational malfunctions within some of our Fiber-to-the-Home product line, and has thereby caused damage to the Company. The parties entered into a settlement agreement, in favor of the Company dated August 7, 2007, and have since dismissed all claims with prejudice.

### *UTStarcom, Inc. v. Starent Patent Infringement Litigations*

On February 16, 2005, we filed a suit against Starent for patent infringement in the U.S. District Court for the Northern District of California. In the Complaint, we assert that Starent infringes UTStarcom patent U.S. Reg. No. 6,829,473 ( the 473 patent ) through Starent s development and testing of a software upgrade for its customer s installed ST-16 Intelligent Mobile Gateways. We seek declaratory and injunctive relief. Starent subsequently filed its answer and counterclaims, denying our allegations and seeking a declaration that the patent-in-suit is not infringed, is invalid, and is unenforceable. On June 16, 2005, we filed a motion to strike Starent s affirmative defense and dismiss Starent s counterclaim alleging inequitable conduct. On July 19, 2005, the parties stipulated that Starent would file an amended answer and counterclaim by July 27, 2005 and that we would withdraw our motion to strike. On August 10, 2005, we responded to Starent s amended counterclaim filed on July 27, 2005. In early December 2006, we filed a reissue application for the 473 patent with the United States Patent and Trademark Office. Starent has also filed for reexamination of the 473 patent. The reexamination and reissue are currently copending. The litigation is still in a preliminary stage and its outcome cannot be predicted, although we believe the litigation has merit. Nonetheless, we believe that any adverse judgment on Starent s counterclaims will not have a material adverse effect on our business, financial condition, or results of operations.

On May 8, 2007, we filed an additional suit against Starent and sixteen individual defendants (who were all former employees of 3Com's CommWorks division which we acquired certain assets of in May of 2003) in the Northern District of Illinois. The causes of action include claims for patent infringement, misappropriation of trade secrets, intentional interference with business relations and prospective economic advantage and declarations of ownership of certain patent rights. In its Complaint, we assert that Starent infringes UTStarcom patents U. S. Reg. Nos. 7,173,905; 6,978,128; 6,963,582; 6,975,900; and 6,684,256 through the manufacture, use, offer, for sale, and sale of Starent's ST16 Intelligent Mobile Gateway and ST40 multimedia code platform, that the individual Defendants and Starent have misappropriated valuable Company trade secrets by improperly taking and using our confidential and proprietary information for the benefit of Starent, that the individual defendants and Starent have interfered with our business relations and prospective economic advantage by using the misappropriated information to obtain and enhance sales of Starent's products, and that several of Starent's patent applications and one issued patent are based on information obtained by the former employees while at the Company (CommWorks) and on that basis belong to UTStarcom. We seek compensatory damages, punitive damages and injunctive relief. After the court denied the defendants motion to dismiss the misappropriation of trade secrets claims, on August 30, 2007, Starent answered our complaint, denying our allegations and asserting a number of affirmative defenses and counterclaims, including non-infringement of the subject patents and alleged tortious interference with prospective economic advantage. We have filed a motion to dismiss most of the counterclaims and the court has ordered appointment of a special master to handle discovery, which is just beginning. We believe that any adverse judgment on Starent's counterclaims will not have a material adverse effect on our business, financial condition or results of operations.

*Telemetrix, Inc. Arbitration*

On October 19, 2006, Telemetrix, Inc. ( Telemetrix ) filed a formal Request for Arbitration against us to the World Intellectual Property Organization ( WIPO ) in Geneva, Switzerland. The Request for Arbitration sought unspecified damages arising from a contract between Telemetrix and Telos Technology, Inc., dated October 22, 2003. We assumed Telos' rights and obligations under this contract pursuant to our purchase of Telos' assets on May 19, 2004. Telemetrix alleged nine causes of action, including breach of contract, fraud, negligent misrepresentation, interference with contractual relations, and interference with prospective economic advantage. In December 2006, we filed a formal response to the Request for Arbitration, denying all material factual allegations asserted by Telemetrix. An arbitrator was selected by the parties, and, on August 2, 2007, the arbitrator granted a pleading motion in favor of us due to Telemetrix's failure to allege sufficient facts in support of a majority of its causes of action. On August 17, 2007, Telemetrix filed an Amended Statement of Claim, alleging six causes of action, including breach of contract, fraud, interference with contractual relations and interference with prospective economic advantage. The previous hearing date of December 11-13 has been vacated. No hearing date has been rescheduled. Discovery has begun.

*Telos Technology, Inc. Litigation*



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On November 22, 2005, plaintiffs Telos Technology, Inc., Telos Technology (Canada), Inc., Telos Technology (Bermuda) Ltd., and Telos Engineering Limited (collectively, the Telos Plaintiffs ) filed a Complaint against the Company in the Superior Court of California, County of Santa Clara. The Complaint alleges five causes of action, including breach of contract, breach of the implied covenant of good faith and fair dealing, fraudulent inducement, intentional misrepresentation and negligent misrepresentation, all of which arise from the Asset Purchase Agreement between the parties dated April 21, 2004. The Telos Plaintiffs assert that the Company breached the express and implied terms of the Asset Purchase Agreement and made representations to the Telos Plaintiffs during negotiations that it never intended to fulfill. The Telos Plaintiffs sought at least \$19 million in damages, unspecified punitive damages and attorneys' fees. The parties executed a settlement agreement in the amount of \$4.5 million on August 20, 2007 and the case was dismissed on September 26, 2007 with prejudice.

### *Other Litigation*

We are a party to other litigation matters and claims that are normal in the course of operations, and while the results of such litigation matters and claims cannot be predicted with certainty, we believe that the final outcome of such matters will not have a material adverse impact on our financial position or results of operations.

## ITEM 1A RISK FACTORS

### FACTORS AFFECTING FUTURE OPERATING RESULTS

#### RISKS RELATED TO OUR COMPANY

*The restatement of our consolidated financial statements following the Nominating and Corporate Governance Committee's and management's review of our past stock option granting practices and the Audit Committee's and management's review of certain sales in China has resulted in expanded litigation and regulatory proceedings and may result in future litigation which could harm our financial results*

Our review of our historic option granting practices and certain sales in China has required us to incur substantial expenses for legal, accounting, tax and other professional services, has diverted our management's attention from our business, and could in the future harm our business, financial condition, results of operations and cash flows.

The Audit Committee of our Board of Directors ( Audit Committee ) engaged independent counsel to conduct an investigation of sales in China. The independent counsel engaged forensic accountants. The China sales investigation, which commenced in February 2007 and was completed in September 2007, covered each of the seven years in the period ended December 31, 2006. As a result of the review, management concluded and recommended to the Audit Committee that our previously issued financial statements should be restated to defer the system sales contract revenue and the related cost of net sales for certain sales arrangements in one region of China found to contain post-contract support obligations and recognize such amounts in our consolidated statements of operations over the estimated period of post-contract support. The Audit Committee concurred with management's recommendation.

In November 2006 we announced that the Nominating and Corporate Governance Committee of our Board of Directors ( Governance Committee ), comprised of independent directors, was conducting a voluntary review, with the assistance of independent legal counsel and forensic accounting experts (the Option Grant Review Team ), of our historic option granting practices, the timing of option grants and related accounting matters. The review considered all option grant awards made in the period from February 29, 2000, shortly before the initial public offering of our Common Stock, through August 2006 for compliance with the various stock-based compensation accounting standards applicable as well as the rules of our stock option plans. Upon completion of the review, management concluded the adjustments to correct errors in stock option accounting in our previously issued financial statements for the years ended December 31, 1998 and 2000 through 2005, and the quarterly periods of 2005, as well as in the quarterly periods ended March 31 and June 30, 2006 that are reflected in our consolidated financial statement information included in Exhibit 99.1 in our Annual Report on Form 10-K for the year ended December 31, 2006 should be made.

In determining the restatement adjustments in connection with the review of our historical option granting practices, management used all reasonably available relevant information to form conclusions it believes are reasonable as to the most likely option granting actions that occurred, the dates when such actions occurred, and the determination of grant dates for financial accounting purposes based on when the requirements of the accounting standards were met. The Option Grant Review Team and management considered various alternatives throughout the course of the review and restatement; management believes the adjustments to measurement dates used in our restatement of our financial statements are reasonable and appropriate in our circumstances.

Our restatement of previously issued financial statements to correct revenue recognition for certain sales in China and for the effects of past stock options granting practices has exposed us to greater risks associated with litigation and regulatory proceedings. We have voluntarily provided information about the conduct of our independent investigation and review, the findings of the reviews, and our conclusions to the staff of the Securities and Exchange Commission ( SEC ), and are cooperating, and will continue to cooperate fully with the SEC. In addition, as described in Part II, Item 1, Legal Proceedings, of this Form 10-Q, several derivative complaints have been filed against certain of our current and former officers and directors pertaining to allegations relating to stock option grants. However, our judgments may be challenged in legal proceedings or regulatory reviews, and we could be subject to adverse findings that could require us to again restate our financial statements, to pay damages or penalties, or have other remedies imposed upon us that could harm our business, financial condition, results of operations and cash flows. We may also be exposed to legal proceedings in connection with the results of our investigation of certain sales in China. We cannot guarantee that new lawsuits related to the matters resulting in the restatements will not be filed, and we cannot predict the outcome of any current or potential future litigation or regulatory proceeding against the Company or our current and former directors or officers.

*The matters relating to the Audit Committee's investigation of revenue recognition in China, the Governance Committee's review of our past stock option granting practice, and the restatement of our consolidated financial statements may otherwise adversely impact our business.*



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As a result of our delayed filing of our Quarterly Reports on Form 10-Q for the quarters ended September 30, 2006, March 31, 2007 and June 30, 2007, as well as our Form 10-K for the fiscal year ended December 31, 2006, we will be ineligible to register our securities on Form S-3 for sale by us or resale by others until we have been current in our SEC filings for 12 calendar months. We may use Form S-1 to raise capital, but doing so could increase transaction costs and the time required to complete such transactions.

