

HARMONIC INC  
Form 10-Q  
November 10, 2010

**Table of Contents**

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

**Form 10-Q**

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
For the Quarterly Period Ended October 1, 2010

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934  
**Commission File No. 000-25826**

**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)**

**4300 North First Street  
San Jose, CA 95134  
(408) 542-2500**

**(Address, including zip code, and telephone number,  
including area code, of registrant's principal executive offices)**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

**Yes  No**

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

**Yes  No**

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

**(Do not check if a smaller reporting company)**

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

**Yes  No**

Edgar Filing: HARMONIC INC - Form 10-Q

The number of shares outstanding of the registrant's Common Stock, \$.001 par value, was 111,940,032 on October 29, 2010.

---

---

---

**TABLE OF CONTENTS**

<u>PART I</u>	3
<u>ITEM 1. FINANCIAL STATEMENTS</u>	3
<u>ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	22
<u>ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK</u>	32
<u>ITEM 4. CONTROLS AND PROCEDURES</u>	33
<u>PART II</u>	34
<u>ITEM 1. LEGAL PROCEEDINGS</u>	34
<u>ITEM 1A. RISK FACTORS</u>	34
<u>ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	52
<u>ITEM 3. DEFAULTS UPON SENIOR SECURITIES</u>	53
<u>ITEM 5. OTHER INFORMATION</u>	53
<u>ITEM 6. EXHIBITS</u>	53
<u>SIGNATURES</u>	54
<u>EX-31.1</u>	
<u>EX-31.2</u>	
<u>EX-32.1</u>	
<u>EX-32.2</u>	
<u>EX-101 INSTANCE DOCUMENT</u>	
<u>EX-101 SCHEMA DOCUMENT</u>	
<u>EX-101 CALCULATION LINKBASE DOCUMENT</u>	
<u>EX-101 LABELS LINKBASE DOCUMENT</u>	
<u>EX-101 PRESENTATION LINKBASE DOCUMENT</u>	
<u>EX-101 DEFINITION LINKBASE DOCUMENT</u>	

Table of Contents**PART I****FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

**HARMONIC INC.  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(UNAUDITED)**

(In thousands, except par value amounts)	October 1, 2010	December 31, 2009
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 70,523	\$ 152,477
Short-term investments	39,595	118,593
Accounts receivable, net of allowances of \$5,528 and \$5,163	92,438	64,838
Inventories	57,176	35,066
Deferred income taxes	39,923	26,503
Prepaid expenses and other current assets	24,873	20,821
	<hr/>	<hr/>
Total current assets	324,528	418,298
Property and equipment, net	38,752	25,941
Goodwill	212,475	63,953
Intangibles, net	125,461	25,265
Other assets	1,989	22,847
	<hr/>	<hr/>
Total assets	\$ 703,205	\$ 556,304
<hr/>		
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 28,465	\$ 22,065
Income taxes payable	2,808	609
Deferred revenue	41,412	32,855
Accrued liabilities	40,045	37,584
	<hr/>	<hr/>
Total current liabilities	112,730	93,113
Accrued excess facilities costs, long-term		58
Income taxes payable, long-term	41,768	43,948
Financing liability, long-term		6,908
Deferred income taxes, long-term	15,633	
Other long-term liabilities	4,473	4,804
	<hr/>	<hr/>
Total liabilities	174,604	148,831

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; 111,816 and 96,110 shares issued and outstanding as of October 1, 2010 and December 31, 2009, respectively	112	96
Capital in excess of par value	2,392,101	2,279,945
Accumulated deficit	(1,863,130)	(1,872,533)
Accumulated other comprehensive loss	(482)	(35)
	_____	_____
Total stockholders' equity	528,601	407,473
	_____	_____
Total liabilities and stockholders' equity	\$ 703,205	\$ 556,304
	_____	_____

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

Table of Contents

**HARMONIC INC.**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

(In thousands, except per share amounts)	Three Months Ended		Nine Months Ended	
	October 1, 2010	October 2, 2009	October 1, 2010	October 2, 2009
Product revenue	\$ 90,597	\$72,553	\$249,292	\$202,973
Service revenue	14,187	11,308	35,857	29,936
Net revenue	104,784	83,861	285,149	232,909
Product cost of revenue	53,019	44,477	140,086	126,617
Service cost of revenue	4,233	3,304	11,044	11,281
Total cost of revenue	57,252	47,781	151,130	137,898
Gross profit	47,532	36,080	134,019	95,011
Operating expenses:				
Research and development	19,002	15,879	52,946	45,825
Selling, general and administrative	25,999	19,405	70,917	61,431
Amortization of intangibles	959	1,367	2,026	3,289
Total operating expenses	45,960	36,651	125,889	110,545
Income (loss) from operations	1,572	(571)	8,130	(15,534)
Interest income, net	165	583	974	2,764
Other expense, net	(405)	(212)	(903)	(893)
Income (loss) before income taxes	1,332	(200)	8,201	(13,663)
Provision for (benefit from) income taxes	1,693	(2,777)	(1,202)	10,523

Edgar Filing: HARMONIC INC - Form 10-Q

Net income (loss)	\$ (361)	\$ 2,577	\$ 9,403	\$ (24,186)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net income (loss) per share				
Basic	\$ (0.00)	\$ 0.03	\$ 0.10	\$ (0.25)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Diluted	\$ (0.00)	\$ 0.03	\$ 0.10	\$ (0.25)
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Weighted average shares				
Basic	100,246	96,104	97,975	95,742
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Diluted	100,246	96,732	98,672	95,742
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

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



Table of Contents

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

(In thousands)	Nine Months Ended	
	October 1, 2010	October 2, 2009
Cash flows from operating activities:		
Net income (loss)	\$ 9,403	\$ (24,186)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Amortization of intangibles	8,904	9,222
Depreciation	6,696	6,299
Stock-based compensation	10,180	7,637
Net loss on disposal of fixed assets	73	191
Deferred income taxes	(57)	
Other non-cash adjustments, net	1,344	1,995
Changes in assets and liabilities, net of effect of acquisitions:		
Accounts receivable, net	(10,531)	(303)
Inventories	(11,088)	12,098
Prepaid expenses and other assets	(1,786)	9,064
Accounts payable	(1,898)	(1,279)
Deferred revenue	994	(887)
Income taxes payable	(104)	2,156
Accrued excess facilities costs	(5,230)	(4,446)
Accrued and other liabilities	(5,688)	(27,332)
	1,212	(9,771)
Cash flows used in investing activities:		
Purchases of investments	(39,035)	(101,221)
Proceeds from maturities of investments	83,689	119,001
Proceeds from sales of investments	32,609	27,240
Acquisition of property and equipment	(29,837)	(6,105)
Acquisition of Rhozet		(453)
Acquisition of Scopus, net of cash acquired		(63,053)
Acquisition of Omneon, net of cash acquired	(153,254)	
	(105,828)	(24,591)
Cash flows from financing activities:		

Edgar Filing: HARMONIC INC - Form 10-Q

Proceeds from lease financing liability	18,833	
Proceeds from issuance of common stock, net	3,918	4,239
	<hr/>	<hr/>
Net cash provided by financing activities	22,751	4,239
	<hr/>	<hr/>
Effect of exchange rate changes on cash and cash equivalents	(89)	207
	<hr/>	<hr/>
Net decrease in cash and cash equivalents	(81,954)	(29,916)
Cash and cash equivalents at beginning of period	152,477	179,891
	<hr/>	<hr/>
Cash and cash equivalents at end of period	\$ 70,523	\$ 149,975
	<hr/>	<hr/>
Supplemental disclosure of cash flow information:		
Income tax payments, net	\$ 984	\$ 2,598
Non-cash investing and financing activities:		
Issuance of restricted common stock for Rhomet acquisition	\$	\$ 1,870
Issuance of restricted common stock for Omneon acquisition	\$ 95,938	\$
Fair value of vested portion of stock options and restricted stock units assumed in connection with the Omneon acquisition	\$ 2,125	\$

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

**Table of Contents**

**HARMONIC INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1: BASIS OF PRESENTATION**

*Basis of Presentation.* The accompanying unaudited condensed consolidated financial statements include all adjustments (consisting only of normal recurring adjustments) which Harmonic Inc. ( Harmonic, or the Company ) considers necessary for a fair presentation 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, which was filed with the Securities and Exchange Commission on March 1, 2010. 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, 2010, or any other future period. The Company s fiscal quarters are based on 13-week periods, 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. The year-end condensed balance sheet was derived from audited financial statements, but does not include all disclosures required by accounting principles generally accepted in the United States of America.

*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.

*Reclassifications.* The Company has reclassified certain prior period balances to conform to the current year presentation. These reclassifications have no impact on previously reported total assets, total liabilities, stockholders equity, results of operations or cash flows.

**NOTE 2: RECENT ACCOUNTING PRONOUNCEMENTS**

In October 2009, the FASB issued revised guidance for revenue recognition with multiple deliverables. This guidance impacts the determination of when the individual deliverables included in a multiple-element arrangement may be treated as separate units of accounting. Additionally, this guidance modifies the manner in which the transaction consideration is allocated across the separately identified deliverables by no longer permitting the residual method of allocating arrangement consideration. This revised guidance is effective beginning in the first quarter of fiscal year 2011; however early adoption is permitted. The Company is currently evaluating the potential impact, if any, of the adoption of the revised accounting guidance on its consolidated results of operations, financial condition and cash flows.

In October 2009, the FASB issued revised guidance for the accounting for certain revenue arrangements that include software elements. This guidance amends the scope of pre-existing software revenue guidance by removing from the guidance non-software components of tangible products and certain software components of tangible products. This revised guidance is effective beginning in the first quarter of fiscal year 2011; however early adoption is permitted. The Company is currently evaluating the potential impact, if any, of the adoption of the revised accounting guidance on its consolidated results of operations, financial condition and cash flows.

In January 2010, the FASB issued updated guidance related to fair value measurements and disclosures, which requires a reporting entity to disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and to describe the reasons for the transfers. In addition, in the reconciliation for fair value measurements using significant unobservable inputs, or Level 3, a reporting entity should disclose separately information about purchases, sales, issuances and settlements (that is, on a gross basis rather than one net number). The updated guidance also requires that an entity provide fair value measurement disclosures for each class of assets and liabilities and disclosures about the valuation techniques and inputs used to measure fair value for both recurring and non-recurring fair value measurements for Level 2 and Level 3 fair value measurements. The updated guidance is effective for interim or annual financial reporting periods beginning after December 15, 2009, except for the disclosures about purchases, sales, issuances and settlements in the roll forward activity in Level 3 fair value

measurements, which are effective for

**Table of Contents**

fiscal years beginning after December 15, 2010 and for interim periods within those fiscal years. The adoption of the interim reporting requirements by the Company in the first quarter of 2010 did not have a material impact on its consolidated results of operations or financial condition.

**NOTE 3: ACQUISITIONS****Omneon**

On September 15, 2010, Harmonic completed the acquisition of 100% of the equity interests of Omneon, Inc., a privately-held company organized under the laws of Delaware and headquartered in Sunnyvale, California. Omneon develops and supports a range of video servers, active storage systems and related software applications that media companies use to simultaneously ingest, process, store, manage and deliver digital media in a wide range of formats. When used for television production and on-air operations, the products are designed to provide continuous real-time record and playback capabilities as well as file-based access to and delivery of digital media content. Omneon's products include Spectrum video servers, MediaGrid active storage systems, Media Application server and other software applications which were initially designed for, and have been deployed mostly by, broadcasters that use Omneon's products for the production and transmission of television content.

The acquisition of Omneon is intended to strengthen Harmonic's competitive position in the digital media market and to broaden the Company's relationships with customers who produce and distribute digital video content, such as broadcasters, cable channels and other major owners of content. The acquisition is also intended to broaden Harmonic's technology and product lines with digital storage and playout solutions which complement Harmonic's existing video processing products. In addition, the acquisition provided an assembled workforce, the implicit value of future cost savings as a result of combining entities, and is expected to provide Harmonic with future unidentified new products and technologies. These opportunities were significant factors to the establishment of the purchase price, which exceeded the fair value of Omneon's net tangible and intangible assets acquired resulting in goodwill of approximately \$147.8 million that was recorded in connection with this acquisition.

The purchase price, net of \$40.5 million of cash acquired, was \$251.3 million, which consisted of (i) approximately \$153.3 million in cash, net of cash acquired, (ii) 14.2 million shares of Harmonic common stock with a total fair value of approximately \$95.9 million, based on the price of Harmonic common stock at the time of close, and (iii) approximately \$2.1 million representing the fair value attributed to shares of Omneon equity awards which Harmonic assumed for which services had already been rendered as of the close of the acquisition. The cash portion of the purchase price was paid from existing cash balances and is subject to a post-closing adjustment based on Omneon's working capital. The Company also incurred a total of \$5.7 million of transaction expenses, which were expensed as selling, general and administrative expenses in the second and third quarters of 2010.

The assets and liabilities of Omneon were recorded at fair value at the date of acquisition. The Company will continue to evaluate certain assets and liabilities as new information is obtained about facts and circumstances that existed as of the acquisition date that, if known, would have resulted in the recognition of those assets and liabilities as of that date. Changes to the assets and liabilities recorded may result in a corresponding adjustment to goodwill and the measurement period shall not exceed one year from the acquisition date. Further, any associated restructuring activities will be expensed in future periods and not recorded through purchase accounting as previously done under prior accounting guidance. There are no contingent consideration arrangements in connection with the acquisition. The results of operations of Omneon are included in Harmonic's Consolidated Statements of Operations from September 15, 2010, the date of acquisition. The following table summarizes the allocation of the purchase price based on the fair value of the assets acquired and the liabilities assumed at the date of acquisition:

**Table of Contents****(In thousands)**

Cash acquired	\$ 40,485
Accounts receivable (Gross amount due from accounts receivable of \$17,760)	17,055
Inventory	11,010
Fixed assets	12,391
Deferred income tax assets	17,960
Other tangible assets acquired	2,653
Intangible assets:	
Existing technology	50,800
In-process technology	9,000
Patents/core technology	9,800
Customer contracts and related relationships	29,200
Trade names/trademarks	4,000
Maintenance agreements and related relationships	5,500
Order backlog	800
Goodwill	147,756
	<hr/>
Total assets acquired	358,410
Accounts payable	(6,829)
Deferred revenue	(6,399)
Deferred income tax liabilities	(42,052)
Other accrued liabilities	(11,328)
	<hr/>
Net assets acquired	291,802
Less: cash acquired	(40,485)
	<hr/>
Net purchase price	\$251,317
	<hr/>

The purchase price set forth in the table above was allocated based on the fair value of the tangible and intangible assets acquired and liabilities assumed as of September 15, 2010. The Company used an overall discount rate of 15% to estimate the fair value of the intangible assets acquired, which was derived based on financial metrics of comparable companies operating in Omneon's industry. In determining the appropriate discount rates to use in valuing each of the individual intangible assets, the Company adjusted the overall discount rate giving consideration to the specific risk factors of each asset. The following methods were used to value the identified intangible assets:

The fair value of the existing technology assets acquired was established based on their highest and best use by a market participant using the Income Approach. The Income Approach included an analysis of the markets, cash flows and risks associated with achieving such cash flows to calculate the fair value;

As of the acquisition date, Omneon was developing new versions and incremental improvements to its 3G MediaPort product, which is expected to be used in the Spectrum product line once completed. The in-process project was at a stage of development that required further research and development to determine technical feasibility and commercial viability. The fair value of the in-process technology assets acquired was based on

the valuation premise that the assets would be In-Use using a discounted cash flow model;

The fair value of patents/core technology assets acquired was established based on a variation of the Income Approach called the Profit Allocation Method . In the Profit Allocation Method, we estimated the value of the patents/core technology by capitalizing the profits expected to be saved because Harmonic owns the technology;

The fair value of the customer contracts and related relationships assets acquired was based on the Income Approach;

The fair value of trade names/trademarks assets acquired was established based on the Profit Allocation Method;

The fair value of the maintenance agreements and related relationships assets acquired was based on the Income Approach; and

The fair value of backlog acquired was established based on the Income Approach.

Identified intangible assets are being amortized over the following useful lives:

Existing technology is estimated to have a useful life of four years;

In-process technology will be amortized upon completion over its projected remaining useful life as assessed on the completion date. The completion of the in-process project is expected within the next twelve months;

Patents/core technology are being amortized over their estimated useful life of four years;

**Table of Contents**

Customer contracts and related relationships are being amortized over their estimated useful life of six years;

Trade name/trademarks are being amortized over their estimated useful lives of four years;

Maintenance agreements and related relationships are being amortized over their estimated useful life of six years; and

Order backlog is being amortized over its estimated useful life of three and one half months.

The existing technology, patents/core technology, customer contracts and related relationships, maintenance agreements and related relationships, trade name/trademarks and backlog are being amortized using the straight-line method which reflects the future projected cash flows.

The residual purchase price of \$147.8 million has been recorded as goodwill. The goodwill resulting from this acquisition is not deductible for federal tax purposes.

Substantially all unvested stock options and unvested restricted stock units issued by Omneon and outstanding at closing were assumed by Harmonic. The exchange of stock-based compensation awards was treated as a modification under current accounting guidance. The calculation of the fair value of the exchanged awards immediately before and after the modification did not result in any significant incremental fair value. The fair value of Harmonic's stock options and restricted stock units issued to Omneon employees was \$17.3 million, which was determined using the Black-Scholes option pricing model, of which \$2.1 million represents purchase consideration and \$15.1 million will be recorded as compensation expense over the weighted average service period of 2.5 years.

For the period from closing through October 1, 2010, Omneon products contributed revenues of \$5.6 million and a net operating loss of \$0.9 million.

**Scopus**

On March 12, 2009, Harmonic completed the acquisition of 100% of the equity interests of Scopus Video Networks Ltd., or Scopus, a publicly traded company based in Israel. Scopus was engaged in the development and support of digital video networking products that allowed network operators to transmit, process, and manage digital video content. Scopus' primary products included integrated receivers/decoders ( IRD ), intelligent video gateways ( IVG ), and encoders. In addition, Scopus marketed multiplexers, network management systems ( NMS ), and other ancillary technology to its customers.

The acquisition of Scopus strengthened Harmonic's technology and market leadership, particularly in the broadcast contribution and distribution markets. The acquisition extended Harmonic's diversification strategy, providing it with an expanded international sales force and global customer base, particularly in video broadcast, contribution and distribution markets, as well as complementary video processing technology and expanded research and development capability. In addition, the acquisition provided an assembled workforce, the implicit value of future cost savings as a result of combining entities, and is expected to provide Harmonic with future unidentified new products and technologies. These opportunities were significant factors to the establishment of the purchase price, which exceeded the fair value of Scopus' net tangible and intangible assets acquired resulting in goodwill of approximately \$22.8 million that was recorded in connection with this acquisition.

The purchase price, net of \$23.3 million of cash acquired, was \$63.1 million, which was paid from existing cash balances. The Company also incurred a total of \$3.4 million of transaction expenses, which were expensed as selling, general and administrative expenses in the first quarter of 2009.

