NETLOGIC MICROSYSTEMS INC
Form 10-Q
August 09, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2006

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Transition Period from ______ to ______

Commission File Number: 000-50838

NETLOGIC MICROSYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**77-0455244**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

1875 Charleston Rd.

Mountain View, CA 94043

(650) 961-6676

(Address and telephone number of 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 x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer.

Large accelerated filer ¨ Accelerated filer x Non-accelerated filer ¨

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

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	Outstanding at July 31, 2006
Common Stock, $0.01 par value per share	**20,306,390 shares**

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PART I: FINANCIAL INFORMATION

Item 1. ***Financial Statements***

NETLOGIC MICROSYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS)

(UNAUDITED)

	June 30, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 76,021	$ 65,788
Accounts receivable, net	10,960	5,972
Inventory	11,144	8,822
Prepaid expenses and other current assets	1,616	832
Total current assets	99,741	81,414
Property and equipment, net	6,545	4,012
Goodwill	37,343	
Intangible asset, net	6,012	
Other assets	101	103
Total assets	$ 149,742	$ 85,529
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 8,484	$ 8,458
Accrued liabilities	8,405	7,434
Deferred revenue	135	
Capital lease and other obligations, current	1,362	360
Total current liabilities	18,386	16,252
Capital lease and other obligations, long-term	1,383	327
Other liabilities	291	294
Total liabilities	20,060	16,873
Stockholders equity:		
Common stock and additional paid-in capital	217,262	152,559
Notes receivable from stockholders	(24)	(44)
Deferred stock-based compensation	(484)	(1,114)
Accumulated other comprehensive income	59	
Accumulated deficit	(87,131)	(82,745)
Total stockholders equity	129,682	68,656
Total liabilities and stockholders equity	$ 149,742	$ 85,529

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

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NETLOGIC MICROSYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(IN THOUSANDS, EXCEPT FOR PER SHARE AMOUNTS)

(UNAUDITED)

	Three months ended		Six months ended	
	June 30, 2006	June 30, 2005	June 30, 2006	June 30, 2005
Revenue	$ 25,831	$ 18,707	$ 49,155	$ 40,509
Cost of revenue	10,094	8,220	19,030	17,704
Gross profit	15,737	10,487	30,125	22,805
Operating expenses:				
Research and development	9,703	5,719	17,764	9,813
In-process research and development			10,700	
Selling, general and administrative	3,996	2,479	7,603	5,271
Total operating expenses	13,699	8,198	36,067	15,084
Income (loss) from operations	2,038	2,289	(5,942)	7,721
Interest and other income, net	923	248	1,604	407
Income (loss) before income taxes	2,961	2,537	(4,338)	8,128
Provision for income taxes	23	112	48	280
Net income (loss)	$ 2,938	$ 2,425	$ (4,386)	$ 7,848
Net income (loss) per share - Basic	$ 0.15	$ 0.14	$ (0.23)	$ 0.45
Net income (loss) per share - Diluted	$ 0.14	$ 0.13	$ (0.23)	$ 0.42
Shares used in calculation - Basic	19,923	17,619	19,393	17,564
Shares used in calculation - Diluted	21,508	18,773	19,393	18,661

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

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NETLOGIC MICROSYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

(UNAUDITED)

	Six months ended June 30, 2006	Six months ended June 30, 2005
Cash flows from operating activities:		
Net income (loss)	$ (4,386)	$ 7,848
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	2,438	918
Non-cash interest expense		136
Stock-based compensation	5,591	1,143
Provision for allowance for doubtful accounts	45	(185)
Provision for inventory reserves	1,400	2,147
In-process research and development	10,700	
Changes in assets and liabilities, net of effect of NSE assets acquired:		
Accounts receivable	(5,033)	79
Inventory	(2,858)	488
Prepaid expenses and other assets	(580)	(1,006)
Accounts payable	26	(1,230)
Accrued liabilities	997	347
Deferred revenue	307	
Other long-term liabilities	(3)	119
Net cash provided by operating activities	8,644	10,804
Cash flows from investing activities:		
Purchase of property and equipment	(947)	(863)
Cash paid for acquisition	(1)	
Net cash used in investing activities	(948)	(863)
Cash flows from financing activities:		
Proceeds from issuance of common stock	3,327	859
Payments of software license and capital lease obligations	(800)	(1,558)
Repurchase of common stock		(8)
Proceeds from payment of notes receivable from stockholders	20	340
Net cash provided by (used in) financing activities	2,547	(367)
Effects of exchange rate on cash and cash equivalents	(10)	
Net increase in cash and cash equivalents	10,233	9,574
Cash and cash equivalents at the beginning of period	65,788	41,411
Cash and cash equivalents at the end of period	$ 76,021	$ 50,985
Supplemental disclosure of cash flow information:		

