HARMONIC INC
Form 10-Q
November 08, 2006

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

FORM 10-Q

(Mark One)

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the Quarterly Period Ended September 29, 2006

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File No. 0-25826
HARMONIC INC.
(Exact name of Registrant as specified in its charter)

Delaware	**77-0201147**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

549 Baltic Way
Sunnyvale, CA 94089
(408) 542-2500
(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)

Securities registered pursuant to section 12(b) of the Act:
None
Securities registered pursuant to section 12(g) of the Act:
Common Stock, par value $.001 per share
Preferred Share Purchase Rights

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 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 þ **No** o

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

Large accelerated filer o **Accelerated filer** þ **Non-accelerated filer** o

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o **No** þ

The number of shares outstanding of the Registrant s Common Stock, $.001 par value, was 74,681,986 on October 27, 2006.

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PART I

FINANCIAL INFORMATION

Item 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HARMONIC INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

(In thousands, except par value amounts)		September 29, 2006		December 31, 2005
ASSETS				
Current assets:				
Cash and cash equivalents	$	50,404	$	37,818
Short-term investments		60,320		73,010
Accounts receivable, net of allowances of $4,015 and $3,230		52,423		43,433
Inventories		35,635		38,552
Prepaid expenses and other current assets		16,104		8,335
Total current assets		214,886		201,148
Property and equipment, net		14,943		17,040
Intangibles and other assets		7,238		8,109
Total assets	$	237,067	$	226,297
LIABILITIES AND STOCKHOLDERS EQUITY				
Current liabilities:				
Current portion of long-term debt	$	596	$	812
Accounts payable		22,864		19,378
Income taxes payable		6,952		6,480
Deferred revenue		23,019		18,932
Accrued liabilities		40,990		37,438
Total current liabilities		94,421		83,040
Long-term debt, less current portion		61		460
Accrued excess facilities costs, long-term		17,889		18,357
Other non-current liabilities		7,020		11,458
Total liabilities		119,391		113,315
Commitments and contingencies (Notes 15 and 16)				
Stockholders equity:				
Preferred stock, $0.001 par value, 5,000 shares authorized; no shares issued or outstanding				
Common stock, $0.001 par value, 150,000 shares authorized; 74,645 and 73,636 shares issued and outstanding		75		74
Capital in excess of par value		2,056,519		2,048,090
Accumulated deficit		(1,938,750)		(1,934,715)
Accumulated other comprehensive loss		(168)		(467)
Total stockholders equity		117,676		112,982

Total liabilities and stockholders equity	$	237,067	$	226,297

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

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HARMONIC INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended		Nine Months Ended	
(In thousands, except per share amounts)	**September 29, 2006**	**September 30, 2005**	**September 29, 2006**	**September 30, 2005**
Net sales	$ 62,856	$ 60,960	$ 172,346	$ 193,638
Cost of sales	33,059	39,564	101,064	121,797
Gross profit	29,797	21,396	71,282	71,841
Operating expenses:				
Research and development	10,021	9,403	29,554	28,381
Selling, general and administrative	16,931	15,166	48,623	47,102
Amortization of intangibles	45	110	179	1,233
Total operating expenses	26,997	24,679	78,356	76,716
Income (loss) from operations	2,800	(3,283)	(7,074)	(4,875)
Interest income, net	1,182	669	3,349	1,828
Other income (expense), net	137	(288)	173	(643)
Income (loss) before income taxes	4,119	(2,902)	(3,552)	(3,690)
Provision for (benefit from) income taxes	103	(11)	482	25
Net income (loss)	$ 4,016	$ (2,891)	$ (4,034)	$ (3,715)
Net income (loss) per share basic	$ 0.05	$ (0.04)	$ (0.05)	$ (0.05)
Net income (loss) per share diluted	$ 0.05	$ (0.04)	$ (0.05)	$ (0.05)
Weighted average shares basic	74,588	73,554	74,286	73,168
Weighted average shares diluted	75,050	73,554	74,286	73,168

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

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HARMONIC INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

(In thousands)	**Nine Months Ended September 29, 2006**	**September 30, 2005**
Cash flows from operating activities:		
Net loss	$ (4,034)	$ (3,715)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Amortization of intangibles	672	2,311
Depreciation	5,719	6,278
Stock-based compensation	4,376	9
Loss on disposal of fixed assets	55	15
Deferred income taxes		(282)
Changes in assets and liabilities, net of effect of acquisition:		
Accounts receivable	(9,314)	16,774
Inventories	2,877	22
Prepaid expenses and other assets	(8,133)	2,275
Accounts payable	3,486	(2,727)
Deferred revenue	2,474	4,774
Income taxes payable	366	(706)
Accrued excess facilities costs	683	(3,530)
Accrued and other liabilities	764	(12,475)
Net cash provided by (used in) operating activities	(9)	9,023
Cash flows from investing activities:		
Purchases of investments	(58,061)	(47,202)
Proceeds from sales of investments	71,030	49,053
Acquisition of property and equipment	(3,677)	(4,232)
Acquisition of BTL, net of cash received		(5,955)
Net cash provided by (used in) investing activities	9,292	(8,336)
Cash flows from financing activities:		
Proceeds from issuance of common stock	4,017	6,281
Repayments under bank line and term loan	(615)	(829)
Repayments of capital lease obligations	(61)	(72)
Net cash provided by financing activities	3,341	5,380
Effect of exchange rate changes on cash and cash equivalents	(38)	134
Net increase in cash and cash equivalents	12,586	6,201
Cash and cash equivalents at beginning of period	37,818	26,603
Cash and cash equivalents at end of period	$ 50,404	$ 32,804

Supplemental disclosure of cash flow information:				
Income tax payments, net	$	177	$	118
Interest paid during the period	$	94	$	269
Non-cash investing and financing activities:				
Issuance of restricted common stock for BTL acquisition	$		$	1,831

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

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HARMONIC INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Note 1: Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include all adjustments (consisting only of normal recurring adjustments) which Harmonic Inc. (the Company) considers necessary for a fair statement of the results of operations for the interim periods covered and the consolidated financial condition of the Company at the date of the balance sheets. This Quarterly Report on Form 10-Q should be read in conjunction with the Company s audited consolidated financial statements contained in the Company s Annual Report on Form 10-K/A, which was filed with the Securities and Exchange Commission on April 26, 2006. The interim results presented herein are not necessarily indicative of the results of operations that may be expected for the full fiscal year ending December 31, 2006, or any other future period. The Company s fiscal quarters end on the Friday nearest the calendar quarter end, except for the fourth quarter which ends on December 31.

The condensed consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Certain amounts in the prior year s financial statements and related notes have been reclassified to conform to the 2006 presentation. These reclassifications have no material impact on previously reported net loss or cash flows.

Use of Estimates

The preparation of the consolidated financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

Note 2: Recent Accounting Pronouncements

In March 2006, the Emerging Issues Task Force reached a consensus on Issue No. 06-03, How Taxes Collected from Customers and Remitted to Government Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) (EITF No. 06-03). The Company is required to adopt the provisions of EITF No. 06-03 beginning in fiscal year 2007. The Company does not expect the provisions of EITF No. 06-03 to have a material impact on the Company s consolidated financial position, results of operations or cash flows.

In June 2006, the FASB issued FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the company has taken or expects to take on a tax return. FIN 48 will be effective for fiscal years beginning after December 15, 2006. We are currently in the process of evaluating the effect, if any, FIN 48 will have on our consolidated financial statements.

In September 2006, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements (SAB 108`). SAB 108 provides guidance on how prior year misstatements should be taken into consideration when quantifying misstatements in current year financial statements for purposes of determining whether the current year s financial statements are materially misstated. SAB 108 becomes effective during our 2007 fiscal year. We do not expect the adoption of SAB 108 to have a material impact on our financial statements.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, Fair Value Measurements (SFAS No. 157). This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS No. 157 is effective for fiscal years beginning after November 15, 2007. We have not determined the effect, if any, the adoption of this statement will have on our results of operations or financial position.

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 158, Employers Accounting for Defined Benefit Pension and Other Postretirement Plans, an amendment of FASB Statements No. 87, 106, and 132(R) (SFAS No. 158). SFAS No. 158 requires companies to recognize a net liability or asset and an offsetting adjustment to accumulated other comprehensive income to report the funded status of defined benefit pension and other postretirement benefit plans. SFAS No. 158 requires prospective application, and the recognition and disclosure requirements are effective for the Company s fiscal year ending December 31, 2007. Additionally, SFAS No. 158 requires companies to measure plan assets and obligations at their year-end balance sheet date. This requirement is effective for fiscal years ending after December 15, 2008. We do not expect the adoption of SFAS No. 158 to have a material impact on our financial statements.

Note 3: Stock-based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases related to our Employee Stock Purchase Plan (ESPP) based upon the grant-date fair value of those awards. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations, and provided the required pro forma disclosures prescribed by Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, (SFAS 123) as amended. In addition, we have applied the provisions of Staff Accounting Bulletin No. 107 (SAB 107), issued by the Securities and Exchange Commission, in our adoption of SFAS No. 123(R).

The Company adopted SFAS 123(R) using the modified-prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company s fiscal year 2006. The Company s Condensed Consolidated Financial Statements as of and for the three and nine months ended September 29, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s Condensed Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the three and nine months ended September 29, 2006 was $1.2 million and $4.4 million, respectively, which consisted of stock-based compensation expense related to employee equity awards and employee stock purchases. There was no stock-based compensation expense related to employee equity awards and employee stock purchases recognized during the three and nine months ended September 30, 2005.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service period in the Company s Condensed Consolidated Statement of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for employee equity awards and employee stock purchases using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123. Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company s Condensed Consolidated Statement of Operations because the exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s Condensed Consolidated Statement of Operations for the three and nine months ended September 29, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company changed its method of attributing the value of stock-based compensation costs to expense from the accelerated multiple-option method to the straight-line single-option method. Compensation expense for all share-based payment awards granted on or prior to December 31, 2005 will

continue to be recognized using the accelerated approach while compensation expense for all share-based payment awards related to stock options and employee stock purchase rights granted subsequent to December 31, 2005 are recognized using the straight-line method.

As stock-based compensation expense recognized in our results for the three and nine months ended September 29, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to fiscal year 2006, we accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

The fair value of share-based payment awards is estimated at grant date using a Black-Scholes-Merton option pricing model. The Company s determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as the assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors.

Harmonic currently does not expect to receive any tax benefits in fiscal 2006 for any expense deductions resulting from expensing of stock options or shares issued under its ESPP plan. On November 10, 2005 the FASB issued FASB Staff Position No. FSP FAS 123(R)-3, *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards*. Harmonic currently provides a valuation allowance for most of its deferred tax assets, and a valuation allowance has also been provided for deferred tax assets related to nonqualified stock options.

Also see Note 10 for further discussion of stock-based compensation.

