UTSTARCOM INC
Form 10-Q
August 09, 2002

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2002.

OR

o **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	**52-1782500**
(State of Incorporation)	(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

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 ý No o

As of July 31, 2002 there were 111,897,041 shares of the Registrant's Common Stock outstanding, par value $0.00125.

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PART I FINANCIAL INFORMATION

ITEM 1 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

UTSTARCOM, INC.
CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)
(In thousands, except share and per share data)

	June 30, 2002	December 31, 2001
ASSETS		
Current assets:		
Cash and cash equivalents	$ 338,201	$ 321,136
Short-term investments	64,565	86,176
Accounts receivable, net of allowances for doubtful accounts of $26,038 and $19,053 at June 30, 2002 and December 31, 2001, respectively	229,247	193,046
Inventories, net	269,910	229,050
Other current assets	69,484	67,067
Total current assets	971,407	896,475
Property, plant and equipment, net	56,944	43,942
Long-term investments	19,972	17,818
Goodwill and intangible assets, net	50,981	38,992
Other long-term assets	10,606	8,653

	June 30, 2002	December 31, 2001
Total assets	$ 1,109,910	$ 1,005,880
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 131,830	$ 83,649
Debt-current portion	8,433	58,434
Income taxes payable	15,242	10,536
Deferred revenue	98,479	76,424
Other	76,232	76,329
Total current liabilities	330,216	305,372
Long-term debt	14,283	12,048
Minority interest in consolidated subsidiaries		6,573
Total liabilities	344,499	323,993
Commitments and Contingencies (Note 12)		
Stockholders' equity:		
Common stock: $0.00125 par value; authorized: 250,000,000 shares; issued and outstanding: 111,695,560 and 109,302,816	141	138
Additional paid-in capital	678,358	638,697
Deferred stock compensation	(5,123)	(6,045)
Retained earnings	92,407	49,146
Receivable from stockholders	(342)	(381)
Other comprehensive income (loss)	(30)	332
Total stockholders' equity	765,411	681,887
Total liabilities and stockholders' equity	$ 1,109,910	$ 1,005,880

See accompanying notes to condensed consolidated financial statements.

UTSTARCOM, INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(In thousands, except per share data)

	Three months ended		Six months ended	
	June 30, 2002	June 30, 2001	June 30, 2002	June 30, 2001
Net sales:				
Unrelated parties	$ 184,561	$ 140,047	$ 354,861	$ 259,228
Related parties	46,947		60,337	

	Three months ended		Six months ended	
	$ 231,508	$ 140,047	$ 415,198	$ 259,228
Cost of sales	145,596	90,140	263,644	167,908
Gross profit	85,912	49,907	151,554	91,320
Operating expenses:				
Selling, general and administrative	29,520	18,759	53,206	32,890
Research and development	21,370	13,286	40,567	25,698
In process research and development	670		670	
Amortization of intangible assets	656	1,965	1,133	3,436
Total operating expenses	52,216	34,010	95,576	62,024
Operating income	33,696	15,897	55,978	29,296
Interest income	1,454	1,742	3,028	4,093
Interest expense	(447)	(1,058)	(1,135)	(1,919)
Other income (expenses) net	(1,744)	1,002	(1,551)	(36)
Equity in income (loss) of affiliated companies	(6)	(457)	(799)	(701)
Income before income taxes and minority interest	32,953	17,126	55,521	30,733
Income tax expense	6,590	4,032	11,104	7,684
Minority interest in (earnings) of consolidated subsidiaries	(628)	(834)	(1,156)	(1,427)
Net income	$ 25,735	$ 12,260	$ 43,261	$ 21,622
Basic earnings per share	$ 0.23	$ 0.13	$ 0.39	$ 0.22
Diluted earnings per share	$ 0.22	$ 0.12	$ 0.37	$ 0.21
Weighted average shares used in per-share calculation:				
Basic	111,549	97,269	110,806	97,171
Diluted	117,343	105,264	117,074	105,259

See accompanying notes to condensed consolidated financial statements.

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UTSTARCOM, INC.
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(In thousands)

	Six months ended	
	June 30, 2002	**June 30, 2001**
CASH FLOWS FROM OPERATING ACTIVITIES:		

	Six months ended	
Net income	$ 43,261	$ 21,622
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	10,063	7,551
Non-qualified stock option exercise tax benefits	3,031	7,660
Net loss on sale of assets	251	274
In-process research and development costs	670	
Impairment of long term investment	1,090	1,150
Stock compensation expense	1,858	2,320
Allowance for doubtful accounts	6,985	2,589
Inventory reserve	7,887	2,906
Equity in net loss of affiliated companies	799	701
Minority interest in earnings of consolidated subsidiary	1,156	721
Changes in operating assets and liabilities:		
Accounts receivable	(42,862)	(28,864)
Inventories	(48,056)	(65,102)
Other current and non-current assets	(4,199)	(29,305)
Accounts payable	45,302	26,138
Income taxes payable	4,709	(7,267)
Deferred revenue	22,055	57,963
Other current liabilities	(1,011)	7,134
Net cash provided by operating activities	52,989	8,191
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property, plant and equipment, net	(21,563)	(11,162)
Investment in affiliates	(6,044)	(6,479)
Acquisition of businesses, net of cash acquired	(17,705)	
Proceeds from disposal of property	169	151
Purchase of short-term investments	(49,174)	(17,621)
Sales of short-term investments	70,564	73,518
Net cash provided by (used in) investing activities	(23,753)	38,407
CASH FLOWS FROM FINANCING ACTIVITIES:		
Issuance of stock, net of expenses	35,697	7,336
Proceeds from borrowing	31,149	65,060
Payments for borrowing	(78,915)	(50,607)
Proceeds from stockholder receivables	39	183
Net cash provided by (used in) financing activities	(12,030)	21,972
Effects of exchange rates on cash	(141)	(25)
Net increase in cash and cash equivalents	17,065	68,545
Cash and cash equivalents at beginning of period	321,136	149,112
Cash and cash equivalents at end of period	$ 338,201	$ 217,657

See accompanying notes to condensed consolidated financial statements.

UTSTARCOM, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. BASIS OF PRESENTATION:

The accompanying unaudited condensed consolidated financial statements include the accounts of UTStarcom, Inc. (the "Company") and its wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in the preparation of the condensed consolidated financial statements. Minority interest in consolidated subsidiaries and equity in affiliated companies are shown separately in the condensed consolidated financial statements. Investments in affiliated companies, of which all relate to ownership interests of no greater than 10 percent, are accounted for using the cost method.

The accompanying financial data as of June 30, 2002 and for the three and six months ended June 30, 2002 and June 30, 2001 have been prepared by the Company, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The December 31, 2001 balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. These condensed consolidated financial statements should be read in conjunction with the Company's audited December 31, 2001 financial statements, including the notes thereto, and the other information set forth in the Company's Annual Report on Form 10K/A.

In the opinion of management, the accompanying condensed consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) considered necessary for a fair presentation of the Company's financial condition, the results of its operations and its cash flows for the periods indicated. The results of operations for the three and six months ended June 30, 2002 are not necessarily indicative of the operating results for the full year.

2. REVENUE RECOGNITION:

Revenues from sales of telecommunication equipment are recognized when persuasive evidence of an agreement exists, delivery of the product has occurred, the fee is fixed or determinable and collectibility is reasonably assured. The majority of the Company's revenue is recognized upon the receipt of final acceptance certificates. Where multiple elements exist in an arrangement, revenue is allocated to the different elements based upon verifiable objective evidence of the fair value of the elements. Revenues from sales of telecommunication equipment involving significant modification or customization of the product or where services being provided are deemed to be essential to the functionality of the product are recognized using the percentage completion method if the project cost can be reasonably estimated. If the cost cannot be reasonably estimated, the completed contract method is applied. Any payments received prior to revenue recognition are recorded as deferred revenue.

Revenues from sales of telecommunication equipment incorporating software not considered incidental to the product as a whole ("software contracts") are recognized when persuasive evidence of an agreement exists, the product has been delivered, the fee is fixed or determinable and collectibility is probable. Revenues from software contracts with multiple elements are recognized using the residual method when there is vendor specific objective evidence of the fair value of all undelivered elements in an arrangement but vendor specific objective evidence of fair value does not exist for one or more of the delivered elements in an arrangement. Under the residual method, the fair value of the undelivered elements, as indicated by vendor specific objective evidence, is deferred and the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements regardless of any separate prices stated within the contract for each

element. If the fee due from the customer is not fixed or determinable due to extended payment terms, revenue is recognized as payments become due from the customer, assuming all other criteria for revenue recognition is met.

Revenues from engineering service contracts are recognized upon completion of the project, or using the percentage of completion method where project costs can be reasonably estimated.

3. EARNINGS PER SHARE:

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of shares of the Company's common stock outstanding during the period. Diluted earnings per share is determined in the same manner as basic earnings per share except that the numbers of shares is increased by potentially dilutive common shares outstanding during the period. Potentially dilutive common shares consist of employee stock options and warrants.

The following table presents the calculation of basic and diluted earnings per share (in thousands, except per share data):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2002	2001	2002	2001
Numerator:				
Net income	$ 25,735	$ 12,260	$ 43,261	$ 21,622
Denominator:				
Shares used to compute basic EPS	111,549	97,269	110,806	97,171
Dilutive common stock equivalent shares:				
Stock options	5,766	7,967	6,239	8,060
Warrants	28	28	29	28
Shares used to compute diluted EPS	117,343	105,264	117,074	105,259
Basic earnings per share	$ 0.23	$ 0.13	$ 0.39	$ 0.22
Diluted earnings per share	$ 0.22	$ 0.12	$ 0.37	$ 0.21

Certain potential shares outstanding during the three and six months ended June 30, 2002 and June 30, 2001 were excluded in the diluted per share computations, since their exercise prices were greater than the average market price of the common shares during the period and, accordingly, their effect is anti-dilutive. For the three months ended June 30, 2002 these shares totaled 2.3 million at a weighted average exercise price of $24.24 per share, compared to 1.2 million with a weighted average exercise price of $24.65 per share for the corresponding period in 2001. For the six months ended June 30, 2002 these shares totaled 1.0 million at a weighted average exercise price of $25.95 per share, compared to 1.2 million with a weighted average exercise price of $24.64 per share for the corresponding period in 2001.

4. COMPREHENSIVE INCOME:

The reconciliation of net income to comprehensive income for the three and six months ended June 30, 2002 and 2001 is as follows (in thousands):

	Three Months Ended		Six Months Ended	
	June 30, 2002	June 30, 2001	June 30, 2002	June 30, 2001
Net income	$ 25,735	$ 12,260	$ 43,261	$ 21,622
Unrealized gains (losses) on investments	14	(148)	(221)	7
Change in cumulative translation adjustments	(9)	(25)	(141)	(25)
Total comprehensive income	$ 25,740	$ 12,087	$ 42,899	$ 21,604

5. CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS:

All of the Company's cash equivalents and short-term investments are classified as available-for-sale. At June 30, 2002, $252.8 million of available-for-sale securities were included in cash equivalents and $64.6 million of available-for-sale securities were included in short-term investments. At December 31, 2001, $162.2 million of available-for-sale securities were included in cash equivalents and $86.2 million of available-for-sale securities were included in short-term investments. These available-for-sale securities consist of government-backed notes, commercial paper, floating rate corporate bonds and fixed income corporate bonds.

6. INVENTORIES:

Inventories as of June 30, 2002 and December 31, 2001 consist of the following (in thousands):

	June 30, 2002	December 31, 2001
Raw materials	$ 81,660	$ 59,409
Work-in-process	27,065	33,887
Finished goods	189,416	156,098
	298,141	249,394
Less allowance for obsolete inventory	(28,231)	(20,344)
	$ 269,910	$ 229,050

7. ACQUISITIONS:

On April 19, 2002, the Company completed the purchase of Issanni Communications, Inc. ("Issanni"). The Company's investment in Issanni was $2.0 million prior to the acquisition. The purchase consideration for all the outstanding shares of Issanni, other than those already held by the Company prior to the acquisition, was $2.1 million, $0.5 million of which is held in escrow for, among other things, any undisclosed liabilities or contingencies incurred by Issanni prior to closing. In addition, $2.0 million will be payable in the form of an earnout to all Issanni shareholders of record at closing, subject to the completion of certain performance milestones during 2002, 2003 and 2004. This earnout will be recorded as additional purchase price when earned. Furthermore, the Company issued 39,876 shares of restricted common stock valued at $1.0 million to Issanni employees who will continue to perform services for the Company. These shares vest at the earlier of five years or upon the achievement of certain performance milestones. The Company will record this amount as compensation expense ratably over the vesting period and will accelerate the amortization if the milestones are met. The amount of the purchase price allocated to in-process research and development of $0.7 million was charged to the Company's results of operations, as no alternative future uses existed at the acquisition date. Issanni develops RAS (remote access server) and local access technology, which the Company

incorporates into one of its products. The results of operations of Issanni are included in the Company's results of operations beginning April 19, 2002.

The following represents the allocation of the purchase price and prior investment in Issanni under the purchase method of accounting (in thousands):

Fair value of tangible net assets acquired	$ 18
Fair value of identified intangible assets	3,230
In process research and development	670
Excess of costs of acquiring Issanni over fair value of identified net assets acquired (goodwill)	202
	$ 4,120

In September 1996, the Company purchased a 49% interest in Guangdong UTStarcom, Ltd. ("GUTS"), one of the Company's two primary manufacturing facilities. In February 1998, the Company acquired an additional 2% interest in GUTS, increasing its ownership interest to 51%. This investment was accounted for using the equity method prior to the Company's acquisition of the remaining 49% ownership interest in GUTS in May 2002, as the Company did not have voting control over significant matters. On December 18, 2001, the Company entered into an agreement to acquire the remaining 49% ownership interest in GUTS for a total consideration of $3.6 million in cash. The cash consideration was paid in the first quarter of 2002 and final government approvals were received in May 2002. GUTS is now a wholly-owned subsidiary of the Company and its results of operations are included in the Company's consolidated financial statements beginning June 1, 2002.

The following represents the allocation of the purchase price for the remaining 49% ownership interest in GUTS under the purchase method of accounting (in thousands):

Fair value of tangible net assets acquired	$ 372
Excess of costs of acquiring GUTS over fair value of identified net assets acquired (goodwill)	3,292
	$ 3,664

In July 1997, the Company, as part of its business operations in China, acquired a 88% interest in UTStarcom (Hangzhou) Communication Co., Ltd, which has recently changed its name to UTStarcom Telecom Co., Ltd. ("HUTS"), one of the Company's two primary manufacturing facilities. On January 21, 2002, the Company entered into an agreement to acquire the remaining 12% ownership interest in the joint venture company for a total consideration of $14.5 million in cash. Cash consideration of $7.3 million was paid in January 2002, and the remaining consideration was paid in the second quarter of fiscal 2002. Final government approvals were received in May 2002.

The following represents the allocation of the purchase price for the remaining 12% ownership interest in HUTS under the purchase method of accounting (in thousands):

Fair value of tangible net assets acquired	$ 8,148
Excess of costs of acquiring HUTS over fair value of identified net assets acquired (goodwill)	6,398
	$ 14,546

Had the acquisitions of Issanni and the remaining interests in HUTS and GUTS occurred on January 1, 2002, proforma net income for the three months ended June 30, 2002 would have been $27.5 million, or $0.25 per share basic, and $0.23 per share fully diluted. Proforma net income for the six months ended June 30, 2002 would have been $44.5 million, or $0.40 per share basic, and $0.38 per share fully diluted. Proforma revenues would have been $232.8 million for the three months ended June 30, 2002 and $416.0 million for the six months ended June 30, 2002. Proforma adjustments include the amortization of fixed asset step-ups and intangible assets as if the transactions had occurred on January 1, 2002.

8. DEBT:

The following represents the outstanding borrowings at June 30, 2002 and December 31, 2001 (in thousands):

Note	Rate	Maturity	June 30, 2002	December 31, 2001
Bank of China (1)	From 4.54% to 5.56%	From 09/02 to 10/02	$	$ 34,338
China Merchants Bank (2)	5.31%	03/03	6,024	6,024
Commercial Bank of Hangzhou (3)	6.21%	06/10	14,283	12,048
CITIC Industrial Bank	6.14%	05/02		6,024
China Everbright Bank (4)	4.54%	12/02	2,409	12,048
Total debt			22,716	70,482
Long-term debt			14,283	12,048
Short-term debt			$ 8,433	$ 58,434

(1) Guaranteed by UTStarcom China. This represents drawings on the Company's line of credit with the bank. This line allows for borrowings of up to $174,699.

(2) Guaranteed by HUTS. This line allows for borrowings of up to $6,024 and matures in March 2003.

(3) Guaranteed by UTStarcom-China. This line allows for borrowings of up to $24,096 and matures in June 2010.

(4) Guaranteed by HUTS. This line allows for borrowings of up to $36,145 and matures in December 2002.

The Company has additional unutilized borrowing facilities of $79.6 million as of June 30, 2002.