Cash paid for interest	$	$ 1
Supplemental disclosure of non-cash investing and financing activities:		
Software license obligations	$ 3,233	$ 1,089
Issuance of common stock in connection with the acquisition of Cypress NSE assets	$ 56,201	$

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

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NetLogic Microsystems, Inc.

Notes to Condensed Consolidated Financial Statements

(Unaudited)

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of NetLogic Microsystems, Inc. (we , us , our and the Company) have been prepared in accordance with accounting principles generally accepted in the United States of America and with the instructions for Form 10-Q and Regulation S-X statements. Accordingly, they do not include all of the information and notes required for complete financial statements. In the opinion of management, all adjustments, consisting of only normal recurring items, considered necessary for a fair statement of the results of operations for the periods shown.

These unaudited financial statements should be read in conjunction with the audited financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended December 31, 2005. Operating results for the three and six-month period ended June 30, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

Stock-Based Compensation Expense

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards, including employee stock options and employee stock purchases, based on estimated fair values. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 (SAB 107) relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R). The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company s fiscal year 2006. The Company s Condensed Consolidated Financial Statements as of and for the three and six months ended June 30, 2006 reflect the adoption of SFAS 123(R).

Stock-based compensation expense recognized under SFAS 123(R) for the three and six months ended June 30, 2006 was $3.1 million and $5.6 million, respectively, related to employee stock options and employee stock purchase rights. Under the modified prospective transition method, the Company s Consolidated Financial Statements for prior periods need not be restated to reflect or include the effect of SFAS 123(R). Accordingly, there was no stock-based compensation expense related to employee stock options and employee stock purchase rights recognized in prior periods presented, other than stock-based compensation expense recognized and disclosed previously.

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

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest. Stock-based compensation expense recognized in the Company s Unaudited Condensed Consolidated Statement of Operations for the three and six months ended June 30, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). The Company attributes the value of stock-based compensation to expense on a straight-line single option method for the awards granted subsequent to December 31, 2005, while the accelerated method is being used for awards granted on or prior to December 31, 2005. As stock-based compensation expense recognized in the Unaudited Condensed Consolidated Statement of Operations for the three and six months ended June 30, 2006 is based on awards ultimately expected to vest, it has been reduced for estimated

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forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company s pro forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

The Company uses the Black-Scholes-Merton option-pricing model (Black-Scholes model) as its method of valuation for share-based awards granted beginning in fiscal 2006, the same model used for the Company s pro forma information required under SFAS 123. The Company s determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as assumptions regarding a number of subjective variables. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards as well as actual and projected employee stock option exercise behaviors.

Critical Accounting Policies and Estimates

The preparation of our unaudited condensed consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires us to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base these estimates and assumptions on historical experience and evaluate them on an on-going basis to ensure they remain reasonable under current conditions. Actual results could differ from these estimates. There were no changes to our critical accounting policies and estimates except as noted below.

Stock-based Compensation: We estimate the fair value of stock options using the Black-Scholes-Merton valuation model (the Black-Scholes model), consistent with the provisions of SFAS 123(R), SAB 107 and our prior period pro forma disclosures of net income, including stock-based compensation (determined under a fair value method as prescribed by SFAS 123). Option-pricing model requires the input of highly subjective assumptions, including the option s expected life and the price volatility of the underlying stock. The expected stock price volatility assumption was determined using the historical volatility of the Company s common stock. Changes in the subjective assumptions required in the valuation models may significantly affect the estimated value of the awards, the related stock-based compensation expense and, consequently, our results of operations.

