

INFINERA CORP  
Form 10-K  
March 01, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Form 10-K**

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 25, 2010

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: 001-33486

**Infinera Corporation**

(Exact name of registrant as specified in its charter)

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

**77-0560433**  
(IRS Employer  
Identification No.)

**169 Java Drive**

**Sunnyvale, CA 94089**

(Address of principal executive offices, including zip code)

**(408) 572-5200**

(Registrant's telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Act:**

| Title of Each Class   | Name of Each Exchange on Which Registered |
|---|---|
| <b>Common Stock, \$0.001 Par Value</b>                                  | <b>The NASDAQ Global Select Market</b>    |
| <b>Securities registered pursuant to Section 12(g) of the Act: None</b> |   |

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "accelerated filer, large accelerated filer and smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

The aggregate market value of the registrant's common stock, \$0.001 par value per share, held by non-affiliates of the registrant on June 25, 2010, the last business day of the registrant's most recently completed second fiscal quarter, was approximately \$537,651,540 (based on the closing sales price of the registrant's common stock on that date). Shares of the registrant's common stock held by each officer and director and each person who owns more than 5% or more of the outstanding common stock of the registrant have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status is not necessarily a

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conclusive determination for other purposes. As of February 23, 2011, 103,868,311 shares of the registrant's common stock, \$0.001 par value per share, were issued and outstanding.

### **DOCUMENTS INCORPORATED BY REFERENCE**

- (1) Portions of the registrant's Proxy Statement for its 2011 Annual Meeting of Stockholders to be filed pursuant to Regulation 14A are incorporated by reference into Part III of this Annual Report on Form 10-K where indicated.

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**INFINERA CORPORATION**  
**ANNUAL REPORT ON FORM 10-K**

**For the Fiscal Year Ended December 25, 2010**

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**Part I**

**ITEM 1. BUSINESS**

**Overview**

Infinera Corporation ( we or Infinera ) first introduced its Digital Optical Network architecture to the market in 2005. This architecture is based on our unique photonic integrated circuits ( PICs ) and enables high-capacity low-cost bandwidth in the cloud and distributed switching throughout the network. Rapidly growing and unpredictable bandwidth demand increases the need for the ability to deliver high-capacity low-cost bandwidth anywhere in the network. We believe that traditional point-to-point network architectures do not provide this flexibility. It takes large amounts of low-cost bandwidth, pervasive Optical Transport Network ( OTN ) switching and the intelligence of bandwidth management to manage these larger networks and deliver high-capacity services quickly and cost-effectively. Infinera believes this can only be achieved with PICs and that only through photonic integration can network operators scale their network bandwidth without significant increases in space, power or operational workload. Over 80 customers, including national and multi-national telecom carriers, cable television operators and internet content providers use our network architecture in their fiber optic backbone networks.

Infinera created what we believe to be the world's only commercially-deployed, large-scale PIC. Our first generation PICs transmit and receive 100 Gigabits per second ( Gbps ) of optical capacity and incorporate the functionality of over 60 discrete optical functions into a pair of indium phosphide chips approximately the size of a child's fingernail. Our next-generation PICs, which are currently in development, will transmit and receive 500Gbps and will incorporate over 600 discrete functions into a pair of chips. Our PICs enable our Digital Optical Network architecture and allow us to offer customers the unique advantages of low-cost bandwidth, advanced digital bandwidth management and an intelligent software operating system.

Since 2005, our strategy has been to extend the benefits of our Digital Optical Network throughout the optical networking market. We have made significant enhancements to our Digital Transport Node System ( DTN System ) during this time by increasing reach and fiber capacity for the long-haul market, adding the Infinera MTC, a 19-inch chassis option tailored for the metro core market, and adding a submarine version of the DTN System for the Submarine Line Terminating Equipment ( SLTE ) market. In addition, we launched our ATN metro access platform, extending Infinera's digital bandwidth management and intelligent network benefits to the network edge. Both the DTN and ATN Systems are designed to operate as a tightly-integrated network with a single management system providing an end-to-end Digital Optical Network experience. We currently have 22 ATN customers enjoying the benefits of an ATN network and 19 of these customers have deployed an integrated ATN-DTN solution.

Traffic patterns in the optical networking market continue to grow to accommodate increased bandwidth demand from video, mobility and cloud computing. The optical networking market is seeing growing demand for increased fiber capacity with networks migrating from the current 10Gbps wavelength solutions to 40Gbps solutions in the short-term and to 100Gbps solutions in the longer-term. Our current DTN System delivers 10Gbps wavelengths of capacity per fiber on a cost-effective dollar per-bit basis. Infinera plans to introduce a 100Gbps PIC-based platform in 2012. This system will incorporate our 500Gbps PICs and our 5 Terabit OTN switch and will combine competitive fiber capacity with the unique features of our Digital Optical Network. We plan to introduce a 40Gbps line module for the DTN System in mid-2011 to address customer needs for higher fiber capacity in advance of the release of our 100Gbps platform. This non-PIC based 40Gbps solution will increase the fiber capacity of the DTN System from 1.6 Terabits per second ( Tb/s ) to 6.4 Tb/s and we believe that it will represent the highest fiber capacity 40Gbps system in the market at that time.

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Infinera's 100Gbps PIC-based platform is architected to increase availability of low-cost bandwidth with superior bandwidth management and service delivery capabilities. We believe that it will be more cost-effective for customers with large bandwidth demands to move to our 100Gbps systems as soon as these become broadly available as these systems will offer the most favorable network economics.

Infinera, Infinera DTN, ATN, IQ, I-PIC, Infinera Digital Optical Network, Bandwidth Virtualization and other trademarks or service marks of Infinera Corporation appearing in this report are the property of Infinera Corporation. This report contains additional trade names, trademarks and service marks of other companies. We do not intend our use or display of other companies' trade names, trademarks or service marks to imply a relationship with, or endorsement or sponsorship of us by, these other companies.

Infinera was founded in December 2000, originally operated under the name Zepton Networks, and is headquartered in Sunnyvale, California. We are incorporated in the State of Delaware. Our principal executive offices are located at 169 Java Drive, Sunnyvale, CA 94089. Our telephone number is (408) 572-5200.

## **Industry Background**

Optical networking equipment carries digital information using light waves over fiber optic networks. The advent of wavelength division multiplexing ( WDM ) systems has enabled the transmission of larger amounts of data by using multiple wavelengths over a single optical fiber. Service providers often use wavelength division multiplexing systems to carry communications traffic between cities, referred to as long-haul networks, and within large metropolitan areas, referred to as metro networks. Fiber optic networks are generally capable of carrying most types of communications traffic, from conventional long-distance telephone calls to e-mails and web sessions to high-definition video streams. As traffic grows, service providers add capacity to existing networks or purchase and deploy additional systems to keep pace with bandwidth demands and service expansion. Fiber optic networks typically are expensive and complex, and service providers have focused on generating new revenue while continuing to reduce operating and capital costs.

### *Increased Demand for Network Capacity*

We believe that a number of trends in the communications industry are driving growth in demand for network capacity and ultimately will increase demand for optical networking systems, including our DTN System and ATN System. These trends include growth in bandwidth-intensive applications like video and proliferation of the wireless Internet due to smartphones and computers with wireless access, as well as continued penetration of broadband Internet connectivity.

We believe that service providers and other network operators are constantly seeking solutions that allow them to increase their profit margins or expand their service offerings, specifically demanding:

lower costs for deploying, provisioning, and managing bandwidth;

more efficient use of bandwidth, fiber capacity, electrical power, and physical space;

faster operations to reduce cycle times of common operational tasks;

improved integration between the Internet Protocol ( IP ) equipment such as routers and optical networking equipment; and

higher reliability to avoid costs of downtime.

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We believe that Infinera's Digital Optical Network architecture, which includes unique features enabled by our PICs, including low-cost bandwidth, distributed switching, digital bandwidth management and intelligent software, is uniquely enabled to deliver improvements in these areas compared to conventional WDM systems offered by our competitors.

We believe that our Digital Optical Network architecture and our DTN System and ATN System enable the improvement of the economics, operating simplicity, flexibility, reliability and scalability of our customers' optical networks.

### **The Infinera Strategy**

Our goal is to be a preeminent provider of optical networking systems to communications service providers. Key aspects of our strategy are:

*Increase our customer footprint.* During 2010, we continued to diversify our customer base. Internet content providers have become an increasingly important customer set for us, as their bandwidth demands grow with the growth of new high-bandwidth applications, and they increasingly opt to build and operate their own optical networks. Cable providers also continue to increase the size and capacity of their optical networks. We now count all of the top five North American Multiple System Operators (MSOs) as customers. In 2010, we began deploying equipment in the regulated portion of Qwest's network. We intend to increase penetration of our installed base of customers while also targeting new U.S. and international communications service providers, including U.S. regional Bell operating companies, international postal, telephone and telegraph companies, and other operators of fiber optic networks around the world. In 2010, our presence outside of North America grew with the addition of new customers in Europe and Asia, as well as deployments in the Other Americas region. We also had continued success in the submarine market, as subsea network operators deployed Infinera systems over existing subsea networks to increase capacity and utilize the efficiencies of our Digital Optical Network.

*Penetrate adjacent markets.* We believe that our Digital Optical Network can benefit submarine network operators and operators with networks that extend to the metro edge. We intend to increase our addressable markets by continually adding functionality to our products and by developing the service and support infrastructure needed to address these markets.

*Maintain and extend our technology lead.* We intend to continue to incorporate the functionality of additional discrete functions into our PICs in order to continue to increase the availability of higher-capacity low-cost bandwidth. In addition, we will pursue the expansion of our digital switching and bandwidth management capabilities in order to enhance the performance, scalability and economic advantages of our products. We intend to introduce systems with new, higher-capacity features and greater functionality in 2011 and beyond.

*Continue investment in PIC manufacturing activities.* We believe that our vertical integration and manufacturing capabilities serve as a competitive advantage and intend to continue to invest in the manufacturing capabilities needed to produce new generations of our PICs. We are currently expanding our PIC fabrication (PIC FAB) plant in preparation for volume shipments of our new 500Gbps PICs in 2012.

### **Products**

#### *Infinera DTN System*

Our DTN System utilizes our PIC technology to enable digital processing and management of data with the capability to generate wavelength division multiplexing wavelengths and to add, drop, switch, manage, protect and restore network traffic digitally. The DTN System can automate the connection of circuits and provisioning of new services without costly and cumbersome manual intervention.

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Our DTN System is modular in design to provide our customers with the ability to add capacity in a cost-efficient manner. The initial deployment of our DTN System at a customer site involves the installation of a line system (including common equipment, such as a chassis, management controller and related equipment). Customers can add capacity to the DTN System by purchasing our Digital Line Modules, or DLMs, Tributary Adapter Modules, or TAMs and Tributary Optical Modules, or TOMs. We believe that the density and the modular architecture of the DTN System enable significant flexibility and scalability for communications service providers. Our current DTN System delivers 10Gbps wavelengths of capacity per fiber on a cost-effective basis. In order to address customer needs for higher fiber capacities, we plan to introduce a non-PIC based 40Gbps solution that will increase the fiber capacity of the DTN System from 1.6 Tb/s to 6.4 Tb/s. We expect to introduce this system in mid-2011 and believe that it will represent the highest fiber capacity 40Gbps system in the market at that time.

Our DTN System is carrier-class, which means that it complies with applicable Telcordia and equivalent major international standards for central office-based network elements. Our DTN System supports a broad range of optical service interfaces including Ethernet (Gigabit Ethernet ( GbE ) and 10GbE) and separate synchronous optical network/synchronous digital hierarchy.

### *Infinera DTN for Submarine Network Applications*

For submarine transport applications, the DTN System can be used as an SLTE node at submarine cable head-end sites, enabling undersea service providers to upgrade existing submarine cables to 25GHz channel spacing, thereby doubling the total optical capacity of many traditional submarine systems to a maximum of up to 160 wavelengths and distances up to 8,000 km. The introduction of our 40Gbps line module for the DTN System will increase this capacity from 1.6 Tb/s to 6.4 Tb/s. The DTN System also provides dispersion compensation that is significantly simpler and cheaper than the per-channel dispersion management of many existing SLTE systems. Combined with the benefits of our DTN System's digital operations and software automation, we believe that Infinera's SLTE solution using the DTN System significantly reduces engineering complexity for submarine cable upgrade deployments and channel adds, allowing submarine network operators to deploy additional capacity on existing cable systems faster, and often at lower cost compared to existing SLTE systems.

### *Infinera Line System*

Infinera DTN Systems are built upon and connected to one another using an optical line system. The Infinera Line System ( ILS ) provides optical amplification, provides the management communications channel between network nodes and allows the customer to deploy optical capacity to carry customer traffic on its network. ILS currently combines up to 1.6 Tb/s of optical capacity onto a single fiber. Infinera's bandwidth management allows our customers to manage and utilize this pool of available capacity to satisfy its customer requirements, including a range of services at speeds from 1Gbps up to 40Gbps. In addition to providing for increased capacity and reach, ILS also lays the foundation for future Infinera systems and is designed to scale in the future to support up to 8 Tb/s of optical capacity on a single fiber pair as we introduce our 40Gbps and 100Gbps systems. ILS is fully integrated into Infinera's management and control software and can be managed seamlessly within the DTN System.

### *Infinera ATN System*

The Infinera ATN System's metro edge platform is a state-of-the-art coarse and dense wavelength division multiplexing aggregation and transport solution designed with 400Gbps of total capacity, which can be allocated in various transmission speeds, including for example, using up to 40 wavelengths of 10Gbps. The ATN System's platform can be used to extend the Digital Optical Network architecture benefits of the Infinera DTN platform, and can also be used as a standalone WDM access system.

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Implementing numerous features in support of simplicity of use and operations, the Infinera ATN System is a cost-effective, efficient multiservice aggregation and transport platform. The Infinera ATN System supports direct wavelength connectivity to DTN nodes, reducing equipment costs and providing unique Bandwidth Virtualization capabilities across our integrated Digital Optical Networks.

### *Infinera IQ Network Operating System*

The IQ Network Operating System is our embedded software operating system which enables our customers to simplify and speed up the tasks they perform to deliver, differentiate, and manage services and to optimize the utilization of their networks. The IQ Network Operating System for the DTN System utilizes Generalized Multi-Protocol Label Switching ( GMPLS ) for end-to-end provisioning, protection and restoration services, and a host of performance monitoring and software-definable testing capabilities. The ATN System supports end-to-end provisioning through software features similar to the DTN System.

### *Infinera Management Suite*

The Infinera Management Suite is a broad set of standards-based network and element management tools and Operations Support System integration interfaces that are used by our customers to manage their DTN Systems and ATN Systems. Our management suite software includes our Digital Network Administrator, a scalable, robust, feature-rich Element Management System, and our Graphical Node Manager, an easy-to-use web-based management interface. Our hardware platforms, the DTN System and ATN System, are managed in an integrated fashion by the Infinera Management Suite.

### *Infinera Future Platforms*

Infinera plans to introduce its 100Gbps PIC-based platform in 2012. This system will incorporate our 500Gbps PICs and our 5 Terabit OTN switch and will combine competitive fiber capacity with the unique features of our Digital Optical Network.

## **Technology**

### *Digital Optical Network Architecture*

Infinera was founded with a vision of increasing the functionality and improving the economics of optical transport systems. To that end, our core engineering team consists of optical component and systems experts who have collaborated to create an innovative optical networking architecture that combines the delivery of large amounts of low-cost bandwidth with distributed switching and the embedded software intelligence of bandwidth management to manage larger networks and deliver high-capacity services quickly and cost-effectively. We have focused our efforts, time and capital on developing our Digital Optical Network architecture and our system products.

Our Digital Optical Network architecture is designed to allow our customers to expand service reach, expedite service provisioning, ensure reliability and more effectively manage, monitor and scale their networks by processing data digitally rather than in analog format. We believe that the key to delivering this capability in a cost-effective manner is integrating the functionality of multiple discrete devices into a single set of semiconductor chips. This integration allows us to eliminate separate optical packages for each discrete optical device, which we believe is the largest cost challenge facing traditional systems. This integration has further enabled us to provide additional functionality and intelligence to our optical networking systems.

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### *Infinera PIC*

We believe that our proprietary PICs are a key source of our value proposition and competitive advantage. We manufacture and package our PICs at our own facilities for use exclusively with our DTN System. We began the design and manufacture of our PICs shortly after we were founded in December 2000. We employ a multi-disciplinary approach towards the development and manufacturing of our PICs, with significant interaction between our manufacturing, system engineering and advanced technology groups. As a leader in the development of photonic integration, we have protected the intellectual property associated with our PIC manufacturing through a combination of trade secrets, patents and contractual protections. We believe that as a result of the combination of the multiple disciplines that were required to develop our PIC, together with the intellectual property protections that we have established, it will be difficult for others to duplicate the technology we have developed.

Our DTN System transmits optical capacity, utilizing a pair of PICs, in increments of 100Gbps of optical capacity, based on 10Gbps optical signals. Our transmitter PIC integrates the functionality of 51 optical functions onto a single chip, including lasers and modulators. In addition, our receiver PIC integrates the functionality of 11 optical functions onto a single chip, including photo-detectors and an optical de-multiplexer. We have designed our next-generation PICs to transmit optical capacity in increments of 500Gbps, based on 100Gbps optical signals. Our next-generation commercial PICs are designed to integrate the functionality of over 600 discrete functions into a pair of chips. Large-scale photonic integration brings Moore's Law economics of semiconductor manufacturing to optical networking, allowing future optical transport cost reductions to be viably sustained on a cost curve defined by volume manufacturing efficiencies, greater functional integration, increased device density, and manufacturing yield enhancements. We have forecasted a Moore's Law-like PIC product plan, which posits that the capacity per PIC will double every three years.

### **Customers**

As of December 25, 2010, we have sold our Digital Optical Networks for deployment to 82 customers worldwide, including customers in each of the following customer segments:

carrier;

MSO;

internet content provider;

incumbent carrier;

research and education/government; and

reseller.

Our announced customers include Cox Communications, Deutsche Telekom, Global Crossing, Interoute and Level 3 Communications (Level 3). In addition, we currently have 22 customer deployments where customers have purchased our ATN platform to extend the Digital Optical Network experience to their metro edge deployments. We believe that in the longer-term, the metro dense wavelength division multiplexing (DWDM) market represents one of our most promising growth opportunities. We do not have long-term sales commitments from our customers.

In 2010, 2009 and 2008, Level 3 accounted for approximately 15%, 17% and 25% of our revenue, respectively. We had no other customer that represented over 10% of our revenue for these periods.



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### **Support and Services**

We offer our customers a range of product support offerings, including 24/7/365 hardware and software technical support, installation and deployment services, spares management, first line maintenance services, on-site technical services, professional services, product technical training and extended product warranties. In 2010, we expanded our customer service offerings with a number of new services including outsourced network monitoring and management, provided from two Technical Assistance Centers, one in Annapolis Junction, Maryland, and the other in the United Kingdom. Our customer support services are provided by our employees and augmented where necessary by third-party strategic support partners. We believe that providing ongoing customer and technical support is critical to successful long-term relationships with, and follow-on sales to, our customers. We are committed to providing our customers with the highest levels of technical support and service on a global scale.

### **Sales and Marketing**

We market and sell our products and related support services primarily through our direct sales force, supported by marketing and product management personnel. We may also use distribution or support partners to enter new markets or when requested by a potential customer. Our sales team has significant previous experience with the buying process and sales cycles typical of high-value telecommunications products. We expect to continue to add sales and support employees as we grow our business.

The sales process for our products entails discussions with prospective customers, analyzing their existing networks and identifying how they can utilize our systems capabilities within their networks. This process requires developing strong customer relationships, and we expect to leverage our sales force and customer support capabilities to establish relationships with both domestic and international service providers.

Over the course of the sales cycle, service providers often test our products before buying. Prior to commercial deployment, the service provider will generally perform a field trial of our products. Upon successful completion, the service provider generally accepts the products installed in its network and may continue with commercial deployment of additional products. We anticipate that our sales cycle, from initial contact with a service provider through the signing of a purchase agreement, may, in some cases, take several quarters.

*Direct Sales Force.* Our sales team sells directly to service providers worldwide. We maintain sales presences throughout the United States as well as in a number of international locations, including Argentina, China, France, Germany, Italy, Japan, Netherlands, Singapore, Spain, and the United Kingdom. We intend to expand our sales force around the world during 2011 as we address new geographical markets and begin selling our broader portfolio of products.

*Indirect Sales Force.* We have and will continue to employ business consultants, resale partners and sales agents to assist in our sales efforts to accelerate and strengthen our customer relationships. We expect to work with business partners to assist our customers in the sale, deployment and maintenance of our systems and have entered into distribution and resale agreements to facilitate the sale of our products.

*Marketing and Product Management.* Our product management team is responsible for defining the product features and development plan required to maximize our success in the marketplace. Product management supports our sales efforts with product and application expertise. Our marketing team works to create demand for our products by communicating our value proposition and differentiation through direct customer interaction, public relations, attendance at tradeshow and other events, and via the Internet and other marketing channels.

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### **Research and Development**

Continued investment in research and development is critical to our business. To this end, we have assembled a team of engineers with expertise in various fields, including systems, sub-systems and components. Our research and development efforts are currently focused in Sunnyvale, California, Allentown, Pennsylvania, Beijing, China, Bangalore, India and Kanata, Canada. We have invested significant time and financial resources into the development of our Digital Optical Network architecture, our DTN System and ATN System, including the IQ Network Operating System and Management Suite software, the PIC and our manufacturing capabilities. We will continue to expand our product offerings and capabilities in the future and plan to dedicate significant resources to these continued research and development efforts. We are continually increasing the scalability and software features of our current DTN System, and developing additional functionality and new products, including products for metro applications. We are also working to develop new generations of PICs, and we intend to enable further integration in our Digital Optical Network architecture and our DTN System through continued research and development and investments in our manufacturing capabilities.

Our research and development expenses were \$118.5 million, \$97.3 million and \$80.6 million in 2010, 2009 and 2008, respectively.

### **Employees**

As of December 25, 2010, we had 1,072 employees. A total of 342 of those employees were located outside of the United States. None of our U.S. employees are subject to a collective bargaining agreement. Employees in certain foreign jurisdictions may be represented by local workers councils and/or collective bargaining agreements as may be customary or required in those jurisdictions. We have not experienced any work stoppages, and we consider our employee relationships to be good.

### **Manufacturing**

We have invested significant time and capital to develop and improve the manufacturing process that we use to produce and package our PICs. This includes significant investments in personnel, equipment and the facilities needed to manufacture and package our PICs in Sunnyvale, California and Allentown, Pennsylvania. We also have invested in automating our manufacturing process and in training and maintaining the quality of our manufacturing workforce. As a leader in the development of photonic integration, we have protected the intellectual property associated with our PIC manufacturing through a combination of trade secrets, patents and contractual provisions. We believe that as a result of the combination of the multiple disciplines that were required to develop our PICs, together with the intellectual property protections that we have established, it will be difficult for others to duplicate the technology we have developed. Our manufacturing processes have been developed over several years and are protected by a significant number of trade secrets. We believe that the trade secrets associated with the manufacturing and packaging of our PICs provide us with a significant competitive advantage.

We use both domestic and international manufacturing partners to manufacture certain components of our products. Our contract manufacturers manufacture our products based on our specifications and bill of materials. In addition, the lead times associated with certain components are lengthy and preclude rapid changes in product specifications or delivery schedules. To date, we have not experienced any significant delays or material unanticipated costs resulting from the use of these contract manufacturers; however, such a strategy involves certain risks, including the potential absence of adequate capacity, the unavailability of or interruptions in access to certain process technologies, and reduced control over delivery schedules, manufacturing yields, quality and costs. Despite outsourcing manufacturing operations for cost-effective scale and flexibility, we perform rigorous in-house quality control testing to ensure the reliability of our products.

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Shortages in components that we use in our products are possible and our ability to predict the availability of such components may be limited. Some of these components are available only from single or limited sources of supply. Our products include some components that are proprietary in nature and only available from a single source, as well as some components that are generally available from a number of suppliers. Recently, we have increased our reliance on third parties to develop and manufacture components for our products. In some cases, significant time would be required to establish relationships with alternate suppliers or providers of proprietary components. We do not have any long-term contracts with any component providers that guarantee supply of components or their manufacturing services. If we encounter difficulty continuing our relationship with a supplier, or if a supplier is unable to meet our needs, we may encounter manufacturing delays that could adversely affect our business. Our ability to timely deliver products to our customers would be materially adversely impacted if we needed to qualify replacements for any of a number of the components used in our products.

We believe that our current manufacturing facilities can accommodate an increase in capacity for PIC production sufficient for our current product offerings. In December 2010, we completed the first phase of our PIC FAB manufacturing expansion in Sunnyvale, California. We expect to continue expansion activities throughout 2011, expanding our PIC manufacturing capabilities in advance of volume shipments of our 100Gbps platform in 2012.

## **Backlog**

As of December 25, 2010, our backlog was \$35.5 million. These orders are subject to future events that could cause the amount or timing of the related revenue to change, and, in certain cases, may be cancelled without penalty. We do not believe that backlog should be viewed as an indicator of future performance. A backlogged order may not result in revenue in a particular period, and the actual revenue may not be equal to our backlog amounts. Our presentation of backlog may not be comparable with that of other companies in our industry.

## **Competition**

The optical communications network equipment market is highly competitive. Competition in this market is based on any one or a combination of the following factors:

price and other commercial terms;

functionality;

existing business and customer relationships;

the ability of products and services to meet customers' immediate and future network requirements;

installation capability;

services;

scalability; and

manufacturing capability.

Competition in the optical networking market is dominated by a small number of very large, multi-national companies. Many of our competitors have substantially greater name recognition and technical, financial, and marketing resources, and greater manufacturing capacity, as well as better established relationships with the incumbent carriers, than we do. Many of our competitors have more resources to develop or acquire, and

more experience in developing or acquiring, new products and

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technologies and in creating market awareness for these products and technologies. In addition, many of our competitors have the financial resources to offer competitive products at below market pricing levels that could prevent us from competing effectively. Further, many of our competitors have built long-standing relationships with some of our prospective customers and have the ability to provide financing to customers and could, therefore, have an inherent advantage in selling products to those customers. Strong growth of bandwidth demand is driving the need for higher fiber capacity systems. Some of our competitors offer 40Gbps and 100Gbps systems to customers today allowing them to increase the capacity of their fiber. Infinera plans to introduce a 100Gbps PIC-based system in 2012. This system will incorporate our 500Gbps PICs and our 5 Terabit OTN switch and will combine competitive fiber capacity with the unique features of the Digital Optical Network. In order to respond to customer needs in the interim, we will introduce a non-PIC based 40Gbps solution that will increase the fiber capacity of the DTN System from 1.6 Tb/s to 6.4 Tb/s. We expect to introduce this system in mid-2011 and believe that it will represent the highest fiber capacity 40Gbps system in the market at that time.

Our competitors include current wavelength division multiplexing suppliers, such as Alcatel-Lucent, Ciena Corporation, Cisco Systems, Ericsson, Fujitsu Limited, Huawei Technologies Co. Ltd., NEC Corporation, Nokia-Siemens Networks, Tellabs and ZTE Corporation. These companies have historically set the competitive benchmarks for price and functionality. There are also smaller companies, including startups, that have announced plans or developed products that would compete for long-haul and metro optical transport business. We also face additional competition in certain market segments from companies which offer one or more products that compete directly or indirectly with our products. In addition, we may compete with other companies as we expand into new markets or as other companies develop products that are competitive with us.

## **Intellectual Property**

Our success as a company depends upon our ability to protect our core technology and intellectual property. To accomplish this, we rely on a combination of intellectual property rights, including patents, trade secrets, copyrights and trademarks, as well as customary contractual protections.

We rely primarily on trade secret protection for our PIC and PIC manufacturing processes, including design, fabrication and testing of our PICs. However, there can be no assurances that trade secrets will be sufficient to provide us with a competitive advantage or that others have not or will not reverse engineer our designs or discover, develop or disclose the same or similar designs and manufacturing processes.

As of December 25, 2010, we held 143 U.S. patents and three international patents expiring between 2021 and 2028, and held 162 U.S. and 26 foreign pending patent applications. We do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims.

We may not receive competitive advantages from the rights granted under our patents and other intellectual property. Any patents granted to us may be contested, circumvented or invalidated over the course of our business, and we may not be able to prevent third parties from infringing these patents. Therefore, the exact effect of the protection of these patents cannot be predicted with certainty.

We believe that the frequency of assertions of patent infringement is increasing as patent holders, including entities that are not in our industry and who purchase patents as an investment or to monetize such rights by obtaining royalties, use such actions as a competitive tactic as well as a source of additional revenue. We have been sued by Cheetah Omni LLC ( Cheetah ) for alleged

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infringement of their patents. See the section set forth in Part I, Item 3. Legal Proceedings for additional information regarding this lawsuit. Any claim of infringement from a third party, even those without merit, could cause us to incur substantial costs defending against such claims, and could distract our management from running our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment could also include an injunction or other court order that could prevent us from selling our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms or at all. Alternatively, we may be required to develop non-infringing technology, which would require significant effort and expense and may ultimately not be successful.

In addition to trade secret and patent protections, we generally control access to and the use of our proprietary software and other confidential information. This protection is accomplished through a combination of internal and external controls, including contractual protections with employees, contractors, customers, and partners, and through a combination of U.S. and international copyright laws. We incorporate a number of third party software programs into our DTN System and ATN System pursuant to license agreements.

We license some of our software pursuant to agreements that impose restrictions on our customers' ability to use such software, such as prohibiting reverse engineering and limiting the use of copies. We also seek to avoid disclosure of our intellectual property by relying on non-disclosure and assignment of intellectual property agreements with our employees and consultants that acknowledge our exclusive ownership of all intellectual property developed by the individual during the course of his or her work with us. The agreements also require that each person maintain the confidentiality of all proprietary information disclosed to them. Other parties may not comply with the terms of their agreements with us, and we may not be able to enforce our rights adequately against these parties. We also rely on contractual rights to establish and protect our proprietary rights in our DTN System and ATN System.

We incorporate open source software into our products. Although we monitor our use of open source closely, the terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that such licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our products. In such event, we could be required to seek licenses from third parties in order to continue offering our products, to re-engineer our products or to discontinue the sale of our products in the event re-engineering cannot be accomplished on a timely basis, any of which could adversely affect our business, operating results and financial condition.

## **Environmental Matters**

Our business and operations are subject to environmental laws in various jurisdictions around the world including the Waste Electrical and Electronic Equipment and Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment regulations adopted by the European Union. We seek to operate our business in compliance with such laws. We are currently subject to laws relating to the materials and content of our products and certain requirements relating to product take back and recycling. Environmental regulation is increasing, particularly outside of the United States, and we expect that our international operations will be subject to additional environmental compliance requirements, which may expose us to additional costs. To date, our compliance costs relating to environmental regulations have not resulted in a material adverse effect on our business, results of operations or financial condition.

**Table of Contents****Business Segment Data and Our Foreign Operations**

We operate in the single industry segment of optical networking systems. Information concerning revenues, results of operations and revenues by geographic area is set forth in Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and in Note 15, Segment Information, of Notes to Consolidated Financial Statements, both of which are incorporated herein by reference. Information concerning identifiable assets is also set forth in Note 15, Segment Information, of Notes to Consolidated Financial Statements. Information on risks attendant to our foreign operations is set forth below in Item 1A. Risk Factors.

**Executive Officers and Directors**

Our executive officers and directors, and their ages and positions as of December 25, 2010, are set forth below:

| <b>Name</b>                              | <b>Age</b> | <b>Position</b>   |
|--|------------|---|
| Thomas J. Fallon                         | 49         | President, Chief Executive Officer and Director                           |
| David F. Welch, Ph.D.                    | 50         | Co-founder, Executive Vice President, Chief Strategy Officer and Director |
| Ita M. Brennan                           | 43         | Chief Financial Officer   |
| Ronald D. Martin                         | 62         | Vice President, Worldwide Sales   |
| Michael O. McCarthy III                  | 45         | Chief Legal and Administrative Officer                                    |
| Kambiz Y. Hooshmand <sup>(1)(2)(3)</sup> | 49         | Chairman of the Board   |
| Kenneth A. Goldman <sup>(3)(4)</sup>     | 61         | Director  |
| Philip Koen <sup>(3)(4)</sup>            | 58         | Director  |
| Dan Maydan, Ph.D. <sup>(1)(2)</sup>      | 75         | Director  |
| Paul Milbury <sup>(2)(4)</sup>           | 62         | Director  |
| Carl Redfield <sup>(1)(2)</sup>          | 63         | Director  |

<sup>(1)</sup> Member of Nominating and Governance Committee

<sup>(2)</sup> Member of Compensation Committee

<sup>(3)</sup> Member of Acquisition Committee

<sup>(4)</sup> Member of Audit Committee

**Thomas J. Fallon** has served as our President and Chief Executive Officer since January 2010 and as a member of our board of directors since July 2009. Mr. Fallon served as our Chief Operating Officer from October 2006 to December 2009 and as our Vice President of Engineering and Operations from April 2004 to September 2006. From August 2003 to March 2004, Mr. Fallon was Vice President, Corporate Quality and Development Operations of Cisco Systems, Inc., a networking and telecommunications company. From May 2001 to August 2003, Mr. Fallon served as Cisco's General Manager of the Optical Transport Business Unit. Mr. Fallon is currently a member of the Engineering Advisory Board of the University of Texas at Austin. Mr. Fallon holds a B.S.M.E. and M.B.A. from the University of Texas at Austin.

**David F. Welch, Ph.D.** co-founded our company and has served as our Executive Vice President, Chief Strategy Officer since January 2004 and as a member of our board of directors since October 2010. From May 2004 to January 2007, he served as our Chief Development Officer/Chief Technology Officer. From May 2001 to November 2006, Dr. Welch also served as a member of our board of directors. From February 2001 to April 2001, Dr. Welch served as Chief Technology Officer of the Transmission Division of JDS Uniphase Corporation, an optical component company. From January 1985 to February 2001, Dr. Welch served in various executive roles, including Chief Technology

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Officer and Vice President of Corporate Development of SDL, an optical component company. Dr. Welch is the Founder and President of Students First, a non-profit organization focused on education reform. Dr. Welch holds a B.S. in Electrical Engineering from the University of Delaware and a Ph.D. in Electrical Engineering from Cornell University.

**Ita M. Brennan** has served as our Chief Financial Officer since July 2010. Prior to becoming CFO, Ms. Brennan served as our Vice President of Finance and Corporate Controller since July 2006. From September 1997 to July 2006, Ms. Brennan held various roles at Maxtor Corporation, an information storage solutions company, including Vice President of Finance for Maxtor's worldwide operations. Ms. Brennan is a chartered accountant and public accounting alumna of Deloitte and Touche, having worked at the firm in Ireland and the U.S.

**Ronald D. Martin** has served as our Vice President of Worldwide Sales since August 2009. From November 2007 to June 2009, Mr. Martin served as Chief Marketing and Strategy Officer and president of ADVA Optical Networking's North American subsidiary, an optical networking company. From May 2001 to November 2007, Mr. Martin served as Vice President and General Manager of the optical business unit of Cisco Systems, a networking and telecommunications company. From May 1987 to May 2001, Mr. Martin served as Chief Operating Officer at Fujitsu Network Communications, a networking and telecommunications company. Mr. Martin holds an A.A. from Iowa Lakes College.

**Michael O. McCarthy III** has served as our Chief Legal and Administrative Officer since March 2010. From January 2008 to March 2010, Mr. McCarthy served as our Chief Legal Officer. From May 2003 to January 2008, Mr. McCarthy served as our Vice President and General Counsel. Prior to joining our Company, Mr. McCarthy served in various executive roles, including Senior Vice President of Worldwide Sales and Support and Senior Vice President and General Counsel of Ciena Corporation, a communications equipment company. Mr. McCarthy holds a B.A. in Mathematical-Economics from Colgate University and a J.D. from Vanderbilt University's School of Law.

**Kambiz Y. Hooshmand** has been a member of our board of directors since December 2009 and has served as Chairman of our board of directors since October 2010. From March 2005 to May 2009, Mr. Hooshmand served as President and CEO of Applied Micro Circuits Corporation, a communications solutions company. From February 2000 to March 2005, Mr. Hooshmand served as Vice President and Division General Manager of Cisco Systems. From June 1997 to February 2000, Mr. Hooshmand served as Cisco's Vice President of Engineering. From January 1992 to June 1997, Mr. Hooshmand served as Director of Engineering of StrataCom, a networking solutions company. Mr. Hooshmand holds a B.S. in Electrical Engineering & Computer Science from California State University, Chico and an M.S. in Engineering from Stanford University.

**Kenneth A. Goldman** has been a member of our board of directors since February 2005. Mr. Goldman has been the Senior Vice President, Finance and Administration, and Chief Financial Officer of Fortinet Inc., a provider of unified threat management solutions, since September 2007. From November 2006 to August 2007, Mr. Goldman served as Executive Vice President and Chief Financial Officer of Dexterra, Inc. From August 2000 until March 2006, Mr. Goldman served as Senior Vice President, Finance and Administration, and Chief Financial Officer of Siebel Systems, Inc., a supplier of customer software solutions and services. From December 1999 to December 2003, Mr. Goldman served as an advisory council member of the Financial Accounting Standards Board Advisory Council. Mr. Goldman serves on the board of directors of NXP Semiconductor, a mixed signal and standards product semiconductor company and BigBand Networks, Inc., a provider of broadband multimedia infrastructure. Mr. Goldman is currently on the board of trustees of Cornell University and was formerly a member of the Treasury Advisory Committee on the Auditing Profession, a public committee that made recommendations in September 2008 to encourage a more sustainable auditing profession. Mr. Goldman holds a B.S. in Electrical Engineering from Cornell University and an M.B.A. from the Harvard Business School.

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**Philip Koen** has been a member of our board of directors since February 2010. Mr. Koen has been the Chief Executive Officer of Montero Partners, an advisory services company, since February 2010. From March 2006 to January 2010, Mr. Koen served as Chief Executive Officer and Director of SAVVIS, Inc., an IT infrastructure services company. From July 1999 until March 2006, Mr. Koen was employed by Equinix, Inc., a provider of network neutral data centers and Internet exchange services, as President and Chief Operating Officer and as Chief Financial Officer. Mr. Koen is currently on the board of trustees of Webster University. Mr. Koen holds a B.A. in Economics from Claremont McKenna College and an M.B.A. from the University of Virginia.