Employees who were awarded options at a discount from fair market value and were totally or partially vested as of December 31, 2004, may be subject to a penalty tax under Internal Revenue Code Section 409A ( Section 409A ) and corresponding states taxes upon exercise of these stock options. We are considering certain actions, which we believe would be in the best interests of our stockholders and employees that might substantially reduce or eliminate the federal and state penalty taxes. However, there is no guarantee that we will be successful in developing effective measures to address employees' adverse tax consequences, and any such measures may cause us to incur additional cash or noncash compensation expense. Furthermore, such measures, or the failure of such measures, may require the Company to incur substantial expenses for legal, accounting, tax and other professional services and may divert management's attention from our business, which could in the future harm our business, financial condition, results of operations and cash flows.

*Our future product sales are unpredictable and, as a result, our operating results are likely to fluctuate from quarter to quarter.*

Our quarterly and annual operating results have fluctuated in the past and are likely to fluctuate in the future due to a variety of factors, some of which are outside of our control. Factors that may affect our future operating results include:

- the timing and size of the orders for our products;
- consumer acceptance of new products we may introduce to market;
- changes in the growth rate of customer purchases of communications services;
- the lengthy and unpredictable sales cycles associated with sales of our products;
- revenue recognition, which is based primarily on customer acceptance of delivered products, is unpredictable;
- cancellation, deferment or delay in implementation of large contracts;
- quality issues resulting from the design or manufacture of the products, or from the software used in the product;
- cash collection cycles in China and other emerging markets;
- reliance on product, software and component suppliers who may constitute a sole source of supply or may have going concern issues;
- the decline in business activity we typically experience during the Chinese Lunar New Year, which leads to decreased sales and collections during our first fiscal quarter;
- issues that might arise from the integration of acquired entities or the inability to achieve expected results from such acquisitions; and
- shifts in our product mix or market focus.

As a result of these and other factors, period-to-period comparisons of our operating results are not necessarily meaningful or indicative of future performance. In addition, the factors noted above may make it difficult for us to forecast and provide in a timely manner public guidance (including updates to prior guidance) related to our projected financial performance. Furthermore, it is possible that in some future quarters our operating results will fall below the expectations of securities analysts or investors. If this occurs, the trading price of our common stock could decline.

*Competition in our markets may lead to reduced prices, revenues and market share.*

We have experienced intense competition in the past years, and we believe that we will continue to face intense competition from both domestic and international companies in our target markets, many of which may operate under lower cost

85

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structures or may be given preferential treatment by applicable governmental regulators and policies and have much larger sales forces than we do. Additionally, other companies not presently offering competing products may also enter our target markets. Many of our competitors have significantly greater financial, technical, product development, sales, marketing and other resources than we do. As a result, our competitors may be able to respond more quickly to new or emerging technologies and changes in service provider requirements. Our competitors may also be able to devote greater resources than we can to the development, promotion and sale of new products. These competitors may be able to offer significant financing arrangements to service providers, which may give them a competitive advantage in selling systems to service providers with limited financial resources. In many of the developing markets in which we operate or intend to operate, relationships with local governmental telecommunications agencies are important to establish and maintain. In many such markets, our competitors may have or be able to establish better relationships with local governmental telecommunications agencies than we have, which could result in their ability to influence governmental policy formation and interpretation to their advantage. Additionally, our competitors might have better relationships with their third party suppliers and obtain component parts at a reduced rate, allowing them to offer their end products at reduced prices. Moreover, the telecommunications and data transmission industries have experienced significant consolidation, and we expect this trend to continue. If we have fewer significant customers, we may be more reliant on such large customers and our bargaining position and profit margins may suffer. Increased competition is likely to result in price reductions, reduced gross profit as a percentage of net sales and loss of market share, any one of which could materially harm our business, cash flows and financial condition, including potential impairment in value of our tangible and intangible assets and goodwill if extended losses were incurred.

*We have incurred net losses in the past and will need to renew our lines of credit in China, refinance our convertible subordinated notes, and transfer cash from our subsidiaries in China to have sufficient cash resources and liquidity. Our ability to accomplish these actions is not assured, and our ability to raise funds for other purposes is uncertain.*

At March 31, 2007, we had cash and short-term investments of \$572.9 million to meet our liquidity requirements of which \$414.6 million was held by our subsidiaries in China. China imposes currency exchange controls on transfers of funds outside of China; such controls limit transfers of approximately \$200 million of our net assets outside of China without first obtaining the consent of the Chinese government. While we believed the China subsidiaries could freely transfer at least \$200 million as of March 31, 2007, the amount of cash available for transfer from the China subsidiaries is limited both by the liquidity needs of the subsidiaries in China and by the Chinese government requirements that the China subsidiaries retain adequate capital levels in China to protect creditors and to have funds available for mandated employee benefits. Additionally, available credit facilities in China at March 31, 2007 totaled \$692.7 million, of which \$353.5 million was available for working capital purposes and \$339.2 million was available for use in support of letters of credit and corporate guarantees. These credit facilities expire principally in November and December 2007, and we had borrowed \$103.6 million at March 31, 2007 under the working capital portion of the available credit lines and such borrowings increased to \$140.1 million at September 30, 2007. We also have outstanding long-term debt outside of China in the form of our convertible subordinated notes with a principal balance of \$274.6 million that mature in March 2008 (the Notes).

During the nine months ended September 30, 2007 our China subsidiaries made transfers of funds out of China to the Company totaling \$150 million. Although we believe the Company now has sufficient amount of cash resources to finance the Company's anticipated working capital and capital expenditure requirements for the next 12 months, we do not have enough cash outside of China to repay the convertible notes maturing in March 2008, and we expect our recent financial performance and financial position will cause the lenders to reduce the total available credit facilities when we negotiate renewals of the lines of credit in China in late 2007. Management's liquidity plans include a partial or complete refinancing of the convertible notes, renewal of the lines of credit in China, transfers of additional cash from its subsidiaries in China to the extent necessary, and, if needed, liquidation of certain investments and/or seeking new financing arrangements. In addition, it may be necessary for us to make significant changes to our business plan to maintain adequate liquidity for at least the next 12 months in the event of various matters, such as:

- changes in financial market conditions or our business condition that could limit our access to existing credit facilities or make planned re-financings more costly or even unfeasible;
- changes in China's currency exchange control regulations that could limit our ability to access cash in China to meet liquidity requirements outside of China; and
- inability to achieve planned operating results that could increase liquidity requirements beyond those considered in our financial plans.

We may desire to raise additional funds for purposes not presently included in our financial plans such as to develop new or enhanced products, respond to competitive pressures, take advantage of acquisition opportunities or raise capital for strategic purposes. There is no assurance that additional financing for these or other purposes would be available on acceptable



terms or at all. If we raise additional funds through the issuance of equity securities, our stockholders will experience dilution of their ownership interest, and the newly issued securities may have rights superior to those of common stock. If we raise additional funds by issuing debt, our ability to meet our debt service obligations will be dependent upon our future performance, which will be subject to financial, business and other factors affecting our operations, many of which are beyond our control, we may be subject to limitations on our operations, and our leverage may increase. The degree to which we are leveraged could materially and adversely affect our ability to obtain financing for working capital, acquisitions or other purposes and could make us more vulnerable to industry downturns and competitive pressures.

*Our ability to meet our obligations under the terms of our outstanding convertible notes and to continue operations may be compromised if we are unable to transfer funds from our China operations as needed.*

During the nine months ended September 30, 2007 our China subsidiaries made transfers of funds out of China to the Company totaling \$150 million. Although we believe the Company now has sufficient amount of cash resources to finance the Company's anticipated working capital and capital expenditure requirements for the next 12 months, we do not have enough cash outside of China to also repay the convertible notes, aggregating \$274.6 million and maturing on March 1, 2008. Because we are limited by the Chinese government's imposition of currency controls on transfer of funds outside of China, it may be time-consuming, difficult and /or expensive for us to transfer funds from China to repay the Notes. As a result, if an Event of Default on the Notes were to occur, we may not have sufficient cash resources to repay the Notes and to continue operations without seeking new financing arrangements. We cannot be certain that additional financing for these purposes would be available on acceptable terms or at all, and if such financing is not available, our business could be seriously harmed. See the risk factor entitled

*We face a variety of risks related to our convertible subordinated notes* for a further description of our obligations under the Notes, our recent consent solicitation of the noteholders and our compliance with certain covenants under the Indenture.

*Sales in China have historically accounted for a material portion of our total sales, and our business, financial condition and results of operations are to a significant degree subject to economic, political and social events, and the performance of our senior management team in China.*

Approximately \$785.5 million, or 32%, \$870.6 million, or 30%, and \$2,028.2 million, or 79%, of our net sales for fiscal years 2006, 2005 and 2004, respectively, occurred in China. While we have expanded into other markets, we have made substantial investments in China and, therefore, our business, financial condition and results of operations are to a significant degree subject to economic, political, legal and social developments and other events in China. In addition, we have had significant changes within our senior management team in China recently, and our current senior management team as a whole does not have the same degree of experience in China as our senior management team had in the past. (See the risk factor entitled *Our success is dependent on continuing to hire and retain qualified personnel, including for senior management positions, and if we are not successful in attracting and retaining these personnel and in managing key employee turnover, our business will suffer* ). If our current senior management in China cannot maintain and /or establish key relationships with customers, governmental entities and others in China, our business in China may decline significantly. If our business in China declines, our financial condition and results of operations may be significantly harmed.