The assets and liabilities of Scopus were recorded at fair value at the date of acquisition. Further, any associated restructuring activities will be expensed in future periods and not recorded through purchase accounting as previously done under prior accounting guidance. Subsequent to the acquisition, the Company recorded expenses of \$8.2 million in the year ended December 31, 2009, primarily for excess and obsolete inventories related to product discontinuances and severance costs.

The results of operations of Scopus are included in Harmonic's Consolidated Statements of Operations from March 12, 2009, the date of acquisition. The following table summarizes the allocation of the purchase price based on the fair



value of the assets acquired and the liabilities assumed at the date of acquisition:

9

---

**Table of Contents****(In thousands)**

Cash acquired	\$ 23,316
Investments	1,899
Accounts receivable (Gross amount due from accounts receivable of \$6,977)	6,308
Inventory	15,899
Fixed assets	4,280
Other tangible assets acquired	2,312
Intangible assets:	
Existing technology	10,100
In-process technology	2,400
Patents/core technology	3,500
Customer contracts and related relationships	4,000
Trade names/trademarks	2,100
Maintenance agreements and related relationships	1,000
Order backlog	2,000
Goodwill	22,847
	<hr/>
Total assets acquired	101,961
Accounts payable	(2,963)
Deferred revenue	(336)
Other accrued liabilities	(12,293)
	<hr/>
Net assets acquired	86,369
Less: cash acquired	(23,316)
	<hr/>
Net purchase price	\$ 63,053
	<hr/>

The purchase price set forth in the table above was based on the fair value of the tangible and intangible assets acquired and liabilities assumed as of March 12, 2009. The Company used an overall discount rate of 16% to estimate the fair value of the intangible assets acquired, which was derived based on financial metrics of comparable companies operating in Scopus industry. In determining the appropriate discount rates to use in valuing each of the individual intangible assets, the Company adjusted the overall discount rate giving consideration to the specific risk factors of each asset. The following methods were used to value the identified intangible assets:

The fair value of the existing technology assets acquired was established based on their highest and best used by a market participant using the Income Approach. The Income Approach included an analysis of the markets, cash flows and risks associated with achieving such cash flows to calculate the fair value. As of the acquisition date, Scopus was developing new versions and incremental improvements to its IRD, encoder and IVG products;

The in-process projects were at a stage of development that required further research and development to determine technical feasibility and commercial viability. The fair value of the in-process technology assets acquired was based on the valuation premise that the assets would be In-Use using a discounted cash flow

model;

The fair value of patents/core technology assets acquired was established based on a variation of the Income Approach called the Profit Allocation Method . In the Profit Allocation Method, we estimated the value of the patents/core technology by capitalizing the profits saved because Harmonic owns the technology;

The fair value of the customer contracts and related relationships assets acquired was based on the Income Approach;

The fair value of trade names/trademarks assets acquired was established based on the Profit Allocation Method;

The fair value of the maintenance agreements and related relationships assets acquired was based on the Income Approach; and

The fair value of backlog acquired was established based on the Cost Savings Approach.

Identified intangible assets are being amortized over the following useful lives:

Existing technology is estimated to have a useful life between three years and five years;

In-process technology is being amortized upon completion over its projected remaining useful life as assessed on the completion date. Three of the in-process projects were completed in the fourth quarter of 2009 and the remaining three projects were completed in the first quarter of 2010. The completed technology is estimated to have useful lives between three and six years;

Patents/core technology are being amortized over their useful life of four years;

Customer contracts and related relationships are being amortized over their useful life of between four years and five years;

Trade name/trademarks are being amortized over their estimated useful lives of five years;

Maintenance agreements and related relationships are being amortized over their useful life of four years; and

Order backlog was amortized over its estimated useful life of six months.

**Table of Contents**

The existing technology, patents/core technology, customer contracts, maintenance agreements and related relationships, trade name/trademarks and backlog are being amortized using the straight-line method which reflects the future projected cash flows.

The residual purchase price of \$22.8 million has been recorded as goodwill. The goodwill as a result of this acquisition is not deductible for federal tax purposes.

For the three month period ended October 2, 2009, Scopus products contributed revenues of \$6.9 million and a net operating loss of \$1.5 million. For the period from March 12, 2009 to October 2, 2009, Scopus products contributed revenues of \$14.5 million and a net operating loss of \$13.7 million.

**Pro Forma Financial Information**

The unaudited pro forma financial information presented below for the 2009 periods summarizes the combined results of operations as if the Scopus and Omneon acquisitions had been completed on January 1, 2009. The unaudited pro forma financial information for the three months ended October 2, 2009 combines the results for Harmonic for the three months ended October 2, 2009 and the historical results of Omneon for the three months ended September 30, 2009. The unaudited pro forma financial information for the nine months ended October 2, 2009 combines the results for Harmonic for the nine months ended October 2, 2009, the historical results of Scopus through March 12, 2009, the date of acquisition and the historical results of Omneon for the nine months ended September 30, 2009.

The unaudited pro forma financial information presented below for the 2010 periods summarizes the combined results of operations as if the Omneon acquisition had been completed on January 1, 2010. The unaudited pro forma financial information for the three and nine months ended October 1, 2010 combines the results for Harmonic for the three and nine months ended October 1, 2010 and the historical results of Omneon through September 15, 2010, the date of acquisition.

The pro forma financial information is presented for informational purposes only and does not purport to be indicative of what would have occurred had the merger actually been completed on such dates or of results which may occur in the future.

	Three Months Ended		Nine Months Ended	
	October 1, 2010	October 2, 2009	October 1, 2010	October 2, 2009
(In thousands, except per share data)				
Net revenue	\$128,198	\$107,229	\$368,709	\$314,235
Net income (loss)	\$ (2,852)	\$ (6,694)	\$ (4,940)	\$ (60,851)
Net income (loss) per share basic	\$ (0.03)	\$ (0.06)	\$ (0.04)	\$ (0.55)
Net income (loss) per share diluted	\$ (0.03)	\$ (0.06)	\$ (0.04)	\$ (0.55)

**NOTE 4: FAIR VALUE**

The applicable accounting guidance establishes a framework for measuring fair value and expands required disclosure about the fair value measurements of assets and liabilities. This guidance requires the Company to classify and disclose assets and liabilities measured at fair value on a recurring basis, as well as fair value measurements of assets and liabilities measured on a nonrecurring basis in periods subsequent to initial measurement, in a three-tier fair value hierarchy as described below.

The guidance defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The guidance describes three levels of inputs that may be used to measure fair value:

Level 1 Observable inputs that reflect quoted prices for identical assets or liabilities in active markets.

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. The Company primarily uses

broker quotes for valuation of its short-term investments.

**Table of Contents**

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company uses the market approach to measure fair value for its financial assets and liabilities. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities. During the nine months ended October 1, 2010, there were no nonrecurring fair value measurements of assets and liabilities subsequent to initial recognition.

The following table sets forth the fair value of the Company's financial assets measured at fair value on a recurring basis as of October 1, 2010 and December 31, 2009 based on the three-tier fair value hierarchy:

(In thousands)	Level 1	Level 2	Level 3	Total
<b>October 1, 2010</b>				
Money market funds	\$38,976	\$	\$	\$38,976
Corporate bonds		15,038		15,038
U.S. federal government bonds		11,122		11,122
State, municipal and local government agencies bonds		13,435		13,435
	_____	_____	-	_____
Total assets	\$38,976	\$39,595	\$	\$78,571
	_____	_____	-	_____

(In thousands)	Level 1	Level 2	Level 3	Total
<b>December 31, 2009</b>				
Money market funds	\$114,898	\$	\$	\$114,898
Corporate bonds		35,707		35,707
U.S. federal government bonds		46,536		46,536
State, municipal and local government agencies bonds		30,381		30,381
Other debt securities		5,969		5,969
	_____	_____	-	_____
Total assets	\$114,898	\$118,593	\$	\$233,491
	_____	_____	-	_____

At October 1, 2010 and December 31, 2009, maturities of short-term investments are as follows:

(In thousands)	October 1, 2010	December 31, 2009
<b>Short-term investments:</b>		
Less than one year	\$ 35,595	\$ 84,771
Due in 1-2 years	4,000	27,821
Due in 3-27 years		6,001

Total	\$ 39,595	\$ 118,593
-------	-----------	------------

The following is a summary of available-for-sale securities:

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
<b>October 1, 2010</b>				
U.S. federal, state, municipal and local government agencies bonds	\$ 24,508	\$ 50	\$ (1)	\$ 24,557
Corporate debt securities	14,997	42	(1)	15,038
Total	\$ 39,505	\$ 92	\$ (2)	\$ 39,595
<b>December 31, 2009</b>				
U.S. federal, state, municipal and local government agencies bonds	\$ 76,712	\$ 214	\$ (9)	\$ 76,917
Corporate debt securities	35,655	74	(22)	35,707
Other debt securities	5,744	234	(9)	5,969
Total	\$ 118,111	\$ 522	\$ (40)	\$ 118,593

#### *Impairment of Investments*

Harmonic monitors its 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

**Table of Contents**

cost basis for the investment is established. In order to determine whether a decline in value is other-than-temporary, the Company evaluates, among other factors: the duration and extent to which the fair value has been less than the carrying value; the Company's financial condition and business outlook, including key operational and cash flow metrics, current market conditions and future trends in the industry; and the Company's relative competitive position within the industry. At the present time, the Company does not intend to sell its investments that have unrealized losses in accumulated other comprehensive loss. In addition, the Company does not believe that it is more likely than not that it will be required to sell its investments that have unrealized losses in accumulated other comprehensive loss before the Company recovers the principal amounts invested. The Company believes that the unrealized losses are temporary and do not require an other-than-temporary impairment, based on our evaluation of available evidence as of October 1, 2010.

As of October 1, 2010, there were no individual available-for-sale securities in a material unrealized loss position and the amount of unrealized losses on the total investment balance was insignificant.

**NOTE 5: INVENTORIES**

<b>(In thousands)</b>	<b>October 1, 2010</b>	<b>December 31, 2009</b>
Raw materials	\$ 13,352	\$ 8,633
Work-in-process	2,858	3,072
Finished goods	40,966	23,361
	<u>57,176</u>	<u>\$ 35,066</u>

**NOTE 6: GOODWILL AND IDENTIFIED INTANGIBLES**

The following is a summary of goodwill and intangible assets as of October 1, 2010 and December 31, 2009:

<b>(In thousands)</b>	<b>October 1, 2010</b>			<b>December 31, 2009</b>		
	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Amount</b>	<b>Gross Carrying Amount</b>	<b>Accumulated Amortization</b>	<b>Net Carrying Amount</b>
Identified intangibles:						
Developed core technology	\$ 126,051	\$ (54,859)	\$ 71,192	\$ 64,864	\$(48,013)	\$ 16,851
In-process technology	9,000		9,000	600		600
Customer relationships/contracts	67,099	(34,612)	32,487	37,900	(33,541)	4,359
Trademarks and tradenames	11,367	(5,656)	5,711	7,369	(5,136)	2,233
Supply agreements	3,423	(3,423)		3,427	(3,427)	
Maintenance agreements and related relationships	7,100	(695)	6,405	1,600	(405)	1,195
Software license, intellectual property and assembled workforce	309	(300)	9	309	(282)	27
Order backlog	2,800	(2,143)	657	2,000	(2,000)	



	_____	_____	_____	_____	_____	_____
Subtotal of identified intangibles	227,149	(101,688)	125,461	118,069	(92,804)	25,265
Goodwill	212,475		212,475	63,953		63,953
	_____	_____	_____	_____	_____	_____
Total goodwill and other intangibles	\$439,624	\$(101,688)	\$337,936	\$182,022	\$(92,804)	\$89,218
	_____	_____	_____	_____	_____	_____

The changes in the carrying amount of goodwill for the nine months ended October 1, 2010 are as follows:

(In thousands)	Goodwill
Balance as of December 31, 2009	\$ 63,953
Acquisition of Omneon	147,756
Adjustment to deferred tax liability associated with the Scopus acquisition	786
Foreign currency translation adjustments	(20)
	_____
Balance as of October 1, 2010	\$212,475
	_____

For the three and nine months ended October 1, 2010, the Company recorded a total of \$3.7 million and \$8.9 million of amortization expense for identified intangibles, of which \$2.7 million and \$6.9 million, was included in cost of revenue, respectively. For the three and nine months ended October 2, 2009, the Company recorded a total of \$3.6 million and \$9.2 million of amortization expense for

**Table of Contents**

identified intangibles, of which \$2.2 million and \$5.9 million was included in cost of revenue, respectively. The estimated future amortization expense of purchased intangible assets with definite lives is as follows:

(In thousands)

Years Ending December 31,	Cost of Revenue	Operating Expenses	Total
2010 (remaining 3 months)	\$ 5,635	\$ 2,887	\$ 8,522
2011	19,364	8,907	28,271
2012	17,991	8,715	26,706
2013	16,719	8,096	24,815
2014	11,231	6,775	18,006
2015 and after	261	9,880	10,141
Total	\$ 71,201	\$45,260	\$116,461

**NOTE 7: RESTRUCTURING AND EXCESS FACILITIES**

The Company has recorded restructuring and excess facilities charges beginning in 2001 and throughout subsequent years as a result of changing conditions in the use of its facilities in the United States and the United Kingdom. The initial expenses that had been recorded to selling, general and administrative expense and the related liabilities have been adjusted periodically for changes in sublease income estimates.

In the first quarter of 2009, the Company recorded a total of \$7.4 million of expenses related to activities resulting from the Scopus acquisition, including the termination of approximately 65 Scopus employees. A charge of \$6.3 million was recorded in cost of revenue, consisting of excess and obsolete inventories expenses from product discontinuances and severance expenses for terminated Scopus employees. Research and development expenses were \$0.6 million for terminated Scopus employees. Selling, general and administrative expenses totaled \$0.5 million consisting primarily of severance expenses for terminated Scopus employees. Substantially all of the severance was paid during the three months ended April 3, 2009.

As of October 1, 2010, accrued excess facilities cost totaled \$0.1 million, which was included in current accrued liabilities and is expected to be substantially paid in the remainder of 2010. The Company incurred cash outlays of \$5.0 million during the first nine months of 2010 principally for lease payments, property taxes, insurance and other maintenance fees related to vacated facilities.

Harmonic reassesses this liability quarterly and adjusts as necessary based on changes in the timing and amounts of expected sublease rental income.

The following table summarizes the activities in the restructuring accrual during the first nine months of 2010:

(In thousands)	Excess Facilities	Campus Consolidation	BTL Closure	Scopus Facilities	Total
Balance at December 31, 2009	\$ 3,117	\$ 1,715	\$ 276	\$ 224	\$ 5,332
Provisions/(recoveries)	(157)	(2)	(71)	4	(226)
Cash payments, net of sublease income	(2,960)	(1,713)	(205)	(127)	(5,005)

Balance at October 1, 2010	\$	\$	\$	\$ 101	\$ 101
	_____	_____	_____	_____	_____

**NOTE 8: CREDIT FACILITIES**

Harmonic has a bank line of credit facility with Silicon Valley Bank, which provides for borrowings of up to \$10.0 million that matures on March 2, 2011. As of October 1, 2010, other than standby letters of credit and guarantees (Note 15), there were no amounts outstanding under the line of credit facility and there were no borrowings in 2009 or 2010. This facility, which was amended and restated in March 2010, contains a financial covenant with the requirement for Harmonic to maintain unrestricted cash, cash equivalents and short-term investments, net of credit extensions, of not less than \$35.0 million. If Harmonic were unable to maintain this cash, cash equivalents and short-term investments balance, Harmonic would not be in compliance 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. At October 1, 2010, Harmonic was in compliance with the covenants under this line of credit facility. Future borrowings pursuant to the line would bear interest at the bank's prime rate (4.0% at October 1, 2010). Borrowings are payable monthly and are not collateralized.

**Table of Contents****NOTE 9: FINANCING LIABILITY FOR CONSTRUCTION IN PROGRESS**

The lease for the building at the Company's Sunnyvale location ended in September 2010. In December 2009, the Company entered into a lease for a building in San Jose, California, which was intended to become the Company's new headquarters. In January 2010, the Company began a build-out of this facility and during the construction incurred approximately \$18.9 million in structural leasehold improvements. Under the terms of the lease, the landlord reimbursed \$18.8 million of the construction costs. Because certain improvements constructed by the Company were considered structural in nature and the Company was responsible for any cost overruns, the Company was considered to be the owner of the construction project for accounting purposes under applicable accounting guidance on the effect of lessee involvement in asset construction.

As a result, the Company capitalized the fair value of the building of \$6.9 million with a corresponding credit to financing liability. The fair value was determined as of December 31, 2009 using a combination of the revenue comparison approach and the income capitalization approach. During the nine months ended October 1, 2010, the liability increased by \$18.9 million due to additional structural leasehold improvements, by \$0.2 million due to land lease expense and by \$0.2 million due to capitalized interest expense.

Construction was completed in September 2010 at which time the Company relocated to the new building. Upon completion of construction in September 2010, the Company assessed and concluded that it qualified for sale-leaseback accounting under applicable accounting guidance since the Company has no form of continuing involvement other than the leaseback. In connection with the sale-leaseback of the building the Company removed from its books the carrying value of the building, the structural leasehold improvements and the financing liability.

**NOTE 10: BENEFIT PLANS**

*Stock Option Plans.* Harmonic has reserved 22,809,000 shares of Common Stock for issuance under various employee stock option plans. Stock 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 per month thereafter. Beginning on February 27, 2006, option grants had a term of seven years. Restricted stock units have no exercise price and generally vest over four years with 25% vesting at one year from date of grant or the vesting commencement date chosen for the award, and either an additional 1/16 per quarter thereafter, or 1/8 semiannually thereafter. In May 2010, Harmonic stockholders approved amendments to the 1995 Stock Plan (the "1995 Plan") and increased the maximum number of shares of common stock authorized for issuance by an additional 10,600,000 shares, decreased the maximum term of stock options to seven years and changed the share counting provisions to provide that each award with an exercise price below 100% of the fair market value on the grant date (or no exercise price) would decrease the 1995 Plan reserve 1.5 shares for every unit or share granted and any forfeitures of these awards due to their not vesting would increase the 1995 Plan reserve by 1.5 shares for every unit or share forfeited. Previously, restricted stock units granted reduced the number of shares reserved for grant under the plans by two shares for every unit granted. Stock options are granted having exercise prices equal to the fair market value of the stock at the date of grant. Certain awards provide for accelerated vesting if there is a change in control. In the three and nine months of 2010, employees received restricted stock units valued at \$10.2 million and \$19.7 million, respectively. In the three and nine months ended October 2, 2009, employees received restricted stock units valued at \$2.0 million and \$9.3 million, respectively.

