

UTSTARCOM INC
Form 10-Q
October 19, 2007

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 June 30, 2007

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 000-29661

UTSTARCOM, INC.

(Exact name of registrant as specified in its charter)

DELAWARE
(State of Incorporation)

52-1782500
(I.R.S. Employer Identification No.)

1275 HARBOR BAY PARKWAY
ALAMEDA, CALIFORNIA
(Address of principal executive offices)

94502
(zip code)

Registrant's telephone number, including area code: **(510) 864-8800**

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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 is a large accelerated filer, an accelerated filer, or non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer Accelerated Filer 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

As of September 30, 2007 there were 121,294,645 shares of the registrant's common stock outstanding, par value \$0.00125.

TABLE OF CONTENTS

<u>PART I FINANCIAL INFORMATION</u>	13
<u>ITEM 1 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (RESTATED)</u>	13
<u>ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS</u>	48
<u>ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS</u>	76
<u>ITEM 4 CONTROLS AND PROCEDURES</u>	78
<u>PART II OTHER INFORMATION</u>	83
<u>ITEM 1 LEGAL PROCEEDINGS</u>	83
<u>ITEM 1A RISK FACTORS</u>	86
<u>ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS</u>	104
<u>ITEM 3 DEFAULTS UPON SENIOR SECURITIES</u>	104
<u>ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS</u>	104
<u>ITEM 5 OTHER INFORMATION</u>	104
<u>ITEM 6 EXHIBITS</u>	105
<u>SIGNATURES</u>	106

EXPLANATORY NOTE

The Company was unable to file timely its Form 10-Q for the quarterly period ended June 30, 2007 because we had commenced a voluntary review of historical stock option practices and the Audit Committee had also engaged independent counsel to conduct an investigation of sales in China and the results of those reviews / investigations were not known at the date the Form 10-Q filing was due. Information contained herein about the restatements of previously issued financial statements has been taken from the 2006 Annual Report on Form 10-K that was filed with the Securities and Exchange Commission on October 10, 2007. The 2006 Annual Report contains additional information about the restatements which is not included herein.

Our consolidated financial statements and related financial information included in this Quarterly Report on Form 10-Q for accounting periods prior to the third quarter of 2006 have been restated, as described below.

Summary

In July 2007, the Company announced the Audit Committee of the Board of Directors (the "Audit Committee") was conducting an independent investigation of historical sales with certain customers in China and stated that it could not rule out the possibility that the outcome of the investigation could impact revenue recognized for certain of such contracts as recorded in previously issued financial statements. In September 2007, the Company announced the investigative phase of the Audit Committee's investigation had been completed. After consultation with and upon the recommendation of management, the Audit Committee determined revenue in the Company's Western Region of China was recognized earlier than it should have been and that the financial statements for the affected periods should be restated. The Company also announced that its previously issued financial statements for each of the fiscal years ended December 31 in the period 2000 through 2005, the financial statements for the interim periods contained in the Quarterly Reports on Form 10-Q filed with respect to each of these years, and the quarterly reports on Form 10-Q filed with respect to each of the quarterly periods ended March 31 and June 30, 2006 should not be relied upon. In this Quarterly Report we have corrected for the effects of net sales and related costs of net sales that were recorded earlier than they should have been and have restated the financial statements for the three and six months ended June 30, 2006. The net effects for the three and six months ended June 30, 2006 were to recognize previously deferred revenue and an increase (decrease) of gross profit of \$2.4 million and (\$0.4) million, respectively, and \$7.8 million and \$1.0 million, respectively.