*The average selling prices of our products may decrease, which may reduce our revenues and our gross profit. As a result, we must introduce new products and reduce our costs in order to maintain profitability.*

The average selling prices for communications access and switching systems and handsets have historically declined as a result of a number of factors, including:

- increased competition;
- aggressive price reductions by competitors;
- rapid technological change; and
- constant change in customer buying behavior and market trends.

The average selling prices of our products may continue to decrease in the future in response to product introductions by us or our competitors or other factors, including price pressures from customers. Certain of our products, including wireless handsets, have historically had low gross profit margins, and any further deterioration of our profit margins on such products could result in losses with respect to such products. Therefore, we must continue to develop, source and introduce new products





and enhancements to existing products that incorporate features that can be sold at higher average selling prices. Failure to do so or the failure of consumers or our direct customers to accept such new products could cause our revenues and gross profit to decline.

Our cost reduction efforts initiated in 2005 and our subsequent efforts in the remainder of 2007 and early 2008 may not allow us to keep pace with competitive pricing pressures or lead to improved gross profit, as a percentage of net sales. In order to be competitive, we must continually reduce the cost of manufacturing our products through design and engineering changes. We may not be successful in these efforts or in delivering our products to market in a timely manner. In addition, any redesign may not result in sufficient cost reductions to allow us to reduce the prices of our products to remain competitive or to improve or maintain our gross profit, as a percentage of net sales, which would cause our financial results to suffer.

*Our market is subject to rapid technological change, and to compete effectively, we must continually introduce new products and product enhancements that achieve market acceptance.*

The market for communications equipment is characterized by rapid technological developments, frequent new product introductions, changes in consumer preferences and evolving industry and regulatory standards. Our success will depend in large part on our ability to enhance our technologies and develop and introduce new products and product enhancements that anticipate changing service provider requirements, technological developments and evolving consumer preferences. We may need to make substantial capital expenditures and incur significant research and development costs to develop and introduce new products and enhancements. If we fail to develop and introduce new products or enhancements to existing products that effectively respond to technological change on a timely basis, our business, financial condition and results of operations could be materially adversely affected. Certain of our products, including wireless handsets, have a short product life. Moreover, from time to time, our competitors or we may announce new products or product enhancements, technologies or services that have the potential to replace or shorten the life cycles of our products and that may cause customers to defer purchasing our existing products, resulting in charges for inventory obsolescence reserves. Future technological advances in the communications industry may diminish or inhibit market acceptance of our existing or future products or render our products obsolete. Even if we are able to develop and introduce new products, they may not gain market acceptance. Market acceptance of our products will depend on various factors, including:

- our ability to obtain necessary approvals from regulatory organizations within the countries in which we operate and for any new technologies that we introduce;
- the length of time it takes service providers to evaluate our products, causing the timing of purchases to be unpredictable;
- the compatibility of our products with legacy technologies and standards existing in previously deployed network equipment;
- our ability to attract customers who may have pre-existing relationships with our competitors;
- product pricing relative to performance;
- the level of customer service available to support new products; and
- the timing of new product introductions meeting demand patterns.

If our products fail to obtain market acceptance in a timely manner, our business and results of operations could suffer.

*We depend on some sole source and key suppliers for handsets, base stations, components and materials used in our products. If we cannot secure adequate supplies of high quality products at competitive prices or in a timely manner from these suppliers or sources, or if the suppliers successfully market their products directly to our customers, our competitive position, reputation and business could be harmed.*

We have contracts with a limited group of suppliers to purchase some components and materials used in our products. If any supplier is unwilling or unable to provide us with high-quality components and materials in the quantities required and at the costs specified by us, we may not be able to find alternative sources on favorable terms, in a timely manner, or at all. Further, a supplier could market its products directly to our customers. The possibility of a supplier marketing its own products would create direct competition and may affect our ability to obtain adequate supplies. Our inability to obtain or to develop



alternative sources if and as required could result in delays or reductions in manufacturing or product shipments. From time to time, there could be shortages of certain products or components. Moreover, our suppliers may supply us with inferior quality products. If an inferior product supplied by a third party is embedded in our end product and causes a problem, it might be difficult to identify the source of the problem as being due to the component parts. If any of these events occur, our competitive position, reputation and business could suffer.

Our ability to source a sufficient quantity of high-quality, cost-effective components used in our products may also be limited by import restrictions and duties in the foreign countries in which we manufacture our products. We require a significant number of imported components to manufacture our products, and imported electronic components and other imported goods used in the operation of our business may be limited by a variety of permit requirements, approval procedures, patent infringement claims, import duties and licensing requirements. As an example, a recent court case between a third party and one of our suppliers involved a patent dispute potentially restricting the importation of handsets into the U.S. While this case has been resolved in the supplier's favor at the trial court level, our supply of products could be affected by similar cases in the future. Moreover, import duties on such components increase the cost of our products and may make them less competitive.

*Product defects or performance quality issues could cause us to lose customers and revenue or to incur unexpected expenses.*

Many of our products are highly complex and may have quality deficiencies resulting from the design or manufacture of such product, or from the software or components used in the product. For example, during 2005 we recorded warranty charges of \$70.6 million, including special warranty charges of \$11.7 million for certain asynchronous digital subscriber line (ADSL) products, \$4.0 million for NetRing equipment and \$14.9 million for GEAPON equipment sold to SBBC, an affiliate of SOFTBANK CORP and SOFTBANK America Inc., during 2003 and 2004. Often these issues are identified prior to the shipment of the products and may cause delays in market acceptance of our products, delays in shipping products to customers, or the cancellation of orders. In other cases, we may identify the quality issues after the shipment of products. In such cases, we may incur unexpected expenses and diversion of resources to replace defective products or correct problems. Such pre-shipment and post-shipment quality issues could result in delays in the recognition of revenue, loss of revenue or future orders, and damage to our reputation and customer relationships. In addition, we may be required to pay damages for failed performance under certain customer contracts, and may receive claims from customers related to the performance of our products. Such pre-shipment and post-shipment quality issues could result in delays in the recognition of revenue, loss of revenue or future orders, and damage to our reputation and customer relationships. In addition, we may be required to pay damages for failed performance under certain customer contracts and may receive claims from customers related to the performance of our products.

*Our global diversification strategy and growth has strained our resources, adversely affected our reported gross margins, and if we are unable to manage this growth, our future operating results will be further negatively affected.*

Over the last four years we have experienced a rapid expansion of our international operations and anticipate that we must continue to transform our operations to address market demands and potential market opportunities globally.

Competition in international markets for new service provider customers and for new infrastructure deployments is particularly intense and increasingly focused on price. To meet competitive offerings we may accept contracts with low profitability or even enter into contracts with anticipated losses if we believe it is necessary to establish a relationship with a customer or a presence in a market that we consider important to our international expansion strategy. We believe these decisions will facilitate the development of our international business, but we can provide no assurance that they will. Accepting a contract with an anticipated loss requires us to recognize a provision for the entire loss in the period in which it becomes evident rather than in later periods in which contract performance occurs. Accepting contracts with low gross margins adversely affects our reported results when the revenues from such contracts are recognized; in some cases revenue recognition must be deferred until all revenue recognition criteria have been met, and this would result in recognizing the adverse effects of low gross margin contracts in periods subsequent to when contract performance occurred.

Our transformation to a global focus will place a significant strain on our management, operational, financial and other resources. To manage this transformation effectively, we will need to take various actions, including:

- enhancing management information systems, including forecasting procedures;
- further developing our operating, administrative, financial and accounting systems and controls;
- managing our working capital and sources of financing;



- maintaining close coordination among our engineering, accounting, finance, marketing, sales and operations organizations;
- retaining, training and managing our employee base;
- enhancing human resource operations and improving employee hiring and training programs;
- reorganizing our business structure to more effectively allocate and utilize our internal resources;
- improving and sustaining our supply chain capability; and
- managing both our direct and indirect sales channels in a cost-efficient and competitive manner.

If we fail to implement or improve systems or controls or to manage any future growth and transformation effectively, our business could suffer.

*Any failure by us to execute planned cost reductions successfully could result in total costs and expenses that are greater than expected.*

From time to time we have undertaken restructuring plans to bring operational expenses to appropriate levels for each of our businesses, while simultaneously implementing extensive new company-wide expense-control programs. For example, in 2005, we announced workforce restructurings. These programs resulted in the termination of approximately 1,595 employees worldwide through December 31, 2005. We anticipate making further workforce reductions and taking additional rebalancing actions in the future. In October 2007, our Board of Directors approved a restructuring plan which includes a worldwide reduction in force of approximately 11% of the Company's headcount, or approximately 700 employees. We expect cost savings from planned restructuring activities to be used to offset market forces or to be reinvested in our businesses to strengthen our competitiveness, but we cannot be certain that we will be successful in these efforts. Significant risks associated with these actions and other workforce management issues that may impair our ability to achieve anticipated cost reductions or may otherwise harm our business include delays in implementation of anticipated workforce reductions in highly regulated locations outside of the United States, particularly in Europe and Asia, redundancies among restructuring programs, decreases in employee morale and the failure to meet operational targets due to the loss of employees, particularly sales employees.

*Our success is dependent on continuing to hire and retain qualified personnel, including for senior management positions, and if we are not successful in attracting and retaining these personnel and in managing key employee turnover, our business will suffer.*

The success of our business depends in significant part upon the continued contributions of key technical and senior management personnel, many of whom would be difficult to replace. In particular, our success depends in large part on the knowledge, expertise and services of Hong Liang Lu, our Chief Executive Officer, Peter Blackmore, our President and Chief Operating Officer, Francis P. Barton, Executive Vice President and Chief Financial Officer and Philip Christopher, President and Chief Executive Officer of our Personal Communications Division. The loss of any key employee, the failure of any key employee to perform satisfactorily in his or her current position or our failure to attract and retain other key technical and senior management employees could have a significant negative impact on our operations. We have had significant changes within our senior management team recently, and our current senior management team as a whole does not have the same degree of experience in China as our senior management had in the past. If our current senior management cannot maintain and/or establish key relationships with customers, governmental entities and others in China, our business in China may decline significantly and our financial condition and results of operations may be significantly harmed.

