NEXT LEVEL COMMUNICATIONS INC
Form 10-Q
August 14, 2002

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SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

[X]	QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
	For the quarterly period ended June 30, 2002
	OR
[ ]	TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission file number: 0-27877

NEXT LEVEL COMMUNICATIONS, INC.
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE	**94-3342408**
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

6085 State Farm Drive
Rohnert Park, California 94928
(Address of Principal Executive Offices, Including Zip Code)

Registrant s Telephone Number, Including Area Code: **(707) 584-6820**

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

The number of shares of our common stock, par value $0.01 per share, outstanding as of July 31, 2002 was approximately 86,356,213.

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PART I. FINANCIAL INFORMATION

Item 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Next Level Communications, Inc.

Condensed Consolidated Statements of Operations
Three months and six months ended June 30, 2002 and 2001
(In Thousands, except per share data) (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	**2001**	**2002**	**2001**
Revenues	$ 16,778	$ 31,904	$ 30,856	$ 60,642
Cost of revenues	14,112	25,926	26,357	48,566
Inventory charges		72,016		72,016
Gross profit (loss)	2,666	(66,038)	4,499	(59,940)
Operating expenses				
Research and development	5,319	12,858	13,530	26,953
Selling, general and administrative	8,686	14,838	17,919	29,348
Asset impairments and disposals, net		796		796
Total operating expenses	14,005	28,492	31,449	57,097
Operating loss	**(11,339)**	**(94,530)**	**(26,950)**	**(117,037)**
Interest expense, net	(9,231)	(3,192)	(14,848)	(3,084)
Investment impairments and other expense, net	(548)	(4,413)	(838)	(4,412)
Net loss	(21,118)	(102,135)	(42,636)	(124,533)
Accretion and dividends payable on preferred stock	(1,160)		(1,623)	
Net loss available to common shareholders	$(22,278)	$(102,135)	$(44,259)	$(124,533)
Basic and diluted net loss per common share	$ (0.26)	$ (1.20)	$ (0.51)	$ (1.47)
Shares used to compute basic and diluted net loss per common share	86,255	85,233	86,095	84,932

See notes to condensed consolidated financial statements

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Next Level Communications, Inc.

Condensed Consolidated Balance Sheets
June 30, 2002 and December 31, 2001
(In Thousands, except share data) (Unaudited)

	June 30, 2002	December 31, 2001
Assets		
Current Assets		
Cash and cash equivalents	$ 24,632	$ 20,580
Trade receivables, less allowance for doubtful accounts of $1,200 and $1332, respectively	11,909	15,989
Other receivables	5,688	3,373
Inventories	51,659	62,645
Prepaid expenses and other current assets	1,910	3,104
Total current assets	95,798	105,691
Property and Equipment, net	42,128	46,740
Long-Term Investments and Other Assets	1,604	1,604
Total Assets	$ 139,530	$ 154,035
Liabilities and Stockholders Deficit		
Current Liabilities		
Accounts payable	$ 7,447	$ 13,938
Accrued liabilities	15,057	19,213
Notes and loans payable current	8,734	24,340
Notes and loans payable due to Motorola	51,011	
Deferred revenue	374	415
Total current liabilities	82,623	57,906
Long-Term Liabilities		
Due to Motorola		
Note payable, net of discount		55,984
Tax sharing agreement liability	29,346	29,346
Mortgage Note, net of discount	18,594	19,098
Total long term liabilities	47,940	104,428
Redeemable Convertible Preferred Stock	51,491	
Stockholders Deficit		
Common stock $.01 par value, 400,000,000 shares authorized, 86,356,213 and 85,869,316 shares issued and outstanding, respectively	796	791
Additional paid-in-capital	487,831	479,426
Accumulated deficit	(531,151)	(488,516)
Total Stockholders Deficit	(42,524)	(8,299)
Total Liabilities and Stockholders Deficit	$ 139,530	$ 154,035

See notes to condensed consolidated financial statements.

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Next Level Communications, Inc.

Condensed Consolidated Statements of Cash Flows
Six Months Ended June 30, 2002 and 2001
(In Thousands) (Unaudited)

	June 30,	
	2002	**2001**
CASH FLOWS FROM OPERATING ACTIVITIES		
Net loss	$(42,636)	$(124,533)
Adjustments to reconcile net loss to net cash used in operating activities:		
Inventory charge		72,016
Depreciation and amortization	4,955	8,558
Amortization of discount on notes payable	11,072	2,617
Non-cash warrant expense	407	
Write-down of investments and property and equipment		6,286
Other	95	784
Changes in assets and liabilities:		
Trade receivables	4,080	(1,881)
Inventories	10,986	(59,978)
Other assets	(1,121)	(527)
Accounts payable	(6,491)	(17,642)
Accrued liabilities and deferred revenue	(4,197)	17,231
Net cash used in operating activities	(22,850)	(97,069)
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchases of property and equipment	(438)	(3,224)
Long-term investments		(5,000)
Net cash used in investing activities	(438)	(8,224)
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from issuance of convertible stock and warrants to Motorola	43,000	
Issuance of common stock	481	2,166
Proceeds from Motorola debt financing		60,000
(Repayment of)/proceeds from vendor note payable and other borrowings	(16,141)	24,340
Repayment of capital lease obligations		(157)
Net cash provided by financing activities	27,340	86,349
Net Increase (Decrease) in Cash and Cash Equivalents	4,052	(18,944)
Cash and Cash equivalents, Beginning of period	20,580	35,863
Cash and Cash equivalents, End of period	$ 24,632	$ 16,919

See notes to condensed consolidated financial statements.

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NEXT LEVEL COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. BASIS OF PRESENTATION

Next Level Communications, Inc. (the Company) is a leading provider of broadband communications systems that enable telephone companies and other emerging communications service providers to cost effectively deliver voice, data and video services over the existing copper wire telephone infrastructure.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. While these financial statements reflect all adjustments which are, in the opinion of management, necessary to present fairly the results of the interim period, they do not include all information and footnotes required by generally accepted accounting principles for complete financial statements. These financial statements and notes should be read in conjunction with the financial statements and notes thereto, for the year ended December 31, 2001 contained in the Company s Annual Report on Form 10-K. Certain prior period amounts have been reclassified to conform to the current period presentation. The results of operations for the six months ended June 30, 2002 are not necessarily indicative of the operating results for the full year.

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

New Accounting Pronouncements

In June 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 146, Accounting for Costs Associated with Exit or Disposal Activities , which addresses accounting for restructuring and similar costs. SFAS 146 supersedes previous accounting guidance, principally Emerging Issues Task Force Issue No. 94-3. The Company will adopt the provisions of SFAS 146 for restructuring activities initiated after December 31, 2002. SFAS 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost was recognized at the date of the Company s commitment to an exit plan. SFAS 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized.

2. REDEEMABLE CONVERTIBLE PREFERRED STOCK ISSUANCES TO MOTOROLA, INC.

Series A-1 Preferred Stock Issuance

On June 25, 2002 the Company issued to Motorola, Inc. (Motorola) 277,311 shares of the Series A-1 Redeemable Convertible Preferred Stock of the Company (Series A-1 Preferred) at a per share purchase price of $119.00, for a total purchase price of approximately $33.0 million. The total purchase price consisted of (i) the conversion of the $20.0 million Promissory Note dated December 11, 2001 issued by the Company to Motorola into shares of Series A-1 Preferred and (ii) cash in the amount of $13.0 million.