Note 4: BTL Acquisition

On February 25, 2005, Harmonic purchased all of the issued and outstanding shares of Broadcast Technology Limited, or BTL, a private UK company, for a purchase consideration of £4.0 million, or approximately $7.6 million. The purchase consideration consisted of a payment of £3.0 million in cash and the issuance of 169,112 shares of Harmonic common stock. In addition, Harmonic paid approximately $0.3 million in transaction costs for a total transaction price of approximately $7.9 million. The addition of BTL has expanded Harmonic s product line to include professional video/audio receivers and decoders. This enabled us to expand the scope of solutions we provide for existing and emerging cable, satellite, terrestrial broadcast and telecom applications. These factors contributed to a purchase price exceeding the fair value of BTL s net tangible and intangible assets acquired; as a result, we have recorded goodwill in connection with this transaction.

The BTL acquisition was accounted for under SFAS No. 141 and certain specified provisions of SFAS No. 142. The results of operations of BTL are included in Harmonic s Condensed Consolidated Statements of Operations from February 25, 2005, the date of acquisition. The following table summarizes the allocation of the purchase price based on the estimated fair value of the tangible assets acquired and the liabilities assumed at the date of acquisition (in thousands):

Cash acquired	$ 149
Other tangible assets acquired	2,508
Amortizable intangible assets:	
Existing technology	2,050
Customer relationships	540
Tradenames/trademarks	320
Order backlog	60
Goodwill	3,745
Total assets acquired	9,372
Liabilities assumed	(568)
Deferred tax liability for acquired intangibles	(891)

Net assets acquired	$ 7,913

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Identified intangible assets, including existing technology and customer relationships are being amortized over their useful lives of three years; tradename/trademarks are being amortized over their useful lives of two years; and order backlog was amortized over its useful life of three months.

The residual purchase price of $3.7 million has been recorded as goodwill. The goodwill as a result of this acquisition is not expected to be deductible for tax purposes. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill relating to the acquisition of BTL is not being amortized and will be tested for impairment annually or whenever events indicate that an impairment may have occurred.

Supplemental pro forma information is not provided because the acquisition of BTL was not material to the Company s financial statements for all periods presented.

Note 5: Cash, Cash Equivalents and Investments

At September 29, 2006 and December 31, 2005, cash, cash equivalents and short-term investments are summarized as follows (in thousands):

	September 29, 2006	December 31, 2005
Cash and cash equivalents	$ 50,404	$ 37,818
Short-term investments:		
Less than one year	57,326	56,605
Due in 1-2 years	2,994	16,405
Total short-term investments	60,320	73,010
Total cash, cash equivalents and short-term investments	$ 110,724	$ 110,828

The following is a summary of available-for-sale securities (in thousands).

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
September 29, 2006				
U.S. government debt securities	$ 21,992	$ 20	$ (65)	$ 21,947
Corporate debt securities	36,826	26	(54)	36,798
Other debt securities	1,575			1,575
Total	$ 60,393	$ 46	$ (119)	$ 60,320
December 31, 2005				
U.S. government debt securities	$ 20,264	$	$ (146)	$ 20,118
Corporate debt securities	46,873	3	(209)	46,667
Other debt securities	6,225			6,225
Total	$ 73,362	$ 3	$ (355)	$ 73,010

Impairment of Investments

We monitor our investment portfolio for impairment on a periodic basis. In the event that the carrying value of an investment exceeds its fair value and the decline in value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis for the investment is established. In order to determine whether a decline in value is other-than-temporary, we evaluate, among other factors: the duration and extent to which the fair value has been less than the carrying value; our financial condition and business outlook, including key operational and cash flow metrics, current market conditions and future trends in the company s industry; our relative competitive position within the industry; and our intent and ability to retain the investment for a period of time sufficient to allow any anticipated recovery in fair value.

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In accordance with FASB Staff Position Nos. 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1), the following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of September 29, 2006 (in thousands):

	Less than 12 months		Greater than 12 months		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government debt securities	$ 8,206	$ (43)	$ 8,260	$ (22)	$ 16,466	$ (65)
Corporate debt securities	8,293	(33)	14,010	(20)	22,303	(53)
Total	$ 16,499	$ (76)	$ 22,270	$ (42)	$ 38,769	$ (118)

The decline in the estimated fair value of these investments relative to amortized cost is primarily related to changes in interest rates and is considered to be temporary in nature.

Note 6: Inventories

(In thousands)	September 29, 2006	December 31, 2005
Raw materials	$ 11,690	$ 14,392
Work-in-process	2,881	4,131
Finished goods	21,064	20,029
	$ 35,635	$ 38,552

Note 7: Goodwill and Identified Intangibles

The following is a summary of goodwill and intangible assets as of September 29, 2006 and December 31, 2005 (in thousands):

	September 29, 2006			December 31, 2005		
	Gross Carrying Amount *	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount *	Accumulated Amortization	Net Carrying Amount
Identified intangibles:						
Developed core technology	$ 29,839	$ (28,875)	$ 964	$ 29,663	$ (28,315)	$ 1,348
Customer base	31,909	(31,909)		31,904	(31,904)	
Trademark and tradename	4,218	(4,218)		4,190	(4,142)	48
Supply agreement	3,510	(3,256)	254	3,464	(3,109)	355
Subtotal of identified intangibles	69,476	(68,258)	1,218	69,221	(67,470)	1,751
Goodwill	4,614		4,614	4,896		4,896

Total goodwill and other intangibles	$ 74,090	$ (68,258)	$ 5,832	$ 74,117	$ (67,470)	$ 6,647

* Foreign currency translation adjustments, reflecting movement in the currencies of the underlying entities, totaled approximately $0.1 and $0.3 million for intangible assets and approximately $0.3 and $0.3 million for goodwill as of September 29, 2006 and December 31, 2005, respectively.

The changes in the carrying amount of goodwill for the nine months ended September 29, 2006 are as follows (in thousands):

	Goodwill
Balance as of January 1, 2006	$ 4,896
Purchase price adjustments*	(531)
Foreign currency translation adjustments	249
Balance as of September 29, 2006	$ 4,614

* Purchase price adjustments that affect existing goodwill were due to deferred taxes.

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For the three and nine months ended September 29, 2006, the Company recorded a total of $0.2 million and $0.7 million, of amortization expense for identified intangibles, of which $0.2 million and $0.5 million, was included in cost of sales, respectively. For the three and nine months ended September 30, 2005, the Company recorded a total of $0.3 and $2.3 million of amortization expense for identified intangibles, of which $0.2 million and $1.1 million was included in cost of sales, respectively. The estimated future amortization expense of purchased intangible assets with definite lives for the next three years is as follows (in thousands):

Years Ending December 31,	Amounts
2006 (remaining 3 months)	$ 215
2007	860
2008	143
Total	$ 1,218

Note 8: Restructuring and Excess Facilities

During 2001, Harmonic recorded a charge for excess facilities costs of $21.8 million. As a result of uncertain market conditions and lower sales during the second half of 2002, the Company changed its estimates related to accrued excess facilities with regard to the expected timing and amount of sublease income due to the substantial surplus of vacant commercial space in the San Francisco Bay Area. In connection with these actions, Harmonic recorded an additional excess facilities charge of $22.5 million, net of sublease income, to selling, general and administrative expenses during the second half of 2002.

As of September 29, 2006, accrued excess facilities cost totaled $24.3 million of which $6.4 million was included in current accrued liabilities and $17.9 million in other non-current liabilities. The Company incurred cash outlays of $3.5 million during the first nine months of 2006 principally for lease payments, property taxes, insurance and other maintenance fees related to vacated facilities. Harmonic expects to pay approximately $1.7 million of excess facility lease costs, net of estimated sublease income, for the remainder of 2006 and to pay the remaining $22.6 million, net of estimated sublease income, over the remaining lease terms through September 2010.

Harmonic reassesses this liability quarterly and adjusts as necessary based on changes in the timing and amounts of expected sublease rental income. In the fourth quarter of 2005 the excess facilities liability was decreased by $1.1 million due to subleasing a portion of an unoccupied building for the remainder of the lease.

During the fourth quarter of 2005, in response to the consolidation of the Company s two operating segments into a single segment as of January 1, 2006, the Company implemented workforce reductions of approximately 40 full-time employees across all functions and primarily in our U.S. operations and recorded severance and other costs of approximately $1.1 million. No liability remains as of September 29, 2006.

During the second quarter of 2006, the Company streamlined its senior management team primarily in the U.S. operations and recorded severance and other costs of approximately $1.0 million. We expect the remaining payments related to these actions to be paid by the end of the second quarter of 2007.

During the third quarter of 2006, the Company recorded a net charge in selling, general and administrative expenses for excess facilities of $2.1 million. The Company recorded a charge of $3.8 million, net of estimated sublease income, in accordance with the provisions of FAS No. 146 Accounting for Costs Associated with Exit or Disposal Activities for two buildings which were vacated during the third quarter in connection with a plan to make more efficient use of our Sunnyvale campus. The $5.9 million accrued excess facility costs for these buildings also includes the reclassification of a deferred rent liability of $2.1 million. In addition, during the third quarter of 2006, the Company recorded a benefit of $1.7 million as a result of a revision to estimates of projected sublease income on entering into sublease agreements for certain buildings previously exited under EITF 94-3 Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring). This benefit partially offsets the charge recorded by the Company in the third quarter of 2006 from the consolidation of its Sunnyvale campus.

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The following table summarizes restructuring activities (in thousands):

	Workforce Reduction	Management Reduction	Excess Facilities	Campus Consolidation	Total
Balance at December 31, 2005	$ 635	$	$ 23,576	$	$ 24,211
Provisions/(recoveries)	(25)	962	(1,743)	5,947	5,141
Cash payments, net of sublease income	(610)	(451)	(3,521)		(4,582)
Balance at September 29, 2006	$	$ 511	$ 18,312	$ 5,947	$ 24,770

Note 9: Credit Facilities and Long-Term Debt

Harmonic has a bank line of credit facility with Silicon Valley Bank, which provides for borrowings of up to $23.7 million, including $3.7 million for equipment under a secured term loan. This facility, which was amended and restated in December 2005, expires in December 2006, and contains financial and other covenants including the requirement for Harmonic to maintain cash, cash equivalents and short-term investments, net of credit extensions, of not less than $30.0 million. If Harmonic is unable to maintain this cash, cash equivalents and short-term investments balance or satisfy the additional affirmative covenant requirements, Harmonic would be in noncompliance with the facility. In the event of noncompliance by Harmonic with the covenants under the facility, Silicon Valley Bank would be entitled to exercise its remedies under the facility which include declaring all obligations immediately due and payable and disposing of the collateral if obligations were not repaid. At September 29, 2006, Harmonic was in compliance with the covenants under this line of credit facility. The December 2005 amendment resulted in the company paying a fee of approximately $33,000 and requiring payment of approximately $43,000 of additional fees if the company does not maintain an unrestricted deposit of $20.0 million with the bank. Future borrowings pursuant to the line bear interest at the bank s prime rate (8.25% at September 29, 2006) or prime plus 0.5% for equipment borrowings. Borrowings are payable monthly and are collateralized by all of Harmonic s assets except intellectual property. As of September 29, 2006, $0.7 million was outstanding under the equipment term loan portion of this facility and there were no additional borrowings in 2005 or 2006. The term loan is repayable monthly, including principal and interest at 8.75% per annum on outstanding borrowings as of September 29, 2006 and matures at various dates through December 2007. Other than standby letters of credit and guarantees (Note 15), there were no other outstanding borrowings or commitments under the line of credit facility as of September 29, 2006.