9. LONG TERM INVESTMENTS:

The Company's investments are as follows (in thousands):

	June 30, 2002	December 31, 2001
Investment in GUTS	$	$ 750
Investment in Softbank China	7,874	8,314
Investment in Issanni Communication		2,001
Investment in Cellon International	5,000	2,000
Investment in Restructuring Fund No. 1	1,981	
Investment in Global Asia	1,000	
Investment in others	4,117	4,753
Total	$ 19,972	$ 17,818

The Company has invested $10.0 million in Softbank China, an investment fund established by SOFTBANK CORP. focused on investments in Internet companies in China. This investment permits the Company to participate in the anticipated growth of Internet-related businesses in China. SOFTBANK CORP. and its related companies are significant stockholders of the Company. The Company's investment constitutes 10% of the funding for Softbank China, with SOFTBANK CORP. contributing the remaining 90%. The Company is a passive investor and has no decision-making authority with respect to investments by the fund. The fund has a separate management team, and none of the Company's employees are employed by the fund. Many of the fund's investments are and

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will be in privately held companies, many of which can still be considered in the start-up or development stages. These investments are inherently risky as the market for the technologies or products the companies have under development are typically in the early stages and may never materialize. During the three and six months ended June 30, 2002, based upon a review of the carrying value of this investment, impairment charges of $0.0 million and $0.4 million, respectively, were recognized to provide for the decline in the fair value below the carrying value of this investment. Impairment charges of $0.2 million and $1.2 million, respectively, were recognized in the corresponding periods in fiscal 2001. The balance remaining in this investment as of June 30, 2002 was $7.9 million.

The Company has also invested directly in a number of private technology-based companies in the early stages of development. The Company continually evaluates the carrying value of these investments for possible impairment based on the achievement of business objectives and milestones, the financial condition and prospects of these companies and other relevant factors. During the three and six months ended June 30, 2002, impairment charges in respect of these private technology investments were $0.7 million and $0.7 million, respectively. There were no impairment charges in respect of these investments in the corresponding periods in 2001.

During the first quarter of fiscal 2002, the Company invested $2.0 million in Restructuring Fund No. 1, a venture capital investment limited partnership established by SOFTBANK INVESTMENT CORP., an affiliate of SOFTBANK CORP. SOFTBANK America Inc., an entity affiliated with SOFTBANK CORP., is a significant stockholder of the Company. The fund will focus on leveraged buyout investments in companies in Asia undergoing restructuring or bankruptcy procedures. The total fund offering is expected to be between approximately $150.0 million and $226.0 million, with each investor contributing a minimum of $0.8 million. The Company is a passive investor and has no decision-making authority with respect to investments by the fund. The fund has a separate management team, and none of the Company's employees are employed by the fund. The Company will account for this investment under the equity method of accounting.

In June 2002, the Company invested $1.0 million in Global Asia Partners L.P., with a commitment to invest up to a maximum of $5.0 million. The remaining amount is due at such times and in such amounts as shall be specified in one or more future capital calls to be issued by the general partner. The fund size is anticipated to be $100 million and was formed to make private equity investments in private or pre-IPO technology and telecommunications companies. The fund's geographic focus is on technology investments in Asia, in particular India and China. The Company will account for this investment under the equity method of accounting.

10. GOODWILL AND INTANGIBLE ASSETS:

The Company's goodwill and intangible assets are as follows (in thousands):

	June, 2002	December 31, 2001
Goodwill	$ 57,528	$ 47,636
Purchased technology	7,570	4,340
	65,098	51,976
Less accumulated amortization:		
Goodwill	(12,823)	(12,823)
Purchased technology	(1,294)	(161)
	$ 50,981	$ 38,992

Amortization expense was $0.7 million and $2.0 million for the three months ended June 30, 2002 and June 30, 2001, respectively and $1.1 million and $3.4 million for the six months ended June 30, 2002 and June 30, 2001, respectively. Expected amortization expense for the next five fiscal years,

beginning the year ended December 31, 2003, is $2.5 million, $2.4 million, $0.4 million, $0.0 million and $0.0 million, respectively.

Goodwill increased by $9.9 million during the six months ended June 30, 2002. Goodwill totaling $6.4 million was recorded on the acquisition of the remaining 12% ownership interest in HUTS, goodwill of $3.3 million was recorded on the acquisition of the remaining 49% ownership in GUTS, and goodwill of $0.2 million was recorded on the acquisition of Issanni.

In July 2001, the Financial Accounting Standards Board (the "FASB") issued SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually. SFAS No. 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets".

SFAS No. 142 was adopted by the Company on January 1, 2002. SFAS No. 142 had the effect of reducing amortization of goodwill commencing January 1, 2002; however, impairment reviews may result in future periodic write-downs. The Company completed the required transitional assessment of goodwill during the first quarter of fiscal 2002. Based on this assessment, there was no transition goodwill impairment charge. The Company plans to perform its annual impairment review in the fourth quarter of each year.

The reconciliation of net income to adjusted net income as if there had been no goodwill amortization for the three and six months ended June 30, 2001 is as follows (in thousands):

	Three Months Ended	Six Months Ended
	June 30, 2001	June 30, 2001
Reported net income	$ 12,260	$ 21,622
Add back: goodwill amortization	1,850	3,269

	Three Months Ended	Six Months Ended
Adjusted net income	$ 14,110	$ 24,891
Basic earnings per share:		
Reported net income	$ 0.13	$ 0.22
Goodwill amortization	0.02	0.03
Adjusted net income	$ 0.15	$ 0.26
Diluted earnings per share:		
Reported net income	$ 0.12	$ 0.21
Goodwill amortization	0.02	0.03
Adjusted net income	$ 0.13	$ 0.24
Average number of shares outstanding:		
Basic	97,269	97,171
Diluted	105,264	105,259

11. SEGMENT REPORTING:

The Company provides telecommunications equipment through an integrated suite of network access systems, optical transmission products and subscriber terminal products. The Company primarily operates in two geographic areas, China and other regions. The chief operating decision makers evaluate performance, make operating decisions, and allocate resources based on consolidated financial data. Gross profit, operating income and income taxes are not allocated to specific individual departments within the organization. In accordance with SFAS No. 131 "Disclosures about Segments of an Enterprise and Related Information", the Company is considered a single reportable segment. The Company is required to disclose certain information about product revenues, information about geographic areas, information about major customers, and information about long-lived assets. For the three months ended June 30, 2002, sales to BB Technologies Corporation and Wenzhou PTB each accounted for 20% of net sales. For the three months ended June 30, 2001, sales to NingBo PTB and Jiaxing PTB accounted for 18% and 12% of net sales, respectively. For the six months ended June 30, 2002, sales to BB Technologies Corporation and Wenzhou PTB accounted for 14% and 11% of net sales, respectively. For the six months ended June 30, 2001, no customer accounted for more than 10% of net sales. Revenue attributable to Japan was primarily due to sales to BB Technologies Corporation. Sales to BB Technologies Corporation was $46.9 million for the three months ended June 30, 2002 and $56.9 million for the six months ended June 30, 2002.

Geographical area data and product data are as follows (in thousands):

	Three Months Ended June 30, 2002			Three Months Ended June 30, 2001		
	Telecommunications Equipment	Subscriber Handsets	Total	Telecommunications Equipment	Subscriber Handsets	Total
Net sales:						
China	$ 98,332	$ 83,760	$ 182,092	$ 88,534	$ 50,695	$ 139,229
Japan	46,948		46,948			
Other	2,468		2,468	669	149	818
Total net sales	$ 147,748	$ 83,760	$ 231,508	$ 89,203	$ 50,844	$ 140,047

	Six Months Ended June 30, 2002	Six Months Ended June 30, 2001

	Telecommunications Equipment	Subscriber Handsets	Total	Telecommunications Equipment	Subscriber Handsets	Total
Net sales:						
China	$ 195,957	$ 153,333	$ 349,290	$ 171,888	$ 84,119	$ 256,007
Japan	60,677		60,677			
Other	5,231		5,231	3,072	149	3,221
Total net sales	$ 261,865	$ 153,333	$ 415,198	$ 174,960	$ 84,268	$ 259,228

Revenue attributable to the United States of America was insignificant during the three and six months ended June 30, 2002 and 2001.

Long-lived assets by geography are as follows (in thousands):

	June 30, 2002	December 31, 2001
China	$ 63,059	$ 41,289
U.S.	44,867	41,645
Total long-lived assets	$ 107,926	$ 82,934

12. COMMITMENTS AND CONTINGENCIES:

Litigation:

The Company, some of our directors and officers and various underwriters for our IPO have been named as defendants in a putative shareholder action filed in United States District Court for the Southern District of New York, captioned *In re UTStarcom, Inc. Sec. Litig*., Civil Action No. 01-CV-9604. Plaintiffs generally allege undisclosed improper underwriting practices concerning the allocation of IPO shares in exchange for excessive brokerage commissions or agreements to purchase shares at higher prices in the aftermarket, in violation of the Securities Act of 1933 and the Securities Exchange Act of 1934. The complaint seeks unspecified damages on behalf of a purported class of purchasers of the Company's common stock between March 2, 2000 and December 6, 2000. Substantially similar actions have been filed concerning the initial public offerings for more than 300 different issuers, and the cases have been coordinated as *In re Initial Public Offering Securities Litigation*, 21 MC 92. Defendants have filed motions to dismiss. The Company believes that it has meritorious defenses to this lawsuit and intends to defend this lawsuit vigorously.

Investment commitments:

In June 2002, the Company invested $1.0 million in Global Asia Partners L.P. The fund size is anticipated to be $100 million and was formed to make private equity investments in private or pre-IPO technology and telecommunications companies in Asia. The Company has a commitment to invest up to a maximum of $5.0 million. The remaining amount is due at such times and in such amounts as shall be specified in one or more future capital calls to be issued by the general partner.

13. RELATED PARTY TRANSACTIONS:

The Company has entered into transactions with several companies that are stockholders or are affiliated with one of the Company's stockholders as follows:

During 2000 and 2001, the Company entered into engineering services agreements with Matsushita Communication Industrial Co., Ltd. ("Matsushita"), a stockholder of the Company, pursuant to which the Company, in partnership with Matsushita, will develop a complete end-to-end third generation cellular network (3G W-CDMA) standard compliant system, targeting the next generation of communications systems in the global communications marketplace, as well as develop and manufacture a public exchange switch (Internet Protocol Telephony Switch). The Company recognized no revenue in connection with these agreements during the three months ended June 30, 2002 and June 30, 2001, and $3.4 million and $0.0 million during the six months ended June 30, 2002 and June 30, 2001, respectively. There were no amounts included in accounts receivable at June 30, 2002 and December 31, 2001. Included in deferred revenue in respect of these agreements at June 30, 2002 and December 31, 2002 was $0.3 million and $2.4 million, respectively. In addition, the Company purchases telecommunications equipment from a subsidiary of Matsushita. Purchases of PAS equipment from such subsidiary of Matsushita during the three and six months ended June 30, 2002 were $2.4 million and $7.0 million, respectively. Purchases of handsets and base stations from this subsidiary of Matsushita during the three and six months ended June 30, 2001 were $25.5 million and $82.2 million, respectively. There were no amounts payable at June 30, 2002 and December 31, 2001.

During 2001, the Company entered into an engineering services agreement with Mitsubishi Electric Corporation ("MEI"), a stockholder of the Company, to jointly develop and market a complete suite of 3G W-CDMA infrastructure products. The Company recognized no revenue in connection with this agreement during the three and six months ended June 30, 2002 and 2001, respectively. Included in deferred revenue in respect of this agreement at June 30, 2002 was $0.7 million. There were no amounts included in accounts receivable in respect of this agreement at June 30, 2002. Included in

deferred revenue in respect of this agreement at December 31, 2001 was $0.7 million. There were no amounts included in accounts receivable in respect of this agreement at December 31, 2001.

The Company recognized revenue of $46.9 million and $56.9 million during the three and six months ended June 30, 2002, respectively, and $0.0 million during the three and six months ended June 30, 2001, with respect to sales of telecommunications equipment to BB Technologies Corporation ("BBTC"), an affiliate of SOFTBANK CORP. SOFTBANK America Inc., an entity affiliated with SOFTBANK CORP., is a significant stockholder of the Company. BBTC offers asynchronous digital subscriber line ("ADSL") coverage throughout Japan which is marketed under the name YAHOO. The Company provides ADSL technology to BBTC. The contract was competitively bid and the terms of this contract were on terms no more favorable than those with unrelated parties. Included in accounts receivable at June 30, 2002 is $20,000 related to this agreement. There were no amounts included in deferred revenue in respect of this agreement at June 30, 2002. Included in accounts receivable in respect of this agreement at December 31, 2001 was $13.5 million. There were no amounts included in deferred revenue in respect of this agreement at December 31, 2001.

During 2000, the Company invested $8.0 million and during 2001, the Company invested an additional $2.0 million in Softbank China, an investment fund established by SOFTBANK CORP. focused on investments in Internet companies in China. This investment permits the Company to participate in the anticipated growth of Internet-related businesses in China. The Company's investment constitutes 10% of the funding for Softbank China, with SOFTBANK CORP. contributing the remaining 90%. The Company is a passive investor and has no decision-making authority with respect to investments by the fund. The fund has a separate management team, and none of the Company's employees are employed by the fund. Many of the fund's investments are and will be in privately held companies, many of which can still be considered in the start-up or development stages. These investments are inherently risky as the market for the technologies or products the companies have under development are typically in the early stages and may never materialize. During the three and six months ended June 30, 2002, based upon a review of the carrying value of this investment, an impairment charge of $0.0 million and $0.4 million, respectively, was recognized to provide for the decline in the fair value below the carrying value of this investment. An impairment charge of $0.2 million and $1.2 million, respectively, was recognized in the corresponding periods in fiscal 2001. The balance remaining in this investment as of June 30, 2002 was $7.9 million.

During the three months ended June 30, 2002, the Company invested $2.0 million in Restructuring Fund No. 1, a venture capital investment limited partnership, established by SOFTBANK INVESTMENT CORP., an affiliate of SOFTBANK CORP. The fund will focus on leveraged buyout investments in companies in Asia undergoing restructuring or bankruptcy procedures. The total fund offering is expected to be between approximately $150.0 million and $226.0 million, with each investor contributing a minimum of $0.8 million. The Company is a passive investor and has no decision-making authority with respect to investments by the fund. The fund has a separate management team, and none of the Company's employees are employed by the fund.

On July 5, 2002, the Company entered into a joint venture agreement with Matsushita Communication Industrial Co., Ltd., a stockholder of the Company, and Matsushita Electric Industrial Co., Ltd., a subsidiary of such stockholder, to jointly design and develop, manufacture and sell telecommunication products. The Company will have a 49% ownership interest in the joint venture company, which will have a registered share capital of $10.0 million. The cash consideration of $4.9 million payable by the Company will be paid in the third quarter of fiscal 2002. As the Company does not have voting control over significant matters of the joint venture company, the investment in and results of operations of the joint venture company will be accounted for using the equity method of accounting.

14. COUNTRY RISKS:

Approximately 79% and 84% of the Company's sales for the three and six months ended June 30, 2002, respectively, and 99% and 99% for the three and six months ended June 30, 2001, respectively, were made in China. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environment in China, and by the general state of China's economy. The Company's operations in China are subject to special considerations and significant risks not typically associated with companies in the United States. These include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company's results may be adversely affected by, among other things, changes in the political, economic and social conditions in China, and by changes in governmental policies with respect to laws and regulations, changes in China's telecommunications industry and regulatory rules and policies, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation.

Under China's current regulatory structure, the communications products that the Company offers in China must meet government and industry standards, and a network access license for the equipment must be obtained. Without the license, the equipment is not allowed to be connected to public telecommunications networks or sold in China. Moreover, the Company must ensure that the quality of the telecommunications equipment for which it has obtained a network access license is stable and reliable, and may not lower the quality or performance of other installed licensed products. The State Council's product quality supervision department, in concert with the Ministry of Information Industry, performs spot checks to track and supervise the quality of licensed telecommunications equipment and publishes the results of such spot checks.

The regulations implementing these requirements are not very detailed, have not been applied by a court and may be interpreted and enforced by regulatory authorities in a number of different ways. The Company obtained the required network access licenses for its AN-2000 platform. The Company applied for, but has not yet received, a network access license for its PAS systems and handsets. Based upon conversations with the Ministry of Information Industry, the Company understands that its PAS systems and handsets are considered to still be in the trial period and that sales of the Company's PAS systems and handsets may continue to be made during this trial period, but a license will ultimately be required. Network access licenses will also be required for most additional products that the Company is selling or may sell in China, including the mSwitch platform. If the Company fails to obtain the required licenses, the Company could be prohibited from making further sales of the unlicensed products, including the PAS systems and handsets, in China, which would substantially harm its business, financial condition and results of operations. The Company's counsel in China has advised that China's governmental authorities may interpret or apply the regulations with respect to which licenses are required and the ability to sell a product while a product is in the trial period in a manner that is inconsistent with the information received by such counsel in China, either of which could have a material adverse effect on the Company's business and financial condition.