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Each share of Series A-1 Preferred is initially convertible into 100 shares of the Company s common stock at an initial conversion price of $1.19 per share; is entitled to cumulative dividends at an annual rate of 7.5%, payable in cash or additional shares of Series A-1 Preferred; and is entitled to a liquidation preference of $297.50 per share in the event of insolvency or dissolution of the Company, certain change in control, merger or consolidation events, or sales or transfers of a material portion of Company s assets outside the ordinary course of business. Motorola has waived its right to receive the liquidation preference in the event of a change of control or sale of a material portion of the Company s assets if such event occurs prior to November 1, 2002. Holders of a majority of the Series A-1 Preferred may require the Company to redeem the Series A-1 Preferred on or after June 25, 2007 at a per share redemption price of $142.80. Holders of Series A-1 Preferred may vote their shares together with holders of Common Stock on an as-converted to common stock basis, and certain material actions require the consent of holders of a majority of the Series A-1 Preferred. In connection with the issuance of the Series A-1 Preferred, the Company granted Motorola a warrant to purchase 6,008,403 shares of the Company s common stock which is currently exercisable with an exercise price of $1.19 per share and a warrant to purchase 330,000 shares of the Company s common stock which is exercisable after June 25, 2007 with an exercise price of $2.00 per share. The warrants expire on June 24, 2007 and June 24, 2012, respectively.

On June 25, 2002, $20.0 million of the Company s $82.3 million note payable to Motorola was converted into shares of the Company s Series A-1 Preferred (as described above). The remaining unamortized value of the $20.0 million note payable of $3.6 million was charged to interest expense at the time of conversion. On June 25, 2002, the Company drew down such $13.0 million under the $35.0 million financing commitment from Motorola entered into on March 29, 2002. Under this financing commitment, draw downs by the Company, when they occur, are treated, at Motorola s option, as either (i) additions to the existing note payable agreement with Motorola and subject to substantially the same terms under such agreement or (ii) additional issuances of redeemable convertible preferred stock, subject to substantially the same terms as the February 2002 issuance of redeemable convertible preferred stock described above. At June 30, 2002, $22.0 million remains available under the financing commitment.

The Company allocated the proceeds from the Series A-1 Preferred as follows: $3.9 million to the fair value of the warrants, $2.7 million to the related beneficial conversion feature through a reduction in the carrying value of the preferred stock with a corresponding increase to additional paid-in capital and the remaining $26.4 million to the Series A-1 Preferred. The fair value of the warrants was estimated using the Black-Scholes option pricing model with the following assumptions: no dividends; risk free interest rate of 4.6%; volatility 107%; and the contractual life of the warrants. The Company is accreting the Series A-1 Preferred up to its redemption value ($39.6 million) using the effective interest method over the period to the redemption date.

Series A Preferred Stock Issuance On February 20, 2002, the Company issued $30.0 million of Redeemable Convertible Preferred Stock (Series A Preferred) to Motorola, consisting of 6,912,442 shares at a purchase price of $4.34 per share. Each share of Series A Preferred is convertible, at the option of the holder, into two shares of the Company s common stock, or 13,824,884 shares in total. The Series A Preferred is redeemable, at the option of the holder, at an initial redemption price of $5.21 per share, on or after February 19, 2007. Dividends are cumulative at a rate of 7.5%, payable in cash or additional shares of Series A Preferred, at the Company s option. Liquidation value is $10.85 per share. In conjunction with this financing, the Company also issued to Motorola warrants to purchase 3,456,221 shares of common stock at an exercise price of $2.17 per share and warrants to purchase 3,456,221 shares of common stock at an exercise price of $2.60 per share. The warrants have a term of five years. The Company allocated $6.5 million (fair value of the warrants) of the proceeds from the Series A Preferred to the warrants through a reduction in the carrying value of the Series A Preferred with a corresponding increase to additional paid-in capital. The fair value of the warrants was estimated using the Black-Scholes option pricing model with the following assumptions: no dividends; risk free interest rate of 4.6%; volatility 101%; and a contractual life of five years. The Company is accreting the carrying value of the Series A Preferred up to the redemption value of the $36.0 million using the effective interest method over the period to the February 10, 2007 redemption date.

The Company accreted $0.6 million on all outstanding Series A and A-1 Preferred Stock in the current quarter, which has been reflected as an increase in the carrying value of the preferred stock and a corresponding decrease to additional paid in capital. During the quarter ended June 30 2002, $0.6 million had been accrued for the payment of dividends.

Letter of Certification

On April 22, 2002, in connection with the Company maintaining compliance under the NASDAQ listing requirements, Motorola provided to the NASDAQ a Letter of Certification that agreed to (i) waive, through November 1, 2002, Motorola s right of redemption under Section B(2) of the Certificate of Designation of the Series A Preferred in the event of a change of control or sale of a material portion of the Company s assets and (ii) not to transfer the Series A Preferred unless the transferee agrees in writing to be bound by the waiver. As consideration for the Letter of Certification, the Company issued to Motorola the following fully vested and non-forfeitable warrants to purchase common stock, exercisable five years from the date of the letter all with an exercise price of $2.00 per share and expiring on April 22, 2012: (i) 100,000 warrants for the Letter of Certification and the overall contingent re-structuring; and (ii) 300,000 warrants for the waiver of the redemption in the event of a change of control relating to the $30.0 million Series A Preferred issued to Motorola in February 2002.

The fair value of the warrants ($0.4 million) was charged to other expense on the date of issuance. The fair value of the warrants was estimated using the Black-Scholes option pricing model with the following assumptions: no dividends; risk free interest rate of 4.6%; volatility 101%; and a contractual life of ten years.

3. NOTES PAYABLE

Vendor Note Payable

On May 18, 2002, a principal and interest payment of $13.0 million was made under the Company s vendor note payable. The remaining principal and interest payment of $9.5 million is due on March 31, 2003.

Note Payable to Motorola

On May 17, 2002, 1,000,000 common stock warrants issued in connection with the Note Payable to Motorola became exercisable as full repayment under the note had not been made by that date. In addition, on May 30, 2002, the Company and Motorola amended the note payable such that the remaining 2,000,000 common stock warrants became fully vested and exercisable. As a result, a measurement date was reached with respect to these warrants and their value was fixed. As of June 30, 2002, the unamortized discount on the note payable related to such warrants was $0.3 million and will be amortized using the effective interest method through May 17, 2003.

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The fair value of the warrants was estimated using the Black-Scholes option pricing model with the following assumptions: no dividends; risk free interest rate of 4.6%; volatility 101%; and a contractual life of four years.

4. INVENTORIES

Inventories at June 30, 2002 and December 31, 2001 consisted of (in millions):

	June 30, 2002	December 31, 2001
Raw materials	$23.8	$24.5
Work-in-process	2.3	1.7
Finished goods	25.6	36.4
Total	$51.7	$62.6

5. LEGAL PROCEEDINGS

The Company is a party to various claims, litigation and other matters. Management believes that the ultimate resolution of these matters will not have a material adverse effect on the Company s condensed consolidated financial statements taken as a whole.

6. NET LOSS PER SHARE

Basic net loss per share excludes dilution and is computed by dividing net loss by the weighted average number of shares of common stock outstanding for the period. Diluted net loss per share is computed based on the weighted average number of common shares outstanding plus the dilutive effect of outstanding stock options and warrants. Diluted net loss per common share was the same as basic net loss per common share for all periods presented. As of June 30, 2002 and 2001, the Company had securities outstanding that could potentially dilute basic earnings per share in the future, but were excluded from the computation of diluted net loss per share, as their effect would have been anti-dilutive, given the Company s losses. Such outstanding securities consisted of the following (in millions):

	June 30,	
	2002	2001
Motorola warrants	24.0	
Other shareholder warrants	5.6	5.6
Outstanding employee stock options	22.0	22.9
Total	51.6	28.5

7. COMPREHENSIVE LOSS

During the three and six months ended June 30, 2002 and 2001, comprehensive loss was the same as net loss.