Notwithstanding our workforce restructurings, to effectively manage our operations, we will need to recruit, train, assimilate, motivate and retain qualified employees both locally and internationally. Competition for qualified employees is intense, and the process of recruiting personnel in all fields, including technology, research and development, sales and marketing, administration and management with the combination of skills and attributes required to execute our business strategy can be difficult, time-consuming and expensive. As we grow globally, we must implement hiring and training processes that are capable of quickly deploying qualified local residents to knowledgeable support our products and services. Alternatively, if there is an insufficient number of qualified local residents available, we might incur substantial costs importing expatriates to service new global markets. For example, we have historically experienced difficulty finding qualified accounting personnel knowledgeable in both U.S. and Chinese accounting standards who are Chinese residents. If we fail to attract, hire,



assimilate or retain qualified personnel, our business would be harmed. Competitors and others have in the past, and may in the future, attempt to recruit our employees. In addition, companies in the telecommunications industry whose employees accept positions with competitors frequently claim that the competitors have engaged in unfair hiring practices. We may be the subject of these types of claims in the future as we seek to hire qualified personnel. Some of these claims may result in material litigation and disruption to our operations. We could incur substantial costs in defending ourselves against these claims, regardless of their merit.

*Any acquisitions and divestitures that we undertake could be difficult to integrate, disrupt our business, dilute our stockholders and harm our operating results.*

We have acquired and divested certain businesses, products and technologies. Anticipated benefits of these acquisitions and divestitures may not be realized. We have in the past and will continue to evaluate acquisition prospects that would complement our existing product offerings, augment our market coverage, enhance our technological capabilities, or that may otherwise offer growth opportunities. Acquisitions may result in dilutive issuances of equity securities, use of our cash resources, the incurrence of debt and the amortization of expenses related to intangible assets. In addition, acquisitions involve numerous risks, including difficulties in the assimilation of operations, technologies, products and personnel of the acquired company, diversion of management's attention from other business concerns, risks of entering markets in which we have no direct or limited prior experience, the potential loss of key employees of the acquired company, unanticipated costs and, in the case of the acquisition of financially troubled businesses, challenges as to the validity of such acquisitions from third party creditors of such businesses. For example, in the fourth quarter 2004, we encountered difficulties in integrating Hyundai Syscomm, Inc. ( HSI ) legacy operations into our operations and determined to abandon a substantial amount of HSI's legacy operations. As a result, in the fourth quarter 2004, we wrote off the entire goodwill and intangibles associated with HSI.

*We may be unable to adequately protect the loss or misappropriation of our intellectual property, which could substantially harm our business.*

We rely on a combination of patents, copyrights, trademarks, trade secret laws and contractual obligations to protect our technology. We have applied for patents in the United States and internationally. Additional patents may not be issued from our pending patent applications, and our issued patents may not be upheld. In addition, we have, from time to time, chosen to abandon previously filed patent and trademark applications. Moreover, we may face difficulties in registering our existing trademarks in new jurisdictions in which we operate, and we may be forced to abandon or change product or service trademarks because of the unavailability of our existing trademarks or because of oppositions filed or legal challenges to our trademark filings. We cannot guarantee that the intellectual property protection measures that we have taken will be sufficient to prevent misappropriation of our technology or trademarks or that our competitors will not independently develop technologies that are substantially equivalent or superior to ours. In addition, the legal systems of many foreign countries do not protect or honor intellectual property rights to the same extent as the legal system of the United States. For example, in China, the legal system in general, and the intellectual property regime in particular, are still in the development stage. It may be very difficult, time-consuming and costly for us to attempt to enforce our intellectual property rights in these jurisdictions.

*We may be subject to claims that we infringe the intellectual property rights of others, which could substantially harm our business.*

The industry in which we compete is moving towards aggressive assertion, licensing, and litigation of patents and other intellectual property rights. From time to time, we have become aware of the possibility or have been notified that we may be infringing certain patents or other intellectual property rights of others. Regardless of their merit, responding to such claims could be time consuming, divert management's attention and resources and cause us to incur significant expenses. In addition, although some of our supplier contracts provide for indemnification from the supplier with respect to losses or expenses incurred in connection with any infringement claim, certain contracts with our key suppliers do not provide for such protection. Moreover, certain of our sales contracts provide that we must indemnify our customers against claims by third parties for intellectual property rights infringement related to our products. There are no limitations on the maximum potential future payments under these guarantees. Therefore, we may incur substantial costs related to any infringement claim, which may substantially harm our results of operations and financial condition.

We have been and may in the future become subject to litigation to defend against claimed infringements of the rights of others or to determine the scope and validity of the proprietary rights of others. Future litigation may also be necessary to enforce and protect our patents, trade secrets and other intellectual property rights. Any intellectual property litigation or threatened intellectual property litigation could be costly, and adverse determinations or settlements could result in the loss of our proprietary rights, subject us to significant liabilities, require us to seek licenses from or pay royalties to third parties which



may not be available on commercially reasonable terms, if at all, and/or prevent us from manufacturing or selling our products, which could cause disruptions to our operations.

In the event that there is a successful claim of infringement against us and we fail to develop non-infringing technology or license the proprietary rights on commercially reasonable terms and conditions, our business, results of operations and financial condition could be materially and adversely impacted.

*Our multinational operations subject us to various economic, political, regulatory and legal risks.*

We market and sell our products globally, with a significant portion of our sales made in China. The expansion of our existing multinational operations and entry into new markets will require significant management attention and financial resources. Multinational operations are subject to a variety of risks, such as:

- the burden of complying with a variety of foreign laws and regulations;
- the burden of complying with United States laws and regulations for foreign operations, including the Foreign Corrupt Practices Act;
- difficulty complying with continually evolving and changing global product and communications standards and regulations for both our end products and their component technology;
- market acceptance of our new products, including longer product acceptance periods in new markets into which we enter;
- reliance on local original equipment manufacturers ( OEMs ), third party distributors and agents to effectively market and sell our products;
- unusual contract terms required by customers in developing markets;
- changes in local governmental control or influence over our customers;
- changes to import and export regulations, including quotas, tariffs, licensing restrictions and other trade barriers;
- the burden of compliance with complex and varying taxation requirements of multiple jurisdictions;
- evolving and unpredictable nature of the economic, regulatory, competitive and political environments;
- reduced protection for intellectual property rights in some countries;
- unproven business operation models developed or operated in specific countries or regions;
- longer accounts receivable collection periods; and
- difficulties and costs of staffing, monitoring and managing multinational operations, including but not limited to internal controls and compliance.

*We do business in markets that are not fully developed, which subjects us to various economic, political, regulatory and legal risks unique to developing economies.*

Less developed markets present additional risks, such as the following:

- customers that may be unable to pay for our products in a timely manner or at all;
- new and unproven markets for our products and the telecommunications services that our products enable;
- lack of a large, highly trained workforce;

92

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- difficulty in controlling local operations from our headquarters;
- variable ethical standards and an increased potential for fraud;
- unstable political and economic environments; and
- lack of a secure environment for our personnel, facilities and equipment.

In particular, these factors create the potential for physical loss of inventory and misappropriation of operating assets. We have in the past experienced cases of vandalism and armed theft of our equipment that had been or was being installed in the field. If disruptions for any of these reasons become too severe in any particular market, it may become necessary for us to terminate contracts and withdraw from that market and suffer the associated costs and lost revenue.

*Our wireless handset products are subject to a wide range of environmental, health and safety laws, and may expose us to potential health and environmental liability claims.*

Our handset products are subject to a wide range of environmental, health and safety laws, including laws relating to the use, disposal and clean up of, and human exposure to hazardous substances. In the United States, these laws often require parties to fund remedial action regardless of fault. Factors such as the discovery of additional contaminants, the extent of remediation and compliance expenses, and the imposition of additional clean up obligations could cause us to incur substantial costs relating to remediation activities. Compliance with existing or future environmental, health and safety laws could also cause us to incur substantial costs relating to such compliance, including the expense of modifying product designs and manufacturing processes. In addition, restrictions on the use of certain materials in our facilities or products in the future could have a negative impact on our operations.

Additionally, there have been claims made alleging a link between the use of wireless handsets and the development or aggravation of certain cancers, including brain cancer. The scientific community is divided on whether there is a risk from wireless handset use, and if so, the magnitude of the risk. Even if there is no link established between wireless handset use and cancer, the negative publicity and possible litigation could have a material adverse effect on our business. In the past, several plaintiffs' groups have brought class actions against wireless handset manufacturers and distributors, alleging that wireless handsets have caused cancer. To date, we have not been named in any of these actions and none of these actions has been successful. In the future we could incur substantial costs in defending ourselves against similar claims, regardless of their merit. Also, claims may be successful in the future and may have a material adverse effect on our business.

Furthermore, there have been claims made alleging a link between the use of Bluetooth enabled mobile phone handsets and noise-induced hearing loss. To date, we have not been named in any of these actions. In the future we could incur substantial costs in defending ourselves against similar claims, regardless of their merit. Also, claims may be successful in the future and may have a material adverse effect on our business.