Revenue Recognition: We derive revenue mainly from product sales and, to a lesser extent, from engineering services. Revenue from product sales is recognized upon shipment (except for shipments to a distributor) when persuasive evidence of an arrangement exists, legal title and risk of ownership has transferred, the price is fixed or determinable, and collection of the resulting receivables is reasonably assured. Our sales agreements do not provide for any customer acceptance provisions or return rights. We have no obligation to provide any modification or customization, upgrades, enhancements, post-contract customer support, additional products or enhancements. Customers, other than the distributor discussed below, have no rights of return unless the product does not perform according to specifications. Provisions for warranty expenses are recorded when revenue is recognized.

From time to time we perform engineering services for third parties. Engineering service revenue is recognized as services are performed, agreed-upon milestones are achieved and customer acceptance, if required, is received from the customer.

As a consequence of the acquisition of NSE business assets from Cypress, we began selling our products to a distributor in February 2006. We offer price protection and limited stock rotation rights to the distributor. Given the uncertainties associated with the levels of returns and price protection and other credits potentially issuable to the distributor, revenues and costs relating to the distributor sales are deferred, on a gross basis, until such rights lapse, which is generally upon receiving notification from the distributor that it has resold the products to our end customer.

2. Basic and Diluted Net Income (Loss) Per Share

We compute net income (loss) per share in accordance with SFAS 128, Earnings per Share . Basic net income (loss) per share is computed by dividing net income attributable to common stockholders (numerator) by the weighted average number of common shares outstanding (denominator) during the period. Diluted net income per share gives effect to all dilutive potential common shares outstanding during the period including stock options and warrants using the treasury stock method.

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The following is a reconciliation of the weighted average common shares used to calculate basic net income (loss) per share to the weighted average common and potential common shares used to calculate diluted net income (loss) per share for the three and six months ended June 30, 2006 and 2005 (in thousands, except per share data):

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Numerator:				
Net income (loss)	$ 2,938	$ 2,425	$ (4,386)	$ 7,848
Denominator:				
Common shares outstanding	19,990	17,780	19,460	17,724
Less: shares subject to repurchase	(67)	(161)	(67)	(160)
Shares used in calculation - basic	19,923	17,619	19,393	17,564
Stock options and warrants	1,518	993		937
Shares subject to repurchase	67	161		160
Shares used in calculation - diluted	21,508	18,773	19,393	18,661
Net income (loss) per share:				
Basic	$ 0.15	$ 0.14	$ (0.23)	$ 0.45
Diluted	$ 0.14	$ 0.13	$ (0.23)	$ 0.42

For the three and six months ended June 30, 2006 and 2005, employee stock options to purchase the following number of common shares were excluded from the computation of diluted net income (loss) per share as their effect would be anti-dilutive (in thousands):

Three months ended June 30,		Six months ended June 30,	
2006	2005	2006	2005
634	11	3,394	29

3. Business Combination

On February 15, 2006, we completed the acquisition of net assets of the Network Search Engine business of Cypress Semiconductor Corp. (Cypress) including the Ayama 10000, Ayama 20000, and NSE70000 Network Search Engine families as well as the Sahasra 50000 Algorithmic Search Engine family (the Business). The Sahasra algorithmic technology complements our Layer 7 processing initiative and is a beneficial building block in driving towards low-cost Layer 7 applications acceleration and security processing solutions. In addition, the NSE70000, Ayama 10000 and Ayama 20000 expanded our product offerings in the high-volume, entry-level Layer 3 switch market. These factors contributed to a purchase price in excess of the fair value of net tangible assets acquired from Cypress and as a result, we have recorded goodwill in connection with this transaction. The results of operations relating to the Business have been included in our results of operations from the acquisition date.

Under terms of the agreement, we paid $1,000 in cash and issued 1,488,063 shares of our common stock valued at $49.7 million on February 15, 2006. In addition, we agreed to pay Cypress up to an additional $10.0 million in cash and up to an additional $10.0 million in shares of our common stock if certain revenue milestones associated with the Business are achieved in the twelve-month period after the close of the transaction.