*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. In May 2008, Harmonic stockholders approved amendments to the Plan to, among other things, increase the maximum number of shares of common stock authorized for issuance by an additional 100,000 to 800,000 shares, and to rename the Plan the "2002 Director Stock Plan." In May 2010, Harmonic stockholders approved amendments to the Plan and increased the maximum number of shares of common stock authorized for issuance by an additional 400,000 shares and changed the share counting provisions to provide that each award of restricted stock units would decrease the 2002 Plan reserve 1.5 shares for every unit granted and any forfeitures of unvested restricted stock units would increase the 1995 Stock Plan reserve by 1.5 shares for every unit forfeited. Harmonic had a total of 752,000 shares of Common Stock reserved for issuance under the Plan as of October 1, 2010. The Plan provides for the grant of

non-statutory stock options or restricted stock units to certain non-employee directors of Harmonic. Restricted stock units, or RSUs, have no exercise price and vest either after one year or the vesting date chosen for such award. Previously, restricted stock units granted reduced the number of shares reserved for grant under the Plan by two shares for every unit granted. Stock options are granted at fair market value of the stock at the date of grant for periods not exceeding seven years. Initial option grants generally vest monthly over three years, and subsequent

**Table of Contents**

grants generally vest monthly over one year. In the first nine months of 2010 and 2009, there were 87,367 and 99,463 units granted to non-employee directors, respectively.

A summary of share-based award activity during the nine months ended October 1, 2010 is as follows (in thousands):

	<b>Shares Available for Grant</b>
Balance at December 31, 2009	4,054
Shares authorized	11,000
Options granted	(2,466)
Restricted stock units granted	(5,327)
Restricted stock units canceled	223
Options canceled	510
Options expired	103
	<hr/>
Balance at October 1, 2010	8,097
	<hr/>

The following table summarizes restricted stock unit activity under the Plans:

<b>(In thousands except exercise price)</b>	<b>RSUs Outstanding</b>	<b>Weighted Average Fair Value Per Share</b>	<b>Aggregate Fair Value (1)</b>
Balance at December 31, 2009	1,637	\$ 5.88	
Restricted stock units granted	3,092	6.53	
Restricted stock units released	(757)	5.88	\$ 4,599
Restricted stock units canceled	(112)	6.23	
	<hr/>		
Balance at October 1, 2010	3,860	\$ 6.36	
	<hr/>		

- (1) Represents the fair value of Harmonic common stock on the date that the restricted stock units vested. On the grant date, the fair value for these awards

was  
\$4.5 million.

The following table summarizes stock option activity under the Plans:

<b>(In thousands except exercise price)</b>	<b>Stock Options Outstanding</b>	<b>Weighted Average Exercise Price</b>
Balance at December 31, 2009	10,499	\$ 9.44
Options granted	2,466	3.78
Options exercised	(167)	4.82
Options canceled	(510)	8.40
Options expired	(685)	35.01
	<hr/>	
Balance at October 1, 2010	11,603	\$ 6.84
	<hr/>	
Options vested and exercisable as of October 1, 2010	7,501	\$ 7.66
	<hr/>	
Options vested and expected-to-vest as of October 1, 2010	11,453	\$ 6.87
	<hr/>	

The weighted-average fair value of options granted for the nine months ended October 1, 2010 was \$4.18 The weighted-average fair value of options granted for the nine months ended October 2, 2009 was \$2.80.

**Table of Contents**

The following table summarizes information regarding stock options outstanding at October 1, 2010:

Range of Exercise Prices	Stock Options Outstanding			Stock Options Exercisable	
	Number Outstanding at October 1, 2010	Weighted- Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number Exercisable at October 1, 2010	Weighted Average Exercise Price
(In thousands, except exercise price and life)					
\$ 0.19 -- 3.46	1,794	7.7	\$ 2.31	300	\$ 2.64
3.73 -- 5.86	1,776	4.6	5.53	1,158	5.46
5.87 -- 6.93	1,729	4.2	6.18	963	5.97
6.94 -- 8.17	2,571	4.5	8.12	1,661	8.11
8.20 -- 8.79	1,714	3.5	8.26	1,495	8.25
8.80 -- 11.94	1,971	2.1	9.66	1,876	9.64
12.10 -- 16.73	48	1.2	13.94	48	13.94
	11,603	4.4	\$ 6.84	7,501	\$ 7.66

The weighted-average remaining contractual life for all exercisable stock options at October 1, 2010 was 3.2 years. The weighted-average remaining contractual life of all vested and expected-to-vest stock options at October 1, 2010 was 4.3 years. The weighted-average remaining contractual life of all vested and expected-to-vest restricted stock units at October 1, 2010 was 1.3 years.

Aggregate intrinsic value of options exercisable at October 1, 2010 was \$4.1 million. The aggregate intrinsic value of stock options vested and expected-to-vest net of estimated forfeitures was \$12.1 million at October 1, 2010. Aggregate intrinsic value represents the difference between our closing price on the last trading day of the fiscal period, which was \$7.00 as of October 1, 2010, and the exercise price multiplied by the number of options outstanding or exercisable. The intrinsic value of exercised stock options is calculated based on the difference between the exercise price and the current market value at the time of exercise. The aggregate intrinsic value of exercised stock options was \$0.1 million and \$0.3 million during the three and nine months ended October 1, 2010, 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. As a result of the adoption of the 2002 Purchase Plan and subsequent stockholder-approved amendments, a total of 7.5 million shares have been approved for issuance pursuant to the 2002 Purchase Plan. In addition, in June 2006, the Company's stockholders approved an amendment to the 2002 Purchase Plan to reduce the term of future offering periods to six months which became effective for the offering period beginning January 1, 2007. The 2002 Purchase Plan enables employees to purchase shares at 85% of the fair market value of the Common Stock at the beginning or end of the offering period, whichever is lower. Offering periods generally begin 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 2010 and 2009, the number of shares of stock issued under the purchase plans was 864,800 and 705,206 at weighted average prices of \$4.90 and \$5.24, respectively. The weighted-average fair value of each right to purchase shares of common stock granted under the purchase plans during the first nine months of 2010 and 2009 was \$1.70 and \$2.19, respectively. At October 1, 2010, a total of 1,775,073 shares were 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 can make discretionary contributions to the plan of 25% of the first 4% contributed by eligible participants up to a maximum contribution per participant of \$1,000 per year. This employer contribution was suspended during the first quarter of 2009.

*Stock-based Compensation*

The following table summarizes stock-based compensation costs in our Condensed Consolidated Statements of Operations for the three and nine months ended October 1, 2010 and October 2, 2009:

(In thousands)	Three Months Ended		Nine Months Ended	
	October 1, 2010	October 2, 2009	October 1, 2010	October 2, 2009
Employee stock-based compensation in:				
Cost of revenue	\$ 516	\$ 376	\$ 1,521	\$1,086
Research and development expense	1,169	972	3,435	2,771
Selling, general and administrative expense	1,833	1,346	5,224	3,780
Total employee stock-based compensation in operating expense	3,002	2,318	8,659	6,551
Total employee stock-based compensation	3,518	2,694	10,180	7,637
Amount capitalized as inventory	(14)	8	11	12
Total stock-based compensation	\$3,504	\$2,702	\$10,191	\$7,649

**Table of Contents**

As of October 1, 2010, total unamortized stock-based compensation cost related to unvested stock options and restricted stock units was \$36.5 million. This amount will be recognized as expense using the straight-line attribution method over the remaining weighted-average amortization period of 2.6 years.

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

	<b>Employee Stock Options</b>			
	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>
Expected life (years)	3.52	4.75	4.00	4.75
Volatility	55%	60%	56%	58%
Risk-free interest rate	1.1%	2.6%	1.6%	1.7%
Dividend yield	0.0%	0.0%	0.0%	0.0%

	<b>Employee Stock Purchase Plan</b>			
	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>
Expected life (years)	0.5	0.5	0.5	0.5
Volatility	43%	78%	46%	76%
Risk-free interest rate	0.4%	0.5%	0.4%	0.5%
Dividend yield	0.0%	0.0%	0.0%	0.0%

The expected term for stock options and the 2002 Purchase Plan represents the weighted-average period that the stock options are expected to remain outstanding. Our computation of expected life was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior. The issuance of Harmonic stock options in the third quarter of 2010 due to the assumption of the unvested Omneon stock options had the effect of reducing the expected life due to a shorter remaining vesting period.

We use the historical volatility over the expected term of the options and the 2002 Purchase Plan offering period to estimate the expected volatility. We believe that the historical volatility, at this time, represents fairly the future volatility of our common stock.

We will continue to monitor relevant information to measure expected volatility for future option grants and 2002 Purchase Plan offering periods.

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

**NOTE 11: INCOME TAXES**

The income tax provision includes U.S. federal, state and local, and foreign income taxes and is based on the application of a forecasted annual income tax rate applied to the current quarter's year-to-date pre-tax income (loss). In determining the estimated annual effective income tax rate, the Company analyzes various factors, including projections of the Company's annual earnings, taxing jurisdictions in which the earnings will be generated, the impact of state and local income taxes, the Company's ability to use tax credits and net operating loss carryforwards, and

available tax planning alternatives. Discrete items, including the effect of changes in tax laws, tax rates, and certain circumstances with respect to valuation allowances or other unusual or non-recurring tax adjustments are reflected in the period in which they occur as an addition to or reduction from, the income tax provision, rather than being included in the estimated annual effective income tax rate.

For the three and nine months ended October 1, 2010, our effective tax rate, in thousands, was a provision of \$1,693 and a benefit of \$(1,202), respectively, compared to a benefit of \$(2,777) in the third quarter of 2009 and a provision of \$10,523 for the first nine months of 2009, inclusive of discrete items.

For the three months ended October 1, 2010, the difference between our effective tax rate provision of 127.1% and the federal statutory rate of 35% was primarily attributable to various discrete items, the differential in foreign tax rates, non deductible stock-based compensation expense, non deductible transaction costs, and California research and development credits. The discrete items recorded in the third quarter of 2010 principally related to translation adjustments and accrued interest on uncertain tax positions and a reallocation of expenses between legal entities.

**Table of Contents**

For the nine months ended October 1, 2010, the difference between our effective tax rate benefit of 14.7% and the federal statutory rate of 35% was primarily attributable to various discrete items, the differential in foreign tax rates, non deductible stock-based compensation expense, non deductible transaction costs and California research and development credits. The discrete items recorded for the nine months ended October 1, 2010, principally related to a benefit associated with the reversal of previously provided foreign income taxes due to expiration of the statute of limitations, translation adjustments and accrued interest on uncertain tax positions, a reduction in the valuation allowance on the California deferred tax assets due to an increase in the estimated amount of income that will be apportioned to California, based on anticipated changes in the geographic mix of sales, and a reallocation of expenses between legal entities.

On February 20, 2009, California enacted legislation, which among other things, provides for the election of a single factor apportionment formula beginning in 2011. As a result of our anticipated election of the single sales factor, we are required under applicable accounting guidance on accounting for income taxes to compute our deferred taxes at the end of any reporting period taking into account the reversal pattern and the expected California tax rate under the elective single sales factor. For the first quarter of 2009, the impact of the new legislation resulted in a change to the state effective tax rate used to compute the Company's California deferred tax assets resulting in a corresponding reduction to the amount of previously recorded California deferred tax assets. Any future changes to the estimate may result in an adjustment to the amount of the California deferred tax assets recognized.

In compliance with applicable guidance for accounting for uncertainty in income taxes, the Company had gross unrecognized tax benefits, which include interest and penalties, of approximately \$52.3 million as of December 31, 2009, and approximately \$48.9 million as of October 1, 2010. If all of these unrecognized tax benefits were recognized, the entire amount would impact the provision for income taxes. We anticipate the unrecognized tax benefits to decrease by \$2.4 million in the next 12 months due to statute of limitation expirations.

We recognize interest and penalties related to uncertain tax positions in income tax expense. During the quarter ended October 1, 2010, we recorded a net increase of \$0.5 million for interest and penalties related to uncertain tax positions resulting in a balance at October 1, 2010 of \$5.2 million.

The tax years 2002-2009 remain open to examination by various federal, state and foreign taxing jurisdictions.

**NOTE 12: 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. The diluted net loss per share is the same as basic net loss per share for the three months ended October 1, 2010 and the nine months ended October 2, 2009 because potential common shares, such as common shares issuable under the exercise of stock options or the employee stock purchase plan, are only considered when their effect would be dilutive.

The following table shows the potentially dilutive shares, consisting of options, restricted stock units and ESPP shares, for the periods presented that were excluded from the net income (loss) computations because their effect was antidilutive:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>
<b>(In thousands)</b>				
Potentially dilutive equity awards outstanding	16,529	8,645	15,036	13,280

Following is a reconciliation of the numerators and denominators of the basic and diluted net income (loss) per share computations:

(In thousands, except per share data)	Three Months Ended		Nine Months Ended	
	October 1, 2010	October 2, 2009	October 1, 2010	October 2, 2009
Net income (loss) (numerator)	\$ (361)	\$ 2,577	\$ 9,403	\$ (24,186)
Shares calculation (denominator):				
Weighted average shares outstanding basic	100,246	96,104	97,975	95,742
Effect of dilutive securities:				
Potential common stock relating to equity awards outstanding		628	697	
Average shares outstanding diluted	100,246	96,732	98,672	95,742
Net income (loss) per share basic	\$ (0.00)	\$ 0.03	\$ 0.10	\$ (0.25)
Net income (loss) per share diluted	\$ (0.00)	\$ 0.03	\$ 0.10	\$ (0.25)

**Table of Contents****NOTE 13: COMPREHENSIVE INCOME (LOSS)**

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

(In thousands)	Three Months Ended		Nine Months Ended	
	October 1, 2010	October 2, 2009	October 1, 2010	October 2, 2009
Net income (loss)	\$ (361)	\$ 2,577	\$ 9,403	\$ (24,186)
Change in unrealized gain (loss) on investments, net of tax	5	(90)	(339)	601
Change in unrealized gain (loss) on foreign exchange contracts, net of tax	43	(205)	(19)	
Foreign currency translation	567	(122)	(88)	178
<b>Total comprehensive income (loss)</b>	<b>\$ 254</b>	<b>\$ 2,160</b>	<b>\$ 8,957</b>	<b>\$ (23,407)</b>

**NOTE 14: SEGMENT INFORMATION**

We operate our business in one reportable segment, which is the design, manufacture and sale of video infrastructure solutions, spanning content production to multi-screen video delivery. Harmonic's products enable customers to create, prepare and deliver video services over broadcast, cable, Internet, mobile, satellite and networks. 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 in deciding how to allocate resources and assessing performance. Our chief operating decision maker is our Chief Executive Officer. The acquisition of Omneon resulted in an additional product line, production and playout, but did not impact our reportable segments.

Our revenue by product type is summarized as follows:

*Revenue Information:*

(In thousands)	Three Months Ended		Nine Months Ended	
	October 1, 2010	October 2, 2009	October 1, 2010	October 2, 2009
Revenue by type:				
Video processing products	\$ 51,005	\$ 39,880	\$ 139,893	\$ 113,841
Production and playout	4,880		4,880	
Edge and access products	34,712	32,673	104,519	89,132
Service and support	14,187	11,308	35,857	29,936
<b>Total</b>	<b>\$ 104,784</b>	<b>\$ 83,861</b>	<b>\$ 285,149</b>	<b>\$ 232,909</b>

Our revenue by geographic region, based on the location at which each sale originates, and our property and equipment, net by geographic region is summarized as follows:

*Geographic Information:*

(In thousands)	Three Months Ended		Nine Months Ended	
	October 1, 2010	October 2, 2009	October 1, 2010	October 2, 2009
Net revenue:				
United States	\$ 54,538	\$ 40,282	\$146,387	\$ 118,932
International	50,246	43,579	138,762	113,977
Total	\$ 104,784	\$ 83,861	\$285,149	\$ 232,909
	October 1, 2010	October 2, 2009		
Property and equipment:				
United States	\$ 31,213	\$ 11,547		
International	7,539	7,776		
Total	\$ 38,752	\$ 19,323		

**Table of Contents**

*Major Customers.* For the three and nine months ended October 1, 2010, revenue to Comcast accounted for 26% and 19% of net revenue, respectively. For the three and nine months ended October 2, 2009, revenue to Comcast accounted for 15% and 17% of net revenue, respectively. As of October 1, 2010, Comcast accounted for 17% of net accounts receivable.

**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 records adjustments 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	
	October 1, 2010	October 2, 2009	October 1, 2010	October 2, 2009
Balance at beginning of the period	\$ 3,194	\$ 6,111	\$ 4,186	\$ 5,360
Omneon acquisition	959		959	
Scopus acquisition				2,379
Accrual for current period warranties	1,096	515	2,567	1,761
Warranty costs incurred	(1,267)	(1,300)	(3,730)	(4,174)
Balance at end of the period	<u>\$ 3,982</u>	<u>\$ 5,326</u>	<u>\$ 3,982</u>	<u>\$ 5,326</u>

*Standby Letters of Credit.* As of October 1, 2010, the Company's financial guarantees consisted of standby letters of credit outstanding, which were principally related to performance bonds and state requirements imposed on employers. The maximum amount of potential future payments under these arrangements was \$0.6 million.

*Indemnification.* 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 indemnification provisions through October 1, 2010.

*Guarantees.* As of October 1, 2010, Harmonic had no other guarantees outstanding.

**NOTE 16: LEGAL PROCEEDINGS**

On March 4, 2010 Interkey ELC Ltd, or Interkey, filed a lawsuit in Israel alleging breach of contract against Scopus Video Networks Ltd. (now Harmonic Video Networks Ltd. or HVN), which was acquired by Harmonic Inc. on March 12, 2009, and Harmonic Inc. (Harmonic). HVN responded by filing a motion to remove the proceedings to arbitration as required by the contract. This motion was granted on May 13, 2010. On May 24, 2010, Interkey filed a motion for the provision of an ex-parte judgment against Harmonic although Harmonic maintains that it was not properly served and therefore was not a party to the proceedings. On July 4, 2010, the court ruled against Harmonic and provided an ex-parte judgment in the amount of NIS 6,350,000, or approximately \$1.7 million. On July 14, 2010, Harmonic filed a motion to set aside the ex-parte judgment and delay execution of the judgment along with a Statement of Defense. On August 12, 2010, the ex-parte judgment was set aside. Harmonic believes Interkey's claims are without merit and Harmonic intends to vigorously defend itself against these claims. Based on the foregoing,



Harmonic has not recorded a provision for this claim.

On April 19, 2010, Arris Corporation filed a complaint in United States District Court in Atlanta, alleging that Harmonic's Streamliner 3000 product infringes four patents held by Arris. The complaint seeks injunctive relief and damages. Harmonic was served with the complaint on August 10, 2010. At this time, we cannot predict the outcome of this matter. An unfavorable outcome of this matter could adversely affect our business, operating results, financial position and cash flows.

**Table of Contents**

An unfavorable outcome on the above referenced or any other litigation matters could require that Harmonic pay substantial damages, or, in connection with any intellectual property infringement claims, could require that the Company pay ongoing royalty payments or could prevent the Company from selling certain of its products. As a result, a settlement or an unfavorable outcome on the above referenced or any other litigation matter could have a material adverse effect on Harmonic's business, operating results, financial position and cash flows.