Note 10: Benefit Plans

Stock Option Plans. Harmonic has reserved 12,329,000 shares of Common Stock for issuance under various employee stock option plans. The options are granted for periods not exceeding ten years and generally vest 25% at one year from date of grant, and an additional 1/48 of such grant per month thereafter. Stock options are granted at the fair market value of the stock at the date of grant. Beginning on February 27, 2006, option grants have a term of seven years. Certain option awards provide for accelerated vesting if there is a change in control.

Director Option Plans. In May 2002, Harmonic s stockholders approved the 2002 Director Option Plan (the Plan), replacing the 1995 Director Option Plan. In June 2006, Harmonic s stockholders approved an amendment to the Plan and increased the maximum number of shares of common stock authorized for issuance over the term of the Plan by an additional 300,000 shares to 700,000 shares and reduced the term of future options granted under the Plan to seven years. Harmonic has a total of 728,000 shares of Common Stock reserved for issuance under the Director Plans. The Plan provides for the grant of non-statutory stock options to certain non-employee directors of Harmonic pursuant to an automatic, non-discretionary grant mechanism. Options are granted at the fair market value of the stock at the date of grant for periods not exceeding seven years. Initial grants generally vest monthly over three years, and subsequent grants generally vest monthly over one year.

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The following table summarizes activities under the Plans:

	Shares Available for Grant	Stock Options Outstanding	Weighted Average Exercise Price
	(In thousands except exercise price)		
Balance at December 31, 2005	3,984	9,064	$ 13.05
Shares authorized	300		
Options granted	(1,947)	1,947	5.64
Options exercised		(197)	3.73
Options canceled	1,462	(1,462)	11.41
Options expired		(94)	43.99
Balance at September 29, 2006	3,799	9,258	11.64
Options vested and exercisable as of September 29, 2006		6,297	11.90
Options vested and expected-to-vest as of September 29, 2006		8,859	$ 14.27

The weighted-average fair value of options granted for the nine months ended September 29, 2006 was $3.62.
The following table summarizes information regarding stock options outstanding at September 29, 2006:

		Stock Options Outstanding			Stock Options Exercisable	
Range of Exercise Prices		Number Outstanding at September 29, 2006	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number Exercisable at September 29, 2006	Weighted Average Exercise Price
		(In thousands, except exercise price and life)				
$ 1.75	5.56	1,403	6.3	$ 3.90	866	$ 3.50
5.62	5.87	2,317	7.2	5.86	367	5.84
5.88	8.93	1,450	5.9	8.02	1,122	7.99
9.00	9.29	1,156	5.2	9.17	1,039	9.16
9.53	13.82	1,262	4.7	10.64	1,233	10.64
14.50	25.17	988	3.6	22.96	988	22.96
25.50	121.68	682	3.1	44.57	682	44.57
		9,258	5.6	$ 11.64	6,297	$ 14.27

The weighted-average remaining contractual life for all exercisable stock options at September 29, 2006 was 4.9 years. The weighted-average remaining contractual life of all vested and expected-to-vest stock options at September 29, 2006 was 5.5 years.

Aggregate pre-tax intrinsic value of options outstanding and exercisable at September 29, 2006 was $8.8 million and $4.2 million, respectively. The aggregate intrinsic value of stock options vested and expected-to-vest net of estimated forfeitures was $8.2 million at September 29, 2006. Aggregate pre-tax intrinsic value represents the difference between our closing price on the last trading day of the fiscal period, which was $7.36 as of September 29, 2006, and the exercise price multiplied by the applicable number of options. The intrinsic value of exercised stock options is calculated based on the difference between the exercise price and the quoted market price of our common stock as of the close of the exercise date. The aggregate intrinsic value of exercised stock options was $0.1million and $0.3 million during the three and nine months ended September 29, 2006, respectively.

Employee Stock Purchase Plan.

In May 2002, Harmonic s stockholders approved the 2002 Employee Stock Purchase Plan (the 2002 Purchase Plan) replacing the 1995 Employee Stock Purchase Plan effective for the offering period beginning on July 1, 2002. In May 2004, Harmonic s stockholders approved an amendment to the 2002 Purchase Plan and increased the maximum number of shares of common stock authorized for issuance over the term of the 2002 Purchase Plan by an additional 2,000,000 shares. In June 2006, Harmonic s stockholders approved an amendment to the 2002 Purchase Plan to increase the maximum number of shares of common stock available for issuance under the 2002 Purchase Plan by an additional 2,000,000 shares to 5,500,000 shares and reduce the term of future offering periods to six months. The 2002 Purchase Plan enables employees to purchase shares at 85% of the fair market value of the

Common Stock at the beginning of the offering period or end of the purchase period, whichever is lower. Prior to the approval of the June 2006 amendment, each offering period had a maximum duration of two years and consisted of four six-month purchase periods. Offering periods and purchase periods generally began on the first trading day on or after January 1 and July 1 of each year. The 2002 Purchase Plan is intended to qualify as an employee stock purchase plan under Section 423 of the Internal Revenue Code. During the first nine months of 2006 and the years 2005 and 2004, the number of shares of stock issued under the purchase plans were 811,565; 705,171 and 774,683 shares at weighted average prices of $4.04, $5.05 and $2.32, respectively. The weighted-average fair value of each right to purchase shares of common stock granted under the purchase plans were $1.44, $1.82 and $2.68 for the first nine months of 2006 and the years 2005 and 2004, respectively. At September 29, 2006, there were 2,483,495 shares reserved for future issuances under the 2002 Purchase Plan.

Retirement/Savings Plan. Harmonic has a retirement/savings plan which qualifies as a thrift plan under Section 401(k) of the Internal Revenue Code. This plan allows participants to contribute up to 20% of total compensation, subject to applicable Internal Revenue Service limitations. Harmonic makes discretionary contributions to the plan of 25% of the first 4% contributed by eligible participants up to a maximum contribution per participant of $750 per year. This amount has been increased to $1,000 effective January 1, 2006. Such amounts totaled $0.1 million and $0.3 million in the third quarter and first nine months of 2006, respectively.

Stock-based Compensation

The following table summarizes the impact of options from SFAS 123(R) on stock-based compensation costs for employees on our Condensed Consolidated Statements of Operations for the three and nine months ended September 29, 2006 and September 30, 2005:

(In thousands)	**Three Months Ended September 29, 2006**	**Nine Months Ended September 29, 2006**
Employee stock-based compensation in:		
Cost of sales	$ 184	$ 727
Research and development expense	331	1,304
Sales, general and administrative expense	729	2,342
Total employee stock-based compensation in operating expense	1,060	3,646
Total employee stock-based compensation	1,244	4,373
Amount capitalized in inventory	38	38
Total other stock-based compensation (1)		2
Total stock-based compensation	$ 1,282	$ 4,413

(1) Other stock-based compensation represents charges related to non-employee

stock options.

As of September 29, 2006, total unamortized stock-based compensation cost related to unvested stock options was $6.9 million, with the weighted average recognition period of 1.4 years.

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The table below reflects net loss and net loss per share, and pro forma information for the three and nine months ended September 30, 2005 (in thousands, except per share amounts):

	Three Months Ended September 30, 2005 (pro forma)	Nine Months Ended September 30, 2005 (pro forma)
Net loss, before stock-based compensation for employees, prior period	$ (2,891)	$ (3,715)
Less: Stock-based compensation expense previously determined under fair value based method, net of related tax effects	(2,594)	(6,740)
Net loss, after effect of stock-based compensation for employees	$ (5,485)	$ (10,455)
Net loss per share:		
Basic as reported for prior period	$ (0.04)	$ (0.05)
Basic after effect of stock-based compensation for employees	$ (0.07)	$ (0.14)
Diluted as reported for prior period	$ (0.04)	$ (0.05)
Diluted after effect of stock-based compensation for employees	$ (0.07)	$ (0.14)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes-Merton multiple option pricing model with the following weighted average assumptions:

	Employee Stock Options			
	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Expected life (years)	4.75	3.2	4.75	3.7
Volatility	69%	91%	76%	96%
Risk-free interest rate	4.9%	3.8%	4.6%	3.8%
Dividend yield	0.0%	0.0%	0.0%	0.0%

	Employee Stock Purchase Plan			
	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Expected life (years)	0.5	0.8	0.5	0.8
Volatility	56%	61%	56%	69%
Risk-free interest rate	5.07%	3.7%	5.07%	3.7%

Dividend yield	0.0%	0.0%	0.0%	0.0%

The expected term for employee stock options and the ESPP represents the weighted-average period that the stock options are expected to remain outstanding. We derived the expected term using the SAB 107 simplified method. As alternative sources of data become available in order to determine the expected term we will incorporate these data into our assumption.

We use the historical volatility over the expected term of the options and the ESPP offering period to estimate the expected volatility. We believe that the historical volatility, at this time, represents fairly the future volatility of its common stock. We will continue to monitor relevant information to measure expected volatility for future option grants and ESPP offering periods.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of our employee stock options. The dividend yield assumption is based on our history and expectation of dividend payouts.

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Note 11: Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing the net income (loss) attributable to common stockholders for the period by the weighted average number of the common shares outstanding during the period. Diluted net income per share is computed by dividing the net income (loss) for the period by the weighted average number of common shares and potential common shares outstanding during the period if their effect is dilutive. The diluted net loss per share is the same as basic net loss per share for the nine months ended September 29, 2006 because potential common shares, such as common shares issuable upon the exercise of stock options, are only considered when their effect would be dilutive. During the three and nine months ended September 29, 2006, 8.9 million and 11.0 million, respectively, of potentially dilutive shares, consisting of options, were excluded from the net income (loss) per share computations, because their effect was antidilutive. During the three and nine months ended September 30, 2005, 9.7 million and 10.3 million, respectively, of potentially dilutive shares, consisting of options, were excluded from the net income (loss) per share computations, because their effect was antidilutive.