We also conducted a voluntary review of historical stock option practices under the direction of the Nominating and Corporate Governance Committee of our Board of Directors ("Governance Committee"). This review considered all option grant awards made in the period from February 29, 2000, shortly before the initial public offering of our Common Stock, through August 2006 for compliance with the various stock-based compensation accounting standards applicable during this period as well as the rules of our stock option plans. We found that in a number of instances we did not use the proper date as the measurement date in determining whether stock options had been issued with exercise prices below the fair value of our common stock. Therefore, we have restated our previously issued financial statements for the years ended December 31, 1998 through 2005 to account for an additional \$25.5 million of stock compensation expense that should have been recognized over the period together with an equal increase in additional paid-in capital to recognize the intrinsic value assigned to these issuances of equity securities. Related adjustments of payroll and income taxes resulted in an additional \$0.5 million of expense being recognized for the 1998 through 2005 period and total stockholders' equity being reduced by a total of \$2.1 million at December 31, 2005. During the first six months of 2006 an additional \$1.2 million of stock compensation expense was recognized, which reduces our previously reported operating results for this period. We have restated the financial statements for the three and six months ended June 30, 2006, and during that period incremental stock compensation expense totaling \$0.5 million and \$1.2 million was recognized, respectively.

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None of these restatements had any effect on any of our cash balances, however cash equivalents were reduced at June 30, 2006 due to the correction in classifications described below.

Additional information about these restatements and their effects on our financial statements is presented below as well as in the Notes to Consolidated Financial Statements.

China Sales Investigation

The Audit Committee engaged independent counsel to conduct an investigation of sales in China following a determination by the Internal Audit group that allegations of improper activities in a sales office in the Western Region were credible. The allegations were made by a Company employee using the Company's whistle blower program. The independent counsel engaged the assistance of forensic accountants, and this group is collectively referred to as the Investigating Team in the rest of this discussion.

In conducting its procedures, the Investigating Team found instances where the customer contracts that evidenced the arrangement contained obligations for the Company to deliver software upgrades when and if made available for the equipment sold for no additional consideration and for an unspecified period that could extend over the term of the contract. This additional contract obligation is an element of post contract support. In these cases, the Investigating Team found that the contract documentation for the same transaction submitted by the sales office to the Company's China headquarters for accounting purposes and utilized by the Company in determining the amount of revenue recognized did not include evidence of such post contract support obligations.

Accounting standards governing revenue recognition for system sales require all revenue to be deferred while there are undelivered elements under the arrangement unless the seller has established vendor specific objective evidence (VSOE) of fair value for such contract elements. Because these arrangements included such undelivered elements, revenue should be deferred based on the VSOE of the fair value of the underlying elements. VSOE of fair value represents the price charged when the same element is sold separately. Since the Company does not sell this element separately, it has not established VSOE for such undelivered elements, and as such the revenue from such contracts is required to be deferred and recognized over the period the Company is obligated to provide the post contract support.

The China sales investigation covered each of the seven years in the period ended December 31, 2006 and included: investigating approximately 1,200 contracts in all of our five regions in China; reviews of the electronic files of 45 employees; and formal interviews of 96 employees in China. Additionally, the China sales investigation included reviewing contract files, performing various financial analyses including comparison of payments received per our accounting records to the contract terms, and computer forensic procedures where destruction of electronic documents was suspected. In the aggregate, the Investigating Team expended approximately 25,000 hours in conducting this investigation, which commenced in February 2007 and was completed in September 2007 when the independent counsel and forensic accountants presented their final report to the Audit Committee. In July 2007, we announced the Audit Committee was conducting an independent investigation of historical sales with certain customers in China and we stated that we could not rule out the possibility that the outcome of the investigation could impact revenue recognized for certain of such contracts as recorded in our previously issued financial statements.

Upon completion of the investigative phase of the independent investigation by the Audit Committee, our management:

conducted follow-up procedures to attempt to locate any additional relevant information to ensure the Company considered all available information and documents;

evaluated the accounting for identified system sales using the contract template and documentation found in the sales contract files from the Western Region offices. This included calculating the financial statement effects of correcting the accounting for all system sales where the contract template found at our sales offices contained post contract support obligations to recognize revenue and cost of net sales over the estimated period of post contract support; and

concluded that as a result of the existence of this undelivered post contract support obligation our previously issued financial statements should be restated to defer system sales contract revenue and the related cost of net sales over the estimated period of post contract support when a contract contained unspecified software upgrade rights.