On April 11, 2006, we issued an additional 165,344 shares of our common stock to Cypress upon Cypress furnishing to us the audited financial statements related to the NSE Assets. The value of the additional shares of $6.5 million was considered additional purchase price and recorded as an increase to goodwill during the three months ended June 30, 2006.

The acquisition was accounted for as a purchase business combination. The purchase price of the Business, including the additional 165,344 shares issued on April 11, 2006, was approximately $57.0 million, which has been determined as follows (in 000 s):

Cash	$ 1
Value of NetLogic common stock issued	56,201
Estimated direct transaction costs	753
Total estimated purchase price	$ 56,955

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The value of the 1,488,063 shares of our common stock issued on February 15, 2006 was determined based on the average price of our common stock over a five-day period including the two days before and after January 25, 2006 (the date the definitive agreement was signed and announced), or $33.43 per share. The value of the additional 165,344 shares of our common stock issued on April 11, 2006 upon Cypress furnishing to us the audited financial statements related to the NSE Assets was determined based on the closing price of our common stock on that date, or $39.03 per share.

Under the purchase method of accounting, the total estimated purchase price is allocated to the Business net tangible and intangible assets based on their estimated fair values as of the date of the completion of the acquisition. Based on management estimates of the fair values, the estimated purchase price was allocated as follows (in thousands):

Tangible assets	$ 1,576
Amortizable intangible assets:	
Developed technology	6,500
Backlog	836
In-process research and development	10,700
Goodwill	37,343
Total estimated purchase price allocation	$ 56,955

Developed technology comprises products which have reached technological feasibility and includes the Ayama10000, Ayama 20000, and NSE70000 Network Search Engine product families. The value assigned to developed technology was based upon future discounted cash flows related to the existing products projected income streams using a discount rate of 20%. The Company believes the discount rate was appropriate given the business risks inherent in marketing and selling these products. Factors considered in estimating the discounted cash flows to be derived from the existing technology include risks related to the characteristics and applications of the technology, existing and future markets and an assessment of the age of the technology within its life span. The company expects to amortize the existing technology intangible asset on a straight-line basis over an estimated life of five years.

The backlog intangible asset represents the value of the sales and marketing costs required to establish the order backlog and was valued using the cost savings approach. We expect these orders to be delivered and billed within six months from the acquisition date, which is the period over which the asset is amortized.

Of the total estimated purchase price, an estimate of $10.7 million has been allocated to in-process research and development (IPRD) based upon management s estimate of the fair values of assets acquired and was charged to expense in the six months ended June 30, 2006. We acquired only one IPRD project, which is related to the Sahasra algorithmic technology that has not reached technological feasibility and has no alternative use. The Sahasra algorithmic technology complements our Layer 7 processing initiative and is a beneficial building block in driving towards low-cost Layer 7 applications acceleration and security processing solutions.

The fair value assigned to IPRD was determined using the income approach, under which we considered the importance of products under development to our overall development plans, estimated the costs to develop the purchased IPRD into commercially viable products, estimated the resulting net cash flows from the products when completed and discounted the net cash flows to their present values. We used a discount rate of 23% in the present value calculations, which we derived from a weighted-average cost of capital analysis, adjusted to reflect additional risks related to the products development and success as well as the products stage of completion. The estimates used in valuing IPRD were based upon assumptions believed to be reasonable but which are inherently uncertain and unpredictable. Those assumptions may be incomplete or inaccurate, and unanticipated events and circumstances may occur. Accordingly, actual results may vary from the projected results.

To date, there have been no significant differences between the actual and estimated results of the IPRD project. As of June 30, 2006, we have incurred total post-acquisition costs of approximately $0.4 million related to the IPRD project and estimate that an additional investment of approximately $2.7 million will be required to complete the project. We expect to complete the project by June 2007 and to benefit from the IPRD project beginning in fiscal 2008, which is consistent with our original estimate.