*We are subject to a wide range of environmental, health and safety laws and efforts to comply with such laws may be costly and may adversely impact our financial performance.*

Our operations and the products we manufacture and/or sell are subject to a wide range of global environmental, health and safety laws. Compliance with existing or future environmental, health and safety laws could subject us to future costs, liabilities, impact our production capabilities, constrict our ability to sell, expand or acquire facilities and generally impact our financial performance. Some of these laws relate to the use, disposal, clean up of, and exposure to hazardous substances. In the United States, laws often require parties to fund remedial studies or action regardless of fault. Over the last several years, the European Union (the "EU") countries have enacted environmental laws regulating electronic products. For example, beginning July 1, 2006, our products have been subject to laws that mandate the recycling of waste in electronic products sold in the EU and that limit or prohibit the use of certain substances in electronic products. Other countries outside of Europe are expected to adopt similar laws. We may incur additional expenses to comply with these laws.

*Currency rate fluctuations and exchange controls may adversely affect our cash flow and operating results.*

Because a significant percentage of our sales are made in foreign countries and denominated in local currency, we are exposed to market risk for changes in foreign exchange rates on our foreign currency denominated accounts and notes receivable balances. Historically, the majority of our sales have been made in China and denominated in Renminbi. Prior to July 2005, the impact of currency fluctuations of Renminbi were insignificant as it was fixed to the U.S. dollar. However, in July 2005, China



uncoupled the Renminbi from the U.S. dollar and let it float in a narrow band against a basket of foreign currencies. The move revalued the Renminbi by 2.1% against the U.S. dollar; however, it is uncertain what further adjustments may be made in the future. The Renminbi-U.S. dollar exchange rate could float, and the Renminbi could appreciate relative to the U.S. dollar. For example, the Renminbi-U.S. dollar exchange rate was 8.28 to the U.S. dollar prior to the float of the Renminbi in July 2005 and 7.74 Renminbi to the U.S. dollar at March 31, 2007. Any significant revaluation of the Renminbi may materially and adversely affect our cash flows, revenues, operating results and financial position.

Outside of China, our primary foreign currency exposures have related to non-dollar denominated sales and purchases in Japan, Europe and Canada. Additionally, we have exposures to emerging market currencies, which can have extreme currency volatility. We have experienced material adverse impacts on our results of operations from fluctuations in currency exchange rates and may continue to do so in the future.

We may, from time to time, enter into foreign exchange forward contracts to minimize the short-term impact of foreign currency fluctuations on certain foreign currency receivables and payables. Our attempts to hedge against these risks may not be successful, resulting in an adverse impact on our results of operations. Moreover, some of the foreign countries in which we do business might impose currency restrictions that may limit the ability of our subsidiaries and joint ventures in such countries to obtain and remit foreign currency necessary for the purchase of imported components and may limit our ability to obtain and remit foreign currency in exchange for foreign earnings. For example, China employs currency controls restricting Renminbi conversion, limiting our ability to engage in currency hedging activities in China. Various foreign exchange controls may also make it difficult for us to repatriate earnings, which could have a material adverse effect on our ability to conduct business globally.

*Business interruptions could adversely affect our business.*

Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, external interference with our information technology systems, incidents of terrorism and other events beyond our control. For example, our Hangzhou manufacturing facility's ability to produce sufficient products is dependent upon a continuous power supply. However, the Hangzhou facility has in the past been subject to power shortages, which has affected our ability to produce and ship sufficient products. Also, our operations in Alameda, California are located in an area prone to earthquakes. We do not have a detailed disaster recovery plan, and the occurrence of any events like these that disrupt our business could harm our business and operating results.

*We may suffer losses with respect to equipment held at customer sites, which could harm our business.*

We face the risk of loss relating to our equipment held at customer sites. In some cases, our equipment held at customer sites is under contract, pending final acceptance by the customer. We generally do not hold title or risk of loss on such equipment, as title and risk of loss are typically transferred to the customer upon delivery of our equipment. However, we do not recognize revenue and accounts receivable with respect to the sale of such equipment until we obtain acceptance from the customer. If we do not obtain final acceptance, we may not be able to collect the contract price and recover this equipment or its associated costs. In other cases, particularly in China, where governmental approval is required to finalize certain contracts, inventory not under contract may be held at customer sites. We hold title and risk of loss on this inventory until the contracts are finalized and, as such, are subject to any losses incurred resulting from any damage to or loss of this inventory.

If our contract negotiations fail or if the government of China otherwise delays approving contracts, we may not recover or receive payment for this inventory. Moreover, our insurance may not cover all losses incurred if our inventory at customer sites not under contract is damaged prior to contract finalization. If we incur a loss relating to inventory for any of the above reasons, our financial condition, cash flows, and operating results could be harmed.

*Restrictions on the use of handsets while driving could affect our future growth.*

Several foreign governments and U.S. state and local governments have adopted or are considering adopting legislation that would restrict or prohibit the use of wireless handsets while driving. Widespread legislation that restricts or prohibits the use of wireless handsets while driving could negatively affect our future growth.

*We have been named as a defendant in securities litigation and other lawsuits, as well as lawsuits in the ordinary course of business.*

Currently, we are a defendant in securities litigation class action lawsuits, as well as other lawsuits. Additionally, from time to time we are plaintiffs or defendants in other lawsuits including lawsuits in the ordinary course of our business. The pursuit or defense of these lawsuits may divert our management's attention, and we may incur significant expenses in pursuing or defending these lawsuits. In addition, we may be required to pay judgments or settlements that could have a material adverse effect on our results of operations, financial condition and liquidity.

*We face risks related to pending governmental inquiries.*

In September 2005, we received notice of a formal inquiry by the staff of the Securities & Exchange Commission ( SEC ) into certain aspects of our financial disclosures during prior reporting periods and certain other issues. In addition, in December 2005, the U.S. Embassy in Mongolia informed us that it had forwarded to the Department of Justice ( DOJ ) allegations that an agent of our Mongolia joint venture had offered payments to a Mongolian government official in possible violation of the Foreign Corrupt Practices Act (the FCPA ). We, through our Audit Committee, authorized an independent investigation into possible violations of the FCPA, and we have been in contact with the DOJ and SEC regarding the investigation. The investigation has identified possible FCPA violations in Mongolia, Southeast Asia, India and China, as well as possible violations of U.S. immigration laws. The DOJ has requested that the Company voluntarily produce documents related to the investigation and the SEC has subpoenaed the Company for documents. The Company has executed tolling agreements extending the statute of limitations for the FCPA issues under investigation by the SEC and the DOJ and the immigration issues under investigation by the DOJ. At this time, we cannot predict when any inquiry will be completed or what the outcome of any inquiry will be. These inquiries could harm relationships with existing customers and our ability to obtain new customers and partners. If the SEC or the DOJ makes a determination that we have violated federal laws, we may face sanctions including, but not limited to, fines, disgorgement and an injunction. Additionally, such a determination by the SEC or the DOJ could adversely affect our business, results of operations, financial position and cash flow, and ultimately our stock price.

We have also been in communication with the SEC regarding our voluntary review of our historical option grant awards grant practices and our review of certain historical sales contracts in China. Although we have now completed both of those voluntary reviews, it is possible that the SEC may question the findings of our reviews or initiate its own review into related matters.

It is possible that the findings and outcome of any of these inquiries may affect other lawsuits that are pending. These inquiries could divert management attention and resources, which could harm our business.

*Failure to achieve and maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act of 2002 could have a material adverse effect on our business and stock price.*

Section 404 of the Sarbanes-Oxley Act of 2002 ( Sarbanes-Oxley Act ) requires that we establish and maintain an adequate internal control structure and procedures for financial reporting and include a report of management on our internal control over financial reporting. Our annual report on Form 10-K must contain an assessment by management of the effectiveness of our internal control over financial reporting and must include disclosure of any material weaknesses in internal control over financial reporting that we have identified. In addition, our independent registered public accounting firm must attest to and report on management's assessment of the effectiveness of our internal control over financial reporting.

We have identified material weaknesses in our internal control over financial reporting. See Part I Item 4 Controls and Procedures Management's Report on Internal Control Over Financial Reporting. As of the date of this quarterly report on Form 10-Q, we are still in the process of implementing remedial measures related to the material weaknesses identified in 2004 through 2006. If our efforts to remediate the weaknesses we identified are not successful, our business and operating results could be harmed and the reliability of our financial statements could be impaired, which could adversely affect our stock price. The requirements of Section 404 of the Sarbanes-Oxley Act are ongoing and also apply to future years. We expect that our internal control over financial reporting will continue to evolve as we continue in our efforts to transform our business. Although we are committed to continue to improve our internal control processes and we will continue to diligently and vigorously review our internal control over financial reporting in order to ensure compliance with the Section 404 requirements, any control system, regardless of how well designed, operated and evaluated, can provide only reasonable, not absolute, assurance that its objectives will be met. In addition, successful remediation of the noted control deficiencies is dependent on the Company's ability to hire and retain qualified personnel. Therefore, we cannot be certain that in the future additional material weaknesses or significant deficiencies will not exist or otherwise be discovered.



## RISKS RELATED TO CONDUCTING BUSINESS IN CHINA

*China's governmental and regulatory reforms may impact our ability to do business in China.*

Since 1978, the Chinese government has been in a state of evolution and reform. The reforms have resulted in and are expected to continue to result in significant economic and social development in China. Many of the reforms are unprecedented or experimental and may be subject to change or readjustment due to a variety of political, economic and social factors. Multiple government bodies are involved in regulating and administering affairs in the telecommunications and information technology industries, among which the Ministry of Information Industry ( MII ), the National Development and Reform Commission ( NDRC ), the State-owned Assets Supervision and Administration Commission ( SASAC ) and the State Administration of Radio, Film and Television ( SARFT ) play the leading roles. These government agencies have broad discretion and authority over all aspects of the telecommunications and information technology industry in China, including but not limited to, setting the telecommunications tariff structure, granting carrier licenses and frequencies, approving equipment and products, granting product licenses, approving of the form and content of transmitted data, specifying technological standards as well as appointing carrier executives, all of which may impact our ability to do business in China.