Following is a reconciliation of the numerators and denominators of the basic and diluted net loss per share computations (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Net income (loss) (numerator)	$ 4,016	$ (2,891)	$ (4,034)	$ (3,715)
Shares calculation (denominator):				
Weighted average shares outstanding basic	74,588	73,554	74,286	73,168
Effect of dilutive securities:				
Potential common stock relating to stock options	462			
Average shares outstanding diluted	75,050	73,554	74,286	73,168
Net income (loss) per share basic	$ 0.05	$ (0.04)	$ (0.05)	$ (0.05)
Net income (loss) per share diluted	$ 0.05	$ (0.04)	$ (0.05)	$ (0.05)

Note 12: Comprehensive Income (Loss)

The Company s total comprehensive income (loss) was as follows (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Net income (loss)	$ 4,016	$ (2,891)	$ (4,034)	$ (3,715)
Change in unrealized gain (loss) on investments, net	83	(35)	173	(46)
Foreign currency translation	19	(286)	125	(164)
Total comprehensive income (loss)	$ 4,118	$ (3,212)	$ (3,736)	$ (3,925)

Note 13: Segment Information

Operating segments are defined as components of an enterprise that engage in business activities for which separate financial information is available and evaluated by the chief operating decision maker. Previously, the Company was organized into two operating segments: BAN, for fiber optic systems, and CS, for digital headend systems. Each segment had its own management team directing its product development, marketing strategies and its customer service requirements. A separate sales force generally supported both segments with appropriate product and market specialization as required.

The Company restructured its CS and BAN segments into one consolidated group in the fourth quarter of 2005 and effective as of January 1, 2006 no longer has two operating segments. The restructuring involved merging the manufacturing operations, research and development, and marketing departments into one segment.

Geographic Information (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Net sales:				
United States	$ 29,265	$ 33,954	$ 81,968	$ 115,526
Canada	7,408	2,591	12,216	6,515
International	26,183	24,415	78,162	71,597
Total	$ 62,856	$ 60,960	$ 172,346	$ 193,638

In the third quarter of 2006, sales to Cox Communications and Comcast accounted for 13% and 10% of net sales, respectively, and in the third quarter of 2005, sales to a reseller for a major telco accounted for 13% of net sales. In the first nine months of 2006, no customer had sales that accounted for more than 10% of net sales, and in the first nine months of 2005, sales to Comcast accounted for 21% of net sales.

Note 14: Related Party

A director of Harmonic is also a director of Terayon Communications, from which the Company purchases products for resale. Product purchases from Terayon were approximately $1.3 million and $2.8 million, for the three and nine months ended September 29, 2006, respectively. Product purchases from Terayon were approximately $1.9 million and $18.9 million, for the three and nine months ended September 30, 2005, respectively. As of September 29, 2006 and December 31, 2005, Harmonic had liabilities to Terayon of approximately $0.9 million and $0.7 million, respectively, for inventory purchases.

Note 15: Guarantees

Warranties. The Company accrues for estimated warranty costs at the time of product shipment. Management periodically reviews the estimated fair value of its warranty liability and adjusts based on the terms of warranties provided to customers, historical and anticipated warranty claims experience, and estimates of the timing and cost of specified warranty claims. Activity for the Company s warranty accrual, which is included in accrued liabilities is summarized below (in thousands):

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Balance at beginning of the period	$ 6,018	$ 5,425	$ 6,166	$ 5,429
Accrual for warranties	1,383	1,517	3,404	4,042
Warranty costs incurred	(985)	(1,128)	(3,154)	(3,678)
BTL acquisition				21
Balance at end of the period	$ 6,416	$ 5,814	$ 6,416	$ 5,814

Standby Letters of Credit. As of September 29, 2006 the Company s financial guarantees consisted of standby letters of credit outstanding, which were principally related to customs bond requirements, performance bonds and state requirements imposed on employers. The maximum amount of potential future payments under these arrangements was $0.8 million.

Indemnification Obligations. Harmonic is obligated to indemnify its officers and the members of its Board of Directors pursuant to its bylaws and contractual indemnity agreements. Harmonic also indemnifies some of its suppliers and customers for specified intellectual property matters pursuant to certain contractual arrangements, subject to certain limitations. The scope of these indemnities varies, but in some instances, includes indemnification for damages and expenses (including reasonable attorneys fees). There have been no claims against us for indemnification pursuant to any of these arrangements and, accordingly, no amounts have been accrued in respect of the indemnifications provisions through September 29, 2006.

Guarantees. As of September 29, 2006, Harmonic had no other guarantees outstanding.

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Note 16: Legal Proceedings

Between June 28 and August 25, 2000, several actions alleging violations of the federal securities laws by Harmonic and certain of its officers and directors (some of whom are no longer with Harmonic) were filed in or removed to the United States District Court (the District Court) for the Northern District of California. The actions subsequently were consolidated.

A consolidated complaint, filed on December 7, 2000, was brought on behalf of a purported class of persons who purchased Harmonic s publicly traded securities between January 19 and June 26, 2000. The complaint also alleged claims on behalf of a purported subclass of persons who purchased C-Cube securities between January 19 and May 3, 2000. In addition to Harmonic and certain of its officers and directors, the complaint also named C-Cube Microsystems Inc. and several of its officers and directors as defendants. The complaint alleged that, by making false or misleading statements regarding Harmonic s prospects and customers and its acquisition of C-Cube, certain defendants violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the Exchange Act). The complaint also alleged that certain defendants violated section 14(a) of the Exchange Act and sections 11, 12(a)(2), and 15 of the Securities Act of 1933 (the Securities Act) by filing a false or misleading registration statement, prospectus, and joint proxy in connection with the C-Cube acquisition.

On July 3, 2001, the District Court dismissed the consolidated complaint with leave to amend. An amended complaint alleging the same claims against the same defendants was filed on August 13, 2001. Defendants moved to dismiss the amended complaint on September 24, 2001. On November 13, 2002, the District Court issued an opinion granting the motions to dismiss the amended complaint without leave to amend. Judgment for defendants was entered on December 2, 2002. On December 12, 2002, plaintiffs filed a motion to amend the judgment and for leave to file an amended complaint pursuant to Rules 59(e) and 15(a) of the Federal Rules of Civil Procedure. On June 6, 2003, the District Court denied plaintiffs motion to amend the judgment and for leave to file an amended complaint. Plaintiffs filed a notice of appeal on July 1, 2003. The appeal was heard by a panel of three judges of the United States Court of Appeals for the Ninth Circuit (the Ninth Circuit) on February 17, 2005.

On November 8, 2005, the Ninth Circuit panel affirmed in part, reversed in part, and remanded for further proceedings the decision of the District Court. The Ninth Circuit affirmed the District Court s dismissal of the plaintiffs fraud claims under Sections 10(b), 14(a), and 20(a) of the Exchange Act with prejudice, finding that the plaintiffs failed to adequately plead their allegations of fraud. The Ninth Circuit reversed the District Court s dismissal of the plaintiffs claims under Sections 11 and 12(a)(2) of the Securities Act, however, finding that those claims did not allege fraud and therefore were subject to only minimal pleading standards. Regarding the secondary liability claim under Section 15 of the Securities Act, the Ninth Circuit reversed the dismissal of that claim against Anthony J. Ley, Harmonic s Chairman and Chief Executive Officer, and affirmed the dismissal of that claim against Harmonic, while granting leave to amend. The Ninth Circuit remanded the surviving claims to the District Court for further proceedings.

On November 22, 2005, both the Harmonic defendants and the plaintiffs petitioned the Ninth Circuit for a rehearing of the appeal. On February 16, 2006 the Ninth Circuit denied both petitions. On May 17, 2006 the plaintiffs filed an amended complaint on the issues remanded for further proceedings by the Ninth Circuit, to which the Harmonic defendants responded on with a Motion to Dismiss. Briefing on the motion was completed in August 2006. There will be no hearing unless the Court requests one.

A derivative action purporting to be on behalf of Harmonic was filed against its then-current directors in the Superior Court for the County of Santa Clara on September 5, 2000. Harmonic also was named as a nominal defendant. The complaint is based on allegations similar to those found in the securities class action and claims that the defendants breached their fiduciary duties by, among other things, causing Harmonic to violate federal securities laws. The derivative action was removed to the United States District Court for the Northern District of California on September 20, 2000. All deadlines in this action were stayed pending resolution of the motions to dismiss the securities class action. On July 29, 2003, the Court approved the parties stipulation to dismiss this derivative action without prejudice and to toll the applicable limitations period pending the Ninth Circuit s decision in the securities action. Pursuant to the stipulation, defendants have provided plaintiff with a copy of the mandate issued by the Ninth Circuit in the securities action.

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A second derivative action purporting to be on behalf of Harmonic was filed in the Superior Court for the County of Santa Clara on May 15, 2003. It alleged facts similar to those previously alleged in the securities class action and the federal derivative action. The complaint named as defendants former and current Harmonic officers and directors, along with former officers and directors of C-Cube Microsystems, Inc., who were named in the securities class action. The complaint also named Harmonic as a nominal defendant. The complaint alleged claims for abuse of control, gross mismanagement, and waste of corporate assets against the Harmonic defendants, and claims for breach of fiduciary duty, unjust enrichment, and negligent misrepresentation against all defendants. On July 22, 2003, the Court approved the parties stipulation to stay the case pending resolution of the appeal in the securities class action. Following the decision of the Ninth Circuit discussed above, on May 9, 2006, defendants filed demurrers to this complaint. The plaintiffs then filed an amended complaint on July 10, 2006, which names only the Harmonic defendants. The defendants filed demurrers to the amended complaint, and a case management conference and hearing are scheduled for December 19, 2006.

Based on its review of the surviving claims in the securities class actions, Harmonic believes that it has meritorious defenses and intends to defend itself vigorously. There can be no assurance, however, that Harmonic will prevail. No estimate can be made of the possible range of loss associated with the resolution of this contingency, and accordingly, Harmonic has not recorded a liability. An unfavorable outcome of this litigation could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of Harmonic s products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint seeks injunctive relief, royalties and damages. Harmonic has not been served in the case. At this time, we are unable to determine whether we will be able to settle this litigation on reasonable terms or at all, nor can we predict the impact of an adverse outcome of this litigation if we elect to defend against it. No estimate can be made of the possible range of loss associated with the resolution of this contingency and accordingly, we have not recorded a liability associated with the outcome of a negotiated settlement or an unfavorable verdict in litigation. An unfavorable outcome of this matter could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

Harmonic is involved in other litigation and may be subject to claims arising in the normal course of business. In the opinion of management the amount of ultimate liability with respect to these matters in the aggregate will not have a material adverse effect on the Company or its operating results, financial position or cash flows.

Note 17: Entone Acquisition

In the third quarter of 2006, Harmonic entered into a definitive agreement to acquire the video networking software business of Entone Technologies, Inc., a privately-held company based in San Mateo, Ca, with research and development facilities in Hong Kong. The Entone software solutions encompassing content ingest, distributed content management and video streaming facilitate the provisioning of personalized video services including video-on-demand (VOD), network personal video recording (nPVR), time-shifted television and targeted advertisement insertion. By combining Harmonic s industry-leading video headend, edge and access network solutions with Entone s on-demand software, Harmonic expects to be able to provide cable, satellite and telco/IPTV service providers an advanced and uniquely integrated delivery system for the next generation of both broadcast and personalized IP-delivered video services.

The agreed upon purchase price is comprised of $26 million in cash and the value of 3.54 million shares of Harmonic common stock (with an approximate market value of $19.0 million at August 21, 2006), as determined in accordance with the terms of the definitive agreement. In addition, Harmonic will assume certain liabilities of $1.5 million and invest $2.5 million in the form of a convertible note in Entone s consumer premise equipment (CPE) business, which will be spun out to Entone s existing stockholders immediately prior to the closing of the acquisition. The Company currently expects the acquisition of Entone will be completed in the fourth quarter of 2006.

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding our expectations of continued customer concentration; our expectations regarding future sales for a major telecommunications operator; our expectations that sales to cable television, satellite and telecommunications operators will constitute a significant portion of net sales for the foreseeable future; our expectation that international sales will continue to account for a significant portion of our net sales for the foreseeable future; our expectation that, following the acquisition of Entone, we will be able to provide cable, satellite and telco/IPTV service providers with an advanced and uniquely integrated delivery system for the next generation of broadcast and personalized IP-delivered video services; our expectations regarding our capital expenditures during the remainder of 2006; our expectation that we will not receive any tax benefits in fiscal 2006 for any expense deductions resulting from expensing of stock options or shares issued under our ESPP; our expectations regarding the amount of amortization expense we will incur during the remainder of 2006; our expectation that near-term changes in foreign exchange rates will not have a material impact on our operating results, financial position and liquidity; our belief that any ultimate liability of Harmonic with respect to certain litigation arising in the normal course of business will not, in the aggregate, have a material adverse effect on us or our operating results, financial position or cash flows; our belief that our existing liquidity sources will satisfy our cash requirement for at least the next 12 months; and our expectation that operating results are likely to fluctuate in the future. These statements involve risks and uncertainties as well as assumptions that, if they were to never materialize or prove incorrect, could cause actual results to differ materially from those projected, expressed or implied in the forward-looking statements. These risks and uncertainties include those set forth under Risk Factors below and elsewhere in this Quarterly Report on Form 10-Q and that are otherwise described from time to time in Harmonic s filings with the Securities and Exchange Commission.

Overview

Harmonic designs, manufactures and sells products for video processing and edge and access applications. In addition, we provide network management software and have recently introduced new application software products. Harmonic also provides technical support services to its customers worldwide. Our video processing products provide broadband operators with the ability to accept a variety of signals from different sources, in different protocols, and to organize, manage and distribute this content to maximize use of the available bandwidth. Our edge products enable operators to deliver customized broadcast or narrowcast on-demand services to their subscribers, and our access products, which consist mainly of optical transmission products, node platforms and return path products, allow operators to deliver video, data and voice services over their physical networks.

These products and services enable network operators to provide a range of interactive and advanced digital services that include digital video, video-on-demand (VOD), high-definition television (HDTV), high-speed Internet access and telephony. They enable our customers to process video for distribution over cable, satellite, telephone and wireless networks. We also provide fiber optic transmission systems to cable television operators and to certain telephone companies that offer video services to their customers.

The sequential increases in net sales in 2005 and 2004 that Harmonic experienced reflected an improved industry capital spending environment worldwide which favorably impacted us. We believe that this improvement in the industry capital spending environment was, in part, a result of the intensifying competition between cable and satellite operators to offer more channels of digital video and new services, such as VOD and HDTV, and in part the result of the entry of telephone companies into the business of delivering video services to their subscribers. We also believe that the improvement was due to more favorable conditions in industry capital markets and the completion or resolution of certain major business combinations, financial restructurings and regulatory issues.

In the third quarter of 2006, Harmonic s net sales increased 3% compared to the third quarter of 2005, although net sales in the first nine months of 2006 decreased by 11% compared to the first nine months of 2005. We believe that the increase in sales in the third quarter of 2006 compared to the same period in 2005 was due to increased shipments of a broad range of new video delivery solutions to domestic cable customers and new international telco and satellite customers. The decrease in net sales in the first nine months of 2006 compared to the first nine months of 2005 was attributable to weaker spending by domestic cable customers in the first half of 2006, the significant

amount of third party products sold to our end customers in the first nine months of 2005, as well as supply chain constraints and delays in the completion of projects for our international telco customers during the first nine months of 2006. Our quarterly and annual results may fluctuate significantly due to spending by our customers, our revenue recognition policies and the timing of the receipt of orders, as well as other factors, including those set forth in the section entitled Risk Factors in this Quarterly Report on Form 10-Q.

Harmonic often recognizes a significant portion, or the majority, of its revenues in the last month of the quarter. Harmonic establishes its expenditure levels for product development and other operating expenses based on projected sales levels, and expenses are relatively fixed in the short term. Accordingly, variations in timing of sales can cause significant fluctuations in operating results. In addition, because a significant portion of Harmonic s business is derived from orders placed by a limited number of large customers, the timing of such orders can also cause significant fluctuations in our operating results. Harmonic s expenses for any given quarter are typically based on expected sales and if sales are below expectations, our operating results may be adversely impacted by our inability to adjust spending to compensate for the shortfall.

Historically, a majority of our net sales have been to relatively few customers, and due in part to the consolidation of ownership of cable television and direct broadcast satellite systems, we expect this customer concentration to continue for the foreseeable future. In the third quarter of 2006, sales to Cox Communications and Comcast accounted for 13% and 10% of net sales, respectively, and in the third quarter of 2005, sales to a reseller for a major telco accounted for 13% of net sales. In the first nine months of 2006, no customer had sales that accounted for more than 10% of net sales, and in the first nine months of 2005, sales to Comcast accounted for 21% of net sales.

Sales to customers outside of the U.S. in the third quarter and first nine months of 2006 represented 53% and 52% of net sales, respectively, compared to 44% and 40% for the comparable periods in 2005. A significant portion of international sales are made to distributors and system integrators, which are generally responsible for importing the products and providing installation and technical support and service to customers within their territory. Sales denominated in foreign currencies were approximately 9% of net sales in the first nine months of 2006 compared to 7% for the comparable period of 2005. We expect international sales to continue to account for a significant portion of our net sales for the foreseeable future.

In the third quarter of 2006, the Company completed its facilities rationalization plan resulting in more efficient use of our Sunnyvale campus and vacated several buildings, some of which were subsequently subleased. The Company also revisited its estimates of excess facilities reserves for buildings previously vacated due to entering into sublease agreements during the quarter. This resulted in a net charge for excess facilities of $2.1 million in the third quarter of 2006.

In May 2006, the Company s Board of Directors appointed Patrick J. Harshman as President and Chief Executive Officer, replacing Anthony Ley, who retired after 18 years with the Company. Mr. Ley carries on as a consultant to the Company and as chairman of its Board of Directors. Following Dr. Harshman s appointment, the Company announced a reorganization of its senior management, resulting in a charge of approximately $1 million in severance costs in the second quarter of 2006.

In the fourth quarter of 2005, Harmonic announced a restructuring that combined our product development, marketing and manufacturing operations and resulted in the BAN and CS operating segments being combined into a single segment, effective January 1, 2006. In connection with this restructuring, Harmonic reduced its workforce by approximately 40 employees and recorded an expense of $1.1 million for severance costs related to the restructuring.

In the fourth quarter of 2005, the excess facilities liability was decreased by $1.1 million due to subleasing a portion of the unoccupied portion of one building for the remainder of the lease. Although we entered into new subleases for approximately 60,000 square feet of space in 2004 and approximately 30,000 square feet of space in 2005, in the event we are unable to achieve expected levels of sublease rental income, we will need to revise our estimate of the liability, which could materially impact our financial position, liquidity, cash flows and results of operations.

On February 25, 2005, Harmonic purchased all of the issued and outstanding shares of Broadcast Technology Ltd., a private UK company, for a total purchase consideration of £4.0 million, or approximately $7.6 million. The purchase consideration consisted of a payment of £3.0 million in cash and the issuance of 169,112 shares of Harmonic common stock. Broadcast Technology Ltd. develops, manufactures and distributes professional video/ audio receivers and decoders and had 42 employees at the time of the acquisition.

In the third quarter of 2006, Harmonic entered into a definitive agreement to acquire the video networking software business of Entone Technologies, Inc., a privately-held company based in San Mateo, Ca, with research and development facilities in Hong Kong. The Entone software solutions encompassing content ingest, distributed content management and video streaming facilitate the provisioning of personalized video services including video-on-demand (VOD), network personal video recording (nPVR), time-shifted television and targeted advertisement insertion. By combining Harmonic s industry-leading video headend, edge and access network solutions with Entone s on-demand software, Harmonic expects to be able to provide cable, satellite and telco/IPTV service providers an advanced and uniquely integrated delivery system for the next generation of both broadcast and personalized IP-delivered video services.

The agreed upon purchase price is comprised of $26 million in cash and the value of 3.54 million shares of Harmonic common stock (with an approximate market value of $19.0 million at August 21, 2006), as determined in accordance with the terms of the definitive agreement. In addition, Harmonic will assume certain liabilities of $1.5 million and invest $2.5 million in the form of a convertible note in Entone s consumer premise equipment (CPE) business, which will be spun out to Entone s existing stockholders immediately prior to the closing of the acquisition.

Critical Accounting Policies, Judgments and Estimates

The preparation of financial statements and related disclosures requires Harmonic to make judgments, assumptions and estimates that affect the reported amounts of assets and liabilities, the disclosure of contingencies and the reported amounts of revenue and expenses in the financial statements and accompanying notes. Material differences may result in the amount and timing of revenue and expenses if different judgments or different estimates were made.

Our significant accounting policies are described in Note 1 to the annual consolidated financial statements as of and for the year ended December 31, 2005, included in our Annual Report on Form 10-K filed with the SEC on March 14, 2006 and notes to condensed consolidated financial statements as of and for the three and nine month periods ended September 29, 2006, included herein. Our most critical accounting policies include the following:

- revenue recognition;
- allowances for doubtful accounts, returns and discounts;
- valuation of inventories;
- impairment of long-lived assets;
- restructuring costs and accruals for excess facilities;
- assessment of the probability of the outcome of current litigation;
- accounting for income taxes; and
- stock-based compensation.

Since January 1, 2006, our accounting policy for stock-based compensation for employee stock-based awards was modified due to the adoption of SFAS 123(R) and is described below.

Stock-Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases related to our Employee Stock Purchase Plan (ESPP) based upon the grant-date fair value of those awards. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations, and provided the required pro forma disclosures prescribed by Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, (SFAS 123) as amended. In addition, we have applied the provisions of Staff Accounting Bulletin No. 107 (SAB 107), issued by the Securities and Exchange Commission, in our adoption of SFAS No. 123(R).

The Company adopted SFAS 123(R) using the modified-prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company s fiscal year 2006. The Company s Condensed Consolidated Financial Statements as of and for the three and nine months ended September 29, 2006 reflects the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s Condensed Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the three and nine months ended September 29, 2006 was $1.2 million and $4.4 million, respectively, which consisted of stock-based compensation expense related to employee equity awards and employee stock purchases. There was no stock-based compensation expense related to employee equity awards and employee stock purchases recognized during the three and nine months ended September 30, 2005.

SFAS 123(R) requires companies to estimate the fair value of share-based payment awards on the date of grant using an option-pricing model. The value of the portion of the award that is ultimately expected to vest is recognized as expense over the requisite service period in the Company s Condensed Consolidated Statement of Operations. Prior to the adoption of SFAS 123(R), the Company accounted for employee equity awards and employee stock purchases using the intrinsic value method in accordance with APB 25 as allowed under SFAS 123. Under the intrinsic value method, no stock-based compensation expense had been recognized in the Company s Condensed Consolidated Statement of Operations because the exercise price of the Company s stock options granted to employees and directors equaled the fair market value of the underlying stock at the date of grant.

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s Condensed Consolidated Statement of Operations for the three and nine months ended September 29, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company changed its method of attributing the value of stock-based compensation costs to expense from the accelerated multiple-option method to the straight-line single-option method. Compensation expense for all share-based payment awards granted on or prior to December 31, 2005 will continue to be recognized using the accelerated approach while compensation expense for all share-based payment awards related to stock options and employee stock purchase rights granted subsequent to December 31, 2005 are recognized using the straight-line method.

As stock-based compensation expense recognized in our results for the third quarter and the first nine months of fiscal year 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to fiscal year 2006, we accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

The fair value of share-based payment awards is estimated at grant date using a Black-Scholes-Merton option pricing model. The Company s determination of fair value of share-based payment awards on the date of grant using

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an option-pricing model is affected by the Company s stock price as well as the assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. Harmonic currently does not expect to receive any tax benefits in fiscal 2006 for any expense deductions resulting from expensing of stock options or shares issued under its ESPP. On November 10, 2005 the FASB issued FASB Staff Position No. FSP FAS 123(R)-3, *Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards*. Harmonic currently provides a valuation allowance for most of its deferred tax assets, and a valuation allowance has also been provided for deferred tax assets related to nonqualified stock options.
Also see Note 10 to the Condensed Consolidated Financial Statements on Stock-Based Compensation.

Results of Operations

Harmonic s historical consolidated statements of operations data for the third quarter and first nine months of 2006 and 2005 as a percentage of net sales, are as follows:

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Net sales	100%	100%	100%	100%
Cost of sales	53	65	59	63
Gross profit	47	35	41	37
Operating expenses:				
Research and development	16	15	17	15
Selling, general and administrative	27	25	28	24
Amortization of intangibles				1
Total operating expenses	43	40	45	40
Income (loss) from operations	4	(5)	(4)	(3)
Interest income, net	2	1	2	1
Other income (expense), net		(1)		
Income (loss) before income taxes	6	(5)	(2)	(2)
Provision for (benefit from) income taxes				
Net income (loss)	6%	(5)%	(2)%	(2)%

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Net Sales Consolidated

Harmonic s consolidated net sales in the third quarter and first nine months of 2006 compared with the corresponding periods in 2005 are presented by product line in the table below. Also presented is the related dollar and percentage increase (decrease) in consolidated net sales in the third quarter and first nine months of 2006 compared with the corresponding periods in 2005 (in thousands, except percentages).

	Three Months Ended		Nine Months Ended	
Product Sales Data:	**September 29, 2006**	**September 30, 2005**	**September 29, 2006**	**September 30, 2005**
Video Processing	$ 26,116	$ 24,668	$ 66,363	$ 99,077
Edge and Access	25,143	27,412	77,029	68,947
Software, Support and Other	11,597	8,880	28,954	25,614
Net sales	$ 62,856	$ 60,960	$ 172,346	$ 193,638
Video Processing increase (decrease)	$ 1,448		$ (32,714)	
Edge and Access increase (decrease)	(2,269)		8,082	
Software, Support and Other increase	2,717		3,340	
Total increase (decrease)	$ 1,896		$ (21,292)	
Video Processing percent change	5.9%		(33.0)%	
Edge and Access percent change	(8.3)%		11.7%	
Software, Support and Other percent change	30.6%		13.0%	
Total percent change	3.1%		(11.0)%	

Net sales increased in the third quarter of 2006 compared to the same period of 2005 due to increased shipments to domestic cable customers and shipments to new international telco and satellite customers. In the video processing product lines, revenue increased primarily due to shipments of encoder and stream processing products to domestic cable customers, partially offset by a decrease in the sale of third party products. The edge and access products line experienced a decrease in sales in the third quarter of 2006 compared to the third quarter of 2005 as sales to a major domestic telco decreased significantly, which were partially offset by an increase in sales to international telco customers, primarily in Europe. Software revenue increased in the third quarter of 2006 compared to the prior year primarily due to the introduction of new products. Third party product sales decreased by approximately $2.1 million in the third quarter of 2006, compared to the corresponding period in 2005.

Net sales decreased in the first nine months of 2006 compared to the same period of 2005 principally due to the decrease in the sale of third party products to our end customers, supply chain constraints resulting in product shortages, delays in the completion of certain projects for international telco customers and decreased spending by domestic cable customers for major digital headend projects. In the video processing product line, sales of encoder and stream processing products decreased by approximately $18.2 million in the first nine months of 2006 compared to the same period in the prior year due to lower spending for major digital headend projects by domestic cable companies. Delays in the completion of certain projects underway with our international telco customers resulted in less revenue being recognized. In addition, sales of third party products to end customers decreased by approximately $14.6 million in the first nine months of 2006 compared to the same period in 2005. The edge and access products line, which includes certain VOD products, experienced a significant increase in revenue in the first nine months of 2006 compared to the first nine months of 2005 as telcos and other broadband operators continued to introduce and expand video and other services, primarily in the U.S. and European markets.

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Net Sales Geographic

Harmonic s domestic and international net sales in the third quarter and first nine months of 2006 compared with the corresponding periods in 2005 are presented in the table below. Also presented is the related dollar and percentage increase (decrease) in domestic and international net sales in the third quarter and first nine months of 2006 compared with the corresponding periods in 2005 (in thousands, except percentages).

	Three Months Ended		Nine Months Ended	
Geographic Sales Data:	**September 29, 2006**	**September 30, 2005**	**September 29, 2006**	**September 30, 2005**
U.S	$ 29,265	$ 33,954	$ 81,968	$ 115,526
International	33,591	27,006	90,378	78,112
Net sales	$ 62,856	$ 60,960	$ 172,346	$ 193,638
U.S. decrease	$ (4,689)		$ (33,558)	
International increase	6,585		12,266	
Total increase (decrease)	$ 1,896		$ (21,292)	
U.S. percent change	(13.8)%		(29.0)%	
International percent change	24.4%		15.7%	
Total percent change	3.1%		(11.0)%	

The decreased U.S. sales in the third quarter and the first nine months of 2006 compared to the corresponding periods in 2005 was principally due to fewer sales of third party products to end customers and lower spending by a major domestic telco.

International sales in the third quarter and the first nine months of 2006 increased significantly compared to the corresponding periods in 2005 primarily due to sales to telcos in the European market. The increased international sales in the third quarter of 2006 as compared to the same period of 2005, was also due to increased international capital spending by customers primarily in Europe, Canada and Asia. As a result of these factors, we expect that international sales will continue to account for a significant portion of our net sales for the foreseeable future.

Gross Profit

Harmonic s gross profit and gross profit as a percentage of consolidated net sales in the third quarter and first nine months of 2006 as compared with the corresponding prior year periods of 2005 are presented in the tables below. Also presented is the related dollar and percentage decrease in gross profit in the third quarter and first nine months of 2006 as compared with the corresponding periods of 2005 (in thousands, except percentages).

	Three Months Ended		Nine Months Ended	
	September 29, 2006	**September 30, 2005**	**September 29, 2006**	**September 30, 2005**
Gross profit	$ 29,797	$ 21,396	$ 71,282	$ 71,841
As a % of net sales	47.4%	35.1%	41.4%	37.1%
Increase (decrease)	$ 8,401		$ (559)	
Percent change	39.3%		(0.8)%	

The increase in gross profit in the third quarter of 2006 as compared to the corresponding period of 2005 was primarily due to higher sales, an increase in gross margin percentage, lower amortization of intangibles and a one-time benefit arising from successful progress on a European telco project. The gross margin percentage in the third quarter and first nine months of 2006 compared to the corresponding periods of 2005 was higher primarily due to a higher proportion of digital video and service revenue, which carry higher gross margins than the average gross margins for our products, lower sales of third party products to our end customers in the third quarter and first nine months of 2006 compared to the corresponding periods of 2005, sales of which products have significantly lower gross margins than the average gross margin on sales of our products and the benefit for successful progress on a European telco project.

In the first nine months of 2006, $0.5 million of amortization of intangibles was included in cost of sales compared to $1.1 million in the first nine months of 2005. The lower amortization in the first nine months of 2006 was due to certain intangibles arising from the BTL acquisition being fully amortized in the third quarter of 2006. We expect to record approximately $0.2 million in amortization of intangibles in cost of sales in the remaining three months of 2006 due to the acquisition of BTL in February 2005.

Research and Development

Harmonic s research and development expense and the expense as a percentage of consolidated net sales in the third quarter and first nine months of 2006, as compared with the corresponding periods of 2005, are presented in the table below. Also presented is the related dollar and percentage increase in research and development expense in the third quarter and first nine months of 2006 as compared with the corresponding periods of 2005 (in thousands, except percentages).

	Three Months Ended		Nine Months Ended	
	September 29, 2006	**September 30, 2005**	**September 29, 2006**	**September 30, 2005**
Research and development expense	$ 10,021	$ 9,403	$ 29,554	$ 28,381
As a % of net sales	15.9%	15.4%	17.1%	14.7%
Increase	$ 618		$ 1,173	
Percent change	6.6%		4.1%	

The increase in research and development expense in the third quarter of 2006 as compared to the same period in 2005 was primarily the result of increased use of outside consulting services associated with the development of new products of $0.3 million and stock-based compensation expense of $0.3 million. The increase in research and development expense in the first nine months of 2006 as compared to the same period in 2005 was primarily the result of increased use of outside consulting services associated with the development of new products of $1.3 million and stock-based compensation expense of $1.3 million, which was partially offset by lower compensation expense of $0.9 million from reductions in headcount and incentive compensation and lower prototype materials expense of $0.4 million.

Selling, General and Administrative

Harmonic s selling, general and administrative expense and the expense as a percentage of consolidated net sales in the third quarter and first nine months of 2006, as compared with the corresponding periods of 2005, are presented in the table below. Also presented is the related dollar and percentage decrease in selling, general and administrative expense in the third quarter and first nine months of 2006 as compared with the corresponding periods of 2005 (in thousands, except percentages).

	Three Months Ended		Nine Months Ended	
	September 29, 2006	**September 30, 2005**	**September 29, 2006**	**September 30, 2005**
Selling, general and administrative expense	$ 16,931	$ 15,166	$ 48,623	$ 47,102
As a % of net sales	26.9%	24.9%	28.2%	24.3%
Increase	$ 1,765		$ 1,521	
Percent change	11.6%		3.2%	

The increase in selling, general and administrative expense in the third quarter of 2006 compared to the same period in 2005 was primarily the result of the net excess facilities charge of $2.1 million in the third quarter of 2006 for the campus consolidation and stock-based compensation expense of $0.7 million, partially offset by lower facilities overhead expenses of $0.4 million, lower compensation expenses of $0.2 million and lower trade show expenses of

$0.1 million. The increase in selling, general and administrative expense in the first nine months of 2006 compared to the same period in 2005 was primarily a result of the net excess facilities charge of $2.1 million for the campus consolidation, stock-based compensation expense of $2.3 million, which were partially offset by lower compensation expenses of $1.0 million, lower facilities overhead expenses of $1.0 million, lower trade show expenses of $0.3 million and lower corporate governance costs of $0.4 million.

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Amortization of Intangibles

Harmonic s amortization of intangible assets and the expense as a percentage of consolidated net sales in the third quarter and first nine months of 2006 as compared with the corresponding periods of 2005 are presented in the table below. Also presented is the related dollar and percentage decrease in amortization of intangible assets in the third quarter and first nine months of 2006 as compared with the corresponding periods of 2005 (in thousands, except percentages).

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Amortization of intangibles	$ 45	$ 110	$ 179	$ 1,233
As a % of net sales	0.1%	0.2%	0.1%	0.6%
Decrease	$ (65)		$ (1,054)	
Percent change	(59.1)%		(85.5)%	

The decrease in the amortization of intangibles in the third quarter of 2006 compared to the same period in 2005 was primarily due to the completion of amortization of certain items acquired in connection with the BTL transaction during the third quarter of 2006. The decrease in the amortization of intangibles in the first nine months of 2006 compared to the same period in 2005 was primarily due to the completion of amortization of the DiviCom intangible assets during the first nine months of 2005. Harmonic expects to record a total of approximately $45,000 in amortization of intangibles in operating expenses in the remaining three months of 2006 due to the intangible assets resulting from the acquisition of BTL in February 2005.

Interest Income, Net

Harmonic s interest income, net, and interest income, net, as a percentage of consolidated net sales in the third quarter and first nine months of 2006 as compared with the corresponding periods of 2005, are presented in the table below. Also presented is the related dollar and percentage increase in interest income, net, in the third quarter and first nine months of 2006 as compared with the corresponding periods of 2005 (in thousands, except percentages).

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Interest income, net	$ 1,182	$ 669	$ 3,349	$ 1,828
As a % of net sales	1.9%	1.1%	1.9%	0.9%
Increase	$ 513		$ 1,521	
Percent change	76.7%		83.2%	

The increase in interest income, net, in third quarter and the first nine months of 2006 compared to the corresponding periods of 2005 was due primarily to higher interest rates on the cash and short-term investments portfolio and lower interest expense due to a lower debt balance in the third quarter and the first nine months of 2006 as compared to the corresponding periods in 2005.

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Other Income (Expense), Net

Harmonic s other income (expense), net, and other income (expense), net, as a percentage of consolidated net sales in the third quarter and first nine months of 2006 as compared with the corresponding periods of 2005, are presented in the table below. Also presented is the related dollar and percentage increase in other income (expense), net, in the third quarter and first nine months of 2006 as compared with the corresponding periods of 2005 (in thousands, except percentages).

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Other income (expense)	$ 137	$ (288)	$ 173	$ (643)
As a % of net sales	0.2%	(0.5)%	0.1%	(0.3)%
Increase	$ 425		$ 816	
Percent change	147.6%		126.9%	

The increase in other income (expense), net, in the third quarter and first nine months of 2006 compared to the corresponding periods of 2005 was primarily due to lower foreign exchange losses in 2006.

Income Taxes

Harmonic s provision for income taxes, and provision for income taxes as a percentage of consolidated net sales in the third quarter and first nine months of 2006, as compared with the corresponding periods of 2005, are presented in the tables below. Also presented is the related dollar and percentage increase in income taxes in the third quarter and first nine months of 2006 as compared with the corresponding periods of 2005 (in thousands, except percentages).

	Three Months Ended		Nine Months Ended	
	September 29, 2006	September 30, 2005	September 29, 2006	September 30, 2005
Provision for (benefit from) income taxes	$ 103	$ (11)	$ 482	$ 25
As a % of net sales	0.2%	0.0%	0.3%	0.0%
Increase	$ 114		$ 457	
Percent change	1,036.4%		1,828.0%	

The increase in the provision for income taxes in the third quarter and the first nine months of 2006 compared to the corresponding periods in 2005 was due to higher foreign income taxes.

Liquidity and Capital Resources

	Nine Months Ended	
(In thousands)	**September 29, 2006**	**September 30, 2005**
Cash, cash equivalents and short-term investments	$ 110,724	$ 104,883
Net cash provided by (used in) operating activities	$ (9)	$ 9,023
Net cash used provided by (used in) investing activities	$ 9,292	$ (8,336)
Net cash provided by financing activities	$ 3,341	$ 5,380

As of September 29, 2006, cash, cash equivalents and short-term investments totaled $110.7 million, compared to $110.8 million as of December 31, 2005. Cash used in operations was $9,000 in the first nine months of 2006, compared to cash provided by operations of $9.0 million in the first nine months of 2005. The increased use of cash in operating activities in the first nine months of 2006 was primarily due to higher accounts receivable and prepaid expenses, which was partially offset by higher accounts payable and deferred revenue. The higher accounts receivable was due to increased revenue in the third quarter of 2006 compared to the third quarter of 2005 and the timing of shipments during the quarter. The higher prepaid expenses were primarily due to the increase in deferred costs on projects. The higher accounts payable was due to increase in inventory purchases and the timing of payments. The higher deferred revenue was due to new projects and delays in the progress and completion of specific projects due to product shortages resulting in higher deferred costs in prepaid expenses and higher deferred revenue.

Additions to property, plant and equipment were $3.7 million during the first nine months of 2006 compared to $4.2 million in the first nine months of 2005. The decrease in the first nine months of 2006 from the comparable period in 2005 was primarily due to a decrease in the acquisition of test equipment. Harmonic currently expects capital expenditures to be approximately $5 million to $6 million during 2006.

In the third quarter of 2006, Harmonic entered into a definitive agreement to acquire the video networking software business of Entone Technologies, Inc., a privately-held company based in San Mateo, Ca, with research and development facilities in Hong Kong. The agreed upon purchase price is comprised of $26 million in cash and the value of 3.54 million shares of Harmonic common stock (with an approximate market value of $19.0 million at August 21, 2006), as determined in accordance with the terms of the definitive agreement. In addition, Harmonic will assume certain liabilities of $1.5 million and invest $2.5 million in the form of a convertible note in Entone s consumer premise equipment (CPE) business, which will be spun out to Entone s existing stockholders immediately prior to the closing of the acquisition.

On November 3, 2003, Harmonic completed a public offering of 9.0 million shares of its common stock at a price of $7.40 per share. The net proceeds were approximately $62.0 million, which is net of underwriters fees of $3.7 million, and related legal, accounting, printing and other expenses totaling approximately $0.9 million. In connection with this offering, the underwriters exercised their option to purchase 1.35 million additional shares of common stock at $7.40 per share on November 12, 2003 to cover over-allotments which resulted in additional net proceeds of approximately $9.4 million. The net proceeds from the offering are being used for general corporate purposes, including payment of existing liabilities, research and development, the development or acquisition of new products or technologies, equipment acquisitions, strategic acquisitions of businesses, general working capital and operating expenses.

Under the terms of the merger agreement with C-Cube, Harmonic is generally liable for C-Cube s pre-merger tax liabilities. Approximately $10.0 million of pre-merger tax liabilities remained outstanding at September 29, 2006 and are included in accrued liabilities. These liabilities represent estimates of C-Cube s pre-merger tax obligations to various tax authorities in 11 countries. We are working with LSI Logic, which acquired the spun-off semiconductor business in June 2001 and assumed its obligations, to settle these obligations, a process which has been underway since the merger in 2000. Although we expect to make payments within the next 12 months for these tax liabilities, Harmonic is unable to predict when the remaining obligations will be paid, or in what amount. The full amount of the estimated obligation has been classified as a current liability. To the extent that these obligations are finally settled for less than the amounts provided, Harmonic is required, under the terms of the tax-sharing agreement, to refund the difference to LSI Logic. Conversely, if the settlements are more than the $10.0 million pre-merger tax liability, LSI is obligated to reimburse Harmonic.

Harmonic has a bank line of credit facility with Silicon Valley Bank, which provides for borrowings of up to $23.7 million, including $3.7 million for equipment under a secured term loan. This facility, which was amended and restated in December 2005, expires in December 2006 and contains financial and other covenants including the requirement for Harmonic to maintain cash, cash equivalents and short-term investments, net of credit extensions, of not less than $30.0 million. If Harmonic is unable to maintain this cash, cash equivalents and short-term investments balance or satisfy the additional affirmative covenant requirements, Harmonic would be in noncompliance with the facility. In the event of noncompliance by Harmonic with the covenants under the facility, Silicon Valley Bank would be entitled to exercise its remedies under the facility which include declaring all obligations immediately due and payable and disposing of the collateral if obligations were not repaid. At September 29, 2006, Harmonic was in compliance with the covenants under this line of credit facility. The December 2005 amendment resulted in the company paying a fee of approximately $33,000 and requiring payment of approximately $43,000 of additional fees if the Company does not maintain an unrestricted deposit of $20.0 million with the bank. Future borrowings pursuant to the line bear interest at the bank s prime rate (8.25% at September 29, 2006) or prime plus 0.5% for equipment borrowings. Borrowings are repayable monthly and are collateralized by all of Harmonic s assets except intellectual property. As of September 29, 2006, $0.7 million was outstanding under the equipment term loan portion of this facility and there were no additional borrowings in 2005 or 2006. The term loan is payable monthly, including principal and interest at 8.75% per annum on outstanding borrowings as of September 29, 2006 and matures at various dates through December 2007. Other than standby letters of credit and guarantees (Note 15), there were no other outstanding borrowings or commitments under the line of credit facility as of September 29, 2006. Harmonic s cash and investment balances at September 29, 2006 were $110.7 million. We currently believe that our existing liquidity sources, including our bank line of credit facility, will satisfy our requirements for at least the next twelve months, including the acquisition of Entone Technologies, which includes cash payments of $26 million for the acquisition and a $2.5 million investment in Entone s CPE business, and final settlement and payment of C-Cube s pre-merger tax liabilities. However, we may need to raise additional funds if our expectations or estimates change or prove inaccurate, or to take advantage of unanticipated opportunities or to strengthen our financial position. The completed stock offering in the fourth quarter of 2003 was part of a registration statement on Form S-3 declared effective by the SEC in April 2002. In April 2005, we filed another registration statement on Form S-3 with the SEC. Pursuant to these registration statements on Form S-3, which have been declared effective by the SEC, we are able to issue various types of registered securities, including common stock, preferred stock, debt securities, and warrants to purchase common stock from time to time, up to an aggregate of approximately $200 million, subject to market conditions and our capital needs.