**Dan Maydan, Ph.D.** has been a member of our board of directors since September 2001. From December 1993 to April 2003, Dr. Maydan served as President of Applied Materials Inc., a semiconductor equipment manufacturing company, and was appointed President Emeritus of Applied Materials in April 2003. Dr. Maydan was a member of the board of directors of Applied Materials Inc. from June 1992 until March 2006. Dr. Maydan serves on the board of directors of Electronics for Imaging, Inc., a digital imaging and print management solutions company. Dr. Maydan is currently on the board of trustees of The Palo Alto Medical Foundation. Dr. Maydan holds a B.S. and M.S. in Electrical Engineering from the Israel Institute of Technology and a Ph.D. in Physics from Edinburgh University of Scotland.

**Paul Milbury** has been a member of our board of directors since July 2010. Mr. Milbury served as Vice President of Operations and Chief Financial Officer of Starent Networks Corp., a provider of mobile network solutions, from January 2007 until its acquisition by Cisco Systems in 2009. From December 2009 to July 2010 he played a key role in integrating Starent Networks into Cisco Systems to create the Mobile Internet Technology Group. From December 2000 to March 2007, Mr. Milbury served as Vice President and Chief Financial Officer of Avid Technology, Inc., a digital media creation, management, and distribution solutions company. From January 2000 to December 2000, Mr. Milbury served as Chief Financial Officer of iBelong.com, a developer of customized Internet portals. Mr. Milbury holds a B.B.A. in Business and Economics and an M.B.A. from the University of Massachusetts, Amherst.

**Carl Redfield** has been a member of our board of directors since August 2006. From September 2004 to his retirement in May 2008, Mr. Redfield served as Senior Vice President, New England executive sponsor, of Cisco Systems, Inc. From February 1997 through September 2004, Mr. Redfield served as Cisco's Senior Vice President, Manufacturing and Logistics. Mr. Redfield holds a B.S. in Materials Engineering from Rensselaer Polytechnic Institute and has completed post-graduate studies at the Harvard Business School.

Our board of directors is currently composed of eight members. Messrs. Goldman, Hooshmand, Koen, Milbury and Redfield and Dr. Maydan qualify as independent directors in accordance with the listing requirements of NASDAQ Global Select Market ( NASDAQ ). The NASDAQ definition of independence includes a series of objective tests, such as that the director is not, and has not been for at least three years, one of our employees and that neither the director, nor any of his family members, has engaged in various types of business dealings with us. In addition, as further required by the NASDAQ rules, our board of directors has made a subjective determination as to each independent director that no relationships exist that, in the opinion of our board of directors, would interfere with his exercise of independent judgment in carrying out the responsibilities of a director. In making these determinations, our directors reviewed and discussed information provided by the directors and us with regard to each director's business and personal activities as they may relate to us and our management.

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**Available Information**

Our website address is <http://www.infinera.com>. Information contained on our website is not incorporated by reference into this Form 10-K unless expressly noted. We file reports with the Securities and Exchange Commission ( SEC ), which we make available on our website free of charge. These reports include Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, current reports on Form 8-K and amendments to such reports, each of which is provided on our website as soon as reasonably practicable after we electronically file such materials with or furnish them to the SEC. You can also read and copy any materials we file with the SEC at the SEC's Public Reference Room at 100 F Street, N.E., Washington, DC 20549. You can obtain additional information about the operation of the Public Reference Room by calling the SEC at 1-800-SEC-0330. In addition, the SEC maintains a website (<http://www.sec.gov>) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC, including us.

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**ITEM 1A. RISK FACTORS**

*Investing in our securities involves a high degree of risk. Set forth below and elsewhere in this Annual Report on Form 10-K, and in other documents we file with the SEC, are risks and uncertainties that could cause our actual results to differ materially from the results contemplated by the forward-looking statements contained in this Annual Report on Form 10-K. Because of the following factors, as well as other variables affecting our operating results, past financial performance should not be considered as a reliable indicator of future performance and investors should not use historical trends to anticipate results or trends in future periods.*

**We have a history of significant operating losses and may not achieve profitability on an annual basis in the future.**

For the years ended December 25, 2010 and December 26, 2009, we recorded net losses of \$27.9 million and \$86.6 million, respectively. As of December 25, 2010, our accumulated deficit was \$405.3 million. We expect to continue to make significant expenditures related to the continued development of our business. These expenditures may include the addition of personnel related to the sales, marketing and research and development of our products and other costs related to the maintenance and expansion of our manufacturing facilities and research and development operations. We may therefore sustain significant operating losses and negative cash flows in the future. We will have to maintain significant increased revenue and product gross margins to achieve profitability on an annual basis.

**Our revenue and operating results may fluctuate significantly, which could make our future results difficult to predict and could cause our operating results to fall below investor or analyst expectations.**

Our revenue and operating results may fluctuate due to a variety of factors, many of which are outside of our control. Over the past four fiscal quarters, our revenue has ranged from \$95.8 million to \$130.1 million and our operating income (loss) has ranged from an operating loss of \$20.3 million to operating income of \$4.1 million. As a result, comparing our operating results on a period-to-period basis may not be meaningful. Our budgeted expense levels are based, in large part, on our expectations of long-term future revenue and the development efforts associated with these future revenues. As a result, fluctuations in our revenue and gross margins will have a significant impact on our operating results. Given the relatively fixed nature of our operating costs including our personnel and facilities, particularly for our engineering personnel, any substantial adjustment to our expenses to account for lower levels of revenue will be difficult and may take time. Consequently, if our revenue does not meet projected levels in the short-term, our inventory levels and operating expenses would be high relative to revenue, resulting in additional operating losses.

In addition to other risks discussed in this section, factors that may contribute to fluctuations in our revenue and our operating results include:

fluctuations in demand, sales cycles and prices for products and services, including discounts given in response to competitive pricing pressures;

fluctuations in our product mix, including the mix of higher and lower margin products and significant mix changes resulting from new customer deployments;

reductions in customers' budgets for optical communications network equipment purchases and delays in their purchasing cycles;

order cancellations or reductions or delays in delivery schedules by our customers;

timeliness of our customers' payments for their purchases;

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our ability to control costs, including our operating expenses and the costs of components we purchase for our products;

readiness of customer sites for installation of our products;

the timing of product releases or upgrades by us or by our competitors. In particular, if we fail to achieve targeted release dates for our higher capacity products, our revenue and operating results may be negatively impacted;

any significant changes in the competitive dynamics of our market, including any new entrants, technological advances or substantial discounting of products;

availability of third party suppliers to provide contract engineering and installation services for us;

the timing of recognizing revenue in any given quarter, including the impact of recently announced revenue recognition standards and any future changes in U.S. GAAP or new interpretations of existing accounting rules; and

general economic conditions in domestic and international markets.

Many factors affecting our results of operations are beyond our control and make it difficult to predict our results for a particular quarter or to accurately predict future revenues beyond a one-quarter time horizon. If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may in the future provide to the market, the price of our common stock may decline substantially.

**Our gross margin may fluctuate from quarter-to-quarter and may be adversely affected by a number of factors, some of which are beyond our control.**

Our gross margin fluctuates from period to period and varies by customer and by product specification. Over the past four fiscal quarters, our gross margins have ranged from 39% to 50%. Our gross margins are likely to continue to fluctuate and will be affected by a number of factors, including:

the mix in any period of the customer's purchasing our products and the product mix, including the relative mix of higher and lower margin products and services;

significant new customer deployments, often with a higher portion of lower or negative margin common equipment;

price discounts negotiated by our customers;

sales volume from each customer during the period;

the amount of equipment we sell or expect to sell for a loss in any given quarter;

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increased price competition, including competition from low-cost producers from China;

charges for excess or obsolete inventory;

changes in the price or availability of components for our products;

changes in our manufacturing costs, including fluctuations in yields and production volumes;

introduction of new products, with initial sales at relatively small volumes and higher product costs; and

increased warranty or repair costs.

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It is likely that the average unit prices of our products will decrease over time in response to competitive pricing pressures, increased negotiated sales discounts, new product introductions by us or our competitors or other factors. In addition, some of our customer contracts contain annual technology discounts that require us to decrease the sales price of our products to these customers. In response, we will need to reduce the cost of our products through manufacturing efficiencies, design improvements and cost reductions. If these efforts are not successful or if we are unable to reduce our costs to a greater extent than the reduction in the price of our products, our revenue and gross margin will decline, causing our operating results to decline. Fluctuations in gross margin may make it difficult to manage our business and achieve or maintain profitability.

### **Aggressive business tactics by our competitors may harm our business.**

The markets in which we compete are extremely competitive and have resulted in aggressive business tactics by our competitors, including:

aggressively pricing their products, including offering significant one-time discounts and guaranteed future price decreases;

providing financing, marketing and advertising assistance to customers;

announcing competing products prior to market availability combined with extensive marketing efforts;

influencing customer requirements to emphasize different product capabilities, such as greater minimum bandwidth requirements or higher transport speeds;

offering to repurchase our equipment from existing customers;

selling at a discount used equipment or inventory that had previously been written-down or written-off; and

asserting intellectual property rights.

The level of competition and pricing pressure tend to increase during periods of economic weakness or during periods when there are fewer network build-out projects. If we fail to compete successfully against our current and future competitors, or if our current or future competitors continue or expand aggressive business tactics, including those described above, demand for our products could decline, we could experience delays or cancellations of customer orders, or we could be required to reduce our prices or increase our expenses.

### **We must respond to rapid technological change and comply with evolving industry standards and requirements for our products to be successful.**

The optical networking equipment market is characterized by rapid technological change, changes in customer requirements and evolving industry standards. We continually invest in research and development to sustain or enhance our existing products, but the introduction of new communications technologies and the emergence of new industry standards or requirements could render our products obsolete. Further, in developing our products, we have made, and will continue to make, assumptions with respect to which standards or requirements will be adopted by our customers and competitors. If the standards or requirements adopted by our prospective customers are different from those on which we have focused our efforts, market acceptance of our products would be reduced or delayed and our business would be harmed.

We are continuing to invest in a significant portion of our research and development efforts in the development of our next-generation products. We expect our competitors to continue to improve the performance of their existing products and to introduce new products and technologies and to influence customers' buying criteria so as to emphasize product capabilities that we do not, or may not, possess.



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To be competitive, we must properly anticipate future customer requirements and we must continue to invest significant resources in research and development, sales and marketing and customer support. If we do not anticipate these future customer requirements and invest in the technologies necessary to enable us to have and to sell the appropriate solutions, it may limit our competitive position and future sales, which would have an adverse effect on our business and financial condition. We may not have sufficient resources to make these investments and we may not be able to make the technological advances necessary to be competitive.

### **Our ability to increase our revenue will depend upon continued growth of demand by consumers and businesses for additional network capacity.**

Our future success depends on factors such as the continued growth of the Internet and IP traffic and the continuing adoption of high-capacity, revenue-generating services to increase the amount of data transmitted over communications networks and the growth of optical communications networks to meet the increased demand for bandwidth. If demand for such bandwidth does not continue, or slows down, the need for increased bandwidth across networks and the market for optical communications network products may not continue to grow. If this growth does not continue or slows down, our product sales would be negatively impacted. In addition, if general economic conditions weaken, our customers and potential customers may slow or delay their purchase decisions, which would have an adverse effect on our business and financial condition.

### **Any delays in the development and introduction of our products, and any future delays in releasing new products or in releasing enhancements to our existing products may harm our business.**

Because our products are based on complex technology, including, in some cases, the development of next-generation PICs and specialized application-specific integrated circuits (ASICs), we may experience unanticipated delays in developing, improving, manufacturing or deploying these products. The development process for our PICs is lengthy, and any modifications to our PICs, including the development of our next-generation PICs, entail significant development cost and risks.

At any given time, various new product introductions and enhancements to our existing products, such as future products based on our next-generation PICs, are in the development phase and are not yet ready for commercial manufacturing or deployment. Recently, we have increased our reliance on third parties, some of which are relatively early stage companies, to develop and manufacture components for our next-generation (40Gbps and 100Gbps) products, some of which require custom development. The maturing process from laboratory prototype to customer trials, and subsequently to general availability, involves a significant number of simultaneous development efforts. These efforts often must be completed in a timely manner so that they may be introduced into the product development cycle for our systems, and include:

completion of product development, including the completion of any associated PIC development, such as our next-generation PICs, and the completion of associated module development, including modules developed by third parties;

the qualification and multiple sourcing of critical components;

validation of manufacturing methods and processes;

extensive quality assurance and reliability testing and staffing of testing infrastructure;

validation of software; and

establishment of systems integration and systems test validation requirements.

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Each of these steps, in turn, presents risks of failure, rework or delay, any one of which could decrease the speed and scope of product introduction and marketplace acceptance of our products. New generations of our PICs, specialized ASICs and intensive software testing and validation are important to the timely introduction of new products, enhancements to our existing products and our entrance into new markets. In addition, unexpected intellectual property disputes, failure of critical design elements, and a host of other execution risks may delay, or even prevent, the introduction of new products or enhancements to our existing products. If we do not develop and successfully introduce or enhance products in a timely manner, our competitive position will suffer. In addition, if we do not develop and successfully introduce or enhance products in sufficient time so as to satisfy our customer's expectations, we may lose future business from such customers and harm our reputation and our customer relationships, either of which would harm our business and operating results.

### **We have a limited operating history and limited history of selling our DTN Systems and ATN Systems, both of which make it difficult to predict our future operating results.**

We were incorporated in December 2000, shipped our first DTN System in November 2004 and shipped our first ATN System in August 2009. Our limited operating history gives very little basis upon which to evaluate our ability to accomplish our business objectives. In making an investment decision, you should evaluate our business in light of the risks, expenses and difficulties frequently encountered by companies in early stages of development, particularly companies in the rapidly changing optical networking market. We may not be successful in addressing these risks. It is difficult to accurately forecast our future revenue and plan expenses accordingly and, therefore, predict our future operating results.

### **The markets in which we compete are highly competitive and dominated by large corporations, and we may not be able to compete effectively.**

Competition in the optical networking equipment market is intense, and we expect such competition to increase. A number of very large companies have historically dominated the optical communications network equipment industry. Our competitors include current wavelength division multiplexing suppliers, such as Alcatel-Lucent, Ciena Corporation, Cisco Systems, Ericsson, Fujitsu Limited, Huawei Technologies Co., NEC Corporation, Nokia-Siemens Networks, Tellabs and ZTE Corporation. Competition in these markets is based on price, commercial terms, functionality, manufacturing capability, pre-existing installation, services, existing business and customer relationships, scalability and the ability of products and breadth and quality of services to meet our customers' immediate and future network requirements. Other companies have, or may in the future develop, products that are or could be competitive with our products. In particular, if a competitor develops a photonic integrated circuit with similar functionality to our PICs, our business could be harmed. Recent mergers from our competitors and any future acquisitions or combinations between or among our competitors may adversely affect our competitive position by strengthening our competitors.

Many of our competitors have substantially greater name recognition and technical, financial and marketing resources, greater manufacturing capacity and better established relationships with incumbent carriers and other potential customers than we have. Many of our competitors have more resources to develop or acquire, and more experience in developing or acquiring, new products and technologies and in creating market awareness for those products and technologies. In addition, many of our competitors have the financial resources to offer competitive products at aggressive pricing levels that could prevent us from competing effectively. Further, many of our competitors have built long-standing relationships with some of our prospective customers and have the ability to provide financing to customers and could, therefore, have an inherent advantage in selling products to those customers.

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We also compete with low-cost producers from China that can increase pricing pressure on us and a number of smaller companies that provide competition for a specific product, customer segment or geographic market. These competitors often base their products on the latest available technologies. Due to the narrower focus of their efforts, these competitors may achieve commercial availability of their products more quickly than we can and may provide attractive alternatives to our customers.

**We are dependent on a small number of key customers for a significant portion of our revenue and the loss of, or a significant reduction in, orders from one or more of our key customers would reduce our revenue and harm our operating results.**

A relatively small number of customers account for a large percentage of our net revenue. As a result, our business will be harmed if any of our key customers, including Level 3, do not generate as much revenue as we forecast, stop purchasing from us, or substantially reduce their orders to us. In addition, our business would be harmed if we fail to maintain our competitive advantage with our key customers.

Our ability to continue to generate revenue from our key customers will depend on our ability to maintain strong relationships with these customers and introduce new products that are desirable to these customers at competitive prices, and we may not be successful at doing so. Because, in most cases, our sales are made to these customers pursuant to standard purchase agreements rather than long-term purchase commitments, orders may be cancelled or reduced readily. In the event of a cancellation or reduction of an order, we may not have enough time to reduce operating expenses to minimize the effect of the lost revenue on our business. Our operating results will continue to depend on our ability to sell our products to our key customers.

**Our large customers have substantial negotiating leverage, which may require that we agree to terms and conditions that result in increased cost of sales, decreased revenue and lower average selling prices and gross margins, all of which would harm our operating results.**

Substantial changes in the optical networking industry have occurred over the last few years. Many potential customers have confronted static or declining revenue. Many of our customers have substantial debt burdens, many have experienced financial distress, and some have gone out of business have been acquired by other service providers or announced their withdrawal from segments of the business. Consolidation in the markets in which we compete has resulted in changes in the structure of the communications networking industry, with greater concentration of purchasing power in a small number of large service providers, cable operators, internet content providers and government agencies. This increased concentration among our customer base may also lead to increased competition for new network deployments and increased negotiating power for our customers. This may require us to decrease our average selling prices and have an adverse impact on our operating results.

Further, many of our customers are large communications service providers that have substantial purchasing power and leverage in negotiating contractual arrangements with us. Our customers have and may continue to seek advantageous pricing, payment and other commercial terms and may require us to develop additional features in the products we sell to them. If we are required to develop additional features for our product for a customer, we may be required to defer some of our revenue for such a customer until we have developed and delivered such additional features. We have and may continue to be required to agree to unfavorable commercial terms with these customers, including reducing the average selling price of our products or agreeing to extended payment terms in response to these commercial requirements or competitive pricing pressures. To maintain acceptable operating results, we will need to comply with these commercial terms, develop and introduce new products and product enhancements on a timely basis and continue to reduce our costs.

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We expect the factors described above to continue to affect our business and operating results for an indeterminate period, in several ways, including:

overall capital expenditures by many of our customers or potential customers may be flat or reduced;

we will continue to have only limited ability to forecast the volume and product mix of our sales;

managing expenditures and inventory will be difficult in light of the uncertainties surrounding our business; and

increased competition will enable customers to insist on more favorable terms and conditions for sales, including product discounts, extended payment terms or financing assistance, as a condition of procuring their business.

If we are unable to offset any reductions in our average selling prices with increased sales volumes and reduced production costs, or if we fail to develop and introduce new products and enhancements on a timely basis, or if we disagree on our interpretation and compliance with the commercial terms of our customer agreements, our relationships with our customers and our operating results would be harmed.

**We are dependent on sole source and limited source suppliers for several key components, and if we fail to obtain these components on a timely basis, we will not meet our customers' product delivery requirements.**

We currently purchase several key components for our products from single or limited sources. In particular, we rely on our own production of certain components of our products, such as PICs, and on third parties as sole source suppliers for certain of the components of our products, including: ASICs, field-programmable gate arrays, processors, and other semiconductor and optical components. We purchase these items on a purchase order basis and have no long-term contracts with many of these sole source suppliers. Recently, we have increased our reliance on third parties to develop and manufacture components for our next-generation (40Gbps and 100Gbps) products, some of which require custom development. For example, for the 40Gbps application of our DTN System, we will be purchasing a customized discrete component. If any of our sole or limited source suppliers suffer from capacity constraints, lower than expected yields, deployment delays, work stoppages or any other reduction or disruption in output, they may be unable to meet our delivery schedule which could result in lost revenue, additional product costs and deployment delays that could harm our business and customer relationships. Further, our suppliers could enter into exclusive arrangements with our competitors, refuse to sell their products or components to us at commercially reasonable prices or at all, go out of business or discontinue their relationships with us. We may be unable to develop alternative sources for these components.

The loss of a source of supply, or lack of sufficient availability of key components, could require us to redesign products that use such components, which could result in lost revenue, additional product costs and deployment delays that could harm our business and customer relationships. If we do not receive critical components for our products in a timely manner, we will be unable to deliver those components to our contract manufacturer in a timely manner and would, therefore, be unable to meet our prospective customers' product delivery requirements. In addition, the sourcing from new suppliers may require us to re-design our products, which could cause delays in the manufacturing and delivery of our products. In the past, we have experienced delivery delays because of lack of availability of components or reliability issues with components that we were purchasing. In addition, some of our suppliers have gone out of business, limited their supply of components to us, or indicated that they may be going out of business. Historically, we have seen a tightening of supply with a number of our suppliers and we have experienced longer than normal lead times and supply delays. We may in the

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future experience a shortage of certain components as a result of our own manufacturing issues, manufacturing issues at our suppliers or contract manufacturers, capacity problem experiences by our suppliers or contract manufacturers, or strong demand in the industry for such components. A return to growth in the economy is likely to continue to create pressure on us and our suppliers to accurately project overall component demand and manufacturing capacity. These supplier disruptions may continue to occur in the future, which could limit our ability to produce our products and cause us to fail to meet a customer's delivery requirements. Such events could harm our reputation and our customer relationships, either of which would harm our business and operating results.

**If our contract manufacturers do not perform as we expect, our business may be harmed.**

We rely on third party contract manufacturers to perform a significant portion of the manufacturing of our products, and our future success will depend on our ability to have sufficient volumes of our products manufactured in a cost-effective and quality-controlled manner. We have engaged third parties to manufacture certain elements of our products at multiple contract manufacturing sites located around the world but do not have long-term agreements in place with some of our manufacturers and suppliers. There are a number of risks associated with our dependence on contract manufacturers, including:

reduced control over delivery schedules, particularly for international contract manufacturing sites;

reliance on the quality assurance procedures of third parties;

potential uncertainty regarding manufacturing yields and costs;

potential lack of adequate capacity during periods of excess demand;

potential uncertainty related to the use of international contract manufacturing sites;

limited warranties on components supplied to us;

potential misappropriation of our intellectual property; and

potential manufacturing disruptions (including disruptions caused by geopolitical events, military actions or natural disasters).

Any of these risks could impair our ability to fulfill orders. Our contract manufacturers may not be able to meet the delivery requirements of our customers, which could decrease customer satisfaction and harm our product sales. We do not have long-term contracts or arrangements with our contract manufacturers that will guarantee product availability, or the continuation of particular pricing or payment terms. If our contract manufacturers are unable or unwilling to continue manufacturing our products or components of our products in required volumes or our relationship with any of our contract manufacturers is discontinued for any reason, we would be required to identify and qualify alternative manufacturers, which could cause us to be unable to meet our supply requirements to our customers and result in the breach of our customer agreements. Qualifying a new contract manufacturer and commencing volume production is expensive and time-consuming and if we are required to change or qualify a new contract manufacturer, we would likely lose sales revenue and damage our existing customer relationships.

**We are dependent on a single product, and the lack of continued market acceptance of our DTN System would harm our business.**

Although we added the ATN System as part of our product offering in 2009, our DTN System accounts for substantially all of our revenue and will continue to do so for the foreseeable future. As a result, our business could be harmed by:

any decline in demand for our DTN System;

the failure of our existing DTN System to achieve continued market acceptance;

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the introduction of products and technologies that serve as a replacement or substitute for, or represent an improvement over, our DTN System;

technological innovations or new communications standards that our DTN System does not address; and

our inability to release enhanced versions of our DTN System on a timely basis.

**If we fail to expand sales of our products into international markets or to sell our products to new types of customers, such as U.S. regional Bell operating companies and international postal, telephone and telegraph companies, our revenue will be harmed.**

We believe that, in order to grow our revenue and business and to build a large and diverse customer base, we must successfully sell our products in international markets and to new types of customers, such as U.S. regional Bell operating companies and international postal, telephone and telegraph companies. We have limited experience selling our products internationally and to U.S. regional Bell operating companies and international postal, telephone and telegraph companies. Sales cycles for these customers are often very lengthy and competition for these customers is intense. To succeed in these sales efforts, we believe we must hire additional sales personnel to develop our relationships with these potential customers and develop and manage new sales channels through resellers, distributors and systems integrators. If we do not succeed in our efforts to sell to these customers, the size of our total addressable market will be limited. This, in turn, would harm our ability to grow our customer base and revenue.

**If we fail to protect our intellectual property rights, our competitive position could be harmed or we could incur significant expense to enforce our rights.**

We depend on our ability to protect our proprietary technology. We rely on a combination of methods to protect our intellectual property, including limiting access to certain information, and utilizing trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. The steps we have taken to protect our proprietary rights may be inadequate to preclude misappropriation or unauthorized disclosure of our proprietary information or infringement of our intellectual property rights, and our ability to police such misappropriation, unauthorized disclosure or infringement is uncertain, particularly in countries outside of the United States. This is likely to become an increasingly important issue as we expand our operations and product development into countries that provide a lower level of intellectual property protection. We do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated. Moreover, the rights granted under any issued patents may not provide us with a competitive advantage, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future.

Protecting against the unauthorized use of our products, trademarks and other proprietary rights is expensive, difficult, time consuming and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity or scope of the proprietary rights of others. Such litigation could result in substantial cost and diversion of management resources, either of which could harm our business, financial condition and operating results. Furthermore, many of our current and potential competitors have the ability to dedicate substantially greater resources to enforce their intellectual property rights than we do. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property.

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**Claims by others that we infringe their intellectual property could harm our business.**

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In particular, many leading companies in the optical networking industry, including our competitors, have extensive patent portfolios with respect to optical networking technology. We expect that infringement claims may increase as the number of products and competitors in our market increases and overlaps occur. From time to time, third parties may assert exclusive patent, copyright, trademark and other intellectual property rights to technologies and related standards that are important to our business or seek to invalidate the proprietary rights that we hold. Competitors or other third parties have, and may continue to assert claims or initiate litigation or other proceedings against us or our manufacturers, suppliers or customers alleging infringement of their proprietary rights, or seeking to invalidate our proprietary rights, with respect to our products and technology. In the event that we are unsuccessful in defending against any such claims, or any resulting lawsuit or proceedings, we could incur liability for damages and/or have valuable proprietary rights invalidated.

Any claim of infringement from a third party, even one without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from running our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment could also include an injunction or other court order that could prevent us from offering our products. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms or at all. Alternatively, we may be required to develop non-infringing technology, which would require significant effort and expense and may ultimately not be successful. Any of these events could harm our business, financial condition and operating results. Competitors and other third parties have and may continue to assert infringement claims against our customers and sales partners. Any of these claims would require us to initiate or defend potentially protracted and costly litigation on their behalf, regardless of the merits of these claims, because we generally indemnify our customers and sales partners from claims of infringement of proprietary rights of third parties. If any of these claims succeed, we may be forced to pay damages on behalf of our customers or sales partners, which could have an adverse effect on our business, financial condition and operating results.

We incorporate open source software into our products. Although we monitor our use of open source software closely, the terms of many open source licenses have not been interpreted by U.S. courts, and there is a risk that such licenses could be construed in a manner that could impose unanticipated conditions or restrictions on our ability to commercialize our products. In such event, we could be required to seek licenses from third parties in order to continue offering our products, to re-engineer our products or to discontinue the sale of our products in the event re-engineering cannot be accomplished on a timely basis, any of which could adversely affect our business, operating results and financial condition.

We are currently involved in litigation with Cheetah Omni LLC and Level 3 in the United States District Court for the Eastern District of Texas Texarkana Division whereby Cheetah alleges that Infinera and Level 3 infringe on two Cheetah patents. Information regarding the Company's lawsuit with Cheetah is set forth below under Part I, Item 3. Legal Proceedings and is incorporated herein by reference. We believe this lawsuit is without merit and intend to defend ourselves vigorously, but are unable to predict the likelihood of an unfavorable outcome. In the event that Cheetah is successful in obtaining a judgment requiring us to pay damages or obtains an injunction preventing the sale of our products, our business and operating results could be harmed.

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### **Our manufacturing process is very complex and the partial or complete loss of our manufacturing facility, or a reduction in yields or an inability to scale capacity to meet customer demands could harm our business.**

The manufacturing process for certain components of our products, including our PICs, is technically challenging. In the event that any of these manufacturing facilities were fully or partially destroyed, as a result of fire, water damage, or otherwise, it would limit our ability to produce our products. Because of the complex nature of our manufacturing facilities, such loss would take a considerable amount of time to repair or rebuild. The partial or complete loss of any of our manufacturing facilities, or an event causing the interruption in our use of such facility for any extended period of time would cause our business, financial condition and operating results to be harmed.

Minor deviations in the PIC manufacturing process can cause substantial decreases in yields and, in some cases, cause production to be suspended. In the past, we have had significant variances in our PIC yields, including production interruptions and suspensions and may have continued yield variances, including additional interruptions or suspensions in the future. We expect our manufacturing yield for our next-generation PICs to be lower initially and increase as we achieve full production. Poor yields from our PIC manufacturing process or defects, integration issues or other performance problems in our products could limit our ability to satisfy customer demand requirements, and could cause us customer relations and business reputation problems, harming our business and operating results.

Although we are currently in the process of expanding our manufacturing facilities, our manufacturing facilities may not have adequate capacity to meet the demand for our products or we may not be able to increase our capacity to meet potential increases in demand for our products. Our inability to obtain sufficient manufacturing capacity to meet demand, either in our own facilities or through foundry or similar arrangements with third parties, could harm our relationships with customers, our business and our operating results.

### **Unfavorable macroeconomic and market conditions may adversely affect our industry, business and gross margins.**

Our business depends on the overall demand for additional bandwidth capacity and on the economic health and willingness of our customers and potential customers to make capital commitments to purchase our products and services. As a result of macroeconomic or market uncertainty, we may face new risks that we have not yet identified. In addition, a number of the risks associated with our business, which are disclosed in these risk factors, may increase in likelihood, magnitude or duration.

In the past, unfavorable macroeconomic and market conditions have resulted in sustained periods of decreased demand for optical communications products. These conditions may also result in the tightening of credit markets, which may limit or delay our customers' ability to obtain necessary financing for their purchases of our products. A lack of liquidity in the capital markets or the continued uncertainty in the global economic environment may cause our customers to delay or cancel their purchases, increase the time they take to pay or default on their payment obligations, each of which would negatively affect our business and operating results. Continued weakness and uncertainty in the global economy could cause some of our customers to become illiquid, delay payments or adversely affect our collection of their accounts, which could result in a higher level of bad debt expense. In addition, currency fluctuations could negatively affect our international customers' ability or desire to purchase our products.

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Challenging economic conditions have from time to time contributed to slowdowns in the telecommunications industry in which we operate. Such slowdowns may result in:

reduced demand for our products as a result of constraints on capital spending by our customers, particularly service providers;

increased price competition for our products, not only from our competitors, but also as a result of our customer's or potential customer's utilization of inventoried or underutilized products, which could put additional pressure on our near term gross profits;

risk of excess or obsolete inventories;

excess manufacturing capacity and higher associated overhead costs as a percentage of revenue; and

more limited ability to accurately forecast our business and future financial performance.

A lack of liquidity and economic uncertainty may adversely affect our suppliers or the terms on which we purchase products from these suppliers. It may also cause some of our suppliers to become illiquid. Any of these impacts could limit our ability to obtain components for our products from these suppliers and could adversely impact our supply chain or the delivery schedule to our customers. This also could require us to purchase more expensive components, or re-design our products, which could cause increases in the cost of our products and delays in the manufacturing and delivery of our products. Such events could harm our gross margins and harm our reputation and our customer relationships, either of which could harm our business and operating results.

### **If we fail to accurately forecast demand for our products, we may have excess or insufficient inventory, which may increase our operating costs, decrease our revenue and harm our business.**

We are required to generate forecasts of future demands for our products several months prior to the scheduled delivery to our prospective customers, which requires us to make significant investments before we know if corresponding revenue will be recognized. Lead times for materials and components, including ASICs, that we need to order for the manufacture of our products vary significantly and depend on factors such as the specific supplier, contract terms and demand for each component at a given time. In the past, we have experienced the lengthening in lead times for certain components. If the lead times for components are lengthened, we may be required to purchase increased levels of such components to satisfy our delivery commitments to our customers.

If we overestimate demand for our products or particular elements of our products and increase our inventory in anticipation of customer orders that do not materialize, we will have excess inventory, we will face a risk of obsolescence and significant inventory write-downs and our fixed costs will be spread across fewer units raising our per unit costs. If we underestimate demand for our products, we will have inadequate inventory, which could slow down or interrupt the manufacturing of our products and result in delays in shipments and our ability to recognize revenue. If actual market conditions are less favorable than our internal projections, additional inventory write-offs may be required. In addition, we may be unable to meet our supply commitments to customers which could result in a breach of our customer agreements and require us to pay damages.

### **Product performance problems, including undetected errors in our hardware or software, or deployment delays could harm our business and reputation.**

The development and production of new products with high technology content is complicated and often involves problems with software, components and manufacturing methods. Complex hardware and software systems, such as our products, can often contain undetected errors when first introduced

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or as new versions are released. In addition, errors associated with components we purchase from third parties, including customized components, may be difficult to resolve. We have experienced errors in the past in connection with our DTN System, including failures due to the receipt of faulty components from our suppliers. We suspect that errors, including potentially serious errors, will be found from time to time in our products. Our products may suffer degradation of performance and reliability over time.

If reliability, quality or network monitoring problems develop, a number of negative effects on our business could result, including:

delays in our ability to recognize revenue;

costs associated with fixing software or hardware defects or replacing products;

high service and warranty expenses;

delays in shipments;

high inventory excess and obsolescence expense;

high levels of product returns;

diversion of our engineering personnel from our product development efforts;

delays in collecting accounts receivable;

payment of damages for performance failures;

reduced orders from existing customers; and

declining interest from potential customers.

Because we outsource the manufacturing of certain components of our products, we may also be subject to product performance problems as a result of the acts or omissions of third parties.

From time to time, we encounter interruptions or delays in the activation of our products at a customer's site. These interruptions or delays may result from product performance problems or from issues with installation and activation, some of which are outside our control. If we experience significant interruptions or delays that we cannot promptly resolve, the associated revenue for these installations may be delayed or confidence in our products could be undermined, which could cause us to lose customers and fail to add new customers.

### **If we lose key personnel or fail to attract and retain additional qualified personnel when needed, our business may be harmed.**

Our success depends to a significant degree upon the continued contributions of our key management, engineering, sales and marketing, and finance personnel, many of whom would be difficult to replace. For example, senior members of our engineering team have unique technical

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experience that would be difficult to replace. We do not have long-term employment contracts or key person life insurance covering any of our key personnel. Because our products are complex, we must hire and retain a large number of highly trained customer service and support personnel to ensure that the deployment of our products do not result in network disruption for our customers. We believe our future success will depend in large part upon our ability to identify, attract and retain highly skilled managerial, engineering, sales, marketing, finance and customer service and support personnel. Competition for these individuals is intense in our industry, especially in the San Francisco Bay Area. We may not succeed in identifying, attracting and retaining appropriate personnel. The loss of the services of any of our key personnel, the inability to identify, attract or retain qualified personnel in the future or delays in hiring qualified personnel, particularly engineers and sales personnel, could make it difficult for us to manage our business and meet key objectives, such as timely product introductions.

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### **Our sales cycle can be long and unpredictable, which could result in an unexpected revenue shortfall in any given quarter.**

Our products have a lengthy sales cycle, which can extend from six to twelve months and may take even longer for larger prospective customers such as U.S. regional Bell operating companies, international postal, telephone and telegraph companies and U.S. competitive local exchange carriers. Our prospective customers conduct significant evaluation, testing, implementation and acceptance procedures before they purchase our products. We incur substantial sales and marketing expenses and expend significant management effort during this time, regardless of whether we make a sale.

Because the purchase of our equipment involves substantial cost, most of our customers wait to purchase our equipment until they are ready to deploy it in their network. As a result, it is difficult for us to accurately predict the timing of future purchases by our customers. In addition, product purchases are often subject to budget constraints, multiple approvals and unplanned administrative processing and other delays. If sales expected from customers for a particular quarter are not realized in that quarter or at all, our revenue will be negatively impacted.

### **Our international sales and operations subject us to additional risks that may harm our operating results.**

We market, sell and service our products globally. In 2010, 2009 and 2008, we derived approximately 25%, 31% and 21%, respectively, of our revenue from customers outside of the United States. We have sales and support personnel in numerous countries worldwide. In addition, we have a large group of development personnel located in Bangalore, India, Beijing, China and Kanata, Canada. We expect that significant management attention and financial resources will be required for our international activities over the foreseeable future as we continue to expand our international presence. In some countries, our successes in selling our products will depend in part on our ability to form relationships with local partners. Our inability to identify appropriate partners or reach mutually satisfactory arrangements for international sales of our products could impact our ability to maintain or increase international market demand for our products.

Our international operations are subject to inherent risks, and our future results could be adversely affected by a variety of factors, many of which are outside of our control, including:

greater difficulty in collecting accounts receivable and longer collection periods;

difficulties of managing and staffing international offices, and the increased travel, infrastructure and legal compliance costs associated with multiple international locations;

the impact of recessions in economies outside the United States;

tariff and trade barriers and other regulatory requirements or contractual limitations on our ability to sell or develop our products in certain foreign markets;

certification requirements;

greater difficulty documenting and testing our internal controls;

reduced protection for intellectual property rights in some countries;

potentially adverse tax consequences;

political and economic instability;

effects of changes in currency exchange rates which could negatively affect our financial results and cash flows; and

service provider and government spending patterns.

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International customers may also require that we comply with certain testing or customization of our products to conform to local standards. The product development costs to test or customize our products could be extensive and a material expense for us.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks could harm our international operations and reduce our international sales.

### **We may be adversely affected by fluctuations in currency exchange rates.**

A portion of our sales are from countries outside of the United States, and are in currencies other than U.S. dollars, particularly the Euro. Accordingly, fluctuations in foreign currency rates, most notably the strengthening of the dollar against the Euro, could have a material impact on our revenue in future periods. We enter into foreign currency forward exchange contracts to hedge against the short-term impact of currency fluctuations related to certain forecasted sales transactions denominated in Euro and into foreign currency exchange forward contracts to reduce the impact of foreign currency fluctuations on accounts receivable denominated in Euro. These hedging programs reduce the impact of currency exchange rate movements on certain transactions, but do not cover all foreign-denominated transactions and therefore do not entirely eliminate the impact of fluctuations in exchange rates which could negatively affect our results of operations and financial condition.