Approximately 20% and 15% of the Company's sales for the three and six months ended June 30, 2002, respectively, and 0% for the three and six months ended June 30, 2001, respectively, were made in Japan. Accordingly, the Company's business, financial condition and results of operations may be influenced by the political, economic and legal environment in Japan, and by the general state of Japan's economy.

15. RECENT ACCOUNTING PRONOUNCEMENTS:

In July 2001, the FASB issued SFAS No. 141, "Business Combinations", and SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated or completed after June 30, 2001. SFAS

No. 141 also specifies the criteria intangible assets acquired in a purchase method business combination must meet to be recognized and reported apart from goodwill. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually. SFAS No. 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets."

The Company adopted SFAS No. 141 in July 2001. SFAS No. 142 is effective for fiscal years beginning after December 15, 2001, and was adopted by the Company on January 1, 2002. The Company completed the required transitional assessment of goodwill impairment during the first quarter of fiscal 2002. Based on this assessment, it was determined that there was no impairment of goodwill and thus no transition goodwill impairment charge.

On October 3, 2001, the FASB issued SFAS No. 144, which is effective for financial statements issued for fiscal years beginning after December 15, 2001 and interim periods within those fiscal years. This statement supercedes SFAS No. 121, "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed Of", and amends APB 30 "Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business." SFAS No. 144 also requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. The Company adopted SFAS No. 144 on January 1, 2002, and the adoption had no impact on the Company's consolidated financial statements.

ITEM 2 MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITIONS AND RESULTS OF OPERATIONS

FORWARD-LOOKING STATEMENTS

This Report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws. These statements are based on information that is currently available to management. We intend such forward-looking statements to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, and we are including this statement for purposes of complying with those provisions. The forward-looking statements include, without limitation, those concerning the following: our expectation regarding continued growth in our business and operations; our expectation that our PAS network access system will continue to be allowed in China's county-level cities and counties; our expectation that there will be no penalties or fines for our non-compliance with the licensing requirements in China for our PAS system and other products; our expectation that there will be fluctuations in our overall gross profit, gross margin, product mix and selling prices; our plans for expanding the direct sales organization and our selling and marketing campaigns and activities; our expectation that we may use part of the net proceeds of our initial and follow on public offerings to acquire or invest in complementary businesses, technologies or product offerings; our expectation that there will be increases in selling, marketing, research and development, general and administrative expenses; our expectation that we will continue to invest significantly in research and development; our expectation that we will fill the majority of our current backlog orders; our expectation regarding our future investments, particularly in Softbank China; and our expectation that existing cash and cash equivalents will be sufficient to finance our operations for at least the next 12 months. Additional forward-looking statements may be identified by the words, "anticipate," "expect," "believe," "intend," "will" and similar expressions, as they relate to us or our management. Investors are cautioned that these forward-looking statements are inherently uncertain. These statements are subject to risks and uncertainties that may cause actual results and events to differ materially. For a detailed discussion of these risks and uncertainties, see the "Factors Affecting Future Operating Results" section of this Form 10-Q. We do not guarantee future results and undertake no obligation to update the forward-looking statements to reflect events or circumstances occurring after the date of this Form 10-Q.

OVERVIEW

We design, manufacture and market wireline and wireless broadband access and switching equipment that enables migration to next generation IP-based networks. Our operations are conducted primarily by our foreign subsidiaries that manufacture, distribute and support our products, principally in China. Our systems and products allow service providers to offer cost-efficient and expandable voice, data and Internet access services. Because our systems are based on widely adopted international communications standards, service providers can easily integrate our systems into their existing networks and deploy our systems in new broadband, Internet Protocol and wireless network rollouts.

We incorporated in Delaware in 1991. Since our incorporation, we have focused our resources on developing products for China's communications market. We shipped our first network access products in 1993. In 1995, we acquired StarCom Network Systems, Inc. and changed our name to UTStarcom, Inc. In 1996, we introduced our advanced, V5.1 and V5.2 compliant, multi-service network access platform, the AN-2000. Late in 1996, we introduced our PAS wireless access system. In December 1999, we completed the acquisition of the portion of our Wacos, Inc. subsidiary owned by the minority shareholders. Wacos, Inc. is a research and development subsidiary that develops IP-based switching systems. In November 2001, we completed the acquisition of Advanced Communications Devices Corporation, or ACD, for $21.3 million. ACD is a system on chip semiconductor company focusing on LAN and IP switching technology. On April 19, 2002, the Company completed the purchase of Issanni Communications, Inc. ("Issanni"). Our investment in Issanni was $2.0 million prior to the acquisition. The purchase consideration for all the outstanding shares of Issanni, other than

those already held by us prior to the acquisition, was $2.1 million. In addition, $2.0 million will be payable in the form of an earnout to all Issanni shareholders of record at closing, subject to the completion of certain performance milestones during 2002, 2003 and 2004. We also issued shares of restricted common stock valued at $1.0 million to Issanni employees who will continue to perform services for us. On

December 18, 2001, we entered into an agreement to acquire the remaining 49% ownership interest in GUTS, one of our two primary manufacturing facilities in China, for a total consideration of $3.6 million in cash, in order to achieve 100% ownership in the joint venture. On January 21, 2002, we entered into an agreement to acquire the remaining 12% ownership interest in HUTS, our other manufacturing facility, for a total consideration of $14.5 million in cash. As a result of the GUTS and HUTS transactions which closed in the second quarter of 2002, we now conduct our operations in China through wholly owned subsidiaries.

We have derived most of our revenues from sales of telecommunications equipment to service providers in China. However, we continue to expand our sales to service providers in other growing communications markets outside of China, including Japan, Vietnam, and Latin America. Our customers often make a large initial purchase of our equipment followed by supplemental purchases of enhancements and upgrades. As a result, our largest revenue-producing customers typically vary from period to period. The evaluation period for our products by potential customers may span a year or more and our business generally depends on a relatively small number of large deployments. We sell our products in China through a direct sales force.

Approximately 79% and 84% of our net sales for the three and six months ended June 30, 2002 and approximately 99% and 99% of our net sales for the three and six months ended June 30, 2001 were made in China. Accordingly, our business, financial condition and results of operations are likely to be influenced by the political, economic and legal environment in China, and by the general state of China's economy. Our results may be adversely affected by, among other things, changes in the political, economic, competitive and social conditions in China, including changes in governmental policies with respect to laws and regulations, changes in telecommunications industry and regulatory rules and policies, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation. Our first and second largest customers accounted for 20.2% and 19.6%, respectively, of our net sales for the three months ended June 30, 2002, 13.7% and 10.9%, respectively, of our net sales for the six months ended June 30, 2002 and 16.3% and 13.5% of accounts receivable, respectively, as of June 30, 2002. Our first and second largest customers accounted for 17.5% and 11.7% of our net sales, respectively, for the three months ended June 30, 2001, 9.5% and 7.1% of our net sales, respectively, for the six months ended June 30, 2001 and 9.0% and 5.0% of accounts receivable, respectively, as of December 31, 2001. We extend credit to our customers in China without requiring collateral. We monitor our exposure for credit losses and maintain allowances for doubtful accounts.

Under China's current regulatory structure, the communications products that we offer in China must meet government and industry standards, and a network access license for the equipment must be obtained. Without the license, the equipment is not allowed to be connected to public telecommunications networks or sold in China. Moreover, we must ensure that the quality of the telecommunications equipment for which we have obtained a network access license is stable and reliable, and may not lower the quality or performance of other installed licensed products. The State Council's product quality supervision department, in concert with the Ministry of Information Industry, performs spot checks to track and supervise the quality of licensed telecommunications equipment and publishes the results of such spot checks.

The regulations implementing these requirements are not very detailed, have not been applied by a court and may be interpreted and enforced by regulatory authorities in a number of different ways. We have obtained the required network access licenses for our AN-2000 platform. We have applied for, but have not yet received, a network access license for our PAS systems and handsets. Based upon

conversations with the Ministry of Information Industry, we understand that our PAS systems and handsets are considered to still be in the trial period and that sales of our PAS systems and handsets may continue to be made by us during this trial period, but a license will ultimately be required. Network access licenses will also be required for most additional products that we are selling or may sell in China, including our mSwitch platform. If we fail to obtain the required licenses, we could be prohibited from making further sales of the unlicensed products, including our PAS systems and handsets, in China, which would substantially harm our business, financial condition and results of operations. Our counsel in China has advised us that China's governmental authorities may interpret or apply the regulations with respect to which licenses are required and the ability to sell a product while a product is in the trial period in a manner that is inconsistent with the information received by our counsel in China, either of which could have a material adverse effect on our business and financial condition and results of operations.

Remittances from China, which are of a capital nature, such as the repayment of bank loans denominated in foreign currencies, require approval from appropriate governmental authorities before Renminbi can be used to purchase foreign currency. Although the payment of cash dividends is permitted so long as our subsidiaries have sufficient reserves and adequate amounts of Renminbi to purchase foreign currency, regulations restrict the ability of our subsidiaries to transfer funds to us through intercompany loans and advances.

Additionally, business activity in China and many other countries in Asia declines considerably during the first quarter of each year in observance of the Lunar New Year. As a result, sales during the first quarter of our fiscal year have typically been lower than sales during the fourth quarter of the preceding year, and we expect this trend to continue.

Revenues from sales of telecommunications equipment are recognized when persuasive evidence of an agreement exists, delivery of the product has occurred as evidenced by customer acceptance, the fee is fixed or determinable and collectibility is reasonably assured. The majority of our revenue is recognized upon receipt of final acceptance certificates. Where multiple elements exist in an arrangement, revenue is allocated to the different elements based upon verifiable objective evidence of the fair value of the elements. Revenues from sales of telecommunications equipment involving significant production, modification or customization of the product or where services being provided are deemed to be essential to the functionality of the product are recognized using the percentage of completion method if the project cost can be reasonably estimated. If the cost cannot be reasonably estimated, the completed contract method is applied. Any payments received prior to revenue recognition are recorded as deferred revenue.

Revenues from sales of telecommunications equipment incorporating software not considered incidental to the product as a whole ("software contracts") are recognized when persuasive evidence of an agreement exists, the product has been delivered as evidenced by customer acceptance, the fee is fixed or determinable and collectibility is probable. Revenues from software contracts with multiple elements are recognized using the residual method when there is vendor specific objective evidence of the fair value of all undelivered elements in an arrangement but vendor specific objective evidence of fair value does not exist for one or more of the delivered elements in an arrangement. Under the residual method, the fair value of the undelivered elements, as indicated by vendor specific objective evidence, is deferred and the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements regardless of any separate prices stated within the contract for each element. If the fee due from the customer is not fixed or determinable due to extended payment terms, revenue is recognized as payments become due from the customer, assuming all other criteria for revenue recognition are met. Revenues from engineering service contracts are recognized upon completion of the project, or using the percentage of completion method when project costs can be reasonably estimated.

Cost of sales consists primarily of material costs, third party commissions, costs associated with manufacturing, assembly and testing of products, costs associated with installation and customer training and overhead and warranty costs. Cost of sales also includes import taxes and tariffs on components and assemblies. Some components and materials used in our products are purchased from a single supplier or a limited group of suppliers and, in some cases, are subject to our obtaining Chinese import permits and approvals. We also rely on third party manufacturers in China to manufacture and assemble most of our handsets.

Our gross profit has been affected by product mix, average selling prices and material costs. Our gross profit, as a percentage of net sales, varies among our product families. The gross profit, as a percentage of net sales, on our handsets is low compared to our other products. We expect that our overall gross profit, as a percentage of net sales, will fluctuate from period to period as a result of shifts in product mix, anticipated decreases in average selling prices and our ability to reduce cost of sales.

Selling, general and administrative expenses include compensation and benefits, professional fees, sales commissions, provision for doubtful accounts receivable and travel and entertainment costs. A large percentage of our costs are fixed and are difficult to quickly reduce in periods of reduced sales. We intend to pursue aggressive selling and marketing campaigns and to expand our direct sales organization, and, as a result, our sales and marketing expenses will increase in future periods. We also expect that in support of our continued growth, general and administrative expenses will continue to increase for the foreseeable future.

Research and development expenses consist primarily of salaries and related costs of employees engaged in research, design and development activities, the cost of parts for prototypes, equipment depreciation and third party development expenses. A large percentage of our costs are fixed and are difficult to quickly reduce in periods of reduced sales. We believe that continued investment in research and development is critical to our long-term success. Accordingly, we expect that our research and development expenses will increase in future periods.

Net deferred stock compensation represents the difference between the fair value of common stock and the option exercise price for the options at the date of grant. Deferred compensation is presented as a reduction of stockholders' equity, with amortization recorded over the vesting period of the option, which is generally four years. No net deferred compensation expense was recorded in connection with the grant of stock options to our employees during the three and six months ended June 30, 2002 and 2001, respectively. We recorded stock compensation expense of approximately $0.5 million and $1.9 million during the three and six months ended June 30, 2002, respectively and $1.0 million and $2.3 million, respectively, during the corresponding periods in 2001. At June 30, 2002, approximately $5.1 million of deferred stock compensation remained to be amortized.

In connection with the acquisition of Issanni Communications Inc. in April 2002, 39,876 shares of restricted common stock valued at $1.0 million were issued to Issanni employees, who will continue to perform services for us. These shares vest at the earlier of five years or upon the achievement of certain performance milestones. We will record this as compensation expense ratably over the vesting period and will accelerate the amortization if the milestones are met. We completed the acquisition of Advanced Communications Devices Corporation ("ACD"), in November 2001. In connection with the acquisition, we issued 208,594 shares of restricted common stock valued at $5.0 million to

ACD employees who will continue to perform services for us. We record this amount as compensation expense over a period of five years or upon the achievement of certain performance milestones. The first milestone was met in December 2001, resulting in a charge of $1.3 million to operations in 2001. The second milestone was met in March 2002, resulting in a charge of $0.8 million to operations during the six months ended June 30, 2002.

Amortization of intangible assets consists primarily of the amortization of intangible assets associated with acquisitions in China, our acquisition of a minority interest in Wacos, Inc. and our acquisitions of Stable Gain International Ltd. and ACD.

Consolidated equity in net income (loss) of affiliated companies comprised our 51% share of the earnings from Guangdong UTStarcom, Ltd. ("GUTS"), our Guangdong manufacturing subsidiary, which was accounted for using the equity method prior to our acquisition of the remaining 49% ownership interest in GUTS in May 2002. This was previously accounted for under the equity method because we did not have voting control over significant matters.

Under current regulations in China, foreign investment enterprises that have been accredited as technologically advanced enterprises are entitled to additional tax incentives. These tax incentives vary in different locales and could include preferential national enterprise income tax treatment at 50% of the usual rates for different periods of time. All of our active subsidiaries in China were accredited as technologically advanced enterprises. The tax holidays applicable to our wholly-owned subsidiaries UTStarcom China and UTStarcom (Hangzhou) Communication Co., Ltd. ("HUTS"), which together accounted for approximately 90.1% of our revenues in 2001, will expire at the end of 2002. At that time, the tax rates for these two subsidiaries will increase from 7.5% to 15%, and from 10% to 15%, respectively, which will negatively impact our financial condition and results of operations by increasing our tax rate. Additionally, the Chinese government is considering the imposition of a "unified" corporate income tax that would phase out, over time, the preferential tax treatment to which foreign-funded enterprises, such as UTStarcom, are currently entitled. It is not certain whether the government will implement such a unified tax structure, or if implemented whether it will adversely affect our financial results.

Minority interest in (earnings) loss of consolidated subsidiaries represented the share of earnings in HUTS, our Zhejiang manufacturing joint venture, attributable to our joint venture partner, prior to our acquisition of the remaining 12% ownership interest in HUTS in May 2002.

As of December 31, 2001, we employed a total of 2,435 full-time employees. We also from time to time employ part-time employees and hire contractors. Of the total number of full-time employees at December 31, 2001, 1,049 were in research and development, 282 in manufacturing, 862 in marketing, sales and support, and 242 in administration. We had 2,049 employees located in China, 331 employees located in the United States, and 55 employees in other countries. In addition to our total full-time employees, GUTS, our manufacturing joint venture had 110 employees at December 31, 2001. Our employees are not represented by any collective bargaining agreement, and we have never experienced a work stoppage. We believe that our employee relations are good.

RECENT DEVELOPMENTS

In September 1996, we purchased a 49% interest in GUTS. In February 1998, we acquired an additional 2% interest in GUTS, increasing our ownership interest to 51%. This was accounted for using the equity method prior to our acquisition of the remaining 49% ownership interest in GUTS in May 2002, because we did not have voting control over all significant matters. On December 18, 2001, we entered into an agreement to acquire the remaining 49% ownership interest in GUTS for a total consideration of $3.6 million payable in cash. The cash consideration was paid in the first quarter of 2002, and final government approvals were received in May 2002. GUTS is now a wholly-owned subsidiary and its results of operations are included in our consolidated financial statements beginning June 1, 2002.

