HARMONIC INC
Form 10-Q
May 10, 2006

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

FORM 10-Q

(Mark One)

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

For the Quarterly Period Ended March 31, 2006

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission File No. 0-25826
HARMONIC INC.
(Exact name of Registrant as specified in its charter)

Delaware	**77-0201147**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**

549 Baltic Way
Sunnyvale, CA 94089
(408) 542-2500
(Address, including zip code, and telephone number, including area code, of Registrant s principal executive offices)
Securities registered pursuant to section 12(b) of the Act:
None
Securities registered pursuant to section 12(g) of the Act:
Common Stock, par value $.001 per share
Preferred Share Purchase Rights

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 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 þ **No** o

Indicate by check mark whether the Registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer (as defined in Rule 12b-2 of the Exchange Act). (Check one):

Large accelerated filer o **Accelerated filer** þ **Non-accelerated filer** o

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

Yes o **No** þ

The number of shares outstanding of the Registrant s Common Stock, $.001 par value, was 74,168,674 on April 28, 2006.

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PART I

FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HARMONIC INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(UNAUDITED)

(In thousands, except par value amounts)	March 31, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 41,123	$ 37,818
Short-term investments	67,435	73,010
Accounts receivable, net of allowances of $3,153 and $3,230	43,329	43,433
Inventories	31,208	38,552
Prepaid expenses and other current assets	8,220	8,335
Total current assets	191,315	201,148
Property and equipment, net	16,463	17,040
Intangibles and other assets	7,384	8,109
Total assets	$ 215,162	$ 226,297
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt	$ 751	$ 812
Accounts payable	16,445	19,378
Income taxes payable	6,586	6,480
Deferred revenue	17,241	19,687
Accrued liabilities	34,407	37,438
Total current liabilities	75,430	83,795
Long-term debt, less current portion	301	460
Accrued excess facilities costs, long-term	17,717	18,357
Other non-current liabilities	10,064	10,703
Total liabilities	103,512	113,315
Commitments and contingencies (Notes 15 and 16)		
Stockholders equity:		
Preferred stock, $0.001 par value, 5,000 shares authorized; no shares issued or outstanding		
Common stock, $0.001 par value, 150,000 shares authorized; 74,150 and 73,636 shares issued and outstanding	74	74
Capital in excess of par value	2,051,834	2,048,090
Accumulated deficit	(1,939,863)	(1,934,715)

Accumulated other comprehensive loss		(395)		(467)
Total stockholders equity		111,650		112,982
Total liabilities and stockholders equity	$	215,162	$	226,297

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

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HARMONIC INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

(In thousands, except per share data)	Three Months Ended March 31, 2006	Three Months Ended April 1, 2005
Net sales	$ 56,221	$ 72,915
Cost of sales	36,341	45,868
Gross profit	19,880	27,047
Operating expenses:		
Research and development	9,948	9,459
Selling, general and administrative	15,713	15,325
Amortization of intangibles	91	958
Total operating expenses	25,752	25,742
Income (loss) from operations	(5,872)	1,305
Interest income, net	992	522
Other income (expense), net	(92)	(49)
Income (loss) before income taxes	(4,972)	1,778
Provision for income taxes	175	72
Net income (loss)	$ (5,147)	$ 1,706
Net income (loss) per share:		
Basic	$ (0.07)	$ 0.02
Diluted	$ (0.07)	$ 0.02
Weighted average shares:		
Basic	74,102	72,839
Diluted	74,102	74,375

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

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

(In thousands)	Three Months Ended March 31, 2006	Three Months Ended April 1, 2005
Cash flows from operating activities:		
Net income (loss)	$ (5,147)	$ 1,706
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Amortization of intangibles	250	1,730
Depreciation	2,170	2,080
Stock-based compensation	1,627	5
Loss on disposal of fixed assets		89
Changes in assets and liabilities, net of effect of acquisition:		
Accounts receivable	(186)	9,148
Inventories	7,324	(171)
Prepaid expenses and other assets	183	2,419
Accounts payable	(2,933)	1,109
Deferred revenue	(3,144)	8,106
Income taxes payable	77	(566)
Accrued excess facilities costs	(1,193)	(1,147)
Accrued and other liabilities	(1,575)	(16,605)
Net cash provided by (used in) operating activities	(2,547)	7,903
Cash flows provided by (used in) investing activities:		
Purchases of investments	(18,609)	(19,787)
Proceeds from sales of investments	24,259	20,747
Acquisition of property and equipment	(1,593)	(1,815)
Acquisition of BTL, net of cash received		(5,955)
Net cash provided by (used in) investing activities	4,057	(6,810)
Cash flows from financing activities:		
Proceeds from issuance of common stock, net	2,073	4,243
Repayments under bank line and term loan	(220)	(386)
Repayments of capital lease obligations	(20)	(32)
Net cash provided by financing activities	1,833	3,825
Effect of exchange rate changes on cash and cash equivalents	(38)	140
Net increase in cash and cash equivalents	3,305	5,058
Cash and cash equivalents at beginning of period	37,818	26,603
Cash and cash equivalents at end of period	$ 41,123	$ 31,661

Supplemental disclosure of cash flow information:				
Income tax payments, net	$	103	$	51
Interest paid during the period	$	36	$	127
Non-cash investing and financing activities:				
Issuance of restricted common stock from BTL acquisition	$		$	1,831

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

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HARMONIC INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Note 1: Basis of Presentation

The accompanying unaudited condensed consolidated financial statements include all adjustments (consisting only of normal recurring adjustments) which Harmonic Inc. (the Company) considers necessary for a fair statement of the results of operations for the interim periods covered and the consolidated financial condition of the Company at the date of the balance sheets. This Quarterly Report on Form 10-Q should be read in conjunction with the Company s audited consolidated financial statements contained in the Company s Annual Report on Form 10-K and Form 10-K/A, which were filed with the Securities and Exchange Commission on March 14, 2006 and April 26, 2006, respectively. The interim results presented herein are not necessarily indicative of the results of operations that may be expected for the full fiscal year ending December 31, 2006, or any other future period. The Company s fiscal quarters end on the Friday nearest the calendar quarter end, except for the fourth quarter which ends on December 31.

The condensed consolidated financial statements include the accounts of the Company and its subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

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

Note 2: Recent Accounting Pronouncements

In November 2004, the Financial Accounting Standards Board, FASB, issued Statement of Financial Accounting Standard, SFAS , No. 151, *Inventory Costs*, to amend the guidance in Chapter 4, *Inventory Pricing*, of FASB Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*. SFAS No. 151 clarifies the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) and requires these costs be treated as current period charges. Additionally, SFAS No. 151 requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. The provisions of SFAS No. 151 are effective for inventory costs incurred during fiscal years beginning after June 15, 2005. The adoption of SFAS No. 151 did not have a significant impact on the Company s financial condition or results of operations.

In May 2005, FASB issued SFAS No. 154, *Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3*. SFAS No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle, and applies to all voluntary changes in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. This statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. SFAS No. 154 is effective for accounting change made in fiscal years beginning after December 15, 2005. The adoption of this standard did not have an impact on our results of operations or financial condition.

Note 3: Stock-based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee

stock purchases related to our Employee Stock Purchase Plan (ESPP) based upon the grant-date fair value of those awards. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations, and provided the required pro forma disclosures prescribed by Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, (SFAS 123) as amended. In addition, we have applied the provisions of Staff Accounting Bulletin No. 107 (SAB 107), issued by the Securities and Exchange Commission, in our adoption of SFAS No. 123(R).

The Company adopted SFAS 123(R) using the modified-prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company s fiscal year 2006. The Company s Condensed Consolidated Financial Statements as of and for the three months ended March 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s Condensed Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the three months ended March 31, 2006 was $1.6 million which consisted of stock-based compensation expense related to employee equity awards and employee stock purchases. There was no stock-based compensation expense related to employee equity awards and employee stock purchases recognized during the three months ended April 1, 2005.

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

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s Condensed Consolidated Statement of Operations for the three months ended March 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company changed its method of attributing the value of stock-based compensation costs to expense from the accelerated multiple-option method to the straight-line single-option method. Compensation expense for all share-based payment awards granted on or prior to December 31, 2005 will continue to be recognized using the accelerated approach while compensation expense for all share-based payment awards related to stock options and employee stock purchase rights granted subsequent to December 31, 2005 are recognized using the straight-line method.

As stock-based compensation expense recognized in our results for the first quarter of fiscal year 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to fiscal year 2006, we accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

The fair value of share-based payment awards is estimated at grant date using a Black-Scholes-Merton option pricing model. The Company s determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as the assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors.

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Harmonic currently does not expect to receive any tax benefits in fiscal 2006 for any expense deductions resulting from expensing of stock options or shares issued under its ESPP plan. Harmonic currently provides a valuation allowance for most of its deferred tax assets, and a valuation allowance has also been provided for any tax effects of stock-based compensation expense pursuant to SFAS 123(R).

Note 4: BTL Acquisition

On February 25, 2005, Harmonic purchased all of the issued and outstanding shares of Broadcast Technology Limited, or BTL, a private UK company, for a purchase consideration of £4.0 million, or approximately $7.6 million. The purchase consideration consisted of a payment of £3.0 million in cash and the issuance of 169,112 shares of Harmonic common stock. In addition, Harmonic paid approximately $0.3 million in transaction costs for a total transaction price of approximately $7.9 million. The addition of BTL has expanded Harmonic s product line to include professional video/audio receivers and decoders. This enabled us to expand the scope of solutions we provide for existing and emerging cable, satellite, terrestrial broadcast and telecom applications. These factors contributed to a purchase price exceeding the fair value of BTL s net tangible and intangible assets acquired; as a result, we have recorded goodwill in connection with this transaction.

The BTL acquisition was accounted for under SFAS No. 141 and certain specified provisions of SFAS No. 142. The results of operations of BTL are included in Harmonic s Condensed Consolidated Statements of Operations from February 25, 2005, the date of acquisition. The following table summarizes the allocation of the purchase price based on the estimated fair value of the tangible assets acquired and the liabilities assumed at the date of acquisition (in thousands):

Cash acquired	$ 149
Other tangible assets acquired	2,508
Amortizable intangible assets:	
Existing technology	2,050
Customer relationships	540
Tradenames/trademarks	320
Order backlog	60
Goodwill	3,745
Total assets acquired	9,372
Liabilities assumed	(568)
Deferred tax liability for acquired intangibles	(891)
Net assets acquired	$ 7,913

Identified intangible assets, including existing technology and customer relationships are being amortized over their useful lives of three years; tradename/trademarks are being amortized over their useful lives of two years; and order backlog is being amortized over its useful life of three months.

The residual purchase price of $3.7 million has been recorded as goodwill. The goodwill as a result of this acquisition is not expected to be deductible for tax purposes. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill relating to the acquisition of BTL is not being amortized and will be tested for impairment annually or whenever events indicate that an impairment may have occurred.

Supplemental pro forma information is not provided because the acquisition of BTL was not material to the Company s financial statements for all periods presented.

Note 5: Cash, Cash Equivalents and Investments

At March 31, 2006 and December 31, 2005, cash, cash equivalents and short-term investments are summarized as follows (in thousands):

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	March 31, 2006	December 31, 2005
Cash and cash equivalents	$ 41,123	$ 37,818
Short-term investments:		
Less than one year	61,696	56,605
Due in 1-2 years	5,739	16,405
Total short-term investments	67,435	73,010
Total cash, cash equivalents and short-term investments	$ 108,558	$ 110,828

The following is a summary of available-for-sale securities (in thousands).

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
March 31, 2006				
U.S. government debt securities	$ 28,131	$ ¾	$ (152)	$ 27,979
Corporate debt securities	30,531	¾	(125)	30,406
Other debt securities	9,050	¾	¾	9,050
Total	$ 67,712	$ ¾	$ (277)	$ 67,435
December 31, 2005				
U.S. government debt securities	$ 20,264	$ ¾	$ (146)	$ 20,118
Corporate debt securities	46,873	3	(209)	46,667
Other debt securities	6,225	¾	¾	6,225
Total	$ 73,362	$ 3	$ (355)	$ 73,010

Impairment of Investments

We monitor our investment portfolio for impairment on a periodic basis. In the event that the carrying value of an investment exceeds its fair value and the decline in value is determined to be other-than-temporary, an impairment charge is recorded and a new cost basis for the investment is established. In order to determine whether a decline in value is other-than-temporary, we evaluate, among other factors: the duration and extent to which the fair value has been less than the carrying value; our financial condition and business outlook, including key operational and cash flow metrics, current market conditions and future trends in the company s industry; our relative competitive position within the industry; and our intent and ability to retain the investment for a period of time sufficient to allow any anticipated recovery in fair value.

In accordance with FASB Staff Position Nos. 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1), the following table summarizes the fair value and gross unrealized losses related to available-for-sale securities, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, as of March 31, 2006 (in thousands):

	Less than 12 months		Greater than 12 months		Total	
	Fair Value	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**	**Fair Value**	**Gross Unrealized Losses**
U.S. Government debt securities	$ 11,399	$ (74)	$ 16,564	$ (78)	$ 27,963	$ (152)
Corporate debt securities	13,758	(74)	15,969	(51)	29,727	(125)
Total	$ 25,157	$ (148)	$ 32,533	$ (129)	$ 57,690	$ (277)

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The decline in the estimated fair value of these investments relative to amortized cost is primarily related to changes in interest rates and is considered to be temporary in nature.

Note 6: Inventories

(In thousands)		March 31, 2006		December 31, 2005
Raw materials	$	12,687	$	14,392
Work-in-process		1,955		4,131
Finished goods		16,566		20,029
	$	31,208	$	38,552

Note 7: Goodwill and Identified Intangibles

The following is a summary of goodwill and intangible assets as of March 31, 2006 and December 31, 2005 (in thousands):

	March 31, 2006			December 31, 2005		
	Gross Carrying Amount *	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Identified intangibles:						
Developed core technology	$ 29,684	$ (28,478)	$ 1,206	$ 29,663	$ (28,315)	$ 1,348
Customer base	31,904	(31,904)		31,904	(31,904)	
Trademark and tradename	4,194	(4,194)		4,190	(4,142)	48
Supply agreement	3,469	(3,151)	318	3,464	(3,109)	355
Subtotal of identified intangibles	69,251	(67,727)	1,524	69,221	(67,470)	1,751
Goodwill	4,399		4,399	4,896		4,896
Total goodwill and other intangibles	$ 73,650	$ (67,727)	$ 5,923	$ 74,117	$ (67,470)	$ 6,647

* Foreign currency translation adjustments, reflecting movement in the currencies of the underlying

entities, totaled approximately $0.2 and $0.3 million for intangible assets and approximately $0.3 and $0.3 million for goodwill as of March 31, 2006 and December 31, 2005, respectively.