The Audit Committee concurred with management's decisions.

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The effect of correcting improperly recognized revenue and cost of net sales was to (reduce) increase previously reported net sales, gross profit and net income by the following amounts (in thousands of dollars):

<u>Year ended December 31,</u>	Net sales		Gross profit		Net income	
2000	\$	(12,408)	\$	(5,294)	\$	(4,781)
2001		(17,154)		(6,330)		(5,779)
2002		(64,732)		(22,924)		(19,697)
2003		(21,060)		(8,014)		(6,382)
Totals through December 31, 2003		(115,354)		(42,562)		(36,639)
2004		(104,965)		(27,241)		(18,594)
2005		(58,232)		(27,863)		(42,433)
2000 - 2005 Total	\$	(278,551)	\$	(97,666)	\$	(97,666)
<u>2006 quarter ended</u>						
March 31		5,410		1,360		1,360
June 30		2,379		(371)		(371)
Total China Sales Restatement		(270,762)		(96,677)		(96,677)

The cumulative effect of all of the China sales restatement adjustments to our consolidated balance sheet as of December 31, 2003 resulted in a decrease in retained earnings of \$36.6 million, an increase in deferred revenue of \$115.4 million to account for previously recognized sales, an increase in deferred costs of \$72.8 million to account for previously recognized cost of net sales, and an increase in deferred tax assets and prepaid taxes of \$5.9 million. In our consolidated balance sheet at June 30, 2007 the net reduction in previously recognized net sales is accounted for as deferred revenue, of which \$37.6 million is classified as current and \$227.2 million as non-current, and the related net reduction in cost of net sales of \$169.7 million is accounted for as deferred costs. These amounts are being recognized in our consolidated statements of operations over the estimated remaining period of post contract support.

Upon completing its investigation, the Audit Committee concluded that the conditions and practices relating to systems contracts prevalent in the Western Region resulted primarily from the failure to prevent or detect instances of override related to controls in China over customer agreements, lack of proper management oversight, unclear record retention policies and procedures relating to systems contracts, and inadequate employee training. The Investigating Team and the Audit Committee also concluded that with respect to four regions other than the Western Region there was no evidence of fraud or misconduct or reason to suspect such occurred. The Investigating Team and the Audit Committee also concluded that there was no credible evidence of knowledge by senior management in China or the United States of the conditions and practices related to the Western Region of China that were discovered in the investigation. The Audit Committee concluded that local management in several of the sales offices in the Western Region of China did not submit appropriate information to the Company's senior management in China and the United States. Therefore, in prior years, neither the Company's management nor the Company's independent registered accounting firm were able to properly evaluate the effect of that information on revenue recognition. The Audit Committee also concluded that certain members of management in China bear varying degrees of responsibility for inadequate oversight of activities. As a result, certain employees in China

have either been terminated or placed on suspension for failure to provide adequate oversight of activities.

We have restructured the management of the Western Region sales organization and are working to identify and implement changes to our policies and procedures and enhance employee training to improve internal control consciousness and lessen the possibility of accounting errors occurring in the future.

Stock Option Accounting

In November 2006, we announced we had commenced a voluntary review of historical stock option practices under the leadership of the Governance Committee following a preliminary review by management which identified potential deficiencies and discrepancies in the documentation of stock option grants. The review considered all option grant awards

made in the period from February 29, 2000, shortly before the initial public offering of our Common Stock, through August 2006 (Review Period) for compliance with the various stock-based compensation accounting standards applicable during the Review Period as well as the rules of our stock option plans. The Governance Committee engaged independent outside legal counsel to assist in the review who, in turn, engaged forensic accountants. (Separate law firms and separate forensic accounting firms were engaged by the Audit Committee and the Governance Committee for the China sales investigation and the stock option accounting review.) In the rest of this discussion, this group collectively is referred to as the Stock Option Review Team and their actions and activities are referred to as the Stock Option Review. The Stock Option Review Team members spent over 11,000 hours in this review, and the Governance Committee met with the Stock Option Review Team on more than a dozen occasions to receive, discuss, and consider the Stock Option Review Team's information and findings.