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Of the total estimated purchase price, approximately $37.3 million has been allocated to goodwill. Goodwill represents the excess of the purchase price of an acquired business over the fair value of the underlying net tangible and intangible assets and is deductible for tax purposes. In accordance with the Statement of Financial Accounting Standards No. 142, Goodwill and Other Intangible Assets, goodwill will not be amortized but instead will be tested for impairment at least annually (more frequently if certain indicators are present). In the event that management determines that the value of goodwill has become impaired, we will incur an accounting charge for the amount of impairment during the fiscal quarter in which the determination is made.

Unaudited pro forma results of operations

Summarized below are the unaudited pro forma results of the Company as though the acquisition described above occurred at the beginning of the periods indicated. Adjustments have been made for the estimated amortization of intangibles and other appropriate pro forma adjustments. The charges for purchased in-process research and development are not included in the pro forma results, because they are non-recurring. The information presented does not purport to be indicative of the results that would have been achieved had the acquisition been made as of those dates nor of the results which may occur in the future.

(in thousands, except per share amounts)	Three months ended June 30, 2005	Six months ended June 30, 2005	Six months ended June 30, 2006
Revenue	$ 21,184	$ 44,572	$ 49,965
Net income (loss)	$ (2,967)	$ (2,481)	$ 4,864
Net income (loss) per share - basic	$ (0.16)	$ (0.13)	$ 0.25
Net income (loss) per share - diluted	$ (0.16)	$ (0.13)	$ 0.23

4. Goodwill and Other Intangible Assets

The following table summarizes the components of goodwill, other intangible assets and related accumulated amortization balances, which were recorded as a result of business combination described in Note 3 (in thousands):

	June 30, 2006		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Goodwill	$ 37,343	$	$ 37,343
Other intangible assets:			
Developed technology	6,500	(488)	6,012
Backlog	836	(627)	209
Total	$ 7,336	$ (1,115)	$ 6,221

Backlog, with an estimated useful life of six months, is classified within prepaid expenses and other current assets on the accompanying condensed consolidated balance sheet as of June 30, 2006. For the three and six months ended June 30, 2006, amortization expense related to other intangible assets was $0.7 million and $1.1 million, respectively, all of which was included in cost of sales as they related to the products sold during such periods. As of June 30, 2006, the estimated future amortization expense of other intangible assets in the table above is as follows (in thousands):

Fiscal Year	Estimated Amortization
Remainder of 2006	$ 859
2007	1,300
2008	1,300
2009	1,300
2010 and thereafter	1,462

Total	$	6,221

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In accordance with SFAS 142, the Company evaluates goodwill for impairment at least on an annual basis or whenever events and changes in circumstances suggest that the carrying amount may not be recoverable from its estimated future cash flow. No assurances can be given that future evaluations of goodwill will not result in charges as a result of future impairment.

5. Cash and Cash Equivalents

We consider all highly liquid investments purchased with a remaining maturity of three months or less at the date of purchase to be cash equivalents. At June 30, 2006 and December 31, 2005, our cash and cash equivalents of $76.0 million and $65.8 million, respectively, consisted of cash, cash equivalents and money market funds.

6. Balance Sheet Components

The components of our inventory at June 30, 2006 and December 31, 2005 were as follows (in thousands):

	June 30, 2006	December 31, 2005
Inventories:		
Finished goods	$ 1,783	$ 2,108
Work-in-progress	9,361	6,714
	$ 11,144	$ 8,822

The components of our accrued liabilities at June 30, 2006 and December 31, 2005 were as follows (in thousands):

	June 30, 2006	December 31, 2005
Accrued liabilities:		
Accrued payroll and related expenses	$ 2,687	$ 2,489
Accrued inventory purchases	1,399	692
Accrued warranty	1,501	531
Accrued professional services	796	991
Accrued adverse purchase commitments	138	931
Other accrued expenses	1,884	1,800
	$ 8,405	$ 7,434

7. Product Warranties

We provide a limited product warranty of one year from the date of sale. We provide for the estimated future costs of repair or replacement upon shipment of the product. Our warranty accrual is estimated based on actual and historical claims compared to historical revenue and assumes that we have to replace products subject to a claim. The following table summarizes activity related to product warranty liability during the three and six months ended June 30, 2006 and 2005 (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Warranty accrual:				
Beginning balance	$ 1,265	$ 545	$ 531	$ 381