In July 1997, we, as part of our business operations in China, acquired an 88% interest in HUTS. On January 21, 2002, we entered into an agreement to acquire the remaining 12% ownership in the joint venture company for a total consideration of $14.5 million in cash. Cash consideration of $7.3 million was paid in January 2002, and the remaining consideration was paid in the second quarter

of fiscal 2002. Final government approvals were received in May 2002. HUTS is now a wholly-owned subsidiary.

On April 19, 2002, we completed the purchase of Issanni Communications, Inc. ("Issanni"). Issanni develops remote access server and local access technology. Prior to the acquisition, the Company had invested $2.0 million in Issanni. The purchase consideration for all the outstanding shares of Issanni, other than those already held by us prior to the acquisition, was $2.1 million. In addition, $2.0 million will be payable in the form of an earnout to all Issanni shareholders of record at closing, subject to the completion of certain performance milestones during 2002, 2003 and 2004. This earnout will be recorded as additional purchase price when earned. Furthermore, we issued shares of restricted common stock valued at $1.0 million to Issanni employees who will continue to perform services for us.

CRITICAL ACCOUNTING POLICIES

The financial condition and results of operations of the Company are based on certain critical accounting policies, which include judgments, estimates, and assumptions on the part of management. Estimates are based on historical experience, knowledge of economic and market factors and various other assumptions that management believes to be reasonable under the circumstances. Actual results may differ from those estimates. The following summary of critical accounting policies highlights those areas of significant judgment in the application of our accounting policies that affect our financial condition and results of operations.

Revenue Recognition, Allowances for Doubtful Accounts and Product Warranty

We recognize revenue from sales of telecommunication equipment when persuasive evidence of an agreement exists, delivery of the product has occurred, the fee is fixed or determinable and collectibility is reasonably assured. For transactions where we have yet to obtain customer acceptance, revenue is deferred until the terms of acceptance are satisfied. Management judgment is required in the assessment of collectibility. A sales reserve is established based on historical trends in sales returns. If actual future sales returns do not reflect the historical data, or the credit-worthiness of a major customer deteriorates, our revenue could be affected. Historically, the level of sales returns and our collection history have been within our expectations.

We also maintain allowances for doubtful accounts based on our assessment of the collectibility of our accounts receivable. We continually monitor collections from our customers and maintain allowances for doubtful accounts based upon the age of outstanding invoices and any specific customer collection issues. Historically, doubtful accounts or credit losses have been within our expectations, and our doubtful account allowances have been adequate. Our accounts receivable are concentrated in China. Therefore, a material adverse change in economic, political and social conditions in China could have an adverse effect on the collectibility of our accounts receivable, resulting in the need for additional doubtful account allowances.

We provide a warranty on our equipment and handset sales for a period not greater than one year. We provide for the expected cost of product warranties at the time that we recognize revenue, based on our assessment of past warranty experience. We continually monitor the level of our warranty expenses. If, however, there were a material adverse change in our product failure rates, an additional warranty provision would be required. Historically, our warranty experience has been within our expectations.

Inventory Reserve

Our inventories are stated at the lower of cost or net realizable value, net of a reserve for excess, slow moving and obsolete inventory. The reserve is based on our assumptions about future market conditions and customer demand. We continually monitor our inventory reserve. Historically, the level

of inventory reserves, our inventory turnover, and obsolescence experience have been within our expectations. Our sales are, however, concentrated in China. Therefore a material adverse change in economic, political and social conditions in China could have an adverse effect on expected future market conditions and demand from our customers, resulting in the need for additional inventory reserves.

Research and Development and Software Development Costs

Our research and development costs are charged to expense as incurred in accordance with Statement of Financial Accounting Standards (SFAS) No. 2. We capitalize costs incurred in the development of software that will ultimately be sold when technological feasibility has been attained. Management judgment is required in assessing expected future revenues and changes in product technologies, and the ultimate recoverability of our capitalized software development costs. Our business is concentrated in China. Therefore, a material change in market conditions in China could significantly impact these assessments and assumptions, and require an adjustment to our capitalized software development costs.

Deferred Income Taxes

We recognize deferred income taxes as the difference between the tax bases of assets and liabilities and their financial statement amounts based on enacted tax rates. Management judgment is required in the assessment of the recoverability of our deferred tax assets based on our assessment of projected taxable income. Although we are recently profitable, numerous factors could affect our results of operations in the future. If there were a significant material decline in our future operating results, our assessment of the recoverability of our deferred tax asset would need to be revised, and any such adjustment to our deferred tax asset would be charged to income in that period.

Goodwill and Intangibles

We have recorded goodwill and intangible assets in connection with our business acquisitions. Management judgment is required in the assessment of the related useful lives, assumptions regarding our ability to successfully develop and ultimately commercialize acquired technology, and assumptions regarding the fair value and the recoverability of these assets. Historically, there have been no circumstances that resulted in revised assumptions or impairment charges. We completed the required transitional assessment of goodwill during the first quarter of fiscal 2002. Based on this assessment, there was no transition goodwill impairment charge. Our business is concentrated in China. Therefore, a material change in market conditions in China could significantly impact these assessments and assumptions, and result in impairment in our recorded goodwill and intangible assets.

Long-Term Investments

We have invested in a fund focused on investments in Internet companies in China and a fund focused on investments in companies in Asia undergoing restructuring or bankruptcy procedures. We have also invested directly in a number of private technology-based companies in the early stages of development. Management judgment is required in evaluating the carrying value of these private company investments for possible impairment based on the achievement of business objectives and milestones, the financial condition and prospects of these companies and other relevant factors. We continually monitor these investments for impairment, and charge to income any impairment amounts in the period such a determination is made.

RELATED PARTY TRANSACTIONS

We have entered into transactions with several companies that are stockholders or are affiliated with one of our stockholders as follows:

During 2000 and 2001, we entered into engineering services agreements with Matsushita Communication Industrial Co., Ltd. ("Matsushita"), one of our stockholders, pursuant to which the Company, in partnership with Matsushita, will develop a complete end-to-end third generation cellular network (3G W-CDMA) standard compliant system, targeting the next generation of communications systems in the global communications marketplace, as well as develop and manufacture a public exchange switch (Internet Protocol Telephony Switch). We recognized no revenue in connection with these agreements during the three months ended June 30, 2002 and June 30, 2001, and $3.4 million and $0.0 million during the six months ended June 30, 2002 and June 30, 2001, respectively. There were no amounts included in accounts receivable at June 30, 2002 and December 31, 2001. Included in deferred revenue in respect of these agreements at June 30, 2002 and December 31, 2001 was $0.3 million and $2.4 million, respectively. In addition, we purchase telecommunications equipment from a subsidiary of Matsushita. Purchases of PAS equipment from such subsidiary of Matsushita during the three and six months ended June 30, 2002 were $2.4 million and $7.0 million, respectively. Purchases of handsets and base stations from this subsidiary of Matsushita during the three and six months ended June 30, 2001 were $25.5 million and $82.2 million, respectively. There were no amounts payable at June 30, 2002 and December 31, 2001.

During 2001, we entered into an engineering services agreement with Mitsubishi Electric Corporation ("MEI"), one of our stockholders, to jointly develop and market a complete suite of 3G W-CDMA infrastructure products. We recognized no revenue in connection with this agreement during the three and six months ended June 30, 2002 and 2001. Included in deferred revenue in respect of this agreement at June 30, 2002 was $0.7 million. There were no amounts included in accounts receivable in respect of this agreement at June 30, 2002. Included in deferred revenue in respect of this agreement at December 31, 2001 was $0.7 million. There were no amounts included in accounts receivable in respect of this agreement at December 31, 2001.

We recognized revenue of $46.9 million and $56.9 million during the three and six months ended June 30, 2002, respectively, and $0.0 million during the three and six months ended June 30, 2001, respectively, with respect to sales of telecommunications equipment to BB Technologies Corporation ("BBTC"), an affiliate of SOFTBANK CORP. SOFTBANK America Inc., an entity affiliated with SOFTBANK CORP., is a significant stockholder of the Company. BBTC offers asynchronous digital subscriber line ("ADSL") coverage throughout Japan which is marketed under the name YAHOO. We provide ADSL technology to BBTC. The contract was competitively bid and the terms of this contract were on terms no more favorable than those with unrelated parties. Included in accounts receivable at June 30, 2002 is $20,000 related to this agreement. There were no amounts included in deferred revenue in respect of this agreement at June 30, 2002. Included in accounts receivable in respect of this agreement at December 31, 2001 was $13.5 million. There were no amounts included in deferred revenue in respect of this agreement at December 31, 2001.

During 2000, we invested $8.0 million and during 2001, we invested an additional $2.0 million in Softbank China, an investment fund established by SOFTBANK CORP. focused on investments in Internet companies in China. This investment permits us to participate in the anticipated growth of Internet-related businesses in China. Our investment constitutes 10% of the funding for Softbank China, with SOFTBANK CORP. contributing the remaining 90%. We are a passive investor and have no decision-making authority with respect to investments by the fund. The fund has a separate management team, and none of the Company's employees are employed by the fund. Many of the fund's investments are and will be in privately held companies, many of which can still be considered in the start-up or development stages. These investments are inherently risky as the market for the technologies or products the companies have under development are typically in the early stages and may never materialize. During the three and six months ended June 30, 2002, based upon a review of the carrying value of this investment, an impairment charge of $0.0 million and $0.4 million, respectively, was recognized to provide for the decline in the fair value below the carrying value of this investment. An impairment charge of $0.2 million and $1.2 million, respectively, was recognized in the corresponding periods in fiscal 2001. The balance remaining in this investment as of June 30, 2002 was $7.9 million. Due to the risky nature of this investment, we may experience further losses in connection with this investment in Softbank China.

During the three months ended June 30, 2002, we invested $2.0 million in Restructuring Fund No. 1, a venture capital investment limited partnership, established by SOFTBANK INVESTMENT CORP., an affiliate of SOFTBANK CORP. The fund will focus on leveraged buyout investments in companies in Asia undergoing restructuring or bankruptcy procedures. The total fund offering is expected to be between approximately $150.0 million and $226.0 million, with each investor contributing a minimum of $0.8 million. We are a passive investor and have no decision-making authority with respect to investments by the fund. The fund has a separate management team, and none of the Company's employees are employed by the fund. Due to the risky nature of this investment, we may experience losses in connection with our investment in Restructuring Fund No. 1.

On July 5, 2002, we entered into a joint venture agreement with Matsushita Communication Industrial Co., Ltd., one of our stockholders, and Matsushita Electric Industrial Co., Ltd., a subsidiary of such stockholder, to jointly design, develop, manufacture and sell telecommunication products. We will have a 49% ownership interest in the joint venture company, which will have a registered share capital of $10.0 million. The cash consideration of $4.9 million will be paid in the third quarter of fiscal 2002. As we do not have voting control over significant matters of the joint venture company, the investment in and results of operations of the joint venture company will be accounted for using the equity method of accounting.

RESULTS OF OPERATIONS

THREE MONTHS ENDED JUNE 30, 2002 AND JUNE 30, 2001

NET INCOME

For the three months ended June 30, 2002, we reported net income of $25.7 million as compared to net income of $12.3 million for the three months ended June 30, 2001. Net income for the three months ended June 30, 2002 reflects the adoption of SFAS No. 142, "Goodwill and Other Intangible Assets," on January 1, 2002. With the adoption of SFAS No. 142, goodwill is no longer amortized, but rather tested annually for impairment. The Company completed its transition impairment test during the first quarter of fiscal 2002, and no impairment charge was required. Had SFAS No. 142 been in effect during the three months ended June 30, 2001, net income reported for that period would have been $14.1 million.

NET SALES

Our net sales increased 65% to $231.5 million for the three months ended June 30, 2002 from $140.0 million for the corresponding period in 2001. Sales of telecommunications equipment for the three months ended June 30, 2002 were $147.7 million, an increase of $58.5 million or

66% as compared to the three months ended June 30, 2001. Sales of subscriber handsets for the three months ended June 30, 2002 were $83.8 million, an increase of $32.9 million or 65%, as compared to the three months ended June 30, 2001. Sales of telecommunications equipment and sales of subscriber handsets increased due to the continued growth in spending on telecommunications infrastructure in China, which accounted for 79% and 99% of our net sales for the three months ended June 30, 2002 and 2001, respectively. Sales of telecommunication equipment also increased due to a $48.6 million increase in international sales, primarily driven by the sale of equipment to BB Technologies Corporation ("BBTC") in Japan to support its ADSL rollout. For the three months ended June 30, 2002, sales to BBTC and Wenzhou PTB each accounted for 20% of our net sales, respectively. For the three months ended June 30, 2001, sales to NingBo PTB and Jiaxing PTB accounted for 18% and 12% of our net sales, respectively.

GROSS PROFIT

Gross profit increased 72% to $85.9 million for the three months ended June 30, 2002 from $49.9 million for the corresponding period in 2001. Gross profit, as a percentage of net sales, increased to 37% for the three months ended June 30, 2002 from 36% for the three months ended June 30, 2001. Gross profit, as a percentage of net sales, increased due to increasing margins on our handset sales, which comprised 36% of sales for both the three months ended June 30, 2002 and 2001.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses increased 57% to $29.5 million for the three months ended June 30, 2002 from $18.8 million for the corresponding period in 2001. The increase in selling, general and administrative expenses was primarily due to increased sales and administrative personnel and related expenses, including sales commissions, associated with the growth in net sales and the expansion of our overall level of business activities. Selling, general and administrative expenses as a percentage of net sales were 13% for both the three months ended June 30, 2002 and 2001. We expect our selling, general and administrative expenses to increase in absolute dollar amounts in future periods as sales and marketing activities increase and we incur additional expenses related to the anticipated growth of our business and operations.

RESEARCH AND DEVELOPMENT

Research and development expenses increased 61% to $21.4 million for the three months ended June 30, 2002 from $13.3 million for the corresponding period in 2001. The increase in research and

development expenses was primarily due to the hiring of additional technical personnel, increased prototype expenses and licensing fees to support our research and development efforts. As a percentage of net sales, research and development expenses were 9% for both the three months ended June 30, 2002 and 2001. We expect our research and development expenses to increase in absolute dollar amounts in future periods as we expand our research and development organization to support new product development.

IN-PROCESS RESEARCH AND DEVELOPMENT

In-process research and development expense was $0.7 million for the three months ended June 30, 2002. This arose from our acquisition of Issanni on April 19, 2002 and was based on an independent appraisal. There was no in-process research and development expense during the corresponding period in 2001.

AMORTIZATION OF INTANGIBLE ASSETS

Amortization of intangible assets was $0.7 million for the three months ended June 30, 2002 and $2.0 million for the three months ended June 30, 2001. The decrease in amortization of intangible assets was primarily due to the elimination of goodwill amortization upon the adoption of SFAS No. 142 on January 1, 2002 of $1.9 million, offset by amortization of additional intangibles of $0.5 million. Had SFAS No. 142 been in effect during the quarter ended June 30, 2001, amortization expense would have been $0.1 million.

INTEREST INCOME (EXPENSE), NET

Net interest income was $1.0 million for the three months ended June 30, 2002 and $0.7 million for the corresponding period in 2001. The increase was primarily due to a decrease in short-term debt during the period.

OTHER INCOME (EXPENSE), NET

Other net income (expense) was $1.7 million of expense for the three months ended June 30, 2002 and $1.0 million of income for the corresponding period in 2001. The increase in expense in 2002 was primarily due to investment impairment losses of $0.6 million and foreign exchange losses of $0.9 million. Additionally, in 2001 there were gains on the sale of investments of $0.5 million.

EQUITY IN LOSS OF AFFILIATED COMPANIES

Consolidated equity in the net loss of affiliated companies was $6,000 for the three months ended June 30, 2002 and $0.5 million for the corresponding period in 2001. The change between the two periods was primarily due to the acquisition of the remaining 49% ownership interest in GUTS in May 2002. GUTS is now a wholly-owned subsidiary, and its results of operations are included in our consolidated financial statements beginning June 1, 2002. In the corresponding period in 2001, GUTS was accounted for using the equity method of accounting.

INCOME TAX EXPENSE

Income tax expense was $6.6 million for the three months ended June 30, 2002 and $4.0 million for the corresponding period in 2001. The increase in the income tax expense was due to our increasing income. The effective tax rate was 20% and 25% for the three months ended June 30, 2002 and 2001, respectively. The reduction in our effective tax rate can primarily be attributed to the increased income attributable to our China operations. The future rate may vary due to a variety of factors, including but not limited to, the relevant income contribution by domestic and foreign operations, changes in statutory tax rates, the amount of tax exempt interest income generated during the year, the ability to utilize foreign tax credits and non-deductible items relating to acquisitions, or other non-recurring charges. We will continue to monitor the effective tax rate on a quarterly basis.

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MINORITY INTEREST IN (EARNINGS) OF CONSOLIDATED SUBSIDIARIES

Minority interest in earnings of consolidated subsidiaries was $0.6 million for the three months ended June 30, 2002 and $0.8 million for the corresponding period in 2001. The decrease is due to the acquisition of the remaining 12% ownership interest in HUTS during the three months ended June 30, 2002. HUTS is now a wholly- owned subsidiary of the Company.