At the time the review commenced, the Governance Committee consisted of three members of the Board of Directors, all of whom are independent directors. The Committee decided to delegate supervision of the review to Mr. Jeff Clarke, its Chairman, who joined our Board in 2005 and had not served on the Compensation Committee of the Board of Directors (Compensation Committee) during the period under review. The Governance Committee also consisted of two other independent directors, Mr. Larry D. Horner and Mr. Thomas Toy, who also serve on the Board's Compensation Committee. Mr. Allen Lenzmeier was appointed to the Governance Committee on April 27, 2007.

Review procedures included:

- interviews of individuals involved with granting, advising, administering, or accounting for stock options, including current and former: management, members of the Board of Directors, employees, and non-employee professionals;

- review of relevant stock administration, human resource, legal, and finance department files and records;

- review of stock option grant information in select employee personnel files;

- review by at least 30 attorneys and 15 forensic accountants of approximately 250,000 potentially relevant e-mails and documents in electronic format selected through electronic discovery techniques from over 1.8 million electronic documents processed;

- review of the electronic database of the Company's stock option activity maintained by a third party along with communications to and from this service provider;

- reconciliation of grant activity from approval documents executed by the Compensation Committee with the electronic database;

- reconciliation of stock option grant, exercise, and cancellation information from SEC filings with select employee personnel files and the electronic database;

- statistical and judgmental pattern analysis;

- follow-up on matters raising questions about the option granting process and its history, conduct of those involved with granting, advising, administering, or accounting for stock options, or the accounting treatment for stock options; and

- follow-up on items or issues requested or identified by management or the Company's independent registered public accounting firm.

The Stock Option Review Team, management, and the Governance Committee decided to group stock option grants into six award categories based on differences in what constituted substantive approval for each category under our stock option granting practices as well as giving consideration to the risk of intentional misstatement of the grant date. Guidance in a September 19, 2006 letter publicly issued by the SEC's Chief Accountant focuses on the concept that a measurement date under Accounting Principles Board Opinion No. 25 *Accounting for Stock Issued to Employees* (APB 25), the accounting standard governing our stock option accounting through 2005, does not occur until the number of

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shares an individual employee is entitled to receive and the exercise price is determined with finality (i.e., no longer subject to change). This is the date on which substantive approval occurred, and depending on a company's facts and circumstances the guidance from the SEC discussed above recognizes a company may determine that the measurement date for some stock option grants may occur before all required granting actions have occurred—such as final approval by the Compensation Committee. This alternative is available only when a review of all facts and circumstances supports a conclusion that substantive approval occurs earlier than when all required granting actions have occurred and there is no evidence of fraudulent or manipulative conduct in the company's option granting practices.

In determining the measurement date to be used, the Stock Option Review Team, management, and the Governance Committee agreed to use the following definitions as constituting the proper measurement date, and generally these dates were used in testing the stated grant dates or establishing corrected measurement dates:

Discretionary Director and Officer Grants	The date of a Compensation Committee meeting where the grant was approved or the date the final Compensation Committee signer approved the grant when approval occurred through unanimous written consent documents (UWC).
Automatic Director Grants	The date specified in the relevant stock option plan.
Broadbase	The date the grantee list, including the allocation of shares to individual grantees, was complete. Compensation Committee approval was considered perfunctory due to delegation of authority to management.
Acquisition	The first Compensation Committee meeting following the acquisition, provided grantees had received employment offer letters stating the number of stock options to be granted before such date, because this was the date at which the option exercise price was established. Compensation Committee approval was considered perfunctory due to delegation of authority to management.
New Hire	The first scheduled Compensation Committee meeting following the first day of employment, because this was the date at which the option exercise price was established. The number of options was based on either grant amounts specified in an employment offer letter or, in some cases, on a matrix that assigned grant amounts based on position and level within the Company. Compensation Committee approval was considered perfunctory due to delegation of authority to management.
Other Merit	The date the grantee list, including the allocation of shares to grantees, was substantially complete. Compensation Committee approval was considered perfunctory due to delegation of authority to management.