Any of the following changes in China's political and economic conditions and governmental policies could have a substantial impact on our business:

- the promulgation of new laws and regulations and the interpretation of those laws and regulations;
- inconsistent enforcement and application of the telecommunications industry's rules and regulations by the Chinese government between foreign and domestic companies;
- the restructuring of telecommunications carriers in China, including policy making governing 3G network infrastructure and licensing;
- restrictions on IPTV license grants, which could limit the potential market for our products;
- the introduction of measures to control inflation or stimulate growth;
- the introduction of new guidelines for tariffs and service rates, which affect our ability to competitively price our products and services;
- changes in the rate or method of taxation;
- the imposition of laws, rules or regulations affecting the direct or indirect nationalization of assets controlled by non-governmental persons or entities;
- the imposition of additional restrictions on currency conversion and remittances abroad; or
- any actions that limit our ability to develop, manufacture, import or sell our products in China, or to finance and operate our business in China.

In addition to modifying the existing telecommunications regulatory framework, the Chinese government is currently preparing a draft of a standard, national telecommunications law ( Telecommunications Law ) to provide a uniform regulatory framework for the telecommunications industry. Currently a draft of the law has been finished and delivered to the National People's Congress for discussion. We do not yet know the final nature or scope of the regulations that would be created if the Telecommunications Law is passed. Accordingly, we cannot predict whether it will have a positive or negative effect on us or on some or all aspects of our business.

Under China's current regulatory structure, the communications products that we offer in China must meet government and industry standards. In addition, a network access license for the equipment must be obtained. Without a license, telecommunications equipment is not allowed to be connected to public telecommunications networks or sold in China. Moreover, we must ensure that the quality of the telecommunications equipment for which we have obtained a network access license is stable and reliable, and will not negatively affect the quality or performance



of other installed licensed products.

96

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*China's changing economic environment may impact our ability to do business in China.*

Since 1978, the Chinese government has been reforming the economic system in China to increase the emphasis placed on decentralization and the utilization of market forces in the development of China's economy. These reforms have resulted in significant economic growth. However, any economic reform policies or measures in China may from time to time be modified or revised by the Chinese government. While we may be able to benefit from the effects of some of these policies, these policies and other measures taken by the Chinese government to regulate the economy could also have a significant negative impact on economic conditions in China, which would result in a negative impact on our business.

*China's entry into the World Trade Organization and relaxation of trade restrictions have led to increased foreign investment in China's telecommunications industry and may lead to increased competition in our markets which may have an adverse impact on our business.*

China's economic environment has been changing as a result of China's entry, in December of 2001, into the World Trade Organization (WTO). Foreign investment in the telecommunications sector is regulated by the Provisions on Administration of Foreign Invested Telecommunications Enterprises promulgated by the State Council in December 2001 and effective as of January 1, 2002. The provisions brought foreign equity limits into conformity with China's WTO commitments, allowing foreign investors to own equity generally up to 49% for basic telecom services enterprises and up to 50% for value-added telecom services enterprises. Furthermore, China is gradually introducing a market oriented pricing mechanism for telecommunication services. On July 13, 2005, China's Ministry of Information Industry (MII) and National Development and Reform Commission (NDRC) approved the launch of plan-based pricing for fixed-line telephone service by China's two fixed-line operators, China Telecom and China Netcom. In August 2005, MII and NDRC endorsed a Circular on the Changes in Administration of Telecom Service Pricing, which became effective on October 1, 2005 and further relaxed the pricing administration on certain telecom services. As China gradually relaxes such legal provisions, international telecommunication service vendors may seize this opportunity to adjust their China strategy, increasing their investment in China and converting some of their joint-ventures into fully-owned enterprises.

As the existing international vendors increase their investment in China, and more vendors enter the China market, the competition in the telecommunication equipment market may increase, and as a result, our business may suffer. If China's entry into the WTO results in increased competition or has a negative impact on China's economy, our business could suffer. In addition, although China is increasingly according foreign companies and foreign investment enterprises established in China the same rights and privileges as Chinese domestic companies as a result of its admission into the WTO, special laws, administrative rules and regulations governing foreign companies and foreign investment enterprises in China may still place foreign companies at a disadvantage in relation to Chinese domestic companies and may adversely affect our competitive position.

*Uncertainties with respect to the Chinese legal system may adversely affect us.*

We conduct our business in China primarily through our wholly owned subsidiaries incorporated in China. Our subsidiaries are generally subject to laws and regulations applicable to foreign investment in China. Accordingly, our business might be affected by China's developing legal system. Since 1978, many new laws and regulations covering general economic matters have been promulgated in China, and government policies and internal rules promulgated by governmental agencies may not be published in time, or at all. As a result, we may operate our business in violation of new rules and policies without having any knowledge of their existence. In addition, there are uncertainties regarding the interpretation and enforcement of laws, rules and policies in China. Governmental authorities have broad discretion in the interpretation and enforcement of the laws, regulations and rules. The Chinese legal system is based on written statutes, and prior court decisions have limited precedential value. Because many laws and regulations are relatively new and the Chinese legal system is still evolving, the interpretations of many laws, regulations and rules are not always uniform. Moreover, the relative inexperience of China's judiciary in many cases creates additional uncertainty as to the outcome of any litigation, and the interpretation of statutes and regulations may be subject to government policies reflecting domestic political changes. Finally, enforcement of existing laws or contracts based on existing law may be uncertain and sporadic, and it may be difficult to obtain swift and equitable enforcement, or to obtain enforcement of a judgment by a court of another jurisdiction. Any litigation in China may be protracted and result in substantial costs and diversion of resources and management's attention.

*If tax benefits available to our subsidiaries located in China are reduced or repealed, our business could suffer.*

On March 16, 2007, China's top legislature, the National People's Congress, passed the China Corporate Income Tax Law (CIT Law). CIT Law will be effective on January 1, 2008. Under the CIT Law, China's dual tax system for

domestic enterprises and foreign investment enterprises ( FIEs ) would be effectively replaced by a unified system. The new law establishes a tax rate of 25% for most enterprises and a reduced tax rate of 15% for certain qualified high technology enterprises.

Prior to this change in tax law, certain subsidiaries and joint ventures located in China enjoyed tax benefits in China which are generally available to FIEs. The tax holidays/incentives for FIEs were applicable or potentially applicable to UTStarcom ChongQing Telecom Co. Ltd. ( CUTS ), UTStarcom Telecom Co., Ltd. ( HUTS ), Hangzhou UTStarcom Telecom Co., Ltd. ( HSTC ) and UTStarcom China Co., Ltd. ( UTSC ), our active subsidiaries in China, because these entities may qualify as accredited technologically advanced enterprises.

CIT Law targets certain industries for the reduced 15% tax rate for certain qualified high technology enterprises. For FIEs established before the promulgation of the new law who currently enjoy lower tax rates, any increase in their tax rates would be gradually phased in over five years. Significant regulations regarding the interpretation and implementation of the new tax law are still pending. There is potential risk that our subsidiaries may not qualify for the reduced 15% tax rate. Therefore, the new law may have an adverse impact on our future tax expense in China.

Moreover, the Chinese central government may review and audit tax benefits granted by local or provincial authorities and could determine to disallow such benefits. Certain of our subsidiaries and joint ventures located in China enjoy tax benefits in China that are generally available to foreign investment enterprises. If these tax benefits are reduced, disallowed or repealed due to changes in tax laws or determination by the Chinese government, our business could suffer.

*Our ability to continue successful deployment of PAS system and sales of PAS handsets are limited by certain factors, including the following:*

*Maturing PAS market and increased competition in handsets and tariffs.*

The market for PAS exceeded 96 million users as of the end of fiscal year 2006 and is available in most of the provinces throughout China. We believe the PAS market has matured. For example, during fiscal year 2005, net sales of the PAS/iPAS system and the wireless infrastructure market declined significantly as compared to fiscal year 2004. This decline continued through fiscal year 2006, and the first quarter of 2007. If additional handset competitors enter the market, or if competitors decide to further reduce pricing, our sales of PAS handsets may be adversely impacted.

Furthermore, competition from mobile operators, such as China Mobile and China Unicom, has increased in cities where PAS is deployed. Mobile operators offering special promotional pricing or incentives to customers, such as free incoming calls or free mobile-to-mobile calls, have harmed the ability of our customers, China Telecom and China Netcom, to compete effectively. The continued use of such incentive programs by mobile operators may adversely impact China Telecom and China Netcom's ability to increase PAS subscriptions. Due to our relationships with China Telecom and China Netcom, reduced subscription growth at these carriers may have a material adverse effect on our pricing and harm our business or results of operations.

*Our PAS system and handsets sales may experience a sharp decline if China Telecom or China Netcom obtain licenses allowing them to deliver mobile services.*

China's media sources have widely reported that the MII may grant 3G mobile licenses to China Telecom or China Netcom, or to both in 2007. If China Telecom or China Netcom obtains 3G mobile licenses, they may re-allocate capital expenditures to construct 3G networks, and as a consequence, may significantly reduce capital expenditures relating to PAS networks that utilize our existing products. In addition, it is possible that current PAS frequency bands utilized by PAS networks may be reallocated for use by 3G networks, resulting in the restriction of or shutting down of PAS networks. If this were to occur, we could lose current and potential future customers of our products, and our financial condition and results of operations could be significantly harmed.