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

Some of the statements in the following discussion and elsewhere in this report constitute 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. We intend these forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and we are including this statement for purposes of complying with these safe harbor provisions. These statements relate to future events or our future financial performance. In some cases, you can identify forward-looking statements by terminology such as may, will, should, expect, p anticipate, believe, estimate, predict, potential or continue or the negative of such terms or other comparable terminology. These statemen involve known and unknown risks, uncertainties and other factors that may cause our or our industry s actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. These factors include, among other things, those listed under Risk Factors below and elsewhere in this report.

Although we believe that the expectations reflected in the forward-looking statements are reasonable, we cannot guarantee future results, levels of activity, performance or achievements.

OVERVIEW

We design and market broadband communications equipment that enables telephone companies and other communications service providers to cost-effectively deliver a full suite of voice, data and video services over the existing copper wire telephone infrastructure. We commenced operations in July 1994 and recorded our first sale in September 1997. From January 1998 until November 1999, we operated through Next Level Communications L.P., which was formed in connection with the transfer of all of the net assets, management and workforce of a wholly-owned subsidiary of General Instrument. In November 1999, the business and assets of that partnership were merged into Next Level Communications, Inc. as part of our recapitalization. In January 2000, General Instrument was acquired by Motorola, Inc., making us an indirect subsidiary of Motorola.

We generate our revenues primarily from sales of our equipment. A small number of customers have accounted for a large part of our revenues to date, and we expect this concentration to continue in the future. Qwest accounted for 35% of our total revenues for the quarter ended June 30, 2002 and 54% of our total revenues for the quarter ended June 30, 2001. Sales to Qwest were significantly reduced in the current quarter due to an overall reduction in capital spending by Qwest. Additionally, Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to Qwest in the future are dependent upon its decision regarding the deployment of our product and its overall capital spending plans. In this regard, Qwest has recently undergone changes in its senior management, has reported significant operating losses for the second quarter of 2002, and has reported that it is the subject of on-going investigation by the SEC which may require it to restate prior year s earnings. These factors could well have an impact on Qwest s decision regarding the deployment of our product. Our agreements with our largest customers do not obligate the customers to purchase any products. In addition, our significant customer agreements generally contain fixed-price provisions. As a result, our ability to generate a profit on these contracts depends upon our ability to produce and market our products at costs lower than these fixed prices.

The timing of our revenues is difficult to predict because of the length and variability of the sales cycle for our products. Customers view the purchase of our products as a significant and strategic decision. As a result, customers typically undertake significant evaluation, testing and trial of our products before deploying them. This evaluation process frequently results in a lengthy sales cycle, typically ranging from nine months to more than a year. While our customers are evaluating our products and before they place an order, if at all, we may incur substantial sales and marketing expenses and expend significant management efforts.

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RESULTS OF OPERATIONS

Revenues. Total revenues in the quarter ended June 30, 2002 decreased to $16.8 million from $31.9 million in the second quarter of 2001. Total revenues in the six months ended June 30, 2002 decreased to $30.9 million from $60.6 million in the year earlier period. The decrease was primarily due to a decrease in equipment sales to Qwest. A revenue analysis by channel is detailed in the following chart. Our equipment revenue is analyzed using three channels: Independent operating companies (IOC), major carriers which currently include Qwest and other North American regional bell operating companies (MAJOR CARRIERS), and other customers which include, among others, multiple service organizations and international customers (OTHER).

(In millions)	Three Months Ended June 30,		Six Months Ended June 30,	
CHANNEL	2002	2001	2002	2001
IOC	$10.4	$12.1	$20.9	$23.2
MAJOR CARRIERS (PRIMARILY QWEST)	6.3	17.7	9.7	33.4
OTHER EQUIPMENT	0.1	1.2	0.3	2.5
SOFTWARE		0.9		1.5
TOTAL REVENUE	$16.8	$31.9	$30.9	$60.6

Sales to Qwest were significantly reduced in the current quarter due to an overall reduction in capital spending by Qwest. Additionally, Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to Qwest in the future are dependent upon its decision regarding the deployment of our product and its overall capital spending plans. In this regard, Qwest has recently undergone changes in its senior management, has reported significant operating losses for the second quarter of 2002 and has reported that it is the subject of on-going investigation by the SEC which may require it to restate prior years earnings. These factors would well have an impact on Qwest s decision regarding the deployment of our product. Sales to IOCs and our other customers decreased in the current quarter due to a general slowdown in the telecommunications industry and the resulting reduction of our customers capital expenditures.

We expect to continue to derive substantially all of our revenues from sales of equipment to regional bell operating companies and local, foreign and independent telephone companies for the foreseeable future. Revenue levels in future quarters will depend significantly upon Qwest s and other major carriers future decisions and general economic conditions, as well as whether and how quickly our existing customers roll out broadband services in their coverage areas and whether and how quickly we obtain new customers.

Cost of Revenues. Total cost of revenues decreased to $14.1 million in the quarter ended June 30, 2002 from $97.9 million in the quarter ended June 30, 2001. Total cost of revenues in the first six months of 2002 decreased to $26.4 million from $120.6 million in the first six months of 2001. The decrease in our cost of revenues was primarily due to a $72.0 million inventory charge related to excess inventory, obsolescence and lower of cost or market adjustments taken in the second quarter of 2001. The remaining difference resulted from lower sales of equipment.

At June 30, 2002, we had inventories of $51.7 million. At each reporting period we perform a detailed review of raw material and finished goods inventories on hand, components under purchase commitments, and a detailed analysis of our sales forecast and product end of life estimates, to determine whether any inventory charges, in addition to those taken in 2001, are required.

Our gross margin percentage decreased to 15.9% in the second quarter of 2002 from 19.9% in the second quarter of 2001 (excluding inventory write-down related charges). Our gross margin percentage decreased to 14.6% in the six month period ended June 30, 2002 from 20.1% in the first six months of 2001 (excluding inventory write-down related charges). The decline in our gross margin percentage was primarily related to spreading the manufacturing overhead elements of product cost

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over reduced sales volumes. In the future, gross margin percentage may fluctuate due to a wide variety of factors, including customer mix, product mix, the timing and size of orders which are received, the availability of adequate supplies of key components and assemblies, our ability to introduce new products and technologies on a timely basis, the timing of new product introductions or announcements by us or our competitors, price competition and unit volume. In addition, gross margin percentages will approximate current levels until sales volume increases sufficiently to reduce the impact of the manufacturing element of product costs.

Research and development. Research and development expenses decreased to $5.3 million in the quarter ended June 30, 2002 from $12.9 million in the quarter ended June 30, 2001. Research and development expenses decreased to $13.5 million in the six months ended June 30, 2002 from $27.0 million in the first six months of 2001. The decrease in the research and development expenses was primarily due to cost-cutting measures, including a reduction in research and development personnel. In the near term, research and development expenses could increase slightly, primarily due to costs associated with new product introductions.

Selling, general and administrative. Selling, general and administrative expenses decreased to $8.7 million in the quarter ended June 30, 2002 from $14.8 million in the quarter ended June 30, 2001. Selling, general and administrative expenses decreased to $17.9 million in the six months ended June 30, 2002 from $29.3 million in the first six months of 2001. The decrease was primarily due to cost-cutting measures, including a reduction in selling, general and administrative personnel. In addition, the three and six month 2001 periods included $1.7 million and $3.3 million, respectively, in goodwill amortization, of which there is none in 2002.

Asset impairments and disposals, net. In the three and six month periods ended June 30, 2002, there were no asset impairments. In the three and six month periods ended June 30, 2001, asset impairments totaled $0.8 million and related to the discontinuation of our Vietnam operation. We continually evaluate our occupancy needs, particularly with respect to the force reductions we have experienced in the past several quarters. If, in the future, we decide to further consolidate our facilities, we may incur related termination costs.