### **If we fail to maintain effective internal control over financial reporting in the future, the accuracy and timing of our financial reporting may be adversely affected.**

We are required to comply with Section 404 of the Sarbanes-Oxley Act of 2002. The provisions of the act require, among other things, that we maintain effective internal control over financial reporting and disclosure controls and procedures. Preparing our financial statements involves a number of complex processes, many of which are done manually and are dependent upon individual data input or review. These processes include, but are not limited to, calculating revenue, deferred revenue and inventory costs. While we continue to automate our processes and enhance our review and put in place controls to reduce the likelihood for errors, we expect that for the foreseeable future, many of our processes will remain manually intensive and thus subject to human error.

Prior to 2007, we identified several material weaknesses in our internal control over financial reporting. We have remediated these identified material weaknesses, but cannot give any assurances that additional material weaknesses will not be identified in the future in connection with our compliance with the provisions of Section 404 of the Sarbanes-Oxley Act of 2002. If we are not able to comply with the requirements of Section 404 in the future, or if we or our independent registered public accounting firm identify deficiencies in our internal controls over financial reporting that are deemed to be material weaknesses, the market price of our stock may decline and we could be subject to sanctions or investigations by the Nasdaq Global Select Market ( NASDAQ ), the SEC or other regulatory authorities, which would require significant additional financial and management resources.

### **Any acquisitions we make could disrupt our business and harm our financial condition and operations.**

We have made strategic acquisitions of businesses, technologies and other assets in the past. While we have no current agreements or commitments, we may in the future acquire businesses, product lines or technologies. In the event of any future acquisitions, we may not ultimately strengthen our competitive position or achieve our goals, or they may be viewed negatively by customers, financial markets or investors and we could:

issue stock that would dilute our current stockholders' percentage ownership;

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incur debt and assume other liabilities; or

incur amortization expenses related to goodwill and other intangible assets and/or incur large and immediate write-offs. Acquisitions also involve numerous risks, including:

problems integrating the acquired operations, technologies or products with our own;

diversion of management's attention from our core business;

assumption of unknown liabilities;

adverse effects on existing business relationships with suppliers and customers;

increased accounting compliance risk;

risks associated with entering new markets; and

potential loss of key employees.

We may not be able to successfully integrate any businesses, products, technologies or personnel that we might acquire in the future. Our failure to do so could have an adverse effect on our business, financial condition and operating results.

**Our use and reliance upon development resources in India, China and Canada may expose us to unanticipated costs or liabilities.**

We have established development centers in India, China and Canada and expect to continue to increase hiring of personnel for these facilities. There is no assurance that our reliance upon development resources in India, China or Canada will enable us to achieve meaningful cost reductions or greater resource efficiency. Further, our development efforts and other operations in these countries involve significant risks, including:

difficulty hiring and retaining appropriate engineering resources due to intense competition for such resources and resulting wage inflation;

the knowledge transfer related to our technology and exposure to misappropriation of intellectual property or confidential information, including information that is proprietary to us, our customers and other third parties;

heightened exposure to changes in the economic, security and political conditions of India, China and Canada;

fluctuation in currency exchange rates and tax risks associated with international operations; and

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development efforts that do not meet our requirements because of language, cultural or other differences associated with international operations, resulting in errors or delays.

Difficulties resulting from the factors above and other risks related to our operations in these countries could expose us to increased expense, impair our development efforts, harm our competitive position and damage our reputation.

### **Unforeseen health, safety and environmental costs could harm our business.**

Our manufacturing operations use substances that are regulated by various federal, state and international laws governing health, safety and the environment, including the Waste Electrical and Electronic Equipment and Restriction of the Use of Certain Hazardous Substances in Electrical and Electronic Equipment regulations adopted by the European Union. If we experience a problem with

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these substances, it could cause an interruption or delay in our manufacturing operations or could cause us to incur liabilities for any costs related to health, safety or environmental remediation. We could also be subject to liability if we do not handle these substances in compliance with safety standards for storage and transportation and applicable laws. If we experience a problem or fail to comply with such safety standards, our business, financial condition and operating results may be harmed.

### **We are subject to governmental import and export controls that could subject us to liability or impair our ability to compete in international markets.**

We are subject to export control laws that limit which products we sell and where and to whom we sell our products. U.S. export control laws also limit our ability to conduct product development activities in certain countries. In addition, various countries regulate the import of certain technologies and have enacted laws that could limit our ability to distribute our products or could limit our customers' ability to implement our products in those countries. Changes in our products or changes in import and export regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products throughout their global systems or, in some cases, prevent the import and export of our products to certain countries altogether. Any change in import and export regulations or related legislation, shift in approach to the enforcement or scope of existing regulations, or change in the countries, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers with international operations. Failure to comply with these and similar laws on a timely basis, or at all, decreased use of our products or any limitation on our ability to export or sell our products would adversely affect our business, financial condition and operating results.

### **If we need additional capital in the future, it may not be available to us on favorable terms, or at all.**

Our business requires significant capital. We have historically relied on significant outside debt and equity financing as well as cash flow from operations to fund our operations, capital expenditures and expansion. We may require additional capital from equity or debt financings in the future to fund our operations or respond to competitive pressures or strategic opportunities. We have a history of significant operating losses. For 2010, we had a net loss of \$27.9 million. In the event that we require additional capital, we may not be able to secure timely additional financing on favorable terms, or at all. The terms of any additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer dilution in their percentage ownership of our company, and any new securities we issue could have rights, preferences and privileges senior to those of holders of our common stock. If we are unable to obtain adequate financing or financing on terms satisfactory to us, if and when we require it, our ability to grow or support our business and to respond to business challenges could be limited and our business will be harmed.

### **We are subject to government regulations that could adversely impact our business.**

The Federal Communications Commission, or FCC, has jurisdiction over the entire U.S. communications industry and, as a result, our products and our U.S. customers are subject to FCC rules and regulations. Current and future FCC regulations affecting communications services, our products or our customers' businesses could negatively affect our business. In addition, international regulatory standards could impair our ability to develop products for international customers in the future. Delays caused by our compliance with regulatory requirements could result in postponements

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or cancellations of product orders. Further, we may not be successful in obtaining or maintaining any regulatory approvals that may, in the future, be required to operate our business. Any failure to obtain such approvals could harm our business and operating results.

### **Natural disasters, terrorist attacks or other catastrophic events could harm our operations.**

Our headquarters and the majority of our infrastructure, including our PIC FAB manufacturing facility, are located in Northern California, an area that is susceptible to earthquakes and other natural disasters. Further, a terrorist attack aimed at Northern California or at our nation's energy or telecommunications infrastructure could hinder or delay the development and sale of our products. In the event that an earthquake, terrorist attack or other catastrophe were to destroy any part of our facilities, or certain of our contract manufacturers' facilities, destroy or disrupt vital infrastructure systems or interrupt our operations for any extended period of time, our business, financial condition and operating results would be harmed.

### **The trading price of our common stock has been volatile and is likely to be volatile in the future.**

The trading prices of our common stock and the securities of other technology companies have been and may continue to be highly volatile. Further, our common stock has limited prior trading history. Factors affecting the trading price of our common stock include:

variations in our operating results;

announcements of technological innovations, new services or service enhancements, strategic alliances or agreements by us or by our competitors;

the gain or loss of customers;

recruitment or departure of key personnel;

changes in the estimates of our future operating results or external guidance on those results or changes in recommendations by any securities analysts that elect to follow our common stock;

market conditions in our industry, the industries of our customers and the economy as a whole; and

adoption or modification of regulations, policies, procedures or programs applicable to our business.

In addition, if the market for technology stocks or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, financial condition or operating results. The trading price of our common stock might also decline in reaction to events that affect other companies in our industry even if these events do not directly affect us. Each of these factors, among others, could harm the value of your investment in our common stock. Some companies that have had volatile market prices for their securities have had securities class action lawsuits filed against them. If a suit were filed against us, regardless of its merits or outcome, it could result in substantial costs and divert management's attention and resources.

### **Anti-takeover provisions in our charter documents and Delaware law could discourage delay or prevent a change in control of our company and may affect the trading price of our common stock.**

We are a Delaware corporation and the anti-takeover provisions of the Delaware General Corporation Law, which apply to us, may discourage, delay or prevent a change in control by prohibiting us from engaging in a business combination with an interested stockholder for a period of



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three years after the person becomes an interested stockholder, even if a change of control would be beneficial to our existing stockholders. In addition, our amended and restated certificate of incorporation and amended and restated bylaws may discourage, delay or prevent a change in our management or control over us that stockholders may consider favorable. Our amended and restated certificate of incorporation and amended and restated bylaws:

authorize the issuance of blank check convertible preferred stock that could be issued by our board of directors to thwart a takeover attempt;

establish a classified board of directors, as a result of which the successors to the directors whose terms have expired will be elected to serve from the time of election and qualification until the third annual meeting following their election;

require that directors only be removed from office for cause and only upon a supermajority stockholder vote;

provide that vacancies on the board of directors, including newly-created directorships, may be filled only by a majority vote of directors then in office rather than by stockholders;

prevent stockholders from calling special meetings; and

prohibit stockholder action by written consent, requiring all actions to be taken at a meeting of the stockholders.

**ITEM 1B. UNRESOLVED STAFF COMMENTS**

Not applicable.

**ITEM 2. PROPERTIES**

Our headquarters are located in Sunnyvale, California. We lease facilities in North America and Asia. The following is a summary of the locations, functions and approximate square footage of those facilities as of December 25, 2010:

| <b>Location</b>        | <b>Function</b>                               | <b>Square Footage</b> |
|------------------------|---|-----------------------|
| Sunnyvale, CA          | Corporate headquarters and manufacturing      | 236,000               |
| Allentown, PA          | Manufacturing and research and development    | 44,000                |
| Annapolis Junction, MD | Research and development, service and support | 12,000                |
| Jessup, MD             | Warehouse                                     | 9,000                 |
| Bangalore, India       | Research and development                      | 39,000                |
| Beijing, China         | Research and development                      | 13,000                |
| Kanata, Canada         | Research and development                      | 3,000                 |

The above leases expire between 2010 and 2020. Subsequent to our fiscal year ended 2010, a lease associated with 25,000 square feet of the total 236,000 square feet facilities in Sunnyvale, CA, expired on December 31, 2010. We intend to add new facilities and to expand existing facilities as we add employees, and we believe that suitable additional or substitute space will be available as needed to accommodate any such expansion of our operations. We believe that our existing facilities are adequate to meet our business needs through the next 12 months.

**ITEM 3. LEGAL PROCEEDINGS**

On May 9, 2006, we and Level 3 were sued by Cheetah in the U.S. District Court for the Eastern District of Texas Texarkana Division for alleged infringement of patent no. 6,795,605 (the 605 Patent ), and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which

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requested an order to enjoin the sale of the Company's DTN System and to recover all damages caused by the alleged willful infringement including any and all compensatory damages available by law, such as actual and punitive damages, attorneys' fees, associated interest and Cheetah's costs incurred in the lawsuit. Cheetah's complaint does not request a specific dollar amount for these compensatory damages. We are contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent its product supplied by us is found to infringe, and we have assumed the defense of this matter. On July 20, 2006, we and Level 3 filed an amended response denying all infringement claims under the '605 Patent and asserting that the claims of the '605 Patent are invalid and that the DTN System does not infringe the '605 Patent. On November 28, 2006, Cheetah filed a second amended complaint and added patent no. 7,142,347 (the '347 Patent) to the lawsuit. On December 18, 2006, we and Level 3 filed responses to Cheetah's second amended complaint denying all infringement claims under the '347 Patent and we and Level 3 asserted counterclaims against Cheetah asserting that the claims are invalid and that the DTN System does not infringe the patents.

On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, we and Level 3 filed responses to Cheetah's third amended complaint denying all infringement claims, and we and Level 3 asserted counterclaims against Cheetah asserting that the claims of the patents are invalid and that the DTN System does not infringe the patents.

On March 14, 2007, we submitted requests to the U.S. PTO for inter partes reexamination of the '605 Patent and the '347 Patent asking the U.S. PTO to reexamine the patents based on prior art in order to invalidate the patents or limit the scope of each patent's claims. On March 21, 2007, we and Level 3 filed a motion with the court to stay all proceedings in the lawsuit pending the reexamination of the '605 Patent and the '347 Patent.

On April 11, 2007, we, Level 3 and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. PTO as to whether it will reexamine the '605 Patent and the '347 Patent; and (2) if the U.S. PTO decides to reexamine either the '605 Patent and the '347 Patent, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. Patent and Trademark Office. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. On June 26, 2007, the U.S. PTO also ordered reexamination of the '605 Patent. On August 1, 2007, the U.S. PTO ordered reexamination of the '347 Patent. As a result, all proceedings in this lawsuit are stayed until the final resolution of these reexaminations.

In a communication we received from the U.S. PTO dated December 4, 2009, we were advised that various claims in the '347 Patent reexamination have been allowed, while other claims have been rejected. In a communication we received from the U.S. PTO dated June 22, 2010, we were advised that various claims in the '605 Patent reexamination have been allowed, while other claims have been rejected. We have appealed the allowance of certain claims in the '347 Patent and '605 Patent reexaminations to the Board of Patent Appeals and Interferences at the U.S. Patent and Trademark Office and will have an opportunity to appeal the allowance of certain claims in the '605 Patent reexamination. We do not know when the U.S. PTO reexamination process will be completed.

On January 26, 2010, Cheetah's counsel filed a motion requesting the court to lift the stay in order to litigate those claims relating to the '347 Patent reexamination that the U.S. PTO allowed. The court denied the motion on April 16, 2010. On April 30, 2010, Cheetah filed a motion for reconsideration of the order denying Cheetah's motion to lift the stay. On May 17, 2010, we filed our opposition to Cheetah's motion for reconsideration. On August 24, 2010, after a hearing on the matter, the court issued an order keeping the stay in place. We believe the suit is without merit and intend to defend ourselves vigorously, but we are unable to predict the likelihood of an unfavorable outcome.

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On May 14, 2010, Aloft Media, LLC ( Aloft ) filed a complaint in the U.S. District Court for the Eastern District of Texas Tyler Division alleging that we infringe U.S. patent nos. 7,593,910 and 7,596,538. On August 2, 2010, the Company filed its answer to Aloft s complaint denying all infringement claims and asserting counterclaims. On August 25, 2010, Aloft filed its answer to our counterclaims. On December 16, 2010, Aloft s complaint was dismissed without prejudice.

In addition to the matters described above, the Company is subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material effect on our consolidated financial position, results of operations, or cash flows.

**ITEM 4. RESERVED**

**Table of Contents****PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is listed on the NASDAQ Global Select Market under the symbol INFN. The following table sets forth, for the time periods indicated, the high and low sales prices of our common stock as reported on the NASDAQ Global Select Market.

|                     | <b>High</b> | <b>Low</b> |
|---------------------|-------------|------------|
| Fourth Quarter 2010 | \$ 12.53    | \$ 7.79    |
| Third Quarter 2010  | \$ 12.90    | \$ 6.22    |
| Second Quarter 2010 | \$ 10.10    | \$ 5.70    |
| First Quarter 2010  | \$ 9.27     | \$ 6.71    |
| Fourth Quarter 2009 | \$ 9.80     | \$ 7.12    |
| Third Quarter 2009  | \$ 9.43     | \$ 6.49    |
| Second Quarter 2009 | \$ 10.53    | \$ 7.00    |
| First Quarter 2009  | \$ 9.28     | \$ 5.69    |

As of February 23, 2011, there were 150 registered holders of record of Infinera's common stock. A substantially greater number of holders of Infinera common stock are street name or beneficial holders, whose shares are held by banks, brokers and other financial institutions.

We have not paid any cash dividends on our common stock and do not intend to pay any cash dividends on common stock in the foreseeable future.

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**STOCK PERFORMANCE GRAPH**

The following graph compares the cumulative 43-month total return provided stockholders on Infinera Corporation's common stock relative to the cumulative total returns of the NASDAQ Composite Index and the NASDAQ Telecommunications Index. An investment of \$100 (with reinvestment of all dividends) is assumed to have been made in our common stock and in each of the indexes on June 7, 2007 and its relative performance is tracked through December 25, 2010. The NASDAQ Telecommunications Index contains securities of NASDAQ-listed companies classified according to the Industry Classification Benchmark as Telecommunications and Telecommunications Equipment. They include providers of fixed-line and mobile telephone services, and makers and distributors of high-technology communication products. This graph is not deemed to be filed with the SEC or subject to the liabilities of Section 18 of the Securities Exchange Act of 1934, and the graph shall not be deemed to be incorporated by reference into any prior or subsequent filing by Infinera under the Securities Act of 1933 or the Exchange Act.

**COMPARISON OF 43 MONTH CUMULATIVE TOTAL RETURN\***

Among Infinera Corp., the NASDAQ Composite Index  
and the NASDAQ Telecommunications Index

\* \$100 invested on 6/7/07 in stock or 5/31/07 in index, including reinvestment of dividends.

**Table of Contents****ITEM 6. SELECTED FINANCIAL DATA**

You should read the following selected consolidated historical financial data below in conjunction with the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the consolidated financial statements, related notes and other financial information included elsewhere in this Annual Report on Form 10-K. The selected financial data in this section is not intended to replace the financial statements and is qualified in its entirety by the consolidated financial statements and related notes thereto included elsewhere in this Annual Report on Form 10-K.

We derived the statements of operations data for the years ended December 25, 2010, December 26, 2009 and December 27, 2008 and the balance sheet data as of December 25, 2010 and December 26, 2009 from our audited consolidated financial statements and related notes, which are included elsewhere in this Annual Report on Form 10-K. We derived the statements of operations data for the years ended December 29, 2007 and December 31, 2006 and the balance sheet data as of December 27, 2008, December 29, 2007 and December 31, 2006 from our audited consolidated financial statements and related notes which are not included in this Annual Report on Form 10-K. We have not declared or distributed any cash dividends. Additionally, our historical results are not necessarily indicative of the results that should be expected in the future.

|  | December 25,<br>2010                  | December 26,<br>2009 | Years Ended<br>December 27,<br>2008 | December 29,<br>2007 | December 31,<br>2006 |
|--|---------------------------------------|----------------------|-------------------------------------|----------------------|----------------------|
|  | (In thousands, except per share data) |                      |                                     |                      |                      |
| Revenue  | \$ 454,352                            | \$ 309,101           | \$ 519,212                          | \$ 245,852           | \$ 58,236            |
| Gross profit (loss)  | \$ 206,189                            | \$ 102,101           | \$ 233,555                          | \$ 76,589            | \$ (13,189)          |
| Net income (loss)  | \$ (27,932)                           | \$ (86,622)          | \$ 78,728                           | \$ (55,342)          | \$ (89,935)          |
| Net income (loss) per common share   |                                       |                      |                                     |                      |                      |
| Basic  | \$ (0.28)                             | \$ (0.91)            | \$ 0.85                             | \$ (1.09)            | \$ (14.90)           |
| Diluted  | \$ (0.28)                             | \$ (0.91)            | \$ 0.81                             | \$ (1.09)            | \$ (14.90)           |
| Weighted average number of shares used in computing basic and diluted net income (loss) per common share |                                       |                      |                                     |                      |                      |
| Basic  | 99,380                                | 95,468               | 92,427                              | 50,732               | 6,036                |
| Diluted  | 99,380                                | 95,468               | 97,088                              | 50,732               | 6,036                |
| Total cash and cash equivalents, investments and restricted cash   | \$ 295,706                            | \$ 275,477           | \$ 312,585                          | \$ 305,830           | \$ 29,572            |
| Total assets   | \$ 551,525                            | \$ 491,945           | \$ 507,067                          | \$ 529,188           | \$ 230,466           |
| Current and long-term debt   | \$                                    | \$                   | \$                                  | \$                   | \$ 28,382            |
| Convertible preferred stock  | \$                                    | \$                   | \$                                  | \$                   | \$ 320,550           |
| Common and additional paid-in capital  | \$ 817,302                            | \$ 747,677           | \$ 699,799                          | \$ 663,962           | \$ 7,920             |
| Stockholders' equity (deficit)   | \$ 410,749                            | \$ 368,507           | \$ 405,463                          | \$ 294,574           | \$ (306,321)         |

**Table of Contents****ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*This Annual Report on Form 10-K contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include any expectation of earnings, revenues, gross margins, expenses or other financial items; any statements of the plans, strategies and objectives of management for future operations and personnel; factors that may affect our operating results; statements concerning new products or services, including future PIC capacity and new product delivery dates; statements related to capital expenditures; statements related to future economic conditions, performance, market growth or our sales cycle; statements related to the liquidity of our auction rate securities; statements as to industry trends and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. These statements are often identified by the use of words such as anticipate, believe, continue, could, estimate, expect, intend, may, or will, and similar expressions or variations. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included in Item 1A of Part I of this Annual Report on Form 10-K. You should review these risk factors for a more complete understanding of the risks associated with an investment in our securities. Such forward-looking statements speak only as of the date of this report. We disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. The following discussion and analysis should be read in conjunction with our Selected Consolidated Financial Data and consolidated financial statements and notes thereto included elsewhere in this Annual Report on Form 10-K.*

**Overview***Background*

Infinera was founded in December 2000 with a unique vision for optical networking. Prior to Infinera, service provider optical networks were built from fairly commoditized products, broadly known as dense wavelength division multiplexing ( DWDM ) systems. Recent rapid and unpredictable growth in bandwidth demand has increased the need for the delivery of high-capacity low-cost bandwidth throughout the network. We believe that traditional point-to-point network architectures do not provide the required flexibility. It takes large amounts of low-cost bandwidth, pervasive Optical Transport Network ( OTN ) switching, and the intelligence of bandwidth management to manage these larger networks and deliver high-capacity services quickly and cost-effectively. Infinera believes this can only be achieved with photonic integrated circuits ( PICs ) and that only through photonic integration can network operators scale their network bandwidth without significant increases in space, power or operational workload.

We first introduced our Digital Optical Network architecture to the market in 2005. This architecture is based on our unique PICs and enables high-capacity low-cost bandwidth in the cloud and distributed switching throughout the network. Since 2005, our strategy has been to extend the benefits of our Digital Optical Network throughout the optical networking market. We have made significant enhancements to our Digital Transport Node System ( DTN System ) during this time by increasing reach and fiber capacity for the long-haul market, adding the Infinera MTC, a 19-inch chassis option tailored for the metro core market, and adding a submarine version of the DTN System for the Submarine Line Terminating Equipment ( SLTE ) market. In addition, we launched our ATN metro access platform, extending Infinera's digital bandwidth management and intelligent network benefits to

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the network edge. Both the DTN and ATN Systems are designed to operate as a tightly-integrated network with a single management system providing an end-to-end Digital Optical Network experience.

### *2010 Financial and Business Highlights*

47% revenue growth year-over-year

Achieved 49% and 50% gross margins in the third and fourth quarters of 2010, respectively

Reduced operating losses to \$28.7 in 2010 from \$89.7 million in 2009

Generated \$30.5 million of cash from operations

Grew revenues with cable and internet content customers by 82% year-over-year

ATN metro platform now deployed with 22 customers

Established presence in subsea market with 5 customers

Reset product development plans to focus on delivering:  
differentiated double density 40 Gigabits per second ( Gbps ) solution in 2011, and

100Gbps PIC-based platform in 2012

### *Future Business and Industry Trends*

Traffic patterns in the optical network continue to grow to accommodate increased bandwidth demand from video, mobility and cloud computing. The market is seeing growing demand for increased fiber capacity with networks migrating from the current 10Gbps wavelength solutions to 40Gbps solutions in the short-term and 100Gbps solutions in the longer-term. Infinera plans to introduce a 100Gbps PIC-based platform in 2012. This system will incorporate our 500Gbps PICs and our 5 Terabit OTN switch and will combine competitive fiber capacity with the unique features of the Digital Optical Network. To address the needs of customers who require higher fiber capacity in advance of the release of our 100Gbps system, we plan to introduce a non-PIC based 40Gbps solution that will increase the fiber capacity of the DTN System from 1.6 Terabits per second ( Tb/s ) to 6.4 Tb/s. We expect to introduce this system in mid-2011 and believe that it will represent the highest fiber capacity 40Gbps system in the market at that time. We believe that it will be more cost-effective for customers to move to 100Gbps systems when these become broadly available as they will offer more favorable network economics.

We continue to extend our Digital Optical Network into the metro market with new releases of our ATN System and into the submarine market with a product extension of our DTN System. Our ATN System is a metro access platform that extends Infinera's digital bandwidth management and intelligent software operating system benefits to the network edge. Both the DTN System and ATN System are designed to operate as a tightly-integrated network with a single management system providing an end-to-end Digital Optical Network experience.

Our goal is to be a leading provider of optical networking systems to operators of optical networks, including telecom carriers, cable operators, internet or content service providers, and others. Our revenue growth will depend on the continued acceptance of our products, growth of communications traffic and the proliferation of next-generation bandwidth-intensive services, which are expected to drive the need for increased

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levels of bandwidth. Our ability to increase revenue and achieve profitability will be directly affected by the level of acceptance of our products in the long-haul and metro DWDM markets and by our ability to cost-effectively develop and sell innovative products that leverage our technology advantages on a time-to-market basis.

As of December 25, 2010, we have sold our network systems for deployment in the optical networks of 82 customers worldwide, including Cox Communications, Deutsche Telekom, Global Crossing, Interoute and Level 3 Communications ( Level 3 ). We currently have 22 ATN customers

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enjoying the benefits of an ATN network and 19 of those have deployed an integrated ATN-DTN solution. We do not have long-term sales commitments from our customers. To date, a few of our customers have accounted for a significant portion of our revenue. In particular, Level 3 accounted for approximately 15%, 17% and 25% of our revenue in 2010, 2009 and 2008, respectively. As a result, our business will be harmed if any of our key customers, including Level 3, do not generate as much revenue as we forecast, stop purchasing from us, or substantially reduce their orders to us.

We are headquartered in Sunnyvale, California, with employees located throughout the Americas, Europe and the Asia Pacific region. We expect to continue to add personnel in the United States and internationally to develop our products and provide additional geographic sales and technical support coverage. We primarily sell our products through our direct sales force, with a small portion sold indirectly through resellers. We derived 98%, 94% and 97% of our revenue from direct sales to customers for the years ended December 25, 2010, December 26, 2009 and December 27, 2008, respectively. We expect to continue generating a substantial majority of our revenue from direct sales in the future.

Our revenue trends prior to December 27, 2008 had been significantly impacted by the timing of our attainment of vendor specific objective evidence ( VSOE ) of fair value for most of our services and are not indicative of revenue trends in 2009 and future periods. Prior to the first quarter of 2008, revenue from product sales sold in combination with services ( bundled product sales ) was deferred and recognized ratably over a period of approximately one year. This resulted in the accumulation of \$174.4 million of deferred revenue and \$81.6 million of associated deferred inventory costs on the balance sheet as of December 29, 2007. We recognized \$165.8 million of this deferred revenue and \$78.4 million of associated deferred inventory costs in 2008. In addition, the attainment of VSOE of fair value for most of our services beginning in the first quarter of 2008 required us to recognize a majority of our 2008 product sales as revenue in the period in which the bundled products were accepted by the customer. The combined effect of the recognition of the deferred revenue from prior periods and the upfront recognition of revenue from bundled product sales in 2008 resulted in significantly increased levels of revenue, gross margin and net income for 2008. In 2009 and 2010, we did not recognize significant amounts of product related deferred revenue and deferred gross profit from prior periods and do not expect to do so in the future.

The table below illustrates our 2008 results as reported and excluding the impact of the recognition of deferred amounts from prior periods:

|                               | Year Ended December 27, 2008 |                               |                     |
|-------------------------------|------------------------------|-------------------------------|---------------------|
|                               | As Reported Results          | Pre-VSOE Deferred Adjustments | As Adjusted Results |
|                               | (In thousands, except %)     |                               |                     |
| Revenue                       | \$ 519,212                   | \$ (165,787)                  | \$ 353,425          |
| Cost of revenue               | 285,657                      | (78,401)                      | 207,256             |
| Gross profit                  | \$ 233,555                   | \$ (87,386)                   | \$ 146,169          |
| Gross margin                  | 45%                          |                               | 41%                 |
| Income (loss) from operations | \$ 73,433                    | \$ (87,386)                   | \$ (13,953)         |
| Net income (loss)             | \$ 78,728                    | \$ (87,386)                   | \$ (8,658)          |

Our near-term year-over-year and quarter-over-quarter growth in revenue will likely be volatile and may be impacted by several factors including general economic and market conditions, the timing of large product deployments, acquisitions of new customers and time-to-market development of new products.

We will continue to make significant investments in the business, and management currently believes that operating expenses for 2011 will range from \$249 million to \$256 million, including stock-based compensation expense in the range of \$45 million to \$48 million.

**Table of Contents****Results of Operations***Revenue*

The following table sets forth, for periods presented, certain consolidated statements of operations information:

|   | December 25,<br>2010 | % of total<br>revenue | Years Ended<br>December 26,<br>2009<br>(In thousands, except %) | % of total<br>revenue | December 27,<br>2008 | % of total<br>revenue |
|---|----------------------|-----------------------|---|-----------------------|----------------------|-----------------------|
| <b>Revenue:</b>   |                      |                       |   |                       |                      |                       |
| Product   | \$ 401,578           | 89%                   | \$ 276,012  | 89%                   | \$ 306,808           | 59%                   |
| Ratable product and related support and services                  | 6,155                | 1%                    | 4,231   | 1%                    | 193,705              | 37%                   |
| Services  | 46,619               | 10%                   | 28,858  | 10%                   | 18,699               | 4%                    |
| <b>Total revenue</b>  | <b>\$ 454,352</b>    | <b>100%</b>           | <b>\$ 309,101</b>   | <b>100%</b>           | <b>\$ 519,212</b>    | <b>100%</b>           |
| <b>Cost of revenue:</b>   |                      |                       |   |                       |                      |                       |
| Product   | \$ 225,183           | 50%                   | \$ 189,723  | 61%                   | \$ 184,234           | 35%                   |
| Ratable product and related support and services                  | 3,217                | 1%                    | 1,931   | 1%                    | 91,625               | 18%                   |
| Services  | 19,945               | 4%                    | 12,308  | 4%                    | 9,798                | 2%                    |
| Restructuring and other costs (credit) related to cost of revenue | (182)                | %                     | 3,038   | 1%                    |                      | %                     |
| <b>Total cost of revenue</b>                                      | <b>\$ 248,163</b>    | <b>55%</b>            | <b>\$ 207,000</b>   | <b>67%</b>            | <b>\$ 285,657</b>    | <b>55%</b>            |
| <b>Gross profit</b>   | <b>\$ 206,189</b>    | <b>45%</b>            | <b>\$ 102,101</b>   | <b>33%</b>            | <b>\$ 233,555</b>    | <b>45%</b>            |

The following table summarizes our revenue by geography and sales channel for the periods presented:

|                                       | December 25,<br>2010 | Years Ended<br>December 26,<br>2009<br>(In thousands, except %) | December 27,<br>2008 |
|---------------------------------------|----------------------|---|----------------------|
| <b>Total revenue by geography</b>     |                      |   |                      |
| Domestic                              | \$ 342,461           | \$ 212,923  | \$ 412,563           |
| International                         | 111,891              | 96,178  | 106,649              |
|                                       | \$ 454,352           | \$ 309,101  | \$ 519,212           |
| <b>% Revenue by geography</b>         |                      |   |                      |
| Domestic                              | 75%                  | 69%   | 79%                  |
| International                         | 25%                  | 31%   | 21%                  |
|                                       | 100%                 | 100%  | 100%                 |
| <b>Total revenue by sales channel</b> |                      |   |                      |
| Direct                                | \$ 444,168           | \$ 290,972  | \$ 502,763           |
| Indirect                              | 10,184               | 18,129  | 16,449               |

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\$ 454,352                      \$ 309,101                      \$ 519,212

| % Revenue by sales channel |      |      |      |
|----------------------------|------|------|------|
| Direct                     | 98%  | 94%  | 97%  |
| Indirect                   | 2%   | 6%   | 3%   |
|                            | 100% | 100% | 100% |

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*2010 Compared to 2009.* Total revenue increased to \$454.4 million in 2010 from \$309.1 million in 2009. This increase in revenue reflected an overall recovery in the economy combined with increased bandwidth demand across our customer base. We experienced increased business activity with many of our customers, including strong demand from our cable and internet content customers in North America and from Level 3.

Revenue levels in the first half of 2009 were significantly impacted by the downturn in the economy as new and existing customers delayed purchasing decisions and limited their new purchases.

International revenue decreased to 25% of total revenue in 2010 from 31% in 2009. This decrease was primarily attributable to increased levels of sales to domestic customers in 2010. While we expect international revenues to continue to grow in absolute dollars on a long-term basis as we increase our sales activities in Europe, Asia Pacific and other regions, this metric may fluctuate as a percentage of total revenue depending on the size and timing of deployments both internationally and in the United States.

Total product revenue increased to \$401.6 million in 2010 from \$276.0 million in 2009 primarily due to increased sales of our DTN System to new and existing customers, reflecting an overall improvement in the economic environment and continued growth in bandwidth demand.

Product and related support and services revenue that is recognized ratably includes sales of products and services that were deferred because VSOE of fair value had not been established for undelivered elements. Total ratable revenue levels increased to \$6.2 million in 2010 from \$4.2 million in 2009. This increase in 2010 was primarily due to the recognition of revenue from prior period sales of our ATN platform where the products were bundled with new services for which VSOE had not been established. We expect our ratable revenues to decrease in future periods following our adoption of ASU 2009-13 and ASU 2009-14, as discussed in Note 2, Significant Accounting Policies, to the Notes to Consolidated Financial Statements. Under this guidance, revenue is allocated to each element of an arrangement based on relative selling prices, using third-party evidence ( TPE ) or estimated selling price ( ESP ) if VSOE has not been established. We have a number of software offerings and related support services that will continue to be accounted for under the software revenue recognition rules. We expect to continue to record a small amount of ratable revenue when arrangements include bundled services related to our software offerings for which VSOE has not been established.

Total services revenue increased to \$46.6 million in 2010 from \$28.9 million in 2009. This increase primarily reflected the incremental recognition of \$8.3 million related to deployment services revenue, \$4.3 million related to our software subscription service revenue, \$3.0 million related to extended hardware warranty service revenue, and \$1.6 million related to our spares management service revenue. We expect to continue to grow our extended hardware warranty and spares management services revenues in future periods.

We do not have visibility necessary to accurately predict future revenues beyond a one-quarter time horizon. However, we believe that we may be competitively disadvantaged in regard to fiber capacity until our 40Gbps solution is released in mid-2011. This may negatively impact revenues in the first half of 2011.

*2009 Compared to 2008.* Total revenue decreased to \$309.1 million in 2009 from \$519.2 million in 2008. This decrease primarily reflected \$165.8 million of deferred revenue from prior periods recognized in 2008 due to attaining VSOE. Excluding this impact, revenue decreased \$44.3 million on a year-over-year basis primarily due to the impact of the economic downturn resulting in decreased

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purchases of our products by existing customers in the first half of 2009. This was partially offset by a number of large deployments with new and certain existing customers in the second and third quarters of 2009. In addition, we began to see a recovery in overall demand in the fourth quarter of 2009.

Total product revenue decreased to \$276.0 million in 2009 from \$306.8 million in 2008 primarily due to decreased purchases of our DTN System by existing customers; however, this impact was partially offset by the addition of new domestic and international customers and new deployments with certain existing customers.

Total ratable revenue decreased to \$4.2 million in 2009 from \$193.7 million in 2008. The majority of the ratable revenue recognized in 2008 related to deferred revenue from the periods prior to the attainment of VSOE of fair value for most of our services. Excluding this impact, ratable revenue for 2008 would have been \$4.0 million related to new ratable revenue generated from bundled sales made in the period.

Total services revenue increased to \$28.9 million in 2009 from \$18.7 million in 2008, reflecting an increase in software subscription revenue from \$8.6 million in 2008 to \$15.2 million in 2009 and an increase in other non-installation related services revenue from \$0.9 million in 2008 to \$4.3 million in 2009.

*Cost of Revenue and Gross Margin*

*2010 Compared to 2009.* Gross margin increased to 45% from 33% in 2009. A higher proportion of our revenue came from our higher gross margin tributary adaptor and line modules in 2010 as compared to 2009. This reflected strong demand for bandwidth in the year as customers filled out higher capacity footprint. Additionally, the unusually low level of gross margin in 2009 was primarily due to the following factors:

we recognized revenue and costs related to a large number of negative or lower margin common equipment deployments;

gross margin was negatively impacted by the usage of significant common equipment discounts;

we incurred restructuring and other related costs of \$3.0 million related to the closure of our Maryland-based semiconductor fabrication plant (the Maryland FAB ) plan announced in July 2009; and

we incurred inventory write-downs for excess and obsolete inventory of \$6.6 million which includes \$1.5 million of inventory write-downs related to the closure of our Maryland FAB.

See Note 7, Restructuring and Other Related Costs, to the Notes to Consolidated Financial Statements for more information on our Maryland FAB restructuring plan.

*2009 Compared to 2008.* Gross margin decreased to 33% in 2009 from 45% in 2008. However, as illustrated in the table below, gross profit in 2008 was unusually high due to the recognition of \$87.4 million of gross profit related to reductions in the deferred revenue and deferred inventory cost balances from prior periods. Excluding this prior period impact, gross margin for 2008 would have been 41% compared to gross margin of 33% in 2009.

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The table below illustrates our 2008 results as reported and excluding the impact of the recognition of deferred amounts from prior periods.

|                 | Year Ended December 27, 2008 |   |                     |
|-----------------|------------------------------|---|---------------------|
|                 | As Reported Results          | Pre-VSOE Deferred Adjustments<br>(In thousands, except %) | As Adjusted Results |
| Revenue         | \$ 519,212                   | \$ (165,787)  | \$ 353,425          |
| Cost of revenue | 285,657                      | (78,401)  | 207,256             |
| Gross profit    | 233,555                      | (87,386)  | 146,169             |

Gross margin

45%

41%

This significant decline in gross margin in 2009 as compared to adjusted gross margin in 2008 was partially due to lower sales of our higher margin TAM and DLM products in the first half of the year and the recognition of revenue related to a number of large lower margin common equipment deployments with new and existing customers in 2009. Gross margin for 2009 also included restructuring and other related costs of \$3.0 million related to the closure of our Maryland FAB announced in July 2009.