In addition, we actively review potential acquisitions that would complement our existing product offerings, enhance our technical capabilities or expand our marketing and sales presence. Any future transaction of this nature could require potentially significant amounts of capital or could require us to issue our stock and dilute existing stockholders. If adequate funds are not available, or are not available on acceptable terms, we may not be able to take advantage of market opportunities, to develop new products or to otherwise respond to competitive pressures.

Our ability to raise funds may be adversely affected by a number of factors relating to Harmonic, as well as factors beyond our control, including increased market uncertainty surrounding the ongoing U.S. war on terrorism, as well as conditions in capital markets and the cable and satellite industries. There can be no assurance that any financing will be available on terms acceptable to us, if at all.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk represents the risk of loss that may impact the operating results, financial position, or liquidity of Harmonic due to adverse changes in market prices and rates. Harmonic is exposed to market risk because of changes in interest rates and foreign currency exchange rates as measured against the U.S. Dollar and currencies of Harmonic s subsidiaries.

Foreign Currency Exchange Risk

Harmonic has a number of international subsidiaries each of whose sales are generally denominated in U.S. dollars. Sales denominated in foreign currencies were approximately 9% and 7% of net sales in the first nine months of 2006 and the full year of 2005, respectively. In addition, the Company has various international branch offices that provide sales support and systems integration services. Periodically, Harmonic enters into foreign currency forward exchange contracts, or forward contracts, to manage exposure related to accounts receivable denominated in foreign currencies. Harmonic does not enter into derivative financial instruments for trading purposes. At September 29, 2006, we had a forward contract to sell Euros totaling $4.1 million that matures during the fourth quarter of 2006. While Harmonic does not anticipate that near-term changes in exchange rates will have a material impact on Harmonic s operating results, financial position and liquidity, Harmonic cannot assure you that a sudden and significant change in the value of local currencies would not harm Harmonic s operating results, financial position and liquidity.

Interest Rate Risk

Exposure to market risk for changes in interest rates relate primarily to Harmonic s investment portfolio of marketable debt securities of various issuers, types and maturities and to Harmonic s borrowings under its bank line of credit facility. Harmonic does not use derivative instruments in its investment portfolio, and its investment portfolio only includes highly liquid instruments with an original maturity of less than two years. These investments are classified as available for sale and are carried at estimated fair value, with material unrealized gains and losses reported in other comprehensive income. There is risk that losses could be incurred if Harmonic were to sell any of its securities prior to stated maturity. A 10% change in interest rates would not have had a material impact on financial conditions, results of operations or cash flows.

Item 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures.

Our management, with the participation of our chief executive officer and our chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this Quarterly Report on Form 10-Q.

A control system, no matter how well conceived and operated, can provide only reasonable assurance that the objectives of the control system are met. Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures or internal control over financial reporting will prevent all errors and fraud. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues within the company have been detected. These inherent limitations include the reality that judgments in decision-making can be incorrect, and that breakdowns can occur because of simple errors or mistakes. The design of any control system is also 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 control system, misstatements due to error or fraud may occur and not be detected.

Based upon their evaluation of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report on Form 10-Q, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are effective based on their evaluation of these controls and procedures required by paragraph (b) of Exchange Act Rules 13a-15 or 15d-15.

Changes in internal controls.

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II

OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

Shareholder Litigation

Between June 28 and August 25, 2000, several actions alleging violations of the federal securities laws by Harmonic and certain of its officers and directors (some of whom are no longer with Harmonic) were filed in or removed to the U.S. District Court for the Northern District of California. The actions subsequently were consolidated.

A consolidated complaint, filed on December 7, 2000, was brought on behalf of a purported class of persons who purchased Harmonic s publicly traded securities between January 19 and June 26, 2000. The complaint also alleged claims on behalf of a purported subclass of persons who purchased C-Cube securities between January 19 and May 3, 2000. In addition to Harmonic and certain of its officers and directors, the complaint also named C-Cube Microsystems Inc. and several of its officers and directors as defendants. The complaint alleged that, by making false or misleading statements regarding Harmonic s prospects and customers and its acquisition of C-Cube, certain defendants violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the Exchange Act). The complaint also alleged that certain defendants violated section 14(a) of the Exchange Act and sections 11, 12(a)(2), and 15 of the Securities Act of 1933 (the Securities Act) by filing a false or misleading registration statement, prospectus, and joint proxy in connection with the C-Cube acquisition.

On July 3, 2001, the District Court dismissed the consolidated complaint with leave to amend. An amended complaint alleging the same claims against the same defendants was filed on August 13, 2001. Defendants moved to dismiss the amended complaint on September 24, 2001. On November 13, 2002, the District Court issued an opinion granting the motions to dismiss the amended complaint without leave to amend. Judgment for defendants was entered on December 2, 2002. On December 12, 2002, plaintiffs filed a motion to amend the judgment and for leave to file an amended complaint pursuant to Rules 59(e) and 15(a) of the Federal Rules of Civil Procedure. On June 6, 2003, the District Court denied plaintiffs motion to amend the judgment and for leave to file an amended complaint. Plaintiffs filed a notice of appeal on July 1, 2003. The appeal was heard by a panel of three judges of the United States Court of Appeals for the Ninth Circuit (the Ninth Circuit) on February 17, 2005.

On November 8, 2005, the Ninth Circuit panel affirmed in part, reversed in part, and remanded for further proceedings the decision of the District Court. The Ninth Circuit affirmed the District Court s dismissal of the plaintiffs fraud claims under Sections 10(b), 14(a), and 20(a) of the Exchange Act with prejudice, finding that the plaintiffs failed to adequately plead their allegations of fraud. The Ninth Circuit reversed the District Court s dismissal of the plaintiffs claims under Sections 11 and 12(a)(2) of the Securities Act, however, finding that those claims did not allege fraud and therefore were subject to only minimal pleading standards. Regarding the secondary liability claim under Section 15 of the Securities Act, the Ninth Circuit reversed the dismissal of that claim against Anthony J. Ley, Harmonic s Chairman and Chief Executive Officer, and affirmed the dismissal of that claim against Harmonic, while granting leave to amend. The Ninth Circuit remanded the surviving claims to the District Court for further proceedings.

On November 22, 2005, both the Harmonic defendants and the plaintiffs petitioned the Ninth Circuit for a rehearing of the appeal. On February 16, 2006 the Ninth Circuit denied both petitions. On May 17, 2006 the plaintiffs filed an amended complaint on the issues remanded for further proceedings by the Ninth Circuit, to which the Harmonic defendants responded on with a Motion to Dismiss. Briefing on the motion was completed in August 2006. There will be no hearing unless the Court requests one.

A derivative action purporting to be on behalf of Harmonic was filed against its then-current directors in the Superior Court for the County of Santa Clara on September 5, 2000. Harmonic also was named as a nominal defendant. The complaint is based on allegations similar to those found in the securities class action and claims that the defendants breached their fiduciary duties by, among other things, causing Harmonic to violate federal securities laws. The derivative action was removed to the United States District Court for the Northern District of California on September 20, 2000. All deadlines in this action were stayed pending resolution of the motions to dismiss the securities class action. On July 29, 2003, the Court approved the parties stipulation to dismiss this derivative action without prejudice and to toll the applicable limitations period pending the Ninth Circuit s decision in the securities action. Pursuant to the stipulation, defendants have provided plaintiff with a copy of the mandate issued by the Ninth Circuit in the securities action.

A second derivative action purporting to be on behalf of Harmonic was filed in the Superior Court for the County of Santa Clara on May 15, 2003. It alleged facts similar to those previously alleged in the securities class action and the federal derivative action. The complaint named as defendants former and current Harmonic officers and directors, along with former officers and directors of C-Cube Microsystems, Inc., who were named in the securities class action. The complaint also named Harmonic as a nominal defendant. The complaint alleged claims for abuse of control, gross mismanagement, and waste of corporate assets against the Harmonic defendants, and claims for breach of fiduciary duty, unjust enrichment, and negligent misrepresentation against all defendants. On July 22, 2003, the Court approved the parties stipulation to stay the case pending resolution of the appeal in the securities class action. Following the decision of the Ninth Circuit discussed above, on May 9, 2006, defendants filed demurrers to this complaint. The plaintiffs then filed an amended complaint on July 10, 2006, which names only the Harmonic defendants. The defendants filed demurrers to the amended complaint, and a case management conference and hearing are scheduled for December 19, 2006.

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Based on its review of the surviving claims in the securities class actions, Harmonic believes that it has meritorious defenses and intends to defend itself vigorously. There can be no assurance, however, that Harmonic will prevail. No estimate can be made of the possible range of loss associated with the resolution of this contingency, and accordingly, Harmonic has not recorded a liability. An unfavorable outcome of this litigation could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

Other Litigation

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of Harmonic s products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint seeks injunctive relief, royalties and damages. Harmonic has not been served in the case. At this time, we are unable to determine whether we will be able to settle this litigation on reasonable terms or at all, nor can we predict the impact of an adverse outcome of this litigation if we elect to defend against it. No estimate can be made of the possible range of loss associated with the resolution of this contingency and accordingly, we have not recorded a liability associated with the outcome of a negotiated settlement or an unfavorable verdict in litigation. An unfavorable outcome of this matter could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

Harmonic is involved in other litigation and may be subject to claims arising in the normal course of business. In the opinion of management the amount of ultimate liability with respect to these matters in the aggregate will not have a material adverse effect on the Company or its operating results, financial position or cash flows.

Item 1A. RISK FACTORS

We Depend On Cable, Satellite And Telecom Industry Capital Spending For A Substantial Portion Of Our Revenue And Any Decrease Or Delay In Capital Spending In These Industries Would Negatively Impact Our Resources, Operating Results And Financial Condition And Cash Flows.

A significant portion of Harmonic s sales have been derived from sales to cable television, satellite and telecommunications operators, and we expect these sales to constitute a significant portion of net sales for the foreseeable future. Demand for our products will depend on the magnitude and timing of capital spending by cable television operators, satellite operators, telephone companies and broadcasters for constructing and upgrading their systems.

These capital spending patterns are dependent on a variety of factors, including:

- access to financing;

- annual budget cycles;

- the impact of industry consolidation;