The acquisition of BTL resulted in an increase in goodwill and intangible assets of $3.5 million and $2.7 million, respectively, during 2005. In addition, intangible assets decreased by $3.0 million in 2005 from the reversal of a reserve for a DiviCom pre-acquisition uncertain tax provision.

The changes in the carrying amount of goodwill for the three months ended March 31, 2006 are as follows (in thousands):

	Goodwill
Balance as of January 1, 2006	$ 4,896
Deferred taxes related to BTL acquisition	(531)
Foreign currency translation adjustments	34
Balance as of March 31, 2006	$ 4,399

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For the three months ended March 31, 2006, the Company recorded a total of $0.3 million of amortization expense for identified intangibles, of which $0.2 million was included in cost of sales. For the three months ended April 1, 2005, the Company recorded a total of $1.7 million of amortization expense for identified intangibles, of which $0.8 million was included in cost of sales. The estimated future amortization expense of purchased intangible assets with definite lives for the next three years is as follows (in thousands):

Years Ending December 31,	**Amounts**
2006 (remaining 9 months)	$ 607
2007	786
2008	131
Total	$ 1,524

Note 8: Restructuring and Excess Facilities

During 2001, Harmonic recorded a charge for excess facilities costs of $21.8 million. As a result of uncertain market conditions and lower sales during the second half of 2002, the Company changed its estimates related to accrued excess facilities with regard to the expected timing and amount of sublease income due to the substantial surplus of vacant commercial space in the San Francisco Bay Area. In connection with these actions, Harmonic recorded an additional excess facilities charge of $22.5 million, net of sublease income, to selling, general and administrative expenses during the second half of 2002.

As of March 31, 2006, accrued excess facilities cost totaled $22.4 million of which $4.7 million was included in current accrued liabilities and $17.7 million in other non-current liabilities. The Company incurred cash outlays of $1.2 million during the first three months of 2006 principally for lease payments, property taxes, insurance and other maintenance fees related to vacated facilities. Harmonic expects to pay approximately $3.6 million of excess facility lease costs, net of estimated sublease income, for the remainder of 2006 and to pay the remaining $18.8 million, net of estimated sublease income, over the remaining lease terms through September 2010.

Harmonic reassesses this liability quarterly and adjust as necessary based on changes in the timing and amounts of expected sublease rental income. In the fourth quarter of 2005 the excess facilities liability was decreased by $1.1 million due to subleasing a portion of an unoccupied building for the remainder of the lease.

During the fourth quarter of 2005, in response to the consolidation of the Company s two operating segments into a single segment as of January 1, 2006, the Company implemented workforce reductions of approximately 40 full-time employees across all functions and primarily in our U.S. operations and recorded severance and other costs of approximately $1.1 million. We expect to utilize the remaining accrual by the end of the third quarter of 2006.

The following table summarizes restructuring activities (in thousands):

	Workforce Reduction	**Excess Facilities**	**Total**
Balance at December 31, 2005	$ 635	$ 23,576	$ 24,211
Provisions(recoveries)			
Cash payments, net of sublease income	(577)	(1,194)	(1,771)
Balance at March 31, 2006	$ 58	$ 22,382	$ 22,440

Note 9: Credit Facilities and Long-Term Debt

Harmonic has a bank line of credit facility with Silicon Valley Bank, which provides for borrowings of up to $23.7 million, including $3.7 million for equipment under a secured term loan. This facility, which was amended and restated in December 2005, expires in December 2006, and contains financial and other covenants including the

requirement for Harmonic to maintain cash, cash equivalents and short-term investments, net of credit extensions, of not less than $30.0 million. If Harmonic is unable to maintain this cash, cash equivalents and short-term investments balance or satisfy the additional affirmative covenant requirements, Harmonic would be in noncompliance with the facility. In the event of noncompliance by Harmonic with the covenants under the facility, Silicon Valley Bank would be entitled to exercise its remedies under the facility which include declaring all obligations immediately due

and payable and disposing of the collateral if obligations were not repaid. At March 31, 2006, Harmonic was in compliance with the covenants under this line of credit facility. The December 2005 amendment resulted in the Company paying a fee of approximately $33,000 and requiring payment of approximately $43,000 of additional fees if the Company does not maintain an unrestricted deposit of $20.0 million with the bank. Future borrowings pursuant to the line bear interest at the bank s prime rate (7.75% at March 31, 2006) or prime plus 0.5% for equipment borrowings. Borrowings are payable monthly and are collateralized by all of Harmonic s assets except intellectual property. As of March 31, 2006, $1.1 million was outstanding under the equipment term loan portion of this facility and there were no borrowings in 2005 or 2006. The term loan is repayable monthly, including principal and interest at 8.25% per annum on outstanding borrowings as of March 31, 2006 and matures at various dates through December 2007. Other than standby letters of credit and guarantees (Note 15), there were no other outstanding borrowings or commitments under the line of credit facility as of March 31, 2006.

Note 10: Benefit Plans

Stock Option Plans. Harmonic has reserved 12,620,000 shares of Common Stock for issuance under various employee stock option plans. The options are granted for periods not exceeding ten years and generally vest 25% at one year from date of grant, and an additional 1/48 per month thereafter. Stock options are granted at the fair market value of the stock at the date of grant. Beginning on February 27, 2006, option grants had a term of seven years.

Director Option Plans. In May 2002, Harmonic s stockholders approved the 2002 Director Option Plan, replacing the 1995 Director Option Plan. Harmonic has a total of 428,000 shares of Common Stock reserved for issuance under the Director Plans. The Director Plans provide for the grant of non-statutory stock options to certain non-employee directors of Harmonic pursuant to an automatic, non-discretionary grant mechanism. Options are granted at the fair market value of the stock at the date of grant for periods not exceeding ten years. Initial grants generally vest monthly over three years, and subsequent grants generally vest monthly over one year.

The following table summarizes activities under the Plans:

	Shares Available for Grant	Stock Options Outstanding	Weighted Average Exercise Price
	(In thousands except exercise price)		
Balance at December 31, 2005	3,984	9,064	$ 13.05
Options granted	(1,443)	1,443	5.86
Options exercised		(102)	3.47
Options forfeited	708	(708)	12.28
Options expired		(44)	34.50
Balance at March 31, 2006	3,249	9,653	$ 12.04

The weighted-average fair value of options granted for the three months ended March 31, 2006 was $3.76.

We received $353,000 from the exercise of stock options during the three months ended March 31, 2006. No income tax benefits have been realized from exercised stock options due to the Company s current loss position. The Company issues new shares of common stock upon exercise of stock options.

The following table summarizes information regarding stock options outstanding at March 31, 2006:

	Stock Options Outstanding			Stock Options Exercisable	
Range of Exercise	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average	Number Exercisable at	Weighted Average

Prices		at March 31, 2006	(Years)	Exercise Price	March 31, 2006	Exercise Price
			(In thousands, except exercise price and life)			
$ 1.75	5.82	1,219	6.8	$ 3.80	862	$ 3.64
5.84	5.87	2,391	7.8	5.87	1	5.85
5.88	8.93	1,582	6.4	8.11	1,151	7.97
9.00	9.29	1,232	5.7	9.17	1,071	9.15
9.37	11.50	1,271	5.2	10.45	1,240	10.44
11.53	23.57	1,170	4.2	21.93	1,161	22.01
23.75	121.68	787	3.4	43.86	787	43.86
		9,652	6.0	$ 12.04	6,273	$ 15.16

Aggregate pre-tax intrinsic value of options outstanding and exercisable at March 31, 2006 was $4.4 million and $2.4 million, respectively. Aggregate pre-tax intrinsic value represents the difference between our closing stock price on the last trading day of the fiscal period, which was $6.37 as of March 31, 2006, and the exercise price multiplied by the number of options outstanding or exercisable. Total pre-tax intrinsic value of options exercised was $0.1 million for the three month period March 31, 2006.

Employee Stock Purchase Plan. In May 2002, Harmonic s stockholders approved the 2002 Employee Stock Purchase Plan (the 2002 Purchase Plan) replacing the 1995 Employee Stock Purchase Plan effective for the offering period beginning on July 1, 2002. In May 2004, Harmonic s stockholders approved an amendment to the 2002 Purchase Plan and increased the maximum number of shares of common stock authorized for issuance over the term of the 2002 Purchase Plan by an additional 2,000,000 shares to 3,500,000 shares. The 2002 Purchase Plan enables employees to purchase shares at 85% of the fair market value of the Common Stock at the beginning of the offering period or end of the purchase period, whichever is lower. Each offering period has a maximum duration of two years and consists of four six-month purchase periods. Offering periods and purchase periods generally begin on the first trading day on or after January 1 and July 1 of each year. The 2002 Purchase Plan is intended to qualify as an employee stock purchase plan under Section 423 of the Internal Revenue Code. During the first three months of 2006 and the years 2005 and 2004, the number of shares of stock issued under the purchase plans were 411,324, 705,171 and 774,683 shares at weighted average prices of $4.18, $5.05 and $2.32, respectively. The weighted-average fair value of each right to purchase shares of common stock granted under the purchase plans were $1.70, $1.82 and $2.68 for the first three months of 2006 and the years 2005 and 2004, respectively. At March 31, 2005, 884,017 shares were reserved for future issuances under the 2002 Purchase Plan.

Retirement/Savings Plan. Harmonic has a retirement/savings plan which qualifies as a thrift plan under Section 401(k) of the Internal Revenue Code. This plan allows participants to contribute up to 20% of total compensation, subject to applicable Internal Revenue Service limitations. Harmonic makes discretionary contributions to the plan of 25% of the first 4% contributed by eligible participants up to a maximum contribution per participant of $750 per year. This amount has been increased to $1,000 effective January 1, 2006. Such amounts totaled $0.1 million in the first three months of 2006.

Stock-based Compensation

The following table summarizes the impact of SFAS 123(R) on stock-based compensation costs for employees on our Condensed Consolidated Statements of Operations for the three months ended March 31, 2006 :

(In thousands)		**Three Months Ended March 31, 2006**
Employee stock-based compensation in:		
Cost of sales	$	274
Research and development expense		522
Sales, general and administrative expense		830
Total employee stock-based compensation in operating expense		1,352
Total employee stock-based compensation expense		1,626
Amount capitalized in inventory		42
Total other stock-based compensation expense		1
Total stock-based compensation	$	1,669

Other stock-based compensation represents charges related to non-employee stock options. No income tax benefit has been recognized relating to stock-based compensation expense during the three months ended March 31, 2006.

The table below reflects net income (loss) and net income (loss) per share for the three months ended March 31, 2006, compared with pro forma information for the three months ended April 1, 2005 (in thousands, except per share

amounts):

	Three Months Ended			
	March 31, 2006		April 1, 2005 (pro forma)	
Net income (loss), before stock-based compensation for employees, prior period		N/A	$	1,706
Less: Stock-based compensation expense previously determined under fair value based method, net of related tax effects	$	(1,626)		(2,182)
Net loss, after effect of stock-based compensation for employees	$	(5,147)	$	(476)
Net income (loss) per share:				
Basic as reported for prior period		N/A	$	0.02
Basic after effect of stock-based compensation for employees	$	(0.07)	$	(0.01)
Diluted as reported for prior period		N/A	$	0.02
Diluted after effect of stock-based compensation for employees	$	(0.07)	$	(0.01)

As of March 31, 2006, total unamortized stock-based compensation cost related to non-vested stock options was $8.0 million which is expected to be recognized over the remaining vesting period of each grant, up to the next 48 months. The fair value of each option grant is estimated on the date of grant using the Black-Scholes-Merton multiple option pricing model with the following weighted average assumptions:

	Employee Stock Options		Employee Stock Purchase Plan	
	2006	2005	2006	2005
Expected life (years)	4.7	3.6	0.8	0.8
Volatility	77%	96%	69%	69%
Risk-free interest rate	4.5%	3.8%	3.7%	3.7%
Dividend yield	0.0%	0.0%	0.0%	0.0%

The expected term for employee stock options and the ESPP represents the weighted-average period that the stock options are expected to remain outstanding. We derived the expected term using the simplified method included in SAB 107. As alternative sources of data become available in order to determine the expected term we will incorporate these data into our assumption.

We use the historical volatility over the expected term of the options and the ESPP offering period to estimate the expected volatility. We believe that the historical volatility, at this time, represents fairly the future volatility of its common stock. We will continue to monitor relevant information to measure expected volatility for future option grants and ESPP offering periods.

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

Note 11: Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing the net income/(loss) attributable to common stockholders for the period by the weighted average number of the common shares outstanding during the period. The diluted net loss per share is the same as basic net loss per share for the three months ended March 31, 2006 because potential common shares, such as common shares issuable upon the exercise of stock options, are only considered when their

effect would be dilutive. During the three months ended March 31, 2006 and April 1, 2005, 10.5 million and 3.9 million, respectively, of potentially dilutive shares, consisting of options, were excluded from the net income (loss) per share computations, because their effect was antidilutive.

Following is a reconciliation of the numerators and denominators of the basic and diluted net loss per share computations (in thousands, except per share data):

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	Three Months Ended	
	March 31, 2006	April 1, 2005
Net income (loss) (numerator)	$ (5,147)	$ 1,706
Shares calculation (denominator):		
Weighted average shares outstanding basic	74,102	72,839
Effect of Dilutive Securities:		
Potential Common Stock relating to stock options		1,536
Average shares outstanding diluted	74,102	74,375
Net income (loss) per share basic	$ (0.07)	$ 0.02
Net income (loss) per share diluted	$ (0.07)	$ 0.02

Note 12: Comprehensive Income/(Loss)

The Company s total comprehensive income/(loss) was as follows (in thousands):

	Three Months Ended	
	March 31, 2006	April 1, 2005
Net income/(loss)	$ (5,147)	$ 1,706
Change in unrealized gain/(loss) on investments, net	(46)	(94)
Foreign currency translation	(25)	19
Total comprehensive income/(loss)	$ (5,218)	$ 1,631

Note 13: Segment Information

Operating segments are defined as components of an enterprise that engage in business activities for which separate financial information is available and evaluated by the chief operating decision maker. Previously, the Company was organized into two operating segments: BAN, for fiber optic systems, and CS, for digital headend systems. Each segment had its own management team directing its product development, marketing strategies and its customer service requirements. A separate sales force generally supported both segments with appropriate product and market specialization as required.