*We only have trial licenses for the PAS system and handsets in China.*

We only have trial licenses for our PAS systems and handsets. We have applied for, but have not yet received, a final official network access license for our PAS systems and handsets. Based upon communication with the MII, we understand that our PAS systems and handsets are considered to still be in the trial period and sales of our PAS systems and handsets may

continue to be made by us during this trial period, but that licenses will ultimately be required. If we fail to obtain the required licenses, we could be prohibited from making further sales of the unlicensed products, including our PAS systems and handsets, in China, which would substantially harm our business, financial condition and results of operations. The regulations implementing these requirements are not very detailed, have not been applied by a court and may be interpreted and enforced by regulatory authorities in a number of different ways. Our external legal counsel in China has advised us that China's governmental authorities may interpret or apply the regulations with respect to which licenses are required and the ability to sell a product while a product is in the trial period in a manner that is inconsistent with the information received by our legal counsel in China, and either of these conditions could have a material adverse effect on our business, financial condition and results of operations.

*Increasing centralization of purchasing decision-making by carriers may lead to customer concentration and affect the results of our business.*

Most Chinese carriers have three levels of operations: the central headquarters level, the provincial level and the local city/county level. Both central and provincial levels are independent legal persons and have their own corporate mandate. The purchasing decision-making process may take various forms for different projects and may also differ significantly from carrier to carrier. In the case of PAS systems, we negotiate and enter into all China Netcom contracts with the provincial operators. However, the central headquarters of China Telecom has chosen to exert its influence in the purchasing decision-making process by negotiating contractual terms, such as purchase price, payment terms, and acceptance clauses at the central level. The provincial operator then further negotiates the contract based on the guidelines provided by the headquarters. We enter into final contracts with the provincial operator. However, if this trend of centralized decision-making expands to unified purchasing, resulting in the negotiation and execution of contracts at the central headquarter level, there may be a concentration of customers which could have a significant impact on our business. If China Netcom follows China Telecom and exerts the headquarters' influence in price negotiation, it may give downward pressure to the margin of our PAS system products to China Netcom.

*Television over the internet is a new business in China and laws regulating the business have not been fully developed and may be unpredictable. Unfavorable regulation of the industry may adversely affect our IPTV operations in China and negatively impact our business.*

Broadcasting television over the internet has only recently begun in China. The State Administration of Radio, Film and Television (SARFT), the central government's regulatory body, issued a measure in July 2004 to regulate the broadcasting of audio-visual programs through the information network, which includes our Internet Protocol television (IPTV) business. SARFT categorized the information network into the mobile telecommunication network, fixed communications network, microwave communication network, cable television network, satellite or other metropolitan area network, wide area network, local area network and other information networks categories. The receiving terminal equipment includes computers, television sets, mobile phones and other electronic products. While regulating the IPTV business, SARFT is encouraging development in China of the digital television business, a business that may be competitive with IPTV in the target market. The digital television and IPTV target complementary markets and it is not clear the extent of support SARFT will provide for IPTV in setting regulations. For example, the Guangzhou Administration of Radio, Film, and Television, the municipal regulatory body in the city of Guangzhou, issued a notice to stop all IPTV business in Guangzhou on December 25, 2005. The Zhejiang Administration of Radio, Film, and Television, the local regulatory body in the province of Zhejiang, issued a similar notice on January 10, 2006. In both instances, SARFT had not formally endorsed the launch of commercial IPTV services in those localities. Because the IPTV industry relates to both television and telecom sectors, it may be subject to regulation by different governmental authorities, including the Ministry of Information Industry (MII). At the end of 2005, an official of MII declared that MII and SARFT would jointly administer the IPTV industry in the coming years. However, due to a lack of uniform regulation on the development of the IPTV industry, we cannot predict that our IPTV business will operate smoothly in China. Our business may suffer if the law or policy in China does not encourage the IPTV industry.

*We currently do not have a license to engage in the IPTV operator service business in China and development of our IPTV business depends upon the cooperation of IPTV license holder(s) and network operators. If we are unable to work cooperatively with license holder(s) and network operators, our business may suffer.*

Under the measures issued by SARFT in July 2004, entities intending to engage in the IPTV operator service business should obtain a license from SARFT and foreign investment enterprises are prohibited from engaging in the IPTV operator service business. In practice, SARFT only grants such licenses to state-owned companies. Since we are the technical service and equipment provider in this field, our business development will depend on the cooperation of license holders and network operators. Our business may suffer if we fail to cooperate with license holders or network operators, or if the license holder(s) we're cooperating with lose their licenses.

## RISKS RELATED TO OUR STOCK PERFORMANCE AND CONVERTIBLE DEBT SECURITIES

*Our stock price is highly volatile.*

The trading price of our common stock has fluctuated significantly since our initial public offering in March of 2000. Our stock price could be subject to wide fluctuations in the future in response to many events or factors, including those discussed in the preceding risk factors relating to our operations, as well as:

- actual or anticipated fluctuations in operating results, actual or anticipated gross profit as a percentage of net sales, levels of inventory, our actual or anticipated rate of growth and our actual or anticipated earnings per share;
- changes in expectations as to future financial performance or changes in financial estimates or buy/sell recommendations of securities analysts;
- changes in governmental regulations or policies in China;
- our, or a competitor's, announcement of new products, services or technological innovations;
- the operating and stock price performance of other comparable companies; and
- news and commentary emanating from the media, securities analysts or government bodies in China relating to us and to the industry in general.

General market conditions and domestic or international macroeconomic factors unrelated to our performance may also affect our stock price. For these reasons, investors should not rely on recent trends to predict future stock prices or financial results. In addition, following periods of volatility in a company's securities, securities class action litigation against a company is sometimes instituted. We have experienced substantial costs and the diversion of management's time and resources on this type of litigation and may do so in the future.

In addition, public announcements by China Telecom, China Netcom, China Mobile, and China Unicom each of which exert significant influence over many of our major customers in China, may contribute to volatility in the price of our stock. The price of our stock may react to such announcements.

*SOFTBANK CORP. with its related entities, including SOFTBANK America Inc., has significant influence over our management and affairs, which it could exercise against the best interests of our stockholders.*

SOFTBANK CORP. and its related entities, including SOFTBANK America Inc. (collectively, "SOFTBANK"), beneficially owned approximately 12% of our outstanding stock as of March 31, 2007. As a result, SOFTBANK has the ability to influence all matters submitted to our stockholders for approval, as well as our management and affairs. Matters that could require stockholder approval include:

- election and removal of directors;
- our merger or consolidation with or into another entity; and
- sale of all or substantially all of our assets.

This concentration of ownership may delay or prevent a change of control or discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of us, which could decrease the market price of our common stock.

*Delaware law and our charter documents contain provisions that could discourage or prevent a potential takeover, even if the transaction would benefit our stockholders.*

Other companies may seek to acquire or merge with us. Our acquisition or merger could result in benefits to our stockholders, including an increase in the value of our common stock. Some provisions of our Certificate of Incorporation and



Bylaws, as well as provisions of Delaware law, may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable. These provisions include:

- authorizing the board of directors to issue additional preferred stock;
- prohibiting cumulative voting in the election of directors;
- limiting the persons who may call special meetings of stockholders;
- prohibiting stockholder action by written consent;
- creating a classified board of directors pursuant to which our directors are elected for staggered three year terms; and
- establishing advance notice requirements for nominations for election to the board of directors and for proposing matters that can be acted on by stockholders at stockholder meetings.

*We face a variety of risks related to our convertible subordinated notes.*

We face a variety of risks with respect to our convertible subordinated notes due in 2008 ( Notes ), including the following:

- we have significantly increased our leverage as a result of the sale of the Notes which could have an adverse impact on our ability to obtain additional financing for working capital;
- we may be limited in our ability to purchase the Notes in the event of a change in control, either for cash or stock, which could result in our defaulting on the Notes at the time of the change in control, and purchases for stock would be subject to market risk; and
- hedging transactions related to the Notes and our common stock and other transactions, as well as changes in interest rates and our creditworthiness, may affect the value of our common stock.

In addition, we are subject to various covenants pursuant to the terms of the indenture governing the Notes (the Indenture ). Should we fail to comply with certain covenants in the Indenture, including covenants requiring us to file certain reports required to be filed pursuant to the Exchange Act (the SEC Reports ) with the Securities and Exchange Commission (the SEC ) and to provide the Trustee for the notes (the Trustee ) with copies of such reports and certain certificates regarding our compliance with our obligations under the Indenture, the Trustee or the holders of 25% of the aggregate principal amount of the Notes outstanding (the 25% Holders ) could accelerate the maturity of the Notes and the Notes could become immediately due and payable. In the past, there have been delays in filing such reports: For example, as of November 9, 2006 and continuing through the date hereof there has been a delay in the filing of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 (the 2006 Q3 Form 10-Q ), our Annual Report on Form 10-K for the fiscal year ended December 31, 2006 (the 2006 Form 10-K ), our Quarterly Report on Form 10-Q for the quarter ended March 31, 2007 (the 2007 Q1 Form 10-Q ), and our Quarterly Report on Form 10-Q for the quarter ended June 30, 2007 (the 2007 Q2 Form 10-Q, and together with the 2006 Q3 Form 10-Q, the 2006 Form 10-K, and the 2007 Q1 Form 10-Q, the Delayed Reports ). We received a notice from the Trustee on May 31, 2007, asserting that our failure to file the 2006 Q3 Form 10-Q, the 2006 Form 10-K and the 2007 Q-1 Form 10-Q had resulted in a default under the Indenture, and that if we failed to file such reports within 60 days, an event of default would arise under the Indenture.

In July 2007, we sought and obtained the requisite consents from holders of the Notes to certain amendments to the Indenture, which provide that (i) any failure by us to file SEC Reports with the SEC and provide copies of such reports and certain certificates to the Trustee prior to 5:30 p.m. New York City time on October 15, 2007 (the Expiration Date ) will not cause a default under the Indenture, (ii) any such failure continuing after the Expiration Date would cause a default under the Indenture, which would be deemed to have occurred as of the Expiration Date, and (iii) we will pay additional interest on the Notes of (a) 6.75% annually from January 9, 2007 to and including July 25, 2007, and (b) 10.0% annually from and including July 26, 2007 to the date the Notes are paid, prepaid, converted, redeemed or otherwise cease to be outstanding (in each case, in addition to interest of 7/8% annually, as provided by the Indenture, without regard to any amendments). Although we have now filed our Q3 2006 Form 10Q, our 2006 Form 10K and this Q1 2007 Form 10Q, we have not yet filed our Q2 2007 Form 10Q and delivered copies of such

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report and certain certificates to the Trustee. As a result, on October 15, 2007, we received a notice from the Trustee asserting that our failure to file our Q1 2007 Form 10-Q and our Q2 2007 Form 10-Q had resulted in a default under the Indenture, as amended by the First and Second Supplemental Indentures, and that if we failed to file such reports within 60 days of October 15, 2007, an event of default would arise under the Indenture. The Company cannot be certain that it will be able to file all required reports with the SEC by the Demand Date. Furthermore, the Company cannot be certain that consents from holders of the Notes necessary for an additional waiver of its obligations to comply with the Indenture covenants within the required period can be obtained on reasonable terms or at all.

101

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If an event of default were to occur, the Trustee or the 25% Holders would have the right to accelerate the maturity of the Notes and declare all unpaid principal and accrued interest on the Notes then outstanding to be immediately due and payable, as described above. No assurance can be given that we would be able to obtain the requisite consents of the Holders to a further amendment to the Indenture, providing for a waiver of compliance with covenants in the Indenture relating to the filing of our Q2 2007 Form 10Q, on acceptable terms or at all. If an event of default under the Indenture were to occur, and the maturity of the Notes were accelerated, and all unpaid principal and accrued interest is declared immediately due and payable, our business would be seriously harmed. If we have not filed the Q2 2007 Form 10Q, our ability to raise additional capital may be limited, and specifically, we would not be able to refinance indebtedness under the Notes from the proceeds of an issuance of new convertible notes. In addition, if we are able to raise capital to refinance indebtedness under the Notes by issuing new convertible notes, the terms of such notes may be significantly less favorable than the terms of the Notes, and may cause greater dilution to holders of our common stock.

*Our failure to timely file periodic reports with the Securities and Exchange Commission could result in the delisting of our common stock from the NASDAQ Stock Market.*

As a result of our failure to timely file our Quarterly Report on Form 10-Q for the period ended September 30, 2006 ( Q3 2006 Form 10-Q ), our Annual Report on Form 10-K for the year ended December 31, 2006, our Quarterly Report on Form 10-Q for the period ended March 31, 2007 ( Q1 2007 Form 10-Q ) and our Quarterly Report on Form 10-Q for the period ended June 30, 2007 ( Q2 2007 Form 10-Q ), we have not been in full compliance with NASDAQ Marketplace Rule 4310(c)(14), which requires us to make, on a timely basis, all filings with the Securities and Exchange Commission required by the Securities Exchange Act of 1934. Although we have now filed our Q3 2006 10-Q, 2006 Form 10-K and this Q1 2007 Form 10-Q, we have not yet filed our Q2 2007 Form 10-Q and thus continue not to be in full compliance with this rule. We are required to comply with NASDAQ Marketplace Rule 4310(c)(14) as a condition for our common stock to continue to be listed on the NASDAQ Stock Market.

In connection with our failure to timely file our periodic reports, we received four NASDAQ Staff Determination letters, dated November 15, 2006, March 7, 2007, May 16, 2007 and August 13, 2007, respectively, stating that, as a result of each of these non-timely filings, we were not in compliance with the requirements of Marketplace Rule 4310(c)(14) and, therefore, that our stock was subject to delisting from the NASDAQ Stock Market. We appealed the November 15, 2006 determination to the NASDAQ Listing Qualifications Panels (the Panel ) and were granted a conditional extension to our request for continued listing until April 16, 2007. On April 17, 2007 the Panel extended the deadline for filing our Q3 2006 Form 10-Q to May 14, 2007. The Panel also extended the deadline for filing our 2006 Form 10-K until July 16, 2007. On May 2, 2007, we asked the NASDAQ Listing and Hearing Review Council ( Listing Council ) to review the April 17, 2007 decision of the Panel. On May 14, 2007, the Listing Council called the Panel s decision for review and requested that we provide an update on our efforts to file our delinquent filings. We have continued and continue to comply with that request. In addition, the Listing Council stayed the Panel s decision that required us to file our Q3 2006 Form 10-Q by May 14, 2007, and to file our 2006 Form 10-K by July 16, 2007. On August 23, 2007, the Listing Council granted the Company an extension until October 22, 2007 to file our delinquent periodic reports and restatements. As stated above, we have now filed our Q3 2006 Form 10Q, 2006 Form 10K and this Q1 2007 Form 10Q. However, we can provide no assurances that we will be able to file our Q2 2007 Form 10Q by October 22, 2007.

If we are unable to maintain compliance with the conditions for continued listing required by NASDAQ, then our shares of common stock may be subject to delisting from the NASDAQ Stock Market. If our shares of common stock are delisted from the NASDAQ Stock Market, they may not be eligible to trade on any national securities exchange or the over-the counter market. If our common stock is no longer traded through a market system, the liquidity of our common stock may be greatly reduced, which could negatively affect its price. In addition, we may be unable to obtain future equity financing, or use our common stock as consideration for mergers or other business combinations. A delisting from the NASDAQ Stock Market may also have other negative implications, including the potential loss of confidence by suppliers, customers and employees, the loss of institutional investor interest, and fewer business development opportunities.

## **ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

None

## **ITEM 3 DEFAULTS UPON SENIOR SECURITIES**

None

102

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

None

**ITEM 5 OTHER INFORMATION**

None

**ITEM 6 EXHIBITS**

Exhibit Number	EXHIBIT DESCRIPTION
3.1	Thirteenth Amended and Restated Certificate of Incorporation of UTStarcom, Inc., as amended. (incorporated by reference to Exhibit 3.1 of Current Report on Form 8-K filed with the SEC on December 12, 2003)
3.2	First Amended and Restated Bylaws of UTStarcom, Inc., as amended on July 13, 2007 (incorporated by reference to Exhibit 3.2 of the Annual Report on Form 10-K filed with the SEC on October 10, 2007)
4.1	See exhibits 3.1 and 3.2 for provisions of the Certificate of Incorporation and Bylaws defining the rights of holders of Common Stock.
4.2	Specimen Common Stock Certificate. (incorporated by reference to Exhibit 4.1 of Form S-1/A filed with the SEC on February 7, 2000)
4.3	Third Amended and Restated Registration Rights Agreement dated December 14, 1999. (incorporated by reference to Exhibit 4.2 of Form S-1 filed with the SEC on December 20, 1999)
4.4	Convertible Subordinated Notes Indenture dated as of March 12, 2003 between UTStarcom, Inc. and U.S. Bank National Association, including the form of the 7/8% Convertible Subordinated Notes due 2008. (incorporated by reference to Exhibit 4.4 of Quarterly Report on Form 10-Q filed with the SEC on May 12, 2003)
4.5	First Supplemental Indenture, dated January 9, 2007, by and between the Company and U.S. Bank National Association. (incorporated by reference to Exhibit 99.2 of Current Report on Form 8-K filed with the SEC on January 10, 2007)
4.6	Underwriting Agreement, dated January 8, 2004 between the Company and Bank of America Securities LLC, as amended on January 14, 2004. (incorporated by reference to Exhibit 4.7 of Form 10-K filed with the SEC on April 15, 2005)
4.7	Consent Solicitation Statement dated December 22, 2006 related to the Company's 7/8% Convertible Subordinated Notes due 2008 (incorporated by reference to Exhibit 99.2 of Current Report on Form 8-K filed with the SEC on December 22, 2006)
4.8	Amended Letter of Consent related to the Company's 7/8% Convertible Subordinated Notes due 2008 (incorporated by reference to Exhibit 99.3 of Current Report on Form 8-K filed with the SEC on January 8, 2007)
4.9	Supplemental Consent Solicitation Statement dated January 8, 2007 related to the Company's 7/8% Convertible Subordinated Notes due 2008 (incorporated by reference to Exhibit 99.2 of Current Report on Form 8-K filed with the SEC on January 8, 2007)
4.10	Second Consent Solicitation Statement dated July 19, 2007 relating to the Company's Convertible Subordinated Notes due 2008 (incorporated by reference to Exhibit 99.2 to the Form 8-K filed with the SEC on July 19, 2007)
4.11	Letter of Consent relating to the Company's Convertible Subordinated Notes due 2008 (incorporated by reference to Exhibit 99.3 to the Form 8-K filed with the SEC on July 19, 2007)



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- 4.12 Second Supplemental Indenture, dated July 26, 2007, by and between the Company and U.S. Bank National Association (incorporated by reference to Exhibit 99.1 to the Form 8-K filed with the SEC on July 30, 2007)
- 10.1++ Amended and Restated Committed Receivables Purchase Agreement dated March 30, 2007 between UTStarcom Personal Communications LLC and Citibank N.A.
- 31.1 Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.
- 31.2 Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.
- 32.1 Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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++ Portions of this exhibit have been omitted pursuant to a request for confidential treatment filed with the Securities and Exchange Commission

104

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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.

UTSTARCOM, INC.

Date: October 17,  
2007

By:

/s/ FRANCIS P. BARTON

Francis P. Barton  
*Executive Vice President and Chief Financial Officer*  
*(Principal Financial Officer)*

105

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