Interest expense, net. Interest expense in the three and six month periods ended June 30, 2002 was $9.2 million and $14.8 million. Interest expense in the three and six month periods ended June 30, 2001 was $3.2 million and $3.1 million. Interest expense for all periods was primarily attributable to cash and non-cash interest expense related to our credit agreement with Motorola. The current quarter amount included approximately $3.6 million of non-cash interest expense related to the $20.0 million debt to equity conversion in June, 2002 by Motorola, Inc. (See Note 2 to the condensed, consolidated financial statements). Also included in interest expense in the three and six month periods ended June 30, 2002 was approximately $0.8 million and $1.8 million of interest associated with our vendor note payable and mortgage note payable.

Investment impairments and other expense, net. Investment impairments and other expense in the three and six month periods ended June 30, 2002 was $0.5 million and $0.8 million and related primarily to warrant issuance expense (see Note 2 to the condensed consolidated financial statements) and state sales tax expense. Investment impairments and other expense in the three and six month periods ended June 30, 2001 was $4.4 million and related primarily to the write-down of certain investments and certain property, plant and equipment.

Accretion and dividends payable on preferred stock. Accretion and dividends payable on preferred stock in the three and six month periods ended June 30, 2002 was $1.2 and $1.6 million and related to the issuance of Series A and Series A-1 Preferred Stock to Motorola, Inc. in February 2002 and June 2002 (see Note 2 to the condensed consolidated financial statements).

LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities was $22.9 million in the six months ended June 30, 2002 and $97.1 million in the six months ended June 30, 2001. The primary use of cash continues to be our net losses, which were $42.6 million in the six months ended June 30, 2002 and $124.5 million in the six months ended June 30, 2001. This improvement of cash used in operating activities reflects the favorable impact on cash flow of our operating expense reductions, which decreased from $57.1 million in the six months ended June 30, 2001 to $31.4 million in the six months ended June 30, 2002, serving to more than offset the unfavorable impact of the reduction in revenues of $29.8 million over the same period. Cash flows of $3.3 million generated by positive working capital changes in the current six month period primarily related to a $4.1 million reduction in accounts receivable, an $11.0 million reduction in inventories, partially offset by a decrease in accounts payable and accrued liabilities of $10.7 million. During the six month period ended June 30, 2001, the use of working capital of $62.8 million was primarily related to a $60.0 million increase in inventories.

Net cash used in investing activities of $0.4 million in the six month period ended June 30, 2002 was related to capital expenditures. Net cash used in investing activities of $8.2 million in the six month period ended June 30, 2001 was primarily attributable to a $5.0 million investment made in Virtual Access and $3.2 million in capital expenditures made to support our engineering and testing activities.

Net cash provided by financing activities of $27.3 million in the six months ended June 30, 2002 was primarily related to the proceeds received in connection with the issuance of $43.0 million redeemable convertible preferred stock to Motorola, Inc. in February and June 2002, partially offset by principal payments totaling $15.6 million under our vendor note payable and $0.5 million under our mortgage note payable. Net cash provided by financing activities of $86.3 million in the six months ended June 30, 2001 was primarily related to borrowings of $60.0 million from Motorola, Inc. and $24.3 million from a vendor.

Vendor Note Payable During the six months ended June 30, 2002, we made principal and interest payments totaling $18.0 million under our vendor note payable. The remaining principal and interest payment of $9.5 million is due on March 31, 2003.

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Contractual Obligations The following table sets forth our contractual obligations as of June 30, 2002 (in millions):

	Payments Due by Period						
	Second Half 2002	2003	2004	2005	2006	Thereafter	Total
Vendor Note Payable (1)		$ 8.7					$ 8.7
Motorola Debt							
Note Payable (2)		63.0					63.0
Tax Sharing Liability (3)					$29.3		29.3
Mortgage Debt (4)	0.6	1.2	$1.3	$1.4	1.5	$13.5	19.5
Off-Balance Sheet Commitments							
Vendor Purchase Commitments (5)	10.1						10.1
Operating Leases (6)	0.8	1.3	1.0	0.9	0.7		4.7
Total Contractual Obligations	$11.5	$74.2	$2.3	$2.3	$31.5	$13.5	$135.3

(1) Due March 31, 2003.
(2) Due May 17, 2003.(3) Due in 2006 if Motorola does not achieve expected tax benefits. Maturity will be accelerated in whole or in part if certain conditions (such as our completion of a debt or equity offering greater than $25.0 million) are met.(4) Annual principal payments required plus $4.9 million due in 2011.(5) Represents commitments as of June 30, 2002, with various suppliers to purchase certain raw materials and finished

goods.(6) Future minimum lease payments under non-cancelable operating leases for certain facilities and equipment.

At June 30, 2002, we had cash and cash equivalents of $24.6 million and $22.0 million available to us under the March 29, 2002 $35.0 million financing with Motorola. Management believes that given present assumptions about working capital and expense levels, such cash on hand and amounts available to us, will be sufficient to enable us to meet our financial obligations and sustain our operations into the first quarter of 2003.

Since late 2000, we have been significantly dependent on Motorola for financial resources. Loans from Motorola totaled $15.0 million in 2000 and $97.3 million in 2001. In addition, during the six month period ended June 30, 2002, we received a total of $43.0 million in exchange for the issuance of redeemable convertible preferred stock to Motorola, Inc. The note payable of $63.0 million to Motorola is due May 17, 2003 and has been classified as a current liability in our condensed consolidated balance sheet at June 30, 2002. We do not currently have the cash or

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borrowing availability to enable us to repay such note. Accordingly, we have begun exploring alternative financing arrangements, which may include, but are not limited to, obtaining new debt or equity financing, extending the repayment date with Motorola, or requesting Motorola to convert all or a portion of the note payable into redeemable convertible preferred stock or another form of equity. However, there can be no assurance that we will be successful in our efforts to obtain additional funding sources or to extend or convert the note payable to Motorola.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based on our condensed consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. Our preparation of these condensed consolidated financial statements requires us to make judgments and estimates that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from such estimates under different assumptions or conditions. The following summarizes our critical accounting policies and significant estimates used in preparing our consolidated financial statements:

Revenue We recognize revenue when contractual obligations have been satisfied, title and risk of loss have been transferred to the customer and collection of the resulting receivable is reasonably assured. Generally, we recognize revenue from equipment sales upon shipment. In cases where title and risk of loss pass upon delivery, we recognize revenue from equipment sales upon receipt by the customer. Revenue from installation services is recognized when the services have been completed and acceptance by the customer has occurred. Revenue from field trials is recognized when the trial has been completed and full payment has been received. We accrue a provision for estimated sales returns as a reduction of revenue at the time of revenue recognition.

Accrued Warranty Reserves We accrue the estimated cost of product warranties at the time revenues are recognized. While we engage in product quality programs and processes, including actively monitoring and evaluating the quality of our contract manufacturers, our warranty obligation is affected by actual warranty costs including, material usage and service delivery costs incurred in correcting a product failure. If actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability would be required.

Employee stock-based compensation We account for employee stock-based compensation under Accounting Principles Board Opinion No. 25. If we were to account for this compensation under Statement of Financial Accounting Standards No. 123, results would have changed.

NEW ACCOUNTING PRONOUNCEMENTS

In June 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 146, Accounting for Costs Associated with Exit or Disposal Activities, which addresses accounting for restructuring and similar costs. SFAS 146 supersedes previous accounting guidance, principally Emerging Issues Task Force Issue No. 94-3. We will adopt the provisions of SFAS 146 for restructuring activities initiated after December 31, 2002. SFAS 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under Issue 94-3, a liability for an exit cost was recognized at the date of our commitment to an exit plan. SFAS 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized.