SIX MONTHS ENDED JUNE 30, 2002 AND JUNE 30, 2001

NET INCOME

For the six months ended June 30, 2002, we reported net income of $43.3 million as compared to net income of $21.6 million for the six months ended June 30, 2001. Net income for the six months ended June 30, 2002 reflects the adoption of SFAS No. 142, "Goodwill and Other Intangible Assets," on January 1, 2002. With the adoption of SFAS No. 142, goodwill is no longer amortized, but rather tested annually for impairment. The Company completed its transition impairment test during the first quarter of fiscal 2002, and no impairment charge was required. Had SFAS No. 142 been in effect during the six months ended June 30, 2001, net income reported for that period would have been $24.9 million.

NET SALES

Our net sales increased 60% to $415.2 million for the six months ended June 30, 2002 from $259.2 million for the corresponding period in 2001. Sales of telecommunications equipment for the six months ended June 30, 2002 were $261.9 million, an increase of $86.9 million or 50%, as compared to the six months ended June 30, 2001. Sales of subscriber handsets for the six months ended June 30, 2002 were $153.3 million, an increase of $69.1 million or 82%, as compared to the six months ended June 30, 2001. Sales of telecommunications equipment and sales of subscriber handsets increased due to the continued growth in spending on telecommunications infrastructure in China, which accounted for 84% and 99% of our net sales for the six months ended June 30, 2002 and 2001, respectively. Sales of telecommunication equipment also increased due to a $62.7 million increase in international sales, primarily driven by the sale of equipment to BBTC in Japan to support its ADSL rollout. For the six months ended June 30, 2002, sales to BBTC accounted for 14% and sales to Wenzhou PTB accounted for 11% of our net sales. For the six months ended June 30, 2001, no customer accounted for more than 10% of our net sales.

GROSS PROFIT

Gross profit increased 66% to $151.6 million for the six months ended June 30, 2002 from $91.3 million for the corresponding period in 2001. Gross profit, as a percentage of net sales, increased to 37% for the six months ended June 30, 2002 from 35% for the six months ended June 30, 2001. The increase in gross profit, as a percentage of net sales, was primarily due to increasing margins on sales of handsets. Handset sales comprised 37% of sales for the six months ended June 30, 2002 compared to 33% for the corresponding period in 2001.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses increased 62% to $53.2 million for the six months ended June 30, 2002 from $32.9 million for the corresponding period in 2001. The increase in selling, general and administrative expenses was primarily due to increased sales and administrative personnel and related expenses, including sales commissions, associated with the growth in net sales and the expansion of our overall level of business activities. Selling, general and administrative expenses as a percentage of net sales was 13% for both the six months ended June 30, 2002 and 2001. We expect our selling, general and administrative expenses to increase in absolute dollar amounts in future periods as

sales and marketing activities increase and we further invest in infrastructure and incur additional expenses related to anticipated growth of our business and operation.

RESEARCH AND DEVELOPMENT

Research and development expenses increased 58% to $40.6 million for the six months ended June 30, 2002 from $25.7 million for the corresponding period in 2001. The increase in research and development expenses was primarily due to the hiring of additional technical personnel, increased prototype expenses and licensing fees to support our research and development efforts. As a percentage of net sales, research and development expenses were 10% for both the six months ended June 30, 2002 and 2001. We expect our research and development expenses to increase in absolute dollar amounts in future periods as we expand our research and development organization to support new product development.

IN-PROCESS RESEARCH AND DEVELOPMENT

In-process research and development expense was $0.7 million for the six months ended June 30, 2002. This arose from our acquisition of Issanni on April 19, 2002 and was based on an independent appraisal. There was no in-process research and development expense during the corresponding period in 2001.

AMORTIZATION OF INTANGIBLE ASSETS

Amortization of intangible assets decreased to $1.1 million for the six months ended June 30, 2002 from $3.4 million for the corresponding period in 2001. The decrease in amortization of intangible assets was primarily due to the elimination of amortization of goodwill upon the adoption of SFAS No. 142 on January 1, 2002 of $3.3 million, offset by amortization of additional intangibles of $1.0 million. Had SFAS No. 142 been in effect during the six months ended June 30, 2001, amortization expense would have been $0.2 million.

INTEREST INCOME (EXPENSE), NET

Net interest income was $1.9 million for the six months ended June 30, 2002 and $2.2 million for the corresponding period in 2001. The decrease in interest income was primarily due to a decline in interest rates, offset by a decrease in short-term debt.

OTHER INCOME (EXPENSE) NET

Other expense net was $1.6 million for the six months ended June 30, 2002 and other income net was $40,000 for the corresponding period in 2001. The increase was primarily related to a write-down of long-term investment of $1.1 million and loss on disposal of fixed assets of $0.3 million. In the corresponding period in 2001, the impairment charge of $1.2 million relating to our investment in the Softbank fund was offset by a $0.5 million gain on the sale of one of our investments.

EQUITY IN LOSS OF AFFILIATED COMPANIES

Consolidated equity in net loss of affiliated companies was $0.8 million for the six months ended June 30, 2002 and $0.7 million for the corresponding period in 2001. The change between the two periods reflects the increased losses at our Guangdong manufacturing facility prior to the acquisition of the remaining 49% ownership interest in GUTS for a total consideration of $3.6 million. GUTS is now a wholly-owned subsidiary, and its results of operations are included in our consolidated financial statements beginning June 1, 2002. In the corresponding period in 2001, GUTS was accounted for using the equity method of accounting.

INCOME TAX EXPENSE

Income tax expense was $11.1 million for the six months ended June 30, 2002 and $7.7 million for the corresponding period in 2001. The increase in the income tax expenses was due to our increasing

income. The effective tax rate was 20% and 25% for the six months ended June 30, 2002 and 2001, respectively. The future rate may vary due to a variety of factors, including but not limited to, the relevant income contribution by domestic and foreign operations, changes in statutory tax rates, the amount of tax exempt interest income generated during the year, the ability to utilize foreign tax credits and non-deductible items relating to acquisitions or other non recurring charges. The Company will continue to monitor the effective tax rates on a quarterly basis.

MINORITY INTEREST IN (EARNINGS) OF CONSOLIDATED SUBSIDIARIES

Minority interest in earnings of consolidated subsidiaries was $1.2 million for the six months ended June 30, 2002 and $1.4 million for the corresponding period in 2001. The decrease is due to the acquisition of the remaining 12% ownership interest in HUTS during the six months ended June 30, 2002. HUTS is now a wholly-owned subsidiary.

LIQUIDITY AND CAPITAL RESOURCES

In March 2000, we raised $189.4 million in net proceeds from our initial public offering in which we sold 11,500,000 shares of common stock. On August 3, 2001, we completed a follow on public offering and sold an aggregate of 7,400,000 shares of common stock in which we raised net proceeds of $139.9 million. On February 28, 2002, we sold 1,500,000 shares of common stock upon exercise of the underwriter's over-allotment option in connection with the resale public offering of 10,000,000 shares of our common stock by SOFTBANK America Inc., one of our stockholders. Upon such sale, we received aggregate net proceeds of approximately $28.9 million.

As of June 30, 2002, we had lines of credit totaling $343.3 million of which our borrowings were $22.7 million, with the remainder available for future borrowings. Of the amount borrowed, $14.3 million was included in long-term debt. We are not a guarantor of any debt not included in the condensed consolidated balance sheet. As of June 30, 2002, we had working capital of $641.2 million, including $338.2 million in cash and cash equivalents, $64.6 million of short-term investments and $8.5 million of Renminbi-denominated bank borrowings.

Net cash provided by operations for the six months ended June 30, 2002 of $53.0 million was primarily due to net income of $43.3 million, adjusted for depreciation and amortization expense of $10.1 million, amortization of deferred stock compensation expense of $1.9 million, non-qualified stock option exercise tax benefits of $3.0 million, inventory reserve of $7.9 million, allowance for doubtful accounts of $7.0 million, an increase in accounts payable of $45.3 million, deferred revenue of $22.1 million, income taxes payable of $4.7 million, and a long-term investment impairment charge of $1.1 million. This was offset by an increase in inventories, accounts receivable and other current and non-current assets of $48.1 million, $42.9 million and $4.2 million, respectively. Net cash provided by operations for the six months ended June 30, 2001 of $8.2 million was primarily due to net income for the period and to increases in deferred revenue, accounts payable and other current liabilities of $58.0 million, $26.1 million and $7.1 million respectively. The net cash provided was partially offset by increases in inventories, accounts receivable, other current and non-current assets and income taxes payable of $65.1 million, $28.9 million, $29.3 million and $7.3 million, respectively. Net cash provided by operating activities was also increased by adjusting net income for depreciation and amortization expense of $7.6 million, non-qualified stock option exercise tax benefits of $7.7 million, amortization of deferred stock compensation expense of $2.3 million and a long-term investment impairment charge of $1.2 million.

Net cash used in investing activities for the six months ended June 30, 2002 of $23.8 million was primarily due to purchases of plant property and equipment of $21.6 million, business acquisitions of $17.7 million and investment in affiliates of $6.0 million, offset by net sales of short-term investments of $21.4 million. Net cash provided by investing activities for the six months ended June 30, 2001 of $38.4 million was primarily due to sales and maturities of short-term investments of $55.9 million, offset by the acquisition of property, plant and equipment of $11.2 million and investment in affiliates of $6.5 million. Proceeds from sales and maturities of short-term investments were used to finance working capital requirements.

In December 2001, we agreed to acquire the remaining 49% ownership interest in GUTS for a total of $3.6 million in cash, which was paid in January 2002. This transaction closed in the May 2002. In January 2002, we agreed to acquire the remaining 12% ownership interest in HUTS for a total of $14.5 million in cash, of which $7.3 million was paid in January 2002. The remainder was paid during the second quarter of fiscal 2002.

Net cash used by financing activities for the six months ended June 30, 2002 of $12.0 million was primarily due to net payments of $47.8 million on borrowings under our lines of credit. This was offset by $35.7 million in proceeds from the sale of common stock in connection with the Softbank resale and the issuance of common stock through the exercise of stock options. Net cash provided by financing activities for the six months ended June 30, 2001 of $22.0 million was primarily due to net proceeds of $14.5 million from borrowing under our lines of credit and $7.3 million from the issuance of common stock through the exercise of stock options.

Our sales in China are generally denominated in local currency. Due to the limitations on converting Renminbi, we are limited in our ability to engage in currency hedging activities in China. International sales outside China are generally denominated either in US dollars or in local currency. As of June 30, 2002, we were not engaged in any currency hedging activities and did not hold any derivative financial instruments. Although the impact of currency fluctuations to date has been insignificant, we cannot guarantee that fluctuations in currency exchange rates in the future will not have a material adverse effect on revenues from international sales and, correspondingly, on our business, financial condition and results of operations. We also have contracts negotiated in Japanese Yen for purchasing portions of our inventories and supplies. We have a multi-currency bank account for purchasing portions of our inventories and supplies. The balance of Japanese Yen in this account as of June 30, 2002 was approximately $2.7 million.

We believe that our existing cash and cash equivalents, short-term investments and cash from operations will be sufficient to finance our operations through at least the next 12 months.

Our principal commitments, as of June 30, 2002, consist of obligations under operating and capital leases, borrowings under our lines of credit, capital expenditures relating to the construction of a new manufacturing facility, and a commitment to invest up to an additional $5.0 million in one of our investments. We lease certain of our facilities under non-cancelable operating leases, which expire at various dates through 2006. Borrowings under our lines of credit were $22.7 million at June 30, 2002. Please refer to Note 8 of our Notes to Condensed Consolidated Financial Statements for more detailed information on our borrowings under our lines of credit.

In June 2002, we invested $1.0 million in Global Asia Partners L.P., with a commitment to invest up to an additional $5.0 million. The remaining amount is due at such times and in such amounts as shall be specified in one or more future capital calls to be issued by the general partner. The fund size is $100 million and was formed to make private equity investments in private or pre-IPO technology and telecommunications companies. The fund's geographic focus is on technology investments in Asia, in particular India and China.

We have purchased the rights to use 49 acres of land located in Zhejiang Science and Technology Industry Garden of Hangzhou Hi-tech Industry Development Zone. We have completed the design layout for a new manufacturing facility. Construction of the new facility is expected to be completed in 2003 at a projected cost of $90.0 million. Capital expenditures were $5.9 million for the six months ended June 30, 2002, and are expected to be approximately $45.0 million during 2002.

We have not engaged in any transactions or arrangements with unconsolidated entities or other persons that are reasonably likely to materially affect our liquidity or the availability of, or requirements for, capital resources.

RECENT ACCOUNTING PRONOUNCEMENTS

In July 2001, the FASB issued SFAS No. 141, "Business Combinations", and SFAS No. 142, "Goodwill and Other Intangible Assets". SFAS No. 141 requires that the purchase method of accounting be used for all business combinations initiated or completed after June 30, 2001. SFAS No. 141 also specifies the criteria intangible assets acquired in a purchase method business combination must meet to be recognized and reported apart from goodwill. SFAS No. 142 requires that goodwill and intangible assets with indefinite useful lives no longer be amortized, but instead tested for impairment at least annually. SFAS No. 142 also requires that intangible assets with definite useful lives be amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with SFAS No. 144 "Accounting for the Impairment or Disposal of Long-Lived Assets".

The Company adopted SFAS No. 141 in July 2001. SFAS No. 142 is effective for fiscal years beginning after December 15, 2001, and was adopted by the Company on January 1, 2002. The Company completed the required transitional assessment of goodwill impairment during the first quarter of fiscal 2002. Based on this assessment, it was determined that there was no impairment of goodwill and thus no transition goodwill impairment charge.

On October 3, 2001, the FASB issued SFAS No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets." SFAS No. 144 is effective for financial statements issued for fiscal years beginning after December 15, 2001 and interim periods within those fiscal years. This statement supercedes SFAS No. 121 and amends APB 30 "Reporting the Results of Operations Reporting the Effects of Disposal of a Segment of a Business." SFAS No. 144 also requires that long-lived assets that are to be disposed of by sale be measured at the lower of book value or fair value less cost to sell. Additionally, SFAS No. 144 expands the scope of discontinued operations to include all components of an entity with operations that (1) can be distinguished from the rest of the entity and (2) will be eliminated from the ongoing operations of the entity in a disposal transaction. The Company adopted SFAS No. 144 on January 1, 2002, and the adoption had no impact on our consolidated financial statements.

FACTORS AFFECTING FUTURE OPERATING RESULTS

RISKS RELATING TO OUR COMPANY

Our future product sales are unpredictable, our operating results are likely to fluctuate from quarter to quarter, and if we fail to meet the expectations of securities analysts or investors, our stock price could decline significantly

Our quarterly and annual operating results have fluctuated in the past and are likely to fluctuate in the future due to a variety of factors, some of which are outside of our control. As a result, period-to-period comparisons of our operating results are not necessarily meaningful or indicative of future performance. Furthermore, it is likely that in some future quarters our operating results will fall below the expectations of securities analysts or investors. If this occurs, the trading price of our common stock could decline.

Factors that may affect our future operating results include:

- the timing, number and size of orders for our products, as well as the relative mix of orders for each of our products, particularly the volume of lower margin handsets;
- cancellation, deferment or delay in implementation of large contracts;
- the evolving and unpredictable nature of the economic, regulatory, competitive and political environments in China and other countries in which we market or plan to market our products;
- price reductions by our competitors;
- changes in our customers' subscriber growth rate;
- currency fluctuations;
- market acceptance of our products and product enhancements;

the lengthy and unpredictable sales cycles associated with sales of our products combined with the impact of this variability on our suppliers' ability to provide us with components on a timely basis;

longer collection periods of accounts receivable in China and other countries; and

the decline in business activity we typically experience during the Lunar New Year, which leads to decreased sales during our first fiscal quarter.

The limited performance history of some of our products, our limited forecasting experience and processes and the emerging nature of our target markets make forecasting our future sales and operating results difficult. Our expense levels are based, in part, on our expectations regarding future sales, and these expenses are largely fixed, particularly in the short term. In addition, to enable us to promptly fill orders, we maintain inventories of finished goods, components and raw materials. As a result, we commit to considerable costs in advance of anticipated sales. In the past, a substantial portion of our sales in each quarter resulted from orders received and shipped in that quarter, and we have operated with a limited backlog of unfilled orders. Accordingly, we may not be able to reduce our costs in a timely manner to compensate for any unexpected shortfall between forecasted and actual sales. Any significant shortfall of sales may require us to maintain higher levels of inventories of finished goods, components and raw materials than we require, thereby increasing our risk of inventory obsolescence and corresponding inventory write-downs and write-offs.