For 12 tested grant dates where a corrected measurement date was required, the Stock Option Review Team and management were unable to locate sufficient evidence to establish a corrected measurement date using our established criteria for the applicable option grant type. In these situations alternative available evidence was used to establish the corrected measurement date.

During the period covered by the Stock Option Review, we granted stock options on approximately 34 million shares of our Common Stock at 197 grant dates. The review specifically examined the appropriateness of the stated grant date for approximately 90% of the stock options granted, including all stock option grants made to directors and officers, all broadbase grants and all option grants made in connection with business acquisitions.

The findings of this review are summarized as follows:

Grant Type	Number of grants	Grants tested	No change required	Measurement date changed	
				additional compensation expense required	no additional compensation expense required(1)
Discretionary Director & Officer	16	16	8	4	4
Automatic Director	5	5	5		
Broadbase	8	8		6	2
Acquisition	10	10	10		
New Hire	166	48	48		
Other Merit	96	41	4	21	16
Total	301(2)	128	75	31	22

(1) Under APB 25 there is no expense adjustment arising from using the corrected measurement date for these grants because the amount the employee would have to pay to exercise these stock option grants exceeded the quoted market price of our Common Stock at the corrected measurement date, and therefore, these stock option grants contained no intrinsic value at the corrected measurement date.

(2) The number of grants exceeds the number of grant dates because on certain grant dates more than one category of stock option grants were approved.

In late January 2007 the Governance Committee reported its interim findings concerning the use of incorrect measurement dates in our stock option accounting under APB 25 to our Board of Directors. On February 1, 2007, the Audit Committee of the Board of Directors then concluded, in consultation with and upon the recommendation of management, that we should correct for errors in previously reported stock-based compensation expense through restatement of our previously issued financial statements and that our previously issued financial statements for all periods should no longer be relied upon. We communicated this decision in a February 1, 2007 public announcement.

A non-cash compensation charge, to be recognized as an expense over a grantee's service period, arises under APB 25 if a stock option has intrinsic value at its measurement date. This intrinsic value is measured by the excess, if any, of the fair value at the date of grant of the underlying common stock over the stock option's exercise price. Our practice has been to grant stock options with exercise prices equal to the closing price of our Common Stock at each grant date, to use the grant date as the measurement date for stock-based compensation purposes, and as such previously we had determined the granted stock options had no intrinsic value at their grant dates and no compensation expense was recognized. However, APB 25 states the measurement date does not occur until all essential actions necessary to grant the option are completed, including the final determination of both the number of shares to be granted to each employee or director and the exercise price, and the option grant is approved by those with requisite authority. This is reinforced by the September 19, 2006 letter issued by the SEC's Chief Accountant which focuses on the need for the number of shares and exercise price of an award to an individual to be finalized to have a measurement date. This letter clarifies the SEC staff's view that if it is possible that those terms could change, a measurement date has not occurred, even if the award's terms are not actually changed.

Based on the available evidence, the review found that the number of shares an individual employee was entitled to receive and/or the exercise price was not determined with finality at the stated grant date on 53 tested grant dates, and we should have used a later date as the measurement date. The principal reasons for the stated grant date not qualifying as the measurement date under APB 25 include:

certain listings of grantees, below officer level, were incomplete and added to or modified by stock option administration personnel after the grant was approved by the Compensation Committee;

for certain grants where Compensation Committee approval was not considered perfunctory, the date a UWC document was sent to Compensation Committee members for approval was used as the stated grant date for some discretionary officer and director grants rather than the date the UWC was signed by all Compensation Committee members and therefore became effective; and

the Stock Option Review Team was unable to locate contemporaneous documentation of some director and officer, broadbase, new hire, and other merit grants.