RISK FACTORS

You should carefully consider the risk factors set forth below.

We have been financially dependent on Motorola and any change in their level of commitment could have an adverse impact on us.

Since late 2000, we have been significantly dependent on Motorola for financial resources. Loans from Motorola totaled $15.0 million in 2000 and $97.3 million in 2001. At June 30, 2002, the note payable to Motorola has an outstanding balance of $63.0 million, is due May 17, 2003 and has been classified as a current liability in our condensed consolidated balance sheet at June 30, 2002. We do not currently have the cash or borrowing capacity to enable us to repay such note. Accordingly, we have begun exploring alternative financing arrangements, which may include, but are not limited to, obtaining new debt or equity financing, extending the repayment date with Motorola, or requesting Motorola to convert all or a portion of the note payable into redeemable convertible preferred stock or another form of equity. However, there can be no assurance that we will be successful in our efforts to obtain additional funding sources or to extend or convert the note payable to Motorola. We also received $43.0 million in cash from the issuance of redeemable convertible preferred stock to Motorola in the first six months of 2002, and entered into a financing agreement with Motorola in March 2002, of which $22.0 million remains available at June 30, 2002.

We have incurred net losses and negative cash flow for our entire history and we expect to incur future losses and negative cash flow.

We incurred net losses of $42.6 million in the six month period ended June 30, 2002. Our ability to achieve profitability will depend on the successful design, development, testing, introduction, marketing and broad commercial distribution of our broadband equipment products.

We expect to incur significant product development, sales and marketing, and administrative expenses. In addition, we depend in part on cost reductions to improve gross profit margins because the fixed-price nature of most of our long-term customer agreements prevents us from increasing prices. As a result, we will need to generate significant revenues and improve gross profit margins to achieve and maintain profitability. We may not be successful in reducing our costs or in selling our products in sufficient volumes to realize cost benefits from our manufacturers. We cannot be certain that we can achieve sufficient revenues or gross profit margin improvements to generate profitability.

At June 30, 2002, we had cash and cash equivalents of $24.6 million and $22.0 million available to us under the March 29, 2002 $35.0 million financing with Motorola. Management believes that given present assumptions about working capital and expense levels, such cash on hand and amounts available to us, will be sufficient to enable us to meet our financial obligations and sustain our operations into the first quarter of 2003.

Our customer base of telephone companies is extremely concentrated and the loss of or reduction in business from even one of our customers, particularly Qwest, could cause our sales to fall significantly.

A small number of customers have accounted for a large part of our revenues to date. We expect this concentration to continue in the future. If we lose one of our significant customers, our revenues could be significantly reduced. Qwest accounted for 35% and 54% of total revenues in the quarters ended June 30, 2002 and 2001. Our agreements with our customers are cancelable by these customers on short notice, without penalty, do not obligate the customers to purchase any products and are not exclusive. Additionally Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to Qwest in the future are dependent upon its decision regarding the deployment of our product and its overall capital spending plans. In this regard, Qwest has recently undergone changes in its senior management, has reported significant operating losses for the second quarter of 2002, and has reported that it is the subject of on-going investigation by the SEC which may require it to restate prior years earnings. These factors could well have an impact on Qwest s decision regarding the deployment of our product. Any continued significant reduction in purchases of our equipment by Qwest could have a material adverse effect on us.

A significant market for our products may not develop if telephone companies do not successfully deploy broadband services such as high-speed data and video; recent reluctance of telephone companies to make significant capital expenditures may heighten this issue.

Telephone companies have recently begun offering high-speed data services, and most telephone companies have not offered video services at all. Unless telephone companies make the strategic decision to enter the market for providing broadband services, a significant market for our products may not develop. Sales of our products largely depend on the increased use and widespread adoption of broadband services and the ability of our customers to market and sell broadband services, including video services, to their customers. Certain critical issues concerning use of broadband services are unresolved and will likely affect their use. These issues include security, reliability, speed and volume, cost, government regulation and the ability to operate with existing and new equipment. In addition, telephone companies have recently been reluctant to make significant capital expenditures.

Even if telephone companies decide to deploy broadband services, this deployment may not be successful. Our customers have delayed deployments in the past and may delay deployments in the future. Factors that could cause telephone companies not to deploy, to delay deployment of, or to fail to deploy successfully the services for which our products are designed include the following:

- general economic conditions and telephone company capital spending plans;
- industry consolidation;
- regulatory uncertainties and delays affecting telephone companies;
- varying quality of telephone companies network infrastructure and cost of infrastructure upgrades and maintenance;

inexperience of telephone companies in obtaining access to video programming content from third-party providers;

inexperience of telephone companies in providing broadband services and the lack of sufficient technical expertise and personnel to install products and implement services effectively;

uncertain subscriber demand for broadband services; and

inability of telephone companies to predict return on their investment in broadband capable infrastructure and equipment.

Unless our products are successfully deployed and marketed by telephone companies, we will not be able to achieve our business objectives and increase our revenues.

Our limited operating history makes it difficult for you to evaluate our business and prospects.

We recorded our first sale in September 1997. As a result, we have only a limited operating history upon which you may evaluate our business and prospects. You should consider our prospects in light of the heightened risks and unexpected expenses and difficulties frequently encountered by companies in an early stage of development. These risks, expenses and difficulties, which are described further below, apply particularly to us because the market for equipment for delivering voice, data and video services is new and rapidly evolving. Due to our limited operating history, it will be difficult for you to evaluate whether we will successfully address these risks.

We expect our quarterly revenues and operating results to fluctuate, and these fluctuations may make our stock price volatile.

Our quarterly revenues and operating results have fluctuated in the past and are likely to fluctuate significantly in the future. As a result, we believe that quarter-to-quarter comparisons of our operating results may not be meaningful. Fluctuations in our quarterly revenues or operating results may cause volatility in the price of our stock. It is likely that in some future quarter our operating results may be below the expectations of public market analysts and investors, which may cause the price of our stock to fall. Factors likely to cause variations in our quarterly revenues and operating results include:

delays or cancellations of any orders by Qwest, which accounted for approximately 30% of our revenues in the first six months of 2002, or by any other customer accounting for a significant portion of our revenues;

variations in the timing, mix and size of orders and shipments of our products throughout a quarter or year;

new product introductions by us or by our competitors;

the timing of upgrades of telephone companies infrastructure;

general economic conditions and variations in capital spending budgets of telephone companies; and increased expenses, whether related to sales and marketing, product development or administration.

The amount and timing of our operating expenses generally will vary from quarter to quarter depending on the level of actual and anticipated business activity. Because most of our operating expenses are fixed in the short term, we may not be able to quickly reduce spending if our revenues are lower than we had projected and our results of operations could be harmed.

If we fail to meet the continued listing requirements of the Nasdaq Stock Market, our stock could be delisted.