Harmonic may be subject to claims that have arisen 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 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, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements related to:

- Our expectation that customer concentration will continue for the foreseeable future;
- Our expectation that international revenue will continue to account for a significant portion of our net revenue for the foreseeable future;
- Our belief that adverse economic conditions and tight credit markets may reduce capital spending by our customers, which could have a material and adverse affect on sales of our products;
- Our expectation that we will record a total of approximately \$5.6 million in amortization of intangibles in cost of revenue in the remaining three months of 2010;
- Our expectation that we will record a total of approximately \$2.9 million in amortization of intangibles in operating expenses in the remaining three months of 2010;
- Our expectation that our capital expenditures will be in the range of \$15 million to \$17 million during 2010, net of reimbursed building improvements from our landlord;
- Our belief that our existing liquidity sources, including our bank line of credit facility, will satisfy our requirements for at least the next twelve months;
- Our belief that near-term changes in exchange rates will not have a material impact on our operating results, financial position and liquidity;
- Our expectation that revenue from cable television, satellite and telecommunications operators will constitute a significant portion of net revenue for the foreseeable future;
- Our expectation that we will successfully achieve the anticipated benefits of the Omneon acquisition;
- Our expectation that we will make additional acquisitions in the future;
- Our expectation that our operations will be affected by new environmental laws and regulations on an ongoing basis;
- Our expectation that an increasing percentage of our consolidated, pre-tax income will be derived from and reinvested in our international operations and our expectations regarding the associated tax rates;

## **Table of Contents**

Our expectation 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 expectation that the acquisition of Omneon will strengthen Harmonic's competitive position in the digital media market and broaden our relationships with customers who produce and distribute digital video content, such as broadcasters, cable channels and other major owners of content, and that it will broaden Harmonic's technology and product lines with digital storage and play-out solutions which complement its existing video processing products; 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 a comprehensive, innovative and market-leading portfolio of video infrastructure solutions, spanning content production to multi-screen video delivery. Harmonic's products enable customers to efficiently create, prepare and deliver differentiated video services over broadcast, cable, Internet, mobile, satellite and networks, while simplifying end-to-end asset management, reducing costs and streamlining networks.

In the third quarter and first nine months of 2010, Harmonic's net revenue was \$104.8 million and \$285.1 million, respectively, representing increases of 25% and 22% compared to the third quarter and first nine months of 2009, respectively. The increase in revenue in the third quarter of 2010 compared to the corresponding period in 2009 was primarily due to increased demand from our international cable customers for products and solutions related to HDTV, VOD, modular cable modem termination system, or M-CMTS, switched digital video and video transmission applications. In addition, the acquisition of Omneon, Inc. in the third quarter of 2010 resulted in revenue of \$5.6 million primarily in the production and playout product line. Gross margins increased in the third quarter of 2010 compared to the corresponding period in 2009 due to higher revenue volumes in 2010 and a higher product mix of video processing products and service and support revenue which typically carry a higher gross margin than our average gross margins. The increase in revenue in the first nine months of 2010 compared to the corresponding period in 2009 was primarily due to increased demand from our domestic and international cable customers and our domestic satellite customers for products and solutions related to HDTV, VOD, M-CMTS, switched digital video and video transmission applications. Gross margins increased in the first nine months of 2010 compared to the corresponding period in 2009 due to higher revenue volumes in 2010 and reduced inventory provisions, which were partially offset by increased expenses for freight, royalties and warranties.

Historically, a majority of our net revenue has been derived from 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 and first nine months of 2010, revenue from Comcast accounted for 26% and 19% of net revenue, respectively. In the third quarter and first nine months of 2009, revenue from Comcast accounted for 15% and 17% of net revenue, respectively.

Revenue from customers outside of the U.S. in the third quarter and first nine months of 2010 represented 48% and 49% of net revenue, respectively, compared to 52% and 49%, respectively, for the comparable periods in 2009. A significant portion of international revenue is derived from 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. Net revenue denominated in foreign currencies was approximately 6% in the first nine months of 2010 compared to 7% for the comparable period of 2009. We expect international revenue to continue to account for a significant portion of our net revenue for the foreseeable future.

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 revenue levels, and expenses are relatively fixed in the short term. Accordingly, variations in timing of revenue can

cause significant fluctuations in operating results.

**Table of Contents**

Harmonic's expenses for any given quarter are typically based on expected revenue and if revenue is below expectations, our operating results may be adversely impacted by our inability to adjust spending to compensate for the shortfall. 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.

On September 15, 2010, Harmonic completed the acquisition of Omneon, Inc., a privately-held company organized under the laws of Delaware and headquartered in Sunnyvale, California. The purchase price, net of \$40.5 million of cash acquired, was \$251.3 million, which consisted of (i) approximately \$153.3 million in cash, net of cash acquired, (ii) 14.2 million shares of Harmonic common stock with a total fair value of approximately \$95.9 million, based on the price of Harmonic common stock at the time of close, and (iii) approximately \$2.1 million representing the fair value attributed to shares of Omneon equity awards which Harmonic assumed for which services had already been rendered as of the close of the acquisition. The cash portion of the purchase price was paid from existing cash balances and is subject to a post-closing adjustment based on Omneon's working capital. Substantially all unvested stock options and vested restricted stock units issued by Omneon and outstanding at closing were assumed by Harmonic. Omneon develops and supports a range of video servers, active storage systems and related software applications that media companies use to simultaneously ingest, process, store, manage and deliver digital media in a wide range of formats. Omneon's products include Spectrum video servers, MediaGrid active storage systems and MediaTool software applications which were initially designed for, and have been deployed mostly by, broadcasters that use their products for the transmission of television content. The acquisition of Omneon is intended to strengthen Harmonic's competitive position in the digital media market and to broaden our relationships with customers who produce and distribute digital video content, such as broadcasters, cable channels and other major owners of content. The acquisition is also intended to broaden Harmonic's technology and product lines with digital storage and play-out solutions which complement our existing video processing products. The results of operations of Omneon are included in Harmonic's Consolidated Statements of Operations from the closing date of the acquisition, which was September 15, 2010. Revenue from Omneon's products are primarily reported within the production and playout product line.

On March 12, 2009, Harmonic completed the acquisition of Scopus Video Networks Ltd., or Scopus, a publicly traded company based in Israel. The purchase price, net of \$23.3 million of cash acquired, was \$63.1 million, which was paid from Harmonic's existing cash balances. Scopus engaged in the development and support of digital video networking products that allow network operators to transmit, process, and manage digital video content. Scopus' primary products included integrated receivers/decoders (IRD), intelligent video gateways (IVG), and encoders. In addition, Scopus marketed multiplexers, network management systems (NMS), and other ancillary technology to its customers. The acquisition of Scopus strengthened Harmonic's technology and market leadership, particularly in the broadcast contribution and distribution markets. The acquisition extended Harmonic's diversification strategy, providing it with an expanded international sales force and global customer base, particularly in video broadcast, contribution and distribution markets, as well as complementary video processing technology and expanded research and development capability. Results of operations for the Scopus acquisition are reflected in the accompanying Harmonic financial data from the closing date of the acquisition, which was March 12, 2009. Revenue from Scopus products are primarily reported within the video processing product line.

We are in the process of expanding our international operations and staff to better support our expansion into international markets. This expansion includes the implementation of an international structure that includes, among other things, an international support center in Europe, a research and development cost-sharing arrangement, certain licenses and other contractual arrangements by and among the Company and its wholly-owned domestic and foreign subsidiaries. Our foreign subsidiaries have acquired certain rights to sell our existing intellectual property and intellectual property that will be developed or licensed in the future. As a result of these changes and an expanding customer base internationally, we expect that an increasing percentage of our consolidated pre-tax income will be derived from, and reinvested in, our international operations. We anticipate that this pre-tax income will be subject to foreign tax at relatively lower tax rates when compared to the United States federal statutory tax rate in future periods. However, the current presidential administration has begun to put forward proposals that may, if enacted, limit the

ability of U.S. companies to continue to defer U.S. income taxes on foreign earnings.

**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.

**Table of Contents**

Our significant accounting policies are described in Note 1 to the annual consolidated financial statements as of and for the year ended December 31, 2009, included in our Annual Report on Form 10-K filed with the SEC on March 1, 2010 and the notes to the condensed consolidated financial statements as of and for the three and nine month periods ended October 1, 2010, included herein. Our most critical accounting policies have not changed since December 31, 2009 and include the following:

- Revenue recognition;
- Allowances for doubtful accounts, returns and discounts;
- Valuation of inventories;
- Impairment of goodwill or long-lived assets;
- Restructuring costs and accruals for excess facilities;
- Assessment of the probability of the outcome of litigation;
- Accounting for income taxes, and
- Stock-based compensation.

**Results of Operations**

Harmonic's historical condensed consolidated statements of operations data for the third quarter and first nine months of 2010 compared with the corresponding periods in 2009 as a percentage of net revenue, are as follows:

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>
Product revenue	86%	87%	87%	87%
Service revenue	14	13	13	13
	<hr/>	<hr/>	<hr/>	<hr/>
Net revenue	100	100	100	100
Product cost of revenue	51	53	49	54
Service cost of revenue	4	4	4	5
	<hr/>	<hr/>	<hr/>	<hr/>
Cost of revenue	55	57	53	59
	<hr/>	<hr/>	<hr/>	<hr/>
Gross profit	45	43	47	41
Operating expenses:				
Research and development	18	19	18	20
Selling, general and administrative	25	23	25	27
Amortization of intangibles	1	2	1	1
	<hr/>	<hr/>	<hr/>	<hr/>
Total operating expenses	44	44	44	48
	<hr/>	<hr/>	<hr/>	<hr/>

Edgar Filing: HARMONIC INC - Form 10-Q

Income (loss) from operations	1	(1)	3	(7)
Interest income, net		1		1
Other expense, net	—	—	—	—
Income (loss) before income taxes	1		3	(6)
Provision for (benefit from) income taxes	(1)	(3)		4
Net income (loss)	<u>          </u> %	<u>          </u> (3)%	<u>          </u> 3%	<u>          </u> (10)%



**Table of Contents***Net Revenue Consolidated*

Harmonic's consolidated net revenue in the third quarter and first nine months of 2010 compared with the corresponding periods in 2009 are presented in the table below. Also presented are the related dollar and percentage change in consolidated net revenue in the third quarter and first nine months of 2010 compared with the corresponding periods in 2009.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>
<b>Revenue Data:</b>				
Video Processing	\$ 51,005	\$ 39,880	\$ 139,893	\$ 113,841
Production and Payout	4,880		4,880	
Edge and Access	34,712	32,673	104,519	89,132
Service and Support	14,187	11,308	35,857	29,936
Net revenue	\$ 104,784	\$ 83,861	\$ 285,149	\$ 232,909
Video Processing increase	\$ 11,125		\$ 26,052	
Production and Payout	4,880		4,880	
Edge and Access increase	2,039		15,387	
Service and Support increase	2,879		5,921	
Total increase	\$ 20,923		\$ 52,240	
Video Processing percent change	27.9%		22.9%	
Production and Payout	%		%	
Edge and Access percent change	6.2%		17.3%	
Service and Support percent change	25.5%		19.8%	
Total percent change	24.9%		22.4%	

Net revenue increased in the third quarter of 2010 compared to the same period of 2009 principally due to increased demand from our domestic and international cable customers, an improved economic environment worldwide and from revenue generated from products acquired in the Omneon acquisition. Revenue from video processing products was higher in the third quarter of 2010 compared to the same period in the prior year primarily due to increased revenue from broadcast encoders, which are used in HDTV and switched digital video applications. The Company also had revenue of \$4.9 million in the production and payout product line resulting from the acquisition of Omneon in the third quarter of 2010. The increase in revenue in the edge and access products line in the third quarter of 2010 compared to the same period in 2009 was primarily due to an increase in revenue derived from domestic and international cable operators relating to the sale of edge products, which are used for video transmission applications. The increase in revenue from service and support in the third quarter of 2010 compared to the same period in 2009 was primarily from increased support revenue as a result of an expanded customer base and service revenue from the completion of several customer projects.

Net revenue increased in the first nine months of 2010 compared to the same period of 2009 principally due to increased demand from our domestic and international cable customers and our domestic satellite customers, as well as an improved economic environment worldwide and from revenue generated from products acquired in the Omneon acquisition. Revenue from video processing products was higher in the first nine months of 2010 compared to the same period in the prior year primarily due to increased revenue from broadcast encoders and stream processing

products, which are used in HDTV, switched digital video and VOD applications and increased revenue from video contribution and distribution products. The Company also had revenue of \$4.9 million in the production and playout product line resulting from the acquisition of Omneon in the third quarter of 2010. The increase in revenue from the edge and access products line in the first nine months of 2010 compared to the same period in 2009 was primarily due to an increase in revenue derived from domestic and international cable operators relating to the sale of edge and access products, which are used for M-CMTS, switched digital video and video transmission applications. The increase in revenue from service and support in the first nine months of 2010 compared to the same period in 2009 was primarily from increased support revenue as a result of an expanded customer base.

**Table of Contents***Net Revenue Geographic*

Harmonic's domestic and international net revenue in the third quarter and first nine months of 2010 compared with the corresponding periods in 2009 are presented in the table below. Also presented are the related dollar and percentage change in domestic and international net revenue in the third quarter and first nine months of 2010 compared with the corresponding periods in 2009.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>
<b>Geographic Revenue Data:</b>				
U.S.	\$ 54,538	\$ 40,282	\$ 146,387	\$ 118,932
International	50,246	43,579	138,762	113,977
Net revenue	\$ 104,784	\$ 83,861	\$ 285,149	\$ 232,909
U.S. increase	\$ 14,256		\$ 27,455	
International increase	6,667		24,785	
Total increase	\$ 20,923		\$ 52,240	
U.S. percent change	35.4%		23.1%	
International percent change	15.3%		21.7%	
Total percent change	24.9%		22.4%	

The increase in U.S. revenue in the third quarter of 2010 compared to the corresponding period in 2009 was principally due to increased demand from our domestic cable customers for video processing encoder products used in HDTV applications, from revenue generated from products acquired in the Omneon acquisition and increased support revenue. The increased U.S. revenue in the first nine months of 2010 compared to the corresponding period in 2009 was principally due to increased demand from our domestic cable and satellite customers for video processing encoder and stream processing products, which are used in HDTV applications; edge and access products, which are used in M-CMTS, switched digital video and video transmission applications; and increased service and support revenue. The increase in international revenue in the third quarter of 2010 compared to the corresponding period in 2009 was primarily due to increased demand from our international cable customers for encoder products used in HDTV applications; edge and access products, which are used in M-CMTS, switched digital video and video transmission applications; and increased support revenue. International revenue in the first nine months of 2010 increased compared to the corresponding period in 2009 primarily due to increased demand from our international cable customers for encoder, stream processing and network management products, which are used in HDTV and VOD video processing applications; video contribution and distribution products, which were products obtained from the Scopus acquisition in March 2009; edge and access products, which are used in M-CMTS, switched digital video and video transmission applications; and increased support revenue. International revenue increased in the third quarter and the first nine months of 2010 compared to the corresponding periods in 2009 primarily in the European, Middle East and Canadian markets. We expect that international revenue will continue to account for a significant portion of our net revenue for the foreseeable future.

*Gross Profit*

Harmonic's gross profit and gross profit as a percentage of consolidated net revenue in the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009 are presented in the table below. Also presented are the related dollar and percentage change in gross profit in the third quarter and first nine months of 2010 as

compared with the corresponding periods in 2009.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>
Gross profit	\$47,532	\$ 36,080	\$134,019	\$ 95,011
As a % of net revenue	45.4%	43.0%	47.0%	40.8%
Increase	\$11,452		\$ 39,008	
Percent change	31.7%		41.1%	

27

**Table of Contents**

The increase in gross profit in the third quarter of 2010 as compared to the corresponding period in 2009 was primarily due to higher revenue in 2010 and a decrease in manufacturing overhead costs due to outsourcing of specific product lines to contract manufacturers, which was partially offset by increased expense from the acquisition of Omneon in the third quarter of 2010 and increased warranty provisions of \$0.8 million. The gross margin percentage of 45.4% in the third quarter of 2010 compared to 43.0% in the third quarter of 2009 was higher primarily due to favorable factory absorption (lower per unit cost) resulting from higher revenue volumes and a higher product mix of video processing products and service and support revenue which typically carry a higher gross margin than our average gross margins.

The increase in gross profit in the first nine months of 2010 as compared to the corresponding period in 2009 was primarily due to higher revenue in 2010, a decrease in provisions for excess and obsolete inventories and a decrease in manufacturing overhead costs due to outsourcing of specific product lines to contract manufacturers, which was partially offset by higher provisions for service inventory and demo inventory, increased freight expense, increased warranty expense, increased royalty expense and increased expense from the acquisition of Omneon in the third quarter of 2010. The decrease in the provisions for excess and obsolete inventories in the first nine months of 2010 compared to the corresponding period in 2009 was primarily due to provisions of \$5.8 million recorded in the first nine months of 2009 for excess and obsolete inventories associated with the discontinuance of certain Scopus products. The gross margin percentage of 47.0% in the first nine months of 2010 compared to 40.8% in the first nine months of 2009 was higher primarily due to higher margins in the video processing and service and support product lines, and lower provisions for excess and obsolete inventories, which were partially offset by higher provisions for service inventory and demo inventory, increased freight expense, increased warranty expense, increased royalty expense and increased expense from the acquisition of Omneon in the third quarter of 2010.

In the first nine months of 2010, \$6.9 million of amortization of intangibles was included in cost of revenue compared to \$5.9 million in the first nine months of 2009. The higher amortization of intangible expense in the first nine months of 2010 was due to the amortization of intangibles arising from the Scopus acquisition which was completed in March 2009 and the Omneon acquisition which was completed in September 2010. We expect to record approximately \$5.6 million in amortization of intangibles expenses in cost of revenue in the remaining three months of 2010 related to intangible assets acquired in connection with the acquisitions of Omneon, Inc. ( Omneon ), Entone Technologies, Inc. ( Entone ), Rhonet Corporation ( Rhonet ) and Scopus Video Networks Ltd. ( Scopus ).

*Research and Development*

Harmonic's research and development expense and the expense as a percentage of consolidated net revenue in the third quarter and first nine months of 2010, as compared with the corresponding periods of 2009, are presented in the table below. Also presented are the related dollar and percentage change in research and development expense in the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>
Research and development expense	\$ 19,002	\$ 15,879	\$ 52,946	\$ 45,825
As a % of net revenue	18.1%	18.9%	18.6%	19.7%
Increase	\$ 3,123		\$ 7,121	
Percent change	19.7%		15.5%	

The increase in research and development expense in the third quarter of 2010 compared to the corresponding period in 2009 was primarily the result of increased compensation expense of \$1.4 million, increased facilities expense of \$0.9 million, increased consulting services of \$0.4 million, increased stock-based compensation expense of \$0.2 million and a decrease in expense reimbursements from foreign government sponsored research of \$0.2 million. The increased compensation expense was primarily due to increased headcount related to the Omneon acquisition, as

well as additional hiring of employees engaged in engineering activities. The increased facilities expense was primarily due to an increase in additional facilities, such as building leases and overhead, assumed in connection with the Omneon acquisition.