The Company restructured its CS and BAN segments into one consolidated group in the fourth quarter of 2005 and effective as of January 1, 2006 no longer has two operating segments. The restructuring involved merging the manufacturing operations, research and development, and marketing departments into one segment.

Geographic Information (in thousands):

	Three Months Ended	
	March 31, 2006	April 1, 2005
Net sales:		
United States	$ 25,653	$ 46,374

International		30,568		26,541
Total	$	56,221	$	72,915

Note 14: Related Party

A director of Harmonic is also a director of Terayon Communications, from which the Company purchases products for resale. Product purchases from Terayon were approximately $0.6 million and $8.8 million, for the three months ended March 31, 2006 and April 1, 2005, respectively. As of March 31, 2006 and December 31, 2005, Harmonic had liabilities to Terayon of approximately $0.5 million and $0.7 million, respectively, for inventory purchases.

Note 15: Guarantees

Warranties. The Company accrues for estimated warranty costs at the time of product shipment. Management periodically reviews the estimated fair value of its warranty liability and adjusts based on the terms of warranties provided to customers, historical and anticipated warranty claims experience, and estimates of the timing and cost of specified warranty claims. Activity for the Company s warranty accrual, which is included in accrued liabilities is summarized below (in thousands):

	Three Months Ended	
	March 31, 2006	April 1, 2005
Balance at beginning of the period	$ 6,166	$ 5,429
Accrual for warranties	1,042	1,400
Warranty costs incurred	(1,150)	(1,242)
BTL acquisition		21
Balance at end of the period	$ 6,058	$ 5,608

Standby Letters of Credit. As of March 31, 2006 the Company s financial guarantees consisted of standby letters of credit outstanding, which were principally related to customs bond requirements, performance bonds and state requirements imposed on employers. The maximum amount of potential future payments under these arrangements was $0.8 million.

Indemnifications. Harmonic is obligated to indemnify its officers and the members of its Board of Directors pursuant to its bylaws and contractual indemnity agreements. Harmonic also indemnifies some of its suppliers and customers for specified intellectual property matters pursuant to certain contractual arrangements, subject to certain limitations. The scope of these indemnities varies, but in some instances, includes indemnification for damages and expenses (including reasonable attorneys fees). There have been no claims against us for indemnification pursuant to any of these arrangements and, accordingly, no amounts have been accrued in respect of the indemnifications provisions through March 31, 2006.

Guarantees. As of March 31, 2006, Harmonic had no other guarantees outstanding.

Note 16: Legal Proceedings

Between June 28 and August 25, 2000, several actions alleging violations of the federal securities laws by Harmonic and certain of its officers and directors (some of whom are no longer with Harmonic) were filed in or removed to the United States District Court (the District Court) for the Northern District of California. The actions subsequently were consolidated.

A consolidated complaint, filed on December 7, 2000, was brought on behalf of a purported class of persons who purchased Harmonic s publicly traded securities between January 19 and June 26, 2000. The complaint also alleged claims on behalf of a purported subclass of persons who purchased C-Cube securities between January 19 and May 3, 2000. In addition to Harmonic and certain of its officers and directors, the complaint also named C-Cube Microsystems Inc. and several of its officers and directors as defendants. The complaint alleged that, by making false or misleading statements regarding Harmonic s prospects and customers and its acquisition of C-Cube, certain defendants violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the Exchange Act). The complaint also alleged that certain defendants violated section 14(a) of the Exchange Act and sections 11, 12(a)(2), and 15 of the Securities Act of 1933 (the Securities Act) by filing a false or misleading registration statement, prospectus, and joint proxy in connection with the C-Cube acquisition.

On July 3, 2001, the District Court dismissed the consolidated complaint with leave to amend. An amended complaint alleging the same claims against the same defendants was filed on August 13, 2001. Defendants moved to dismiss the amended complaint on September 24, 2001. On November 13, 2002, the District Court issued an opinion granting the motions to dismiss the amended complaint without leave to amend. Judgment for defendants was entered on

December 2, 2002. On December 12, 2002, plaintiffs filed a motion to amend the judgment and for leave to file an amended complaint pursuant to Rules 59(e) and 15(a) of the Federal Rules of Civil Procedure. On June 6,

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2003, the District Court denied plaintiffs motion to amend the judgment and for leave to file an amended complaint. Plaintiffs filed a notice of appeal on July 1, 2003. The appeal was heard by a panel of three judges of the United States Court of Appeals for the Ninth Circuit (the Ninth Circuit) on February 17, 2005.

On November 8, 2005, the Ninth Circuit panel affirmed in part, reversed in part, and remanded for further proceedings the decision of the District Court. The Ninth Circuit affirmed the District Court s dismissal of the plaintiffs fraud claims under Sections 10(b), 14(a), and 20(a) of the Exchange Act with prejudice, finding that the plaintiffs failed to adequately plead their allegations of fraud. The Ninth Circuit reversed the District Court s dismissal of the plaintiffs claims under Sections 11 and 12(a)(2) of the Securities Act, however, finding that those claims did not allege fraud and therefore were subject to only minimal pleading standards. Regarding the secondary liability claim under Section 15 of the Securities Act, the Ninth Circuit reversed the dismissal of that claim against Anthony J. Ley, Harmonic s Chairman and Chief Executive Officer, and affirmed the dismissal of that claim against Harmonic, while granting leave to amend. The Ninth Circuit remanded the surviving claims to the District Court for further proceedings.

On November 22, 2005, both the Harmonic defendants and the plaintiffs petitioned the Ninth Circuit for a rehearing of the appeal. On February 16, 2006 the Ninth Circuit denied both petitions. On April 19, 2006, the District Court issued an order setting forth the schedule for filing and responding to the Third Amended Complaint. Under that schedule, plaintiffs will file their Third Amended Complaint by May 17, 2006, and defendants will respond by June 15, 2006.

A derivative action purporting to be on behalf of Harmonic was filed against its then-current directors in the Superior Court for the County of Santa Clara on September 5, 2000. Harmonic also was named as a nominal defendant. The complaint is based on allegations similar to those found in the securities class action and claims that the defendants breached their fiduciary duties by, among other things, causing Harmonic to violate federal securities laws. The derivative action was removed to the United States District Court for the Northern District of California on September 20, 2000. All deadlines in this action were stayed pending resolution of the motions to dismiss the securities class action. On July 29, 2003, the Court approved the parties stipulation to dismiss this derivative action without prejudice and to toll the applicable limitations period until fourteen days after (1) defendants provide plaintiff with a copy of the mandate issued by the Ninth Circuit in the securities action or (2) either party provides written notice of termination of the tolling period, whichever is first. Defendants have notified plaintiff of the Ninth Circuit s mandate.

A second derivative action purporting to be on behalf of Harmonic was filed in the Superior Court for the County of Santa Clara on May 15, 2003. It alleges facts similar to those previously alleged in the securities class action and the federal derivative action. The complaint names as defendants former and current Harmonic officers and directors, along with former officers and directors of C-Cube Microsystems, Inc., who were named in the securities class action. The complaint also names Harmonic as a nominal defendant. The complaint alleges claims for abuse of control, gross mismanagement, and waste of corporate assets against the Harmonic defendants, and claims for breach of fiduciary duty, unjust enrichment, and negligent misrepresentation against all defendants. On July 22, 2003, the Court approved the parties stipulation to stay the case pending resolution of the appeal in the securities class action. Following the issuance of the Ninth Circuit s mandate the Harmonic and C-Cube defendants filed demurrers to this derivative complaint on May 9, 2006.

Based on its review of the surviving claims in the securities class actions, Harmonic believes that it has meritorious defenses and intends to defend itself vigorously. There can be no assurance, however, that Harmonic will prevail. No estimate can be made of the possible range of loss associated with the resolution of this contingency, and accordingly, Harmonic has not recorded a liability. An unfavorable outcome of this litigation could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of Harmonic s products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint seeks injunctive relief, royalties and damages. Harmonic has not been served in the case. At this time, we are unable to determine whether we will be able to settle this litigation on reasonable terms or at all, nor can we predict the impact of an adverse outcome of this litigation if we elect to defend against it. No estimate can be made of the possible range of loss associated with the

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resolution of this contingency and accordingly, we have not recorded a liability associated with the outcome of a negotiated settlement or an unfavorable verdict in litigation. An unfavorable outcome of this matter could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

Harmonic is involved in other litigation and may be subject to claims arising in the normal course of business. In the opinion of management the amount of ultimate liability with respect to these matters in the aggregate will not have a material adverse effect on the Company or its operating results, financial position or cash flows.

Item 2. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding our expectations of continued customer concentration; our expectations regarding future sales for a major telecommunications operator; our expectations that sales to cable television, satellite and telecommunications operators will constitute a significant portion of net sales for the foreseeable future; our expectation that international sales will continue to account for a significant portion of our net sales for the foreseeable future; our expectations regarding our capital expenditures during the remainder of 2006; our expectations regarding the amount of amortization expense we will incur during the remainder of 2006; our expectation that near-term changes in foreign exchange rates will not have a material impact on our operating results, financial position and liquidity; our belief that any ultimate liability of Harmonic with respect to certain litigation arising in the normal course of business will not, in the aggregate, have a material adverse effect on us or our operating results, financial position or cash flows; our belief that our existing liquidity sources will satisfy our cash requirement for at least the next 12 months; and our expectation that operating results are likely to fluctuate in the future. These statements involve risks and uncertainties as well as assumptions that, if they were to never materialize or prove incorrect, could cause actual results to differ materially from those projected, expressed or implied in the forward-looking statements. These risks and uncertainties include those set forth under Risk Factors below and elsewhere in this Quarterly Report on Form 10-Q and that are otherwise described from time to time in Harmonic s filings with the Securities and Exchange Commission.

Overview

Harmonic designs, manufactures and sells products for video processing, and edge and access products. In addition, we provide network management software and have recently introduced new application software products. Harmonic also provides technical support services to its customers worldwide. Our video processing products provide broadband operators with the ability to accept a variety of signals from different sources, in different protocols, and to organize, manage and distribute this content to maximize use of the available bandwidth. Our edge products enable operators to deliver customized broadcast or narrowcast on-demand services to their subscribers, and our access products, which consist mainly of optical transmission products, node platforms and return path products, allow operators to deliver video, data and voice services over their physical networks.

These products and services enable network operators to provide a range of interactive and advanced digital services that include digital video, video-on-demand (VOD), high-definition television (HDTV), high-speed Internet access and telephony. They enable our customers to process video for distribution over cable, satellite, telephone and wireless networks. We also provide fiber optic transmission systems to cable television operators and to certain telephone companies that offer video services to their customers.

The sequential increases in net sales in 2005 and 2004 that Harmonic experienced reflected an improved industry capital spending environment worldwide which favorably impacted us. We believe that this improvement in the industry capital spending environment is, in part, a result of the intensifying competition between cable and satellite operators to offer more channels of digital video and new services, such as VOD and HDTV, and in part the result of the entry of telephone companies into the business of delivering video services to their subscribers. We also believe that the improvement is due to more favorable conditions in industry capital markets and the completion or resolution of certain major business combinations, financial restructurings and regulatory issues.

In the first quarter of 2006, Harmonic s net sales decreased 12% on a sequential basis compared to the fourth quarter of 2005 and by 23% compared to the first quarter of 2005. We believe that the sequential decrease from the fourth

quarter of 2005 reflects the seasonal nature of the cable business in the U.S. and lower revenue from Verizon. The Company does not expect to have significant revenue from Verizon after the second quarter of 2006. The decrease in net sales in the first quarter of 2006 compared to the first quarter of 2005 was due to the significant amount of third party products sold to our end customers in the first quarter of 2005. Our quarterly and annual results may fluctuate significantly due to revenue recognition policies and the timing of the receipt of orders. For example, revenue from two significant customer orders in the third quarter of 2004 was delayed due to these factors until the fourth quarter of 2004.

Harmonic often recognizes a significant portion, or the majority, of its revenues in the last month of the quarter. Harmonic establishes its expenditure levels for product development and other operating expenses based on projected sales levels, and expenses are relatively fixed in the short term. Accordingly, variations in timing of sales can cause significant fluctuations in operating results. In addition, because a significant portion of Harmonic s business is derived from orders placed by a limited number of large customers, the timing of such orders can also cause significant fluctuations in our operating results. Harmonic s expenses for any given quarter are typically based on expected sales and if sales are below expectations, our operating results may be adversely impacted by our inability to adjust spending to compensate for the shortfall.

Historically, a majority of our net sales have been to relatively few customers, and due in part to the consolidation of ownership of cable television and direct broadcast satellite systems, we expect this customer concentration to continue for the foreseeable future. In the first quarter of 2006, sales to Comcast accounted for 11% of net sales. In the first quarter of 2005, sales to Comcast and Charter Communications accounted for 35% and 10% of net sales, respectively. Sales to customers outside of the U.S. in the first quarter of 2006 and the full year of 2005 represented 54% and 40% of net sales, respectively. A significant portion of international sales are made to distributors and system integrators, which are generally responsible for importing the products and providing installation and technical support and service to customers within their territory. Sales denominated in foreign currencies were approximately 9% and 7% of net sales in the first quarter of 2006 and the full year of 2005, respectively. We expect international sales to continue to account for a significant portion of our net sales for the foreseeable future.

In the fourth quarter of 2005, Harmonic announced a restructuring that combined our product development, marketing and manufacturing operations and resulted in the BAN and CS operating segments being combined into a single segment, effective January 1, 2006. In connection with this restructuring, Harmonic reduced its workforce by approximately 40 employees and recorded an expense of $1.1 million for severance costs related to the restructuring.

In the fourth quarter of 2005, the excess facilities liability was decreased by $1.1 million due to subleasing a portion of the unoccupied portion of one building for the remainder of the lease. Although we entered into new subleases for approximately 60,000 square feet of space in 2004 and approximately 30,000 square feet of space in 2005, in the event we are unable to achieve expected levels of sublease rental income, we will need to revise our estimate of the liability, which could materially impact our financial position, liquidity, cash flows and results of operations.

On February 25, 2005, Harmonic purchased all of the issued and outstanding shares of Broadcast Technology Ltd., a private UK company, for a total purchase consideration of £4.0 million, or approximately $7.6 million. The purchase consideration consisted of a payment of £3.0 million in cash and the issuance of 169,112 shares of Harmonic common stock. Broadcast Technology Ltd. develops, manufactures and distributes professional video/ audio receivers and decoders and had 42 employees at the time of the acquisition.