Our stock is currently listed on the Nasdaq National Market. The Nasdaq Stock Market s Marketplace Rules impose certain minimum financial requirements on us for the continued listing of our stock. Two such requirements are our net tangible assets and the minimum bid price on our stock of $1.00 per share. Beginning in 2002 there have been periods of time during which we have been out of compliance with one or both of the net tangible assets and $1.00 minimum bid requirements of the Nasdaq National Market. In March 2002 we received a letter from Nasdaq notifying us that we were not in compliance with the net tangible assets requirement. In response to that letter, Motorola, which is our largest stockholder and holds all of our Series A Preferred Stock, agreed to waive the change of control redemption right contained in our Series A Preferred Stock through November 2002. In addition, Motorola agreed in a letter of certification to Nasdaq that it would undertake that to the extent necessary for us to achieve compliance with all current Nasdaq National Market listing requirements (including, when applicable, the stockholders equity requirement) by June 30, 2002 and for the remainder of fiscal year 2002, it would: (a) modify all or a portion of its financing facility by amending the terms of the financing facility such that any draw-downs by us under the financing facility will be in exchange for the issuance of Series A Preferred subject to a waiver of the change of control redemption right; (b) if the modification to the financing facility contemplated by clause (a) is not sufficient for us to maintain compliance with the listing requirements, convert up to $6.0 million of our existing indebtedness to Motorola to equity such that the converted indebtedness will be classified as equity on our balance sheet on a going forward basis; and (c) if necessary to comply with the Nasdaq National Market s stockholders equity requirement once it becomes mandatory in the fourth quarter of 2002, further amend the terms of the Series A Preferred such that it would be classified as equity on our balance sheet on a going forward basis for purposes of the stockholders equity listing requirement. In consideration of Motorola s undertakings, we granted Motorola warrants to purchase 400,000 shares of our common stock for $2.00 per share.

On June 25, 2002, we issued to Motorola 277,311 shares of the Series A-1 Preferred at a per share purchase price of $119.00, for a total purchase price of approximately $33.0 million. The total purchase price consisted of (i) the conversion of the $20.0 million under the Convertible Promissory Note issued by the Company to Motorola into shares of Series A-1 Preferred and (ii) cash in the amount of $13.0 million representing a drawdown on the Financing Facility. Through this transaction, we achieved compliance with all current Nasdaq National Market listing requirements as of June 30, 2002.

If we are out of compliance in the future with Nasdaq listing requirements, we may take other actions in addition to the modifications to Motorola s investment in us described above in order to achieve compliance, which actions may include a reverse split of our common stock. If an initial delisting decision is made by the staff, we may appeal the decision as permitted by Nasdaq rules. If we are delisted and cannot obtain listing on another major market or exchange, our stock s liquidity would suffer, and we would likely experience reduced analyst coverage and investor interest. Such factors may result in a decrease in our stock s trading price. Delisting also may restrict us from issuing additional securities or securing additional financing.

Consolidation among telephone companies may reduce our sales.

Consolidation in the telecommunications industry may cause delays in the purchase of our products and cause a reexamination of strategic and purchasing decisions by our customers. In addition, we may lose relationships with key personnel within a customer s organization due to budget cuts, layoffs, or other disruptions following a consolidation. For example, our sales to NYNEX, previously one of our largest customers, have decreased significantly as a result of a shift in focus resulting from its merger with Bell Atlantic, now Verizon. In addition, as a result of the merger between U S WEST and Qwest, Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding deployment of VDSL across its network.

Because our sales cycle is lengthy and variable, the timing of our revenue is difficult to predict, and we may incur sales and marketing expenses with no guarantee of a future sale.

Customers view the purchase of our products as a significant and strategic decision. As a result, customers typically undertake significant evaluation, testing and trial of our products before deployment. This evaluation process frequently results in a lengthy sales cycle, typically ranging from nine months to more than a year. Before a customer places an order, we may incur substantial sales and marketing expenses and expend significant management efforts. In addition, product purchases are frequently subject to unexpected administrative, processing and other delays on the part of our customers. This is particularly true for customers for whom our products represent a very small percentage of their overall purchasing activities. As a result, sales forecasted to be made to a specific customer for a particular quarter may not be realized in that quarter; and this could result in lower than expected revenues.

Government regulation of our customers and related uncertainty could cause our customers to delay the purchase of our products.

The Telecommunications Act requires telephone companies, such as the regional Bell operating companies, to offer their competitors cost-based access to some elements of their networks, including facilities and equipment used to provide high-speed data and video services. These telephone companies may not wish to make expenditures for infrastructure and equipment required to provide broadband services if they will be forced to allow competitors access to this infrastructure and equipment. The Federal Communications Commission (FCC) announced that, except in limited circumstances, it will not require incumbent carriers to offer their competitors access to the facilities and equipment used to provide high-speed data services. Nevertheless, other regulatory and judicial proceedings relating to telephone companies obligations to provide elements of their network to competitors are pending. The FCC also requires incumbent carriers to permit competitive carriers to collocate their equipment with the local switching equipment of the incumbents. The FCC s collocation rules recently have been vacated in part and continue to be subject to regulatory and judicial proceedings. Recently, the FCC issued a ruling that classified cable modem service as an interstate information service that is subject to FCC jurisdiction but not subject to common carrier regulation. As a result, such services are not currently regulated by the FCC and should not be subject to separate state and local regulation. This ruling may improve the competitive position of cable providers who compete with our customers who provide wireline-based broadband services. There is currently a pending rulemaking proceeding in which the FCC proposes to classify broadband Internet access services provided by wireline-based telephone companies as interstate information services. We cannot predict when or how this rulemaking will be decided. The uncertainties caused by these regulatory proceedings may cause these telephone companies to delay purchasing decisions at least until the proceedings and any related judicial appeals are completed. The outcomes of these regulatory proceedings, as well as other FCC regulation, may cause these telephone companies not to deploy services for which our products are designed or to further delay deployment. Additionally, telephone companies deployment of broadband services may be slowed down or stopped because of the need for telephone companies to obtain permits from city, state or federal authorities to implement infrastructure.

Our customers and potential customers will not purchase our products if they do not have the infrastructure necessary to use our products.

The copper wire infrastructures over which telephone companies may deliver voice, data and video services using our products vary in quality and reliability. As a result, some of these telephone companies may not be able to deliver a full set of voice, data and video services to their customers, despite their intention to do so, and this could harm our sales. Even after installation of our products, we remain highly dependent on telephone companies to continue to maintain their infrastructure so that our products will operate at a consistently high performance level. Infrastructure upgrades and maintenance may be costly, and telephone companies may not have the necessary financial resources. This may be particularly true for our smaller customers and potential customers such as independent telephone companies and domestic local telephone companies. If our current and potential customers infrastructure is inadequate, we may not be able to generate anticipated revenues from them.

If competing technologies that offer alternative solutions to our products achieve widespread acceptance, the demand for our products may not develop.

Technologies that compete with our products include other telecommunications-related wireline technologies, cable-based technologies, fixed wireless technologies and satellite technologies. If these alternative technologies are chosen by our existing and potential customers, our business, financial condition and results of operations could be harmed. In particular, cable operators are currently deploying products that will be capable of delivering voice, high-speed data and video services over cable, including products from General Instrument, our principal stockholder, and Motorola, its parent. Our technology may not be able to compete effectively against these technologies on price, performance or reliability.

Our customers or potential customers that also offer cable-based services may choose to purchase cable-based technologies. Cable service providers that offer not only data and video but also telephony over cable systems will give subscribers the alternative of purchasing all communications services from a single communications service provider, allowing the potential for more favorable pricing and a single point of contact for bill payment and customer service. If these services are implemented successfully over cable connections, they will compete directly with the services offered by telephone companies using our products. In addition, several telephone companies have commenced the marketing of video services over direct broadcast satellite while continuing to provide voice and data services over their existing copper wire infrastructure. If any of these services are accepted by consumers, the demand for our products may not develop and our ability to generate revenues will be harmed.

We face intense competition in providing equipment for telecommunications networks from larger and more well-established companies, and we may not be able to compete effectively with these companies.

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Many of our current and potential competitors have longer operating histories, greater name recognition and significantly greater financial, technical, marketing and distribution resources than we do. These competitors may undertake more extensive marketing campaigns, adopt more aggressive pricing policies and devote substantially more resources to developing new products than we are able to, which could result in the loss of current customers and impair our ability to attract potential customers.