Competition in our markets may lead to reduced prices, revenues and market share

We are increasingly facing intense competition in our target markets, especially from domestic companies in China. We believe that our strongest competition in the future may come from these

companies, many of which operate under lower cost structures and more favorable governmental policies and have much larger sales forces than we do. Furthermore, other companies not presently offering competing products may also enter our target markets, particularly with the reduction of trade restrictions as a result of China's admission to the World Trade Organization, or WTO. Many of our competitors have significantly greater financial, technical, product development, sales, marketing and other resources than we do. As a result, our competitors may be able to respond more quickly to new or emerging technologies and changes in service provider requirements. Our competitors may also be able to devote greater resources than we can to the development, promotion and sale of new products. These competitors may also be able to offer significant financing arrangements to service providers, in some cases facilitated by government policies, which is a competitive advantage in selling systems to service providers with limited financial and currency resources. Increased competition is likely to result in price reductions, reduced gross profit as a percentage of net sales and loss of market share, any one of which could materially harm our business, financial condition and results of operations.

Moreover, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties, including Telecommunications Administrations, Telecommunications Companies and other local organizations, to increase the ability of their products to address the needs of prospective customers in our target markets. Accordingly, alliances among competitors or between competitors and third parties may emerge and rapidly acquire significant market share. To remain competitive, we believe that we must continue to partner with Telecommunications Administrations and other local organizations, maintain a high level of investment in research and development and in sales and marketing, and manufacture and deliver products to service providers on a timely basis and without significant defects. If we fail to meet any of these objectives, our business, financial condition and results of operations could be harmed.

The introduction of inexpensive wireless telephone service or other competitive services in China may also have an adverse impact on sales of our PAS systems and handsets in China. We may not be able to compete successfully against current or future competitors, and competitive pressures in the future may materially adversely affect our business, financial condition and results of operations.

Our business may suffer if we are unable to collect payments from our customers on a timely basis

Our customers often must make a significant commitment of capital to purchase our products. As a result, any downturn in a customer's business that affects the customer's ability to pay us could harm our financial condition. Moreover, accounts receivable collection cycles historically tend to be much longer in China than in other markets. The failure of any of our customers to make timely payments could require us to write-off accounts receivable or increase our accounts receivable reserves, either of which could adversely affect our financial condition.

Our market is subject to rapid technological change, and to compete effectively, we must continually introduce new products that achieve market acceptance

The emerging market for telecommunications equipment in developing countries is characterized by rapid technological developments, frequent new product introductions and evolving industry and regulatory standards. Our success will depend in large part on our ability to enhance our network access and switching technologies and develop and introduce new products and product enhancements that anticipate changing service provider requirements and technological developments. We may need to make substantial capital expenditures and incur significant research and development costs to develop and introduce new products and enhancements. If we fail to timely develop and introduce new products or enhancements to existing products that effectively respond to technological change, our business, financial condition and results of operations could be materially adversely affected.

From time to time, our competitors or we may announce new products or product enhancements, technologies or services that have the potential to replace or shorten the life cycles of our products and that may cause customers to defer purchasing our existing products, including the possible adoption and implementation of third generation, or 3G systems, resulting in inventory obsolescence. Future technological advances in the communications industry may diminish or inhibit market acceptance of our existing or future products or render our products obsolete.

Even if we are able to develop and introduce new products, they may not gain market acceptance. Market acceptance of our products will depend on various factors including:

- our ability to obtain necessary approvals from regulatory organizations;
- the perceived advantages of the new products over competing products;
- our ability to attract customers who have existing relationships with our competitors;
- product cost relative to performance; and
- the level of customer service available to support new products.

Specifically, sales of PAS, our wireless access system, will depend in part upon consumer acceptance of the mobility limitations of this service relative to other wireless service systems, such as GSM or CDMA. If our existing or new products fail to achieve market acceptance for any reason, our business could be seriously harmed.

Our business will suffer if we are unable to deliver quality products on a timely and cost effective basis

Our operating results depend on our ability to manufacture products on a timely and cost effective basis. In the past, we have experienced reductions in yields as a result of various factors, including defects in components and human error in assembly. If we experience deterioration in manufacturing performance or a delay in production of any of our products, we could experience delays in shipments and cancellations of orders. Moreover, networking products frequently contain undetected software or hardware defects when first introduced or as new versions are released. In addition, our products are often embedded in or deployed in conjunction with service providers' products, which incorporate a variety of components produced by third parties. As a result, when a problem occurs, it may be difficult to identify the source of the problem. These problems may cause us to incur significant warranty and repair costs, divert the attention of our engineering personnel from our product development efforts and cause significant customer relation problems or loss of customers, any one of which could harm our business.

We contract with third parties in China to undertake high volume manufacturing and assembly of our handsets. In addition, we sometimes use third parties for high volume assembly of circuit boards. We do not have any long-term contracts with these third party manufacturers, and in the event that these manufacturers are unable or unwilling to continue to manufacture our products, we may be unable to secure alternative manufacturers or could experience delays in qualifying new manufacturers. We currently manufacture internally only a very limited quantity of our handsets. However, if future demand for our handsets requires additional manufacturing capacity, we may invest in and build additional manufacturing facilities, most likely in China. However, new manufacturing facilities may not attain the same quality or level of efficiencies as those of our existing third party manufacturers.

We depend on some sole source and other key suppliers for handsets, components and materials used in our products, and if these suppliers fail to provide us with adequate supplies of high quality products at competitive prices, our competitive position, reputation and business could be harmed

Some components and materials used in our products are purchased from a single supplier or a limited group of suppliers. If any supplier is unwilling or unable to provide us with high quality components and materials in the quantities required and at the costs specified by us, we may not be able to find alternative sources on favorable terms, in a timely manner, or at all. Our inability to obtain or to develop alternative sources if and as required could result in delays or reductions in manufacturing or product shipments. Moreover, these suppliers may delay product shipments or supply us with inferior quality products. If any of these events occur, our competitive position, reputation and business could suffer.

Our ability to source a sufficient quantity of high quality components used in our products may be limited by China's import restrictions and duties. We require a significant number of imported components to manufacture our products in China. Imported electronic components and other imported goods used in the operation of our business are subject to a variety of permit requirements, approval procedures, import duties and registration requirements. Non-payment of required import duties could subject us to penalties and fines and could adversely affect our ability to manufacture and sell our products in China. In addition, import duties increase the cost of our products and may make them less competitive.

In particular, an integral component of our PAS system is the handset used by subscribers to make and receive mobile telephone calls. Our inability to obtain a sufficient number of high quality components and assemblies for handsets could severely harm our business. From time to time, there has been a worldwide shortage of handsets, and there currently exists a shortage of low-priced handsets, which we have found to be popular with many consumers in China. We have only used third parties to assemble and manufacture handsets in China for us for a limited period of time. These manufacturers may be unable to produce adequate quantities of high-quality handsets to meet the demand of our customers.

If we are unable to expand our direct sales operation in China and indirect distribution channels elsewhere or successfully manage our expanded sales organization, our operating results may suffer

Our distribution strategy focuses primarily on developing and expanding our direct sales organization in China and our indirect distribution channels outside of China. We may not be able to successfully expand our direct sales organization in China and the cost of any expansion may exceed the revenue generated from these efforts. Even if we are successful in expanding our direct sales organization in China, we may not be able to compete successfully against the significantly larger and better-funded sales and marketing operations of current or potential competitors. In addition, if we fail to develop relationships with significant international resellers or manufacturers' representatives, or if these resellers or representatives are not successful in their sales or marketing efforts, we may be unsuccessful in our expansion efforts outside China.

We expect average selling prices of our products to decrease which may reduce our revenues, and, as a result, we must introduce new products and reduce our costs in order to maintain profitability

The average selling prices for communications access and switching systems and subscriber terminal products, such as handsets, in China have been declining as a result of a number of factors, including:

- increased competition;
- aggressive price reductions by competitors; and

rapid technological change.

We anticipate that average selling prices of our products will decrease in the future in response to product introductions by us or our competitors or other factors, including price pressures from customers. Therefore, we must continue to develop and introduce new products and enhancements to existing products that incorporate features that can be sold at higher average selling prices. Failure to do so could cause our revenues and gross profit, as a percentage of net sales, to decline.

Our cost reduction efforts may not allow us to keep pace with competitive pricing pressures or lead to improved gross profit, as a percentage of net sales. In order to be competitive, we must continually reduce the cost of manufacturing our products through design and engineering changes. We may not be successful in these efforts or delivering our products to market in a timely manner. Any redesign may not result in sufficient cost reductions to allow us to reduce the prices of our products to remain competitive or to improve or maintain our gross profit, as a percentage of net sales.

Shifts in our product mix may result in declines in gross profit, as a percentage of net sales

Our gross profit, as a percentage of net sales, varies among our product groups. Our gross profit, as a percentage of net sales, is generally higher on our access network system products and is significantly lower on our handsets. We also anticipate that the gross profit, as a percentage of net sales, may be lower for our newly developed products due to start-up costs and may improve as unit volumes increase and efficiencies can be realized. Our overall gross profit, as a percentage of net sales, has fluctuated from period to period as a result of shifts in product mix, the introduction of new products, decreases in average selling prices for older products and our ability to reduce manufacturing costs.

Service providers sometimes evaluate our products for long and unpredictable periods which causes the timing of purchases and our results of operations to be unpredictable

The period of time between our initial contact with a service provider and the receipt of an actual purchase order may span a year or more. During this time, service providers may subject our products to an extensive and lengthy evaluation process before making a purchase. The length of these qualification processes may vary substantially by product and service provider, making our results of operations unpredictable. We may incur substantial sales and marketing expenses and expend significant management effort during this process, which ultimately may not result in a sale. These qualification processes often make it difficult to obtain new customers, as service providers are reluctant to expend the resources necessary to qualify a new supplier if they have one or more existing qualified sources.

Our multi-national operations subject us to various economic, political, regulatory and legal risks

We market and sell our products in China and other markets, including Taiwan, Japan, Vietnam, India and Latin America. The expansion of our existing multi-national operations and entry into additional international markets will require significant management attention and financial resources. Multi-national operations are subject to inherent risks, including:

- difficulties in designing products that are compatible with varying international communications standards;
- longer accounts receivable collection periods and greater difficulty in accounts receivable collection;
- unexpected changes in regulatory requirements or the regulatory environment;
- changes in governmental control or influence over our customers;
- changes to import and export regulations, including quotas, tariffs and other trade barriers;

- delays or difficulties in obtaining export and import licenses;

potential foreign exchange controls and repatriation controls on foreign earnings;

exchange rate fluctuations and currency conversion restrictions;

the burdens of complying with a variety of foreign laws and regulations;

difficulties and costs of staffing and managing multi-national operations, including but not limited to internal control and compliance;

reduced protection for intellectual property rights in some countries;

potentially adverse tax consequences; and

political and economic instability.

Multi-national companies are required to establish intercompany pricing for transactions between their separate legal entities operating in different taxing jurisdictions. These intercompany transactions are subject to audit by taxing authorities in the jurisdictions in which multi-national companies operate. An additional tax liability may be incurred if it is determined that intercompany pricing was not done at arm's length. We believe we have adequately estimated and recorded our liability arising from intercompany pricing, but an additional tax liability may result from audits of our intercompany pricing policies.

In markets outside of China, we rely on a number of original equipment manufacturers, or OEMs, and third-party distributors and agents to market and sell our network access products. If these OEMs, distributors or agents fail to provide the support and effort necessary to service developing markets effectively, our ability to maintain or expand our operations outside of China will be negatively impacted. We may not successfully compete in these markets, our products may not be accepted and we may not successfully overcome the risks associated with international operations.

Moreover, in less developed markets we may face additional risks, such as inconsistent infrastructure support, unstable political and economic environments, and lack of a secure environment for our personnel, facilities and equipment. We have in the past experienced cases of vandalism and armed theft of our equipment that had been or was being installed in the field. If disruptions for any of these reasons become too severe in any particular market, it may become necessary for us to terminate contracts and withdraw from that market and suffer the associated costs and lost revenue.

Due to the multi-national nature of our business and operations, we are subject to regulation in multiple governmental jurisdictions. Furthermore, as a result of the heavily regulated nature of the markets in which we operate, we are continually subject to the risk of governmental investigations regarding our compliance with the rules and regulations of such jurisdictions. Should we become subject to any such investigations, there may be significant and unanticipated expenses, and risks such as the distraction of our key employees and disruptions to our operations. Such expenses and risks may result even in the event that such investigations are decided in our favor and no instances of non-compliance are found.

We are subject to risks relating to currency exchange rate fluctuations

We are exposed to foreign exchange rate risk because our sales to China are denominated in Renminbi and portions of our accounts payable are denominated in Japanese Yen. Due to the limitations on converting Renminbi, we are limited in our ability to engage in currency hedging activities in China. Although the impact of currency fluctuations of Renminbi to date has been insignificant, fluctuations in currency exchange rates in the future may have a material adverse effect on our results of operations.

Our failure to meet international and governmental product standards could be detrimental to our business

Many of our products are required to comply with numerous government regulations and standards, which vary by market. As standards for products continue to evolve, we will need to modify our products or develop and support new versions of our products to meet emerging industry standards, comply with government regulations and satisfy the requirements necessary to obtain approvals. Our inability to obtain regulatory approval and meet established standards could delay or prevent our entrance into or force our departure from particular markets.

Our recent growth has strained our resources, and if we are unable to manage and sustain our growth, our operating results will be negatively affected

We have recently experienced a period of rapid growth and anticipate that we must continue to expand our operations to address potential market opportunities. If we fail to implement or improve systems or controls or to manage any future growth and expansion effectively, our business could suffer.

Our expansion has placed and will continue to place a significant strain on our management, operational, financial and other resources. To manage our growth effectively, we will need to take various actions, including:

- enhancing management information systems and forecasting procedures;
- further developing our operating, administrative, financial and accounting systems and controls;
- maintaining close coordination among our engineering, accounting, finance, marketing, sales and operations organizations;
- expanding, training and managing our employee base; and
- expanding our finance, administrative and operations staff.

We may not be able to sustain profitability

We may not be able to remain profitable in future periods. We anticipate continuing to incur significant sales and marketing, research and development and general and administrative expenses and, as a result, we will need to generate higher revenues to remain profitable. Numerous factors could negatively impact our results of operations, including a decrease in sales, price pressures and significant fixed costs. Our past results should not be relied on as an indication of our future performance.

Our success is dependent on continuing to hire and retain qualified personnel, and if we are not successful in attracting and retaining these personnel, our business would be harmed

The success of our business depends in significant part upon the continued contributions of key technical and senior management personnel, many of whom would be difficult to replace. In particular, our success depends in large part on the knowledge, expertise and services of Hong Liang Lu, our President and Chief Executive Officer, and Ying Wu, our Executive Vice President and Chief Executive Officer of China Operations. The loss of any key employee, the failure of any key employee to perform satisfactorily in his or her current position or our failure to attract and retain other key technical and senior management employees could have a significant negative impact on our operations.

To effectively manage our recent growth as well as any future growth, we will need to recruit, train, assimilate, motivate and retain qualified employees. Competition for qualified employees is intense, and the process of recruiting personnel with the combination of skills and attributes required to execute our business strategy can be difficult, time-consuming and expensive. We are actively searching for research

and development engineers and sales and marketing personnel, who are in short supply. Additionally, we have a need for and have experienced difficulty in finding qualified accounting personnel knowledgeable in U.S. and China accounting standards who are resident in China. If we fail to attract, hire, assimilate or retain qualified personnel, our business would be harmed.

Competitors and others have in the past and may in the future attempt to recruit our employees. In addition, companies in the telecommunications industry whose employees accept positions with competitors frequently claim that the competitors have engaged in unfair hiring practices. We may be the subject of these types of claims in the future as we seek to hire qualified personnel. Some of these claims may result in material litigation and disruption to our operations. We could incur substantial costs in defending ourselves against these claims, regardless of their merit.

Any acquisitions that we undertake could be difficult to integrate, disrupt our business, dilute our stockholders and harm our operating results

We may acquire complementary businesses, products and technologies. For example, in November 2001, we acquired Advanced Communication Devices Corporation, a system on chip semiconductor company. On April 19, 2002, the Company completed the purchase of Issanni Communications, Inc., a RAS (remote access server) and local access technology company, providing broadband over ADSL. On December 18, 2001, we entered into an agreement to acquire the remaining 49% ownership interest in GUTS, one of our two primary manufacturing facilities in China, in order to achieve 100% ownership in the joint venture. On January 21, 2002, we entered into an agreement to acquire the remaining 12% ownership interest in HUTS, our other manufacturing facility. Any anticipated benefits of an acquisition may not be realized. We have in the past and will continue to evaluate acquisition prospects that would complement our existing product offerings, augment our market coverage, enhance our technological capabilities, or that may otherwise offer growth opportunities. Acquisitions of other companies may result in dilutive issuances of equity securities, the incurrence of debt and the amortization of expenses related to goodwill and other intangible assets. In addition, acquisitions involve numerous risks, including difficulties in the assimilation of operations, technologies, products and personnel of the acquired company, diversion of management's attention from other business concerns, risks of entering markets in which we have no direct or limited prior experience, and the potential loss of key employees of the acquired company.