Critical Accounting Policies, Judgments and Estimates

The preparation of financial statements and related disclosures requires Harmonic to make judgments, assumptions and estimates that affect the reported amounts of assets and liabilities, the disclosure of contingencies and the reported amounts of revenue and expenses in the financial statements and accompanying notes. Material differences may result in the amount and timing of revenue and expenses if different judgments or different estimates were made.

Our significant accounting policies are described in Note 1 to the annual consolidated financial statements as of and for the year ended December 31, 2005, included in our Annual Report on Form 10-K filed with the SEC on March 14, 2006 and notes to condensed consolidated financial statements as of and for the three month period ended March 31, 2006, included herein. Our most critical accounting policies have not changed since December 31, 2005 and include the following:

§ Revenue recognition;

§ Allowances for doubtful accounts, returns and discounts;

§ Valuation of inventories;

§ Impairment of long-lived assets;

§ Restructuring costs and accruals for excess facilities;

§ Assessment of the probability of the outcome of current litigation; and

§ Accounting for income taxes.

§ Stock-based compensation

Our accounting policy for stock-based compensation for employee stock-based awards was recently modified due to the adoption of SFAS 123(R) and is described below.

Stock-Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123(R), Share-Based Payment, (SFAS 123(R)) which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options and employee stock purchases related to our Employee Stock Purchase Plan (ESPP) based upon the grant-date fair value of those awards. SFAS 123(R) supersedes the Company s previous accounting under Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees (APB 25) and related interpretations, and provided the required pro forma disclosures prescribed by Statement of Financial Accounting Standards No. 123, Accounting for Stock-Based Compensation, (SFAS 123) as amended. In addition, we have applied the provisions of Staff Accounting Bulletin No. 107 (SAB 107), issued by the Securities and Exchange Commission, in our adoption of SFAS No. 123(R).

The Company adopted SFAS 123(R) using the modified-prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company s fiscal year 2006. The Company s Condensed Consolidated Financial Statements as of and for the three months ended March 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company s Condensed Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). Stock-based compensation expense recognized under SFAS 123(R) for the three months ended March 31, 2006 was $1.6 million which consisted of stock-based compensation expense related to employee equity awards and employee stock purchases. There was no stock-based compensation expense related to employee equity awards and employee stock purchases recognized during the three months ended April 1, 2005.

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

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Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company s Condensed Consolidated Statement of Operations for the three months ended March 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). In conjunction with the adoption of SFAS 123(R), the Company changed its method of attributing the value of stock-based compensation costs to expense from the accelerated multiple-option method to the straight-line single-option method. Compensation expense for all share-based payment awards granted on or prior to December 31, 2005 will continue to be recognized using the accelerated approach while compensation expense for all share-based payment awards related to stock options and employee stock purchase rights granted subsequent to December 31, 2005 are recognized using the straight-line method.

As stock-based compensation expense recognized in our results for the first quarter of fiscal year 2006 is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Prior to fiscal year 2006, we accounted for forfeitures as they occurred for the purposes of pro forma information under SFAS 123, as disclosed in our Notes to Consolidated Financial Statements for the related periods.

The fair value of share-based payment awards is estimated at grant date using a Black-Scholes-Merton option pricing model. The Company s determination of fair value of share-based payment awards on the date of grant using an option-pricing model is affected by the Company s stock price as well as the assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the Company s expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors.

Harmonic currently does not expect to receive any tax benefits in fiscal 2006 for any expense deductions resulting from expensing of stock options or shares issued under its ESPP plan. Harmonic currently provides a valuation allowance for most of its deferred tax assets, and a valuation allowance has also been provided for any tax effects of stock-based compensation expense pursuant to SFAS 123(R).

Also see Note 10 to the Condensed Consolidated Financial Statements on Stock-Based Compensation.

Results of Operations

Harmonic s historical consolidated statements of operations data for the first quarter of 2006 and 2005 as a percentage of net sales, are as follows:

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	Three Months Ended	
	March 31, 2006	April 1, 2005
Net sales	100%	100%
Cost of sales	65	63
Gross profit	35	37
Operating expenses:		
Research and development	18	13
Selling, general and administrative	28	21
Amortization of intangibles	¾	1
Total operating expenses	46	35
Income (loss) from operations	(11)	2
Interest and other income (expense), net	2	¾
Income (loss) before income taxes	(9)	2
Provision for (benefit from) income taxes	¾	¾
Net income (loss)	(9)%	2%

Net Sales Consolidated

Harmonic s consolidated net sales in the first quarter of 2006 compared with the corresponding period in 2005 is presented in the table below. Also presented is the related dollar and percentage increase (decrease) in consolidated net sales in the first quarter of 2006 compared with the corresponding period in 2006 (in thousands, except percentages).

	Three Months Ended	
Product Sales Data:	**March 31, 2006**	**April 1, 2005**
Video Processing	$ 19,685	$ 43,731
Edge and Access	28,452	21,240
Software, Support and Other	8,084	7,944
Net sales	$ 56,221	$ 72,915
Video Processing decrease	$ (24,046)	
Edge and Access increase	7,212	
Software, Support and Other increase	140	
Total decrease	$ (16,694)	
Video Processing percent change	(55.0)%	
Edge and Access percent change	34.0%	
Software, Support and Other percent change	1.8%	
Total percent change	(22.9)%	

Net sales decreased in the first quarter of 2006 compared to the same period of 2005 principally due to weaker spending by domestic cable customers for major digital headend projects and the decrease in the sale of third party products to our end customers. In the video processing product line, encoder sales were lower by approximately $12.2 million in the first quarter of 2006 compared to the same period in the prior year due to lower spending for major digital headend projects by domestic cable companies. In addition, sales of third party products to end customers decreased by approximately $9.8 million in the first quarter of 2006 compared to the same period in 2005. The edge and access products line experienced a significant increase in telco revenue in the first quarter of 2006 compared to the first quarter of 2005 as telcos continue to introduce and expand video and other services, primarily in the U.S. and European markets. We also experienced an increase in sales of VOD products.

Net Sales Geographic

Harmonic s domestic and international net sales in the first quarter of 2006 compared with the corresponding period

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in 2005 are presented in the table below. Also presented is the related dollar and percentage increase (decrease) in domestic and international net sales in the first quarter of 2006 compared with the corresponding period in 2005 (in thousands, except percentages).

	Three Months Ended	
Geographic Sales Data:	**March 31, 2006**	**April 1, 2005**
U.S.	$ 25,653	$ 46,374
International	30,568	26,541
Net sales	$ 56,221	$ 72,915
U.S. decrease	$ (20,721)	
International increase	4,027	
Total decrease	$ (16,694)	
U.S. percent change	(44.7)%	
International percent change	15.2%	
Total percent change	(22.9)%	

The decreased U.S. sales in the first quarter of 2006 compared to the corresponding period in 2005 was principally due to fewer sales of third party products to end customers and weaker spending by domestic cable customers for major digital headend projects. Partially offsetting the decreased revenue was sales of optical products for fiber-to-the-premises, or FTTP, projects to a domestic telco in the first quarter of 2006, which was not a significant customer in the first quarter of 2005. However, sales to this customer in the first quarter of 2006 were lower than the previous two quarters.

International sales in the first quarter of 2006 increased significantly compared to the corresponding period in 2005 primarily due to sales to telcos in the European market. The increased international sales in the first quarter of 2006 as compared to the same period of 2005, was also due to increased international capital spending primarily in Europe and Asia. As a result of these factors, we expect that international sales will continue to account for a significant portion of our net sales for the foreseeable future.

Gross Profit

Harmonic s gross profit and gross profit as a percentage of consolidated net sales in the first quarter of 2006 as compared with the corresponding prior year period of 2005 are presented in the tables below. Also presented is the related dollar and percentage increase in gross profit in the first quarter of 2006 as compared with the corresponding period of 2005 (in thousands, except percentages).

	Three Months Ended	
	March 31, 2006	**April 1, 2005**
Gross profit	$19,880	$ 27,047
As a % of net sales	35.4%	37.1%
Decrease	$ (7,167)	
Percent change	(26.5)%	

The decrease in gross profit in the first quarter of 2006 as compared to the corresponding period of 2005 was primarily due to lower sales, increased expense from the write-down of cost for obsolete and excess inventories of $0.9 million, and stock-based compensation expense of $0.3 million. The gross margin percentage of 35.4% in the first quarter of 2006 compared to 37.1% in the first quarter of 2005 was lower primarily due to low gross margin on

certain product sales to telcos, the expense from the write-down of cost for obsolete and excess inventories, and the stock-based compensation expense, which was partially offset by lower sales of third party products to our end customers compared to the first quarter of 2005, sales of which products have significantly lower gross margins than our average gross margin on sales of our products.

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In the first quarter of 2006, $0.2 million of amortization of intangibles was included in cost of sales compared to $0.8 million in the first quarter of 2005. The lower amortization in the first quarter of 2006 was due to the intangibles arising from the DiviCom acquisition becoming fully amortized during the first quarter of 2005. We expect to record approximately $0.5 million in amortization of intangibles in cost of sales in the remaining nine months of 2006 due to the acquisition of BTL in February 2005.

Research and Development

Harmonic s research and development expense and the expense as a percentage of consolidated net sales in the first quarter of 2006, as compared with the corresponding period of 2005, are presented in the table below. Also presented is the related dollar and percentage increase in research and development expense in the first quarter of 2006 as compared with the corresponding period of 2005 (in thousands, except percentages).

	Three Months Ended	
	March 31, 2006	**April 1, 2005**
Research and development expense	$9,948	$ 9,459
As a % of net sales	17.7%	13.0%
Increase	$ 489	
Percent change	5.2%	

The increase in research and development expense in the first quarter of 2006 as compared to the same period in 2005 was primarily the result of increased use of outside services of $0.3 million associated with the development of new products and stock-based compensation expense of $0.5 million, which was partially offset by lower compensation expense of $0.6 million from reductions in headcount and incentive compensation.

Selling, General and Administrative

Harmonic s selling, general and administrative expense and the expense as a percentage of consolidated net sales in the first quarter of 2006, as compared with the corresponding period of 2005, are presented in the table below. Also presented is the related dollar and percentage increase in selling, general and administrative expense in the first quarter of 2006 as compared with the corresponding period of 2005 (in thousands, except percentages).

	Three Months Ended	
	March 31, 2006	**April 1, 2005**
Selling, general and administrative expense	$15,713	$ 15,325
As a % of net sales	27.9%	21.0%
Increase	$ 388	
Percent change	2.5%	

The increase in selling, general and administrative expense in the first quarter of 2006 compared to the same period in 2005 was primarily a result of stock-based compensation expense of $0.8 million, which was partially offset by lower corporate governance costs of $0.4 million.

Amortization of Intangibles

Harmonic s amortization of intangible assets and the expense as a percentage of consolidated net sales in the first quarter of 2006 as compared with the corresponding period of 2005 are presented in the table below. Also presented is the related dollar and percentage decrease in amortization of intangible assets in the first quarter of 2006 as compared with the corresponding period of 2005 (in thousands, except percentages).

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	Three Months Ended	
	March 31, 2006	April 1, 2205
Amortization of intangibles	$ 91	$ 958
As a % of net sales	0.2%	1.3%
Decrease	$ (867)	
Percent change	(90.5)%	

The decrease in the amortization of intangibles in the first quarter of 2006 compared to the same period in 2005 was primarily due to the completion of amortization of the DiviCom intangible assets during the first quarter of 2005. Harmonic expects to record a total of approximately $0.1 million in amortization of intangibles in operating expenses in the remaining nine months of 2006 due to the intangible assets resulting from the acquisition of BTL in February 2005.

Interest Income, Net

Harmonic s interest income, net, and interest income, net, as a percentage of consolidated net sales in the first quarter of 2006 as compared with the corresponding period of 2005, are presented in the table below. Also presented is the related dollar and percentage increase in interest income, net, in the first quarter of 2006 as compared with the corresponding period of 2005 (in thousands, except percentages).

	Three Months Ended	
	March 31, 2006	April 1, 2005
Interest income, net	$ 992	$ 522
As a % of net sales	1.8%	0.7%
Increase	$ 470	
Percent change	90.0%	

The increase in interest income, net, in the first three months of 2006 compared to the corresponding period of 2005, was due primarily to a larger cash and short-term investment portfolio during the respective period of 2006 as compared to 2005, higher interest rates on the portfolio and lower interest expense due to a lower debt balance in the first quarter of 2006.

Other Income (Expense), Net

Harmonic s other income (expense), net, and other income (expense), net, as a percentage of consolidated net sales in the first quarter of 2006 as compared with the corresponding period of 2005, are presented in the table below. Also presented is the related dollar and percentage decrease in other income (expense), net, in the first quarter of 2006 as compared with the corresponding periods of 2005 (in thousands, except percentages).

	Three Months Ended	
	March 31, 2006	April 1, 2005
Other income (expense)	$ (92)	$ (49)
As a % of net sales	(0.2)%	(0.1)%
Decrease	$ (43)	
Percent change	(87.8)%	

The increase in other expense, net, in the first quarter of 2006 compared to the same period of 2005 was primarily due to foreign exchange losses.

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Income Taxes

Harmonic s provision for income taxes, and provision for income taxes as a percentage of consolidated net sales in the first quarter of 2006, as compared with the corresponding period of 2005, are presented in the table below. Also presented is the related dollar and percentage increase in income taxes in the first quarter of 2006 as compared with the corresponding period of 2005 (in thousands, except percentages).

	Three Months Ended	
	March 31, 2006	**April 1, 2005**
Provision for income taxes	$ 175	$ 72
As a % of net sales	0.3%	0.1%
Increase	$ 103	
Percent change	143.1%	

The increase in the provision for income taxes in the first quarter of 2006 compared to the same period in 2005 was due to higher foreign income taxes.

Liquidity and Capital Resources

	Three Months Ended	
(in thousands)	**March 31, 2006**	**April 1, 2005**
Cash, cash equivalents and short-term investments	$ 108,558	$ 104,554
Net cash provided by (used in) operating activities	$ (2,547)	$ 7,903
Net cash used in investing activities	$ (4,057)	$ (6,810)
Net cash provided by financing activities	$ 1,833	$ 3,825

As of March 31, 2006, cash, cash equivalents and short-term investments totaled $108.6 million, compared to $110.8 million as of December 31, 2005. Cash used in operations was $2.5 million in the first three months of 2006, compared to cash provided by operations of $7.9 million in the first three months of 2005. The increased use of cash in operating activities in the first three months of 2006 was primarily due to the net loss of $5.1 million for the quarter, lower deferred revenue of $3.1 million, lower accounts payable of $2.9 million and lower amortization of intangibles of $0.3 million, which was partially offset by lower inventories of $7.3 million. The lower deferred revenue was primarily due to the timing of revenue based on our revenue recognition policy and the completion stage of customers orders. The lower accounts payable and inventory was due to a decrease in the purchase of production inventory, along with the write-down of cost for obsolete and excess inventory. The lower amortization is due to the completion of amortization of the DiviCom intangible assets during the first quarter of 2005.