Our significant current competitors include Advanced Fibre Communications, Alcatel, Cisco Systems, Efficient Networks, Ericsson, Lucent Technologies, Nokia, Nortel Networks, RELTEC (acquired by BAE Systems, CNI Division, formerly GEC Marconi), Scientific Atlanta, Siemens and our largest stockholder, General Instrument/Motorola, as well as emerging companies that are developing new technologies. Some of these competitors have existing relationships with our current and prospective customers. In addition, we anticipate that other large companies, such as Matsushita Electric Industrial which markets products under the Panasonic brand name, Microsoft, Network Computer, Philips, Sony, STMicroelectronics and Toshiba America will likely introduce products that compete with our N(3) Residential Gateway product in the future. Our customer base may be attracted by the name and resources of these large, well-known companies and may prefer to purchase products from them instead of us.

Consolidation of our competitors may cause us to lose customers and negatively affect our sales.

Consolidation in the telecommunications equipment industry may strengthen our competitors positions in our market, cause us to lose customers and hurt our sales. For example, Alcatel acquired DSC Communications, Lucent acquired Ascend Communications and BAE Systems, CNI Division, formerly GEC Marconi, acquired RELTEC. Acquisitions such as these may strengthen our competitors financial, technical and marketing resources and provide them access to regional Bell operating companies and other potential customers. Consolidation may also allow some of our competitors to penetrate new markets that we have targeted, such as domestic local, independent and international telephone companies. This consolidation may negatively affect our ability to increase revenues.

If we do not respond quickly to changing customer needs and frequent new product introductions by our competitors, our products may become obsolete.

Our position in existing markets or potential markets could be eroded rapidly by product advances. The life cycles of our products are difficult to estimate. Our growth and future financial performance will depend in part upon our ability to enhance existing products and develop and introduce new products that keep pace with:

- the increasing use of the Internet;
- the growth in remote access by telecommuters;
- the increasingly diverse distribution sources for high quality digital video; and
- other industry and technological trends.

We expect that our product development efforts will continue to require substantial investments. We may not have sufficient resources to make the necessary investments. If we fail to timely and cost-effectively develop new products that respond to new technologies and customer needs, the demand for our products may fall and we could lose revenues.

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Our executive officers and certain key personnel are critical to our business and the loss of their services could disrupt our operations and our customer relationships.

Except for J. Michael Norris, our President and Chief Executive Officer, none of our executive officers or key employees is bound by an employment agreement. Many of these employees have a significant number of options to purchase our common stock. Many of these options are currently vested and some of our key employees may leave us once they have exercised their options. In addition, our engineering and product development teams are critical in developing our products and have developed important relationships with our regional Bell operating company customers and their technical staffs. The loss of any of these key personnel could harm our operations and customer relationships.

Our limited ability to protect our intellectual property may affect our ability to compete, and we could lose customers.

We rely on a combination of patent, copyright and trademark laws, and on trade secrets and confidentiality provisions and other contractual provisions to protect our intellectual property. There is no guarantee that these safeguards will protect our intellectual property and other valuable confidential information. If our methods of protecting our intellectual property in the United States or abroad are not adequate, our competitors may copy our technology or independently develop similar technologies and we could lose customers. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. If we fail to adequately protect our intellectual property, it would be easier for our competitors to sell competing products, which could harm our business.

Third-party claims regarding intellectual property matters could cause us to stop selling our products, license additional technology or pay monetary damages.

From time to time, third parties, including our competitors and customers, have asserted patent, copyright and other intellectual property rights to technologies that are important to us. We expect that we will increasingly be subject to infringement claims as the number of products and competitors in our market grows and the functionality of products overlaps, and our products may currently infringe on one or more United States or international patents. The results of any litigation are inherently uncertain. In the event of an adverse result in any litigation with third parties that could arise in the future, we could be required:

- to pay substantial damages, including paying treble damages if we are held to have willfully infringed;
- to halt the manufacture, use and sale of infringing products;
- to expend significant resources to develop non-infringing technology; and/or
- to obtain licenses to the infringing technology.

Licenses may not be available from any third party that asserts intellectual property claims against us, on commercially reasonable terms, or at all. In addition, litigation frequently involves substantial expenditures and can require significant management attention, even if we ultimately prevail. In addition, we indemnify our customers for patent infringement claims, and we may be required to obtain licenses on their behalf, which could subject us to significant additional costs.

We depend on third-party manufacturers and any disruption in their manufacture of our products would harm our operating results.

We contract for the manufacture of all of our products and have limited in-house manufacturing capabilities. We rely primarily on two large contract manufacturers: Flextronics Enclosures and Sanmina-SCI Systems. The efficient operation of our business will depend, in large part, on our ability to have Flextronics Enclosures and Sanmina-SCI Systems and other companies manufacture our products in a timely manner, cost-effectively and in sufficient volumes while maintaining consistent quality. As our business grows, Flextronics Enclosures and Sanmina-SCI Systems and other contracted manufacturing companies may not have the capacity to keep up with the increased demand. Any manufacturing disruption could impair our ability to fulfill orders and could cause us to lose customers.

We have no long-term contracts with our manufacturers, and we may not be able to deliver our products on time if any of these manufacturers stop making our products.

We have no long-term contracts or arrangements with any of our contract manufacturers that guarantee product availability, the continuation of particular payment terms or the extension of credit limits. If our manufacturers are unable or unwilling to continue manufacturing our products in required volumes, we will have to identify acceptable alternative manufacturers, which could take in excess of three months. It is possible that a source may not be available to us when needed or be in a position to satisfy our production requirements at acceptable prices and on a timely basis. If we cannot find alternative sources for the manufacture of our products, we will not be able to meet existing demand. As a result, we may lose existing customers, and our ability to gain new customers may be significantly constrained.

Our inability to produce sufficient quantities of our products because of our dependence on components from key sole suppliers could result in delays in the delivery of our products and could harm our revenues.

Some parts, components and equipment used in our products are obtained from sole sources of supply. If our sole source suppliers or we fail to obtain components in sufficient quantities when required, delivery of our products could be delayed resulting in decreased revenues. Additional sole-sourced components may be incorporated into our equipment in the future. We do not have any long-term supply contracts to ensure sources of supply. In addition, our suppliers may enter into exclusive arrangements with our competitors, stop selling their products or components to us at commercially reasonable prices or refuse to sell their products or components to us at any price, which could harm our operating results.

The occurrence of any defects, errors or failures in our products could result in delays in installation, product returns and other losses to us or to our customers or end users.

Our products are complex and may contain undetected defects, errors or failures. These problems have occurred in our products in the past and additional problems may occur in our products in the future and could result in the loss of or delay in market acceptance of our products. In addition, we have limited experience with commercial deployment and we expect additional defects, errors and failures as our business expands from trials to commercial deployment at certain customers. We will have limited experience with the problems that could arise with any new products that we introduce. Further, our customer agreements generally include a longer warranty for defects than our manufacturing agreements. These defects could result in a loss of sales and additional costs and liabilities to us as well as damage to our reputation and the loss of our customers.

We do not have significant experience in international markets and may have unexpected costs and difficulties in developing international revenues.

We plan to extend the marketing and sales of our products internationally. International operations are generally subject to inherent risks and challenges that could harm our operating results, including:

- unexpected changes in telecommunications regulatory requirements;
- limited number of telephone companies operating internationally;
- expenses associated with developing and customizing our products for foreign countries;
- tariffs, quotas and other import restrictions on telecommunications equipment;
- longer sales cycles for our products; and
- compliance with international standards that differ from domestic standards.

To the extent that we generate international sales in the future, any negative effects on our international business could harm our business, operating results and financial condition. In particular, fluctuating exchange rates may contribute to fluctuations in our results of operations.

Motorola may exercise significant influence over our business and affairs and our stockholder votes and, for its own reasons, could prevent transactions which our other stockholders may view as favorable.