We may be unable to adequately protect our intellectual property and may be subject to claims that we infringe the intellectual property of others, either of which could substantially harm our business

We rely on a combination of patents, copyrights, trademarks, trade secret laws and contractual obligations to protect our technology. We have applied for patents in the United States, three of which have been issued. We have also filed patent applications in other countries. Additional patents may not be issued from our pending patent applications and our issued patents may not be upheld. In addition, we have, from time to time, chosen to abandon previously filed applications. Moreover, we have not yet obtained, and may not be able to obtain, patents in China on our products or the technology that we use to manufacture our products. Our subsidiaries and joint ventures in China rely upon our trademarks, technology and know-how to manufacture and sell our products. We cannot guarantee that these and other intellectual property protection measures will be sufficient to prevent misappropriation of our technology or that our competitors will not independently develop technologies that are substantially equivalent or superior to ours. In addition, the legal systems of many foreign countries, including China, do not protect intellectual property rights to the same extent as the legal system of the United States. If we are unable to adequately protect our proprietary information and technology, our business, financial condition and results of operations could be materially adversely affected.

The increasing dependence of the communications industry on proprietary technology has resulted in frequent litigation based on allegations of the infringement of patents and other intellectual

property. In the future we may be subject to litigation to defend against claimed infringements of the rights of others or to determine the scope and validity of the proprietary rights of others. Future litigation also may be necessary to enforce and protect our trade secrets and other intellectual property rights. Any intellectual property litigation could be costly and could cause diversion of management's attention from the operation of our business. Adverse determinations in any litigation could result in the loss of our proprietary rights, subject us to significant liabilities or require us to seek licenses from third parties which may not be available on commercially reasonable terms, if at all. We could also be subject to court orders preventing us from manufacturing or selling our products.

Business interruptions could adversely affect our business

Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure and other events beyond our control. We do not have a detailed disaster recovery plan. Our headquarters facility in the State of California is currently subject to electrical blackouts as a consequence of a shortage of available electrical power. In the event these blackouts continue or increase in severity, they could disrupt the operations at our headquarters. In addition, we do not carry sufficient business interruption insurance to compensate us for losses that may occur and any losses or damages incurred by us could have a material adverse effect on our business.

We have been named as a defendant in securities litigation

The Company, some of our directors and officers and various underwriters for our initial public offering have been sued in a putative shareholder class action. The complaint alleges undisclosed improper underwriting practices concerning the allocation of IPO shares, in violation of the federal securities laws. Similar complaints have been filed concerning the IPOs of more than 300 companies, and the litigation has been coordinated in federal court for the Southern District of New York as *In re Initial Public Offering Securities Litigation*, 21 MC 92. We believe we have meritorious defenses to the claims against us and intend to defend the litigation vigorously. However, as litigation is by its nature uncertain, an unfavorable resolution of the lawsuit could have a material adverse effect on our business, results of operations, or financial condition.

RISKS RELATING TO THE STRUCTURE AND REGULATION OF CHINA'S TELECOMMUNICATIONS INDUSTRY

China's telecommunications industry is subject to extensive government regulation

China's telecommunications industry is heavily regulated by the Ministry of Information Industry. The Ministry of Information Industry has broad discretion and authority to regulate all aspects of the telecommunications and information technology industry in China, including managing spectrum bandwidths, setting network equipment specifications and standards and drafting laws and regulations related to the electronics and telecommunications industries. Additionally, the Ministry of Information Industry can decide what types of equipment may be connected to the national telecommunications networks, the forms and types of services that may be offered to the public, the rates that are charged to subscribers for those services and the content of material available in China over the Internet. If the Ministry of Information Industry sets standards with which we are unable to comply or which render our products noncompetitive, our ability to sell products in China may be limited, resulting in substantial harm to our operations.

At the end of May 2000, we became aware of an internal notice, circulated within the Ministry of Information Industry, announcing a review of PHS-based telecommunications equipment for future installation into China's telecommunications infrastructure. The Ministry of Information Industry requested service providers to temporarily halt new deployments of PHS-based telecommunications equipment, including our PAS systems and handsets, pending conclusion of a review by the Ministry of Information Industry. Subsequently, at the end of June 2000, the Ministry of Information Industry issued a notice stating that it had concluded its review of PHS-based equipment and that the continued deployment of PHS-based systems, such as our PAS systems and handsets, in China's county-level cities and towns and villages would be permitted. In addition, the notice stated that deployments within large and medium-sized cities would only be allowed in very limited areas of dense population, such as campuses, commercial buildings and special development zones. The notice confirmed, however, that new citywide deployments of our PAS system in large and medium cities would not be permitted. Failure of the Ministry of Information Industry to permit the sale or deployment of our PAS systems and handsets, or the sale or deployment of our other products, or the imposition of additional limitations on their sale in the future could have a material adverse effect on our business and financial condition. The Ministry of Information Industry may conduct further reviews or evaluations of PHS-based telecommunications equipment or may change its position regarding PHS-based systems in the future.

China's telecommunications regulatory framework is in the process of being developed, which has led to uncertainties regarding how to conduct our business in China

China does not yet have a national telecommunications law. However, with China's recent admission into the WTO the Ministry of Information Industry, under the direction of the State Council, must shortly present the first draft of the Telecommunications Law of the People's Republic of China for ultimate submission to the National People's Congress for review and adoption. We do not know the nature and scope of regulation that the Telecommunications Law would create. Accordingly, we cannot predict whether it will have a positive or negative effect on us or on some or all aspects of our business.

China's telecommunications regulatory framework is in the process of being developed. In September 2000, the State Council issued the Telecommunications Regulations of the People's Republic of China, known as the Telecom Regulations. The Telecom Regulations cover telecommunications services and market regulations, pricing, interconnection and connection, as well as telecommunications construction and security issues. In May 2001, the Ministry of Information Industry issued the Administrative Measures of Network Access Licenses to implement the Telecom Regulations.

Regulations in this area often require subjective interpretation and, given the relative infancy of the Telecom Regulations and the implementing regulations, we do not know how the regulations will be interpreted or enforced. As a result, our attempts to comply with these regulations may be deemed insufficient by the appropriate regulatory agencies, which could subject us to penalties that adversely affect our business.

Our business may suffer as a result of the recent restructuring of China Telecom

In February 1999, the State Council approved a restructuring plan for the China Telecom system, under which the telecommunications operations of the China Telecom system were separated along four business lines: fixed line, mobile, paging and satellite communications services. Following the announcement, we observed a reduction in orders from Telecommunications Companies, which we attributed to the uncertainties surrounding the restructuring and the ultimate impact the restructuring would have on the Telecommunications Companies.

On December 11, 2001, the Chinese government announced that China Telecom would be further split into two entities by region, Northern and Southern. The 10 Northern provinces, municipalities and autonomous regions of China Telecom will be merged with China Netcom Co. Ltd. and China Jitong Network Communications Co. Ltd. to form a new company which we refer to as the New CNC. The remaining 21 provinces, municipalities and autonomous regions will constitute the Southern entity, which will keep the name of China Telecom (the "New China Telecom"). The New CNC will inherit 30% of the old China Telecom's national backbone network, with the rest going to the New China Telecom. As this change is very recent and its implementation is ongoing, we cannot be certain what impact the restructuring will have on our business operations. However, we may experience another decline in orders and related revenues similar to that which we experienced following the 1999 restructuring, resulting from uncertainty among our Telecommunications Company customers associated with the restructuring. Moreover, following any restructuring, the New CNC, the New China Telecom or any other entity that may replace it as a result of any subsequent restructuring may restrict or prohibit the sales of our products, which could cause substantial harm to our business.

We do not have some of the licenses we are required to have to sell our network access products in China

Under China's current regulatory structure, the communications products that we offer in China must meet government and industry standards, and a network access license for the equipment must be obtained. Without the license, the equipment is not allowed to be connected to public telecommunications networks or sold in China. Moreover, we must ensure that the quality of the telecommunications equipment for which we have obtained a network access license is stable and reliable, and may not lower the quality or performance of other installed licensed products. The State Council's product quality supervision department, in concert with the Ministry of Information Industry, performs spot checks to track and supervise the quality of licensed telecommunications equipment and publishes the results of such spot checks.

The regulations implementing these requirements are not very detailed, have not been applied by a court and may be interpreted and enforced by regulatory authorities in a number of different ways. We have obtained the required network access licenses for our AN-2000 platform. We have applied for, but have not yet received, a network access license for our PAS systems and handsets. Based upon conversations with the Ministry of Information Industry, we understand that our PAS systems and handsets are considered to still be in the trial period and that sales of our PAS systems and handsets may continue to be made by us during this trial period, but a license will ultimately be required. Network access licenses will also be required for most additional products that we are selling or may sell in China, including our mSwitch platform. If we fail to obtain the required licenses, we could be prohibited from making further sales of the unlicensed products, including our PAS systems and

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handsets, in China, which would substantially harm our business, financial condition and results of operations. Our counsel in China has advised us that China's governmental authorities may interpret or apply the regulations with respect to which licenses are required and the ability to sell a product while a product is in the trial period in a manner that is inconsistent with the information received by our counsel in China, either of which could have a material adverse effect on our business and financial condition.

We are required to register the software incorporated in our products in accordance with relevant Chinese regulations

In October 2000, the Ministry of Information Industry issued regulations which prohibit the production and sale of software products, or products incorporating software, in China unless the software is registered with the government. We have accomplished the necessary registration with regards to the software incorporated in our AN-2000 and PAS. However, additional registration is required for software incorporated in additional products that we are selling or may sell in China, including mSwitch. Based upon verbal advice received from the Ministry of Information Industry, we believe that we will be able to sell products incorporating our software while any of our applications for registration may be pending. However, the Chinese government may interpret or apply the regulations in such a way as to prohibit sales of products incorporating our unregistered software prior to registration. If the government prohibits sales pending registration, or if we fail in our efforts to register any software required to be registered, we could be prohibited from making further sales of products incorporating our unregistered software in China, which could substantially harm our business and financial condition.

Most of our customers in China have historically been part of the China Telecom system and under China Telecom's ultimate control; following the recent restructuring of China Telecom, most of our customers in China are now part of the New China Telecom or the New CNC, and are subject to their ultimate control

Our main customers in China are the local Telecommunications Companies (formerly known as Telecommunications Bureaus) which historically operated under China Telecom, China's state-owned fixed line operator, and were subject to its ultimate control. Following the recent restructuring of China Telecom, the Telecommunications Companies now operate under the ultimate control of the New China Telecom or the New CNC. Policy statements may be issued and decisions may be made by the New China Telecom and the New CNC, which govern the equipment purchasing decisions of most of our customers in China. For example, in late 1999, China Telecom prohibited all Telecommunications Companies from purchasing PHS systems, such as our PAS systems, for implementation in large cities, even before these sales were prohibited by the Ministry of Information Industry. As most of our sales are generated from our operations in China, any decisions by the New China Telecom or the New CNC restricting or prohibiting the sales or deployment of our products could cause significant harm to our business.

Our ability to sell our PAS wireless systems and handsets could be significantly impaired if the New China Telecom or the New CNC are granted, or if they otherwise acquire, mobile licenses allowing the New China Telecom or the New CNC to deliver cellular services

The New China Telecom and the New CNC hold and operate the fixed line telephone and data communications assets in China, and currently do not have the licenses necessary to offer cellular services. To offer wireless services to end users, the Telecommunications Companies must offer services that can be delivered over wireline networks, such as those delivered over our PAS wireless systems and handsets. China's media sources have widely reported that after the restructuring of China Telecom, the Ministry of Information Industry may grant mobile licenses to the New China Telecom or the New

CNC, or to both. If the Ministry of Information Industry does grant a mobile license to the New China Telecom or the New CNC, or to both, or if such entities otherwise acquire mobile licenses, local Telecommunications Companies will be free to offer cellular services such as GSM or CDMA to their customers, and they may therefore elect not to deploy our PAS systems and handsets. If this were to occur, we could lose current and potential customers for our PAS systems and handsets, and our financial condition and results of operations could be significantly harmed.

Changes in telecommunications rates or pricing policies may result in decreased demand for our products

In November 2000, the Ministry of Information Industry announced significant changes in rates for telecommunications services in China. While long distance, international, leased line and Internet connection fees were cut by up to 70%, the rates for local telephone services, which include certain types of wireless access services such as those offered over our PAS systems and handsets, were increased, from approximately $0.01 per minute to approximately $0.02 per minute. The increase in rates may result in a reduced demand by end users for wireless services delivered over our PAS system and a corresponding decline in demand for our products. In addition, mobile operators are offering price incentive plans that could impact demand for our products. Additionally, the Ministry of Information Industry may implement future rate changes for wireline or wireless services in China or change telecommunications pricing policies, including allowing carriers to set prices based on market conditions, any of which may lead to reduced demand for our systems and products and result in a material adverse effect on our business or results of operations.

RISKS RELATING TO CONDUCTING OPERATIONS IN CHINA

Sales in China have accounted for most of our sales, and therefore, our business, financial condition and results of operations are to a significant degree subject to economic, political and social events in China

Approximately $182.0 million and $349.3 million, or 79% and 84%, of our net sales for the three and six months ended June 30, 2002, and $139.2 million and $256.0 million, or 99% and 99%, of our net sales for the corresponding periods in 2001, occurred in China. Additionally, a substantial portion of our fixed assets are located in China. Of our total fixed assets, approximately 80% as of June 30, 2002 and 75% as of December 31, 2001 were in China. We expect to make further investments in China in the future. Therefore, our business, financial condition and results of operations are to a significant degree subject to economic, political and social events in China.

Devaluation in the value of the Renminbi and fluctuations in exchange rates could adversely affect our financial results

Exchange rate fluctuations could have a substantial negative impact on our financial condition and results of operations. We purchase substantially all of our materials in the United States and Japan and a significant portion of our cost of goods sold is incurred in U.S. dollars and Japanese yen. A significant portion of our operating expenses are incurred in U.S. dollars. At the same time, most of our sales are denominated in Renminbi. The value of the Renminbi is fixed by China's national government and is subject to changes in China's governmental policies and to international economic and political developments. China may choose to devalue the Renminbi against the U.S. dollar. Additionally, China's government has considered from time to time whether to partially or fully abandon the official exchange rate for Renminbi to the U.S. dollar. The abandonment of this official exchange rate policy may lead to sharp depreciation of the Renminbi against the U.S. dollar and other foreign currencies and to significantly more volatility in the Renminbi exchange rate in the future, both of which would adversely affect our financial results and make our future results more subject to fluctuation.

In the past, financial markets in many Asian countries have experienced severe volatility and, as a result, some Asian currencies have experienced significant devaluation from time to time. The devaluation of some Asian currencies may have the effect of rendering exports from China more expensive and less competitive and therefore place pressure on China's government to devalue the Renminbi. Any devaluation of the Renminbi could result in an increase in volatility of Asian currency and capital markets. Future volatility of Asian financial markets could have an adverse impact on our ability to expand our product sales into Asian markets outside of China. Moreover, due to the limitations on the convertibility of Renminbi, we are limited in our ability to engage in currency hedging activities in China and do not currently engage in currency hedging activities with respect to international sales outside of China.

Currency restrictions in China may limit the ability of our subsidiaries and joint ventures in China to obtain and remit foreign currency necessary for the purchase of imported components and may limit our ability to obtain and remit foreign currency in exchange for Renminbi earnings

China's government imposes controls on the convertibility of Renminbi into foreign currencies and, in certain cases, the remittance of currency out of China. Under the current foreign exchange control system, sufficient foreign currency may not be available to satisfy our currency needs. Shortages in the availability of foreign currency may restrict the ability of our Chinese subsidiaries to obtain and remit sufficient foreign currency to pay dividends to us, or otherwise satisfy their foreign currency denominated obligations, such as payments to us for components which we export to them and for technology licensing fees. We may also experience difficulties in completing the administrative

procedures necessary to obtain and remit needed foreign currency. Our business could be substantially harmed if we are unable to convert and remit our sales received in Renminbi into U.S. dollars. Under existing foreign exchange laws, Renminbi held by our China subsidiaries can be converted into foreign currencies and remitted out of China to pay current account items such as payments to suppliers for imports, labor services, payment of interest on foreign exchange loans and distributions of dividends so long as the subsidiaries have adequate amounts of Renminbi to purchase the foreign currency. Expenses of a capital nature such as the repayment of bank loans denominated in foreign currencies, however, require approval from appropriate governmental authorities before Renminbi can be used to purchase foreign currency and then remitted out of China. This system could be changed at any time by executive decision of the State Council to impose limits on current account convertibility of the Renminbi or other similar restrictions. Moreover, even though the Renminbi is intended to be freely convertible under the current account, the State Administration of Foreign Exchange, which is responsible for administering China's foreign currency market, has a significant degree of administrative discretion in implementing the laws. From time to time, the State Administration of Foreign Exchange has used this discretion in ways which effectively limit the convertibility of current account payments and restrict remittances out of China. Furthermore, in many circumstances the State Administration of Foreign Exchange must approve foreign currency conversions and remittances. Under the current foreign exchange control system, sufficient foreign currency may not be available at a given exchange rate to satisfy our currency demands.