Provision for warranty	256	271	1,028	984
Settlements made during the period	(20)	(226)	(58)	(775)
Ending balance	$ 1,501	$ 590	$ 1,501	$ 590

During the three and six months ended June 30, 2006, we provided an additional warranty reserve of $0.2 million and $0.9 million, respectively, to address a warranty issue related to specific devices sold to one of our international customers. The devices were tested by both us and the customer and passed quality assurance inspection at the time they were sold. The customer subsequently identified malfunctioning systems that included our devices. We believe that our devices continue to meet the Product Specification; however, we are currently working with the customer to determine the cause of the system malfunctions and have established a warranty reserve for the products that may be replaced.

We entered into a master purchase agreement with Cisco in November 2005 under which we provided Cisco and its contract manufacturers a warranty period of as much as five years (in the case of epidemic failure). The extended warranty period in the master purchase agreement with Cisco has not had a material impact on our results of operations or financial condition based on our warranty analysis, which included an evaluation of our historical warranty cost information and experience.

8. Commitments and Contingencies

Purchase Commitments

At June 30, 2006, we had approximately $7.6 million in firm, non-cancelable and unconditional purchase commitments with our suppliers, including $0.1 million of adverse purchase commitments, which was included in accrued liabilities as of June 30, 2006.

Contingencies

We may be party to claims and litigation proceedings arising from time to time in the normal course of business. Although the legal responsibility and financial impact with respect to such claims and litigation cannot currently be ascertained, we do not believe that we currently have any matters that will result in the payment of monetary damages, net of any applicable insurance proceeds, that, in the aggregate, would be material in relation to our consolidated financial position or results of operations. There can be no assurance, however, that any such matters will be resolved without costly litigation in a manner that is not adverse to our financial position, results of operations or cash flows, or without requiring royalty payments in the future, which may adversely impact gross margins.

Indemnities, Commitments and Guarantees

In the normal course of business, we have made certain indemnities, commitments and guarantees under which we may be required to make payments in relation to certain transactions. These indemnities include intellectual property indemnities to our customers in connection with the sales of our products, indemnities for liabilities associated with the infringement of other parties technology based upon our products, indemnities to various lessors in connection with facility leases for certain claims arising from such facility or lease, and indemnities to our directors and officers to the maximum extent permitted under the corporation laws of Delaware. The duration of each of these indemnities, commitments and guarantees varies and, in certain cases, is indefinite. We have not recorded any liability for these indemnities, commitments and guarantees in the accompanying balance sheets. We do, however, accrue for losses for any known contingent liability, including those that may arise from indemnification provisions, when future payment is probable.

In addition, under the master purchase agreement signed with Cisco in November 2005, we have agreed to indemnify Cisco and its contract manufacturers for costs incurred in rectifying epidemic failures, up to the greater of (on a per claim basis) 25% of all amounts paid to us by Cisco during the preceding 12 months or $9.0 million, plus replacement costs. If we are required to make payments under this indemnity obligation, our operating results, financial condition and cash flows may be adversely affected.

9. Stock Option Plans

We have two stock option plans, the 2004 Equity Incentive Plan and the 2000 Stock Plan (collectively, the Plans). The Plans provide for the granting of stock options to employees and consultants. Options granted under the Plans may be either incentive stock options or nonqualified stock options. Incentive stock options (ISO) may be granted only to our employees (including officers and directors who are also employees). Nonqualified stock options (NSO) may be granted to our employees and consultants. We no longer grant options under the 2000 Stock Plan. A total of 5,823,191 shares of common stock have been reserved for awards issuable under the 2004 Equity Incentive Plan, which further provides for an annual increase of 150,000 shares on each January 1.