Motorola beneficially owns (as defined in Rule 13d-3 under the Securities Exchange Act of 1934, as amended (the Exchange Act)) approximately 85% of the outstanding shares of our common stock as of July 31, 2002. Motorola also has designated three directors on our board. As a result, Motorola will be able to exercise significant influence over all matters relating to our business and affairs, including approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us and could prevent you from receiving a premium for your shares.

We do not know whether Motorola s plans for our business and affairs will be different than our existing plans and whether any changes that may be implemented under Motorola s control will be beneficial or detrimental to our other stockholders.

Our principal stockholder and its parent may have interests that conflict with the best interests of our other stockholders and us and may cause us to forgo opportunities or take actions that disproportionately benefit our principal stockholder.

It is possible that Motorola could be in a position involving a conflict of interest with us. In addition, individuals who are officers or directors of Motorola and of us may have fiduciary duties to both companies. For example, a conflict may arise if our principal stockholder were to engage in activities or pursue corporate opportunities that may overlap with our business. These conflicts could harm our business and operating results. Our certificate of incorporation contains provisions intended to protect our principal stockholder and these individuals in these situations. These provisions limit your legal remedies.

The price of our common stock has been and may continue to be highly volatile.

The stock markets have in general, and with respect to high technology companies, including us, in particular, recently experienced extreme stock price and volume volatility, often unrelated to the financial performance of particular companies. The price at which our common stock will trade in the future is likely to also be highly volatile and may fluctuate substantially due to factors such as:

- actual or anticipated fluctuations in our operating results;
- changes in or our failure to meet securities analysts expectations;
- announcements of technological innovations by us or our competitors;
- introduction of new products and services by us or our competitors;
- limited public float of our common stock;
- conditions and trends in the telecommunications and other technology industries; and
- general economic and market conditions.

Sales of shares of our common stock by existing stockholders could cause the market price of our common stock to drop significantly.

As of July 31, 2002, Motorola owned 64,100,000 shares of our common stock, 7,189,753 shares of preferred stock convertible into 41,555,984 shares of common stock and warrants to purchase an additional 24,000,000 shares of our common stock; Kevin Kimberlin Partners, LP and its affiliates owned 2,900,000 shares of our common stock and its affiliates held warrants to purchase an additional 4,300,000 shares of our common stock. If Motorola, Kevin Kimberlin Partners LP and its affiliates, or any of our other stockholders sells substantial amounts of common stock, including shares issued upon exercise of outstanding options and warrants, in the public market, the market price of the common stock could fall. In addition, any distribution of shares of our common stock by Motorola to its stockholders could also have an adverse effect on the market price.

Motorola and Kevin Kimberlin Partners LP and its related persons and their transferees are entitled to registration rights pursuant to which they may require that we register their shares under the Securities Act.

In addition, as of July 31, 2002, there were outstanding options to purchase approximately 22,400,000 shares of our common stock. Subject to vesting provisions and, in the case of our affiliates, volume and manner of sale restrictions, the shares of common stock issuable upon the exercise of our outstanding employee options will be eligible for sale into the public market at various times.

Anti-takeover provisions in our charter documents and Delaware law could prevent or delay a

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change in control of our company that a stockholder may consider favorable.

Several provisions of our certificate of incorporation and by laws and Delaware law may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable. These provisions include:

- authorizing the issuance of preferred stock without stockholder approval;
- providing for a classified board of directors with staggered, three-year terms;
- prohibiting cumulative voting in the election of directors;
- restricting business combinations with interested stockholders;
- limiting the persons who may call special meetings of stockholders;
- prohibiting stockholder action by written consent;
- establishing advance notice requirements for nominations for election to the board of directors and for proposing matters that can be acted on by stockholders at stockholder meetings; and
- requiring super-majority voting to effect amendments to our certificate of incorporation and by laws.

Some of these provisions do not currently apply to Motorola and its affiliates.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk is limited to interest rate fluctuation. Interest on our debt to Motorola is variable, payable monthly and is determined on either the base rate, as defined in the agreement, plus 2% or the Eurodollar rate plus 3 1/2% (5.4% at June 30, 2002). If interest rates increased by 10% (0.5% change in interest rate), our interest expense on this debt would increase by approximately $0.3 million. We do not engage in any hedging activities, and we do not use derivatives or equity investments for cash investment purposes.

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PART II. OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

From time to time, we are a party to other actions which arise in the normal course of business. In our opinion, the ultimate disposition of these matters will not have a material adverse effect on our condensed consolidated financial statements taken as a whole.

Item 2. CHANGES IN SECURITIES AND USE OF PROCEEDS

(c) The following is a summary of transactions by us during the fiscal quarter ended June 30, 2002, involving sales of the Company s securities that were not registered under the Securities Act of 1993 (the Securities Act):

On June 25, 2002, we sold 277,311 shares of our Series A-1 Redeemable Convertible Preferred Stock under the terms of a Securities Purchase Agreement to an accredited investor in conformity with Rule 506 under Regulation D and under Section 4(2) of the Securities Act at a price of $119.00 per share. The total purchase price consisted of (i) the conversion of the $20.0 million Promissory Note dated December 11, 2001 issued by us to Motorola into shares of Series A-1 Preferred and (ii) cash in the amount of $13.0 million. We and the investor concurrently entered into a Registration Rights Agreement under which we agreed to register such 277,311 shares under the Securities Act under certain circumstances set forth within the Registration Rights Agreement. Concurrently, we also issued warrants to purchase (i) an aggregate of 6,008,403 shares of our Common Stock under the terms of certain warrants at an exercise price of $1.19 per share and (ii) an aggregate of 330,000 shares of our common stock under the terms of certain warrants at an exercise price of $2.00 per share. These warrants were issued pursuant to Rule 506 under Regulation D and under Section 4(2) of the Securities Act. Pursuant to the terms of the Warrants we have undertaken to register such 277,311 shares under the Securities Act within a time frame specified in the warrants. No underwriting or broker s commissions were paid in connection with the foregoing transactions.

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

Our 2001 annual meeting of stockholders was held on May 29, 2002. The following matters were voted upon by the stockholders:

ELECTION OF DIRECTORS:

Election of two Class II Directors. Craig Kornblau was elected to serve a two-year term expiring at our annual meeting of stockholders in 2004. The result of the voting was as follows: 84,176,160 shares in favor, with 524,170 shares withheld.

Election of two Class III Directors. Eugene Delaney and J. Michael Norris were re-elected to serve a three-year term expiring at the annual meeting of stockholders to be held in 2005. The result of the voting was as follows: 84,359,443 shares in favor of Eugene Delaney, with 340,887 shares withheld and 84,357,669 shares in favor of J. Michael Norris, with 342,661 shares withheld.

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RATIFICATION OF THE SELECTION OF DELOITTE & TOUCHE:

Ratification of the selection of Deloitte & Touche LLP as our independent auditors for our current fiscal year ending December 31, 2002. The result of the vote was 84,127,643 shares in favor, 517,650 shares against and 55,037 shares abstaining.

Item 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

The following exhibit is included as part of this report:

Exhibit No.	Description of Exhibit
10.1	Amendment No. 5 (dated May 30, 2002) to Credit Agreement, dated as of May 16, 2001 between Next Level Communications, Inc. and Motorola, Inc.

(b) Reports on Form 8-K:

We filed a Current Report on Form 8-K, on June 25, 2002 relating to our issuance of Series A-1 Preferred to Motorola, Inc.

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SIGNATURES

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

		NEXT LEVEL COMMUNICATIONS, INC.
Date: August 14, 2002	By:	/s/ J. MICHAEL NORRIS
		J. Michael Norris Chief Executive Officer and President
Date: August 14, 2002	By:	/s/ JAMES F. IDE
		James F. Ide Chief Financial Officer

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