The increase in research and development expense in the first nine months of 2010 compared to the corresponding period in 2009 was primarily the result of increased compensation expense of \$2.5 million, increased facilities expense of \$2.1 million, increased stock-based compensation expense of \$0.7 million, increased outside engineering services of \$0.5 million, a decrease in expense

**Table of Contents**

reimbursements from foreign government sponsored research of \$0.5 million, increased consulting services of \$0.4 million and increased depreciation of \$0.4 million. The increased compensation expense was primarily due to increased headcount related to the Scopus and Omneon acquisitions as well as additional hiring of employees engaged in engineering activities. The increased facilities expense was primarily due to an increase in additional facilities, such as building leases and overhead, assumed in connection with the Scopus and Omneon acquisitions.

*Selling, General and Administrative*

Harmonic's selling, general and administrative expense and the expense as a percentage of consolidated net revenue in the third quarter and first nine months of 2010, as compared with the corresponding periods of 2009, are presented in the table below. Also presented are the related dollar and percentage change in selling, general and administrative expense in the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>
Selling, general and administrative expense	\$25,999	\$19,405	\$70,917	\$61,431
As a % of net revenue	24.8%	23.1%	24.9%	26.4%
Increase	\$ 6,594		\$ 9,486	
Percent change	34.0%		15.4%	

The increase in selling, general and administrative expense in the third quarter of 2010 compared to the corresponding period in 2009 was primarily a result of higher acquisition-related expenses of \$3.4 million associated with the acquisition of Omneon, increased compensation expense of \$2.4 million, increased stock-based compensation of \$0.5 million and increased facilities expense of \$0.5 million. The increased facilities expense was primarily due to additional facilities costs assumed in connection with the Omneon acquisition. The increased compensation expense was primarily due to higher commission expense resulting from increased net revenue in 2010, increased incentive compensation and increased headcount related to the Omneon acquisition.

The increase in selling, general and administrative expense in the first nine months of 2010 compared to the corresponding period in 2009 was primarily a result of increased compensation expense of \$3.8 million, higher acquisition-related expenses of \$2.7 million associated with the acquisition of Omneon, increased stock-based compensation expense of \$1.4 million, increased facilities expense of \$0.9 million and increased travel and entertainment expenses of \$0.6 million. The increased compensation expense was primarily due to increased headcount related to the Scopus and Omneon acquisitions, increased commission expense resulting from increased net revenue in 2010, higher incentive compensation expense and expenses associated with the retirement of the Company's former chief financial officer. The increased facilities expense was primarily due to the additional facilities costs assumed in connection with the Scopus and Omneon acquisitions.

*Amortization of Intangibles*

Harmonic's amortization of intangible assets and the expense as a percentage of consolidated net revenue in the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009 are presented in the table below. Also presented are the related dollar and percentage change in amortization of intangible assets in the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>

Edgar Filing: HARMONIC INC - Form 10-Q

Amortization of intangible assets expense	\$ 959	\$ 1,367	\$ 2,026	\$ 3,289
As a % of net revenue	0.9%	1.6%	0.7%	1.4%
Decrease	\$ (408)		\$ (1,263)	
Percent change	(29.8)%		(38.4)%	

The decrease in the amortization of intangibles expense in the third quarter and first nine months of 2010 compared to the corresponding periods in 2009 was primarily due to reduced amortization of intangible assets in the third quarter and first nine months of 2010 related to the acquisition of Scopus. Harmonic expects to record a total of approximately \$2.9 million in amortization of intangibles expense in operating expenses in the remaining three months of 2010 due to the amortization of intangible assets resulting from the acquisitions of Omneon, Entone, Rhozet and Scopus.



**Table of Contents***Interest Income, Net*

Harmonic's interest income, net, and interest income, net, as a percentage of consolidated net revenue in the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009, are presented in the table below. Also presented are the related dollar and percentage change in interest income, net, in the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>
Interest income, net	\$ 165	\$ 583	\$ 974	\$ 2,764
As a % of net revenue	0.2%	0.7%	0.3%	1.2%
Decrease	\$ (418)		\$ (1,790)	
Percent change	(71.7)%		(64.8)%	

The decrease in interest income, net, in the third quarter and first nine months of 2010 compared to the corresponding periods of 2009 was due primarily to the lower interest rates earned on Harmonic's cash, cash equivalents and short-term investment portfolio balances and a lower investment portfolio balance during the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009.

*Other Expense, Net*

Harmonic's other expense, net, and other expense, net, as a percentage of consolidated net revenue in the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009, are presented in the table below. Also presented are the related dollar and percentage change in other expense, net, in the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009.

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>
Other expense, net	\$ (405)	\$ (212)	\$ (903)	\$ (893)
As a % of net revenue	(0.4)%	(0.3)%	(0.3)%	(0.4)%
Increase	\$ 193		\$ 10	
Percent change	91.0%		1.1%	

The increase in other expense, net, in the third quarter and the first nine months of 2010 compared to the corresponding periods of 2009 was primarily due to higher foreign exchange losses.

*Income Taxes*

Harmonic's provision for (benefit from) income taxes in the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009, are presented in the table below. Also presented are the income (loss) before income taxes and the related dollar and percentage change in income taxes in the third quarter and first nine months of 2010 as compared with the corresponding periods of 2009.

<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
<b>October 1, 2010</b>	<b>October 2, 2009</b>	<b>October 1, 2010</b>	<b>October 2, 2009</b>

Edgar Filing: HARMONIC INC - Form 10-Q

Income (loss) before income taxes	\$1,332	\$ (200)	\$ 8,201	\$ 13,663
Provision for (benefit from) income taxes	\$1,693	\$ (2,777)	\$ (1,202)	\$ 10,523
Increase (decrease) in provision for (benefit from) income taxes	\$4,470		\$(11,725)	
Percent change	161.0%		(111.4)%	

---

30

**Table of Contents**

The increase in the provision for income taxes in the third quarter of 2010 compared to the same period in 2009 was primarily attributable to translation adjustments and accrued interest on uncertain tax positions and a reallocation of expenses between legal entities.

The decrease in the provision for income taxes in the first nine months of 2010 compared to the same period in 2009 was primarily attributable to a benefit from the reversal of foreign taxes previously accrued as uncertain tax benefits due to an expiration of the statute of limitations, translation adjustments and accrued interest on uncertain tax positions, a reduction in the valuation allowance on the California deferred tax assets due to an increase in the estimated amount of income that will be apportioned to California based on anticipated changes in the geographic mix of sales and a reallocation of expenses between legal entities.

On February 20, 2009, California enacted legislation, which among other things, provides for the election of a single factor apportionment formula beginning in 2011. As a result of our anticipated election of the single sales factor, we are required under applicable accounting guidance on accounting for income taxes to compute our deferred taxes at the end of any reporting period taking into account the reversal pattern and the expected California tax rate under the elective single sales factor. In the first quarter of 2009, the impact of the new legislation resulted in a change to the state effective tax rate used to compute the Company's California deferred tax assets resulting in a corresponding reduction to the amount of previously recorded California deferred tax assets. At the end of each quarter, the Company will review the estimated amount of income to be apportioned to California under the single factor formula. Any future changes to the estimate may result in an adjustment to the amount of the California deferred tax assets to be recorded.

**Liquidity and Capital Resources**

(In thousands)	<b>Nine months Ended</b>	
	<b>October 1, 2010</b>	<b>October 2, 2009</b>
Net cash provided by (used in) operating activities	\$ 1,212	\$ (9,771)
Net cash used in investing activities	\$(105,828)	\$ (24,591)
Net cash provided by financing activities	\$ 22,751	\$ 4,239

As of October 1, 2010, cash, cash equivalents and short-term investments totaled \$110.1 million, compared to \$271.1 million as of December 31, 2009. Cash provided by operations in the first nine months of 2010 was \$1.2 million, resulting from net income of \$9.4 million, adjusted for \$27.1 million in non-cash charges, and a \$35.3 million net use of cash relating to the changes in assets and liabilities. The significant non-cash charges included stock-based compensation, amortization of intangible assets and depreciation. The net change in assets and liabilities included an increase in inventories primarily due to an increase in service and demo inventories, an increase in accounts receivable due to higher shipments in the first nine months of 2010, a decrease in accrued liabilities primarily from the payment of incentive compensation and lower accrued excess facilities costs.

To the extent that non-cash items impact our future operating results, there will be no corresponding impact on our cash flows. After excluding the effects of these non-cash charges, the primary changes in cash flows relating to operating activities resulted from changes in working capital. Our primary source of operating cash flows is the collection of accounts receivable from our customers. Our operating cash flows are also impacted by the timing of payments to our vendors for accounts payable and other liabilities. We generally pay our vendors and service providers in accordance with the invoice terms and conditions. In addition, we usually pay our annual incentive compensation to employees in the first quarter.

Net cash used in investing activities was \$105.8 million for the nine months ended October 1, 2010, compared to net cash used in investing activities of \$24.6 million in the corresponding period in 2009. The increase in net cash used in the first nine months of 2010 was primarily due to the acquisition of Omneon in the third quarter of 2010 which used \$153.3 million of cash and the acquisition of property and equipment of \$29.8 million primarily for leasehold improvements to our new corporate headquarters, which was partially offset by net cash provided by the maturing of

investments which exceeded additional purchases of such investments during the period. Cash used for investing activities for the first nine months of 2009 was primarily due to our acquisition of Scopus. Harmonic currently expects capital expenditures to be in the range of \$15 million to \$17 million during 2010, net of reimbursed building improvements from our landlord.

Net cash provided by financing activities was \$22.8 million for the nine months ended October 1, 2010, compared to \$4.2 million in the corresponding period in 2009. The increase over 2009 was primarily due to proceeds relating to lessor financing of building construction for our new headquarters of \$18.8 million.

**Table of Contents**

Harmonic has a bank line of credit facility with Silicon Valley Bank, which provides for borrowings of up to \$10.0 million that matures on March 2, 2011. As of October 1, 2010, other than standby letters of credit and guarantees (Note 15), there were no amounts outstanding under the line of credit facility and there were no borrowings in 2009 or 2010. This facility, which was amended and restated in March 2010, contains a financial covenant with the requirement for Harmonic to maintain unrestricted cash, cash equivalents and short-term investments, net of credit extensions, of not less than \$35.0 million. If Harmonic were unable to maintain this cash, cash equivalents and short-term investments balance, Harmonic would not be in compliance 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. At October 1, 2010, Harmonic was in compliance with the covenants under this line of credit facility. Future borrowings pursuant to the line would bear interest at the bank's prime rate (4.0% at October 1, 2010). Borrowings are payable monthly and are not collateralized.

The use of approximately \$153 million, net of approximately \$40 million of cash acquired, upon closing of the Omneon acquisition significantly reduced our cash balances. Nevertheless, we believe that our existing liquidity sources will satisfy our cash requirements for at least the next twelve months. However, if our expectations are incorrect, we may need to raise additional funds to fund our operations, to take advantage of unanticipated strategic opportunities or to strengthen our financial position.

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 additional shares of our stock which would 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 the global economic slowdown, market uncertainty surrounding the ongoing U.S. war on terrorism, as well as conditions in financial 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.

**Off-Balance Sheet Arrangements**

None as of October 1, 2010.

**Contractual Obligations and Commitments**

Future payments under contractual obligations, and other commercial commitments, as of October 1, 2010 were as follows:

	<b>Payments Due by Period</b>				
	<b>Total Amounts Committed</b>	<b>1 year or less</b>	<b>2-3 years (In thousands)</b>	<b>4-5 years</b>	<b>Over 5 years</b>
Operating Leases	\$40,028	\$ 3,695	\$ 8,442	\$8,577	\$ 19,314
Inventory Purchase Commitment	24,030	24,030			
<b>Total Contractual Obligations</b>	<b>\$64,058</b>	<b>\$ 27,725</b>	<b>\$ 8,442</b>	<b>\$8,577</b>	<b>\$ 19,314</b>

**Other Commercial Commitments:**

Standby Letters of Credit Indemnification obligations <sup>(1)</sup>	\$ 563	\$ 563	\$	\$	\$
	_____	_____	_____	_____	_____
Total Commercial Commitments	\$ 563	\$ 563	\$	\$	\$
	_____	_____	_____	_____	_____

1. Harmonic indemnifies 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 and other vendors, such as building contractors, pursuant to certain parameters and restrictions. The scope of these indemnities varies, but in some instances, includes indemnification for damages and expenses (including reasonable attorney's fees). There have been no claims for indemnification and, accordingly, no amounts have been accrued in respect of the indemnification provisions at October 1, 2010.

### **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.

**Table of Contents***Foreign Currency Exchange Risk*

Harmonic has a number of international customers each of whose sales are generally denominated in U.S. dollars. Sales denominated in foreign currencies were approximately 6% and 7% of net revenue in the first nine months of 2010 and 2009, respectively. In addition, the Company has various international offices that provide sales support, engineering and systems integration services. Periodically, Harmonic enters into foreign currency exchange contracts and options to manage exposure related to accounts receivable and expenses denominated in foreign currencies. Harmonic does not enter into derivative financial instruments for trading purposes. At October 1, 2010, we had forward contracts to sell Euros totaling \$3.9 million that mature during the fourth quarter of 2010. In addition, we had forward exchange contracts to sell Israeli Shekels totaling \$0.4 million maturing during the fourth quarter of 2010. 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 provide any assurance that a sudden and significant change in the value of foreign currencies would not harm the Company's operating results, financial position and liquidity.

*Interest Rate Risk*

Exposure to market risk for changes in interest rates relates 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. 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. As of October 1, 2010, our cash, cash equivalents and investments balance was \$110.1 million. Based on our estimates, a 100 basis points, or 1%, change in interest rates would have increased or decreased the fair value of our investments by approximately \$0.2 million.

**ITEM 4. CONTROLS AND PROCEDURES***Evaluation of disclosure controls and procedures.*

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation 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 were effective at a reasonable assurance level.

*Changes in internal controls.*

On March 12, 2009, we acquired Scopus and, as a result, we have begun integrating the processes, systems and controls relating to Scopus into our existing system of internal control over financial reporting in accordance with our integration plans. Also, on September 15, 2010, we acquired Omneon and, as a result, we have begun integrating the processes, systems and controls relating to Omneon into our existing system of internal control over financial reporting in accordance with our integration plans. In addition, various transitional controls designed to supplement existing internal controls have been implemented with respect to the acquired processes and systems. Except for the processes, systems and controls relating to the integration of Scopus and Omneon, there have not been any changes in

the Company's internal control over financial reporting during the nine months ended October 1, 2010 that have materially affected, or are reasonably likely to materially affect, its internal control over financial reporting.



**Table of Contents**

**PART II**

**OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

On March 4, 2010 Interkey ELC Ltd, or Interkey, filed a lawsuit in Israel alleging breach of contract against Scopus Video Networks Ltd. (now Harmonic Video Networks Ltd. or HVN ), which was acquired by Harmonic Inc. on March 12, 2009, and Harmonic Inc. ( Harmonic ). HVN responded by filing a motion to remove the proceedings to arbitration as required by the contract. This motion was granted on May 13, 2010. On May 24, 2010, Interkey filed a motion for the provision of an ex-parte judgment against Harmonic although Harmonic maintains that it was not properly served and therefore was not a party to the proceedings. On July 4, 2010, the court ruled against Harmonic and provided an ex-parte judgment in the amount of NIS 6,350,000, or approximately \$1.7 million. On July 14, 2010, Harmonic filed a motion to set aside the ex-parte judgment and delay execution of the judgment along with a Statement of Defense. On August 12, 2010, the ex-parte judgment was set aside. Harmonic believes Interkey's claims are without merit and Harmonic intends to vigorously defend itself against these claims. Based on the foregoing, Harmonic has not recorded a provision for this claim.

On April 19, 2010, Arris Corporation filed a complaint in United States District Court in Atlanta, alleging that Harmonic's Streamliner 3000 product infringes four patents held by Arris. The complaint seeks injunctive relief and damages. Harmonic was served with the complaint on August 10, 2010. At this time, we cannot predict the outcome of this matter. An unfavorable outcome of this matter could adversely affect our business, operating results, financial position and cash flows.

Harmonic 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 and 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 operating results, financial condition and cash flows.*

A significant portion of our revenue has been derived from sales to cable television, satellite and telecommunications operators, and we expect this revenue to constitute a significant portion of net revenue for the foreseeable future.

Demand for our products will depend on the magnitude and timing of capital spending by cable television operators, satellite operators, telecommunications 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;

the status of federal, local and foreign government regulation of telecommunications and television broadcasting;

overall demand for communication services and consumer acceptance of new video and data services;

evolving industry standards and network architectures;

competitive pressures, including pricing pressures;

discretionary customer spending patterns; and

general economic conditions.

In the past, specific factors contributing to reduced capital spending have included:

uncertainty related to development of digital video industry standards;

34

---

**Table of Contents**

delays associated with the evaluation of new services, new standards and system architectures by many operators;

emphasis on generating revenue from existing customers by operators instead of new construction or network upgrades;

a reduction in the amount of capital available to finance projects of our customers and potential customers;

proposed and completed business combinations and divestitures by our customers and regulatory review thereof;

weak or uncertain economic and financial conditions in domestic and international markets; and

bankruptcies and financial restructuring of major customers.

The financial difficulties of certain of our customers and changes in our customers' deployment plans adversely affected our business in the past. Recently, economic conditions in the countries in which we operate and sell products have been very weak, and global economic conditions and financial markets have experienced a severe downturn stemming from a multitude of factors, including adverse credit conditions, slower economic activity, concerns about inflation and deflation, rapid changes in foreign exchange rates, increased energy costs, decreased consumer confidence, reduced corporate profits and capital spending, adverse business conditions and liquidity concerns and other factors. Economic growth in the U.S. and in many other countries has slowed significantly or receded in recent years, and economic growth may remain sluggish during 2010, although there has been an increase in economic activity recently. The severity or length of time that these adverse economic and financial market conditions may persist is unknown. During challenging economic times, and in tight credit markets, many customers may delay or reduce capital expenditures, which in turn often results in lower demand for our products.

Further, we have a number of customers internationally to whom sales are denominated in U.S. dollars. Over the past two years, the value of the U.S. dollar has fluctuated significantly against many foreign currencies, which includes the local currencies of many of our international customers. If the U.S. dollar appreciates relative to the local currencies of our customers, then the price of our products correspondingly increases for such customers. These factors could result in reductions in sales of our products, longer sales cycles, difficulties in collection of accounts receivable, slower adoption of new technologies and increased price competition. If the U.S. dollar would weaken against many major currencies, there can be no assurance that a weaker dollar would lead to growth in our revenue. Financial difficulties among our customers could adversely affect our operating results and financial condition.

In addition, industry consolidation has in the past constrained, and may in the future constrain capital spending among our customers. As a result, we cannot assure you that we will maintain or increase our net revenue in the future. Also, if our product portfolio and product development plans do not position us well to capture an increased portion of the capital spending of U.S. cable operators and other major customers, our revenue may decline and our operating results would be adversely affected.