*Operating Expenses*

|                               | Years Ended       |                    |   |                    |                   |                           |
|-------------------------------|-------------------|--------------------|---|--------------------|-------------------|---------------------------|
|                               | December 25, 2010 | % of total revenue | December 26, 2009<br>(In thousands, except %) | % of total revenue | December 27, 2008 | % of total revenue<br>(1) |
| Operating expenses:           |                   |                    |   |                    |                   |                           |
| Research and development      | \$ 118,518        | 26%                | \$ 97,288                                     | 31%                | \$ 80,578         | 16%                       |
| Sales and marketing           | 58,103            | 13%                | 48,391  | 16%                | 43,262            | 8%                        |
| General and administrative    | 58,098            | 13%                | 45,269  | 15%                | 36,282            | 7%                        |
| Restructuring and other costs | 159               | %                  | 814   | %                  |                   | %                         |
| Total operating expenses      | \$ 234,878        | 52%                | \$ 191,762                                    | 62%                | \$ 160,122        | 31%                       |

(1) Operating expenses as a percent of total revenue in 2008 is not a meaningful trend indicator because of the impact of our revenue recognition policy on the timing and amount of revenue recorded in 2008.

The following table summarizes the stock-based compensation expense included in our operating expenses:

|                            | Years Ended       |                                     |                   |
|----------------------------|-------------------|-------------------------------------|-------------------|
|                            | December 25, 2010 | December 26, 2009<br>(In thousands) | December 27, 2008 |
| Research and development   | \$ 14,301         | \$ 10,302                           | \$ 6,543          |
| Sales and marketing        | 7,896             | 6,505                               | 4,440             |
| General and administration | 19,903            | 15,061                              | 7,463             |
| Total                      | \$ 42,100         | \$ 31,868                           | \$ 18,446         |



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### *Research and Development Expenses*

*2010 Compared to 2009.* Research and development expenses increased \$21.2 million in 2010 from 2009 primarily due to increased headcount and personnel-related costs of \$14.2 million, including \$10.2 million of cash compensation and \$4.0 million of stock-based compensation expenses. In addition, in 2010, we incurred \$7.5 million of increased spending related to materials, prototype and new product spending and \$0.6 million in professional and outside services. This was partially offset by a decrease of \$1.1 million related to depreciation expense and other costs. This increase in research and development expenses reflects ongoing investments in our higher fiber capacity platforms combined with investments in our ATN metro platform.

*2009 Compared to 2008.* Research and development expenses increased \$16.7 million in 2009 from 2008 primarily due to increased headcount and personnel-related costs of \$12.6 million, including \$6.8 million of cash compensation, \$3.8 million of stock-based compensation expense and \$2.0 million of incremental facilities and infrastructure costs. In addition, in 2009, we incurred \$4.2 million of increased prototype and new product spending.

### *Sales and Marketing Expenses*

*2010 Compared to 2009.* Sales and marketing expenses increased \$9.7 million in 2010 from 2009 primarily due to an increase of \$5.8 million in cash compensation and personnel expenses. This increase included \$4.4 million of sales commissions primarily related to an over-achievement of the sales plan for the year. Additionally, stock-based compensation expense increased \$1.4 million and travel and entertainment expenses and other costs increased \$1.1 million. In 2010, we also incurred \$0.9 million related to incremental customer lab trials and marketing prototype materials, and \$0.5 million of additional professional and outside services.

*2009 Compared to 2008.* Sales and marketing expenses increased \$5.1 million in 2009 from 2008 primarily due to increased headcount and personnel-related costs of \$4.8 million, including \$2.5 million of cash compensation, \$2.1 million of stock-based compensation expense and \$0.2 million of incremental facilities and infrastructure costs. In addition, in 2009, we incurred \$0.6 million of increased spending on a mobile demo vehicle in Europe, partially offset by \$0.3 million reduction on sales lab trials.

### *General and Administrative Expenses*

*2010 Compared to 2009.* General and administrative expenses increased \$12.8 million in 2010 from 2009 primarily due to \$5.0 million of cash compensation, which includes the impact of increased headcount and management bonuses, and \$4.8 million of stock-based compensation expense. In addition, facilities and professional services costs increased by \$0.8 million and depreciation and amortization expense increased by \$0.5 million. Additionally, 2009 was impacted by a recovery of doubtful accounts of \$1.7 million.

*2009 Compared to 2008.* General and administrative expenses increased \$9.0 million in 2009 from 2008 primarily due to \$7.6 million of stock-based compensation expense, \$3.8 million of cash compensation and \$1.3 million of depreciation and amortization expense. These increases were offset by a \$3.4 million change in bad debt expense due to \$1.7 million of provision for doubtful accounts recorded in 2008 which was subsequently recovered in 2009. Additionally, costs related to facilities and professional services decreased \$0.3 million.

### *Restructuring and Other Costs*

In 2010, we incurred \$0.2 million of restructuring and other costs associated with the closure of our Maryland FAB. We incurred \$0.8 million of restructuring and other related costs in 2009 which was

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comprised of non-cash charges of \$0.6 million associated with operating lease termination costs and equipment and facilities-related costs and \$0.2 million related to severance and related expenses and other exit costs. For more information, see Note 7, Restructuring and Other Related Costs, to the Notes to Consolidated Financial Statements.

*Other Income (Expense), Net*

|  | December 25,<br>2010 | Years Ended<br>December 26,<br>2009<br>(In thousands) | December 27,<br>2008 |
|--|----------------------|---|----------------------|
| Interest income  | \$ 1,390             | \$ 2,688  | \$ 8,549             |
| Interest expense                                       |                      |   | (3)                  |
| Total other-than-temporary impairment losses           |                      | (2,747)   |                      |
| Portion of loss recognized in other comprehensive loss |                      | 1,653   |                      |
| Net impairment losses recognized in earnings           |                      | (1,094)   |                      |
| Other gain (loss), net                                 | (316)                | (426)   | (528)                |
| Total other income (expense), net                      | \$ 1,074             | \$ 1,168  | \$ 8,018             |

*2010 Compared to 2009.* Interest income decreased in 2010 from 2009 due to lower interest rates on investments and lower average investment balances. In 2009, we recognized net credit impairment losses of \$1.1 million related to the determination that our available-for-sale auction rate securities ( ARS ) were other-than-temporarily impaired, as discussed in Note 3, Fair Value Measurements and Other-Than-Temporary Impairments, of the Notes to Consolidated Financial Statements. Other gain (loss), net for 2010 includes \$0.7 million of unrealized and realized losses due to foreign currency exchange re-measurement and \$0.3 million gain on asset sales.

*2009 Compared to 2008.* Interest income decreased in 2009 from 2008 due to lower interest rates on investments and lower investment balances. We also recognized net credit impairment losses of \$1.1 million in 2009 related to the determination that our available-for-sale ARS were other-than-temporarily impaired. Other gain (loss), net for 2009 included \$3.8 million loss due to a decrease in the fair value of the Put Rights offset by a \$4.6 million unrealized holding gain related to ARS trading securities. Additionally, we recorded \$1.7 million of unrealized and realized losses due to foreign currency exchange re-measurement and \$0.4 million gain on asset sales in 2009. Other gain (loss), net for 2008 included \$1.1 million gain on asset sales, and a gross unrealized loss of \$16.8 million related to our ARS trading securities offset by a gain of \$15.9 million related to the associated Put Rights. Additionally, other gain (loss), net reflected \$0.6 million loss from foreign exchange re-measurement and \$0.1 million net loss from sale of investments.

*Income Tax Provision (Benefit)*

During 2009, we recognized a tax benefit of approximately \$2.1 million for a reversal of the 2008 federal and state tax provision, following a favorable ruling by the Internal Revenue Service in the third quarter of 2009. Exclusive of this one-time benefit in 2009, we recognized income tax expense of approximately \$0.3 million in each of fiscal years 2010 and 2009, on pre-tax book losses of \$27.6 million and \$88.5 million, respectively. Exclusive of the one-time benefit mentioned above, the resulting effective tax rates of 1.1% and 0.4% for 2010 and 2009, respectively, differs from the expected statutory rate of 35% based upon unbenefited U.S. losses, non-deductible stock compensation charges and foreign taxes provided on foreign subsidiary earnings, offset by the benefit related to refundable research and development tax credits in 2009. This compares to an effective tax rate of

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approximately 3.3% for 2008, which reflects tax benefits arising from the release of certain valuation allowances on domestic tax attribute carryforwards which was partially offset by the impact of certain non-deductible stock compensation charges, federal alternative minimum tax and state income taxes.

As of December 25, 2010, we recorded a full valuation allowance against our net deferred tax assets based upon our cumulative loss incurred since inception. Realization of deferred tax assets is dependent upon future taxable earnings, if any, the timing and amount of which are uncertain. Accordingly, the net deferred tax assets were fully offset by a valuation allowance. As of December 25, 2010, we had net operating loss carryforwards available to offset future taxable income for federal income tax purposes of approximately \$255.8 million, which expire beginning in 2021 if not utilized. As of December 25, 2010, we also had net operating loss carryforwards available to offset future taxable income for state income tax purposes of approximately \$237.6 million, which expire beginning in 2013, if not utilized. The amount of net operating loss carryforwards noted above and related to excess stock option deductions is approximately \$35.9 million for federal tax purposes. When the excess stock option deductions are used to offset future taxable income, these estimated tax benefits of approximately \$13.7 million will result in a credit to stockholders' equity. Additionally, as of December 25, 2010, we had federal and California research and development tax credits available to reduce future income tax expense of approximately \$18.3 million and \$13.6 million, respectively. The federal research credits will begin to expire in the year 2021 if not utilized, while the California research credits have no expiration date.

Utilization of these net operating losses and tax credit carryforwards will be subject to an annual limitation due to provisions of the Internal Revenue Code of 1986, as amended, that are applicable if we experience an ownership change that may occur, for example, by a change in significant stockholder allocation or equity structure. Based upon our analysis performed, we have determined that an ownership change has occurred, however, the resulting limitation is not significant enough to cause our tax loss and credit carryforwards to expire unutilized.

In determining future taxable income, we make assumptions to forecast federal, state and international operating income, the reversal of temporary differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with our income forecasts used to manage our business. We intend to maintain the remaining valuation allowance until sufficient further positive evidence exists to support a reversal of, or decrease, in the existing valuation allowance.

**Liquidity and Capital Resources**

|                                      | December 25,<br>2010 | Years Ended<br>December 26,<br>2009<br>(In thousands) | December 27,<br>2008 |
|--------------------------------------|----------------------|---|----------------------|
| Net cash flow provided by (used in): |                      |   |                      |
| Operating activities                 | \$ 30,537            | \$ (32,646)   | \$ 19,918            |
| Investing activities                 | \$ (45,722)          | \$ (33,347)   | \$ 44,205            |
| Financing activities                 | \$ 18,985            | \$ 8,944  | \$ 11,701            |

|  | December 25,<br>2010 | Years Ended<br>December 26,<br>2009<br>(In thousands) |
|--|----------------------|---|
| Cash and cash equivalents                | \$ 113,649           | \$ 109,859  |
| Short-term and long-term investments     | 177,966              | 161,605   |
| Short-term and long-term restricted cash | 4,091                | 4,013   |
|  | \$ 295,706           | \$ 275,477  |

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Cash, cash equivalents, short-term and long-term investments and short-term and long-term restricted cash consist generally of highly liquid investments in certificates of deposits, money market funds, commercial paper, corporate bonds, U.S. agency notes and U.S. treasuries. Long-term investments include \$8.9 million (par value) of available-for-sale ARS which have contractual maturity terms of up to 35 years. No agreement has been reached to sell these ARS back to the original broker or on the open market and it is therefore unclear when these securities will become liquid and whether we can recover their full par value. The restricted cash balance amounts are pledged as collateral for certain stand-by and commercial letters of credit.

*Operating Activities*

Net cash provided by operating activities during 2010 was \$30.5 million as compared to net cash usage of \$32.7 million for 2009 and net cash provided by operating activities of \$19.9 million for 2008. Cash flow from operating activities consists of net income (loss), adjusted for non-cash charges, plus or minus working capital changes. Our working capital requirements can fluctuate significantly depending on the timing of deployments and the acceptance, billing and payment terms on those deployments. Additionally, our ability to manage inventory turns and our ability to negotiate favorable payment terms with our vendors may also impact our working capital requirements.

Net loss for 2010 was \$27.9 million, which included non-cash charges of \$69.2 million, compared to a net loss of \$86.6 million in 2009, including non-cash charges of \$55.0 million. This improvement in operating results was the key driver for the improvement in cash flows for 2010. Net cash used to fund working capital was \$10.8 million for 2010 primarily due to an increase in inventory of \$13.1 million and an increase in accounts receivable of \$6.8 million, offset by an increase in accrued liabilities of \$9.2 million. We increased our inventory levels in early 2010 in response to industry supply chain constraints and expected increased customer demand for our products. However, revenues in the fourth quarter were lower than expected resulting in higher inventory levels exiting 2010. Accounts receivable increased primarily reflecting invoicing trends that were weighted towards the end of the period. Accrued liabilities and other expenses increased due to the timing and level of compensation related payments.

Net cash used to fund working capital was \$1.0 million for 2009. Accrued liabilities increased by \$19.0 million primarily due to increases in compensation accruals of \$5.8 million related to timing of payroll payments and an increase in management bonuses and sales commissions at the end of 2009. In addition, included in the increase in accrued liabilities was a \$6.9 million increase in deferred tax liabilities which was offset by a corresponding increase in long-term deferred tax assets included in other non-current assets in our consolidated balance sheet. The remainder of the increase in accrued liabilities related to accruals for outside services incurred at the end of the year. These favorable changes in working capital were offset by an increase in inventories of \$8.6 million related to increased levels of inventory awaiting customer acceptance at customer sites and increased service depot inventory required to support new service contracts sold during the year. In addition, deferred inventory costs increased by \$6.2 million primarily due to a number of sales contracts where the earnings process was not complete at the end of 2009.

Net income for 2008 was \$78.8 million, which included non-cash charges of \$37.7 million. However, this included the recognition of \$165.8 million of deferred revenue and \$78.4 million of associated deferred inventory costs related to prior period sales. See the Overview section above for more information. Net cash used to fund working capital was \$96.6 million. This reflected the reduction of deferred revenue of \$152.0 million offset by a reduction in deferred inventory costs of \$76.5 million. Accounts receivable increased by \$31.8 million primarily due to delays in customer payments and a number of customers deciding not to take early pay discounts in the period. This was offset by an

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increase in accounts payable of \$16.8 million reflecting longer payment terms received from key suppliers at the end of the year. Accrued liabilities and other expenses increased by \$3.4 million due to the timing of payments made during the period.

*Investing Activities*

Net cash used in investing activities in 2010 was \$45.7 million primarily reflecting a net usage of cash of \$20.8 million from purchases, net of maturities and calls of investments which also included proceeds of \$24.5 million related to our exercise of the Put Rights associated with our UBS Financial Services, Inc. ( UBS ) ARS. Additionally, we purchased \$20.7 million of capital expenditures during the year and we made a \$4.5 million cost-method investment in the second quarter of 2010. During 2009, net cash used in investing activities was \$33.3 million primarily due to the purchase of available-for-sale investments of \$163.9 million and additions to property, plant and equipment for the period of \$15.4 million. This was offset by proceeds of \$144.8 million from maturities and calls of investments, \$1.5 million of proceeds from sales of available-for-sale investments during the period and \$1.1 million change in restricted cash. During 2008, net cash provided by investing activities was \$44.2 million, primarily consisting of net proceeds from the purchase, maturity and sale of investments in the period of \$65.5 million, reflecting the transfer of funds from corporate bonds, agency notes and commercial paper to money market funds during the period. This was offset by additions to property, plant and equipment for the period of \$22.9 million.

*Financing Activities*

Net proceeds from financing activities in 2010 were \$19.0 million primarily related to \$19.3 million in proceeds from the issuance of common stock under our Employee Stock Purchase Plan ( ESPP ) and other equity plans. This was offset by \$0.3 million related to payments for purchase of assets under a financing arrangement. Net proceeds from financing activities in 2009 were \$8.9 million primarily due to \$9.3 million in proceeds from the issuance of common stock under our ESPP and other equity plans partially offset by \$0.2 million reduction of tax benefit from stock option transactions. Net proceeds from financing activities in 2008 were \$11.7 million due to \$11.5 million in proceeds from the issuance of common stock under our ESPP and other equity plans and \$0.2 million related to excess tax benefit from stock option transactions.

*Auction Rate Securities*

As of December 25, 2010, we held \$8.9 million (par value) of available-for-sale ARS with two issuers, one of which is AAA rated and the other of which is A3 rated. During the second quarter of 2009, we determined that we did not intend to sell these securities and did not believe that it was more likely than not that we would be required to sell the securities before recovery of their par value. However, given that the present value of the expected cash flows for these securities was below their par value, as of June 27, 2009, an initial other-than-temporary impairment ( OTTI ) of \$2.7 million, equal to the difference between the fair value and the par value had occurred. During 2010, \$0.8 million of these ARS (par value) were called at par value.

Failed auctions resulted in a lack of liquidity in the available-for-sale ARS but do not affect the underlying collateral of the securities. We do not anticipate that any potential lack of liquidity in our available-for-sale ARS, even for an extended period of time, will affect our ability to finance our operations, including our continued investments in research and development and planned capital expenditures. We continue to monitor efforts by the financial markets to find alternative means for restoring the liquidity of these investments. Our available-for-sale ARS investments are classified as non-current assets until we have better visibility as to when their liquidity will be restored.

**Table of Contents***Liquidity*

At December 25, 2010, we held \$8.9 million (par value) of available-for-sale ARS which have contractual maturity terms of up to 35 years and it is not clear when we will be able to liquidate these investments.

In the next twelve months, capital expenditures are expected to be approximately \$40 million, primarily for product development and manufacturing expansion related to new products. In addition, we may experience an increase in working capital requirements as we complete future product transitions. We believe that our current cash and cash equivalents and investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least twelve months. If these sources of cash are insufficient to satisfy our liquidity requirements beyond 12 months, we may require additional capital from equity or debt financings to fund our operations, to respond to competitive pressures or strategic opportunities, or otherwise. We may not be able to secure timely additional financing on favorable terms, or at all. The terms of any additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer dilution in their percentage ownership of us, and any new securities we issue could have rights, preferences and privileges senior to those of holders of our common stock.

**Contractual Obligations**

The following is a summary of our contractual obligations as of December 25, 2010:

|   | Total            | Payments Due by Period |                 |                 | More than<br>5 years |
|---|------------------|------------------------|-----------------|-----------------|----------------------|
|   |                  | Less than<br>1 year    | 1 - 3<br>years  | 3 - 5<br>years  |                      |
| Purchase obligations <sup>(1)</sup>                 | \$ 41,714        | \$ 41,714              | \$              | \$              | \$                   |
| Operating leases                                    | 32,928           | 4,243                  | 7,622           | 6,627           | 14,436               |
| <b>Total contractual obligations <sup>(2)</sup></b> | <b>\$ 74,642</b> | <b>\$ 45,957</b>       | <b>\$ 7,622</b> | <b>\$ 6,627</b> | <b>\$ 14,436</b>     |

<sup>(1)</sup> We have service agreements with our major production suppliers under which we are committed to purchase certain parts.

<sup>(2)</sup> Tax liabilities of \$0.8 million related to uncertain tax positions are not included in the table because we are unable to determine the timing of settlement if any, of these future payments with a reasonably reliable estimate.

We had \$4.0 million of standby letters of credit outstanding as of December 25, 2010. These consisted of \$1.7 million related to a customer proposal guarantee, \$1.3 million related to a value added tax license and \$1.0 million related to property leases. We had \$4.0 million of standby letters of credit outstanding as of December 26, 2009. These consisted of \$1.5 million related to a customer proposal guarantee, \$1.5 million related to a value added tax license and \$1.0 million related to property leases.

**Off-Balance Sheet Arrangements**

As of December 25, 2010, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.

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### **Critical Accounting Policies and Estimates**

Our consolidated financial statements are prepared in accordance with United States generally accepted accounting principles, or GAAP. These accounting principles require us to make certain estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the consolidated financial statements, as well as the reported amounts of revenue and expenses during the periods presented. Significant estimates and assumptions made by management include revenue recognition, stock-based compensation, inventory valuation, allowances for doubtful accounts, accrued warranty, fair value measurement of investments, cash and cash equivalents, short-term and long-term investments, other-than-temporary impairments and accounting for income taxes. By their nature, these estimates and judgments are subject to an inherent degree of uncertainty. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that these estimates and judgments are made. To the extent there are material differences between these estimates and actual results, our consolidated financial statements will be affected.

#### *Revenue Recognition*

In October 2009, the FASB amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product's essential functionality from the scope of industry specific software revenue recognition guidance. In October 2009, the FASB also amended the accounting standards for multiple deliverable revenue arrangements to:

provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

require an entity to allocate revenue in an arrangement using ESP of deliverables if a vendor does not have VSOE of selling price or TPE of selling price; and

eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price.

We elected to early adopt this accounting guidance at the beginning of our first quarter of 2010 on a prospective basis for applicable transactions entered into or materially modified after December 26, 2009.

In connection with our adoption of these standards, we re-evaluated the appropriate revenue recognition treatment of our products and determined that the majority of our products, which have both software and non-software components that function together to deliver the product's essential functionality, are scoped out of the previous software specific revenue recognition guidance.

Substantially all of our product sales are sold in combination with software support services comprised of either software warranty or software subscription services. We also periodically sell training, installation and deployment services, spares management and on-site hardware replacement services with our product sales. Training services include the right to a specified number of training classes and installation and deployment services may include customer site assessments, equipment installation and testing. Training and installation and deployment services are generally delivered over a 90-120 day period. Software warranty provides customers with maintenance releases and patches during the warranty support period. Software subscription also includes maintenance releases and patches and provides customers with rights to receive unspecified software product upgrades released during the support period. These support services are generally delivered over a one-year period. Spares management and on-site hardware replacement services include the replacement of defective units at customer sites in accordance with specified service level agreements and are generally delivered over a one-year period.

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We recognize product revenue when all of the following have occurred: (1) we have entered into a legally binding arrangement with the customer; (2) delivery has occurred, which is when product title and risk of loss have transferred to the customer; (3) customer payment is deemed fixed and determinable; and (4) collectability is reasonably assured.

We allocate revenue to each element in our multiple-element arrangements based upon their relative selling prices. We determine the selling price for each deliverable based on a selling price hierarchy. The selling price for a deliverable is based on its VSOE if available, TPE if VSOE is not available, or ESP if neither VSOE nor TPE is available. Revenue allocated to each element is then recognized when the basic revenue recognition criteria for that element has been met.

VSOE of selling price is used in the selling price allocation in all instances where it exists. VSOE of selling price for products and services is determined when a substantial majority of the selling prices fall within a reasonable range when sold separately. In certain instances, we are not able to establish VSOE for all deliverables in an arrangement with multiple elements. This mainly occurs where insufficient standalone sales transactions have occurred or where pricing for that element has not been consistent.

TPE of selling price can be established by evaluating largely interchangeable competitor products or services in standalone sales to similarly situated customers. As our products contain a significant element of proprietary technology and the solution offered differs substantially from that of competitors, it is typically difficult to obtain the reliable standalone competitive pricing necessary to establish TPE.

ESP represents the best estimate of the price at which we would transact a sale if the product or service was sold on a standalone basis. We determine ESP for a product or service by considering multiple factors including, but not limited to customer type, geography, market conditions, competitive landscape, gross margin objectives and pricing practices. The determination of ESP is made through formal approval by our management, taking into consideration the overall go-to-market pricing strategy.

As our go-to-market strategies evolve, we may modify our pricing practices in the future, which could result in changes in selling prices, including both VSOE and ESP. As a result, our future revenue recognition for multiple element arrangements could differ materially from that recorded in the current period. We regularly review VSOE, TPE, and ESP and maintain internal controls over the establishment and update of these inputs.

We limit the amount of revenue recognition for delivered elements to the amount that is not contingent on the future delivery of products or services, future performance obligations or subject to customer-specified return or refund privileges. We evaluate each deliverable in an arrangement to determine whether they represent separate units of accounting. Under the new revenue recognition guidance, more of our products and services qualify as separate units of accounting based on the selling price hierarchy for determination of relative selling price.

Our adoption of the new accounting guidance for revenue recognition resulted in an increase in total revenues of \$31.0 million, from \$423.4 million to \$454.4 million in the year ended December 25, 2010. In addition, the new accounting guidance for revenue recognition resulted in a decrease in net loss of \$12.3 million, from a net loss of \$40.2 million to net loss of \$27.9 million in the year ended December 25, 2010.

These increases in revenues are primarily related to an increase in net product revenues from bundled arrangements which would have previously been deferred until all deliverables had been completed or recognized ratably over the longest undelivered service period as VSOE of selling price had not been established for the undelivered element. In addition, we recognized product revenue on a

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number of purchase orders which had been partially shipped at the end of 2010. The impact of the new revenue recognition guidance in future periods will depend on the number of bundled arrangements entered into by us with undelivered elements for which VSOE of selling price had not been established under the existing software revenue recognition guidance.

We have a limited number of software offerings which are not required to deliver the tangible product's essential functionality and can be sold separately. Revenue from sales of these software products and related post-contract support will continue to be accounted for under software revenue recognition rules. Our multiple-element arrangements may therefore have a software deliverable that is subject to the existing software revenue recognition guidance. The revenue for these multiple-element arrangements is allocated to the software deliverable and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the hierarchy in the new revenue recognition accounting guidance. Revenues related to these software offerings are not expected to be material.

Revenue arrangements entered into prior to the first quarter of 2010 continue to be accounted for under our previous revenue recognition policy.

Services revenue includes software subscription services, training, installation and deployment services, spares management, on-site hardware replacement services and extended hardware warranty services. Revenue from software subscription, spares management, on-site hardware replacement services and extended hardware warranty contracts is deferred and is recognized ratably over the contractual support period, which is generally one year. Revenue related to training and installation and deployment services is recognized as the services are completed.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. In addition, shipping documents and customer acceptances, when applicable, are used to verify delivery and transfer of title. Revenue is recognized only when title and risk of loss pass to customers. In instances where acceptance of the product occurs upon formal written acceptance, revenue is deferred until such written acceptance has been received. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction. Payment terms to customers generally range from net 30 to 120 days from invoice, which are considered to be standard payment terms. However, payment terms greater than 120 days but less than or equal to one year from invoice may be considered standard if payment is supported by an irrevocable commercial letter of credit ( LOC ) issued by a creditworthy bank or the LOC has been accepted and confirmed by a creditworthy bank. In the event payment terms are provided that differ from our standard business practices, the fees are deemed to not be fixed or determinable and, therefore, revenue is not recognized until the fees become fixed or determinable which we believe is when they are legally due and payable. We assess our ability to collect from our customers based primarily on the creditworthiness and past payment history of the customer.

For sales to resellers, the same revenue recognition criteria apply. It is our practice to identify an end-user prior to shipment to a reseller. We do not offer rights of return or price protection to our resellers.

Shipping charges billed to customers are included in product revenue and related shipping costs are included in product cost. We report revenue net of any required taxes collected from customers and remitted to government authorities, with the collected taxes recorded as current liabilities until remitted to the relevant government authority.

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*Stock-Based Compensation*

Stock-based compensation cost is measured at the grant date based on the fair value of the award, and is recognized as expense over the requisite service period (generally the vesting period) under the straight-line amortization method.

We estimate the fair value of the stock options granted using the Black-Scholes option pricing formula and a single option award approach. For new-hire grants, options typically vest with respect to 25% of the shares one year after the option's vesting commencement date and the remainder ratably on a monthly basis over three years, commencing one year after the vesting commencement date. For annual refresh grants, options typically vest ratably on a monthly basis over three, four or five years. In the third quarter of 2009, we granted retention options to executives which vest ratably on a monthly basis over two years. We make a number of estimates and assumptions in determining stock-based compensation related to options including the following:

The expected forfeiture rate is estimated based on our historical forfeiture data and compensation costs are recognized only for those equity awards expected to vest. The estimation of the forfeiture rate requires judgment, and to the extent actual forfeitures differ from expectations, changes in estimate will be recorded as an adjustment in the period when such estimates are revised. Actual results may differ substantially from the estimates.

In October 2009, we started using our own historical data to estimate the expected term. Previously, we elected to use the simplified method to estimate the expected term due to increased liquidity of the underlying options in the post-IPO era as compared to our historical grants.

Expected volatility of our stock is based on the weighted-average implied and historical volatility of Infinera and our peer group. The peer group is comprised of similar companies in the same industrial sector. As we gain more historical volatility data, the weighting of our own data in the expected volatility calculation associated with options will gradually increase.

We estimate the fair value of the rights to acquire stock under our ESPP using the Black-Scholes option pricing formula. Our ESPP typically provides for consecutive six-month offering periods, except for the first such offering period which commenced on June 7, 2007 and ended on February 15, 2008. We use our own historical volatility data in the valuation of ESPP shares.

We accounted for the fair value of restricted stock units ( RSUs ) using the closing market price of our common stock on the date of grant. For new-hire grants, RSUs typically vest ratably on an annual basis over four years. For annual refresh grants, RSUs typically vest ratably on an annual basis over three, four or five years. In 2009, we granted retention RSUs to executives which cliff vest after an approximate two-year period and to other employees which vest ratably on a monthly basis over one or two years.

We estimate the fair value of performance share units ( PSUs ) granted using a Monte Carlo simulation model. We granted PSUs in 2009 as part of our annual refresh grant process. The PSUs entitle our executive officers and members of our board of directors to receive a number of shares of our common stock based on our stock price performance over a three-year or four-year period as compared to the NASDAQ Composite Index ( NASDAQ ) for the same period. The PSUs cliff vest after three or four years and the number of shares to be issued upon vesting ranges from 0.5 to 2.0 times the number of PSUs granted depending on the relative performance of our common stock price compared to NASDAQ. This performance metric is classified as a market condition.

The Monte Carlo simulation model is based on a discounted cash flow approach, with the simulation of a large number of possible Company and NASDAQ stock price outcomes. The use of the Monte Carlo simulation model requires the input of a number of assumptions including expected

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volatility of our stock price, expected volatility of NASDAQ, correlation between changes in our stock price and changes in NASDAQ, risk-free interest rate, and expected dividends. Expected volatility of our stock is based on the weighted-average implied and historical volatility of our peer group in the industry in which we do business. Expected volatility of NASDAQ is based on the historical and implied data. Correlation is based on the historical relationship between our peer group stock price and NASDAQ composite average. The risk-free interest rate is based upon the treasury zero-coupon yield appropriate for the term of the PSU as of the grant date. The expected dividend yield is zero for us as we do not expect to pay dividends in the future. The expected dividend yield for NASDAQ is the annual dividend yield expressed as a percentage of the composite average of NASDAQ on the grant date.

*Inventory Valuation*

Inventories, net consist of raw materials, work-in-process and finished goods and are stated at standard cost adjusted to approximate the lower of actual cost (first-in, first-out method) or market. Market value is based upon an estimated selling price reduced by the estimated cost of disposal. The determination of market value involves numerous judgments including estimated average selling prices based upon recent sales volumes, industry trends, existing customer orders, current contract price, future demand and pricing and technological obsolescence of our products.

Inventory that is obsolete or in excess of our forecasted demand or is anticipated to be sold at a loss is written down to its estimated net realizable value based on historical usage and expected demand. As of December 25, 2010 and December 26, 2009, our inventory value had been reduced by \$5.2 million and \$2.7 million, respectively, for excess and obsolescence. In valuing our deferred inventory costs, we considered whether the utility of the products delivered or expected to be delivered at less than cost, primarily comprised of common equipment, had declined. We concluded that, in the instances where the utility of the products delivered or expected to be delivered was less than cost, it was appropriate to value the inventory costs and deferred inventory costs at cost or market, whichever is lower, thereby recognizing the cost of the reduction in utility in the period in which the reduction occurred or can be reasonably estimated. We have, therefore, recognized inventory write-downs as necessary in each period in order to reflect common equipment inventory at the lower of cost or market ( LCM ). As of December 25, 2010 and December 26, 2009, our inventory value had been reduced by \$2.5 million and \$2.6 million, respectively, for LCM adjustments. In addition, our deferred inventory costs were reduced by \$1.0 million for net realizable value adjustments as of December 25, 2010.

We considered whether we should accrue losses on firm purchase commitments related to inventory items. Given that the expected selling price of common equipment in the future remains below-cost, we have also recorded losses on these firm purchase commitments in the period in which the commitment is made. When the inventory parts related to these firm purchase commitments are received, that inventory is recorded at the purchase price less the accrual for the loss on the purchase commitment.

If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

*Accounts Receivable and Allowances for Doubtful Accounts*

Accounts receivable consist of trade receivables recorded upon recognition of revenue for product and services revenues, reduced by reserves for estimated bad debts and returns. Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Credit is extended based on evaluation of the customer's financial condition. We record our accounts receivable at the invoiced value. We make judgments as to our ability to collect outstanding receivables and provide allowances for a portion of receivables when collection becomes doubtful. Provisions are made based upon a

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review of all significant outstanding invoices. At December 25, 2010 and December 26, 2009, our allowance for doubtful accounts was zero. In 2009, we recorded a recovery of doubtful accounts for \$1.7 million.

### *Accrued Warranty*

We warrant that our products will operate substantially in conformity with product specifications. Upon delivery of our products, we provide for the estimated cost to repair or replace products or the related components that may be returned under warranty. Our hardware warranty periods range from one to five years from date of acceptance for hardware and 90 days to 60 months for software warranty. The hardware warranty accrual is based on actual historical returns experience and the application of those historical return rates to our in-warranty installed base. We periodically assess the adequacy of our recorded warranty liabilities and adjust the amounts as necessary. We have software warranty support obligations to a small number of our customers and the costs associated with providing these software warranties have been immaterial to our consolidated financial statements to date.

### *Cash, Cash Equivalents and Short-term and Long-term Investments*

We consider all highly liquid instruments with an original maturity at the date of purchase of 90 days or less to be cash equivalents. These instruments may include cash, money market funds and commercial paper. We maintain our cash in bank deposit accounts which, at times, may exceed federally insured limits. We have not experienced any losses in such accounts.

Marketable securities consist of certificates of deposit, commercial paper, corporate bonds, U.S. agency notes and ARS and Put Rights. We consider all debt instruments with original maturities at the date of purchase greater than 90 days and remaining time to maturity of one year or less to be short-term investments. We classify debt instruments with remaining maturities greater than one year as long-term investments, unless we intend to settle our holdings within one year or less and in such case it is considered to be short-term investments. We determine the appropriate classification of our marketable securities at the time of purchase and re-evaluate such designations as of each balance sheet date.

Available-for-sale investments are stated at fair market value with unrealized gains and losses recorded in Accumulated other comprehensive income (loss) in the accompanying consolidated balance sheets and Other income (expense), net in the accompanying consolidated statements of operations. We evaluate our available-for-sale marketable debt securities for other-than-temporary impairments as discussed below and record any credit loss portion in Other income (expense), net in our consolidated statements of operations. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity and for any credit losses incurred on these securities. Gains and losses are recognized when realized in the consolidated statements of operations under the specific identification method. Trading securities investments are stated at fair value with unrealized gains and losses reported in Other income (expense), net in the consolidated statements of operations, consisting of ARS trading securities and related Put Rights.

### *Fair Value Measurement of Investments*

The fair value of our financial instruments reflects the estimates of amounts that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The fair value estimates presented in our consolidated financial statements are based on information available to us as of December 25, 2010.

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We apply a fair value hierarchy based on three levels of inputs as follows:

- Level I            Quoted prices in active markets for identical assets or liabilities.
- Level II          Inputs other than Level I that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. In addition, Level II could include unobservable inputs that are not significant to the fair value of the assets or liabilities.
- Level III          Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

We measure our cash equivalents, debt securities and Put Rights at fair value and classify our securities in accordance with a fair value hierarchy. Our money market funds and U.S. treasuries are classified within Level I of the fair value hierarchy and are valued based on quoted prices in active markets for identical securities.

We classify our certificates of deposit, commercial paper, corporate bonds and U.S. agency notes within Level II of the fair value hierarchy as follows:

*Certificates of Deposit*

We review market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day. In the absence of any observable market transactions for a particular security, the fair market value at period end would be equal to the par value. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data, and result in the classification of these securities as Level II of the fair value hierarchy.

*Commercial Paper*

We review market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day and then follows a revised accretion schedule to determine the fair market value at period end. In the absence of any observable market transactions for a particular security, the fair market value at period end is derived by accreting from the last observable market price. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data accreted mathematically to par, and result in the classification of these securities as Level II of the fair value hierarchy.

*Corporate Bonds*

We review trading activity and pricing for each of the corporate bond securities in our portfolio as of the measurement date and determine if pricing data of sufficient frequency and volume in an active market exists in order to support Level I classification of these securities. Since sufficient quoted pricing for identical securities is not available, we obtain market pricing and other observable market inputs for similar securities from a number of industry standard data providers. In instances where multiple prices exist for similar securities, these prices are used as inputs into a distribution-curve to determine the fair market value at period end. As a result, we classify our corporate bonds as Level II of the fair value hierarchy.

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### *U.S. Agency Notes*

We review trading activity and pricing for our U.S. agency notes as of the measurement date. When sufficient quoted pricing for identical securities is not available, we use market pricing and other observable market inputs for similar securities obtained from a number of industry standard data providers. These inputs represent quoted prices for similar assets in active markets or these inputs have been derived from observable market data, and result in the classification of these securities as Level II of the fair value hierarchy.