Options under the Plans may be granted for periods of up to ten years. Under the Plans the exercise price of (i) an ISO shall not be less than 100% of the estimated fair value of the shares on the date of grant, and (ii) an ISO granted to a 10% stockholder shall not be less than 110% of the estimated fair value of the shares on the date of grant. The exercise

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price of an NSO under the 2004 Plan may be any price as determined by the board of directors. Options granted under the 2000 Stock Plan were exercisable immediately subject to repurchase options held by us which lapse over a maximum period of five years at such times and under such conditions as determined by the board of directors. We have an option to repurchase, in the event of a termination of the optionee s employment relationship, any unvested shares at a price per share equal to the original exercise price per share for the option. When the unvested shares were issued with a promissory note, we have a right to repurchase these unvested shares at the lower of the fair market value of our common stock as of the time the repurchase option is exercised and the original purchase price per share. To date, options granted generally vest over four years. As of June 30, 2006, approximately 67,000 shares of common stock granted under the 2000 Stock Plan were subject to repurchase.

The 2004 Plan also allow for the grant of restricted common stock. During the six months ended June 30, 2006, the Board of Directors granted 0.2 million shares of restricted common stock to certain employees. No shares of restricted common stock were granted in 2005. We calculated deferred compensation expense for restricted stock granted during the six months ended June 30, 2006 based on the fair value of the common stock on the date of grant. We amortize such deferred compensation expense over the vesting period of 2 years.

At the Company s 2006 Annual Meeting of Stockholders held on May 18, 2006, the Company s stockholder s approved an increase in the number of shares reserved for issuance under the 2004 Equity Incentive Plan by adding an additional 1,500,000 shares and transferring to the 2004 Equity Incentive Plan an additional 700,000 shares currently available for issuance under the Company s 2004 Employee Stock Purchase Plan (the 2004 ESPP). They also approved the material terms of the 2004 Equity Incentive Plan for the purposes of Internal Revenue Code Section 162(m).

A summary of all options activity under the Plans is presented below (number of shares in thousands):

		Options Outstanding	
	Shares Available for Grant	Number of Shares Outstanding	Weighted Average Exercise Price
Balances at December 31, 2005	1,526	3,140	$ 12.63
Additional shares authorized	2,350		
Options granted	(636)	636	34.93
Restricted shares granted	(216)		
Options exercised		(318)	9.68
Options forfeited	64	(64)	27.63
Balances at June 30, 2006	3,088	3,394	16.81

	Options Outstanding at June 30, 2006				Options Exercisable at June 30, 2006		
Exercise Price	Number of Shares	Weighted-Average Remaining Contractual Life (in Years)	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in thousands)	Number of Shares	Weighted-Average Exercise Price	Aggregate Intrinsic Value (in thousands)
$0.80 - $2.00	550	6.81	$ 1.97	$ 16,654	352	$ 1.96	$ 10,662
$2.00 - $12.00	670	8.20	9.50	15,243	240	9.77	5,395
$12.00 - $15.28	623	8.47	12.84	12,092	207	12.90	4,005
$15.28 - $21.34	523	9.18	19.25	6,799	56	18.64	762
$21.34 - $27.85	435	9.37	24.78	3,249	205	27.23	1,029
$27.85 - $40.43	593	9.58	34.94	115		35.80	
	3,394	8.57	16.80	$ 52,437	1,060	11.64	$ 21,854

The aggregate intrinsic value in the table above represents the total pretax intrinsic value, based on the Company s closing stock price of $32.25 as of June 30, 2006, which would have been received by the option holders had all option holders exercised their options as of that date. The total number of in-the-money options exercisable as of June 30, 2006 was 1.1 million.

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The total intrinsic value of options exercised and total cash received from employees for those exercises during the three and six months ended June 30, 2006 and 2005 were as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2006	2005	2006	2005
Total intrinsic value of options exercised	$ 3,515	$ 1,281	$ 8,239	$ 2,722
Total cash received for option exercises	$ 1,062	$ 329	$ 3,078	$ 609

Deferred Stock-Based Compensation

During the three months ended June 30, 2005, we recorded deferred stock-based compensation of $0.7 million due to the difference between the exercise price and the estimated fair value of common stock. Deferred-stock based compensation is being amortized over the vesting period of four years. Beginning in fiscal 2006, stock-based compensation expense is calculated based on an estimated fair value under SFAS 123(R) and recognized over the remaining vesting periods. However, as the deferred stock-based compensation recorded as of December 31, 2005 related to the awards granted prior to our becoming a publicly traded company, the remaining balance of deferred stock-based compensation will continue to be accounted for under APB 25 and be amortized for the remaining vesting period. During the three and six months ended June 30, 2006, we amortized $0.2 million an $0.5 million, respectively, of deferred stock-based compensation, which is included in the total stock-based compensation expense of $3.1 million and $5.6 million, respectively, for the same periods.