Additions to property, plant and equipment were $1.6 million during the first three months of 2006 compared to $1.8 million in the first three months of 2005. The decrease in the first quarter of 2006 from the comparable period in 2005 was primarily due to a decrease in the acquisition of test equipment. Harmonic currently expects capital expenditures to be approximately $6 million during 2006.

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Under the terms of the merger agreement with C-Cube, Harmonic is generally liable for C-Cube s pre-merger tax liabilities. Approximately $10.0 million of pre-merger tax liabilities remained outstanding at March 31, 2006 and are included in accrued liabilities. These liabilities represent estimates of C-Cube s pre-merger tax obligations to various tax authorities in 11 countries. We are working with LSI Logic, which acquired the spun-off semiconductor business in June 2001 and assumed its obligations, to settle these obligations, a process which has been underway since the merger in 2000. Although we expect to make payments in 2006 for these tax liabilities, Harmonic is unable to predict when the remaining obligations will be paid, or in what amount. The full amount of the estimated obligation has been classified as a current liability. To the extent that these obligations are finally settled for less than the amounts provided, Harmonic is required, under the terms of the tax-sharing agreement, to refund the difference to LSI Logic. Conversely, if the settlements are more than the $10.0 million pre-merger tax liability, LSI is obligated to reimburse Harmonic.

Harmonic has a bank line of credit facility with Silicon Valley Bank, which provides for borrowings of up to $23.7 million, including $3.7 million for equipment under a secured term loan. This facility, which was amended and restated in December 2005, expires in December 2006 and contains financial and other covenants including the requirement for Harmonic to maintain cash, cash equivalents and short-term investments, net of credit extensions, of not less than $30.0 million. If Harmonic is unable to maintain this cash, cash equivalents and short-term investments balance or satisfy the additional affirmative covenant requirements, Harmonic would be in noncompliance with the facility. In the event of noncompliance by Harmonic with the covenants under the facility, Silicon Valley Bank would be entitled to exercise its remedies under the facility which include declaring all obligations immediately due and payable and disposing of the collateral if obligations were not repaid. At March 31, 2006, Harmonic was in compliance with the covenants under this line of credit facility. The December 2005 amendment resulted in the Company paying a fee of approximately $33,000 and requiring payment of approximately $43,000 of additional fees if the Company does not maintain an unrestricted deposit of $20.0 million with the bank. Future borrowings pursuant to the line bear interest at the bank s prime rate (7.75% at March 31, 2006) or prime plus 0.5% for equipment borrowings. Borrowings are repayable monthly and are collateralized by all of Harmonic s assets except intellectual property. As of March 31, 2006, $1.1 million was outstanding under the equipment term loan portion of this facility and there were no borrowings in 2005 or 2006. The term loan is payable monthly, including principal and interest at 8.25% per annum on outstanding borrowings as of March 31, 2006 and matures at various dates through December 2007. Other than standby letters of credit and guarantees (Note 15), there were no other outstanding borrowings or commitments under the line of credit facility as of March 31, 2006.

Harmonic s cash and investment balances at March 31, 2006 were $108.6 million. We currently believe that our existing liquidity sources, including our bank line of credit facility, will satisfy our requirements for at least the next twelve months, including the final settlement and payment of C-Cube s pre-merger tax liabilities. However, we may need to raise additional funds if our expectations or estimates change or prove inaccurate, or to take advantage of unanticipated opportunities or to strengthen our financial position. The completed stock offering in the fourth quarter of 2003 was part of a registration statement on Form S-3 declared effective by the SEC in April 2002. In April 2005, we filed another registration statement on Form S-3 with the SEC. Pursuant to these registration statements on Form S-3, which have been declared effective by the SEC, we are able to issue various types of registered securities, including common stock, preferred stock, debt securities, and warrants to purchase common stock from time to time, up to an aggregate of approximately $200 million, subject to market conditions and our capital needs.

In addition, we actively review potential acquisitions that would complement our existing product offerings, enhance our technical capabilities or expand our marketing and sales presence. Any future transaction of this nature could require potentially significant amounts of capital or could require us to issue our stock and dilute existing stockholders. If adequate funds are not available, or are not available on acceptable terms, we may not be able to take advantage of market opportunities, to develop new products or to otherwise respond to competitive pressures.

Our ability to raise funds may be adversely affected by a number of factors relating to Harmonic, as well as factors beyond our control, including increased market uncertainty surrounding the ongoing U.S. war on terrorism, as well as conditions in capital markets and the cable and satellite industries. There can be no assurance that any financing will be available on terms acceptable to us, if at all.

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Off-Balance Sheet Arrangements

None as of March 31, 2006.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Market risk represents the risk of loss that may impact the operating results, financial position, or liquidity of Harmonic due to adverse changes in market prices and rates. Harmonic is exposed to market risk because of changes in interest rates and foreign currency exchange rates as measured against the U.S. Dollar and currencies of Harmonic s subsidiaries.

Foreign Currency Exchange Risk

Harmonic has a number of international subsidiaries each of whose sales are generally denominated in U.S. dollars. Sales denominated in foreign currencies were approximately 9% and 7% of net sales in the first three months of 2006 and the full year of 2005, respectively. In addition, the Company has various international branch offices that provide sales support and systems integration services. Periodically, Harmonic enters into foreign currency forward exchange contracts, or forward contracts, to manage exposure related to accounts receivable denominated in foreign currencies. Harmonic does not enter into derivative financial instruments for trading purposes. At March 31, 2006, we had a forward contract to sell Euros totaling $5.4 million that matures during the second quarter of 2006. While Harmonic does not anticipate that near-term changes in exchange rates will have a material impact on Harmonic s operating results, financial position or liquidity, Harmonic cannot assure you that a sudden and significant change in the value of local currencies would not harm Harmonic s operating results, financial position or liquidity.

Interest Rate Risk

Exposure to market risk for changes in interest rates relate primarily to Harmonic s investment portfolio of marketable debt securities of various issuers, types and maturities and to Harmonic s borrowings under its bank line of credit facility. Harmonic does not use derivative instruments in its investment portfolio, and its investment portfolio only includes highly liquid instruments with an original maturity of less than two years. These investments are classified as available for sale and are carried at estimated fair value, with material unrealized gains and losses reported in other comprehensive income. There is risk that losses could be incurred if Harmonic were to sell any of its securities prior to stated maturity. A 10% change in interest rates would not have had a material impact on financial conditions, results of operations or cash flows.

Item 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures.

Our management, with the participation of our chief executive officer and our chief financial officer, evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act)) as of the end of the period covered by this quarterly report on Form 10-Q.

A control system, no matter how well conceived and operated, can provide only reasonable assurance that the objectives of the control system are met. Our management, including our chief executive officer and chief financial officer, does not expect that our disclosure controls and procedures or internal control over financial reporting will prevent all errors and fraud. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues within the company have been detected. These inherent limitations include the reality that judgments in decision-making can be incorrect, and that breakdowns can occur because of simple errors or mistakes. The design of any control system is also based, in part, upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, controls may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a control system, misstatements due to error or

fraud may occur and not be detected.

Based upon their evaluation of the effectiveness of our disclosure controls and procedures as of the end of the period covered by this quarterly report on Form 10-Q, our chief executive officer and chief financial officer have concluded that our disclosure controls and procedures are effective based on their evaluation of these controls and procedures required by paragraph (b) of Exchange Act Rules 13a-15 or 15d-15.

Changes in internal controls.

There were no changes in our internal control over financial reporting identified in connection with the evaluation required by paragraph (d) of Exchange Act Rules 13a-15 or 15d-15 that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II

OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

Shareholder Litigation

Between June 28 and August 25, 2000, several actions alleging violations of the federal securities laws by Harmonic and certain of its officers and directors (some of whom are no longer with Harmonic) were filed in or removed to the U.S. District Court for the Northern District of California. The actions subsequently were consolidated.

A consolidated complaint, filed on December 7, 2000, was brought on behalf of a purported class of persons who purchased Harmonic s publicly traded securities between January 19 and June 26, 2000. The complaint also alleged claims on behalf of a purported subclass of persons who purchased C-Cube securities between January 19 and May 3, 2000. In addition to Harmonic and certain of its officers and directors, the complaint also named C-Cube Microsystems Inc. and several of its officers and directors as defendants. The complaint alleged that, by making false or misleading statements regarding Harmonic s prospects and customers and its acquisition of C-Cube, certain defendants violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the Exchange Act). The complaint also alleged that certain defendants violated section 14(a) of the Exchange Act and sections 11, 12(a)(2), and 15 of the Securities Act of 1933 (the Securities Act) by filing a false or misleading registration statement, prospectus, and joint proxy in connection with the C-Cube acquisition.

On July 3, 2001, the District Court dismissed the consolidated complaint with leave to amend. An amended complaint alleging the same claims against the same defendants was filed on August 13, 2001. Defendants moved to dismiss the amended complaint on September 24, 2001. On November 13, 2002, the District Court issued an opinion granting the motions to dismiss the amended complaint without leave to amend. Judgment for defendants was entered on December 2, 2002. On December 12, 2002, plaintiffs filed a motion to amend the judgment and for leave to file an amended complaint pursuant to Rules 59(e) and 15(a) of the Federal Rules of Civil Procedure. On June 6, 2003, the District Court denied plaintiffs motion to amend the judgment and for leave to file an amended complaint. Plaintiffs filed a notice of appeal on July 1, 2003. The appeal was heard by a panel of three judges of the United States Court of Appeals for the Ninth Circuit (the Ninth Circuit) on February 17, 2005.

On November 8, 2005, the Ninth Circuit panel affirmed in part, reversed in part, and remanded for further proceedings the decision of the District Court. The Ninth Circuit affirmed the District Court s dismissal of the plaintiffs fraud claims under Sections 10(b), 14(a), and 20(a) of the Exchange Act with prejudice, finding that the plaintiffs failed to adequately plead their allegations of fraud. The Ninth Circuit reversed the District Court s dismissal of the plaintiffs claims under Sections 11 and 12(a)(2) of the Securities Act, however, finding that those claims did not allege fraud and therefore were subject to only minimal pleading standards. Regarding the secondary liability claim under Section 15 of the Securities Act, the Ninth Circuit reversed the dismissal of that claim against Anthony J. Ley, Harmonic s Chairman and Chief Executive Officer, and affirmed the dismissal of that claim against Harmonic, while granting leave to amend. The Ninth Circuit remanded the surviving claims to the District Court for further proceedings.

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On November 22, 2005, both the Harmonic defendants and the plaintiffs petitioned the Ninth Circuit for a rehearing of the appeal. On February 16, 2006 the Ninth Circuit denied both petitions. On April 19, 2006, the District Court issued an order setting forth the schedule for filing and responding to the Third Amended Complaint. Under that schedule, plaintiffs will file their Third Amended Complaint by May 17, 2006, and defendants will respond by June 15, 2006.

A derivative action purporting to be on behalf of Harmonic was filed against its then-current directors in the Superior Court for the County of Santa Clara on September 5, 2000. Harmonic also was named as a nominal defendant. The complaint is based on allegations similar to those found in the securities class action and claims that the defendants breached their fiduciary duties by, among other things, causing Harmonic to violate federal securities laws. The derivative action was removed to the United States District Court for the Northern District of California on September 20, 2000. All deadlines in this action were stayed pending resolution of the motions to dismiss the securities class action. On July 29, 2003, the Court approved the parties stipulation to dismiss this derivative action without prejudice and to toll the applicable limitations period until fourteen days after (1) defendants provide plaintiff with a copy of the mandate issued by the Ninth Circuit in the securities action or (2) either party provides written notice of termination of the tolling period, whichever is first. Defendants have notified plaintiff of the Ninth Circuit mandate.

A second derivative action purporting to be on behalf of Harmonic was filed in the Superior Court for the County of Santa Clara on May 15, 2003. It alleges facts similar to those previously alleged in the securities class action and the federal derivative action. The complaint names as defendants former and current Harmonic officers and directors, along with former officers and directors of C-Cube Microsystems, Inc., who were named in the securities class action. The complaint also names Harmonic as a nominal defendant. The complaint alleges claims for abuse of control, gross mismanagement, and waste of corporate assets against the Harmonic defendants, and claims for breach of fiduciary duty, unjust enrichment, and negligent misrepresentation against all defendants. On July 22, 2003, the Court approved the parties stipulation to stay the case pending resolution of the appeal in the securities class action. Following the issuance of the Ninth Circuit s mandate the Harmonic and C-Cube defendants filed demurrers to this derivative complaint on May 9, 2006.

Based on its review of the surviving claims in the securities class actions, Harmonic believes that it has meritorious defenses and intends to defend itself vigorously. There can be no assurance, however, that Harmonic will prevail. No estimate can be made of the possible range of loss associated with the resolution of this contingency, and accordingly, Harmonic has not recorded a liability. An unfavorable outcome of this litigation could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

Other Litigation

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of Harmonic s products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint seeks injunctive relief, royalties and damages. Harmonic has not been served in the case. At this time, we are unable to determine whether we will be able to settle this litigation on reasonable terms or at all, nor can we predict the impact of an adverse outcome of this litigation if we elect to defend against it. No estimate can be made of the possible range of loss associated with the resolution of this contingency and accordingly, we have not recorded a liability associated with the outcome of a negotiated settlement or an unfavorable verdict in litigation. An unfavorable outcome of this matter could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

Harmonic is involved in other litigation and may be subject to claims arising in the normal course of business. In the opinion of management the amount of ultimate liability with respect to these matters in the aggregate will not have a material adverse effect on the Company or its operating results, financial position or cash flows.

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Item 1A. RISK FACTORS

We Depend On Cable, Satellite And Telecom Industry Capital Spending For A Substantial Portion Of Our Revenue And Any Decrease Or Delay In Capital Spending In These Industries Would Negatively Impact Our Resources, Operating Results And Financial Condition And Cash Flows.

A significant portion of Harmonic s sales have been derived from sales to cable television, satellite and telecommunications operators, and we expect these sales to constitute a significant portion of net sales for the foreseeable future. Demand for our products will depend on the magnitude and timing of capital spending by cable television operators, satellite operators, telephone companies and broadcasters for constructing and upgrading their systems.

These capital spending patterns are dependent on a variety of factors, including:

§ access to financing;

§ annual budget cycles;

§ the impact of industry consolidation;

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

§ overall demand for communication services and the acceptance of new video, voice and data services;

§ evolving industry standards and network architectures;

§ competitive pressures, including pricing pressures;

§ discretionary customer spending patterns; and

§ general economic conditions.

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

§ uncertainty related to development of digital video industry standards;

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

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

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

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

§ economic and financial conditions in domestic and international markets; and

§ bankruptcies and financial restructuring of major customers.

The financial difficulties of certain of our customers and changes in our customers deployment plans adversely affected our business in recent years. However, we believe that the financial condition of many of our customers has stabilized or improved, and our net sales increased in 2005 compared to 2004, and in 2004 compared to 2003. However, an economic downturn or other factors could cause additional financial difficulties among our customers,

and customers whose financial condition has stabilized may not purchase new equipment at levels we have seen in the past. Continued financial difficulties among our customers would adversely affect our operating results and financial condition. In addition, industry consolidation has, in the past and may in the future, constrain capital spending among our customers. In this regard, we believe that the bankruptcy of Adelphia Communications has led to capital spending delays and we cannot currently predict the impact of the proposed sale of Adelphia Communications cable systems to Comcast and Time-Warner Cable on our future sales. As a result, we cannot assure you that we will maintain or increase our net sales in the future.

Major U.S. cable operators have indicated that the substantial completion of major network upgrades, which involved significant labor and construction costs, will lead to lower capital expenditures in the future. If our product portfolio and product development plans do not position us well to capture an increased portion of the capital spending of U.S. cable operators, our revenue may decline and our operating results would be adversely affected.

Our Customer Base Is Concentrated And The Loss Of One Or More Of Our Key Customers, Or a Failure to Diversify Our Customer Base, Could Harm Our Business.

Historically, a majority of our sales have been to relatively few customers, and due in part to the consolidation of ownership of cable television and direct broadcast satellite systems, we expect this customer concentration to continue in the foreseeable future. Sales to our ten largest customers in the first quarter of 2006 and the years 2005 and 2004 accounted for approximately 51%, 54% and 55% of net sales, respectively. Although we are attempting to broaden our customer base by penetrating new markets such as the telecommunications and broadcast markets and expand internationally, we expect to see continuing industry consolidation and customer concentration due in part to the significant capital costs of constructing broadband networks. For example, Comcast acquired AT&T Broadband in November 2002, thereby creating the largest U.S. cable operator, reaching approximately 22 million subscribers. In the DBS market, The News Corporation Ltd. acquired an indirect controlling interest in Hughes Electronics, the parent company of DIRECTV in 2003. NTL and Telewest, the two largest cable operators in the UK have recently completed their announced merger. In the telco market, AT&T has announced an agreement to acquire Bell South. In addition, the sale or financial restructuring of companies such as Adelphia Communications and several European operators may lead to further industry consolidation. In the first quarter of 2006 and the years 2005 and 2004, sales to Comcast accounted for 11%, 18% and 17%, respectively, of net sales. The loss of Comcast or any other significant customer or any reduction in orders by Comcast or any significant customer, or our failure to qualify our products with a significant customer could adversely affect our business, operating results and liquidity. In this regard, sales to Comcast declined in 2004 compared to 2003, both in absolute dollars and as a percentage of revenues. Furthermore, in the third and fourth quarters of 2005, sales for a major telco accounted for 13% of net sales. However, we do not expect to make continuing significant shipments for this telco after the second quarter of 2006. The loss of, or any reduction in orders from, a significant customer would harm our business.

In addition, historically we have been dependent upon capital spending in the cable and satellite industry. We are attempting to diversify our customer base beyond cable and satellite customers, principally into the telco market. Major telcos have begun to implement plans to rebuild or upgrade their networks to offer bundled video, voice and data services. While we have recently increased our revenue from telco customers, we are relatively new to this market. In order to be successful in this market, we may need to build alliances with telco equipment manufacturers, adapt our products for telco applications, take orders at prices resulting in lower margins, and build internal expertise to handle the particular contractual and technical demands of the telco industry. As a result of these and other factors, we cannot assure you that we will be able to increase our revenues from the telco market, or that we can do so profitably, and any failure to increase revenues and profits from telco customers could adversely affect our business.

Our Operating Results Are Likely To Fluctuate Significantly And May Fail To Meet Or Exceed The Expectations Of Securities Analysts Or Investors, Causing Our Stock Price To Decline.

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

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

§ changes in market demand;

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

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

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

§ the need to replace revenue from shipments to a distributor for a major telco, which we do not expect to continue at the same level of revenue in 2006 as in 2005;

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

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

§ our unpredictable sales cycles;

§ the amount and timing of sales to telcos, which are particularly difficult to predict;

§ new product introductions by our competitors or by us;

§ changes in domestic and international regulatory environments;

§ market acceptance of new or existing products;

§ the cost and availability of components, subassemblies and modules;

§ the mix of our customer base and sales channels;

§ the mix of our products sold;

§ changes in our operating expenses and extraordinary expenses;

§ the impact of FAS 123(R), a new accounting standard which will require us to expense stock options;

§ our development of custom products and software;

§ the quantity of third-party products we sell, which products carry lower gross margins, compared to our own products;

§ the quantity of FTTP products we sell, which products carry lower gross margins than our other products;

§ the level of international sales; and

§ economic and financial conditions specific to the cable, satellite and telco industries, and general economic conditions.

The timing of deployment of our equipment can be subject to a number of other risks, including the availability of skilled engineering and technical personnel, the availability of other equipment such as compatible set top boxes, and

our customers need for local franchise and licensing approvals.

For example, during the first quarter of 2006, our net sales declined sequentially due to a reduction in sales to Verizon, one of our major customers, and in comparison to the comparable period in 2005 due to a decrease in the volume of third party products we sold.

In addition, we often recognize a substantial portion of our revenues in the last month of the quarter. We establish our expenditure levels for product development and other operating expenses based on projected sales levels, and expenses are relatively fixed in the short term. Accordingly, variations in timing of sales can cause significant fluctuations in operating results. As a result of all these factors, our operating results in one or more future periods may fail to meet or exceed the expectations of securities analysts or investors. In that event, the trading price of our common stock would likely decline. In this regard, due to lower than expected sales during the first quarter of 2003, the third quarter of 2004, a decrease in gross profit percentage in 2005, and lower than expected sales during the first quarter of 2006, we failed to meet our internal expectations, as well as the expectations of securities analysts and investors, and the price of our common stock declined, in some cases significantly.

Our Future Growth Depends on Market Acceptance of Several Emerging Broadband Services, on the Adoption of New Broadband Technologies and on Several Other Broadband Industry Trends.

Future demand for our products will depend significantly on the growing market acceptance of several emerging broadband services, including digital video; VOD; HDTV; very high-speed data services and voice-over-IP (VoIP) telephony.

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

§ new video compression standards such as MPEG-4/H.264 and Microsoft s Windows Media 9 broadcast profile (VC-1);

§ FTTP and DSL networks designed to facilitate the delivery of video services by telcos;

§ the greater use of protocols such as IP; and

§ the introduction of new consumer devices, such as advanced set-top boxes and personal video recorders (PVRs).

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

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

§ convergence, or the desire of certain network operators to deliver a package of video, voice and data services to consumers, also known as the triple play ;

§ the use of digital video by businesses, governments and educators;

§ the entry of telcos into the video business to allow them to offer the triple play ;

§ growth in HDTV, on-demand services and mobile video;

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

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

If, for instance, operators do not pursue the triple play as aggressively as we expect, our net sales growth would be materially and adversely affected. Similarly, if our expectations regarding these and other trends are not met, our net sales may be materially and adversely affected.

We Need To Develop And Introduce New And Enhanced Products In A Timely Manner To Remain Competitive.
Broadband communications markets are characterized by continuing technological advancement, changes in customer requirements and evolving industry standards. To compete successfully, we must design, develop, manufacture and sell new or enhanced products that provide increasingly higher levels of performance and reliability. However, we may not be able to successfully develop or introduce these products if our products:

§ are not cost effective;

§ are not brought to market in a timely manner;

§ are not in accordance with evolving industry standards and architectures;

§ fail to achieve market acceptance; or

§ are ahead of the market.

We are currently developing and marketing products based on new video compression standards. Encoding products based on the current MPEG-2 compression standards have represented a significant portion of the Company s sales since the acquisition of DiviCom in 2000. New standards, such as MPEG-4/H.264 and Microsoft s Windows Media 9 broadcast profile (VC-1), have been adopted which provide significantly greater compression efficiency, thereby making more bandwidth available to operators. The availability of more bandwidth is particularly important to those DBS and telco operators seeking to launch, or expand, HDTV services. One of our competitors has already announced significant orders for MPEG-4 HD encoders from a major DBS operator. Harmonic is developing products, including HD encoders, based on these new standards in order to remain competitive and is devoting considerable resources to this effort. There can be no assurance that these efforts will be successful in the near future, or at all, or that competitors will not take significant market share in HD encoding.

We are also currently marketing products for FTTP networks which certain telcos have begun to build. We believe that a number of our existing products can be deployed successfully in these networks and we have devoted considerable resources to obtaining orders, qualifying our products and hiring knowledgeable personnel. Shipments of products for a major telco s FTTP projects represented 13% of sales in our third and fourth quarters of 2005. However, we do not expect to make significant shipments for this telco after the second quarter of 2006, and we have reduced the amount of resources devoted to these products. While we expect to continue to market these products to other customers, there can be no assurance that these efforts will be successful in the near future, or at all.

Also, to successfully develop and market certain of our planned products for digital applications, we may be required to enter into technology development or licensing agreements with third parties. We cannot assure you that we will be able to enter into any necessary technology development or licensing agreement on terms acceptable to us, or at all. The failure to enter into technology development or licensing agreements when necessary could limit our ability to develop and market new products and, accordingly, could materially and adversely affect our business and operating results.

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

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The Markets In Which We Operate Are Intensely Competitive And Many Of Our Competitors Are Larger And More Established.

The markets for fiber optics systems and digital video systems are extremely competitive and have been characterized by rapid technological change and declining average selling prices. Pressure on average selling prices was particularly severe during the most recent economic downturn as equipment suppliers competed aggressively for customers reduced capital spending. Harmonic s competitors in the fiber optics systems business include corporations such as Motorola, Cisco Systems and C-Cor. In the digital and video broadcasting systems business, we compete broadly with vertically integrated system suppliers including Motorola, Cisco Systems, Tandberg Television and Thomson Multimedia, and in certain product lines with a number of smaller companies.

Many of our competitors are substantially larger and have greater financial, technical, marketing and other resources than Harmonic. Many of these large organizations are in a better position to withstand any significant reduction in capital spending by customers in these markets. They often have broader product lines and market focus and may not be as susceptible to downturns in a particular market. In addition, many of our competitors have been in operation longer than we have and therefore have more long-standing and established relationships with domestic and foreign customers. We may not be able to compete successfully in the future, which may harm our business.

If any of our competitors products or technologies were to become the industry standard, our business could be seriously harmed. For example, new standards for video compression are being introduced and products based on these standards are being developed by Harmonic and certain competitors. If our competitors are successful in bringing these products to market earlier, or if these products are more technologically capable than ours, then our sales could be materially and adversely affected. In addition, companies that have historically not had a large presence in the broadband communications equipment market have begun recently to expand their market share through mergers and acquisitions. The continued consolidation of our competitors could have a significant negative impact on us. Further, our competitors, particularly competitors of our digital and video broadcasting systems business, may bundle their products or incorporate functionality into existing products in a manner that discourages users from purchasing our products or which may require us to lower our selling prices resulting in lower gross margins.

If Sales Forecasted For A Particular Period Are Not Realized In That Period Due To The Unpredictable Sales Cycles Of Our Products, Our Operating Results For That Period Will Be Harmed.

The sales cycles of many of our products, particularly our newer products and products sold internationally, are typically unpredictable and usually involve:

§ a significant technical evaluation;

§ a commitment of capital and other resources by cable, satellite, and other network operators;

§ time required to engineer the deployment of new technologies or new broadband services;

§ testing and acceptance of new technologies that affect key operations; and

§ test marketing of new services with subscribers.

For these and other reasons, our sales cycles generally last three to six months, but can last up to 12 months. If orders forecasted for a specific customer for a particular quarter do not occur in that quarter, our operating results for that quarter could be substantially lower than anticipated. In this regard, our sales cycles with our current and potential satellite and telco customers are particularly unpredictable. Additionally, orders may include multiple elements, the timing of delivery of which may impact the timing of revenue recognition. Quarterly and annual results may fluctuate significantly due to revenue recognition policies and the timing of the receipt of orders. For example, revenue from two significant customer orders in the third quarter of 2004 was delayed due to these factors until the fourth quarter of 2004.

In addition, a significant portion of our revenue is derived from solution sales that principally consist of and include the system design, manufacture, test, installation and integration of equipment to the specifications of Harmonic s customers, including equipment acquired from third parties to be integrated with Harmonic s products. Revenue forecasts for solution contracts are based on the estimated timing of the system design, installation and integration of projects. Because the solution contracts generally span several quarters and revenue recognition is based on progress under the contract, the timing of revenue is difficult to predict and could result in lower than expected revenue in any particular quarter.

We Depend On Our International Sales And Are Subject To The Risks Associated With International Operations, Which May Negatively Affect Our Operating Results.

Sales to customers outside of the U.S. in the first quarter of 2006 and the years 2005 and 2004 represented 54%, 40% and 42% of net sales, respectively, and we expect that international sales will continue to represent a meaningful portion of our net sales for the foreseeable future. Furthermore, a substantial portion of our contract manufacturing occurs overseas. Our international operations, the international operations of our contract manufacturers, and our efforts to increase sales in international markets, are subject to a number of risks, including:

§ changes in foreign government regulations and telecommunications standards;

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

§ fluctuations in currency exchange rates;

§ difficulty in collecting accounts receivable;

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

§ difficulty in staffing and managing foreign operations;

§ political and economic instability; and

§ changes in economic policies by foreign governments.

Certain of our international customers have accumulated significant levels of debt and have announced during the past three years reorganizations and financial restructurings, including bankruptcy filings. Even if these restructurings are completed, we cannot assure you that these customers will be in a position to purchase new equipment at levels we have seen in the past.

While our international sales and operating expenses have typically been denominated in U.S. dollars, fluctuations in currency exchange rates could cause our products to become relatively more expensive to customers in a particular country, leading to a reduction in sales or profitability in that country.

Following implementation of the Euro in January 2002, a higher portion of our European business is denominated in Euros, which may subject us to increased foreign currency risk. Gains and losses on the conversion to U.S. dollars of accounts receivable, accounts payable and other monetary assets and liabilities arising from international operations may contribute to fluctuations in operating results. Furthermore, payment cycles for international customers are typically longer than those for customers in the U.S. Unpredictable sales cycles could cause us to fail to meet or exceed the expectations of security analysts and investors for any given period. In addition, foreign markets may not develop in the future. Any or all of these factors could adversely impact our business and results of operations.

Pending Business Combinations And Other Financial And Regulatory Issues Among Our Customers Could Adversely Affect Our Business.

Many of our domestic and international customers accumulated significant levels of debt and announced reorganizations and financial restructurings during the past three years, including bankruptcy filings. In particular, Adelphia Communications, a major domestic cable operator, declared bankruptcy in June 2002. The stock prices of

other domestic cable companies came under pressure following the Adelphia bankruptcy due to concerns about debt levels and capital expenditure requirements for new and expanded services, thereby making the raising of capital more difficult and expensive.

While the capital market concerns about the domestic cable industry have eased, market conditions remain difficult and capital spending plans are generally constrained. It is likely that further industry restructuring will take place via mergers or spin-offs, such as the Comcast/AT&T Broadband transaction in 2002 and the acquisition by The News Corporation Ltd. in December 2003 of an indirect controlling interest in Hughes Electronics, the parent company of DIRECTV. This transaction followed regulatory opposition to the proposed acquisition of DIRECTV by EchoStar. We believe that uncertainty during 2002 regarding the proposed DIRECTV and EchoStar merger adversely affected capital spending by both of these parties as well as other customers. More recently, restructuring of the industry has continued with the privatization of Cox Communications, the planned sale of Adelphia Communications out of bankruptcy to Comcast and Time-Warner, the proposed sale of Cablevision s VOOM! satellite assets to Echostar and the recently completed merger of UK cable operators NTL and Telewest. In addition, further business combinations may occur in our industry, and these further combinations could adversely affect our business. Regulatory issues, financial concerns and business combinations among our customers are likely to significantly affect the industry, its capital spending plans, and our levels of business for the foreseeable future.

Changes in Telecommunications Legislation and Regulations Could Harm Our Prospects And Future Sales.

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

Competition For Qualified Personnel, Particularly Management Personnel, Can Be Intense. In Order To Manage Our Growth, We Must Be Successful In Addressing Management Succession Issues And Attracting And Retaining Qualified Personnel.

Our future success will depend, to a significant extent, on the ability of our management to operate effectively, both individually and as a group. We must successfully manage transition and replacement issues that may result from the departure or retirement of members of our senior management. For example, on May 4, 2006 we announced that our Chairman, President and Chief Executive Officer, Anthony J. Ley, was retiring from his position as President and Chief Executive Officer effective immediately, and that he was being succeeded by our current Executive Vice President, Patrick Harshman. We cannot assure you that this transition of management personnel will not cause disruption to our operations or customer relationships, or a decline in our financial results.

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

Recent And Proposed Regulations Related To Equity Compensation Could Adversely Affect Earnings, Affect Our Ability To Raise Capital And Affect Our Ability To Attract And Retain Key Personnel.

Since our inception, we have used stock options as a fundamental component of our employee compensation packages. We believe that our stock option plans are an essential tool to link the long-term interests of stockholders and employees, especially executive management, and serve to motivate management to make decisions that will, in the long run, give the best returns to stockholders. The Financial Accounting Standards Board (FASB) has issued FAS 123(R) that requires us to record a charge to earnings for employee stock option grants and employee stock

purchase plan rights for all future periods beginning on January 1, 2006. The adoption of this standard has negatively impacted and will continue to negatively impact our earnings and may affect our ability to raise capital on acceptable terms. For the three months ended March 31, 2006, stock-based compensation expense recognized under SFAS 123(R) was $1.6 million, which consisted of stock-based compensation expense related to employee equity awards and employee stock purchases.

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

We Are Exposed To Additional Costs And Risks Associated With Complying With Increasing And New Regulation Of Corporate Governance And Disclosure Standards.

We are spending an increased amount of management time and external resources to comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, SEC regulations and Nasdaq Stock Market rules. Particularly, Section 404 of the Sarbanes-Oxley Act requires management s annual review and evaluation of our internal control over financial reporting, and attestation of the effectiveness of our internal control over financial reporting by management and the Company s independent registered public accounting firm in connection with the filing of the annual report on Form 10-K for each fiscal year. We have documented and tested our internal control systems and procedures and have made improvements in order for us to comply with the requirements of Section 404. This process required us to hire additional personnel and outside advisory services and has resulted in significant additional expenses. While our assessment of our internal control over financial reporting resulted in our conclusion that as of December 31, 2005, our internal control over financial reporting was effective, we cannot predict the outcome of our testing in future periods. If we conclude in future periods that our internal control over financial reporting is not effective or if our independent registered public accounting firm is unable to provide an unqualified opinion as of future year-ends, investors may lose confidence in our financial statements, and the price of our stock may suffer.

We May Need Additional Capital In The Future And May Not Be Able To Secure Adequate Funds On Terms Acceptable To Us.

We have generated substantial operating losses since we began operations in June 1988. We have been engaged in the design, manufacture and sale of a variety of broadband products since inception, which has required, and will continue to require, significant research and development expenditures. As of March 31, 2006 we had an accumulated deficit of $1.9 billion. These losses, among other things, have had and may have an adverse effect on our stockholders equity and working capital.

We believe that the proceeds of the stock offering we completed in November 2003, together with our existing liquidity sources, will satisfy our cash requirements for at least the next twelve months, including the final settlement and payment of C-Cube s pre-merger tax liabilities. However, we may need to raise additional funds if our expectations are incorrect, to fund our operations, to take advantage of unanticipated strategic opportunities or to strengthen our financial position. The stock offering we completed in November 2003 related to a registration statement on Form S-3 declared effective by the SEC in April 2002. In April 2005, we filed another registration statement on Form S-3 with the SEC. Pursuant to these registration statements on Form S-3, which have been declared effective by the SEC, we will continue to be able to issue registered common stock, preferred stock, debt securities and warrants to purchase common stock from time to time, up to an aggregate of approximately $200 million, subject to market conditions and our capital needs. Our ability to raise funds may be adversely affected by a number of factors relating to Harmonic, as well as factors beyond our control, including conditions in capital markets and the cable, telecom and satellite industries. There can be no assurance that such financing will be available on terms acceptable to us, if at all.

In addition, we actively review potential acquisitions that would complement our existing product offerings, enhance our technical capabilities or expand our marketing and sales presence. Any future transaction of this nature could require potentially significant amounts of capital to finance the acquisition and related expenses as well as to

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integrate operations following a transaction, and could require us to issue our stock and dilute existing stockholders. If adequate funds are not available, or are not available on acceptable terms, we may not be able to take advantage of market opportunities, to develop new products or to otherwise respond to competitive pressures.

We may raise additional financing through public or private equity offerings, debt financings or additional corporate collaboration and licensing arrangements. To the extent we raise additional capital by issuing equity securities, our stockholders may experience dilution. To the extent that we raise additional funds through collaboration and licensing arrangements, it may be necessary to relinquish some rights to our technologies or products, or grant licenses on terms that are not favorable to us. If adequate funds are not available, we will not be able to continue developing our products.

If Demand For Our Products Increases More Quickly Than We Expect, We May Be Unable To Meet Our Customers Requirements.

Our net sales increased approximately 4% in 2005 compared to 2004, and approximately 36% in 2004 from 2003. If demand for our products increases, the difficulty of accurately forecasting our customers requirements and meeting these requirements will increase. Forecasting to meet customers needs is particularly difficult in connection with newer products. Our ability to meet customer demand depends significantly on the availability of components and other materials as well as the ability of our contract manufacturers to scale their production. Furthermore, we purchase several key components, subassemblies and modules used in the manufacture or integration of our products from sole or limited sources. Our ability to meet customer requirements depends in part on our ability to obtain sufficient volumes of these materials in a timely fashion. Also, in recent years, in response to lower net sales and the prolonged economic recession, we significantly reduced our headcount and other expenses. As a result, we may be unable to respond to customer demand that increases more quickly than we expect. If we fail to meet customers supply expectations, our net sales would be adversely affected and we may lose business.

We Must Be Able To Manage Expenses And Inventory Risks Associated With Meeting The Demand Of Our Customers.

If actual orders are materially lower than the indications we receive from our customers, our ability to manage inventory and expenses may be affected. If we enter into purchase commitments to acquire materials, or expend resources to manufacture products, and such products are not purchased by our customers, our business and operating results could suffer. In this regard, our gross margins and operating results have been in the past adversely affected by significant charges for excess and obsolete inventories.

In addition, the Company must carefully manage the introduction of next generation products in order to balance potential inventory risks associated with excess quantities of older product lines and forecasts of customer demand for new products. For example, in 2005, we wrote down approximately $8.4 million for obsolete and excess inventory, with a major portion of the write-down being the result of product transitions in certain product lines. There can be no assurance that the Company will be able to manage these product transitions in the future without incurring write-downs for excess inventory or having inadequate supplies of new products to meet customer expectations.

We Face Risks Associated With Having Important Facilities And Resources Located In Israel.

Harmonic maintains a facility in Caesarea in the State of Israel with a total of 68 employees as of March 31, 2006, or approximately 11% of our workforce. The employees at this facility consist principally of research and development personnel involved in development of certain digital video products. In addition, we have pilot production capabilities at this facility consisting of procurement of subassemblies and modules from Israeli subcontractors and final assembly and test operations. Accordingly, we are directly influenced by the political, economic and military conditions affecting Israel, and any major hostilities involving Israel or the interruption or curtailment of trade between Israel and its trading partners could significantly harm our business. The September 2001 terrorist attacks, the situation in Iraq, the ongoing U.S. war on terrorism, terrorist attacks and hostilities within Israel, and the election of Hamas representatives to a majority of the seats in the Palestinian Legislative Council have heightened these risks. We cannot assure you that current tensions in the Middle East will not adversely affect our business and results of operations.

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In addition, most of our employees in Israel are currently obligated to perform annual reserve duty in the Israel Defense Forces and several have been called for active military duty recently. We cannot predict the effect of these obligations on Harmonic in the future.

We Purchase Several Key Components, Subassemblies And Modules Used In The Manufacture Or Integration Of Our Products From Sole Or Limited Sources, And We Are Increasingly Dependent On Contract Manufacturers.

Many components, subassemblies and modules necessary for the manufacture or integration of our products are obtained from a sole supplier or a limited group of suppliers. For example, we depend on LSI Logic for video encoding chips. Our reliance on sole or limited suppliers, particularly foreign suppliers, and our increased reliance on subcontractors since the merger with C-Cube involves several risks, including a potential inability to obtain an adequate supply of required components, subassemblies or modules and reduced control over pricing, quality and timely delivery of components, subassemblies or modules. In particular, certain optical components have in the past been in short supply and are available only from a small number of suppliers, including sole source suppliers. While we expend resources to qualify additional optical component sources, consolidation of suppliers in the industry and the small number of viable alternatives have limited the results of these efforts. We do not generally maintain long-term agreements with any of our suppliers. Managing our supplier and contractor relationships is particularly difficult during time periods in which we introduce new products and during time periods in which demand for our products is increasing, especially if demand increases more quickly than we expect. Furthermore, from time to time we assess our relationship with our contract manufacturers. In late 2003, we entered into a three-year agreement with Plexus Services Corp. as our primary contract manufacturer.

Difficulties in managing relationships with current contract manufacturers, could impede our ability to meet our customers requirements and adversely affect our operating results. An inability to obtain adequate deliveries or any other circumstance that would require us to seek alternative sources of supply could negatively affect our ability to ship our products on a timely basis, which could damage relationships with current and prospective customers and harm our business. We attempt to limit this risk by maintaining safety stocks of certain components, subassemblies and modules. As a result of this investment in inventories, we have in the past and in the future may be subject to risk of excess and obsolete inventories, which could harm our business, operating results, financial position and liquidity. In this regard, our gross margins and operating results in the past were adversely affected by significant excess and obsolete inventory charges.

We Need To Effectively Manage Our Operations And The Cyclical Nature Of Our Business.

The cyclical nature of our business has placed, and is expected to continue to place, a significant strain on our personnel, management and other resources. We reduced our work force by approximately 44% between December 31, 2000 and December 31, 2003 due to reduced industry spending and demand for our products. If demand for products increases significantly, we may need to increase our headcount, as we did during 2004, adding 33 employees. In the first quarter of 2005, we added 42 employees in connection with our acquisition of BTL, and in connection with the consolidation of our two operating divisions in December 2005, we reduced our workforce by approximately 40 employees. Our ability to manage our business effectively in the future, including any future growth, will require us to train, motivate and manage our employees successfully, to attract and integrate new employees into our overall operations, to retain key employees and to continue to improve our operational, financial and management systems.

We May Be Materially Affected By The WEEE And RoHS Directives.

The European Parliament and the Council of the European Union have finalized the Waste Electrical and Electronic Equipment (WEEE) directive, which became effective in August 2005, which regulates the collection, recovery, and recycling of waste from electrical and electronic products, and the Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS) directive, which will become effective in July 2006, which bans the use of certain hazardous materials including lead, mercury, cadmium, hexavalent chromium, and polybrominated biphenyls (PBBs), and polybrominated diphenyl ethers (PBDEs) that exceed certain specified levels. Under WEEE, we are responsible for financing operations for the collection, treatment, disposal, and recycling of past and future covered products that we produce. We cannot assure you that compliance with WEEE and RoHS will not have a material adverse effect on our financial condition or results of operations.

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We Are Liable For C-Cube s Pre-Merger Tax Liabilities, Including Tax Liabilities Resulting From The Spin-Off Of Its Semiconductor Business.

Under the terms of the merger agreement with C-Cube, Harmonic is generally liable for C-Cube s pre-merger tax liabilities. As of March 31, 2006, approximately $10.0 million of pre-merger tax liabilities remained outstanding and are included in accrued liabilities. We are working with LSI Logic, which acquired C-Cube s spun-off semiconductor business in June 2001 and assumed its obligations, to develop an approach to settle these obligations, a process which has been underway since the merger in 2000. These liabilities represent estimates of C-Cube s pre-merger tax obligations to various tax authorities in 11 countries. Harmonic paid $5.8 million of these tax obligations in February 2005, but is unable to predict when the remaining tax obligations will be paid, or in what amount. The full amount of the estimated obligation has been classified as a current liability. To the extent that these obligations are finally settled for less than the amounts provided, Harmonic is required, under the terms of the merger agreement, to refund the difference to LSI Logic. Conversely, if the settlements are more than the $10.0 million pre-merger tax liability after the February 2005 payments, LSI Logic is obligated to reimburse Harmonic.

The merger agreement stipulates that Harmonic will be indemnified by the spun-off semiconductor business if the cash reserves are not sufficient to satisfy all of C-Cube s tax liabilities for periods prior to the merger. If for any reason, the spun-off semiconductor business does not have sufficient cash to pay such taxes, or if there are additional taxes due with respect to the non-semiconductor business and Harmonic cannot be indemnified by LSI Logic, Harmonic generally will remain liable, and such liability could have a material adverse effect on our financial condition, results of operations or cash flows.

We May Be Subject To Risks Associated With Acquisitions.

We have made, continue to consider making and may make investments in complementary companies, products or technologies. For example, on February 25, 2005, we acquired all of the issued and outstanding shares of Broadcast Technology Ltd., a private U.K. company. In connection with this and other acquisition transactions, we could have difficulty assimilating or retaining the acquired companies key personnel and operations, integrating the acquired technology or products into ours or complying with internal control requirements of the Sarbanes-Oxley Act as a result of an acquisition. We also may face challenges in achieving the strategic objectives, cost savings or other benefits from these acquisitions and difficulties in expanding our management information systems to accommodate the acquired business. These difficulties could disrupt our ongoing business, distract our management and employees and significantly increase our expenses. Moreover, our operating results may suffer because of acquisition-related expenses, amortization of intangible assets and impairment of acquired goodwill or intangible assets. Furthermore, we may have to incur debt or issue equity securities to pay for any future acquisitions, or to provide for additional working capital requirements, the issuance of which could be dilutive to our existing shareholders. If we are unable to successfully address any of these risks, our business, financial condition or operating results could be harmed.

Cessation Of The Development And Production Of Video Encoding Chips By C-Cube s Spun-off Semiconductor Business May Adversely Impact Us.

The DiviCom business and C-Cube semiconductor business (acquired by LSI Logic in June 2001) collaborated on the production and development of two video encoding microelectronic chips prior to the merger. In connection with the merger, Harmonic and the spun-off semiconductor business entered into a contractual relationship under which Harmonic has access to certain of the spun-off semiconductor business technologies and products on which the DiviCom business previously depended for its product and service offerings. The current term of this agreement is through October 2006, with automatic annual renewal unless terminated by either party in accordance with the agreement provisions. The spun-off semiconductor business is the sole supplier of these chips to Harmonic. Several of these products continue to be important to our business, and we have incorporated these chips into additional products that we have developed. If the spun-off semiconductor business is not able to or does not sustain its development and production efforts in this area our business, financial condition, results of operations and cash flow could be harmed.

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Our Failure To Adequately Protect Our Proprietary Rights May Adversely Affect Us.

We currently hold 38 issued U.S. patents and 19 issued foreign patents, and have a number of patent applications pending. Although we attempt to protect our intellectual property rights through patents, trademarks, copyrights, licensing arrangements, maintaining certain technology as trade secrets and other measures, we cannot assure you that any patent, trademark, copyright or other intellectual property rights owned by us will not be invalidated, circumvented or challenged, that such intellectual property rights will provide competitive advantages to us or that any of our pending or future patent applications will be issued with the scope of the claims sought by us, if at all. We cannot assure you that others will not develop technologies that are similar or superior to our technology, duplicate our technology or design around the patents that we own. In addition, effective patent, copyright and trade secret protection may be unavailable or limited in certain foreign countries in which we do business or may do business in the future.

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

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

We Or Our Customers May Face Intellectual Property Infringement Claims From Third Parties.

Harmonic s industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In particular, leading companies in the telecommunications industry have extensive patent portfolios. From time to time, third parties, including these leading companies, have asserted and may assert exclusive patent, copyright, trademark and other intellectual property rights against us or our customers. Indeed, a number of third parties, including leading companies, have asserted patent rights to technologies that are important to us.

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of Harmonic s products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint seeks injunctive relief, royalties and damages. Harmonic has not been served in the case. At this time, we are unable to determine whether we will be able to settle this litigation on reasonable terms or at all, nor can we predict the impact of an adverse outcome of this litigation if we elect to defend against it. No estimate can be made of the possible range of loss associated with the resolution of this contingency and accordingly, we have not recorded a liability associated with the outcome of a negotiated settlement or an unfavorable verdict in litigation. An unfavorable outcome of this matter could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

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

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We Are The Subject Of Securities Class Action Claims And Other Litigation Which, If Adversely Determined, Could Harm Our Business And Operating Results.

Between June 28 and August 25, 2000, several actions alleging violations of the federal securities laws by Harmonic and certain of its officers and directors (some of whom are no longer with Harmonic) were filed in or removed to the United States District Court (the District Court) for the Northern District of California. The actions subsequently were consolidated.

A consolidated complaint, filed on December 7, 2000, was brought on behalf of a purported class of persons who purchased Harmonic s publicly traded securities between January 19 and June 26, 2000. The complaint also alleged claims on behalf of a purported subclass of persons who purchased C-Cube securities between January 19 and May 3, 2000. In addition to Harmonic and certain of its officers and directors, the complaint also named C-Cube Microsystems Inc. and several of its officers and directors as defendants. The complaint alleged that, by making false or misleading statements regarding Harmonic s prospects and customers and its acquisition of C-Cube, certain defendants violated sections 10(b) and 20(a) of the Securities Exchange Act of 1934 (the Exchange Act). The complaint also alleged that certain defendants violated section 14(a) of the Exchange Act and sections 11, 12(a)(2), and 15 of the Securities Act of 1933 (the Securities Act) by filing a false or misleading registration statement, prospectus, and joint proxy in connection with the C-Cube acquisition.

On July 3, 2001, the District Court dismissed the consolidated complaint with leave to amend. An amended complaint alleging the same claims against the same defendants was filed on August 13, 2001. Defendants moved to dismiss the amended complaint on September 24, 2001. On November 13, 2002, the District Court issued an opinion granting the motions to dismiss the amended complaint without leave to amend. Judgment for defendants was entered on December 2, 2002. On December 12, 2002, plaintiffs filed a motion to amend the judgment and for leave to file an amended complaint pursuant to Rules 59(e) and 15(a) of the Federal Rules of Civil Procedure. On June 6, 2003, the District Court denied plaintiffs motion to amend the judgment and for leave to file an amended complaint. Plaintiffs filed a notice of appeal on July 1, 2003. The appeal was heard by a panel of three judges of the United States Court of Appeals for the Ninth Circuit (the Ninth Circuit) on February 17, 2005.

On November 8, 2005, the Ninth Circuit panel affirmed in part, reversed in part, and remanded for further proceedings the decision of the District Court. The Ninth Circuit affirmed the District Court s dismissal of the plaintiffs fraud claims under Sections 10(b), 14(a), and 20(a) of the Exchange Act with prejudice, finding that the plaintiffs failed to adequately plead their allegations of fraud. The Ninth Circuit reversed the District Court s dismissal of the plaintiffs claims under Sections 11 and 12(a)(2) of the Securities Act, however, finding that those claims did not allege fraud and therefore were subject to only minimal pleading standards. Regarding the secondary liability claim under Section 15 of the Securities Act, the Ninth Circuit reversed the dismissal of that claim against Anthony J. Ley, Harmonic s Chairman and Chief Executive Officer, and affirmed the dismissal of that claim against Harmonic, while granting leave to amend. The Ninth Circuit remanded the surviving claims to the District Court for further proceedings.

On November 22, 2005, both the Harmonic defendants and the plaintiffs petitioned the Ninth Circuit for a rehearing of the appeal. On February 16, 2006 the Ninth Circuit denied both petitions. On April 19, 2006, the District Court issued an order setting forth the schedule for filing and responding to the Third Amended Complaint. Under that schedule, plaintiffs will file their Third Amended Complaint by May 17, 2006, and defendants will respond by June 15, 2006.

A derivative action purporting to be on behalf of Harmonic was filed against its then-current directors in the Superior Court for the County of Santa Clara on September 5, 2000. Harmonic also was named as a nominal defendant. The complaint is based on allegations similar to those found in the securities class action and claims that the defendants breached their fiduciary duties by, among other things, causing Harmonic to violate federal securities laws. The derivative action was removed to the United States District Court for the Northern District of California on September 20, 2000. All deadlines in this action were stayed pending resolution of the motions to dismiss the securities class action. On July 29, 2003, the Court approved the parties stipulation to dismiss this derivative action without prejudice and to toll the applicable limitations period until fourteen days after (1) defendants provide plaintiff with a copy of the mandate issued by the Ninth Circuit in the securities action or (2) either party provides written notice of termination of

the tolling period, whichever is first. Defendants have notified plaintiff of the Ninth Circuit s mandate.

A second derivative action purporting to be on behalf of Harmonic was filed in the Superior Court for the County of Santa Clara on May 15, 2003. It alleges facts similar to those previously alleged in the securities class action and the federal derivative action. The complaint names as defendants former and current Harmonic officers and directors, along with former officers and directors of C-Cube Microsystems, Inc., who were named in the securities class action. The complaint also names Harmonic as a nominal defendant. The complaint alleges claims for abuse of control, gross mismanagement, and waste of corporate assets against the Harmonic defendants, and claims for breach of fiduciary duty, unjust enrichment, and negligent misrepresentation against all defendants. On July 22, 2003, the Court approved the parties stipulation to stay the case pending resolution of the appeal in the securities class action. Following the issuance of the Ninth Circuit s mandate the Harmonic and C-Cube defendants filed demurrers to this derivative complaint on May 9, 2006.

Based on its review of the surviving claims in the securities class actions, Harmonic believes that it has meritorious defenses and intends to defend itself vigorously. There can be no assurance, however, that Harmonic will prevail. No estimate can be made of the possible range of loss associated with the resolution of each of these claims, and, accordingly, Harmonic has not recorded a liability. An unfavorable outcome of any of these litigation matters could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of Harmonic s products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint seeks injunctive relief, royalties and damages. Harmonic has not been served in the case. At this time, we are unable to determine whether we will be able to settle this litigation on reasonable terms or at all, nor can we predict the impact of an adverse outcome of this litigation if we elect to defend against it. No estimate can be made of the possible range of loss associated with the resolution of this contingency and accordingly, we have not recorded a liability associated with the outcome of a negotiated settlement or an unfavorable verdict in litigation. An unfavorable outcome of this matter could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

The Terrorist Attacks Of 2001 And The Ongoing Threat Of Terrorism Have Created Great Uncertainty And May Continue To Harm Our Business.

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

We Rely On A Continuous Power Supply To Conduct Our Operations, And Any Electrical And Natural Gas Crisis Could Disrupt Our Operations And Increase Our Expenses.

We rely on a continuous power supply for manufacturing and to conduct our business operations. Interruptions in electrical power supplies in California in the early part of 2001 could recur in the future. In addition, the cost of electricity and natural gas has risen significantly. Power outages could disrupt our manufacturing and business operations and those of many of our suppliers, and could cause us to fail to meet production schedules and commitments to customers and other third parties. Any disruption to our operations or those of our suppliers could result in damage to our current and prospective business relationships and could result in lost revenue and additional expenses, thereby harming our business and operating results.

The Markets In Which We, Our Customers And Suppliers Operate Are Subject To The Risk Of Earthquakes And Other Natural Disasters.

Our headquarters and the majority of our operations are located in California, which is prone to earthquakes, and some of the other locations in which we, our customers and suppliers conduct business are prone to natural disasters. In the event that any of our business centers are affected by any such disasters, we may sustain damage to our operations and properties and suffer significant financial losses. Furthermore, we rely on third party manufacturers

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for the production of many of our products, and any disruption in the business or operations of such manufacturers could adversely impact our business. In addition, if there is a major earthquake or other natural disaster in any of the locations in which our significant customers are located, we face the risk that our customers may incur losses, or sustained business interruption and/or loss which may materially impair their ability to continue their purchase of products from us. A major earthquake or other natural disaster in the markets in which we, our customers or suppliers operate could have a material adverse effect on our business, financial condition, results of operations and cash flows.

Our Stock Price May Be Volatile.

The market price of our common stock has fluctuated significantly in the past, and is likely to fluctuate in the future. In addition, the securities markets have experienced significant price and volume fluctuations and the market prices of the securities of technology companies have been especially volatile. Investors may be unable to resell their shares of our common stock at or above their purchase price. In the past, companies that have experienced volatility in the market price of their stock have been the object of securities class action litigation.

Some Anti-Takeover Provisions Contained In Our Certificate Of Incorporation, Bylaws And Stockholder Rights Plan, As Well As Provisions Of Delaware Law, Could Impair A Takeover Attempt.

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

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

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

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

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

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

§ providing the board of directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

These provisions, alone or together, could delay hostile takeovers and changes in control or management of Harmonic.

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

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

Any provision of our certificate of incorporation or bylaws, our stockholder rights plan or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for Harmonic stockholders to receive a

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premium for their shares of Harmonic common stock, and could also affect the price that some investors are willing to pay for Harmonic common stock.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

Item 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None.

Item 5. OTHER INFORMATION

None.

Item 6. EXHIBITS

Exhibits

Exhibit Number	
31.1	Section 302 Certification of Principal Executive Officer
31.2	Section 302 Certification of Principal Financial Officer
32.1	Section 906 Certification of Principal Executive Officer
32.2	Section 906 Certification of Principal Financial Officer

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SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Act of 1934, the Registrant, Harmonic Inc., a Delaware corporation, has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Sunnyvale, State of California, on May 10, 2006.

HARMONIC INC.

By: /s/ Robin N. Dickson
Robin N. Dickson
Chief Financial Officer
(Principal Financial and Accounting Officer)

Exhibit Number	Exhibit Index
31.1	Section 302 Certification of Principal Executive Officer
31.2	Section 302 Certification of Principal Financial Officer
32.1	Section 906 Certification of Principal Executive Officer
32.2	Section 906 Certification of Principal Financial Officer