We classify our ARS and related Put Rights within Level III of the fair value hierarchy as follows:

### *Auction Rate Securities*

Our ARS are classified within Level III because they are valued, in part, by using inputs that are unobservable in the market and are significant to the valuation. The recent uncertainties in the credit markets have affected all of our ARS and auctions for these securities have failed to settle on their respective settlement dates. In light of these developments, to determine the fair value for its ARS, we used a combination of the market approach and income approach. The market approach uses pricing based on transactions in an inactive secondary market for similar or comparable securities. In addition, we performed our own discounted cash flow analysis. Management determined that it was most appropriate to value the ARS using the market approach and income approach equally given the facts and circumstances as of December 25, 2010, and therefore incorporated both valuations in the our fair value measurement.

The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of our ARS, as of December 25, 2010, are as follows:

#### *Contractual cash flow*

The model assumed that the principal amount or par value for these securities will be repaid at the end of the estimated workout period. In addition, future interest payments were estimated as described in each individual prospectus and based on the then current U.S. Treasury Bill ( T-Bill ) rate adjusted for a failed auction premium of 150 basis points ( bps ) for our A3 rated securities and 150 bps to 350 bps for its AAA rated securities.

#### *ARS discount rate*

The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the estimated workout period of the securities. As of the measurement date, these rates were then adjusted by a factor that ranged from 235 bps to 410 bps, representing an estimate of the market student loan spread and a discount factor to reflect the lack of liquidity and credit risk associated with these securities. We held \$5.0 million par value of AAA rated securities and \$3.9 million par value of ARS that were downgraded to A3 rating during 2009. Our ARS are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. The discount rate does, however, include a discount factor to reflect the issuer's credit risk and its potential inability to perform its obligations under the terms of the ARS agreements. Our valuation analysis indicates that the estimated credit risk element included in the discount rate was 210 bps for A3 rated securities and 320 bps for AAA rated securities.

#### *Estimated maturity*

Our estimated the workout period of our ARS as the weighted-average life of the underlying trust loan portfolio where this information was available from servicing and other trust reports. In a small number of instances where this information was not available, we used the weighted-average life of the loan portfolio of a similar trust. The estimated time to maturity of the securities as of the measurement date was 15.2 years and 17.2 years.

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*Put Rights*

Put Rights associated with our ARS holdings with UBS were classified as Level III because they were valued, in part, by using inputs that were unobservable in the market and were significant to the valuation. The fair value of the Put Rights was equal to the difference between the fair value of the UBS ARS calculated as described above and their value including the impact of the Put Rights. We performed our own discounted cash flow analysis to calculate the fair value of the UBS ARS including the impact of the Put Rights.

On June 30, 2010, we elected to exercise the Put Rights associated with the \$24.5 million (par value) of the ARS covered by the UBS settlement and received cash proceeds from the sale of these securities to UBS. See Note 3, Fair Value Measurements and Other-Than-Temporary Impairments to the Consolidated Financial Statements for more information.

The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of the UBS ARS including the impact of the Put Rights as of June 26, 2010 were as follows:

*Contractual cash flow*

The model assumed that the principal amount or par value for the ARS would be repaid on June 30, 2010, based on our intent to exercise our Put Rights and sell these securities to UBS on that date. In addition, future interest payments were estimated as described in each individual prospectus and based on the then current T-Bill rate as adjusted for a failed auction premium of 120 bps for all of our ARS, except for 150 bps for A3 rated securities.

*Discount rate*

The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the expected sale date of these securities. As of the measurement date, this rate was adjusted by approximately 50 bps which represented a discount factor to reflect UBS credit risk and UBS potential inability to perform its obligations under the Put Rights agreement.

*Other-Than-Temporary Impairments*

We review our available-for-sale marketable debt securities on a regular basis to evaluate whether or not a security has experienced an other-than-temporary decline in fair value. If a debt security's market value is below amortized cost and we either intend to sell the security or it is more likely than not that we will be required to sell the security before our anticipated recovery, we record an OTTI charge to earnings for the entire amount of the impairment.

When we do not intend to sell an impaired security and it is not more likely than not that we will be required to sell prior to recovery of its amortized cost basis, we separate the OTTI into credit and non-credit loss portions. The amount representing the credit loss is recognized in Other income (expense), net, and the amount related to all other factors is recognized in Accumulated other comprehensive loss.

In determining if a credit loss has occurred, it is our policy to isolate the credit loss related portion of the discount rate used to derive the fair market value of the security and apply this to the expected cash flows in order to determine the portion of the OTTI that is credit loss related. This credit related portion of the discount rate is based on the financial condition of the issuer, changes in rating agency credit ratings for the security or increases in credit related yield spreads on similar securities offered by the same issuer.

Once a credit impairment loss has been recognized in our consolidated statements of operations, the amortized cost basis of that available-for-sale security is reduced by the amount of the credit

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impairment loss, resulting in a new cost basis for the security. Any non-credit related unrealized gains and losses are recorded in Accumulated other comprehensive loss in our consolidated balance sheets. We will continue to monitor the security's credit rating and credit spread and will accrete any reduction in the credit impairment loss to interest income over the expected life of the security.

### ***Derivative Instruments***

As discussed in Note 5, *Derivative Instruments*, to the Notes to Consolidated Financial Statements, we mainly hold non-speculative foreign exchange forward contracts to hedge certain foreign currency exchange exposures. We estimate the fair values of derivatives based on quoted market prices or pricing models using current market rates. Where applicable, these models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, credit risk, foreign exchange rates, and forward and spot prices for currencies. As a result, we classify our derivative instruments as Level II of the fair value hierarchy.

### ***Accounting for Income Taxes***

As part of the process of preparing our consolidated financial statements, we are required to estimate our taxes in each of the jurisdictions in which we operate. We estimate actual current tax expense together with assessing temporary differences resulting from different treatment of items, such as accruals and allowances not currently deductible for tax purposes. These differences result in deferred tax assets and liabilities, which are included in our consolidated balance sheets. In general, deferred tax assets represent future tax benefits to be received when certain expenses previously recognized in our consolidated statements of operations become deductible expenses under applicable income tax laws or loss or credit carryforwards are utilized. Accordingly, realization of our deferred tax assets is dependent on future taxable income within the respective jurisdictions against which these deductions, losses and credits can be utilized within the applicable future periods.

We must assess the likelihood that some portion or all of our deferred tax assets will be recovered from future taxable income within the respective jurisdictions, and to the extent we believe that recovery does not meet the more-likely-than-not standard, we must establish a valuation allowance. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. At December 25, 2010 and December 26, 2009, certain of our domestic net deferred tax assets were fully reserved with a valuation allowance because, based on the available evidence, we believed at that time it was more likely than not that we would not be able to utilize those deferred tax assets in the future. We intend to maintain a valuation allowance until sufficient evidence exists to support the reversal of the valuation allowance. We make estimates and judgments about our future taxable income, by jurisdiction, based on assumptions that are consistent with our plans and estimates. Should the actual amounts differ from our estimates, the amount of our valuation allowance could be materially impacted.

### ***Recent Accounting Pronouncements***

See Note 2, *Significant Accounting Policies*, to the Notes to Consolidated Financial Statements for a full description of recent accounting pronouncements including the respective expected dates of adoptions and effects on us.

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A majority of our revenue, expense and capital purchasing activities are transacted in U.S. dollars. However, we do incur some immaterial operating costs in other currencies. In addition, certain of our sales contracts are priced in Euros and, therefore, a portion of our revenue is subject to foreign currency risks. Our operating expenses and cash flows are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the India Rupee, Chinese Yuan, British pound and the Euro.

The effect of an immediate 10% adverse change in exchange rates on foreign denominated transactions as of December 25, 2010 and December 26, 2009 would result in a loss of approximately \$1.8 million and \$1.3 million, respectively. Beginning in the second quarter of 2009, we established a foreign currency risk management program to help protect against the impact of foreign currency exchange rate movements on our operating results. We enter into foreign currency exchange forward contracts to reduce the impact of foreign currency fluctuations on accounts receivable denominated in currencies other than our functional currency, which is the U.S. dollar. As a result, we do not expect a significant impact to our results from a change in exchange rates on foreign denominated accounts receivable balances in the near-term. Fluctuations in our currency exchange rates could impact our business in the future.

*Interest Rate Sensitivity*

We had cash and cash equivalents, short-term and long-term investments and short-term and long-term restricted cash totaling \$295.7 million and \$275.5 million as of December 25, 2010 and December 26, 2009, respectively. As of December 25, 2010, we invested in certificates of deposit, money market funds, commercial paper, corporate bonds and ARS. The unrestricted cash and cash equivalents are held for working capital purposes. We do not enter into investments for speculative purposes. We believe that we do not have any material exposure to changes in the fair value as a result of changes in interest rates. Declines in interest rates, however, will reduce future investment income. If overall interest rates fell by 10% in 2010 and 2009, our interest income would have declined approximately \$0.1 million and \$0.2 million, respectively, assuming consistent investment levels.

As of December 25, 2010 and December 26, 2009, we had no debt outstanding.

*Auction Rate Securities and Put Rights*

As of December 25, 2010, we held \$8.9 million (par value) of investments comprised of ARS, which are variable-rate debt securities and have a long-term maturity with the interest rate being reset through auctions that are typically held every 7 to 35 days. These securities have historically traded at par value and are callable at par value at the option of the issuer. Interest is typically paid at the end of each auction period or semiannually. Since February 2008, most of the auctions for these ARS have failed and there is no assurance that future auctions will succeed. As a result, our ability to liquidate our investment in the near-term may be limited. These ARS were purchased from a single broker, who to date, has not offered to repurchase these ARS from us. Of these ARS, \$5.0 million and \$3.9 million (par value) are AAA and A3 rated, respectively, and are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. During the year ended December 25, 2010, \$0.8 million of these ARS were called at par value. It is not clear when we will be able to liquidate these investments.

In October 2008, we elected to participate in a rights offering by UBS, which provided us with Put Rights to sell back all of our ARS purchased from UBS at par value of \$65.7 million, at anytime during

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a two-year period beginning June 30, 2010. As of June 26, 2010, \$41.2 million of our ARS trading securities had been called at par value. On June 30, 2010, we elected to exercise the Put Rights and as a result, received net cash proceeds of \$24.5 million, representing a full recovery of par value.

Failed auctions resulted in a lack of liquidity in the available-for-sale ARS but do not affect the underlying collateral of the securities. We do not anticipate that any potential lack of liquidity in our available-for-sale ARS, even for an extended period of time, will affect our ability to finance our operations, including our continued investments in research and development and planned capital expenditures. We continue to monitor efforts by the financial markets to find alternative means for restoring the liquidity of these investments. Our available-for-sale ARS investments are classified as non-current assets until we have better visibility as to when their liquidity will be restored.

See Note 3, Fair Value Measurements and Other-Than-Temporary Impairment, to the Notes to Consolidated Financial Statements for further information.

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**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**  
**INDEX TO CONSOLIDATED FINANCIAL STATEMENTS**

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**Report of Ernst & Young LLP, Independent Registered Public Accounting Firm**

**The Board of Directors and Stockholders**

**Infinera Corporation**

We have audited the accompanying consolidated balance sheets of Infinera Corporation as of December 25, 2010 and December 26, 2009, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 25, 2010. Our audits also included the financial statement schedule listed in the Index at Item 15. These financial statements and schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and schedule based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of Infinera Corporation at December 25, 2010 and December 26, 2009, and the consolidated results of its operations and its cash flows for each of the three years in the period ended December 25, 2010, in conformity with U.S. generally accepted accounting principles. Also, in our opinion, the related financial statement schedule, when considered in relation to the basic financial statements taken as a whole, present fairly in all material respects the information set forth therein.

As discussed in Note 2 to the consolidated financial statements, Infinera Corporation changed its method of accounting for revenue recognition with the adoption of amendments to the Financial Accounting Standards Board Accounting Standards Codification resulting from Accounting Standards Update No. 2009-13, Multiple-Deliverable Arrangements, and Accounting Standards Update No. 2009-14, Certain Revenue Arrangements That Include Software Elements, both adopted effective December 27, 2009.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), Infinera Corporation's internal control over financial reporting as of December 25, 2010, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 1, 2011 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

San Jose, California

March 1, 2011

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**Report of Ernst & Young LLP, Independent Registered Public Accounting Firm**

**The Board of Directors and Stockholders**

**Infinera Corporation**

We have audited Infinera Corporation's internal control over financial reporting as of December 25, 2010, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the "COSO criteria"). Infinera Corporation's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting included in the accompanying Management's Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the company's internal control over financial reporting based on our audit.

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

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

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

In our opinion, Infinera Corporation maintained, in all material respects, effective internal control over financial reporting as of December 25, 2010, based on the COSO criteria.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Infinera Corporation as of December 25, 2010 and December 26, 2009, and the related consolidated statements of operations, stockholders' equity and cash flows for each of the three years in the period ended December 25, 2010 of Infinera Corporation and our report dated March 1, 2011 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP

San Jose, California

March 1, 2011

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**INFINERA CORPORATION**  
**CONSOLIDATED BALANCE SHEETS**

(In thousands, except par values)

|   | December 25,<br>2010 | December 26,<br>2009 |
|---|----------------------|----------------------|
| <b>ASSETS</b>   |                      |                      |
| Current assets:   |                      |                      |
| Cash and cash equivalents   | \$ 113,649           | \$ 109,859           |
| Short-term investments  | 168,013              | 143,350              |
| Short-term restricted cash  | 1,856                | 1,533                |
| Accounts receivable   | 75,931               | 69,483               |
| Other receivables   | 4,420                | 927                  |
| Inventories, net  | 81,893               | 68,872               |
| Deferred inventory costs  | 6,715                | 5,891                |
| Prepaid expenses and other current assets   | 9,118                | 8,313                |
| <b>Total current assets</b>   | <b>461,595</b>       | <b>408,228</b>       |
| Property, plant and equipment, net  | 51,740               | 43,656               |
| Deferred inventory costs, non-current   | 2,512                | 4,438                |
| Long-term investments   | 9,953                | 18,255               |
| Cost-method investment  | 4,500                |                      |
| Long-term restricted cash   | 2,235                | 2,480                |
| Deferred tax asset  | 11,882               | 12,449               |
| Other non-current assets  | 7,108                | 2,439                |
| <b>Total assets</b>   | <b>\$ 551,525</b>    | <b>\$ 491,945</b>    |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>  |                      |                      |
| Current liabilities:  |                      |                      |
| Accounts payable  | \$ 35,658            | \$ 31,129            |
| Accrued expenses  | 19,790               | 13,929               |
| Accrued compensation and related benefits   | 25,098               | 19,248               |
| Accrued warranty  | 5,696                | 6,091                |
| Deferred revenue  | 21,958               | 18,295               |
| Deferred tax liability  | 11,882               | 12,649               |
| <b>Total current liabilities</b>  | <b>120,082</b>       | <b>101,341</b>       |
| Accrued warranty, non-current   | 5,726                | 5,049                |
| Deferred revenue, non-current   | 4,633                | 8,080                |
| Other long-term liabilities   | 10,335               | 8,968                |
| Commitments and contingencies (Note 10)   |                      |                      |
| Stockholders' equity:   |                      |                      |
| Preferred stock, \$0.001 par value  |                      |                      |
| Authorized shares 25,000 and no shares issued and outstanding   |                      |                      |
| Common stock, \$0.001 par value   |                      |                      |
| Authorized shares 500,000 in 2010 and 2009 Issued and outstanding shares 102,492 in 2010 and 96,874 in 2009 | 102                  | 97                   |
| Additional paid-in capital  | 817,200              | 747,580              |
| Accumulated other comprehensive loss  | (1,261)              | (1,810)              |

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|  |            |            |
|--|------------|------------|
| Accumulated deficit                        | (405,292)  | (377,360)  |
| Total stockholders' equity                 | 410,749    | 368,507    |
| Total liabilities and stockholders' equity | \$ 551,525 | \$ 491,945 |

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

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**INFINERA CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share data)

|   | December 25,<br>2010 | Years Ended<br>December 26,<br>2009 | December 27,<br>2008 |
|---|----------------------|-------------------------------------|----------------------|
| <b>Revenue:</b>   |                      |                                     |                      |
| Product   | \$ 401,578           | \$ 276,012                          | \$ 306,808           |
| Ratable product and related support and services                  | 6,155                | 4,231                               | 193,705              |
| Services  | 46,619               | 28,858                              | 18,699               |
| <b>Total revenue</b>  | <b>454,352</b>       | <b>309,101</b>                      | <b>519,212</b>       |
| <b>Cost of revenue:</b>   |                      |                                     |                      |
| Cost of product   | 225,183              | 189,723                             | 184,234              |
| Cost of ratable product and related support and services          | 3,217                | 1,931                               | 91,625               |
| Cost of services  | 19,945               | 12,308                              | 9,798                |
| Restructuring and other costs (credit) related to cost of revenue | (182)                | 3,038                               |                      |
| <b>Total cost of revenue</b>                                      | <b>248,163</b>       | <b>207,000</b>                      | <b>285,657</b>       |
| <b>Gross profit</b>   | <b>206,189</b>       | <b>102,101</b>                      | <b>233,555</b>       |
| <b>Operating expenses:</b>  |                      |                                     |                      |
| Research and development  | 118,518              | 97,288                              | 80,578               |
| Sales and marketing   | 58,103               | 48,391                              | 43,262               |
| General and administrative  | 58,098               | 45,269                              | 36,282               |
| Restructuring and other costs                                     | 159                  | 814                                 |                      |
| <b>Total operating expenses</b>                                   | <b>234,878</b>       | <b>191,762</b>                      | <b>160,122</b>       |
| <b>Income (loss) from operations</b>                              | <b>(28,689)</b>      | <b>(89,661)</b>                     | <b>73,433</b>        |
| <b>Other income (expense), net:</b>                               |                      |                                     |                      |
| Interest income   | 1,390                | 2,688                               | 8,549                |
| Interest expense  |                      |                                     | (3)                  |
| Total other-than-temporary impairment losses                      |                      | (2,747)                             |                      |
| Portion of loss recognized in other comprehensive loss            |                      | 1,653                               |                      |
| <b>Net impairment losses recognized in earnings</b>               |                      | <b>(1,094)</b>                      |                      |
| Other gain (loss), net  | (316)                | (426)                               | (528)                |
| <b>Total other income (expense), net</b>                          | <b>1,074</b>         | <b>1,168</b>                        | <b>8,018</b>         |
| <b>Income (loss) before income taxes</b>                          | <b>(27,615)</b>      | <b>(88,493)</b>                     | <b>81,451</b>        |
| Provision for (benefit from) income taxes                         | 317                  | (1,871)                             | 2,723                |
| <b>Net income (loss)</b>  | <b>\$ (27,932)</b>   | <b>\$ (86,622)</b>                  | <b>\$ 78,728</b>     |
| <b>Net income (loss) per common share:</b>                        |                      |                                     |                      |
| Basic   | \$ (0.28)            | \$ (0.91)                           | \$ 0.85              |
| Diluted   | \$ (0.28)            | \$ (0.91)                           | \$ 0.81              |

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Weighted average shares used in computing net income  
(loss) per common share:

|         |        |        |        |
|---------|--------|--------|--------|
| Basic   | 99,380 | 95,468 | 92,427 |
| Diluted | 99,380 | 95,468 | 97,088 |

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

**Table of Contents****INFINERA CORPORATION****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY**

For the Years Ended December 27, 2008, December 26, 2009 and December 25, 2010

(In thousands, except per share data)

|  | Common Stock |        | Additional<br>Paid-in<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Accumulated<br>Deficit | Total      |
|--|--------------|--------|----------------------------------|---|------------------------|------------|
|  | Shares       | Amount |                                  |   |                        |            |
| Balance at December 29, 2007   | 91,580       | \$ 92  | \$ 663,870                       | \$ 78   | \$ (369,466)           | \$ 294,574 |
| Stock options exercised  | 1,477        | 1      | 3,188                            |   |                        | 3,189      |
| ESPP shares purchased  | 794          | 1      | 8,290                            |   |                        | 8,291      |
| Stock options repurchased  | (20)         |        | (29)                             |   |                        | (29)       |
| Reclassification of options exercised but not vested   |              |        | 1,234                            |   |                        | 1,234      |
| Restricted stock units released  | 101          |        |                                  |   |                        |            |
| Warrants, net exercised  | 231          |        |                                  |   |                        |            |
| Stock-based compensation   |              |        | 22,559                           |   |                        | 22,559     |
| Tax benefit from stock option transactions   |              |        | 593                              |   |                        | 593        |
| Comprehensive income:  |              |        |                                  |   |                        |            |
| Unrealized loss on available-for-sale investments  |              |        |                                  | (2,835)   |                        | (2,835)    |
| Foreign currency translation adjustment  |              |        |                                  | (841)   |                        | (841)      |
| Net income   |              |        |                                  |   | 78,728                 | 78,728     |
| Total comprehensive income   |              |        |                                  |   |                        | 75,052     |
| Balance at December 27, 2008   | 94,163       | \$ 94  | \$ 699,705                       | \$ (3,598)  | \$ (290,738)           | \$ 405,463 |
| Stock options exercised  | 954          | 1      | 2,108                            |   |                        | 2,109      |
| ESPP shares purchased  | 1,239        | 1      | 7,200                            |   |                        | 7,201      |
| Stock options repurchased  | (16)         |        | (31)                             |   |                        | (31)       |
| Reclassification of options exercised but not vested   |              |        | 640                              |   |                        | 640        |
| Restricted stock units released  | 466          | 1      | (1)                              |   |                        |            |
| Warrants, net exercised  | 68           |        |                                  |   |                        |            |
| Stock-based compensation   |              |        | 38,552                           |   |                        | 38,552     |
| Tax benefit from stock option transactions   |              |        | (593)                            |   |                        | (593)      |
| Comprehensive loss:  |              |        |                                  |   |                        |            |
| Unrealized non-credit related other-than-temporary impairment losses on available-for-sale investments, inclusive of tax effect of \$315 |              |        |                                  | (1,238)   |                        | (1,238)    |
| Unrealized gain on all other available-for-sale investments  |              |        |                                  | 2,805   |                        | 2,805      |
| Foreign currency translation adjustment  |              |        |                                  | 221   |                        | 221        |
| Net loss   |              |        |                                  |   | (86,622)               | (86,622)   |
| Total comprehensive loss   |              |        |                                  |   |                        | (84,834)   |
| Balance at December 26, 2009   | 96,874       | \$ 97  | \$ 747,580                       | \$ (1,810)  | \$ (377,360)           | \$ 368,507 |

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



**Table of Contents****INFINERA CORPORATION****CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY****For the Years Ended December 27, 2008, December 26, 2009 and December 25, 2010****(Continued)****(In thousands, except per share data)**

|  | Common Stock |        | Additional<br>Paid-in<br>Capital | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) | Accumulated<br>Deficit | Total      |
|--|--------------|--------|----------------------------------|---|------------------------|------------|
|  | Shares       | Amount |                                  |   |                        |            |
| Balance at December 26, 2009 (brought forward)   | 96,874       | \$ 97  | \$ 747,580                       | \$ (1,810)  | \$ (377,360)           | \$ 368,507 |
| Stock options exercised  | 3,094        | 3      | 11,847                           |   |                        | 11,850     |
| ESPP shares purchased  | 1,205        | 1      | 7,561                            |   |                        | 7,562      |
| Stock options repurchased  | (3)          |        | (14)                             |   |                        | (14)       |
| Reclassification of options exercised but not vested   |              |        | 200                              |   |                        | 200        |
| Restricted stock units released  | 1,322        | 1      | (13)                             |   |                        | (12)       |
| Stock-based compensation   |              |        | 50,039                           |   |                        | 50,039     |
| Comprehensive loss:  |              |        |                                  |   |                        |            |
| Unrealized non-credit related other-than-temporary impairment losses on available-for-sale investments |              |        |                                  | 820   |                        | 820        |
| Unrealized gain on all other available-for-sale investments  |              |        |                                  | (30)  |                        | (30)       |
| Foreign currency translation adjustment  |              |        |                                  | 75  |                        | 75         |
| Tax related to available-for-sale investment   |              |        |                                  | (316)   |                        | (316)      |
| Net loss   |              |        |                                  |   | (27,932)               | (27,932)   |
| Total comprehensive loss   |              |        |                                  |   |                        | (27,383)   |
| Balance at December 25, 2010   | 102,492      | \$ 102 | \$ 817,200                       | \$ (1,261)  | \$ (405,292)           | \$ 410,749 |

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

**Table of Contents****INFINERA CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS**

(In thousands)

|  | December 25,<br>2010 | Years Ended<br>December 26,<br>2009 | December 27,<br>2008 |
|--|----------------------|-------------------------------------|----------------------|
| <b>Cash Flows from Operating Activities:</b>   |                      |                                     |                      |
| Net income (loss)  | \$ (27,932)          | \$ (86,622)                         | \$ 78,728            |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                      |                                     |                      |
| Depreciation and amortization  | 15,619               | 16,547                              | 12,975               |
| Non-cash restructuring and other costs   | 100                  | 2,973                               |                      |
| Net credit impairment losses in earnings   |                      | 1,094                               |                      |
| Provision for (recovery of) doubtful accounts  |                      | (1,700)                             | 1,700                |
| Amortization of premium (accretion of discount) on investments                                     | 3,761                | 604                                 | (893)                |
| Stock-based compensation expense   | 50,335               | 37,375                              | 23,819               |
| Unrealized (gain) loss on Put Rights   | 1,696                | 3,761                               | (15,866)             |
| Unrealized holding (gain) loss for trading securities  | (1,696)              | (4,584)                             | 16,762               |
| Tax benefit (reversal) of stock option transactions  |                      | 248                                 | (248)                |
| Reduction of (excess) tax benefit from stock option transactions                                   |                      | (593)                               | 593                  |
| Non-cash tax benefit   | (316)                | (315)                               |                      |
| Gain on disposal of assets   | (179)                | (284)                               | (1,107)              |
| Other (gain) loss  | (96)                 | (134)                               | 7                    |
| <b>Changes in assets and liabilities:</b>  |                      |                                     |                      |
| Accounts receivable  | (6,755)              | 1,834                               | (31,796)             |
| Inventories, net   | (13,143)             | (8,618)                             | (821)                |
| Prepaid expenses and other current assets  | 1,296                | (2,244)                             | (2,463)              |
| Deferred inventory costs   | 928                  | (6,180)                             | 76,538               |
| Other non-current assets   | (3,936)              | (7,345)                             | (6,081)              |
| Accounts payable   | 1,161                | (2,594)                             | 16,767               |
| Accrued liabilities and other expenses   | 9,196                | 18,964                              | 3,387                |
| Deferred revenue   | 216                  | 3,968                               | (152,030)            |
| Accrued warranty   | 282                  | 1,199                               | (53)                 |
| <b>Net cash provided by (used in) operating activities</b>   | <b>30,537</b>        | <b>(32,646)</b>                     | <b>19,918</b>        |
| <b>Cash Flows from Investing Activities:</b>   |                      |                                     |                      |
| Purchase of available-for-sale investments   | (253,130)            | (163,870)                           | (226,014)            |
| Purchase of cost-method investment   | (4,500)              |                                     |                      |
| Proceeds from sales of available-for-sale investments  |                      | 1,536                               | 108,190              |
| Proceeds from maturities and calls of investments, and exercise of Put Rights                      | 232,333              | 144,795                             | 183,339              |
| Proceeds from disposal of assets   | 324                  | 699                                 | 1,192                |
| Purchase of property and equipment   | (20,672)             | (15,394)                            | (22,941)             |
| Change in restricted cash  | (77)                 | (1,113)                             | 439                  |
| <b>Net cash provided by (used in) investing activities</b>   | <b>(45,722)</b>      | <b>(33,347)</b>                     | <b>44,205</b>        |
| <b>Cash Flows from Financing Activities:</b>   |                      |                                     |                      |
| Proceeds from issuance of common stock   | 19,348               | 9,310                               | 11,482               |
| Excess (reduction of) tax benefit from stock option transactions                                   |                      | (248)                               | 248                  |
| Repurchase of common stock   | (14)                 | (31)                                | (29)                 |
| Payments for purchase of assets under financing arrangement  | (349)                | (87)                                |                      |
| <b>Net cash provided by financing activities</b>   | <b>18,985</b>        | <b>8,944</b>                        | <b>11,701</b>        |

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|  |         |          |        |
|--|---------|----------|--------|
| Effect of exchange rate changes on cash          | (10)    | 138      | (263)  |
| Net change in cash and cash equivalents          | 3,790   | (56,911) | 75,561 |
| Cash and cash equivalents at beginning of period | 109,859 | 166,770  | 91,209 |

|  |            |            |            |
|--|------------|------------|------------|
| Cash and cash equivalents at end of period | \$ 113,649 | \$ 109,859 | \$ 166,770 |
|--|------------|------------|------------|

**Supplemental disclosures of cash flow information:**

|                            |        |          |          |
|----------------------------|--------|----------|----------|
| Cash paid for interest     | \$     | \$       | \$ 3     |
| Cash paid for income taxes | \$ 739 | \$ 1,442 | \$ 1,036 |

**Supplemental schedule of non-cash financing activities**

|  |    |        |    |
|--|----|--------|----|
| Purchase of assets under financing arrangement | \$ | \$ 567 | \$ |
|--|----|--------|----|

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

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Organization and Basis of Presentation**

Infinera Corporation ( "Infinera" or the "Company" ), headquartered in Sunnyvale, California, was founded in December 2000 and incorporated in the State of Delaware. Infinera provides Digital Optical Networking systems to telecommunications carriers worldwide. Infinera's systems are unique in their use of a breakthrough semiconductor technology: the photonic integrated circuit ( "PIC" ). Infinera's systems and PIC technology are designed to provide customers with simpler and more flexible engineering and operations, faster time-to-service, and the ability to rapidly deliver differentiated services without reengineering their optical infrastructure.

The Company operates and reports financial results on a fiscal year of 52 or 53 weeks ending on the last Saturday of December in each year. Accordingly, fiscal years 2010, 2009 and 2008 were all 52-week years that ended on December 25, 2010, December 26, 2009 and December 27, 2008, respectively. The next 52-week year will end on December 29, 2012 and the next 53-week year will end on December 31, 2011.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All intercompany balances and transactions have been eliminated. The Company reclassified certain amounts reported in previous periods to conform to the current presentation.

**2. Significant Accounting Policies**

*Use of Estimates*

The consolidated financial statements are prepared in accordance with United States generally accepted accounting principles ( "GAAP" ). These accounting principles require the Company to make certain estimates, assumptions and judgments that can affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements, as well as the reported amounts of revenue and expenses during the periods presented. Significant estimates, assumptions and judgments made by management include revenue recognition, stock-based compensation, inventory valuation, allowance for doubtful accounts, accrued warranty, cash and cash equivalents, short-term and long-term investments, fair value measurement of investments, other-than-temporary impairments and accounting for income taxes. Management believes that the estimates and judgments upon which they rely are reasonable based upon information available to them at the time that these estimates and judgments are made. To the extent there are material differences between these estimates and actual results, the Company's consolidated financial statements will be affected.

***Revenue Recognition***

In October 2009, the Financial Accounting Standards Board ( "FASB" ) amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product's essential functionality from the scope of industry specific software revenue recognition guidance. In October 2009, the FASB also amended the accounting standards for multiple deliverable revenue arrangements to:

provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

require an entity to allocate revenue in an arrangement using estimated selling price ( "ESP" ) of deliverables if a vendor does not have vendor-specific objective evidence ( "VSOE" ) of selling price or third-party evidence ( "TPE" ) of selling price; and

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price. The Company elected to early adopt this accounting guidance at the beginning of its first quarter of 2010 on a prospective basis for applicable transactions entered into or materially modified after December 26, 2009.

In connection with its adoption of these standards, the Company re-evaluated the appropriate revenue recognition treatment of its products and determined that the majority of its products, which have both software and non-software components that function together to deliver the products' essential functionality, are scoped out of the previous software specific revenue recognition guidance.

Substantially all of the Company's product sales are sold in combination with software support services comprised of either software warranty or software subscription services. The Company also periodically sells training, installation and deployment services, spares management and on-site hardware replacement services with its product sales. Training services include the right to a specified number of training classes and installation and deployment services may include customer site assessments, equipment installation and testing. Training and installation and deployment services are generally delivered over a 90-120 day period. Software warranty provides customers with maintenance releases and patches during the warranty support period. Software subscription also includes maintenance releases and patches and provides customers with rights to receive unspecified software product upgrades released during the support period. These support services are generally delivered over a one-year period. Spares management and on-site hardware replacement services include the replacement of defective units at customer sites in accordance with specified service level agreements and are generally delivered over a one-year period.

The Company recognizes product revenue when all of the following have occurred: (1) it has entered into a legally binding arrangement with the customer; (2) delivery has occurred, which is when product title and risk of loss have transferred to the customer; (3) customer payment is deemed fixed and determinable; and (4) collectability is reasonably assured.

The Company allocates revenue to each element in its multiple-element arrangements based upon their relative selling prices. The Company determines the selling price for each deliverable based on a selling price hierarchy. The selling price for a deliverable is based on its VSOE if available, TPE if VSOE is not available, or ESP if neither VSOE nor TPE is available. Revenue allocated to each element is then recognized when the basic revenue recognition criteria for that element has been met.

VSOE of selling price is used in the selling price allocation in all instances where it exists. VSOE of selling price for products and services is determined when a substantial majority of the selling prices fall within a reasonable range when sold separately. In certain instances, the Company is not able to establish VSOE for all deliverables in an arrangement with multiple elements. This mainly occurs where insufficient standalone sales transactions have occurred or where pricing for that element has not been consistent.

TPE of selling price can be established by evaluating largely interchangeable competitor products or services in standalone sales to similarly situated customers. As the Company's products contain a significant element of proprietary technology and the solution offered differs substantially from that of competitors, it is typically difficult to obtain the reliable standalone competitive pricing necessary to establish TPE.

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

ESP represents the best estimate of the price at which the Company would transact a sale if the product or service was sold on a standalone basis. The Company determines ESP for a product or service by considering multiple factors including, but not limited to customer type, geography, market conditions, competitive landscape, gross margin objectives and pricing practices. The determination of ESP is made through formal approval by the Company's management, taking into consideration the overall go-to-market pricing strategy.

As the Company's go-to-market strategies evolve, the Company may modify its pricing practices in the future, which could result in changes in selling prices, including both VSOE and ESP. As a result, the Company's future revenue recognition for multiple element arrangements could differ materially from that recorded in the current period. The Company regularly reviews VSOE, TPE and ESP and maintains internal controls over the establishment and update of these inputs.

The Company limits the amount of revenue recognition for delivered elements to the amount that is not contingent on the future delivery of products or services, future performance obligations or subject to customer-specified return or refund privileges. The Company evaluates each deliverable in an arrangement to determine whether they represent separate units of accounting. Under the new revenue recognition guidance, more of the Company's products and services qualify as separate units of accounting based on the selling price hierarchy for determination of relative selling price.

The Company's adoption of the new accounting guidance for revenue recognition resulted in an increase in total revenues of \$31.0 million, from \$423.4 million to \$454.4 million in the year ended December 25, 2010. In addition, the new accounting guidance for revenue recognition resulted in a decrease in net loss of \$12.3 million, from a net loss of \$40.2 million to net loss of \$27.9 million in the year ended December 25, 2010.

These increases in revenues are primarily related to an increase in net product revenues from bundled arrangements which would have previously been deferred until all deliverables had been completed or recognized ratably over the longest undelivered service period as VSOE of selling price had not been established for the undelivered element. In addition, the Company recognized product revenue on a number of purchase orders which had been partially shipped at the end of 2010. The impact of the new revenue recognition guidance in future periods will depend on the number of bundled arrangements entered into by the Company with undelivered elements for which VSOE of selling price had not been established under the existing software revenue recognition guidance.

The Company has a limited number of software offerings which are not required to deliver the tangible product's essential functionality and can be sold separately. Revenue from sales of these software products and related post-contract support will continue to be accounted for under software revenue recognition rules. The Company's multiple-element arrangements may therefore have a software deliverable that is subject to the existing software revenue recognition guidance. The revenue for these multiple-element arrangements is allocated to the software deliverable and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the hierarchy in the new revenue recognition accounting guidance. Revenues related to these software offerings are not expected to be material.

Revenue arrangements entered into prior to the first quarter of 2010 continue to be accounted for under the Company's previous revenue recognition policy.

Services revenue includes software subscription services, training, installation and deployment services, spares management, on-site hardware replacement services and extended hardware warranty services. Revenue from software subscription, spares management, on-site hardware

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

replacement services and extended hardware warranty contracts is deferred and is recognized ratably over the contractual support period, which is generally one year. Revenue related to training and installation and deployment services is recognized as the services are completed.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. In addition, shipping documents and customer acceptances, when applicable, are used to verify delivery and transfer of title. Revenue is recognized only when title and risk of loss pass to customers. In instances where acceptance of the product occurs upon formal written acceptance, revenue is deferred until such written acceptance has been received. The Company assesses whether the fee is fixed or determinable based on the payment terms associated with the transaction. Payment terms to customers generally range from net 30 to 120 days from invoice, which are considered to be standard payment terms. However, payment terms greater than 120 days but less than or equal to one year from invoice may be considered standard if payment is supported by an irrevocable commercial letter of credit ( LOC ) issued by a creditworthy bank or the LOC has been accepted and confirmed by a creditworthy bank. In the event payment terms are provided that differ from the Company's standard business practices, the fees are deemed to not be fixed or determinable and, therefore, revenue is not recognized until the fees become fixed or determinable which the Company believes is when they are legally due and payable. The Company assesses its ability to collect from its customers based primarily on the creditworthiness and past payment history of the customer.

For sales to resellers, the same revenue recognition criteria apply. It is the Company's practice to identify an end-user prior to shipment to a reseller. The Company does not offer rights of return or price protection to its resellers.

Shipping charges billed to customers are included in product revenue and related shipping costs are included in product cost. The Company reports revenue net of any required taxes collected from customers and remitted to government authorities, with the collected taxes recorded as current liabilities until remitted to the relevant government authority.

***Stock-Based Compensation***

Stock-based compensation cost is measured at the grant date based on the fair value of the award, and is recognized as expense over the requisite service period (generally the vesting period) under the straight-line amortization method.