***Our customer base is concentrated and the loss of one or more of our key customers, or a failure to diversify our customer base, could harm our business.***

Historically, a majority of our revenue has been derived from 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 in the foreseeable future. Revenue derived from our ten largest customers in the first nine months of 2010 and the fiscal years 2009 and 2008 accounted for approximately 47%, 47% and 58% of net revenue, respectively. Although we are attempting to broaden our customer base by penetrating new markets, such as the telecommunications and broadcast markets, and to further expand internationally, we expect to see continuing industry consolidation and customer concentration due in part to the significant capital costs of constructing broadband networks. For example, Comcast acquired AT&T Broadband in 2002, thereby creating the largest U.S. cable operator, reaching approximately 24 million subscribers. The sale of Adelphia Communications' cable systems to Comcast and Time Warner Cable has led to further industry consolidation. NTL and Telewest, the two largest cable operators in the UK, completed their merger in 2006. In the DBS market, The News Corporation Ltd. acquired an indirect controlling interest in Hughes Electronics, the parent company of DIRECTV, in 2003, and News Corporation

subsequently sold its interest in DIRECTV to Liberty Media in February 2008. In the telco market, AT&T completed its acquisition of Bell South in December 2006.

In the first nine months of 2010, revenue from Comcast accounted for 19% of our net revenue. In fiscal year 2009, revenue from Comcast accounted for 17% of our net revenue. The loss of Comcast or any other significant customer or any reduction in orders by

**Table of Contents**

Comcast or any significant customer, or our failure to qualify our products with a significant customer could adversely affect our business, operating results and liquidity. The loss of, or any reduction in orders from, a significant customer would harm our business if we were not able to offset any such loss or reduction with increased orders from other customers.

In addition, historically, we have been dependent upon capital spending in the cable and satellite industry. We are attempting to diversify our customer base beyond cable and satellite customers, including the telco and the production and transmission of television content markets. Several major telcos have rebuilt or are upgrading their networks to offer bundled video, voice and data services. In order to be successful in this market, we may need to continue to build alliances with telco equipment manufacturers, adapt our products for telco applications, take orders at prices resulting in lower margins, and build internal expertise to handle the particular contractual and technical demands of the telco industry. In addition, telco video deployments, including recent trials of mobile video services, are subject to delays in completion, as video processing technologies and video business models are relatively new to most telcos and many of their largest suppliers. Implementation issues with our products or those of other vendors have caused, and may continue to cause, delays in project completion for our customers and delay the recognition of revenue by Harmonic. Further, during challenging economic times, and in tight credit markets, many customers, including telcos, may delay or reduce capital expenditures. This could result in reductions in sales of our products, longer sales cycles, difficulties in collection of accounts receivable, slower adoption of new technologies and increased price competition. As a result of these and other factors, we cannot assure you that we will be able to increase our revenues from telco customers and other markets, or that we can do so profitably, and any failure to increase revenues and profits from these customers could adversely affect our business.

***Our operating results are likely to fluctuate significantly and may fail to meet or exceed the expectations of securities analysts or investors, causing our stock price to decline.***

Our operating results have fluctuated in the past and are likely to continue to fluctuate in the future, on an annual and a quarterly basis, as a result of several factors, many of which are outside of our control. Some of the factors that may cause these fluctuations include:

- the level and timing of capital spending of our customers, both in the U.S. and in foreign markets;

- access to financing, including credit, for capital spending by our customers;

- economic and financial conditions specific to the cable, satellite and telco industries;

- changes in market demand;

- the timing and amount of orders, especially from significant customers;

- the timing of revenue recognition from solution contracts, which may span several quarters;

- the timing of revenue recognition on sales arrangements, which may include multiple deliverables;

- the timing of acquisitions and the financial impact of such acquisitions;

- the timing of completion of projects;

- competitive market conditions, including pricing actions by our competitors;

- seasonality, with fewer construction and upgrade projects typically occurring in winter months and otherwise being affected by inclement weather;

- our unpredictable sales cycles;

the level and mix of international revenue;

the amount and timing of revenue derived from telcos, which is particularly difficult to predict;

new product introductions by our competitors or by us;

our development of custom products and software;

36

---

**Table of Contents**

changes in domestic and international regulatory environments;

market acceptance of new or existing products;

the evaluation of new services, new standards and system architectures by many operators;

the cost and availability of components, subassemblies and modules;

the mix of our customer base and sales channels;

the mix of products sold and the effect it has on gross margins;

changes in our operating expenses and extraordinary expenses;

impairment of goodwill and intangibles;

the outcome of litigation;

write-downs of inventory and investments;

the impact of applicable accounting guidance that requires us to record the fair value of stock options, restricted stock units and employee stock purchase plan awards as compensation expense;

changes in our tax rate, including as a result of changes in our valuation allowance against certain of our deferred tax assets, and changes in state tax laws including apportionment, as a result of proposed amended tax rules related to the deferral of foreign earnings;

the impact of applicable accounting guidance on accounting for uncertainty in income taxes that requires us to establish reserves for uncertain tax positions and accrue potential tax penalties and interest;

the impact of applicable accounting guidance on business combinations that requires us to record charges for certain acquisition related costs and expenses instead of capitalizing these costs, and generally to expense restructuring costs associated with a business combination subsequent to the acquisition date; and

general economic conditions.

The timing of deployment of our equipment can be subject to a number of other risks, including the availability of skilled engineering and technical personnel, the availability of other equipment such as compatible set top boxes, our customers' ability to negotiate and enter into rights agreements with video content owners that provide the customers with the right to deliver certain video content, and our customers' need for local franchise and licensing approvals. In addition, we often recognize a substantial portion, or majority, of our revenues in the last month of the quarter. We establish our expenditure levels for product development and other operating expenses based on projected revenue levels, and expenses are relatively fixed in the short term. Accordingly, variations in timing of revenue can cause significant fluctuations in operating results.

As a result of these factors, or other factors, our operating results in one or more future periods may fail to meet or exceed the expectations of securities analysts or investors. In that event, the trading price of our common stock would likely decline.

***The markets in which we operate are intensely competitive.***

The markets for digital video systems are extremely competitive and have been characterized by rapid technological change and declining average selling prices. Pressure on average selling prices was particularly severe during previous economic downturns as equipment suppliers competed aggressively for customers' reduced capital spending, and we

have experienced similar pressure during the recent economic slowdown. Our competitors for edge and access products include corporations such as Cisco, Motorola



**Table of Contents**

and Arris. In our video processing products, we compete broadly with products from vertically integrated system suppliers including Motorola, Cisco, Technicolor and Ericsson and, in certain product lines, with a number of smaller companies.

Many of our competitors are substantially larger and have greater financial, technical, marketing and other resources than us. Many of these large organizations are in a better position to withstand any significant reduction in capital spending by customers in these markets. They often have broader product lines and market focus and may not be as susceptible to downturns in a particular market. These competitors may also be able to bundle their products together to meet the needs of a particular customer and may be capable of delivering more complete solutions than we are able to provide. To the extent that larger enterprises which currently do not compete directly with us choose to enter our markets by acquisition or otherwise, competition would likely intensify. Further, some of our competitors have greater financial resources than we do, and they have offered and in the future may offer their products at lower prices than we do or offer more attractive financing terms, which has in the past and may in the future cause us to lose revenue or to reduce our prices in response to competition. Any reduction in revenue or reduced prices for our products would adversely affect our business and results of operations. In addition, many of our competitors have been in operation longer than we have and therefore have more long-standing and established relationships with domestic and foreign customers. We may not be able to compete successfully in the future, which would harm our business.

If any of our competitors' products or technologies were to become the industry standard, our business could be seriously harmed. If our competitors are successful in bringing their products to market earlier than us, or if these products are more technologically capable than ours, our revenue could be materially and adversely affected. In addition, certain companies that have not had a large presence in the broadband communications equipment market have recently begun to expand their presence in this market through mergers and acquisitions. The continued consolidation of our competitors could have a significant negative impact on us. Further, our competitors, particularly companies that offer products that are competitive with our digital video systems, may bundle their products or incorporate functionality into existing products in a manner that discourages users from purchasing our products or which may require us to lower our selling prices, resulting in lower revenues and decreased gross margins.

***We need to develop and introduce new and enhanced products in a timely manner to remain competitive.***

Broadband communications markets are characterized by continuing technological advancement, changes in customer requirements and evolving industry standards. To compete successfully, we must design, develop, manufacture and sell new or enhanced products that provide increasingly higher levels of performance and reliability. However, we may not be able to successfully develop or introduce these products if, among other things, our products:

are not cost effective;

are not brought to market in a timely manner;

are not in accordance with evolving industry standards and architectures;

fail to achieve market acceptance; or

are ahead of the market.

We are currently developing and marketing products based on recently established video compression standards. Encoding products based on the MPEG-2 compression standards have represented a significant portion of our revenue since our acquisition of DiviCom in 2000. Newer standards, such as MPEG-4 AVC/H.264, have been adopted which provide significantly greater compression efficiency, thereby making more bandwidth available to operators. The availability of more bandwidth is particularly important to those operators seeking to launch, or expand, HDTV services. We have developed and launched products, including HD encoders, based on these new standards in order to remain competitive and are devoting considerable resources to this effort. In addition, we have recently launched an encoding platform which is capable of being configured for both MPEG-2 and MPEG-4, in both standard definition and HD formats. There can be no assurance that these efforts will be successful in the near future, or at all, or that competitors will not take significant market share in HD encoding. At the same time, we need to devote development

resources to the existing MPEG-2 standard which our cable customers continue to require. Also, to successfully develop and market certain of our planned products, we may be required to enter into technology development or licensing agreements with third parties. We cannot assure you that we will be able to enter into any necessary technology development or licensing agreements on terms acceptable to us, or at all. If we fail to develop and market new products, our business and operating results could be materially and adversely affected.

**Table of Contents**

***We may not realize the anticipated improvement in our operating results and other benefits expected from our recently completed acquisitions of Omneon and Scopus, any of which could adversely affect our business and cause our stock price to decline.***

Our recently completed acquisitions of Omneon and Scopus involved the integration of companies that had previously operated independently. The integration of previously independent companies is a challenging, time-consuming and costly process. While the integration process began in September 2010, when the Omneon acquisition was consummated, and in March 2009, when the Scopus acquisition was consummated, it will take or has taken some time to complete the integrations. It is possible that the process of combining the companies could result in the loss of key employees, the disruption of our ongoing businesses, or inconsistencies in standards, controls, procedures, and policies that adversely affect our ability to maintain relationships with customers, suppliers, and employees. In addition, the successful combination of the companies requires the dedication of significant management resources, which could temporarily divert attention from the day-to-day business of the combined company. There can be no assurance that these challenges will be met, and that we will realize benefits from the acquisition of Omneon or the acquisition of Scopus. If we are unable to realize these benefits, our business and operating results may be adversely affected, and our stock price may decline.

***We have made and expect to continue to make acquisitions, and such acquisitions could disrupt our operations and adversely affect our operating results.***

As part of our business strategy, from time to time, we have acquired, and continue to consider acquiring, businesses, technologies, assets and product lines that we believe complement or expand our existing business. For example, on September 15, 2010, we completed the acquisition of Omneon, a privately-held company organized under the laws of Delaware and headquartered in Sunnyvale, California.

The purchase price, net of \$40.5 million of cash acquired, was \$251.3 million, which consisted of (i) approximately \$153.3 million in cash, net of cash acquired, (ii) 14.2 million shares of Harmonic common stock with a total fair value of approximately \$95.9 million, based on the price of Harmonic common stock at the time of close, and (iii) approximately \$2.1 million representing the fair value attributed to shares of Omneon equity awards which Harmonic assumed for which services had already been rendered as of the close of the acquisition. The cash portion of the purchase price was paid from existing cash balances and is subject to a post-closing adjustment based on Omneon's working capital. All unvested stock options and unvested restricted stock units issued by Omneon and outstanding at closing were assumed by Harmonic. The Company also incurred a total of \$5.7 million of transaction expenses, which were expensed as selling, general and administrative expenses in the second and third quarters of 2010. In addition, on March 12, 2009, we completed the acquisition of Scopus Video Networks Ltd., on July 31, 2007, we completed the acquisition of Rhozet Corporation and on December 8, 2006, we acquired the video networking software business of Entone Technologies, Inc. We expect to make additional acquisitions in the future.

We may face challenges as a result of these activities, because acquisitions entail numerous risks, including:

the possibility that an acquisition may not close because of, among other things, a failure of a party to satisfy the conditions to closing or an acquisition target entering into an alternative transaction;

unanticipated costs or delays associated with the acquisition transaction;

difficulties in the assimilation and integration of acquired operations, technologies and/or products;

the diversion of management's attention from the regular operations of the business and the challenges of managing a larger and more widespread operation and product portfolio;

difficulties in integrating acquired companies' systems, controls, policies and procedures to comply with the internal control over financial reporting requirements of the Sarbanes-Oxley Act of 2002;

adverse effects on new and existing business relationships with suppliers and customers;

channel conflicts and disputes between distributors and other partners of us and the acquired companies;

potential difficulties in completing projects associated with in-process research and development;

**Table of Contents**

risks associated with entering markets in which we have no or limited prior experience;

the potential loss of key employees of acquired businesses;

difficulties in the assimilation of different corporate cultures and practices;

difficulties in bringing acquired products and businesses into compliance with applicable legal requirements in jurisdictions in which we operate and sell products;

substantial charges for acquisition costs, which are required to be expensed under recent accounting guidance on business combinations;

substantial charges for the amortization of certain purchased intangible assets, deferred stock compensation or similar items;

substantial impairments to goodwill or intangible assets in the event that an acquisition proves to be less valuable than the price we paid for it; and

delays in realizing or failure to realize the benefits of an acquisition.

For example, the government grants that Scopus received for research and development expenditures limits its ability to manufacture products and transfer technologies outside of Israel, and if Scopus fails to satisfy specified conditions, it may be required to refund grants previously received together with interest and penalties and may be subject to criminal charges.

Competition within our industry for acquisitions of businesses, technologies, assets and product lines has been, and may in the future continue to be, intense. As such, even if we are able to identify an acquisition that we would like to consummate, we may not be able to complete the acquisition on commercially reasonable terms or because the target is acquired by another company. Furthermore, in the event that we are able to identify and consummate any future acquisitions, we could:

issue equity securities which would dilute current stockholders' percentage ownership;

incur substantial debt;

incur significant acquisition-related expenses;

assume contingent liabilities; or

expend significant cash.

These financing activities or expenditures could harm our business, operating results and financial condition or the price of our common stock. Alternatively, due to difficulties in the capital and credit markets, we may be unable to secure capital on acceptable terms, or at all, to complete acquisitions.

Moreover, even if we do obtain benefits from acquisitions in the form of increased revenue and earnings, there may be a delay between the time when the expenses associated with an acquisition are incurred and the time when we recognize such benefits.

If we are unable to successfully address any of these risks, our business, financial condition or operating results could be harmed.

***Our future growth depends on market acceptance of several broadband services, on the adoption of new broadband technologies and on several other broadband industry trends.***

Future demand for our products will depend significantly on the growing market acceptance of emerging broadband services, including digital video, VOD, HDTV, IPTV, mobile video services, and very high-speed data services.



**Table of Contents**

The effective delivery of these services will depend, in part, on a variety of new network architectures and standards, such as:

video compression standards such as MPEG-4 AVC/H.264 for both standard definition and high definition services;

fiber to the premises, or FTTP, and digital subscriber line, or DSL, networks designed to facilitate the delivery of video services by telcos;

the greater use of protocols such as IP;

the further adoption of bandwidth-optimization techniques, such as switched digital video and DOCSIS 3.0; and

the introduction of new consumer devices, such as advanced set-top boxes, personal video recorders, or PVRs, and a variety of smart phone mobile devices, such as the iPhone.

If adoption of these emerging services and/or technologies is not as widespread or as rapid as we expect, or if we are unable to develop new products based on these technologies on a timely basis, our net revenue growth will be materially and adversely affected.

Furthermore, other technological, industry and regulatory trends will affect the growth of our business. These trends include the following:

convergence, or the need of many network operators to deliver a package of video, voice and data services to consumers, including mobile delivery options;

the increasing availability of traditional broadcast video content on the Internet;

the entry of telcos into the video business;

the use of digital video by businesses, governments and educational institutions;

efforts by regulators and governments in the U.S. and abroad to encourage the adoption of broadband and digital technologies;

the extent and nature of regulatory attitudes towards such issues as network neutrality, competition between operators, access by third parties to networks of other operators, local franchising requirements for telcos to offer video, and other new services such as mobile video; and

the outcome of litigation and negotiations between content owners and service providers regarding rights of service providers to store and distribute recorded broadcast content.

In 2006, Cablevision announced a plan to offer a network-based digital video recorder service to its customers. In order for Cablevision and other cable companies to deliver a network-based digital video recorder service broadly to their customers, they need to continue to enhance their networks and distribution capabilities by upgrading their video distribution hardware and software, which we believe will enhance the demand for our products and services.

Shortly following Cablevision's announcement that it planned to offer a network-based digital video recorder service to its customers, several major entertainment networks and video production studios sued Cablevision in federal court to enjoin Cablevision from offering this service without securing licensing or programming rights from the content providers. This case was resolved in favor of Cablevision. However, in the event that similar challenges against cable operators offering network-based digital video recorder services are successful, cable operators may not be able to provide a network-based digital video recorder service to their customers, which could reduce the growth in demand for our products and services.

***Conditions and changes in some national and global economic environments may adversely affect our business and financial results.***

Adverse economic conditions in markets in which we operate may harm our business. Recently, economic conditions in some countries in which we operate and sell products have been weak, and global financial markets have experienced a severe downturn stemming from a multitude of factors, including adverse credit conditions, slower economic activity, concerns about inflation and deflation, rapid changes in foreign exchange rates, increased energy costs, decreased consumer confidence, reduced corporate profits



**Table of Contents**

and capital spending, adverse business conditions and liquidity concerns and other factors. Economic growth in the U.S. and in many other countries slowed in the fourth quarter of 2007, remained slow or stopped in 2008, and slowed further or remained relatively flat in 2009 in the U.S. and internationally. The global economic slowdown led many of our customers to decrease their expenditures in 2009, and we believe that this slowdown caused certain of our customers to reduce or delay orders for our products. Many of our international customers, particularly those in emerging markets, have been exposed to tight credit markets and depreciating currencies, further restricting their ability to build out or upgrade their networks. Some customers have difficulty in servicing or retiring existing debt and the financial constraints on certain international customers required us to significantly increase our allowance for doubtful accounts in the fourth quarter of 2008.

During challenging economic times, and in tight credit markets, many customers may delay or reduce capital expenditures. This could result in reductions in revenue of our products, longer revenue cycles, difficulties in collection of accounts receivable, slower adoption of new technologies and increased price competition. If global economic and market conditions, or economic conditions in the United States or other key markets remain weak or deteriorate further, we may experience a material and adverse impact on our business, results of operations and financial condition.

***Broadband communications markets are characterized by rapid technological change.***

Broadband communications markets are subject to rapid changes, making it difficult to accurately predict the markets future growth rates, sizes or technological directions. In view of the evolving nature of these markets, it is possible that cable television operators, telcos or other suppliers of broadband wireless and satellite services will decide to adopt alternative architectures or technologies that are incompatible with our current or future products. Also, decisions by customers to adopt new technologies or products are often delayed by extensive evaluation and qualification processes and can result in delays in revenue of current products. If we are unable to design, develop, manufacture and sell products that incorporate or are compatible with these new architectures or technologies, our business will suffer.