China subjects foreign investors in the telecommunications industry to ownership and geographic limitations

China's government and its agencies, including the Ministry of Information Industry and the State Council, regulate foreign investment in the telecommunications industry through the promulgation of various laws and regulations and the issuance of various administrative orders and decisions. Currently, foreign investors may engage in such activities only in accordance with certain ownership and geographic limitations. China may promulgate new laws or regulations, or issue administrative or judicial decisions or interpretations, which would further restrict or bar foreigners from engaging in telecommunications-related activities. The promulgation of laws or regulations or the issuance of administrative orders or judicial decisions or interpretations restricting or prohibiting telecommunications activities by foreigners could have a substantial impact on our ongoing operations.

Governmental policies in China could impact our business

Since 1978, China's government has been and is expected to continue reforming its economic and political systems. These reforms have resulted in and are expected to continue to result in significant economic and social development in China. Many of the reforms are unprecedented or experimental and may be subject to change or readjustment due to a number of political, economic and social factors. We believe that the basic principles underlying the political and economic reforms will continue to be implemented and provide the framework for China's political and economic system. New reforms or the readjustment of previously implemented reforms could have a significant negative effect on our operations. Changes in China's political, economic and social conditions and governmental policies which could have a substantial impact on our business include:

- new laws and regulations or the interpretation of those laws and regulations;
- the introduction of measures to control inflation or stimulate growth;
- changes in the rate or method of taxation;
- the imposition of additional restrictions on currency conversion and remittances abroad; and

- any actions which limit our ability to develop, manufacture, import or sell our products in China, or to finance and operate our business in China.

Economic policies in China could impact our business

The economy of China differs from the economies of most countries belonging to the Organization for Economic Cooperation and Development in various respects such as structure, government involvement, level of development, growth rate, capital reinvestment, allocation of resources, self-sufficiency, rate of inflation and balance of payments position. In the past, the economy of China has been primarily a planned economy subject to one- and five-year state plans adopted by central government authorities and largely implemented by provincial and local authorities, which set production and development targets.

Since 1978, increasing emphasis had been placed on decentralization and the utilization of market forces in the development of China's economy. Economic reform measures adopted by China's government may be inconsistent or ineffectual, and we may not in all cases be able to capitalize on any reforms. Further, these measures may be adjusted or modified in ways which could result in economic liberalization measures that are inconsistent from time to time or from industry to industry or across different regions of the country. China's economy has experienced significant growth in the past decade. This growth, however, has been accompanied by imbalances in China's economy and has resulted in significant fluctuations in general price levels, including periods of inflation. China's government has implemented policies from time to time to increase or restrain the rate of economic growth, control periods of inflation or otherwise regulate economic expansion. While we may be able to benefit from the effects of some of these policies, these policies and other measures taken by China's government to regulate the economy could also have a significant negative impact on economic conditions in China with a resulting negative impact on our business.

China's entry into the World Trade Organization creates uncertainty as to the future economic and business environments in China

China's entry into the WTO was approved in September 2001. Entry into the WTO will require China to further reduce tariffs and eliminate non-tariff barriers, which include quotas, licenses and other restrictions by 2005 at the latest. While China's entry into the WTO and the related relaxation of trade restrictions may lead to increased foreign investment, it may also lead to increased competition in China's markets from international companies. China's entry into the WTO could have a negative impact on China's economy with a resulting negative impact on our business.

If tax benefits available to our subsidiaries located in China are reduced or repealed, our business could suffer

Our subsidiaries and joint ventures located in China enjoy tax benefits in China which are generally available to foreign investment enterprises, including full exemption from national enterprise income tax for two years starting from the first profit-making year and/or a 50%

reduction in national income tax rate for the following three years. In addition, local enterprise income tax is often waived or reduced during this tax holiday/incentive period. Under current regulations in China, foreign investment enterprises that have been accredited as technologically advanced enterprises are entitled to additional tax incentives. These tax incentives vary in different locales and could include preferential national enterprise income tax treatment at 50% of the usual rates for different periods of time. All of our active subsidiaries in China were accredited as technologically advanced enterprises. Two of our principal subsidiaries, UTStarcom China and HUTS, accounted for approximately 90.1% of our revenues in 2001. The tax holidays applicable to UTStarcom China will expire at the end of 2002. At that time, the tax rate will increase from 7.5% to 15% and will negatively impact our financial condition and results of operations. The tax holiday applicable to our other principal subsidiary, HUTS,

expired in 2001 and is now subject to annual review. HUTS was able to maintain the 10% rate for 2002, following its annual review. However, its tax rate could increase from 10% to 15% if it is unable to maintain a tax holiday in 2003. If we are unable to extend the tax holiday described above to 2003, our financial condition and results of operations may be negatively impacted. Additionally, the Chinese government is considering the imposition of "unified" corporate income tax that would phase out, over time, the preferential tax treatment to which foreign-funded enterprises, such as UTStarcom, are currently entitled. While it is not certain whether the government will implement such a unified tax structure or whether, if implemented, UTStarcom will be grandfathered into the new tax structure, if the new tax structure is implemented, it will adversely affect our financial condition.

We may be exposed to contingent tax liabilities in China resulting from our failure to withhold sufficient amounts for China's income tax purposes

We employ a number of U.S. citizens who work on a full time basis in China. These expatriate employees participate in our stock option plans and have exercised a number of options granted under the plans. The option exercises generated income that may be subject to personal income taxes under China's income tax laws. We did not withhold China income taxes on the option exercises, and the employees have not yet paid any taxes in China that may be due. Should the employees fail to pay the income taxes, we may be liable for such taxes in our capacity as withholding agent. In the event that it is determined that taxes are due in China, we, on behalf of our employees, will apply for a refund from the U.S. tax authorities corresponding to the amount of the foreign tax credit which would then be applicable. The refund amounts are required to be paid to us by the employees who receive them. In addition, our failure to collect and remit China withholding tax may also subject us to penalties.

China's legal system embodies uncertainties that could negatively impact our business

China has a civil law system. Decided court cases do not have binding legal effect on future decisions. Since 1979, many new laws and regulations covering general economic matters have been promulgated in China. Despite this activity to develop the legal system, China's system of laws is not yet complete. Even where adequate law exists in China, enforcement of existing laws or contracts based on existing law may be uncertain and sporadic and it may be difficult to obtain swift and equitable enforcement, or to obtain enforcement of a judgment by a court of another jurisdiction. The relative inexperience of China's judiciary in many cases creates additional uncertainty as to the outcome of any litigation. Further, interpretation of statutes and regulations may be subject to government policies reflecting domestic political changes. Moreover, government policies and internal rules promulgated by governmental agencies may not be published in time, or at all. As a result, we may operate our business in violation of new rules and policies without having any knowledge of their existence.

China has adopted a broad range of related laws, administrative rules and regulations that govern the conduct and operations of foreign investment enterprises and restrict the ability of foreign companies to conduct business in China. These laws, rules and regulations provide some incentives to encourage the flow of investment into China, but also subject foreign companies, and foreign investment enterprises, including our subsidiaries in China, to a set of restrictions that may not always apply to domestic companies in China. As a result of its admission into the WTO, China is increasingly according foreign companies and foreign investment enterprises established in China the same rights and privileges as Chinese domestic companies. These special laws, administrative rules and regulations governing foreign companies and foreign investment enterprises may still place us and our subsidiaries at a disadvantage in relation to Chinese domestic companies and may adversely affect our competitive position. Moreover, as China's legal system develops, the promulgation of new laws, changes to existing laws and the pre-emption of local regulations by national laws may adversely affect foreign investors and companies. Many of our activities and products in China are subject to administrative review and approval by various national and local agencies of China's government. Because of the changes occurring in China's legal and regulatory structure, we may not be able to secure the requisite governmental approval for our activities and products. Failure to obtain the requisite government approval for any of our activities or products could substantially harm our business.

RISKS RELATING TO OUR STOCK PERFORMANCE

Our stock price is highly volatile

The trading price of our common stock has fluctuated significantly since our initial public offering in March 2000. Our stock price could be subject to wide fluctuations in the future in response to many events or factors, including those discussed in the preceding risk factors relating to our operations, as well as:

- actual or anticipated fluctuations in operating results;
- changes in expectations as to future financial performance or changes in financial estimates or buy/sell recommendations of securities analysts;
- changes in governmental regulations or policies in China, such as the temporary suspension of sales of our PAS systems that occurred in May and June of 2000, which caused our stock price to drop;
- our, or a competitor's, announcement of new products, services or technological innovations;
- the operating and stock price performance of other comparable companies; and
- news and commentary emanating from the media, securities analysts, and government bodies in China relating to UTStarcom and to the industry in general.

General market conditions and domestic or international macroeconomic factors unrelated to our performance may also affect our stock price. For these reasons, investors should not rely on recent trends to predict future stock prices or financial results. In addition, following periods of volatility in a company's securities, securities class action litigation against a company is sometimes instituted. This type of litigation could result in substantial costs and the diversion of management time and resources.

SOFTBANK CORP. and its related entities, including SOFTBANK America Inc., has significant influence over our management and affairs, which it could exercise against your best interests

SOFTBANK CORP. and its related entities, including SOFTBANK America Inc., beneficially own 31.3% of our outstanding stock. As a result, SOFTBANK CORP. and its related entities, including SOFTBANK America Inc., have the ability to exercise significant influence over all matters submitted to our stockholders for approval and exert significant influence over our management and affairs. This concentration of ownership may delay or prevent a change of control or discourage a potential acquiror from making a tender offer or otherwise attempting to obtain control of our company, which could decrease the market price of our common stock. Matters that could require stockholder approval include:

- election and removal of directors;
- merger or consolidation of our company; and
- sale of all or substantially all of our assets.

The interests of SOFTBANK America Inc. may not always coincide with our interests. SOFTBANK America Inc., acting through its designees on the Board of Directors and through its ownership of voting securities, will have the ability to exercise significant influence over our actions irrespective of the desires of our other stockholders or directors.

Delaware law and our charter documents contain provisions that could discourage or prevent a potential takeover, even if the transaction would benefit our stockholders

Other companies may seek to acquire or merge with us. An acquisition or merger of our company could result in benefits to our stockholders, including an increase in the value of our common stock. Some provisions of our Certificate of Incorporation and Bylaws, as well as provisions of Delaware law, may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable. These provisions include:

- authorizing the Board of Directors to issue additional preferred stock;
- prohibiting cumulative voting in the election of directors;
- limiting the persons who may call special meetings of stockholders;
- prohibiting stockholder action by written consent;
- creating a classified Board of Directors pursuant to which our directors are elected for staggered three year terms; and
- establishing advance notice requirements for nominations for election to the Board of Directors and for proposing matters that can be acted on by stockholders at stockholder meetings.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

We are exposed to the impact of interest rate changes and changes in foreign currency exchange rates.

Interest Rate Risk. Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. The fair value of our investment portfolio would not be significantly affected by either a 10% increase or decrease in interest rates due mainly to the short term nature of our investment portfolio. However, our interest income can be sensitive to changes in the general level of U.S. interest rates since the majority of our funds are invested in instruments with maturities less than one year. Our policy is to limit the risk of principal loss and ensure the safety of invested funds by limiting market risk. Funds in excess of current operating requirements are invested in government backed notes, commercial paper, floating rate corporate bonds, fixed income corporate bonds and tax exempt instruments. In accordance with our investment policy, all short-term investments are invested in "investment grade" rated securities with minimum A or better ratings. Currently, most of our short-term investments have AA or better ratings.

The table below represents carrying amounts and related weighted-average interest rates of maturity of our investment portfolio at June 30, 2002:

(In thousands, except interest rates)

Cash and cash equivalents	$ 338,201
Average interest rate	1.45%
Short-term investments	64,565
Average interest rate	1.78%
Total investment securities	402,766
Average interest rate	1.5%

Foreign Exchange Rate Risk. We are exposed to foreign exchange rate risk because most of our sales in China are denominated in Renminbi and portions of our accounts payable are denominated in Japanese Yen. Due to the limitations on converting Renminbi, we are limited in our ability to engage in currency hedging activities in China. Although the impact of currency fluctuations of Renminbi to date has been insignificant, fluctuations in currency exchange rates in the future may have a material adverse effect on our results of operations. We have a multi-currency bank account in Japanese Yen for purchasing portions of our inventories and supplies. The balance of this Japanese Yen account as of June 30, 2002 is approximately $2.7 million.

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PART II OTHER INFORMATION

ITEM 2 CHANGES IN SECURITIES AND USE OF PROCEEDS

We completed our initial public offering ("IPO") on March 3, 2000 pursuant to a Registration Statement on Form S-1 (File No. 333-93069). In the IPO, we sold an aggregate of 11,500,000 shares of common stock (including an over-allotment option of 1,500,000 shares) at $18.00 per share.

The managing underwriters of our initial public offering were Merrill Lynch & Co., Banc of America Securities LLC, U.S. Bancorp Piper Jaffray, Merrill Lynch Japan Inc. and E-TRADE Securities Co., Ltd. The sale of the shares of common stock generated aggregate gross proceeds of approximately $207.0 million. The aggregate net proceeds was approximately $189.4 million, after deducting underwriting discounts and commissions of approximately $14.5 million and expenses of the offering of approximately $3.1 million. None of such amounts were direct or indirect payments to our directors or officers or their associates, to persons owning 10 percent or more of any class of our equity securities or to our affiliates.

We completed a follow-on public offering on August 3, 2001 pursuant to a Registration Statement on Form S-3 (File No. 333-63356). A total of 10,350,000 shares of common stock (including the underwriters' over-allotment) were registered. We sold an aggregate of 7,400,000 shares of common stock, which included the underwriters' over-allotment, at a price to the public of $20.00 per share. Selling stockholders sold an additional 2,950,000 shares of common stock in the offering.

The managing underwriter of our follow on public offering was Merrill Lynch & Co. Salomon Smith Barney, Banc of America Securities LLC, HSBC Securities (USA) Inc., and U.S. Bancorp Piper Jaffray served as co-managers of our offering. The sale of the shares of common stock generated aggregate gross proceeds of approximately $148.0 million. The aggregate net proceeds that we received was approximately $139.9 million, after deducting underwriting discounts and commissions of approximately $7.3 million and expenses of the offering of approximately $1.0 million. None of such amounts were direct or indirect payments to our directors or officers or their associates, to persons owning 10 percent or more of any class of our equity securities or to our affiliates. The aggregate gross proceeds for the selling stockholders was approximately $59.0 million.

On February 28, 2002, we sold 1,500,000 shares of common stock upon exercise of the underwriter's over-allotment option in connection with the resale public offering of 10,000,000 shares of our common stock by SOFTBANK America Inc., one of our stockholders, at a price to the public of $20.25 per share, pursuant to a Registration Statement on Form S-3 (File No. 333-82458). A total of 11,500,000 shares of common stock were registered.

The joint book-running managers of this public offering were Merrill Lynch & Co. and Credit Suisse First Boston Corporation. Salomon Smith Barney, Banc of America Securities LLC, U.S. Bancorp Piper Jaffray and HSBC Securities (USA) Inc., served as co-managers of our offering. The aggregate net proceeds we received was approximately $28.9 million, after deducting underwriting discounts and commissions and related expenses of $1.5 million. None of such amounts were direct or indirect payments to our directors or officers or their associates, to persons owning 10 percent or more of any class of our equity securities or to our affiliates. We did not receive any proceeds from the offering of the shares of our common stock by SOFTBANK America Inc. The aggregate gross proceeds for SOFTBANK America Inc., was approximately $202.5 million.

We expect to use the net proceeds from these offerings for general corporate purposes, including research and development, expansion of our sales and marketing organization and working capital and capital expenditures. The amounts actually expended for such purposes may vary significantly and will depend on a number of factors, including our future revenues and cash generated by operations and the other factors described under "Factors Affecting Future Operating Results". Accordingly, we retain broad discretion in the allocation of the net proceeds of the offerings. A portion of the net proceeds

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may also be used to acquire or invest in complementary businesses, technologies or product offerings. As of July 31, 2002 we have not used any of the net proceeds from the offerings described above, and the entire amount of net proceeds from such offerings remains in our cash and cash equivalents and short-term investments accounts.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

ITEM 5 OTHER INFORMATION

Our directors, officers, or employees have entered, and may from time to time enter, into good faith trading plans pursuant to SEC Rule 10b5-1(c).

Our audit committee has approved the performance of non-audit services by PricewaterhouseCoopers LLP.

ITEM 6 EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits:

NUMBER	EXHIBIT DESCRIPTION
10.76	Comprehensive Credit-Extension Agreement between UTStarcom (China) Ltd. and Shenzhen Development Bank, Hangzhou, dated June 26, 2002.
10.77	Merger Agreement by and between UTStarcom Telecom Co., Ltd. and Guangdong UTStarcom Telecom Co., Ltd.
99.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) Reports on Form 8-K:

No reports on Form 8-K were filed during the quarter.

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UTSTARCOM, INC.

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.

Date: August 8, 2002

UTSTARCOM, INC.
(Registrant)

BY:

/s/ Hong Liang Lu

Hong Liang Lu
President, Chief Executive Officer and Director

/s/ Michael J. Sophie

Michael J. Sophie
Chief Financial Officer and Assistant Secretary

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