2004 Employee Stock Purchase Plan

In July 2004, we adopted the 2004 ESPP, which complies with the requirements of Section 423 of the Internal Revenue Code. The shares reserved under the 2004 ESPP are subject to an automatic increase on January 1 of each year in the number of shares equal to the lesser of 75,000 shares or 0.5% of the outstanding shares of our common stock at the end of the preceding fiscal year. The 2004 ESPP permits eligible employees (as defined in the plan) to purchase up to $25,000 worth of our common stock annually over the course of two six-month offering periods, other than the initial two-year offering period which commenced on July 8, 2004. The purchase price to be paid by participants is 85% of the price per share of our common stock either at the beginning or the end of each six-month offering period, whichever is less. At our 2006 Annual Meeting of Stockholders held on May 18, 2006, our stockholders approved the reduction in the number of shares reserved under the 2004 ESPP by 700,000 shares, and the transfer of those reserved shares to our 2004 Equity Incentive Plan. As of June 30, 2006, approximately 57,000 shares had been issued under the Purchase Plan, and approximately 143,000 shares remain available for future issuance. The 2004 ESPP terminates in May 2014.

Stock-Based Compensation under SFAS No. 123(R)

On January 1, 2006, the Company adopted SFAS 123(R), on the modified prospective application method, which requires the measurement and recognition of compensation expense for all share-based awards made to the Company s employees and directors including employee stock options and employee stock purchases outstanding as of and awarded after January 1, 2006. The total stock-based compensation expense recognized for the three and six months ended June 30, 2006 was allocated as follows (in thousands):

	Three months ended June 30, 2006	Six months ended June 30, 2006
Cost of revenues	$ 131	$ 148
Research and development	1,972	3,565
Selling, general and administrative	956	1,878
Total stock-based compensation expense	$ 3,059	$ 5,591

We capitalized approximately $0.2 million of stock-based compensation into inventory as of June 30, 2006, which represented indirect manufacturing expenses related to our inventory.

As of June 30, 2006, there was approximately $19.2 million of total unrecognized stock-based compensation cost, after estimated forfeitures, related to unvested employee stock options, restricted common stock and ESPP, which is expected to be recognized over an estimated weighted average amortization period of 3.01 years. The tax benefit, and the

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resulting effect on cash flows from operations and financing activities, related to stock-based compensation expense was not recognized as the Company currently provides a full valuation allowance for its deferred tax assets.

The method of valuation for share-based awards granted beginning in fiscal 2006 is the Black-Scholes model which was also the method used for the Company s pro forma information required under FAS 123. The expected term of the awards represents the weighted-average period the stock options are expected to remain outstanding which assumes that the employees exercise behavior is a function of the option s remaining contractual life and the extent to which the option is in-the-money (i.e., the average stock price during the period is above the strike price of the stock option). The Company s expected volatility assumption uses the historical volatility of the Company s stock, as applicable for the expected term. The Company also used its historical stock price to determine the fair value of awards for purposes of its pro forma information under FAS 123. Since the Company does not pay dividends, the expected dividend yield is zero. The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of the Company s employee stock options. The post-vesting forfeiture rate is based on the Company s historical option cancellation and employee exercise information as well as the historical information of similar sized companies in the same industry.

Valuation Assumptions

For the three and six months ended June 30, 2006, the fair value of employee stock options granted under the 2004 Equity Incentive Plan and ESPP was estimated using the following weighted average assumptions:

	Three months ended June 30, 2006		Six months ended June 30, 2006
	Stock Options	**Purchase Plan**	