The Company estimates the fair value of the stock options granted using the Black-Scholes option pricing formula and a single option award approach. For new-hire grants, options typically vest with respect to 25% of the shares one year after the option's vesting commencement date and the remainder ratably on a monthly basis over three years, commencing one year after the vesting commencement date. For annual refresh grants, options typically vest ratably on a monthly basis over three, four or five years. In 2009, the Company also granted retention options to executives which vest ratably on a monthly basis over two years. The Company makes a number of estimates and assumptions in determining stock-based compensation related to options including the following:

The expected forfeiture rate is estimated based on the Company's historical forfeiture data and compensation costs are recognized only for those equity awards expected to vest. The estimation of the forfeiture rate requires judgment, and to the extent actual forfeitures differ from expectations, changes in estimate will be recorded as an adjustment in the period when such estimates are revised. Actual results may differ substantially from the estimates.

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In October 2009, the Company started using its own historical data to estimate the expected term. Previously, the Company elected to use the simplified method to estimate the expected term due to increased liquidity of the underlying options in the post-IPO era as compared to the Company's historical grants.

Expected volatility of the Company's stock is based on the weighted-average implied and historical volatility of Infinera and its peer group. The peer group is comprised of similar companies in the same industrial sector. As the Company gains more historical volatility data, the weighting of its own data in the expected volatility calculation associated with options will gradually increase. The Company estimates the fair value of the rights to acquire stock under its Employee Stock Purchase Plan ( ESPP ) using the Black-Scholes option pricing formula. The Company's ESPP typically provides for consecutive six-month offering periods, except for the first such offering period which commenced on June 7, 2007 and ended on February 15, 2008. The Company uses its own historical volatility data in the valuation of ESPP shares.

The Company accounted for the fair value of restricted stock units ( RSUs ) using the closing market price of the Company's common stock on the date of grant. For new-hire grants, RSUs typically vest ratably on an annual basis over four years. For annual refresh grants, RSUs typically vest ratably on an annual basis over three, four or five years. In 2009, the Company also granted retention RSUs to executives which cliff vest after an approximate two-year period and to other employees which vest ratably on a monthly basis over one or two years.

The Company estimates the fair value of performance stock units ( PSUs ) granted using a Monte Carlo simulation model. The Company granted PSUs in 2009 as part of the Company's annual refresh grant process. The PSUs entitle the Company's executive officers and members of its board of directors to receive a number of shares of the Company's common stock based on the Company's stock price performance over a three-year or four-year period as compared to the NASDAQ Composite Index ( NASDAQ ) for the same period. The PSUs cliff vest after three or four years and the number of shares to be issued upon vesting ranges from 0.5 to 2.0 times the number of PSUs granted depending on the relative performance of the Company's common stock price compared to NASDAQ. This performance metric is classified as a market condition.

The Monte Carlo simulation model is based on a discounted cash flow approach, with the simulation of a large number of possible Company and NASDAQ stock price outcomes. The use of the Monte Carlo simulation model requires the input of a number of assumptions including expected volatility of the Company's stock price, expected volatility of NASDAQ, correlation between changes in the Company's stock price and changes in NASDAQ, risk-free interest rate, and expected dividends. Expected volatility of the Company's stock is based on the weighted-average implied and historical volatility of the Company's peer group in the industry in which the Company does business. Expected volatility of NASDAQ is based on the historical and implied data. Correlation is based on the historical relationship between the Company's peer group stock price and NASDAQ composite average. The risk-free interest rate is based upon the treasury zero-coupon yield appropriate for the term of the PSU as of the grant date. The expected dividend yield is zero for the Company as it does not expect to pay dividends in the future. The expected dividend yield for NASDAQ is the annual dividend yield expressed as a percentage of the composite average of NASDAQ on the grant date.

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Inventory Valuation***

Inventories, net consist of raw materials, work-in-process and finished goods and are stated at standard cost adjusted to approximate the lower of actual cost (first-in, first-out method) or market. Market value is based upon an estimated selling price reduced by the estimated cost of disposal. The determination of market value involves numerous judgments including estimated average selling prices based upon recent sales volumes, industry trends, existing customer orders, current contract price, future demand and pricing and technological obsolescence of the Company's products.

Inventory that is obsolete or in excess of the Company's forecasted demand or is anticipated to be sold at a loss is written down to its estimated net realizable value based on historical usage and expected demand. As of December 25, 2010 and December 26, 2009, the Company's inventory value had been reduced by \$5.2 million and \$2.7 million, respectively, for excess and obsolescence. In valuing its deferred inventory costs, the Company considered whether the utility of the products delivered or expected to be delivered at less than cost, primarily comprised of common equipment, had declined. The Company concluded that, in the instances where the utility of the products delivered or expected to be delivered was less than cost, it was appropriate to value the inventory costs and deferred inventory costs at cost or market, whichever is lower, thereby recognizing the cost of the reduction in utility in the period in which the reduction occurred or can be reasonably estimated. The Company has, therefore, recognized inventory write-downs as necessary in each period in order to reflect inventory at the lower of cost or market ( LCM ). As of December 25, 2010 and December 26, 2009, the Company's inventory value had been reduced by \$2.5 million and \$2.6 million, respectively, for LCM adjustments. In addition, the Company's deferred inventory costs were reduced by \$1.0 million for net realizable value adjustments as of December 25, 2010.

The Company considered whether it should accrue losses on firm purchase commitments related to inventory items. Given that the expected selling price of common equipment in the future remains below-cost, the Company has also recorded losses on these firm purchase commitments in the period in which the commitment is made. When the inventory parts related to these firm purchase commitments are received, that inventory is recorded at the purchase price less the accrual for the loss on the purchase commitment.

If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

***Accounts Receivable and Allowances for Doubtful Accounts***

Accounts receivable consist of trade receivables recorded upon recognition of revenue for product and services revenues, reduced by reserves for estimated bad debts and returns. Trade accounts receivable are recorded at the invoiced amount and do not bear interest. Credit is extended based on evaluation of the customer's financial condition. The Company records its accounts receivable at the invoiced value. Management makes judgments as to its ability to collect outstanding receivables and provides allowances for a portion of receivables when collection becomes doubtful. Provisions are made based upon a review of all significant outstanding invoices. At December 25, 2010 and December 26, 2009, the Company's allowance for doubtful accounts was zero. In 2009, the Company recorded a recovery of doubtful accounts for \$1.7 million.

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Allowances for Sales Returns***

Customer product returns are approved on a case by case basis. Specific reserve provisions are made based upon a specific review of all the approved product returns, where the customer has yet to return the products to generate the related sales return credit at the end of a period. Estimated sales returns are provided for as a reduction to revenue in 2008, 2009 and 2010. These were not material for any period presented on the Company's consolidated financial statements. At December 25, 2010 and December 26, 2009, revenue reserves recorded for potential sales returns were immaterial.

***Accrued Warranty***

The Company warrants that its products will operate substantially in conformity with product specifications. Upon delivery of the Company's products, the Company provides for the estimated cost to repair or replace products or the related components that may be returned under warranty. The Company's hardware warranty periods range from one to five years from date of acceptance for hardware and 90 days to 60 months for software warranty. The hardware warranty accrual is based on actual historical returns experience and the application of those historical return rates to the Company's in-warranty installed base. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary. The Company has software warranty support obligations to a small number of its customers and the costs associated with providing these software warranties have been immaterial to the Company's consolidated financial statements to date.

***Cash, Cash Equivalents and Short-term and Long-term Investments***

The Company considers all highly liquid instruments with an original maturity at the date of purchase of 90 days or less to be cash equivalents. These instruments may include cash, money market funds and commercial paper. The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

Marketable securities consist of certificates of deposit, commercial paper, corporate bonds, U.S. agency notes, auction rate securities (ARS) and Put Rights. The Company considers all debt instruments with original maturities at the date of purchase greater than 90 days and remaining time to maturity of one year or less to be short-term investments. The Company classifies debt instruments with remaining maturities greater than one year as long-term investments, unless the Company intends to settle its holdings within one year or less and in such case it is considered to be short-term investments. The Company determines the appropriate classification of its marketable securities at the time of purchase and re-evaluates such designations as of each balance sheet date.

Available-for-sale investments are stated at fair market value with unrealized gains and losses recorded in Accumulated other comprehensive loss in the Company's consolidated balance sheets and Other income (expense), net in the Company's consolidated statements of operations. The Company evaluates its available-for-sale marketable debt securities for other-than-temporary impairments as discussed below and records any credit loss portion in Other income (expense), net in the Company's consolidated statements of operations. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity and for any credit losses incurred on these securities. Gains and losses are recognized when realized in the Company's consolidated statements of operations under the specific identification method. Trading securities investments are stated at fair value with unrealized gains and losses reported in Other income (expense), net in the Company's consolidated statements of operations, consisting of ARS trading securities and related Put Rights.

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Fair Value Measurement of Investments***

The fair value of the Company's financial instruments reflects the estimates of amounts that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (exit price). The fair value estimates presented in the Company's consolidated financial statements are based on information available to us as of December 25, 2010.

The Company applies a fair value hierarchy based on three levels of inputs as follows:

- Level I      Quoted prices in active markets for identical assets or liabilities.
  
- Level II      Inputs other than Level I that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. In addition, Level II could include unobservable inputs that are not significant to the fair value of the assets or liabilities.
  
- Level III      Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company measures its cash equivalents, debt securities and Put Rights at fair value and classifies its securities in accordance with a fair value hierarchy. The Company's money market funds and U.S. treasuries are classified within Level I of the fair value hierarchy and are valued based on quoted prices in active markets for identical securities.

The Company classifies its certificates of deposit, commercial paper, corporate bonds and U.S. agency notes within Level II of the fair value hierarchy as follows:

*Certificates of Deposit*

The Company reviews market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day. In the absence of any observable market transactions for a particular security, the fair market value at period end would be equal to the par value. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data, and result in the classification of these securities as Level II of the fair value hierarchy.

*Commercial Paper*

The Company reviews market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day and then follows a revised accretion schedule to determine the fair market value at period end. In the absence of any observable market transactions for a particular security, the fair market value at period end is derived by accreting from the last observable market price. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data accreted mathematically to par, and result in the classification of these securities as Level II of the fair value hierarchy.



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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

*Corporate Bonds*

The Company reviews trading activity and pricing for each of the corporate bond securities in its portfolio as of the measurement date and determines if pricing data of sufficient frequency and volume in an active market exists in order to support Level I classification of these securities. Since sufficient quoted pricing for identical securities is not available, the Company obtains market pricing and other observable market inputs for similar securities from a number of industry standard data providers. In instances where multiple prices exist for similar securities, these prices are used as inputs into a distribution-curve to determine the fair market value at period end. As a result, the Company classifies its corporate bonds as Level II of the fair value hierarchy.

*U.S. Agency Notes*

The Company reviews trading activity and pricing for its U.S. agency notes as of the measurement date. When sufficient quoted pricing for identical securities is not available, the Company uses market pricing and other observable market inputs for similar securities obtained from a number of industry standard data providers. These inputs represent quoted prices for similar assets in active markets or these inputs have been derived from observable market data, and result in the classification of these securities as Level II of the fair value hierarchy.

The Company classifies its ARS and related Put Rights within Level III of the fair value hierarchy as follows:

*Auction Rate Securities*

The Company's ARS are classified within Level III because they are valued, in part, by using inputs that are unobservable in the market and are significant to the valuation. The recent uncertainties in the credit markets have affected all of the Company's ARS and auctions for these securities have failed to settle on their respective settlement dates. In light of these developments, to determine the fair value for the Company's ARS, the Company used a combination of the market approach and income approach. The market approach uses pricing based on transactions in an inactive secondary market for similar or comparable securities. In addition, the Company performed its own discounted cash flow analysis. Management determined that it was most appropriate to value the ARS using the market approach and income approach equally given the facts and circumstances as of December 25, 2010, and therefore incorporated both valuations in the Company's fair value measurement.

The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of the Company's ARS, as of December 25, 2010, are as follows:

*Contractual cash flow*

The model assumed that the principal amount or par value for these securities will be repaid at the end of the estimated workout period. In addition, future interest payments were estimated as described in each individual prospectus and based on the then current U.S. Treasury Bill ( T-Bill ) rate adjusted for a failed auction premium of 150 basis points ( bps ) for its A3 rated securities and 150 bps to 350 bps for its AAA rated securities.

*ARS discount rate*

The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the estimated workout period of the securities. As of the measurement date, these rates were then



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adjusted by a factor that ranged from 235 bps to 410 bps, representing an estimate of the market student loan spread and a discount factor to reflect the lack of liquidity and credit risk associated with these securities. The Company held \$5.0 million par value of AAA rated securities and \$3.9 million par value of ARS that were downgraded to A3 rating during 2009. The Company's ARS are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. The discount rate does, however, include a discount factor to reflect the issuer's credit risk and its potential inability to perform its obligations under the terms of the ARS agreements. The Company's valuation analysis indicates that the estimated credit risk element included in the discount rate was 210 bps for A3 rated securities and 320 bps for AAA rated securities.

*Estimated maturity*

The Company estimated the workout period of its ARS as the weighted-average life of the underlying trust loan portfolio where this information was available from servicing and other trust reports. In a small number of instances where this information was not available, the Company used the weighted-average life of the loan portfolio of a similar trust. The estimated time to maturity of the securities as of the measurement date ranged from 15.2 years to 17.2 years.

*Put Rights*

Put Rights associated with the Company's ARS holdings with UBS Financial Services, Inc. (UBS) were classified as Level III because they were valued, in part, by using inputs that are unobservable in the market and are significant to the valuation. The fair value of the Put Rights is equal to the difference between the fair value of the UBS ARS calculated as described above and their value including the impact of the Put Rights. The Company performed its own discounted cash flow analysis to calculate the fair value of the UBS ARS including the impact of the Put Rights.

On June 30, 2010, the Company elected to exercise the Put Rights associated with the \$24.5 million (par value) of the ARS covered by the UBS settlement and received cash proceeds from the sale of these securities to UBS.

The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of the UBS ARS including the impact of the Put Rights as of June 26, 2010 were as follows:

*Contractual cash flow*

The model assumed that the principal amount or par value for the ARS would be repaid on June 30, 2010, based on the Company's intent to exercise its Put Rights and sell these securities to UBS on that date. In addition, future interest payments were estimated as described in each individual prospectus and based on the then current T-Bill rate as adjusted for a failed auction premium of 120 bps for all of the Company's ARS, except for 150 bps for A3 rated securities.

*Discount rate*

The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the expected sale date of these securities. As of the measurement date, this rate was adjusted by approximately 50 bps which represented a discount factor to reflect UBS credit risk and UBS potential inability to perform its obligations under the Put Rights agreement.



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The Company reviews its available-for-sale marketable debt securities on a regular basis to evaluate whether or not a security has experienced an other-than-temporary decline in fair value. If a debt security's market value is below amortized cost and the Company either intends to sell the security or it is more likely than not that the Company will be required to sell the security before its anticipated recovery, the Company records an other-than-temporary impairment ( OTTI ) charge to earnings for the entire amount of the impairment.

When the Company does not intend to sell an impaired security and it is not more likely than not that the Company will be required to sell prior to recovery of its amortized cost basis, the Company separates the OTTI into credit and non-credit loss portions. The amount representing the credit loss is recognized in Other income (expense), net, and the amount related to all other factors is recognized in Accumulated other comprehensive loss.

In determining if a credit loss has occurred, it is the Company's policy to isolate the credit loss related portion of the discount rate used to derive the fair market value of the security and apply this to the expected cash flows in order to determine the portion of the OTTI that is credit loss related. This credit related portion of the discount rate is based on the financial condition of the issuer, changes in rating agency credit ratings for the security or increases in credit related yield spreads on similar securities offered by the same issuer.

Once a credit impairment loss has been recognized in the Company's consolidated statements of operations, the amortized cost basis of that available-for-sale security is reduced by the amount of the credit impairment loss, resulting in a new cost basis for the security. Any non-credit related unrealized gains and losses are recorded in Accumulated other comprehensive loss in the Company's consolidated balance sheets. The Company will continue to monitor the security's credit rating and credit spread and will accrete any reduction in the credit impairment loss to interest income over the expected life of the security.

***Property, Plant and Equipment***

Property, plant and equipment are stated at cost. Depreciation is calculated using the straight-line method over the estimated useful lives of the respective assets. Leasehold improvements are amortized using the straight-line method over the shorter of the lease term or estimated useful life of the asset. An assumption of lease renewal where a renewal option exists is used only when the renewal has been determined to be reasonably assured. Repair and maintenance costs are expensed as incurred. The estimated useful life for each asset category is as follows:

|  | <b>Estimated Useful lives</b> |
|--|-------------------------------|
| Laboratory and manufacturing equipment | 1.5 to 10 years               |
| Furniture and fixtures                 | 3 to 5 years                  |
| Computer hardware and software         | 1.5 to 3 years                |
| Leasehold improvements                 | 1 to 10 years                 |

The Company regularly reviews long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of these assets may not be recoverable or that the useful life is shorter than originally estimated. If impairment indicators are present and the projected future undiscounted cash flows are less than the carrying value of the assets, the carrying values are

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

reduced to the estimated fair value. If assets are determined to be recoverable, but the useful lives are shorter than originally estimated, the carrying value of the assets is depreciated over the newly determined remaining useful lives.

***Deferred Inventory Costs***

When the Company's products have been delivered, but the product revenue associated with the arrangement has been deferred as a result of not meeting the revenue recognition criteria or the costs are related to product sales bundled with training, software warranty or product support services where the revenue is deferred and recognized ratably, the Company also defers the related inventory costs for the delivered items and recognizes the inventory costs either ratably or when the related revenue meets the revenue recognition criteria.

***Accounting for Income Taxes***

As part of the process of preparing the Company's consolidated financial statements, the Company is required to estimate its taxes in each of the jurisdictions in which it operates. The Company estimates actual current tax expense together with assessing temporary differences resulting from different treatment of items, such as accruals and allowances not currently deductible for tax purposes. These differences result in deferred tax assets and liabilities, which are included in the Company's consolidated balance sheets. In general, deferred tax assets represent future tax benefits to be received when certain expenses previously recognized in the Company's consolidated statements of operations become deductible expenses under applicable income tax laws or loss or credit carryforwards are utilized. Accordingly, realization of the Company's deferred tax assets is dependent on future taxable income within the respective jurisdictions against which these deductions, losses and credits can be utilized within the applicable future periods.

The Company must assess the likelihood that some portion or all of its deferred tax assets will be recovered from future taxable income within the respective jurisdictions, and to the extent the Company believes that recovery does not meet the more-likely-than-not standard, it must establish a valuation allowance. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management judgment is required in determining the Company's provision for income taxes, its deferred tax assets and liabilities and any valuation allowance recorded against its net deferred tax assets. At December 25, 2010 and December 26, 2009, certain of the Company's domestic net deferred tax assets were fully reserved with a valuation allowance because, based on the available evidence, the Company believed at that time it was more likely than not that it would not be able to utilize those deferred tax assets in the future. The Company intends to maintain a valuation allowance until sufficient evidence exists to support the reversal of the valuation allowance. The Company makes estimates and judgments about its future taxable income, by jurisdiction, based on assumptions that are consistent with its plans and estimates. Should the actual amounts differ from the Company's estimates, the amount of its valuation allowance could be materially impacted.

***Concentration of Credit Risk***

Financial instruments that are potentially subject to concentrations of credit risk consist primarily of cash equivalents, short-term investments, long-term investments, cost-method investments and accounts receivable. Investment policies have been implemented that limit investments to investment-grade securities.

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

As of December 25, 2010, the Company held \$8.9 million (par value) of investments comprised of ARS, which are variable-rate debt securities and have a long-term maturity with the interest rate being reset through auctions that are typically held every 7 to 35 days. These securities have historically traded at par value and are callable at par value at the option of the issuer. Interest is typically paid at the end of each auction period or semiannually. Since February 2008, most of the auctions for these ARS have failed and there is no assurance that future auctions will succeed. As a result, the Company's ability to liquidate its investment in the near term may be limited. These ARS were purchased from a single broker, who to date, has not offered to repurchase these remaining ARS from the Company. Of these ARS, \$5.0 million and \$3.9 million (par value) are AAA and A3 rated, respectively, and are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. During 2010, \$0.8 million of these ARS (par value) were called at par value. It is not clear when the Company will be able to liquidate these investments.

In October 2008, the Company elected to participate in a rights offering by UBS, which provided the Company with Put Rights to sell back all of its ARS purchased from UBS at par value of \$65.7 million, at anytime during a two-year period beginning June 30, 2010. As of June 26, 2010, \$41.2 million of the Company's ARS trading securities had been called at par value. On June 30, 2010, the Company elected to exercise the Put Rights and as a result, received net cash proceeds of \$24.5 million, representing a full recovery of par value.

In May 2010, the Company invested \$4.5 million in a privately-held company. This investment has been accounted for as a cost-basis investment, as the Company owns less than 20% of the voting securities and does not have the ability to exercise significant influence over operating and financial policies of the entity. See Note 4, Cost-method Investment, to the Notes to Consolidated Financial Statements for more information.

The risk with respect to accounts receivable is mitigated by ongoing credit evaluations that the Company performs on its customers. As the Company expands its sales internationally, it may experience increased levels of customer credit risk associated with those regions. Collateral is generally not required for accounts receivable but may be used in the future to mitigate credit risk associated with customers located in certain geographical regions.

As of December 25, 2010, the Company had amounts due from two customers that represented approximately 11% and 12% of the Company's accounts receivable balance. As of December 26, 2009, the Company had amounts due from two customers that represented approximately 21% and 13% of the Company's accounts receivable balance.

To date, a few of our customers have accounted for a significant portion of our revenue. In particular, Level 3 accounted for approximately 15%, 17% and 25% of the Company's revenue in 2010, 2009 and 2008, respectively. The Company had no other customer that represented over 10% of the Company's revenue for these periods.

The Company depends on a single or limited number of suppliers for components and raw materials. The Company generally purchases these single or limited source components and materials through standard purchase orders and does not have long-term contracts with many of these limited-source suppliers. While the Company seeks to maintain sufficient reserve stock of such components and materials, the Company's business and results of operations could be adversely affected by a stoppage or delay in receiving such components and materials, the receipt of defective parts, an increase in the price of such components and materials or the Company's inability to obtain reduced pricing from its suppliers in response to competitive pressures.

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Derivative Instruments***

The Company is exposed to foreign currency exchange rate fluctuations in the normal course of its business. As part of its risk management strategy, the Company uses derivative instruments, specifically forward contracts, to reduce the impact of foreign exchange fluctuations on earnings. The forward contracts are with one high-quality institution and the Company monitors the creditworthiness of the counter party consistently. The Company's objective is to offset gains and losses resulting from these exposures with losses and gains on the derivative contracts used to hedge them, thereby reducing volatility of earnings or protecting fair values of assets. None of the Company's derivative instruments contain credit-risk related contingent features, any rights to reclaim cash collateral or any obligation to return cash collateral. The Company does not have any leveraged derivatives. The Company does not use derivative contracts for trading or speculative purposes.

The Company enters into foreign currency exchange forward contracts to manage its exposure to fluctuations in foreign exchange rates that arise primarily from its Euro denominated receivables. Gains and losses on these contracts are intended to offset the impact of foreign exchange rate changes on the underlying foreign currency denominated accounts receivable, and therefore, do not subject the Company to material balance sheet risk. As of December 25, 2010, the Company did not designate foreign currency exchange forward contracts related to Euro denominated receivables as hedges for accounting purposes.

From time to time, the Company also uses foreign currency exchange forward contracts to hedge exposures related to forecasted sales denominated in Euro. These contracts are designated as cash flow hedges and would match the underlying forecasted transactions in duration. The contracts would be carried on the balance sheet at fair value, and the effective portion of the contracts' gains and losses would be recorded as Accumulated other comprehensive loss until the forecasted transaction occurs. For foreign currency exchange forward contracts designated as cash flow hedges, the Company evaluates and calculates the effectiveness of each hedge quarterly, using the critical terms match method. When the forecasted transaction occurs, the Company reclassifies the related gain or loss on the cash flow hedge to revenue. If it is determined that a hedged forecasted transaction is unlikely to occur, the Company discontinues its cash flow hedges and any gains or losses on the foreign currency exchange forward contracts would be reclassified from other comprehensive income into earnings.

***Foreign Currency Translation and Transactions***

The Company considers the functional currencies of its foreign subsidiaries to be the local currency. Assets and liabilities recorded in foreign currencies are translated at the exchange rate as of the balance sheet date, and costs and expenses are translated at average exchange rates in effect during the period. Equity transactions are translated using historical exchange rates. The effects of foreign currency translation adjustments are recorded as a separate component of Stockholders' equity in the accompanying consolidated balance sheets.

For all non-functional currency account balances, the re-measurement of such balances to the functional currency will result in either a foreign exchange transaction gain or loss which is recorded to Other gain (loss), net in the same period that the re-measurement occurred. Aggregate foreign currency transaction loss recorded in 2010, 2009 and 2008 were \$0.7 million, \$1.7 million and \$0.8 million, respectively. Beginning in the second quarter of 2009, the Company entered into foreign currency exchange forward contracts to reduce the impact of foreign exchange fluctuations on

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

earnings from accounts receivable balances primarily denominated in Euro. The foreign currency transactions on these forward contracts amounted to a gain of \$0.9 million in 2010 and a loss of \$1.0 million in 2009, and substantially offset the transaction gains and losses from the re-measurement of the related accounts receivable.

***Advertising***

All advertising costs are expensed as incurred. Advertising expenses in 2010, 2009 and 2008 were \$1.1 million, \$0.8 million and \$0.5 million, respectively.

***Research and Development***

All costs to develop the Company's hardware products are expensed as incurred. Software development costs are capitalized beginning when a product's technological feasibility has been established and ending when a product is available for general release to customers. Generally, the Company's software products are released soon after technological feasibility has been established. As a result, costs subsequent to achieving technological feasibility have not been significant and all software development costs have been expensed as incurred.

***Recent Accounting Pronouncements***

In January 2010, the FASB issued Accounting Standards Update 2010-06, Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements. ASU 2010-06 requires an entity to disclose separately the amounts of significant transfers in and out of Level I and II fair value measurements, and describe the reasons for the transfers. Also, it requires additional disclosure regarding purchases, sales, issuances and settlements of Level III measurements. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for the additional disclosure of Level III measurements, which is effective for fiscal years beginning after December 15, 2010. Effective in the first quarter of 2010, the Company adopted the provisions of ASU 2010-06 which resulted in the enhancement of certain disclosures but did not have a material impact on the Company's consolidated financial position, results of operations or cash flows. The Company adopted the amended disclosure requirements for Levels 1 and 2 beginning in its fiscal quarter ended March 26, 2010. The adoption of the amended disclosure requirements for fair value measurements did not affect the Company's disclosures because it did not transfer financial assets or liabilities between levels in the fair value hierarchy.

FASB ASU 2009-13 updates the existing guidance on accounting for multiple-element revenue arrangements. Specifically, this guidance expands the criteria in Subtopic 605-25, Revenue Recognition-Multiple-Element Arrangements, for when individual deliverables within a multiple-element arrangement may be treated as separate units of accounting. In addition, the guidance modifies the manner in which the transaction consideration is allocated across the separately identified deliverables or units of accounting by no longer permitting the residual method of allocating arrangement consideration. This standard will be effective for the first annual period beginning on or after June 15, 2010 and may be applied retrospectively, for all periods presented or prospectively, with early adoption permitted. Effective for the first quarter of 2010, the Company elected to early adopt ASU 2009-13 with prospective application. See section titled, Revenue Recognition above for further discussion of the impact of the early adoption of this standard on the Company's consolidated financial position, results of operations or cash flows.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

FASB ASU 2009-14 significantly changes the accounting for revenue arrangements that include both tangible product and software elements. This new standard amends the scope of pre-existing software revenue guidance by excluding non-software components of software-reliant tangible products in addition to software products bundled with tangible products where the software components and non-software components function together to deliver the products' essential functionality. This standard will be effective for the first annual period beginning on or after June 15, 2010 and may be applied retrospectively, for all periods presented or prospectively, with early adoption permitted. Effective for the first quarter of 2010, the Company elected to early adopt ASU 2009-14 with prospective application. See section titled, "Revenue Recognition" above for further discussion of the impact of the early adoption of this standard on the Company's consolidated financial position, results of operations or cash flows.

**3. Fair Value Measurements and Other-Than-Temporary Impairments*****Fair Value Measurements***

The following table represents the Company's fair value hierarchy for its marketable securities measured at fair value:

|                          | December 25, 2010 |                   |                 | Total             |
|--------------------------|-------------------|-------------------|-----------------|-------------------|
|                          | Level I           | Level II          | Level III       |                   |
|                          | (In thousands)    |                   |                 |                   |
| <b>Assets</b>            |                   |                   |                 |                   |
| Money market funds       | \$ 37,010         | \$                | \$              | \$ 37,010         |
| Certificates of deposit  |                   | 240               |                 | 240               |
| Commercial paper         |                   | 82,415            |                 | 82,415            |
| Corporate bonds          |                   | 90,620            |                 | 90,620            |
| ARS                      |                   |                   | 7,790           | 7,790             |
| Derivatives              |                   | 303               |                 | 303               |
| <b>Total assets</b>      | <b>\$ 37,010</b>  | <b>\$ 173,578</b> | <b>\$ 7,790</b> | <b>\$ 218,378</b> |
| <b>Liabilities</b>       |                   |                   |                 |                   |
| Derivatives              | \$                | \$ 74             | \$              | \$                |
| <b>Total liabilities</b> | <b>\$</b>         | <b>\$ 74</b>      | <b>\$</b>       | <b>\$</b>         |

|                         | December 26, 2009 |          |           | Total     |
|-------------------------|-------------------|----------|-----------|-----------|
|                         | Level I           | Level II | Level III |           |
|                         | (In thousands)    |          |           |           |
| Money market funds      | \$ 69,691         | \$       | \$        | \$ 69,691 |
| Certificates of deposit |                   | 720      |           | 720       |
| Commercial paper        |                   | 33,435   |           | 33,435    |
| Corporate bonds         |                   | 42,410   |           | 42,410    |
| U.S. agency notes       |                   | 31,915   |           | 31,915    |

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|  |           |            |           |            |
|--|-----------|------------|-----------|------------|
| ARS                                      |           |            | 7,671     | 7,671      |
| Total available-for-sale investments     | \$ 69,691 | \$ 108,480 | \$ 7,671  | \$ 185,842 |
| ARS trading                              |           |            | 49,911    | 49,911     |
| Put Rights                               |           |            | 10,864    | 10,864     |
| Total investments measured at fair value | \$ 69,691 | \$ 108,480 | \$ 68,446 | \$ 246,617 |

**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

During 2010, there were no transfers of assets or liabilities between Level I and Level II and there were no transfers into or out of Level III financial assets. The following table presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable (Level III) inputs:

|                        | December 26,<br>2009 | Total Net Gains (Losses) Included In<br>Other Income<br>(Expense), Net | Other Comprehensive<br>Income<br>(In thousands) | Calls                   | December 25,<br>2010 |
|------------------------|----------------------|--|---|-------------------------|----------------------|
| ARS available-for-sale | \$ 7,671             | \$   | \$ 763 <sup>(3)</sup>                           | \$ (644) <sup>(4)</sup> | \$ 7,790             |
| ARS trading securities | 49,911               | 1,696 <sup>(1)</sup>   |   | (51,607) <sup>(4)</sup> |                      |
| Put Rights             | 10,864               | (1,696) <sup>(2)</sup>   |   | (9,168) <sup>(4)</sup>  |                      |
| Total                  | \$ 68,446            | \$   | \$ 763  | \$ (61,419)             | \$ 7,790             |

(1) Unrealized holding gains for ARS trading securities were included in Other gain (loss), net in the accompanying consolidated statements of operations.

(2) Amount represents the decrease in the fair value of the Put Rights recorded as Other gain (loss), net in the accompanying consolidated statements of operations.

(3) Amount represents the change in the non-credit loss related OTTI recorded in Accumulated other comprehensive loss in the accompanying consolidated balance sheet.

(4) Amount represents the fair market value of the securities called and related Put Rights. Realized gains on these calls were immaterial.

|                        | December 27,<br>2008 | Total Net Gains (Losses) Included In<br>Other<br>Income<br>(Expense), Net | Other Comprehensive<br>Income<br>(In thousands) | Calls                   | December 26,<br>2009 |
|------------------------|----------------------|---|---|-------------------------|----------------------|
| ARS available-for-sale | \$ 7,361             | \$ (1,094) <sup>(1)</sup>   | \$ 1,663 <sup>(4)</sup>                         | \$ (259) <sup>(5)</sup> | \$ 7,671             |
| ARS trading securities | 48,888               | 4,585 <sup>(2)</sup>  |   | (3,562) <sup>(5)</sup>  | 49,911               |
| Put Rights             | 15,866               | (3,761) <sup>(3)</sup>  |   | (1,241) <sup>(5)</sup>  | 10,864               |
| Total                  | \$ 72,115            | \$ (270)  | \$ 1,663  | \$ (5,062)              | \$ 68,446            |

(1) Amount represents the credit loss related OTTI recorded as Other income (expense), net in the accompanying consolidated statements of operations.

(2) Amount represents the increase in the fair value of ARS trading securities recorded as Other gain (loss), net in the accompanying consolidated statements of operations.

(3) Amount represents the decrease in the fair value of the Put Rights recorded as Other gain (loss), net in the accompanying consolidated statements of operations.

(4) Amount includes the reversal of \$2.6 million of an unrealized loss balance as of December 27, 2008 and a \$1.1 million non-credit loss related to OTTI recorded in Accumulated other comprehensive loss in the accompanying consolidated balance sheets.

<sup>(5)</sup> Amount represents the fair market value of the securities called on the transaction date and the related Put Rights. Realized gains on these calls for 2009 were immaterial.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Investments were as follows:

|                                      | Adjusted<br>Amortized<br>Cost | Non-credit<br>OTTI | December 25, 2010<br>Gross<br>Unrealized<br>Gains<br>(In thousands) | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--------------------------------------|-------------------------------|--------------------|---|-------------------------------|----------------------------|
| Money market funds                   | \$ 37,010                     | \$                 | \$  | \$                            | \$ 37,010                  |
| Certificates of deposit              | 240                           |                    |   |                               | 240                        |
| Commercial paper                     | 82,428                        |                    | 4   | (17)                          | 82,415                     |
| Corporate bonds                      | 90,644                        |                    | 8   | (32)                          | 90,620                     |
| ARS                                  | 7,893 <sup>(1)</sup>          | (103)              |   |                               | 7,790 <sup>(2)</sup>       |
| Total available-for-sale investments | \$ 218,215                    | \$ (103)           | \$ 12   | \$ (49)                       | \$ 218,075                 |

<sup>(1)</sup> Amount represents the par value less \$1.0 million of credit-related OTTI recognized through earnings in the prior year.<sup>(2)</sup> Amount reflects investments in a continuous loss position for twelve months or longer.

|                                      | Adjusted<br>Amortized<br>Cost | Non-credit<br>OTTI | December 26, 2009<br>Gross<br>Unrealized<br>Gains<br>(In thousands) | Gross<br>Unrealized<br>Losses | Estimated<br>Fair<br>Value |
|--------------------------------------|-------------------------------|--------------------|---|-------------------------------|----------------------------|
| Money market funds                   | \$ 69,691                     | \$                 | \$  | \$                            | \$ 69,691                  |
| Certificates of deposit              | 720                           |                    |   |                               | 720                        |
| Commercial paper                     | 33,436                        |                    |   | (1)                           | 33,435                     |
| Corporate bonds                      | 42,426                        |                    | 22  | (38)                          | 42,410                     |
| U.S. agency notes                    | 31,905                        |                    | 10  |                               | 31,915                     |
| ARS                                  | 8,594 <sup>(1)</sup>          | (923)              |   |                               | 7,671 <sup>(2)</sup>       |
| Total available-for-sale investments | \$ 186,772                    | \$ (923)           | \$ 32   | \$ (39)                       | \$ 185,842                 |
| ARS trading                          | 60,775                        |                    |   | (10,864)                      | 49,911 <sup>(2)</sup>      |
| Put Rights                           |                               |                    | 10,864  |                               | 10,864                     |
| Total investments                    | \$ 247,547                    | \$ (923)           | \$ 10,896   | \$ (10,903)                   | \$ 246,617                 |

<sup>(1)</sup> Amount represents the par value less \$1.1 million of credit-related OTTI recognized through earnings for the year ended December 26, 2009.<sup>(2)</sup> Amount reflects investments in a continuous loss position for twelve months or longer.

As of December 25, 2010, the Company's available-for-sale investments in certificates of deposit, commercial paper and corporate bonds have a contractual maturity term of up to approximately one year, and ARS have contractual maturity terms of up to 35 years. The Company recorded

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credit-related OTTI for available-for-sale investments in Other income (expense), net beginning in the second quarter of 2009. Proceeds from maturities and calls of available-for-sale investments, and exercise of Put Rights were \$232.3 million in the year ended December 25, 2010. Proceeds from maturities and calls of available-for-sale investments were \$144.8 million in the year ended December 25, 2009. Gross realized gains (losses) on short-term and long-term investments were immaterial for the period. The specific identification method is used to account for gains and losses on available-for-sale investments.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In October 2008, the Company elected to participate in a rights offering by UBS, which provided the Company with Put Rights to sell back all of its ARS purchased from UBS at par value of \$65.7 million, at any time during a two-year period beginning June 30, 2010. As of June 26, 2010, \$41.2 million of the Company's ARS trading securities had been called at par value. On June 30, 2010, the Company elected to exercise the Put Rights and as a result, received net cash proceeds of \$24.5 million, representing a full recovery of par value. All related assets and liabilities have been removed from the balance sheet and there was no impact to the Company's consolidated statements of operations.

As of December 26, 2009, \$60.8 million (par value) of UBS ARS were recorded at fair value of \$49.9 million with an unrealized loss of \$10.9 million. The Company recorded \$4.6 million of unrealized holding gains related to ARS trading securities in 2009 in Other gain (loss), net. For 2009, the Company recorded a decrease of \$3.8 million in the fair value of the Put Rights in Other gain (loss), net.

**Other-Than-Temporary Impairments**

As of December 25, 2010, the Company held \$8.9 million (par value) of available-for-sale ARS with two issuers, one of which is AAA rated and the other of which is A3 rated. During the second quarter of 2009, the Company determined that it did not intend to sell these securities and did not believe that it was more likely than not that it would be required to sell the securities before recovery of their par value. However, given that the present value of the expected cash flows for these securities was below their par value, as of June 27, 2009, an initial OTTI of \$2.7 million, equal to the difference between the fair value and the amortized cost basis, had occurred. This OTTI write-down was separated into an amount representing credit loss, which is recognized as Other gain (loss), net in the Company's consolidated statements of operations, and an amount related to all other factors, which is recorded in Accumulated other comprehensive loss in the Company's consolidated balance sheets. In determining if a credit loss had occurred, the Company isolated the credit loss related portion of the discount rate used to derive the fair market value of the securities and applied this to the expected cash flows in order to determine the portion of the OTTI that was credit loss related. This credit loss related portion of the discount rate is based on the financial condition of the issuer, rating agency credit ratings for the security and credit related yield spreads on similar securities offered by the same issuer.

These ARS had a net increase in fair value of \$0.8 million for the year ended December 25, 2010. This change was recognized in Accumulated other comprehensive loss in the Company's consolidated balance sheet. The Company did not recognize any additional OTTI credit loss on any of its securities during the year ended December 25, 2010. During the year ended December 25, 2010, \$0.8 million of these ARS (par value) were called at par value.

A roll-forward of amortized cost, cumulative OTTI recognized in earnings and Accumulated other comprehensive loss is as follows:

| (In thousands)               | Amortized<br>Cost | Cumulative<br>OTTI in<br>Earnings | Unrealized<br>Gain | OTTI Loss in<br>Accumulated<br>Other<br>Comprehensive<br>Loss | Accumulated<br>Other<br>Comprehensive<br>Loss |
|------------------------------|-------------------|-----------------------------------|--------------------|---|---|
| Balance at December 26, 2009 | \$ 8,594          | \$ (1,057)                        | \$ 569             | \$ (1,492)  | \$ (923)                                      |
| Unrealized gain              |                   |                                   | 763                |   | 763   |
| Call on investments          | (701)             | 99                                | (46)               | 103   | 57  |
| Balance at December 25, 2010 | \$ 7,893          | \$ (958)                          | \$ 1,286           | \$ (1,389)  | \$ (103)                                      |

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The Company believes that the credit risk associated with its available-for-sale ARS could change significantly in the future based on market conditions and continued uncertainties in the financial markets. The ARS student loan credit spread may be subject to significant volatility and it is difficult to predict future fluctuations. A 10% deterioration in the ARS student loan credit spread would result in an increase of \$0.2 million in the credit loss related portion of the OTTI.

**4. Cost-method Investment**

In May 2010, the Company invested \$4.5 million in a privately-held company. This investment is accounted for as a cost-basis investment, as the Company owns less than 20% of the voting securities and does not have the ability to exercise significant influence over operating and financial policies of the entity. The Company's investment is in an entity that is not publicly traded and, therefore, no established market for the securities exists. The Company's cost-method investment is carried at historical cost in its consolidated financial statements and measured at fair value on a nonrecurring basis. If the Company believes that the carrying value of the cost basis investment is in excess of estimated fair value, the Company's policy is to record an impairment charge in Other income (expense), net in the accompanying consolidated statements of operations to adjust the carrying value to estimated fair value, when the impairment is deemed other-than-temporary. The Company will regularly evaluate the carrying value of this cost-method investment for impairment. As of December 25, 2010, no event had occurred that would adversely affect the carrying value of this investment. The Company did not record any impairment charges for this cost-method investment during 2010.

**5. Derivative Instruments*****Foreign Currency Exchange Forward Contracts***

The Company enters into foreign currency exchange forward contracts to manage its exposure to fluctuations in foreign exchange rates that arise primarily from its Euro denominated receivables. Gains and losses on these contracts are intended to offset the impact of foreign exchange rate changes on the underlying foreign currency denominated accounts receivables, and therefore, do not subject the Company to material balance sheet risk. The forward contracts are with one high-quality institution and the Company monitors the creditworthiness of the counterparty consistently. The forward contracts entered into during 2010 were denominated in Euros and typically had maturities of no more than 30 days. The contracts were settled for U.S. dollars at maturity at rates agreed to at inception of the contracts. As of December 25, 2010, the Company did not designate foreign currency exchange forward contracts related to Euro denominated receivables as hedges for accounting purposes, and accordingly changes in the fair value of these instruments are included in Other gain (loss), net in the accompanying consolidated statements of operations. For the years ended December 25, 2010 and December 26, 2009, the before-tax effect of foreign currency exchange forward contracts for Euro denominated receivables not designated as hedging instruments was a gain of \$0.9 million and a loss of \$1.0 million, respectively, included in Other gain (loss), net in the consolidated statement of operations.

***Cash Flow Hedges***

The Company used foreign currency exchange forward contracts to hedge exposures related to forecasted sales denominated in Euro. These contracts were designated as cash flow hedges and matched the underlying forecasted transactions in duration. The contracts were carried on the balance sheet at fair value, and the effective portion of the contracts' gains and losses was recorded as Accumulated other comprehensive income until the forecasted transaction occurred. For foreign

**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

currency exchange forward contracts designated as cash flow hedges, the Company evaluated and calculated the effectiveness of each hedge quarterly, using the critical terms match method. When the forecasted transaction occurred, the Company reclassified the related gain or loss on the cash flow hedge to revenue. If it was determined that a hedged forecasted transaction was unlikely to occur, any gains or losses on the foreign currency exchange forward contracts were reclassified from other comprehensive income into earnings. In the fourth quarter of 2010, the Company recognized a gain of \$0.3 million in Other gain (loss), net, resulting from the discontinuance of hedge accounting for its cash flow hedges because it was no longer probable that the original forecasted transactions would occur within two months of the originally specified transaction dates.

The before-tax effect of foreign currency forward contracts that were designated as cash flow hedges was as follows:

|   | <b>Year Ended<br/>December 25, 2010<br/>(In thousands)</b> |
|---|--|
| Gain recognized in total revenue  | \$ 26 <sup>(1)</sup>                                       |
| Gain (loss) recognized in Accumulated other comprehensive loss                        | \$ 432   |
| Gain reclassified from Accumulated other comprehensive loss to total revenue          | \$ 129   |
| Gain reclassified from Accumulated other comprehensive loss to Other gain (loss), net | \$ 303   |

<sup>(1)</sup> Amount represents gain recognized in total revenue related to forward contracts initiated during the first quarter of 2010. The fair value of derivative instruments in the Company's consolidated balance sheet as of December 25, 2010 was as follows:

|   | <b>Notional<sup>(1)</sup></b> | <b>Fair Values of<br/>Derivative Instruments</b>                 |  |
|---|-------------------------------|--|--|
|   |                               | <b>Prepaid<br/>Expenses<br/>and Other<br/>Current<br/>Assets</b> | <b>Other<br/>Accrued<br/>Liabilities</b> |
|   |                               | <b>(In thousands)</b>  |  |
| <b>Derivatives not designated as hedging instruments:</b> |                               |  |  |
| Foreign currency exchange forward contracts               |                               |  |  |
| Related to Euro denominated receivables                   | \$ 21,248                     | \$   | \$ 74                                    |
| Related to forecasted sales denominated in Euro           | \$ 5,117                      | 303  |  |
| <b>Total derivatives</b>                                  |                               | <b>\$ 303</b>  | <b>\$ 74</b>                             |

<sup>(1)</sup> Represents the gross notional amount of the forward contracts that were outstanding as of December 25, 2010. As of December 26, 2009, there was a \$14.0 million notional amount of Euro denominated currency exchange forward contracts outstanding with an immaterial fair value amount due to the fact that the contract was entered and valued at the end of the period.



**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****6. Balance Sheet Components*****Restricted Cash***

The Company's restricted cash balances are comprised of certificates of deposit, of which the majority are not insured by the Federal Deposit Insurance Corporation. These amounts primarily collateralize the Company's issuances of stand-by and commercial letters of credit.

***Inventories, Net***

Inventories, net is comprised of the following:

|                 | December 25,<br>2010 | December 26,<br>2009 |
|-----------------|----------------------|----------------------|
|                 | (In thousands)       |                      |
| Raw materials   | \$ 23,104            | \$ 6,870             |
| Work in process | 14,798               | 32,054               |
| Finished goods  | 43,991               | 29,948               |
| Total inventory | \$ 81,893            | \$ 68,872            |

Included in finished goods inventory at December 25, 2010 and December 26, 2009 were \$9.0 million and \$8.0 million, respectively, of inventory at customer locations for which product acceptance had not occurred.

***Property, Plant and Equipment, Net***

Property, plant and equipment, net is comprised of the following:

|  | December 25,<br>2010 | December 26,<br>2009 |
|--|----------------------|----------------------|
|  | (In thousands)       |                      |
| Computer hardware                              | \$ 7,599             | \$ 5,976             |
| Computer software                              | 6,523                | 5,984                |
| Laboratory and manufacturing equipment         | 92,474               | 77,831               |
| Furniture and fixtures                         | 711                  | 651                  |
| Leasehold improvements                         | 22,549               | 16,384               |
|  | \$ 129,856           | \$ 106,826           |
| Less accumulated depreciation and amortization | (78,116)             | (63,170)             |
| Property, plant and equipment, net             | \$ 51,740            | \$ 43,656            |

Depreciation expense was \$15.4 million, \$19.3 million and \$12.7 million for 2010, 2009 and 2008, respectively. In 2009, the Company recognized \$3.0 million of depreciation expense caused by the shortening of the useful life of assets associated with the restructuring plan related to the closure of its Maryland-based semiconductor fabrication (the "Maryland FAB") plan.



**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Accrued Expenses**

Accrued expenses are comprised of the following:

|   | December 25,<br>2010 | December 26,<br>2009 |
|---|----------------------|----------------------|
|   | (In thousands)       |                      |
| Loss contingency related to non-cancelable purchase commitments | \$ 1,421             | \$ 2,029             |
| Taxes payable   | 2,043                | 3,907                |
| Restructuring accrual   | 127                  | 644                  |
| Royalties   | 1,548                | 1,673                |
| Accrued rebate  | 2,850                |                      |
| Leasehold improvements accrual                                  | 3,686                |                      |
| Other accrued expenses  | 8,115                | 5,676                |
| Total accrued expenses  | \$ 19,790            | \$ 13,929            |

**7. Restructuring and Other Related Costs**

In July 2009, the Company announced a restructuring plan under which it closed its Maryland FAB and consolidated these activities into its primary FAB located in Sunnyvale, California. This consolidation of activities into one location was expected to facilitate collaboration across integration platforms in support of the Company's next-generation products. As a result, during 2009, the Company recorded \$3.9 million of restructuring and other related costs including severance and related expenses, equipment and facilities-related costs, operating lease termination costs, and other exit costs. Equipment and facilities-related costs consist of increased depreciation expense related to restructured assets caused by shortening the useful life or updating the salvage value of depreciable fixed assets to coincide with the end of production under the approved restructuring plan. The Company completed its restructuring actions in 2010.

The types of restructuring and other related costs recorded were as follows:

|   | December 25, 2010     |                       | Years Ended |                    |                       | December 26, 2009 |  |
|---|-----------------------|-----------------------|-------------|--------------------|-----------------------|-------------------|--|
|   | Cost<br>of<br>Revenue | Operating<br>Expenses | Total       | Cost of<br>Revenue | Operating<br>Expenses | Total             |  |
|   | (In thousands)        |                       |             |                    |                       |                   |  |
| Severance and related expenses (credits)            | \$ (144)              | \$ 55                 | \$ (89)     | \$ 647             | \$ 154                | \$ 801            |  |
| Equipment and facilities-related expenses (credits) | (38)                  |                       | (38)        | 2,359              | 160                   | 2,519             |  |
| Lease termination                                   |                       | 104                   | 104         |                    | 411                   | 411               |  |
| Other   |                       |                       |             | 32                 | 89                    | 121               |  |
| Total   | \$ (182)              | \$ 159                | \$ (23)     | \$ 3,038           | \$ 814                | \$ 3,852          |  |

Cumulative restructuring and other related costs through December 25, 2010 totaled \$3.8 million.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table sets forth the activity and balance of the restructuring liability account for severance and operating lease and contract termination costs:

|                              | <b>Restructuring<br/>Liability<br/>(In thousands)</b> |
|------------------------------|---|
| Balance at December 27, 2008 | \$  |
| Provision                    | 1,212   |
| Payments                     | (568)   |
| Balance at December 26, 2009 | \$ 644  |
| Provision                    | 211   |
| Payments                     | (580)   |
| Change in estimates          | (148)   |
| Balance at December 25, 2010 | \$ 127  |

**8. Comprehensive Income (Loss)**

Total comprehensive income (loss) consists of other comprehensive income (loss) and net income (loss). Other comprehensive income (loss) includes certain changes in equity that are excluded from net income (loss). Specifically, cumulative foreign currency translation adjustments and unrealized holding gains (losses) on available-for-sale investments are included in Accumulated other comprehensive income (loss) in the consolidated balance sheets.

The components of accumulated other comprehensive income (loss) are as follows:

|  | <b>December 25,<br/>2010</b> | <b>December 26,<br/>2009<br/>(In thousands)</b> | <b>December 27,<br/>2008</b> |
|--|------------------------------|---|------------------------------|
| Accumulated net unrealized loss on foreign currency translation adjustment   | \$ (490)                     | \$ (565)  | \$ (786)                     |
| Accumulated unrealized non-credit related other-than-temporary impairment losses on available-for-sale investments | (103)                        | (923)   |                              |
| Accumulated unrealized holding loss on all other available-for-sale investments                                    | (37)                         | (7)   | (2,812)                      |
| Accumulated tax effect on items related to available-for-sale investments  | (631)                        | (315)   |                              |
| <b>Total accumulated other comprehensive loss</b>  | <b>\$ (1,261)</b>            | <b>\$ (1,810)</b>                               | <b>\$ (3,598)</b>            |



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The following table reconciles net income (loss) to comprehensive income (loss):

|  | December 25,<br>2010 | Years Ended<br>December 26,<br>2009<br>(In thousands) | December 27,<br>2008 |
|--|----------------------|---|----------------------|
| Net income (loss)  | \$ (27,932)          | \$ (86,622)   | \$ 78,728            |
| Change in foreign currency translation gain (loss)   | 75                   | 221   | (841)                |
| Change in unrealized non-credit related other-than-temporary impairment losses on available-for-sale investments | 820                  | (923)   |                      |
| Change in unrealized gain (loss) on all other available-for-sale investments                                     | (30)                 | 2,805   | (2,835)              |
| Change in tax effect related to available-for-sale investments   | (316)                | (315)   |                      |
| Total comprehensive income (loss)  | \$ (27,383)          | \$ (84,834)   | \$ 75,052            |

**9. Basic and Diluted Net Income (Loss) Per Common Share**

Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of vested common shares outstanding during the period. Diluted net income (loss) per common share is computed using net income (loss) and the weighted average number of common shares outstanding plus potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include the assumed exercise of outstanding stock options, assumed vesting of outstanding RSUs and PSUs, assumed exercise of outstanding warrants, and assumed issuance of stock under the employee stock purchase plan using the treasury stock method.

The following table sets forth the computation of net income (loss) per basic and diluted share:

|  | December 25,<br>2010 | Years Ended<br>December 26,<br>2009<br>(In thousands, except per share amounts) | December 27,<br>2008 |
|--|----------------------|---|----------------------|
| <b>Numerator Basic and Diluted</b>                 |                      |   |                      |
| Net income (loss)                                  | \$ (27,932)          | \$ (86,622)   | \$ 78,728            |
| <b>Denominator</b>                                 |                      |   |                      |
| Basic weighted average common shares outstanding   | 99,380               | 95,468  | 92,427               |
| Effect of dilutive securities:                     |                      |   |                      |
| Employee equity plans                              |                      |   | 4,288                |
| Warrants to purchase common stock                  |                      |   | 373                  |
| Diluted weighted average common shares outstanding | \$ 99,380            | \$ 95,468   | \$ 97,088            |
| Net income (loss) per common share basic           | \$ (0.28)            | \$ (0.91)   | \$ 0.85              |

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|  |           |           |         |
|--|-----------|-----------|---------|
| Net income (loss) per common share diluted | \$ (0.28) | \$ (0.91) | \$ 0.81 |
|--|-----------|-----------|---------|

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The Company had the following equity awards outstanding that could potentially dilute basic net loss per common share in the future, but were excluded from the computation of diluted loss per common share in the periods presented as their effect would have been anti-dilutive:

|                                     | December 25,<br>2010 | As of<br>December 26,<br>2009 |
|-------------------------------------|----------------------|-------------------------------|
|                                     | (In thousands)       |                               |
| Stock options outstanding           | 7,815                | 14,568                        |
| Restricted stock units              | 6,783                | 5,066                         |
| Performance stock units             | 2,682                | 3,304                         |
| Employee stock purchase plan shares | 636                  | 677                           |
| Warrants to purchase common stock   | 124                  | 124                           |
| <br>Total                           | <br>18,040           | <br>23,739                    |

For the year ended December 27, 2008, the Company excluded 6.0 million shares related to outstanding stock options from the calculation of diluted earnings per common share because the exercise prices of these stock options were greater than the average market value of the Company's common stock. These options could be included in the calculation in the future if the average market value of the Company's common stock increases.

**10. Commitments and Contingencies*****Operating Leases***

The Company leases facilities under non-cancelable operating lease agreements. The Company leases space in Sunnyvale, California, Allentown, Pennsylvania, Annapolis Junction, Maryland, Bangalore, India, Beijing, China, Kanata, Canada, and in the United Kingdom. These leases have varying terms, predominantly no longer than ten years each and contain leasehold improvement incentives, rent holidays and escalation clauses that range from one to ten years. In addition, some of these leases have renewal options for up to six years. The Company also has contractual commitments to remove leasehold improvements and return certain properties to a specified condition when the leases terminate. Asset retirement obligations were \$1.1 million and \$1.4 million as of December 25, 2010 and December 26, 2009, respectively.

The Company recognizes rent expense on a straight-line basis over the lease period factoring in leasehold improvement incentives, rent holidays and escalation clauses, and has accrued for rent expense incurred but not paid. Rent expense for all leases was \$5.1 million, \$5.1 million and \$4.0 million for 2010, 2009 and 2008, respectively. Sublease rental income was zero, \$0.1 million and \$0.1 million for 2010, 2009 and 2008, respectively.

Future annual minimum operating lease payments at December 25, 2010 were as follows:

|                          | 2011           | 2012     | 2013     | 2014     | 2015     | Thereafter | Total     |
|--------------------------|----------------|----------|----------|----------|----------|------------|-----------|
|                          | (In thousands) |          |          |          |          |            |           |
| Operating lease payments | \$ 4,243       | \$ 4,294 | \$ 3,328 | \$ 3,265 | \$ 3,362 | \$ 14,436  | \$ 32,928 |



**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Purchase Commitments***

The Company has service agreements with its major production suppliers, where the Company is committed to purchase certain parts. These obligations are typically less than our purchases. As of December 25, 2010, December 26, 2009 and December 27, 2008, these non-cancelable purchase commitments were \$41.7 million, \$35.0 million, and \$17.3 million, respectively.

Future purchase commitments at December 25, 2010 were as follows:

|                      | 2011           | 2012 | 2013 | 2014 | 2015 | Thereafter | Total     |
|----------------------|----------------|------|------|------|------|------------|-----------|
|                      | (In thousands) |      |      |      |      |            |           |
| Purchase obligations | \$ 41,714      | \$   | \$   | \$   | \$   | \$         | \$ 41,714 |

The contractual obligation tables above exclude tax liabilities of \$0.8 million related to uncertain tax positions because the Company is unable to determine the timing of settlement if any, of these future payments with a reasonably reliable estimate.

***Indemnification Obligations***

From time to time, the Company enters into certain types of contracts that contingently require it to indemnify parties against third-party claims. These contracts primarily relate to: (i) certain real estate leases under which the Company may be required to indemnify property owners for environmental and other liabilities, and other claims arising from the Company's use of the applicable premises; (ii) certain agreements with the Company's officers, directors and certain key employees, under which the Company may be required to indemnify such persons for liabilities; and (iii) certain provisions in the Company's customer agreements that may require the Company to indemnify their customers and their affiliated parties against certain liabilities, including if the Company's products infringe a third party's intellectual property rights.

The terms of such indemnification obligations vary. Because the maximum obligated amounts under these agreements generally are not explicitly stated, the maximum potential amount of future payments the Company could be required to make under these indemnification agreements is generally unlimited.

To date, the Company has not incurred any material costs as a result of the indemnification obligations and has not accrued any liabilities related to such obligations in the Company's consolidated financial statements. The Company has agreed to indemnify Level 3 in connection with the lawsuit filed by Cheetah Omni LLC (Cheetah) on May 9, 2006 (see Note 12, Legal Matters, to the Notes to Consolidated Financial Statements). The Company is contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent the Company's product is found to infringe the two Cheetah Omni LLC patents at issue (patent nos. 6,795,605 and 7,142,347), and the Company has assumed the defense of this matter.

As permitted under Delaware law and the Company's charter and bylaws, the Company has agreements whereby it indemnifies certain of its officers and each of its directors for certain events or occurrences while the officer or director is, or was, serving at the Company's request in such capacity. The term of the indemnification period is for the officer's or director's lifetime. The maximum potential amount of future payments the Company could be required to make under these indemnification agreements is unlimited; however, the Company has a Director and Officer insurance policy that may reduce its exposure and enable it to recover all or a portion of any future amounts paid. As a result of

**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

its insurance policy coverage, the Company believes the estimated fair value of these indemnification agreements is minimal. The Company has no liabilities recorded for these agreements as of December 25, 2010 and December 26, 2009, as this liability is not reasonably estimable even though liability under these agreements is not remote.

**11. Guarantees*****Product Warranties***

Upon delivery of products, the Company provides for the estimated cost to repair or replace products or the related components that may be returned under the hardware warranty. In general, hardware warranty periods range from one to five years. Hardware warranties provide the purchaser with protection in the event that the product does not perform to product specifications. During the warranty period, the purchaser's sole and exclusive remedy in the event of such defect or failure to perform is limited to the correction of the defect or failure by repair, refurbishment or replacement, at the Company's sole option and expense. The Company estimates its hardware warranty obligations based on the Company's historical experience of known product failure rates, use of materials to repair or replace defective products, and service delivery costs incurred in correcting product failures. In addition, from time to time, specific hardware warranty accruals may be made if unforeseen technical problems arise with specific products. Management periodically assesses the adequacy of the Company's recorded warranty liabilities and adjusts the amounts as necessary. Changes in product warranty liability are summarized below.

|                                   | December 25,<br>2010 | December 26,<br>2009 |
|-----------------------------------|----------------------|----------------------|
|                                   | (In thousands)       |                      |
| Beginning balance                 | \$ 11,140            | \$ 9,940             |
| Charges to operations             | 12,350               | 11,753               |
| Utilization                       | (9,010)              | (6,542)              |
| Change in estimate <sup>(1)</sup> | (3,058)              | (4,011)              |
| Balance at the end of the period  | \$ 11,422            | \$ 11,140            |

<sup>(1)</sup> The Company records hardware warranty liabilities based on the latest quality and cost information available as of that date. The favorable changes in estimate shown here are due to continued improvements in overall actual failure rates and the impact of these improvements on the Company's estimate of expected future returns and changes in the estimated cost of replacing failed units using either repaired or new units.

***Letters of Credit***

The Company had \$4.0 million of standby letters of credit outstanding as of December 25, 2010. These consisted of \$1.7 million related to a customer proposal guarantee, \$1.3 million related to a value added tax license and \$1.0 million related to property leases. The Company had \$4.0 million of standby letters of credit outstanding as of December 26, 2009. These consisted of \$1.5 million related to a customer proposal guarantee, \$1.5 million related to a value added tax license and \$1.0 million related to property leases.

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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**12. Legal Matters**

On May 9, 2006, the Company and Level 3 were sued by Cheetah in the U.S. District Court for the Eastern District of Texas Texarkana Division for alleged infringement of patent no. 6,795,605 (the '605 Patent), and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of the Company's DTN System and to recover all damages caused by the alleged willful infringement including any and all compensatory damages available by law, such as actual and punitive damages, attorneys' fees, associated interest and Cheetah's costs incurred in the lawsuit. Cheetah's complaint does not request a specific dollar amount for these compensatory damages. The Company is contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent its product supplied by the Company is found to infringe, and it has assumed the defense of this matter. On July 20, 2006, the Company and Level 3 filed an amended response denying all infringement claims under the '605 Patent and asserting that the claims of the '605 Patent are invalid and that the DTN System does not infringe the '605 Patent. On November 28, 2006, Cheetah filed a second amended complaint and added patent no. 7,142,347 (the '347 Patent) to the lawsuit. On December 18, 2006, the Company and Level 3 filed responses to Cheetah's second amended complaint denying all infringement claims under the '347 Patent and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims are invalid and that the DTN System does not infringe the patents.

On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, the Company and Level 3 filed responses to Cheetah's third amended complaint denying all infringement claims, and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims of the patents are invalid and that the DTN System does not infringe the patents.

On March 14, 2007, the Company submitted requests to the U.S. Patent and Trademark Office (the U.S. PTO) for inter partes reexamination of the '605 Patent and the '347 Patent asking the U.S. PTO to reexamine the patents based on prior art in order to invalidate the patents or limit the scope of each patent's claims. On March 21, 2007, the Company and Level 3 filed a motion with the court to stay all proceedings in the lawsuit pending the reexamination of the '605 Patent and the '347 Patent.

On April 11, 2007, the Company, Level 3 and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. PTO as to whether it will reexamine the '605 Patent and the '347 Patent; and (2) if the U.S. PTO decides to reexamine either the '605 Patent and the '347 Patent, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. PTO. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. On June 26, 2007, the U.S. PTO also ordered reexamination of the '605 Patent. On August 1, 2007, the U.S. PTO ordered reexamination of the '347 Patent. As a result, all proceedings in this lawsuit are stayed until the final resolution of these reexaminations.

In a communication the Company received from the U.S. PTO dated December 4, 2009, the Company was advised that various claims in the '347 Patent reexamination have been allowed, while other claims have been rejected. In a communication the Company received from the U.S. Patent and Trademark Office dated June 22, 2010, the Company was advised that various claims in the '605 Patent reexamination have been allowed, while other claims have been rejected. The Company has appealed the allowance of certain claims in the '347 Patent and '605 Patent reexaminations to the Board of Patent Appeals and Interferences at the U.S. PTO and will have an opportunity to appeal the allowance of certain claims in the '605 Patent reexamination. The Company does not know when the U.S. PTO reexamination process will be completed.

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On January 26, 2010, Cheetah's counsel filed a motion requesting the court to lift the stay in order to litigate those claims relating to the 347 Patent reexamination that the U.S. PTO allowed. The court denied the motion on April 16, 2010. On April 30, 2010, Cheetah filed a motion for reconsideration of the order denying Cheetah's motion to lift the stay. On May 17, 2010, the Company filed its opposition to Cheetah's motion for reconsideration. On August 24, 2010, after a hearing on the matter, the court issued an order keeping the stay in place. The Company believes the suit is without merit and intends to defend itself vigorously, but it is unable to predict the likelihood of an unfavorable outcome.

On May 14, 2010, Aloft Media, LLC (Aloft) filed a complaint in the U.S. District Court for the Eastern District of Texas Tyler Division alleging that the Company infringes U.S. patent nos. 7,593,910 and 7,596,538. On August 2, 2010, the Company filed its answer to Aloft's complaint denying all infringement claims and asserting counterclaims. On August 25, 2010, Aloft filed its answer to the Company's counterclaims. On December 16, 2010, Aloft's complaint was dismissed without prejudice.

In addition to the matters described above, the Company is subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material effect on its consolidated financial position, results of operations, or cash flows.

**13. Stockholders Equity*****2000 Stock Plan, 2007 Equity Incentive Plan and Employee Stock Purchase Plan***

In December 2000, the Company adopted the 2000 Stock Plan (2000 Plan). Under the 2000 Plan, as amended, the Company had reserved an aggregate of 14.2 million shares of its common stock for issuance. As of December 25, 2010, options to purchase 2.3 million shares of the Company's common stock were outstanding. The Company's board of directors decided not to grant any additional options or other awards under the 2000 Plan following the Company's IPO in 2007. The 2000 Plan expired on December 6, 2010. However, the 2000 Plan will continue to govern the terms and conditions of the outstanding options previously granted under the plan.

In February 2007, the Company's board of directors adopted the 2007 Equity Incentive Plan (2007 Plan) and the Company's stockholders approved the 2007 Plan in May 2007. As of December 25, 2010, the Company reserved a total of 27.7 million shares of common stock for issuance of options, RSUs and PSUs to employees, non-employees and members of the Company's board of directors, pursuant to the 2007 Plan. The 2007 Plan has a maximum term of 10 years from the date of adoption, or it can be earlier terminated by the Company's board of directors.

Additionally, in February 2007, the Company's board of directors adopted, and in May 2007, its stockholders approved the Company's ESPP. The ESPP has a 20-year term, and as of December 25, 2010, the Company had authorized the issuance of approximately 4.6 million shares of common stock.

***Stock Option Exchange Program***

On June 11, 2009, our stockholders approved a one-time stock option exchange program (the Option Exchange Program), and on January 25, 2010, we launched the Option Exchange Program pursuant to which eligible employees were able to exchange certain outstanding stock options under our 2007 Plan with an exercise price greater than or equal to \$8.16 per share and a grant date on or

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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

before January 25, 2009, for a lesser amount of new RSUs or, for new stock options for senior executives. The Option Exchange Program was approved by our stockholders in June 2009 and was available for employees of the Company residing in the U.S., India and U.K. who held eligible shares. The Option Exchange Program expired on February 22, 2010, and there were 4,926,790 shares tendered for exchange. All surrendered options were cancelled effective as of the expiration of the Option Exchange Program, and immediately thereafter, the Company granted (i) new options with an exercise price of \$7.61 per share to purchase an aggregate of 1,564,727 shares of Infinera common stock and (ii) RSUs representing 814,017 shares of Infinera common stock. The Option Exchange Program was an expense neutral exchange and it did not result in any significant incremental stock-based compensation expense.

*Equity Incentive Plans*

As December 25, 2010, there were a total of 9.7 million shares available for grant under the Company's 2007 Plan. The following tables summarize the Company's stock award activity and related information:

|   | Number of<br>Options                  | Weighted-Average<br>Exercise Price<br>Per Share | Aggregate<br>Intrinsic<br>Value |
|---|---------------------------------------|---|---------------------------------|
|   | (In thousands, except per share data) |   |                                 |
| <b>Outstanding at December 29, 2007</b>                               | <b>11,126</b>                         | <b>\$ 6.31</b>                                  | <b>\$ 89,148</b>                |
| Options granted   | 2,453                                 | \$ 12.78  |                                 |
| Options exercised   | (1,477)                               | \$ 2.13   | \$ 14,451                       |
| Options canceled  | (736)                                 | \$ 8.12   |                                 |
| <b>Outstanding at December 27, 2008</b>                               | <b>11,366</b>                         | <b>\$ 8.13</b>                                  | <b>\$ 34,125</b>                |
| Options granted   | 4,697                                 | \$ 7.60   |                                 |
| Options exercised   | (954)                                 | \$ 2.31   | \$ 5,514                        |
| Options canceled  | (541)                                 | \$ 10.59  |                                 |
| <b>Outstanding at December 26, 2009</b>                               | <b>14,568</b>                         | <b>\$ 8.25</b>                                  | <b>\$ 35,462</b>                |
| Options granted   | 836                                   | \$ 8.19   |                                 |
| Options granted in connection with the stock option exchange program  | 1,565                                 | \$ 7.61   |                                 |
| Options exercised   | (3,094)                               | \$ 3.85   | \$ 17,538                       |
| Options canceled in connection with the stock option exchange program | (4,927)                               | \$ 13.53  |                                 |
| Options canceled  | (1,133)                               | \$ 8.28   |                                 |
| <b>Outstanding at December 25, 2010</b>                               | <b>7,815</b>                          | <b>\$ 6.52</b>                                  | <b>\$ 30,923</b>                |
| Vested and expected to vest   | 7,733                                 |   | \$ 30,739                       |

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## INFINERA CORPORATION

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

|   | Number of<br>Restricted<br>Stock Units | Weighted-Average<br>Grant Date<br>Fair Value Per Share<br>(In thousands, except per share data) | Aggregate<br>Intrinsic<br>Value |
|---|--|---|---------------------------------|
| <b>Outstanding at December 29, 2007</b>                           | 616                                    | \$ 20.07  | \$ 8,661                        |
| RSUs granted  | 1,880                                  | \$ 12.01  |                                 |
| RSUs released   | (100)                                  | \$ 19.80  | \$ 865                          |
| RSUs canceled   | (98)                                   | \$ 14.85  |                                 |
| <b>Outstanding at December 27, 2008</b>                           | <b>2,298</b>                           | <b>\$ 13.71</b>   | <b>\$ 19,646</b>                |
| RSUs granted  | 3,584                                  | \$ 7.45   |                                 |
| RSUs released   | (466)                                  | \$ 14.15  | \$ 3,933                        |
| RSUs canceled   | (350)                                  | \$ 10.83  |                                 |
| <b>Outstanding at December 26, 2009</b>                           | <b>5,066</b>                           | <b>\$ 9.44</b>  | <b>\$ 45,287</b>                |
| RSUs granted  | 2,828                                  | \$ 8.92   |                                 |
| RSUs granted in connection with the stock option exchange program | 814                                    | \$ 7.61   |                                 |
| RSUs released   | (1,322)                                | \$ 9.59   | \$ 12,681                       |
| RSUs canceled   | (603)                                  | \$ 9.10   |                                 |
| <b>Outstanding at December 25, 2010</b>                           | <b>6,783</b>                           | <b>\$ 9.03</b>  | <b>\$ 69,927</b>                |
| Expected to vest  | 6,540                                  |   | \$ 67,424                       |

|   | Number<br>of<br>Performance<br>Stock<br>Units | Weighted-Average<br>Grant Date Fair<br>Value Per Share<br>(In thousands, except per share data) | Aggregate<br>Intrinsic<br>Value |
|---|---|---|---------------------------------|
| <b>Outstanding at December 27, 2008</b> |   | \$  | \$                              |
| PSUs granted                            | 3,334   | \$ 10.51  |                                 |
| PSUs released                           |   | \$  |                                 |
| PSUs canceled                           | (30)  | \$ 10.09  |                                 |
| <b>Outstanding at December 26, 2009</b> | <b>3,304</b>                                  | <b>\$ 10.51</b>   | <b>\$ 29,541</b>                |
| PSUs granted                            |   | \$  |                                 |
| PSUs released                           |   | \$  |                                 |
| PSUs canceled                           | (622)   | \$ 10.51  |                                 |
| <b>Outstanding at December 25, 2010</b> | <b>2,682</b>                                  | <b>\$ 10.51</b>   | <b>\$ 27,660</b>                |
| Expected to vest                        | 2,588   |   | \$ 26,681                       |

The aggregate intrinsic value of unexercised options, unreleased RSUs and PSUs is calculated as the difference between the closing price of the Company's common stock of \$10.31 at December 23, 2010 and the exercise prices of the underlying equity awards. The aggregate intrinsic value of the options which have been exercised and RSUs released is calculated as the difference between the fair market value of the common stock at the date of exercise or release and the exercise price of the underlying equity awards.



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The following table summarizes information about options outstanding at December 25, 2010.

| Exercise Price    | Number of Shares<br>(In thousands) | Options Outstanding                                       |                                 | Vested and Exercisable Options     |                                 |
|-------------------|------------------------------------|---|---------------------------------|------------------------------------|---------------------------------|
|                   |                                    | Weighted-Average Remaining Contractual Life<br>(In years) | Weighted-Average Exercise Price | Number of Shares<br>(In thousands) | Weighted-Average Exercise Price |
| \$0.76 - \$1.84   | 649                                | 3.86  | \$ 1.35                         | 649                                | \$ 1.35                         |
| \$2.00 - \$4.04   | 1,502                              | 5.43  | \$ 2.41                         | 1,502                              | \$ 2.41                         |
| \$6.30 - \$7.55   | 2,158                              | 8.42  | \$ 7.10                         | 1,254                              | \$ 7.09                         |
| \$7.61            | 964                                | 6.90  | \$ 7.61                         | 191                                | \$ 7.61                         |
| \$7.68 - \$13.00  | 2,449                              | 7.30  | \$ 9.17                         | 969                                | \$ 9.67                         |
| \$13.16 - \$23.86 | 93                                 | 5.87  | \$ 14.58                        | 83                                 | \$ 14.42                        |
|                   | 7,815                              | 6.90  | \$ 6.52                         | 4,648                              | \$ 5.47                         |

**Employee Stock Options**

During 2010, the Company granted options to employees and directors to purchase an aggregate of 2.4 million shares of common stock at a weighted-average price of \$7.81 per share. These options have exercise prices equal to the closing market prices of the Company's common stock on the dates these options were granted. The options granted during 2010 included 1.6 million shares of common stock granted in connection with the Option Exchange Program, at an exercise price of \$7.61 per share. The weighted-average remaining contractual term of options exercisable was 6.3 years as of December 25, 2010. The aggregate intrinsic value of options currently exercisable was \$23.5 million as of December 25, 2010. Amortization of stock-based compensation in 2010 and 2009 was approximately \$14.9 million and \$17.9 million, respectively, net of estimated forfeitures.

At December 25, 2010 and December 26, 2009, the total stock-based compensation cost related to options granted to employees and members of the Company's board of directors, but not yet amortized was \$14.3 million and \$42.2 million, respectively, net of estimated forfeitures of \$0.4 million and \$1.8 million, respectively. These costs will be amortized on a straight-line basis over a weighted average period of approximately 1.9 years. The unamortized expense at December 25, 2010 decreased by \$27.9 million as compared to December 26, 2009 primarily due to \$14.9 million of stock-based compensation expense recognized in 2010, \$5.5 million related to the termination of employees during 2010, and \$10.9 million from the impact of the Option Exchange Program. These decreases were partially offset by \$3.4 million related to new grants.

Total fair value of stock options granted to employees and directors that vested during 2010 and 2009 was approximately \$11.6 million and \$17.9 million, respectively, based on the grant date fair value.

Excluding options granted in connection with the Option Exchange Program, the ranges of estimated values of employee stock options granted under the 2007 Plan, as well as ranges of assumptions used in calculating these values, were based on estimates as follows:

|  | December 25,<br>2010 | Years Ended<br>December 26,<br>2009 | December 27,<br>2008 |
|--|----------------------|-------------------------------------|----------------------|
| <b>Employee and Director Stock Options</b> |                      |                                     |                      |

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|                         |                 |                 |                 |
|-------------------------|-----------------|-----------------|-----------------|
| Volatility              | 56% - 61%       | 60% - 73%       | 65% - 74%       |
| Risk-free interest rate | 1.4% - 2.9%     | 1.6% - 3.1%     | 2.6% - 3.5%     |
| Expected life           | 4.8 - 5.4 years | 3.8 - 6.1 years | 5.3 - 6.3 years |
| Estimated fair value    | \$3.32 - \$5.72 | \$3.86 - \$5.87 | \$4.70 - \$9.44 |

**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Employee Stock Purchase Plan***

Stock-based compensation costs related to the ESPP were approximately \$2.8 million, \$3.2 million and \$2.8 million for 2010, 2009 and 2008, respectively. The fair value of the ESPP shares was estimated at the date of grant using the following assumptions:

|                                     | <b>December 25,<br/>2010</b> | <b>Years Ended<br/>December 26,<br/>2009</b> | <b>December 27,<br/>2008</b> |
|-------------------------------------|------------------------------|--|------------------------------|
| <b>Employee Stock Purchase Plan</b> |                              |  |                              |
| Volatility                          | 45% - 55%                    | 63% - 95%                                    | 55% - 65%                    |
| Risk-free interest rate             | 0.20% - 0.23%                | 0.36% - 0.54%                                | 1.92% - 2.12%                |
| Expected life                       | 0.5 years                    | 0.5 years                                    | 0.5 years                    |
| Estimated fair value                | \$2.13 - \$2.58              | \$2.32 - \$2.83                              | \$3.51 - \$4.42              |

***Restricted Stock Units***

During 2010 and 2009, the Company granted an aggregate of 3.6 million and 3.6 million shares of common stock, respectively, at no cost. Included in the RSUs granted in 2010 are 0.8 million shares granted in connection with the Option Exchange Program. The Company accounted for the fair value of the RSUs using the closing market price of the Company's common stock on the date of grant. Amortization of RSU stock-based compensation in 2010 and 2009 was approximately \$23.8 million and \$10.8 million, respectively. As of December 25, 2010 and December 26, 2009, total stock-based compensation cost related to RSU awards granted to employees and members of the Company's board of directors, but not yet amortized was approximately \$41.2 million and \$34.7 million, respectively, net of estimated forfeitures of \$4.6 million and \$4.1 million, respectively.

***Performance Stock Units***

During 2009, the Company granted 3.3 million shares of PSUs, primarily to members of the Company's board of directors and executive officers, with the shares cliff vesting at the end of a three-year or four-year period. The number of shares to be issued upon vesting of these PSUs range from 0.5 to 2.0 times the number of PSUs granted depending on the relative performance of the Company's common stock price compared to NASDAQ over a three-year or four-year period. Amortization of stock-based compensation related to PSUs in 2010 and 2009 was approximately \$7.6 million and \$6.7 million, respectively. As of December 25, 2010 and December 26, 2009, total stock-based compensation cost related to PSUs granted to members of the Company's board of directors and executive officers, but not yet amortized was approximately \$13.4 million and \$26.1 million, respectively, net of estimated forfeitures of \$0.5 million and \$1.6 million, respectively. These costs will be amortized on a straight-line basis over a weighted-average period of 1.6 years.

The grant date fair value of PSUs was estimated using a Monte Carlo simulation model with the following assumptions:

|   | <b>Year Ended<br/>December 26,<br/>2009</b> |
|---|---|
| <b>Performance Stock Unit Grants</b>    |   |
| Infinera volatility                     | 70% - 75%                                   |
| NASDAQ volatility                       | 28% - 35%                                   |
| Risk-free interest rate                 | 1.25% - 1.71%                               |
| Correlation between Infinera and NASDAQ | 0.60 - 0.62                                 |

|                      |                  |
|----------------------|------------------|
| Estimated fair value | \$9.65 - \$12.46 |
|----------------------|------------------|

**Table of Contents****INFINERA CORPORATION****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Common Stock Warrants**

During 2009, warrants to purchase 0.1 million shares of common stock were net exercised. The aggregate consideration for such exercises was approximately \$0.3 million. As of December 25, 2010, there were warrants to purchase 0.1 million shares of common stock outstanding with exercise prices ranging from \$5.40 to \$8.96 per share and a weighted average price of \$6.30 per share. These warrants expire between 2011 and 2013.

**Stock-based Compensation Expense**

The following table summarizes the effects of stock-based compensation related to awards granted to employees, members of the Company's board of directors and other non-employees on the Company's consolidated balance sheets and statements of operations:

|  | December 25,<br>2010 | Years Ended<br>December 26,<br>2009<br>(In thousands) | December 27,<br>2008 |
|--|----------------------|---|----------------------|
| Stock-based compensation effects in inventory                                | \$ 2,497             | \$ 2,879  | \$ 1,801             |
| Stock-based compensation effects in deferred inventory cost                  | \$ 287               | \$ 201  | \$ 101               |
| <b>Stock-based compensation effects in income (loss) before income taxes</b> |                      |   |                      |
| Cost of revenue  | \$ 2,598             | \$ 1,861  | \$ 1,086             |
| Research and development   | 14,301               | 10,302  | 6,543                |
| Sales and marketing  | 7,896                | 6,505   | 4,440                |
| General and administrative   | 19,903               | 15,061  | 7,463                |
|  | 44,698               | 33,729  | 19,532               |
| Cost of revenue amortization from balance sheet <sup>(1)</sup>               | 5,637                | 3,646   | 4,287                |
| Total stock-based compensation expense                                       | \$ 50,335            | \$ 37,375   | \$ 23,819            |

<sup>(1)</sup> Represents stock-based compensation expense deferred to inventory and deferred inventory costs in prior periods and recognized in the current period.

**Shares Reserved for Future Issuances**

Common stock reserved for future issuance was as follows:

|   | December 25,<br>2010<br>(In thousands) |
|---|--|
| Outstanding stock options and awards        | 17,281                                 |
| Reserved for future option and award grants | 9,729                                  |
| Reserved for future ESPP                    | 1,399                                  |

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|  |        |
|--|--------|
| Total common stock reserved for stock options and awards | 28,409 |
| Warrants to purchase common stock                        | 124    |
| Total common stock reserved for future issuances         | 28,533 |

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The following is a geographic breakdown of the provision for (benefit from) income taxes:

|                                  | December 25,<br>2010 | Years Ended<br>December 26,<br>2009<br>(In thousands) | December 27,<br>2008 |
|----------------------------------|----------------------|---|----------------------|
| <b>Current:</b>                  |                      |   |                      |
| Federal                          | \$ (264)             | \$ (1,131)  | \$ 551               |
| State                            | (17)                 | (1,145)   | 1,346                |
| Foreign                          | 790                  | 520   | 748                  |
| <b>Total current</b>             | <b>\$ 509</b>        | <b>\$ (1,756)</b>                                     | <b>\$ 2,645</b>      |
| <b>Deferred:</b>                 |                      |   |                      |
| Federal                          | \$ (200)             | \$ (76)   | \$                   |
| State                            |                      | (39)  |                      |
| Foreign                          | 8                    |   | 78                   |
| <b>Total deferred</b>            | <b>\$ (192)</b>      | <b>\$ (115)</b>                                       | <b>\$ 78</b>         |
| <b>Total provision (benefit)</b> | <b>\$ 317</b>        | <b>\$ (1,871)</b>                                     | <b>\$ 2,723</b>      |

Income before provision for income taxes from international operations was \$3.5 million, \$2.4 million and \$1.9 million for the years ended December 25, 2010, December 26, 2009 and December 27, 2008, respectively.

The provisions for income taxes differ from the amount computed by applying the statutory federal income tax rates as follows:

|  | December 25,<br>2010 | Years Ended<br>December 26,<br>2009 | December 27,<br>2008 |
|--|----------------------|-------------------------------------|----------------------|
| Expected tax provision (benefit) at federal statutory rate | (35.0)%              | (35.0)%                             | 35.0%                |
| State taxes, net of federal benefit                        | 0.1%                 | 0.1%                                | 1.1%                 |
| Research credits   | (9.4)%               | (3.6)%                              | (2.2)%               |
| Stock-based compensation                                   | 7.5%                 | 4.9%                                | 4.8%                 |
| Release in prior year taxes following IRS ruling           |                      | (2.4)%                              |                      |
| Change in valuation allowance                              | 40.6%                | 34.6%                               | (35.6)%              |
| Other  | (2.7)%               | (0.7)%                              | 0.2%                 |
| <b>Effective tax rate</b>                                  | <b>1.1%</b>          | <b>(2.1)%</b>                       | <b>3.3%</b>          |

During 2009, the Company recognized a tax benefit of approximately \$2.1 million for a reversal of the 2008 federal and state tax provision, following a favorable ruling by the Internal Revenue Service in the third quarter of 2009. Exclusive of this one-time benefit in 2009, we

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recognized income tax expense of approximately \$0.3 million in each of fiscal years 2010 and 2009, on pre-tax book losses of \$27.6 million and \$88.5 million, respectively. Exclusive of the one-time benefit mentioned above, the resulting effective tax rates of 1.1% and 0.4% for 2010 and 2009, respectively, differs from the expected statutory rate of 35% based upon unbenefited U.S. losses, non-deductible stock compensation

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charges and foreign taxes provided on foreign subsidiary earnings, offset by the benefit related to refundable research and development tax credits in 2009. This compares to an effective tax rate of approximately 3.3% for 2008, which reflects tax benefits arising from the release of certain valuation allowances on domestic tax attribute carryforwards which was partially offset by the impact of certain non-deductible stock compensation charges, federal alternative minimum tax and state income taxes.

During 2010 and 2009, income tax benefits of \$0.3 million for each year were allocated to the tax provision from continuing operations, related to the tax effects of items credited directly to other comprehensive income ( OCI ). Generally, the amount of tax expense or benefit allocated to continuing operations is determined without regard to the tax effects of other categories of income or loss, such as OCI. However, an exception to the general rule is provided within the intra-period tax allocations rules when there is a pre-tax loss from continuing operations and there are items charged or credited to other categories, including OCI, in the current year. The intra-period tax allocation rules related to items charged or credited directly to OCI can result in disproportionate tax effects that remain in OCI until certain events occur.

Deferred income taxes reflect the net effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. Significant components of the Company's deferred tax assets are as follows:

|   | Years Ended          |                      |
|---|----------------------|----------------------|
|   | December 25,<br>2010 | December 26,<br>2009 |
|   | (In thousands)       |                      |
| <b>Deferred tax assets:</b>                   |                      |                      |
| Net operating losses                          | \$ 88,419            | \$ 102,711           |
| Research credits                              | 20,628               | 18,967               |
| Nondeductible accruals                        | 23,058               | 18,212               |
| Property, plant and equipment                 | 3,118                | 4,721                |
| Intangible assets                             | 13,541               | 17,702               |
| Stock-based compensation                      | 23,203               | 12,077               |
| <b>Total deferred tax assets</b>              | <b>\$ 171,967</b>    | <b>\$ 174,390</b>    |
| Valuation allowance                           | (155,847)            | (142,420)            |
| <b>Net deferred tax assets</b>                | <b>\$ 16,120</b>     | <b>\$ 31,970</b>     |
| <b>Deferred tax liabilities:</b>              |                      |                      |
| Deferred revenue tax accounting method change | \$ (16,120)          | \$ (32,170)          |
| Depreciation                                  | (86)                 | (78)                 |
| <b>Total deferred tax liabilities</b>         | <b>\$ (16,206)</b>   | <b>\$ (32,248)</b>   |
| <b>Net deferred tax liabilities</b>           | <b>\$ (86)</b>       | <b>\$ (278)</b>      |

The realization of tax benefits of deferred tax assets is dependent upon future levels of taxable income, of an appropriate character, in the periods the items are scheduled to be deductible or taxable. Based on the available objective evidence, management believes it is more likely than not that the domestic net deferred tax assets will not be realizable. Accordingly, the Company has provided a full valuation allowance against its domestic deferred tax assets, net of deferred tax liabilities, as of December 25, 2010 and December 26, 2009. The valuation allowance for deferred tax assets as of December 25, 2010 and December 26, 2009 was \$155.8 million and \$142.4 million, respectively. The



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net change in the valuation allowance was an increase of \$13.4 million and \$32.8 million for the years ended December 25, 2010 and December 26, 2009, respectively. Of the total valuation allowance at December 25, 2010, approximately \$0.1 million relates to items of other comprehensive income and, if released, will be credited to such.

As of December 25, 2010, the Company has net operating loss carryforwards of approximately \$255.8 million for federal tax purposes and \$237.6 million for state tax purposes. If not utilized, these carryforwards will begin to expire in 2021 for federal tax purposes and 2013 for state tax purposes.

The Company maintains net operating losses and credits generated from excess tax benefits associated with the accumulated stock award attributes in a memo account, not included in the deferred tax inventory balances. The additional tax benefit associated with these stock award attributes, of which the net operating loss amounts are included in the carryforward amounts noted above, is not recognized until the deduction reduces cash taxes payable. At December 25, 2010, the Company had unbenefited stock option deductions for federal and California tax purposes of \$35.9 million and \$19.8 million, respectively. When utilized, the estimated tax benefits of approximately \$13.7 million will result in a credit to stockholders' equity.

The Company has federal and California research and development credits available to reduce future income tax expense of approximately \$18.3 million and \$13.6 million, respectively. The federal research credits will begin to expire in the year 2021 if not utilized, while the California research credits have no expiration date.

Under the Tax Reform Act of 1986, the amount of benefit from net operating loss and tax credit carryforwards may be impaired or limited in certain circumstances. Events which cause limitations in the amount of net operating losses that the Company may utilize in any one year include, but are not limited to, a cumulative ownership change of more than 50 percent as defined, over a three-year testing period. As of December 25, 2010, the Company has determined that ownership changes have occurred that would result in limitations on the current and future utilization of its net operating loss carryforwards. However, based on the work performed, the limitations are not significant enough to impact the future utilization of the tax attributes.

The Company's policy with respect to its undistributed foreign subsidiaries' earnings is to consider those earnings to be indefinitely reinvested and, accordingly, no related provision for U.S. federal and state income taxes has been provided. Upon distribution of those earnings in the form of dividends or otherwise, the Company may be subject to both U.S. income taxes (subject to an adjustment for foreign tax credits) and withholding taxes in the various foreign countries. At December 25, 2010, the undistributed earnings approximated \$8.9 million. The determination of the future tax consequence of the remittance of these earnings is not practicable.

The Company's India subsidiary currently operates under a tax holiday, which will expire on March 31, 2011, based upon current statute. This holiday may be extended by Indian tax legislation. The net impact of this tax holiday was to decrease the Company's net loss by approximately \$0.5 million in fiscal 2010, resulting in no per share effect.

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The aggregate changes in the balance of gross unrecognized tax benefits were as follows:

|                                       | December 25,<br>2010 | December 26,<br>2009<br>(In thousands) | December 27,<br>2008 |
|---------------------------------------|----------------------|--|----------------------|
| Beginning balance                     | \$ 8,295             | \$ 6,350                               | \$ 6,749             |
| Tax position related to current year: |                      |  |                      |
| Additions                             | 1,055                | 1,881                                  | 1,245                |
| Tax positions related to prior years  |                      |  |                      |
| Additions                             | 55                   | 171                                    | 255                  |
| Reductions                            | (402)                | (107)                                  | (1,899)              |
| Lapses of statute of limitations      | (33)                 |  |                      |
| Ending balance                        | \$ 8,970             | \$ 8,295                               | \$ 6,350             |

As of December 25, 2010, the cumulative unrecognized tax benefit was \$9.0 million, of which \$8.2 million was netted against deferred tax assets, which would have otherwise been subjected with a full valuation allowance. Of the total unrecognized tax benefit as of December 25, 2010, approximately \$0.8 million, if recognized, would impact the Company's effective tax rate.

The Company reduced the amount of unrecognized tax benefits during the year ended December 27, 2008, related to tax positions taken in prior years due to further analysis performed with respect to the qualitative aspects of certain tax attribute carryforwards. Since the income tax provision benefits of these tax attributes have not yet been recognized in the financial statements, there was no financial statement effect of this change in unrecognized tax benefits other than the disclosure noted in the table above.

As of December 25, 2010, the Company had \$0.2 million of accrued interest or penalties related to unrecognized tax benefits, of which \$0.1 million was included in the Company's provision for income taxes for the year ended December 25, 2010. The Company's policy is to include interest and penalties related to unrecognized tax benefits within the Company's provision for income taxes.

The Company is potentially subject to examination by the Internal Revenue Service and the relevant state income taxing authorities under the statute of limitations for years 2001 and forward.

During the year ended December 27, 2008, the Company received an assessment of tax resulting from an examination in India for the 2005 tax year. During the year ended December 25, 2010, the Company received an assessment of tax resulting from an examination in India for the 2006 tax year. The Company is appealing the assessment and does not expect a significant adjustment to unrecognized tax benefits as a result of this inquiry. Fiscal years subsequent to March 2007 remain open to examination in India.

The Company does not currently believe there to be a reasonable possibility of a significant change in total unrecognized tax benefits that would occur within the next 12 months and, as such, amounts are classified as other long-term liabilities on the accompanying consolidated balance sheets as of December 25, 2010.

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Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is the Company's chief executive officer. The Company's chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. The Company has one business activity, and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, the Company is considered to be in a single reporting segment and operating unit structure.

Revenue by geographic region is based on the shipping address of the customer. The following table sets forth revenue and long-lived assets by geographic region:

**Revenue**

|                                | December 25,<br>2010 | Years Ended<br>December 26,<br>2009<br>(In thousands) | December 27,<br>2008 |
|--------------------------------|----------------------|---|----------------------|
| Americas:                      |                      |   |                      |
| United States                  | \$ 342,461           | \$ 212,923  | \$ 412,563           |
| Other Americas                 | 16,162               | 9,837   |                      |
|                                | \$ 358,623           | \$ 222,760  | \$ 412,563           |
| Europe, Middle East and Africa | 84,786               | 77,928  | 91,262               |
| Asia Pacific                   | 10,943               | 8,413   | 15,387               |
| Total revenue                  | \$ 454,352           | \$ 309,101  | \$ 519,212           |

**Property, plant and equipment, net**

|  | December 25,<br>2010 | December 26,<br>2009<br>(In thousands) |
|--|----------------------|--|
| United States                            | \$ 49,186            | \$ 41,405                              |
| Other Americas                           | 49                   |  |
| Asia Pacific                             | 2,505                | 2,251                                  |
| Total property, plant and equipment, net | \$ 51,740            | \$ 43,656                              |

**16. Related Party Transactions**

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The Company's former Chief Financial Officer, Mr. Duston M. Williams and the Company signed a consulting agreement, dated January 26, 2010, pursuant to which Mr. Williams will remain a consultant to the Company from June 26, 2010 until April 1, 2011. In exchange for providing consulting services to the Company, Mr. Williams will receive the following compensation: (a) he shall continue to vest in the grant of 170,000 RSUs that were granted to him on August 10, 2009, which shall vest and be settled in

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full no later than March 15, 2011; (b) he shall be paid under the Company's 2010 Bonus Plan at 100% of the pro-rated amount for the actual performance for the Company for the six months from January 1, 2010 through June 26, 2010, and (c) he shall receive reimbursement of six months of COBRA premiums if he elected continuation of health (i.e., medical, dental, and vision) coverage, which he did not. Except for the grant of restricted stock units described above, Mr. Williams shall not vest in any other equity awards after June 26, 2010.

On May 19, 2010, the Company entered into a consulting agreement with Mr. Reed Hundt, a former member of the Company's board of directors, pursuant to which Mr. Hundt will remain a consultant to the Company from May 19, 2010 until November 30, 2011. In exchange for Mr. Hundt's consulting services to the Company, Mr. Hundt was granted 35,000 shares of RSUs which shall vest through November 2011, subject to Mr. Hundt's continued services to the Company.

**17. Employee Benefit Plan**

In July 2001, the Company's board of directors approved the adoption of a savings plan under Section 401(k) of the Internal Revenue Code. Expenses related to the Company's 401(k) plan were immaterial for 2010, 2009 and 2008.

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The following table sets forth the Company's unaudited quarterly consolidated statements of operations data for each of the eight quarters ended December 25, 2010. The data has been prepared on the same basis as the audited consolidated financial statements and related notes included in this report and you should read the following table in conjunction with such financial statements. The table includes all necessary adjustments, consisting only of normal recurring adjustments that the Company considers necessary for a fair presentation of this data. The results of historical periods are not necessarily indicative of the results of operations for a full year or any future period.

|   | For the Three Months Ended (Unaudited) |                 |                   |                    |                    |                    |                    |                    |
|---|--|-----------------|-------------------|--------------------|--------------------|--------------------|--------------------|--------------------|
|   | 2010                                   |                 |                   |                    | 2009               |                    |                    |                    |
|   | Dec. 25                                | Sep. 25         | Jun. 26           | Mar. 27            | Dec. 26            | Sep. 26            | Jun. 27            | Mar. 28            |
|   | (In thousands, except per share data)  |                 |                   |                    |                    |                    |                    |                    |
| <b>Revenue:</b>   |  |                 |                   |                    |                    |                    |                    |                    |
| Product   | \$ 102,255                             | \$ 115,121      | \$ 98,035         | \$ 86,167          | \$ 82,100          | \$ 73,690          | \$ 61,074          | \$ 59,148          |
| Ratable product and related support and services                  | 1,417                                  | 1,460           | 1,664             | 1,614              | 1,025              | 892                | 845                | 1,469              |
| Services  | 13,461                                 | 13,480          | 11,699            | 7,979              | 7,056              | 8,826              | 7,013              | 5,963              |
| <b>Total revenue</b>  | <b>117,133</b>                         | <b>130,061</b>  | <b>111,398</b>    | <b>95,760</b>      | <b>90,181</b>      | <b>83,408</b>      | <b>68,932</b>      | <b>66,580</b>      |
| <b>Cost of revenue:</b>   |  |                 |                   |                    |                    |                    |                    |                    |
| Cost of product   | 53,523                                 | 58,552          | 57,668            | 55,440             | 52,686             | 47,473             | 45,699             | 43,865             |
| Cost of ratable product and related support and services          | 659                                    | 874             | 929               | 755                | 399                | 444                | 358                | 730                |
| Cost of services  | 5,659                                  | 6,223           | 5,520             | 2,542              | 2,627              | 5,049              | 2,617              | 2,015              |
| Restructuring and other costs (credit) related to cost of revenue |  | (60)            | (29)              | (93)               | 302                | 2,736              |                    |                    |
| <b>Total cost of revenue</b>                                      | <b>59,841</b>                          | <b>65,589</b>   | <b>64,088</b>     | <b>58,644</b>      | <b>56,014</b>      | <b>55,702</b>      | <b>48,674</b>      | <b>46,610</b>      |
| <b>Gross profit</b>   | <b>57,292</b>                          | <b>64,472</b>   | <b>47,310</b>     | <b>37,116</b>      | <b>34,167</b>      | <b>27,706</b>      | <b>20,258</b>      | <b>19,970</b>      |
| <b>Operating expenses</b>   | <b>60,067</b>                          | <b>60,342</b>   | <b>57,051</b>     | <b>57,418</b>      | <b>53,793</b>      | <b>46,949</b>      | <b>47,736</b>      | <b>43,284</b>      |
| <b>Income (loss) from operations</b>                              | <b>(2,775)</b>                         | <b>4,130</b>    | <b>(9,741)</b>    | <b>(20,302)</b>    | <b>(19,626)</b>    | <b>(19,243)</b>    | <b>(27,478)</b>    | <b>(23,314)</b>    |
| <b>Other income (expense), net</b>                                | <b>332</b>                             | <b>455</b>      | <b>117</b>        | <b>169</b>         | <b>444</b>         | <b>1,150</b>       | <b>470</b>         | <b>(896)</b>       |
| <b>Income (loss) before income taxes</b>                          | <b>(2,443)</b>                         | <b>4,585</b>    | <b>(9,624)</b>    | <b>(20,133)</b>    | <b>(19,182)</b>    | <b>(18,093)</b>    | <b>(27,008)</b>    | <b>(24,210)</b>    |
| <b>Provision for (benefit from) income taxes</b>                  | <b>297</b>                             | <b>225</b>      | <b>(63)</b>       | <b>(142)</b>       | <b>(531)</b>       | <b>(1,561)</b>     | <b>103</b>         | <b>118</b>         |
| <b>Net income (loss)</b>  | <b>\$ (2,740)</b>                      | <b>\$ 4,360</b> | <b>\$ (9,561)</b> | <b>\$ (19,991)</b> | <b>\$ (18,651)</b> | <b>\$ (16,532)</b> | <b>\$ (27,111)</b> | <b>\$ (24,328)</b> |
| <b>Net income (loss) per common share</b>                         |  |                 |                   |                    |                    |                    |                    |                    |
| Basic   | \$ (0.03)                              | \$ 0.04         | \$ (0.10)         | \$ (0.21)          | \$ (0.19)          | \$ (0.17)          | \$ (0.28)          | \$ (0.26)          |
| Diluted   | \$ (0.03)                              | \$ 0.04         | \$ (0.10)         | \$ (0.21)          | \$ (0.19)          | \$ (0.17)          | \$ (0.28)          | \$ (0.26)          |



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**INFINERA CORPORATION**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The Company's operating results may fluctuate due to a variety of factors, many of which are outside of the Company's control. As a result, comparing the Company's operating results on a period-to-period basis may not be meaningful. You should not rely on the Company's past results as an indication of its future performance.

In July 2009, the Company announced a restructuring plan under which it closed its Maryland FAB and consolidated these activities into its primary FAB located in Sunnyvale, California. This consolidation of activities into one location was expected to facilitate collaboration across integration platforms in support of the Company's next-generation products. As a result, during the third and fourth quarters of 2009, the Company recorded \$3.4 million and \$0.5 million, respectively, of restructuring and other related costs including severance and related expenses, equipment and facilities-related costs, operating lease termination costs, and other exit costs. Equipment and facilities-related costs primarily consist of increased depreciation expense related to restructured assets caused by shortening the useful life or updating the salvage value of depreciable fixed assets to coincide with the end of production under the approved restructuring plan. Cumulative restructuring and other related costs through December 25, 2010 totaled \$3.8 million. The Company completed its restructuring actions in 2010.

The Company elected to early adopt ASU 2009-13 with prospective application at the beginning of its first quarter of 2010 on a prospective basis for applicable transactions entered into or materially modified after December 26, 2009. Adoption of the new accounting guidance for revenue recognition resulted in an increase in total revenues of \$31.0 million, from \$423.4 million to \$454.4 million in the year ended December 25, 2010. In addition, the new accounting guidance for revenue recognition resulted in a decrease in net loss of \$12.3 million, from a net loss of \$40.2 million to net loss of \$27.9 million in the year ended December 25, 2010.

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**ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**ITEM 9A. CONTROLS AND PROCEDURES**

Attached as exhibits to this Form 10-K are certifications of Infinera's Chief Executive Officer ( CEO ) and Chief Financial Officer ( CFO ), which are required in accordance with Rule 13a-14 of the Securities Exchange Act of 1934, as amended ( the Exchange Act ). This Controls and Procedures section includes information concerning the controls and controls evaluation referred to in the certifications.

**Evaluation of Disclosure Controls and Procedures**

As of December 25, 2010, the end of the period covered by this Annual Report on Form 10-K, an evaluation was performed by management, with the participation of our CEO and our CFO, of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act). Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the 1934 Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms.

Based on this evaluation, our CEO and CFO have concluded that our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act ), were effective as of December 25, 2010 to provide reasonable assurance that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Committee rules and forms, and is accumulated and communicated to management, including our CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

**Changes in Internal Control Over Financial Reporting**

There were no changes to our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) that occurred during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Management's Report on Internal Control Over Financial Reporting**

Our management, including our CEO and CFO, is responsible for establishing and maintaining adequate internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) to provide reasonable assurance regarding the reliability of our financial reporting and the preparation of financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

Management assessed the effectiveness of our internal control over financial reporting as of December 25, 2010, the end of our fiscal year. Management based its assessment on criteria established in *Internal Control - Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission ( COSO ). Management's assessment included evaluation of elements such as the design and operating effectiveness of key financial reporting controls, process documentation, accounting policies, and our overall control environment.

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Based on this assessment, management has concluded that our internal control over financial reporting was effective as of the end of the fiscal year to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external reporting purposes in accordance with U.S. generally accepted accounting principles.

The attestation report concerning the effectiveness of our internal control over financial reporting as of December 25, 2010, issued by Ernst & Young, LLP, Independent Registered Public Accounting Firm, appears in Part II, Item 8 of this Annual Report on Form 10-K.

### **Inherent Limitations of Internal Controls**

Our management, including our CEO and CFO, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within us have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected.

### **ITEM 9B. OTHER INFORMATION**

None.

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**Part III**

**ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE**

The information required by this item with respect to Infinera's directors and executive officers is incorporated by reference to the information set forth in Infinera's proxy statement for the 2011 Annual Meeting of Stockholders to be filed with the Commission within 120 days after the end of Infinera's fiscal year ended December 25, 2010. For information pertaining to executive officers and directors of Infinera, refer to the Executive Officers and Directors section of Part 1, Item 1 of this Annual Report on Form 10-K.

As part of our system of corporate governance, our board of directors has adopted a code of business conduct and ethics. The code applies to all of our employees, officers (including our principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions), agents and representatives, including our independent directors and consultants, who are not employees of Infinera, with regard to their Infinera-related activities. The full text of our code of business conduct and ethics is posted on our web site at <http://www.infinera.com>. We intend to disclose future amendments to certain provisions of our code of business conduct and ethics, or waivers of such provisions, applicable to any principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions or our directors on our web site identified above. The inclusion of our web site address in this report does not include or incorporate by reference the information on our web site into this report.

**ITEM 11. EXECUTIVE COMPENSATION**

Information responsive to this item is incorporated herein by reference to Infinera's definitive proxy statement with respect to our 2011 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS**

Information responsive to this item is incorporated herein by reference to Infinera's definitive proxy statement with respect to our 2011 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE**

Information responsive to this item is incorporated herein by reference to Infinera's definitive proxy statement with respect to our 2011 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

**ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES**

Information responsive to this item is incorporated herein by reference to Infinera's definitive proxy statement with respect to our 2011 Annual Meeting of Stockholders to be filed with the SEC within 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

**Table of Contents****PART IV****ITEM 15. EXHIBITS, FINANCIAL STATEMENT SCHEDULES***(a)(1) Consolidated Financial Statements*

This Annual Report on Form 10-K contains the following financial statements which appear under Part II, Item 8 of this Form 10-K on the pages noted below:

|  | <b>Page</b> |
|--|-------------|
| <u>Reports of Ernst &amp; Young LLP, Independent Registered Public Accounting Firm</u> | 66          |
| <u>Consolidated Balance Sheets</u>   | 68          |
| <u>Consolidated Statements of Operations</u>   | 69          |
| <u>Consolidated Statements of Stockholders' Equity</u>                                 | 70          |
| <u>Consolidated Statements of Cash Flows</u>   | 72          |
| <u>Notes to Consolidated Financial Statements</u>                                      | 73          |
| <i>(a)(2) Financial Statement Schedule</i>   |             |

**Schedule II: Valuation and Qualifying Accounts**

|  | <b>December 25,<br/>2010</b> | <b>Years Ended<br/>December 26,<br/>2009</b> | <b>December 27,<br/>2008</b> |
|--|------------------------------|--|------------------------------|
|  | <b>(In thousands)</b>        |  |                              |
| <b>Deferred tax asset, valuation allowance</b> |                              |  |                              |
| Beginning balance                              | \$ 142,420                   | \$ 109,637                                   | \$ 139,639                   |
| Additions                                      | 13,427                       | 32,783                                       |                              |
| Reductions                                     |                              |  | (30,002)                     |
| Ending balance                                 | \$ 155,847                   | \$ 142,420                                   | \$ 109,637                   |
| <b>Allowance for doubtful accounts</b>         |                              |  |                              |
| Beginning balance                              | \$                           | \$ 1,700                                     | \$                           |
| Additions                                      |                              |  | 1,700                        |
| Reductions                                     |                              | (1,700)                                      |                              |
| Ending balance                                 | \$                           | \$   | \$ 1,700                     |

Schedules not listed above have been omitted because the information required to be set forth therein is not applicable or is shown in the consolidated financial statements or notes thereto.

*(a)(3) Exhibits.*

See Index to Exhibits. The Exhibits listed in the accompanying Index to Exhibits are filed or incorporated by reference as part of this Annual Report on Form 10-K.

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**INDEX TO EXHIBITS**

| <b>Exhibit No.</b> | <b>Description</b>   |
|--------------------|--|
| 3.1                | Amended and Restated Certificate of Incorporation of the Registrant. <sup>(1)</sup>  |
| 3.2                | Amended and Restated Bylaws. <sup>(2)</sup>  |
| 4.1                | Form of Common Stock certificate of the Registrant. <sup>(3)</sup>   |
| 10.1*              | Form of Indemnification Agreement between Registrant and each of its directors and executive officers. <sup>(4)</sup>  |
| 10.2*              | 2000 Stock Plan, as amended, and forms of stock option agreements thereunder. <sup>(4)</sup>   |
| 10.3*              | 2007 Equity Incentive Plan. <sup>(4)</sup>   |
| 10.4*              | 2007 Employee Stock Purchase Plan. <sup>(4)</sup>  |
| 10.5*              | Bonus Plan. <sup>(5)</sup>   |
| 10.6*              | Form of CEO Amended and Restated Change of Control Severance Agreement. <sup>(6)</sup>   |
| 10.7*              | Form of Section 16 Officer Amended and Restated Change of Control Severance Agreement. <sup>(6)</sup>  |
| 10.8*              | Form of Section 16 Officer Restricted Stock Unit Agreement under the 2007 Equity Incentive Plan of Registrant. <sup>(7)</sup>  |
| 10.9*              | Form of Section 16 Officer Performance Share Agreement under the 2007 Equity Incentive Plan of Registrant. <sup>(7)</sup>  |
| 10.10*             | Form of Stock Option Agreement under the 2007 Equity Incentive Plan of Registrant. <sup>(8)</sup>  |
| 10.11*             | Form of Stock Option Agreement for International Based Employees under the 2007 Equity Incentive Plan of Registrant. <sup>(8)</sup>  |
| 10.12*             | Form of Annual Performance Share Agreement for the Board of Directors under the 2007 Equity Incentive Plan of Registrant. <sup>(9)</sup>   |
| 10.13*             | Consulting Agreement by and between Registrant and Duston M. Williams dated January 26, 2010. <sup>(10)</sup>  |
| 14.1               | Code of Ethics. <sup>(11)</sup>  |
| 21.1               | Subsidiaries of Registrant.  |
| 23.1               | Consent of Ernst & Young, LLP, Independent Registered Public Accounting Firm.  |
| 31.1               | Certification of Chief Executive Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2               | Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1               | Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |
| 32.2               | Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.   |

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- \* Management contracts or compensation plans or arrangements in which directors or executive officers are eligible to participate.
- (1) Incorporated by reference to exhibit filed with Registrant's Current Report on Form 8-K (No. 001-33486) filed with the SEC on June 12, 2007.
- (2) Incorporated by reference to exhibit filed with Registrant's Current Report on Form 8-K (No. 001-33486) filed with the SEC on February 17, 2009.
- (3) Incorporated by reference to exhibit filed with Registrant's Form S-1/A (No. 333-140876), filed with the SEC on April 27, 2007.
- (4) Incorporated by reference to exhibit filed with Registrant's Form S-1 (No. 333-140876), filed with the SEC on February 26, 2007.
- (5) Incorporated by reference to exhibit filed with Registrant's Current Report on 8-K (No. 001-33486), filed with the SEC on February 14, 2011.
- (6) Incorporated by reference to exhibit filed with Registrant's Current Report on Form 8-K (No. 001-33486) filed with the SEC on September 13, 2010.
- (7) Incorporated by reference to exhibit filed with Registrant's Quarterly Report on Form 10-Q (No. 001-33486), filed with the SEC on November 2, 2010.
- (8) Incorporated by reference to exhibit filed with Registrant's Quarterly Report on Form 10-Q (No. 001-33486), filed with the SEC on May 5, 2010.
- (9) Incorporated by reference to exhibit filed with Registrant's Quarterly Report on Form 10-Q (No. 001-33486), filed with the SEC on May 7, 2009.
- (10) Incorporated by reference to exhibit filed with Registrant's Current Report on Form 8-K (No. 001-33486), filed with the SEC on January 26, 2010.
- (11) Incorporated by reference to exhibit filed with Registrant's Annual Report on Form 10-K (No. 001-33486), filed with the SEC on February 19, 2008.

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**SIGNATURES**

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Dated: March 1, 2011

**Infinera Corporation**

**Registrant**

By: */s/* ITA M. BRENNAN  
Ita M. Brennan

**Chief Financial Officer**

**Principal Financial and Accounting Officer**

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

*/s/* THOMAS J. FALLON  
Thomas J. Fallon

**Director, President, Chief Executive Officer and Principal Executive Officer**

**March 1, 2011**

*/s/* ITA M. BRENNAN  
Ita M. Brennan

**Chief Financial Officer, Principal Financial and Accounting Officer**

**March 1, 2011**

*/s/* DAVID F. WELCH, PH.D.  
David F. Welch, Ph.D.

**Co-founder, Executive Vice President,**

**Chief Strategy Officer and Director**

**March 1, 2011**

*/s/* PHILIP KOEN  
Philip Koen

**Director**

**March 1, 2011**

*/s/* KAMBIZ Y. HOOSHMAND  
Kambiz Y. Hooshmand

**Chairman of the Board**

**March 1, 2011**

*/s/* KENNETH A. GOLDMAN  
Kenneth A. Goldman

**Director**

**March 1, 2011**

*/s/* DAN MAYDAN, PH.D.  
Dan Maydan, Ph.D.

**Director**

**March 1, 2011**

*/s/* PAUL MILBURY  
Paul Milbury

**Director**

**March 1, 2011**

/s/ CARL REDFIELD  
**Carl Redfield**

**Director**

**March 1, 2011**