***We depend on our international revenue and are subject to the risks associated with international operations, which may negatively affect our operating results.***

Revenue derived from customers outside of the U.S. in the first nine months of 2010 and fiscal years 2009 and 2008 represented 49%, 49% and 44% of net revenue, respectively, and we expect that international revenue will continue to represent a meaningful portion of our net revenue for the foreseeable future. Furthermore, a substantial portion of our contract manufacturing occurs overseas. Our international operations, the international operations of our contract manufacturers and our efforts to increase revenue in international markets are subject to a number of risks, including:

- a slowdown in international economies, which may adversely affect our customers capital spending;

- changes in foreign government regulations and telecommunications standards;

- import and export license requirements, tariffs, taxes and other trade barriers;

- fluctuations in currency exchange rates;

- a significant reliance on distributors, resellers and other third parties to sell our products and solutions;

- difficulty in collecting accounts receivable, especially from smaller customers and resellers;

- compliance with the U.S. Foreign Corrupt Practices Act, or FCPA;

- the burden of complying with a wide variety of foreign laws, treaties and technical standards;

- fulfilling country of origin requirements for our products for certain customers;

difficulty in staffing and managing foreign operations;

political and economic instability, including risks related to terrorist activity; and

changes in economic policies by foreign governments.

**Table of Contents**

In the past, certain of our international customers accumulated significant levels of debt and have undertaken reorganizations and financial restructurings, including bankruptcy proceedings. Even where these restructurings have been completed, in some cases these customers have not been in a position to purchase new equipment at levels we have seen in the past.

While our international revenue and operating expenses have typically been denominated in U.S. dollars, fluctuations in currency exchange rates could cause our products to become relatively more expensive to customers in a particular country, leading to a reduction in revenue or profitability in that country. A portion of our European business is denominated in Euros, which subjects us to increased foreign currency risk. Gains and losses on the conversion to U.S. dollars of accounts receivable, accounts payable and other monetary assets and liabilities arising from international operations may contribute to fluctuations in operating results.

Furthermore, payment cycles for international customers are typically longer than those for customers in the U.S. Unpredictable sales cycles could cause us to fail to meet or exceed the expectations of security analysts and investors for any given period.

Our operations outside the United States also require us to comply with a number of United States and international regulations. For example, our operations in countries outside the United States are subject to the FCPA and similar laws, which prohibits United States companies or their agents and employees from providing anything of value to a foreign official for the purposes of influencing any act or decision of these individuals in their official capacity to help obtain or retain business, direct business to any person or corporate entity or obtain any unfair advantage. Our activities in countries outside the United States create the risk of unauthorized payments or offers of payments by one of our employees or agents, including those companies to which we outsource certain of our business operations, which could be in violation of the FCPA, even though these parties are not always subject to our control. We have internal control policies and procedures and have implemented training and compliance programs for our employees and agents with respect to the FCPA. However, we cannot assure you that our policies, procedures and programs will prevent violations of the FCPA or similar laws by our employees or agents, particularly as we expand our international operations. Any such violation, even if prohibited by our policies, could result in criminal or civil sanctions, and this could have a material adverse effect on our business, financial condition and results of operations. Any or all of these factors could adversely impact our business and results of operations.

***We face risks associated with having important facilities and resources located in Israel.***

When we completed the acquisition of Scopus in March 2009, Scopus was headquartered and had a substantial majority of its operations in Israel. This acquisition resulted in the addition of 221 employees based in Israel. In addition, we maintain a facility in Caesarea in Israel with a total of 85 employees. The employees at the Caesarea facility consist principally of research and development personnel. We have pilot production capabilities at this facility consisting of procurement of subassemblies and modules from Israeli subcontractors and final assembly and test operations. As of October 1, 2010, we had a total of 222 employees based in Israel, or approximately 20% of our workforce.

Accordingly, we are directly influenced by the political, economic and military conditions affecting Israel, and this influence has increased with the acquisition of Scopus. Any significant conflict involving Israel could have a direct effect on our business or that of our Israeli subcontractors, in the form of physical damage or injury, reluctance to travel within or to Israel by our Israeli and foreign employees or those of our subcontractors, or the loss of employees to active military duty. Most of our employees in Israel are currently obligated to perform annual reserve duty in the Israel Defense Forces and several have been called for active military duty in recent years. In the event that more employees are called to active duty, certain of our research and development activities may be adversely affected and significantly delayed. In addition, the interruption or curtailment of trade between Israel and its trading partners could significantly harm our business. Terrorist attacks and hostilities within Israel, the hostilities between Israel and Hezbollah, and Israel and Hamas, the conflict between Hamas and Fatah, as well as tensions between Israel and Iran, have also heightened these risks. Current or future tensions in the Middle East may adversely affect our business and results of operations.

***Fluctuations in our future effective tax rates could affect our future operating results, financial condition and cash flows.***

We have evaluated the need for a valuation allowance based on historical evidence, trends in profitability, expectations of future taxable income and implemented tax planning strategies. As such in 2008, we determined that a valuation allowance was no longer

**Table of Contents**

necessary for certain of our U.S. deferred tax assets because, based on the available evidence, we concluded that a realization of these net deferred tax assets was more likely than not. We continue to maintain a valuation allowance for certain foreign deferred tax assets and recorded a valuation allowance on certain of our California deferred tax assets in the first quarter of 2009 as a result of our expectations of future usage of the California deferred tax assets. We are required to periodically review our deferred tax assets and determine whether, based on available evidence, a valuation allowance is necessary. In the event that, in the future, we determine an additional valuation allowance is necessary with respect to our U.S. and certain foreign deferred tax assets, we would incur a charge equal to the amount of the valuation allowance in the period in which we made such determination as a discrete item, and this could have a material and adverse impact on our results of operations for such period.

The calculation of tax liabilities involves dealing with uncertainties in the application of complex global tax regulations. We recognize potential liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on our estimate of whether, and the extent to which, additional taxes will be due. If payment of these amounts ultimately proves to be unnecessary, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary. If the estimate of tax liabilities proves to be less than the ultimate tax assessment, a further charge to expense would result.

We are in the process of expanding our international operations and staffing to better support our expansion into international markets. This expansion includes the implementation of an international structure that includes, among other things, an international support center in Europe, a research and development cost-sharing arrangement, certain licenses and other contractual arrangements between us and our wholly-owned domestic and foreign subsidiaries. As a result of these changes, we anticipate that our consolidated pre-tax income will be subject to foreign tax at relatively lower tax rates when compared to the United States federal statutory tax rate and, as a consequence, our effective income tax rate is expected to be lower than the United States federal statutory rate. However, the current administration has begun to put forward proposals that may, if enacted, limit the ability of U.S. companies to continue to defer U.S. income taxes on foreign income. In addition, recent statements from the IRS have indicated their intent to seek greater disclosure by companies of their reserves for uncertain tax positions.

Our future effective income tax rates could be adversely affected if tax authorities challenge our international tax structure or if the relative mix of United States and international income changes for any reason. Accordingly, there can be no assurance that our income tax rate will be less than the United States federal statutory rate in future periods.

***Changes in telecommunications legislation and regulations could harm our prospects and future revenue.***

Changes in telecommunications legislation and regulations in the U.S. and other countries could affect the revenue from our products. In particular, regulations dealing with access by competitors to the networks of incumbent operators could slow or stop additional construction or expansion by these operators. Increased regulation of our customers' pricing or service offerings could limit their investments and consequently the revenue from our products. Changes in regulations could have a material adverse effect on our business, operating results, and financial condition.

***Negative conditions in the global credit and financial markets may impair the liquidity of a portion of our investment portfolio.***

The recent negative conditions in the global credit and financial markets have had an adverse impact on the liquidity of certain investments. In the event we need or desire to access funds from the short-term investments that we hold, it is possible that we may not be able to do so due to market conditions. If a buyer is found but is unwilling to purchase the investments at par or our cost, we may incur a loss. Further, rating downgrades of the security issuer or the third parties insuring such investments may require us to adjust the carrying value of these investments through an impairment charge. Our inability to sell all or some of our short-term investments at par or our cost, or rating downgrades of issuers of these securities, could adversely affect our results of operations or financial condition.

In addition, we invest our cash, cash equivalents and short-term investments in a variety of investment vehicles in a number of countries with and in the custody of financial institutions with high credit ratings. While our investment policy and strategy attempt to manage interest rate risk, limit credit risk, and only invest in what we view as very high-quality securities, the outlook for our investment holdings is dependent on general economic conditions, interest rate trends and volatility in the financial marketplace, which can all affect the income that we receive, the value of our investments, and our ability to sell them.

During 2008, we recorded an impairment charge of \$0.8 million relating to an investment in an unsecured debt instrument of Lehman Brothers Holdings, Inc. We believe that our investment securities are carried at fair value. However, over time the economic and

**Table of Contents**

market environment may provide additional insight regarding the fair value of certain securities which could change our judgment regarding impairment. This could result in unrealized or realized losses relating to other than temporary declines being charged against future income. Given the current market conditions involved, there is continuing risk that further declines in fair value may occur and additional impairments may be charged to income in future periods.

***In order to manage our growth, we must be successful in addressing management succession issues and attracting and retaining qualified personnel.***

Our future success will depend, to a significant extent, on the ability of our management to operate effectively, both individually and as a group. We must successfully manage transition and replacement issues that may result from the departure or retirement of members of our senior management. For example, we recently hired a new Chief Financial Officer. We cannot assure you that changes of management personnel would not cause disruption to our operations or customer relationships, or a decline in our financial results.

In addition, we are dependent on our ability to retain and motivate high caliber personnel, in addition to attracting new personnel. Competition for qualified management, technical and other personnel can be intense and we may not be successful in attracting and retaining such personnel. Competitors and others have in the past and may in the future attempt to recruit our employees. While our employees are required to sign standard agreements concerning confidentiality and ownership of inventions, we generally do not have employment contracts or non-competition agreements with any of our personnel. The loss of the services of any of our key personnel, the inability to attract or retain qualified personnel in the future or delays in hiring required personnel, particularly senior management and engineers and other technical personnel, could negatively affect our business.

***Stock exchange regulations related to equity compensation could adversely affect our ability to raise capital and our ability to attract and retain key personnel.***

Since our inception, we have used equity compensation, including stock options, restricted stock units and employee stock purchase plan awards, as a fundamental component of our employee compensation packages. We believe that our equity incentive plans are an essential tool to link the long-term interests of stockholders and employees, especially executive management, and serve to motivate management to make decisions that will, in the long run, give the best returns to stockholders. The Financial Accounting Standards Board, or FASB, issued guidance that requires us to record a charge to earnings for employee stock options, restricted stock unit grants and employee stock purchase plan awards for all periods from January 1, 2006. This guidance has negatively impacted and will continue to negatively impact our earnings and may affect our ability to raise capital on acceptable terms. For the first nine months of 2010, stock-based compensation expense recognized under this guidance was \$10.2 million, which consisted of stock-based compensation expense related to restricted stock units, stock options and employee stock purchase plan awards.

In addition, regulations implemented by the NASDAQ Stock Market requiring stockholder approval for all equity incentive plans could make it more difficult for us to grant options or restricted stock units to employees in the future. To the extent that new accounting guidance makes it more difficult or expensive to grant options or restricted stock units to employees, we may incur increased compensation costs, change our equity compensation strategy or find it difficult to attract, retain and motivate employees, each of which could materially and adversely affect our business.

***We are exposed to additional costs and risks associated with complying with increasing regulation of corporate governance and disclosure standards.***

We are spending an increased amount of management time and external resources to comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, SEC regulations and the NASDAQ Stock Market rules. In particular, Section 404 of the Sarbanes-Oxley Act requires management's annual review and evaluation of our internal control over financial reporting and attestation of the effectiveness of our internal control over financial reporting by our independent registered public accounting firm in connection with the filing of the annual report on Form 10-K for each fiscal year. We have documented and tested our internal control systems and procedures and have made improvements in order for us to comply with the requirements of Section 404. This process required us to hire additional personnel and outside advisory services and has resulted in significant additional expenses. While our management's assessment of our internal control over financial reporting resulted in our conclusion that as of December 31, 2009, our internal control over financial

reporting was effective, and our independent registered public accounting firm has attested that our internal control over financial reporting was effective in all material respects as of December 31, 2009, we cannot predict the outcome of our testing and that of our independent registered public



**Table of Contents**

accounting firm in future periods. If we conclude in future periods that our internal control over financial reporting is not effective or if our independent registered public accounting firm is unable to provide an unqualified attestation as of future year-ends, investors may lose confidence in our financial statements, and the price of our stock may suffer.

***We may need additional capital in the future and may not be able to secure adequate funds on terms acceptable to us.***

We have generated substantial operating losses since we began operations in June 1988. We have been engaged in the design, manufacture and sale of a variety of video products and system solutions since inception, which has required, and will continue to require, significant research and development expenditures. As of December 31, 2009 we had an accumulated deficit of \$1.9 billion. These losses, among other things, have had and may have an adverse effect on our stockholders' equity and working capital.

On September 15, 2010, we completed the acquisition of Omneon. The purchase price, net of \$40.5 million of cash acquired, was \$251.3 million, which consisted of (i) approximately \$153.3 million in cash, net of cash acquired, (ii) 14.2 million shares of Harmonic common stock with a total fair value of approximately \$95.9 million, based on the price of Harmonic common stock at the time of close, and (iii) approximately \$2.1 million representing the fair value attributed to shares of Omneon equity awards which Harmonic assumed for which services had already been rendered as of the close of the acquisition. The cash portion of the purchase price was paid from existing cash balances and is subject to a post-closing adjustment based on Omneon's working capital.

Taking into account the acquisition of Omneon and the use of cash required to complete the transaction, we believe that our existing liquidity sources will satisfy our cash requirements for at least the next twelve months. However, we may need to raise additional funds if our expectations are incorrect, to take advantage of unanticipated strategic opportunities, to satisfy our other liabilities, or to strengthen our financial position. 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 weakness in the economic conditions in markets in which we operate and into which we sell our products, increased uncertainty in the financial, capital and credit markets, as well as conditions in the cable and satellite industries. In particular, companies are experiencing difficulty raising capital from issuances of debt or equity securities in the current capital market environment, and may also have difficulty securing credit financing. There can be no assurance that such financing will be available on terms acceptable to us, if at all.

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 to finance the acquisition and related expenses as well as to integrate operations following a transaction, and 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.

We may raise additional financing through public or private equity offerings, debt financings or additional corporate collaboration and licensing arrangements. To the extent we raise additional capital by issuing equity securities, our stockholders may experience dilution. To the extent that we raise additional funds through collaboration and licensing arrangements, it may be necessary to relinquish some rights to our technologies or products, or grant licenses on terms that are not favorable to us. For example, debt financing arrangements may require us to pledge assets or enter into covenants that could restrict our operations or our ability to incur further indebtedness. If adequate funds are not available, we will not be able to continue developing our products.

***If demand for our products increases more quickly than we expect, we may be unable to meet our customers requirements.***

If demand for our products increases, the difficulty of accurately forecasting our customers' requirements and meeting these requirements will increase. Forecasting to meet customers' needs and effectively managing our supply chain is particularly difficult in connection with newer products. Our ability to meet customer demand depends significantly on the availability of components and other materials as well as the ability of our contract manufacturers to scale their production. Furthermore, we purchase several key components, subassemblies and modules used in the manufacture or integration of our products from sole or limited sources. Our ability to meet customer requirements depends in part on our ability to obtain sufficient volumes of these materials in a timely fashion. Recent increases in demand on our

suppliers and subcontractors from other parties have caused sporadic shortages of certain components and products. In response, we have increased our inventories of certain components and products and expedited

**Table of Contents**

shipments of our products when necessary, which has increased our costs. Also, in previous years, in response to lower revenue and the prolonged economic recession, we significantly reduced our headcount and other expenses. As a result, we may be unable to respond to customer demand that increases more quickly than we expect. If we fail to meet customers' supply expectations, our net revenue would be adversely affected and we may lose business.

***We purchase several key components, subassemblies and modules used in the manufacture or integration of our products from sole or limited sources, and we are increasingly dependent on contract manufacturers.***

Many components, subassemblies and modules necessary for the manufacture or integration of our products are obtained from a sole supplier or a limited group of suppliers. For example, we depend on a small private company for certain video encoding chips which are incorporated into several new products. Our reliance on sole or limited suppliers, particularly foreign suppliers, and our increased reliance on subcontractors involves several risks, including a potential inability to obtain an adequate supply of required components, subassemblies or modules and, reduced control over pricing, quality and timely delivery of components, subassemblies or modules. In particular, certain optical components have in the past been in short supply and are available only from a small number of suppliers, including sole source suppliers. These risks are heightened during the current economic slowdown, because our suppliers and subcontractors are more likely to experience adverse changes in their financial condition and operations during such a period. While we expend resources to qualify additional component sources, consolidation of suppliers in the industry and the small number of viable alternatives have limited the results of these efforts. We do not generally maintain long-term agreements with any of our suppliers. Managing our supplier and contractor relationships is particularly difficult during time periods in which we introduce new products and during time periods in which demand for our products is increasing, especially if demand increases more quickly than we expect.

Furthermore, from time to time we assess our relationship with our contract manufacturers. In 2003, we entered into a three-year agreement with Plexus Services Corp. as our primary contract manufacturer, and Plexus currently provides us with a majority of the products that we purchase from our contract manufacturers. This agreement has automatic annual renewals unless prior notice is given and has been renewed until October 2012.

Difficulties in managing relationships with current contract manufacturers, particularly Plexus, could impede our ability to meet our customers' requirements and adversely affect our operating results. An inability to obtain adequate deliveries or any other circumstance that would require us to seek alternative sources of supply could negatively affect our ability to ship our products on a timely basis, which could damage relationships with current and prospective customers and harm our business. We attempt to limit this risk by maintaining safety stocks of certain components, subassemblies and modules. Recent increases in demand on our suppliers and subcontractors from other parties have caused sporadic shortages of certain components and products. In response, we have increased our inventories of certain components and products and expedited shipments of our products when necessary, which has increased our costs. As a result of this investment in inventories, we have in the past and in the future may be subject to risk of excess and obsolete inventories, which could harm our business, operating results, financial position or cash flows. In this regard, our gross margins and operating results in the past were adversely affected by significant excess and obsolete inventory charges.

***Cessation of the development and production of video encoding chips by C-Cube's spun-off semiconductor business may adversely impact us.***

Our DiviCom business, which we acquired in 2000, and the C-Cube semiconductor business (acquired by LSI Logic in June 2001) collaborated on the production and development of two video encoding microelectronic chips prior to our acquisition of the DiviCom business. In connection with the acquisition, we have entered into a contractual relationship with the spun-off semiconductor business of C-Cube, under which we have access to certain of the spun-off semiconductor business technologies and products on which the DiviCom business depends for certain product and service offerings. The current term of this agreement is through October 2010, with automatic annual renewals unless terminated by either party in accordance with the agreement provisions. On July 27, 2007, LSI announced that it had completed the sale of its consumer products business (which includes the design and manufacture of encoding chips) to Magnum Semiconductor, and the agreement which provides us with access to certain of the spun-off semiconductor business technologies and products was assigned to Magnum Semiconductor. If the spun-off semiconductor business is not able to or does not sustain its development and production efforts in this

area, our business, financial condition, results of operations and cash flow could be harmed.