During the review the Company also discovered a stock option grant to a former officer that was modified in 1998 in connection with his termination of employment. This change was never included in the Company's stock option grant records and the additional compensation expense resulting from the change in the option's terms (approximately \$1.2 million) was not recorded previously. This discovery is consistent with the Stock Option Review Team's finding that in certain instances there was a lack of formal documentation in the stock option granting process and/or expected documentation is missing from the stock option administration files. In addition, the Stock Option Review Team found that, in many instances, there was a lack of self-authenticating evidence to corroborate that cash exercises were contemporaneous. As a result, the findings on the issue of backdating of cash exercises were inconclusive.

We restated our consolidated financial statements to recognize additional non-cash stock-based compensation expense arising from using corrected measurement dates for certain stock option grants made during the years 2000 through 2005 and to reflect the modification of the 1998 grant described above. Consistent with our historical accounting policy this additional stock-based compensation expense is being recognized on an accelerated basis by treating each vesting tranche as a separate stock option grant (graded vesting).

Our accounting for stock-based compensation changed to a fair value based method in 2006 when, as required by accounting standards, we ceased accounting for stock-based compensation under the intrinsic value method pursuant to APB 25 and began accounting for stock-based compensation under Statement of Financial Accounting Standards 123(R) *Share-Based Payments* (SFAS 123(R)). Under this method all stock option grants have a fair value determined using an option pricing model, and such fair value is used to recognize non-cash stock-based compensation expense. We restated our unaudited condensed consolidated financial statement information for the first and second fiscal quarters of 2006, included in Exhibit 99.1 in our Annual Report on Form 10-K for the year ended December 31, 2006 (and as reflected in our results for the three and six months ended June 30, 2006 included in this Form 10-Q), to recognize changes in non-cash stock-based compensation expense that arose from a re-determination of the fair value of stock options granted in 2005 and prior where the Governance Committee's review resulted in a corrected measurement date. By January 1, 2006, of the 17.9 million options granted in 2000 - 2005 where corrections were made to the measurement dates in the Stock Option Review, 4.4 million options with corrected measurement dates granted in 2000 and 2001 had fully vested. Therefore, the fair values of the outstanding and unvested portion of the remaining 13.5 million stock options granted in 2002-2005 with incorrect measurement dates were recalculated. We also recorded additional non-cash stock-based compensation expense in the first two quarters of 2006 arising from correcting the measurement date for stock option grants to three individuals in this period. We recognize stock compensation expense on a straight-line basis under SFAS 123(R).

Those stock option grants with corrected measurement dates have also been restated using the fair value based measurement principles of Statement of Financial Accounting Standards 123 *Accounting for Stock-Based Compensation* (SFAS 123) to present, in Note 2, *Restatement of Financial Statements* of Notes to Consolidated Financial Statements contained in Item 8 of the Company's 2006 Annual Report, the pro forma effect on stock-based compensation expense, net income (loss), and earnings (loss) per share amounts in 2004 and 2005 of using the fair value based method to determine stock-based compensation expense rather than using APB 25's intrinsic value method. Such disclosure is required in financial statements for periods prior to the adoption of SFAS 123(R).

In addition to restating the consolidated financial statements in response to the Governance Committee's findings, we recorded additional non-cash adjustments to account for the modification in 1998 of a stock option grant to a former officer in connection with his termination of employment and to record in the first two quarters of 2006 corrections relating to accounting for performance related stock options and restricted stock grants, all of which were previously identified and considered immaterial.

Correcting the measurement date for previously granted stock options in some cases results in additional taxable income to employees on which additional payroll taxes are due from the employees as well as us. We have provided for all additional payroll taxes plus related penalties and interest arising from the restatement of stock-based compensation, including amounts otherwise payable by stock option recipients, and our restated financial statements include an accrual in all affected years of approximately \$1.5 million for all estimated payroll tax related expenses.

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The corrections for the stock option restatement were to increase (reduce) previously reported non-cash compensation expense, payroll taxes, income taxes and net income by the following amounts (in thousands of dollars):

<u>Year ended December 31,</u>	Non-cash stock compensation	Payroll taxes	Income taxes	Net income
1998	\$ 1,244	\$	\$ (448)	\$ (796)
1999				
2000	556		(104)	(452)
2001	4,870		(942)	(3,928)
2002	8,110		(1,550)	(6,560)
2003	12,470	900	(2,281)	(11,089)
Totals through December 31, 2003	27,250	900	(5,325)	(22,825)
2004	(410)	541	250	(381)
2005	(1,290)	60	4,083	(2,853)
2000-2005 Total	25,550	1,501	(992)	(26,059)
<u>2006 quarter ended</u>				
March 31	662	9		(671)
June 30	504	6		(510)
	\$ 26,716	\$ 1,516	\$ (992)	\$ (27,240)

The Governance Committee's review found 17.9 million stock options of the 28.8 million options granted on our Common Stock during 2000 through 2005 had incorrect measurement dates. Using the corrected measurement dates, 7.6 million stock options had exercise prices that exceeded the closing price of our Common Stock and therefore had no intrinsic value to be accounted for under APB 25, and 10.3 million stock options had intrinsic value because their exercise prices were below the closing price of our Common Stock. These 10.3 million stock options resulted in an increase in additional non-cash stock-based compensation expense of \$24.3 million, and an additional \$1.5 million of payroll tax related expenses during 2000-2005 partially offset by \$0.5 million of income tax benefit as shown in the above table. Of the 10.3 million stock options resulting in additional non-cash stock-based compensation expense, 2.0 million options were granted to officers and directors and resulted in \$6.1 million of additional non-cash stock-based compensation expense.

The total effect of the stock option restatement and the amounts for 2006, as shown in the above table, have been reflected in the December 31, 2006 financial statements as well as in the June 30, 2006 financial statements. As a result of this restatement, net loss increased by \$0.5 million and \$1.2 million for the three and six months ended June 30, 2006, respectively.

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Upon completing its review, the Governance Committee concluded it found no evidence of intent to manipulate the Company's operating results or financial statements. A key finding of the Governance Committee was that there were deficiencies with the process by which stock options were granted during the period from our initial public offering in 2000 through at least 2005, which resulted in accounting errors. The Governance Committee concluded that certain members of management bear varying degrees of responsibility for the deficiencies in the process by which options were granted. The Governance Committee's review also concluded that none of the current or former employees or directors of the Company engaged in intentional wrongdoing.

In determining the above restatement amounts, management used all reasonably available relevant information to form conclusions it believes are reasonable as to the most likely option granting actions that occurred, the dates when such actions occurred, and the determination of grant dates for financial accounting purposes based on when the requirements of the accounting standards were met. In light of significant judgment used in establishing revised measurement dates, alternative approaches to those used by the Stock Option Review Team and management could have resulted in different compensation charges than those recorded in the restatement. The Stock Option Review Team and management considered various alternatives throughout the course of the review and restatement, and management believes the adjustments to measurement dates used in our review of stock option grant accounting and restatement of our financial statements were reasonable and appropriate in our circumstances.

Summary of Restatement Amounts

The following table presents the decrease in net earnings from the restatement for each restated year:

	Net income (loss), as previously reported	Restatement adjustments		Total	Net income (loss), as restated
		China Sales	Stock Options (in thousands) (Decrease) Increase		
<u>Year ended December 31,</u>					
1998	\$	\$	(796)	\$	(796)
1999					
2000		(4,781)	(452)		(5,233)
2001		(5,779)	(3,928)		(9,707)
2002	\$ 107,862	(19,697)	(6,560)	(26,257)	\$ 81,605
2003	\$ 209,856	(6,382)	(11,089)	(17,471)	\$ 192,385
Totals through					
December 31, 2003		(36,639)	(22,825)	(59,464)	
2004	\$ 69,824	(18,594)	(381)	(18,975)	\$ 50,849
2005	(\$487,359)	(42,433)	(2,853)	(45,286)	\$ (532,645)
2000 - 2005 Total		(97,666)	(26,059)	(123,725)	
<u>2006 quarter ended</u>					
March 31	(\$10,635)	1,360	(671)	689	\$ (9,946)
June 30	(\$21,443)	(371)	(510)	(881)	\$ (22,324)
	\$	(96,677)	\$ (27,240)	\$	(123,917)

The cumulative effect on stockholders' equity at December 31, 2003 from the above corrections was as follows (in thousands):

Increase (decrease) in paid-in capital and deferred stock compensation:	
Values assigned to stock options	\$ 27,250
Reduction of previously recorded income tax benefits from stock options	(1,278)
Net increase in paid-in capital and deferred stock compensation	25,972
(Increase) decrease in accumulated deficit:	
Revenue and related cost of sales deferral for China system sales	(36,639)
Additional non-cash compensation expense from stock options	(27,250)
Payroll taxes for values assigned to stock options	(900)
Income tax benefit from additional compensation and payroll tax expense	5,325
Net increase in accumulated deficit	(59,464)
Net decrease in stockholders' equity at December 31, 2003	\$ (33,492)

In restating the previously issued financial statements for the investigations discussed above, we also corrected other previously reported amounts. We corrected the reporting of net sales to certain third party resellers and associated cost of net sales for the three and six months ended June 30, 2006 to classify these amounts as related party net sales and related party cost of net sales classifications of \$4.2 million and \$3.0 million, respectively, and \$12.9 million and \$4.8 million, respectively, because in 2006 we determined that sales to these entities were, in substance, sales to a significant shareholder, SOFTBANK CORP. The classification of the accounts receivable from these sales was similarly changed to include them in accounts receivable from related parties in the June 30, 2006 consolidated balance sheet. We also corrected our reporting of \$6.2 million of time deposits at June 30, 2006 because they did not mature within three months. Formerly the time deposits had been reported in error as cash equivalents, but now these amounts are included in short-term investments in the balance sheet and in the statement of cash flows for the June 2006 reporting period.

PART I FINANCIAL INFORMATION

ITEM 1 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

UTSTARCOM, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands, except share data)

	June 30, 2007	December 31, 2006
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 509,423	\$ 661,623
Short-term investments	18,156	9,546
Accounts receivable, net of allowances for doubtful accounts of \$56,856 and \$53,894 at June 30, 2007 and December 31, 2006, respectively	295,557	373,762
Accounts receivable, related parties, net of allowances for doubtful accounts of \$12 and \$19 at June 30, 2007 and December 31, 2006, respectively	27,335	32,318
Notes receivable	4,083	5,060
Inventories	466,222	440,445
Deferred costs	186,734	195,393
Prepays and other current assets	132,882	101,795
Short-term restricted cash and investments	9,797	16,666
Total current assets	1,650,189	1,836,608
Property, plant and equipment, net	212,873	213,155
Long-term investments	96,407	47,809
Goodwill	3,063	3,063
Intangible assets	48,351	56,443
Long-term deferred costs	169,745	176,649
Other long-term assets	38,445	40,223
Total assets	\$ 2,219,073	\$ 2,373,950
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	\$ 219,736	\$ 304,869
Short-term debt	379,935	102,758
Income taxes payable		2,483
Customer advances	298,104	265,812
Deferred revenue	96,422	