***We rely on distributors, value-added resellers and systems integrators for a substantial portion of our revenue, and disruptions to, or our failure to develop and manage our relationships with these customers and the processes and procedures that support them could adversely affect our business.***

**Table of Contents**

We generate a substantial portion of our revenue through net sales to distributors, value-added resellers, or VARs, and systems integrators. We expect that these sales will continue to generate a substantial percentage of our net revenue in the future. Our future success is highly dependent upon establishing and maintaining successful relationships with a variety of distributors, VARs and systems integrators that specialize in video delivery solutions, products and services, and our reliance on such customers has increased since the completion of our acquisition of Scopus in the first quarter of 2009 and Omneon in the third quarter of 2010.

We generally have no long-term contracts or minimum purchase commitments with any of our distributor, VAR or system integrator customers, and our contracts with these parties do not prohibit them from purchasing or offering products or services that compete with ours. Our competitors may be effective in providing incentives to our distributor, VAR and systems integrator customers to favor their products or to prevent or reduce sales of our products. Our distributor, VAR or systems integrator customers may choose not to purchase or offer our products. Many of our distributors, VARs and system integrators are small, are based in a variety of international locations and may have relatively unsophisticated processes and limited financial resources to conduct their business. Any significant disruption to our sales to these customers, including as a result of the inability or unwillingness of these customers to continue purchasing our products, or their failure to properly manage their business with respect to the purchase of and payment for our products, could materially and adversely impact our business and results of operations. In addition, our failure to establish and maintain successful relationships with distributor, VAR and systems integrator customers would likely materially and adversely affect our business, operating results and financial condition.

***We need to effectively manage our operations and the cyclical nature of our business.***

The cyclical nature of our business has placed, and is expected to continue to place, a significant strain on our personnel, management and other resources. Our purchase of the video networking software business of Entone in December 2006 resulted in the addition of 43 employees, most of whom are based in Hong Kong, and we added approximately 18 employees on July 31, 2007, in connection with the completion of our acquisition of Rhozet. Upon the closing of the acquisition of Scopus, we added 221 employees on March 12, 2009, most of whom are based in Israel. Upon the closing of the acquisition of Omneon, we added 286 employees on September 15, 2010, most of whom are based in the U.S. Our ability to manage our business effectively in the future, including any future growth, will require us to train, motivate and manage our employees successfully, to attract and integrate new employees into our overall operations, to retain key employees and to continue to improve our operational, financial and management systems.

***We are subject to various laws and regulations related to the environment and potential climate change that could impose substantial costs upon us and may adversely affect our business, operating results and financial condition.***

Our operations are regulated under various federal, state, local and international laws relating to the environment and potential climate change, including those governing the management, disposal and labeling of hazardous substances and wastes and the cleanup of contaminated sites. We could incur costs and fines, third-party property damage or personal injury claims, or could be required to incur substantial investigation or remediation costs, if we were to violate or become liable under environmental laws. The ultimate costs under these laws and the timing of these costs are difficult to predict.

We also face increasing complexity in our product design as we adjust to new and future requirements relating to the presence of certain substances in electronic products and making producers of those products financially responsible for the collection, treatment, recycling, and disposal of certain products. For example, the European Parliament and the Council of the European Union have enacted the Waste Electrical and Electronic Equipment (WEEE) directive, which regulates the collection, recovery, and recycling of waste from electrical and electronic products, and the Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS) directive, which bans the use of certain hazardous materials including lead, mercury, cadmium, hexavalent chromium, and polybrominated biphenyls (PBBs), and polybrominated diphenyl ethers (PBDEs) that exceed certain specified levels. Legislation similar to RoHS and WEEE has been or may be enacted in other jurisdictions, including in the United States, Japan, and China. Our failure to comply with these laws could result in our being directly or indirectly liable for costs, fines or penalties and third-party claims, and could jeopardize our ability to conduct business in such

countries. We also expect that our operations will be affected by other new environmental laws and regulations on an ongoing basis. Although we cannot predict the ultimate impact of any such new laws and regulations, they will likely result in additional costs or decreased revenue, and could require that we redesign or change how we manufacture our products, any of which could have a material adverse effect on our business.

**Table of Contents*****We are liable for C-Cube's pre-merger liabilities, including liabilities resulting from the spin-off of its semiconductor business.***

Under the terms of the merger agreement with C-Cube, Harmonic is generally liable for C-Cube's pre-merger liabilities. Harmonic and LSI Logic, which acquired C-Cube's spun off semiconductor business in June 2001 and assumed its obligations, reached a settlement agreement in the third quarter of 2009, which resulted in Harmonic reimbursing LSI Logic \$1.0 million of the outstanding liability to settle any future outstanding claims. As a result, the full amount of the estimated obligations was transferred to LSI Logic in the third quarter of 2009. To the extent that these obligations are finally settled for more than the amounts reimbursed by Harmonic, LSI Logic is obligated, under the terms of the settlement agreement, to reimburse Harmonic.

***Our failure to adequately protect our proprietary rights may adversely affect us.***

We currently hold 54 issued U.S. patents and 13 issued foreign patents, and have a number of patent applications pending. Although we attempt to protect our intellectual property rights through patents, trademarks, copyrights, licensing arrangements, maintaining certain technology as trade secrets and other measures, we cannot assure you that any patent, trademark, copyright or other intellectual property rights owned by us will not be invalidated, circumvented or challenged, that such intellectual property rights will provide competitive advantages to us or that any of our pending or future patent applications will be issued with the scope of the claims sought by us, if at all. We cannot assure you that others will not develop technologies that are similar or superior to our technology, duplicate our technology or design around the patents that we own. In addition, effective patent, copyright and trade secret protection may be unavailable or limited in certain foreign countries in which we do business or may do business in the future.

We believe that patents and patent applications are not currently significant to our business, and investors therefore should not rely on our patent portfolio to give us a competitive advantage over others in our industry. We believe that the future success of our business will depend on our ability to translate the technological expertise and innovation of our personnel into new and enhanced products. We generally enter into confidentiality or license agreements with our employees, consultants, vendors and customers as needed, and generally limit access to and distribution of our proprietary information. Nevertheless, we cannot assure you that the steps taken by us will prevent misappropriation of our technology. In addition, we have taken in the past, and may take in the future, legal action to enforce our patents and other intellectual property rights, to protect our trade secrets, to determine the validity and scope of the proprietary rights of others, or to defend against claims of infringement or invalidity. Such litigation could result in substantial costs and diversion of resources and could negatively affect our business, operating results, financial position or cash flows.

In order to successfully develop and market certain of our planned products, we may be required to enter into technology development or licensing agreements with third parties. Although many companies are often willing to enter into technology development or licensing agreements, we cannot assure you that such agreements will be negotiated on terms acceptable to us, or at all. The failure to enter into technology development or licensing agreements, when necessary or desirable, could limit our ability to develop and market new products and could cause our business to suffer.

***Our products include third-party technology and intellectual property, and our inability to use that technology in the future could harm our business.***

We incorporate certain third-party technologies, including software programs, into our products, and intend to utilize additional third-party technologies in the future. Licenses to relevant third-party technologies or updates to those technologies may not continue to be available to us on commercially reasonable terms, or at all. In addition, the technologies that we license may not operate properly and we may not be able to secure alternatives in a timely manner, which could harm our business. We could face delays in product releases until alternative technology can be identified, licensed or developed, and integrated into our products, if we are able to do so at all. These delays, or a failure to secure or develop adequate technology, could materially and adversely affect our business.

***We or our customers may face intellectual property infringement claims from third parties.***

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In particular, leading companies in the telecommunications

industry have extensive patent portfolios. From time to time, third parties have asserted and may assert patent, copyright, trademark and other intellectual property rights against us or our customers. Our suppliers and customers may have similar claims asserted against them. A number of third parties, including companies with greater financial and other resources than us, have asserted patent rights to technologies that are important to us. Any future litigation, regardless of its outcome, could result in substantial expense and significant diversion of the efforts of our management and technical personnel. An adverse determination in any such proceeding could subject us to significant liabilities, temporary or permanent injunctions or require us to seek licenses from third parties or pay royalties that may be substantial. Furthermore, necessary licenses may not be available on satisfactory terms, or at all. An unfavorable outcome on any such litigation



**Table of Contents**

matters could require that Harmonic pay substantial damages, or, in connection with any intellectual property infringement claims, could require that we pay ongoing royalty payments or could prevent us from selling certain of our products and any such outcome could have a material adverse effect on our business, operating results, financial position or cash flows.

On April 19, 2010, Arris Corporation filed a complaint in United States District Court in Atlanta, alleging that Harmonic's Streamliner 3000 product infringes four patents held by Arris. The complaint seeks injunctive relief and damages. Harmonic was served with the complaint on August 10, 2010. At this time, we cannot predict the outcome of this matter. An unfavorable outcome of this matter could adversely affect our business, operating results, financial position and cash flows.

On July 3, 2003, Stanford University and Litton Systems (now Northrop Grumman Guidance and Electronics Company, Inc.) filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of our products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint sought injunctive relief, royalties and damages. On August 6, 2007, the District Court granted our motion to dismiss. The plaintiffs appealed this motion and on June 19, 2008 the U.S. Court of Appeals for the Federal Circuit issued a decision which vacated the District Court's decision and remanded for further proceedings. At a scheduling conference on October 6, 2008, the judge ordered the parties to mediation. Following the mediation sessions, Harmonic and Litton entered into a settlement agreement on January 15, 2009. The settlement agreement provided that in exchange for a one-time lump sum payment from Harmonic to Litton of \$5 million, Litton (i) will not bring suit against Harmonic, any of its affiliates, customers, vendors, representatives, distributors, and its contract manufacturers for any liability for making, using, offering for sale, importing, and/or selling any Harmonic products that may have incorporated technology that was alleged to have infringed on one or more of the relevant patents and (ii) released Harmonic from any liability for making, using, or selling any Harmonic products that may have infringed on such patents. Harmonic paid the settlement amount in January 2009.

Our suppliers and customers may have similar claims asserted against them. We have agreed to indemnify some of our suppliers and customers for alleged patent infringement. The scope of this indemnity varies, but, in some instances, includes indemnification for damages and expenses (including reasonable attorney's fees).

***We may be the subject of litigation which, if adversely determined, could harm our business and operating results.***

In addition to the litigation discussed elsewhere in this quarterly report on Form 10-Q, we may be subject to claims arising in the normal course of business. An unfavorable outcome on any litigation matter could require that we pay substantial damages, or, in connection with any intellectual property infringement claims, could require that we pay ongoing royalty payments or could prevent us from selling certain of our products. In addition, we may decide to settle any litigation, which could cause us to incur significant costs. A settlement or an unfavorable outcome on any litigation matter could have a material adverse effect on our business, operating results, financial position or cash flows.

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

Our products are subject to U.S. export controls and may be exported outside the United States only with the required level of export license or through an export license exception, in most cases because we incorporate encryption technology into our products. In addition, various countries regulate the import of certain technology and have enacted laws that could limit our ability to distribute our products or could limit our customers' ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products throughout their global systems or, in some cases, prevent the export or import of our products to certain countries altogether. Any change in export or import regulations or related legislation, shift in approach to the enforcement or scope of existing regulations, or change in the countries, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers internationally.

In addition, we may be subject to customs duties and export quotas, which could have a significant impact on our revenue and profitability. While we have not encountered significant difficulties in connection with the sales of our

products in international markets, the future imposition of significant increases in the level of customs duties or export quotas could have a material adverse effect on our business.

**Table of Contents**

***The ongoing threat of terrorism has created great uncertainty and may continue to harm our business.***

Current conditions in the U.S. and global economies are uncertain. The terrorist attacks in the U.S. in 2001 and subsequent terrorist attacks in other parts of the world have created many economic and political uncertainties that have severely impacted the global economy, and have adversely affected our business. For example, following the 2001 terrorist attacks in the U.S., we experienced a further decline in demand for our products. The long-term effects of the attacks, the situation in the Middle East and the ongoing war on terrorism on our business and on the global economy remain unknown. Moreover, the potential for future terrorist attacks has created additional uncertainty and makes it difficult to estimate the stability and strength of the U.S. and other economies and the impact of economic conditions on our business.

***The markets in which we, our customers and our suppliers operate are subject to the risk of earthquakes and other natural disasters.***

Our headquarters and the majority of our operations are located in California, which is prone to earthquakes, and some of the other locations in which we, our customers and suppliers conduct business are prone to natural disasters. In the event that any of our business centers are affected by any such disasters, we may sustain damage to our operations and properties and suffer significant financial losses. Furthermore, we rely on third-party manufacturers for the production of many of our products, and any disruption in the business or operations of such manufacturers could adversely impact our business. In addition, if there is a major earthquake or other natural disaster in any of the locations in which our significant customers are located, we face the risk that our customers may incur losses, or sustained business interruption and/or loss which may materially impair their ability to continue their purchase of products from us. A major earthquake or other natural disaster in the markets in which we, our customers or suppliers operate could have a material adverse effect on our business, financial condition, results of operations or cash flows.

***Some anti-takeover provisions contained in our certificate of incorporation, bylaws and stockholder rights plan, as well as provisions of Delaware law, could impair a takeover attempt.***

We have provisions in our certificate of incorporation and bylaws, each of which could have the effect of rendering more difficult or discouraging an acquisition deemed undesirable by our Board of Directors. These include provisions:

authorizing blank check preferred stock, which could be issued with voting, liquidation, dividend and other rights superior to our common stock;

limiting the liability of, and providing indemnification to, our directors and officers;

limiting the ability of our stockholders to call and bring business before special meetings;

requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our Board of Directors;

controlling the procedures for conduct and scheduling of Board and stockholder meetings; and

providing the Board of Directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

These provisions, alone or together, could delay hostile takeovers and changes in control or management of us. In addition, we have adopted a stockholder rights plan. The rights are not intended to prevent a takeover of us, and we believe these rights will help our negotiations with any potential acquirers. However, if the Board of Directors believes that a particular acquisition is undesirable, the rights may have the effect of rendering more difficult or discouraging that acquisition. The rights would cause substantial dilution to a person or group that attempts to acquire us on terms or in a manner not approved by our Board of Directors, except pursuant to an offer conditioned upon redemption of the rights.

## **Table of Contents**

As a Delaware corporation, we are also subject to provisions of Delaware law, including Section 203 of the Delaware General Corporation law, which prevents some stockholders holding more than 15% of our outstanding common stock from engaging in certain business combinations without approval of the holders of substantially all of our outstanding common stock.

Any provision of our certificate of incorporation or bylaws, our stockholder rights plan or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock.

***Our common stock price may be extremely volatile, and the value of your investment may decline.***

Our common stock price has been highly volatile. We expect that this volatility will continue in the future due to factors such as:

general market and economic conditions;

actual or anticipated variations in operating results;

announcements of technological innovations, new products or new services by us or by our competitors or customers;

changes in financial estimates or recommendations by stock market analysts regarding us or our competitors;

announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments;

announcements by our customers regarding end market conditions and the status of existing and future infrastructure network deployments;

additions or departures of key personnel; and

future equity or debt offerings or our announcements of these offerings.

In addition, in recent years, the stock market in general, and the NASDAQ Stock Market and the securities of technology companies in particular, have experienced extreme price and volume fluctuations. These fluctuations have often been unrelated or disproportionate to the operating performance of individual companies. These broad market fluctuations have in the past and may in the future materially and adversely affect our stock price, regardless of our operating results. Investors may be unable to sell their shares of our common stock at or above the purchase price.

***Our stock price may decline if additional shares are sold in the market.***

Future sales of substantial amounts of shares of our common stock by our existing stockholders in the public market, or the perception that these sales could occur, may cause the market price of our common stock to decline. In addition, we may be required to issue additional shares upon exercise of previously granted options that are currently outstanding. Increased sales of our common stock in the market after exercise of currently outstanding options could exert significant downward pressure on our stock price. These sales also might make it more difficult for us to sell equity or equity-related securities in the future at a time and price we deem appropriate.

***If securities analysts do not continue to publish research or reports about our business, or if they downgrade our stock, the price of our stock could decline.***

The trading market for our common stock relies in part on the availability of research and reports that third-party industry or financial analysts publish about us. Further, if one or more of the analysts who do cover us downgrade our stock, our stock price may decline. If one or more of these analysts cease coverage of us, we could lose visibility in the market, which in turn could cause the liquidity of our stock and our stock price to decline.

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

On September 15, 2010, we completed the acquisition of Omneon, Inc. The purchase price included approximately 14.2 million shares of Harmonic common stock.

**Table of Contents**

On September 8, 2010, the Commissioner of Corporations of the State of California granted the Company a fairness permit pursuant to Sections 25121 and 25142 of the California Corporate Securities Law of 1968. After receiving such permit, Harmonic relied on an exemption from registration provided by Section 3(a)(10) of the Securities Act of 1933, as amended, for the issuance and stock of the shares of Harmonic stock in connection with the acquisition of Omneon.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

None.

**ITEM 5. OTHER INFORMATION**

None.

**ITEM 6. EXHIBITS**

<b>Exhibit Number</b>	<b>Exhibit Index</b>
31.1	Section 302 Certification of Principal Executive Officer
31.2	Section 302 Certification of Principal Financial Officer
32.1	Section 906 Certification of Principal Executive Officer
32.2	Section 906 Certification of Principal Financial Officer
101***	The following materials from Registrant's Quarterly Report on Form 10-Q for the quarter ended October 1, 2010, formatted in Extensible Business Reporting Language (XBRL) includes: (i) Condensed Consolidated Balance Sheets at October 1, 2010 and December 31, 2009, (ii) Condensed Consolidated Statements of Operations for the Three and Nine Months Ended October 1, 2010 and October 2, 2009, (iii) Condensed Consolidated Statements of Cash Flows for the Nine Months Ended October 1, 2010 and October 2, 2009, and (iv) Notes to Condensed Consolidated Financial Statements, tagged as blocks of text.
***	XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Exchange Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.

**Table of Contents**

**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.

HARMONIC INC.

By: /s/ Carolyn V. Aver  
Carolyn V. Aver  
Chief Financial Officer  
(Principal Financial and Accounting  
Officer)

Date: November 10, 2010

54

---

**Table of Contents**

<b>Exhibit Number</b>	<b>Exhibit Index</b>
31.1	Section 302 Certification of Principal Executive Officer
31.2	Section 302 Certification of Principal Financial Officer
32.1	Section 906 Certification of Principal Executive Officer
32.2	Section 906 Certification of Principal Financial Officer
101***	The following materials from Registrant's Quarterly Report on Form 10-Q for the quarter ended October 1, 2010, formatted in Extensible Business Reporting Language (XBRL) includes: Condensed Consolidated Balance Sheets at October 1, 2010 and December 31, 2009, (ii) Condensed Consolidated Statements of Operations for the Three and Nine Months Ended October 1, 2010 and October 2, 2009, (iii) Condensed Consolidated Statements of Cash Flows for the Nine Months Ended October 1, 2010 and October 2, 2009, and (iv) Notes to Condensed Consolidated Financial Statements, tagged as blocks of text.
***	XBRL information is furnished and not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Exchange Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections.