

INFINERA CORP  
Form 10-Q  
October 31, 2008  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

**b QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended September 27, 2008

OR

**.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-33486

**Infinera Corporation**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

169 Java Drive

**77-0560433**  
(IRS Employer  
Identification No.)

Edgar Filing: INFINERA CORP - Form 10-Q

Sunnyvale, CA 94089

(Address of principal executive offices, including zip code)

(408) 572-5200

(Registrant's telephone number, including area code)

Indicate by checkmark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

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

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

(Do not check if a smaller reporting company)

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

As of October 24, 2008, 93,818,228 shares of the registrant's Common Stock, \$0.001 par value, were issued and outstanding.

**Table of Contents**

**INFINERA CORPORATION**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE FISCAL QUARTER ENDED SEPTEMBER 27, 2008**

**INDEX**

	<b>Page</b>
<b>PART I. FINANCIAL INFORMATION</b>	
Item 1. <u>Condensed Consolidated Financial Statements</u>	3
<u>Condensed Consolidated Balance Sheets As of September 27, 2008 and December 29, 2007</u>	3
<u>Condensed Consolidated Statements of Operations Three and nine months ended September 27, 2008 and September 29, 2007</u>	4
<u>Condensed Consolidated Statements of Cash Flows Nine months ended September 27, 2008 and September 29, 2007</u>	5
<u>Notes to Condensed Consolidated Financial Statements</u>	6
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	23
Item 3. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	41
Item 4. <u>Controls and Procedures</u>	42
<b>PART II. OTHER INFORMATION</b>	
Item 1. <u>Legal Proceedings</u>	42
Item 1A. <u>Risk Factors</u>	44
Item 6. <u>Exhibits</u>	57
<u>Signature Page</u>	58

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements****INFINERA CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except par values)****(Unaudited)**

	September 27, 2008	December 29, 2007
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 169,439	\$ 91,209
Short-term investments	78,551	181,168
Short-term restricted cash	840	743
Accounts receivable	48,571	39,216
Other receivables	250	1,127
Inventory	58,620	58,579
Deferred inventory costs	6,505	78,362
Prepaid expenses and other current assets	7,016	3,941
<b>Total current assets</b>	<b>369,792</b>	<b>454,345</b>
Property, plant and equipment, net	42,860	36,973
Intangible assets	1,342	1,541
Deferred inventory costs, non-current	2,787	3,260
Long-term investments	73,803	30,116
Long-term restricted cash	1,959	2,594
Other non-current assets	2,297	359
<b>Total assets</b>	<b>\$ 494,840</b>	<b>\$ 529,188</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 24,834	\$ 17,504
Accrued expenses	10,160	9,497
Accrued compensation and related benefits	9,078	17,749
Accrued warranty	5,814	4,974
Deferred revenue	25,444	167,031
<b>Total current liabilities</b>	<b>75,330</b>	<b>216,755</b>
Accrued warranty, non-current	4,862	5,018
Deferred revenue, non-current	7,012	7,406
Long-term exercised unvested options	318	825
Other long-term liabilities	3,747	4,610
Commitments and contingencies (Note 10)		
Stockholders' equity:		
Preferred stock, \$0.001 par value Authorized shares 25,000 and no shares issued and outstanding	94	92

## Edgar Filing: INFINERA CORP - Form 10-Q

Common stock, \$0.001 par value Authorized shares 500,000 as of September 27, 2008 and December 29, 2007, respectively Issued and outstanding shares 93,773 as of September 27, 2008 and 91,580 as of December 29, 2007, respectively

Additional paid-in capital	695,158	663,870
Accumulated other comprehensive income (loss)	(7,631)	78
Accumulated deficit	(284,050)	(369,466)
Total stockholders' equity	403,571	294,574
Total liabilities and stockholders' equity	\$ 494,840	\$ 529,188

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

**Table of Contents**

**INFINERA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share data)

(Unaudited)

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
<b>Revenue:</b>				
Product	\$ 76,130	\$ 25	\$ 226,763	\$ 7,275
Ratable product and related support and services	39,495	62,130	181,462	162,488
Services	4,881		11,643	
<b>Total revenue</b>	<b>120,506</b>	<b>62,155</b>	<b>419,868</b>	<b>169,763</b>
<b>Cost of revenue:</b>				
Cost of product	45,139	18	131,928	3,869
Cost of ratable product and related support and services	18,537	40,804	86,537	116,462
Cost of service	2,592		5,814	
<b>Total cost of revenue</b>	<b>66,268</b>	<b>40,822</b>	<b>224,279</b>	<b>120,331</b>
<b>Gross profit</b>	<b>54,238</b>	<b>21,333</b>	<b>195,589</b>	<b>49,432</b>
<b>Operating expenses:</b>				
Sales and marketing	11,171	7,995	32,277	22,032
Research and development	21,092	14,621	57,172	44,758
General and administrative	8,713	7,069	25,632	17,984
Amortization of intangible assets	37	37	111	111
<b>Total operating expenses</b>	<b>41,013</b>	<b>29,722</b>	<b>115,192</b>	<b>84,885</b>
<b>Income (loss) from operations</b>	<b>13,225</b>	<b>(8,389)</b>	<b>80,397</b>	<b>(35,453)</b>
<b>Other income (expense), net:</b>				
Interest income	1,675	2,459	7,236	3,373
Interest expense		(67)	(3)	(2,249)
Other gain (loss)	37	533	1,213	(16,982)
<b>Total other income (expense), net</b>	<b>1,712</b>	<b>2,925</b>	<b>8,446</b>	<b>(15,858)</b>
<b>Income (loss) before provision for income taxes</b>	<b>14,937</b>	<b>(5,464)</b>	<b>88,843</b>	<b>(51,311)</b>
<b>Provision for income taxes</b>		<b>62</b>	<b>3,427</b>	<b>124</b>
<b>Net income (loss)</b>	<b>\$ 14,937</b>	<b>\$ (5,526)</b>	<b>\$ 85,416</b>	<b>\$ (51,435)</b>
<b>Net income (loss) per common share:</b>				
Basic	\$ 0.16	\$ (0.07)	\$ 0.93	\$ (1.34)
Diluted	\$ 0.15	\$ (0.07)	\$ 0.88	\$ (1.34)
<b>Weighted average shares used in computing net income (loss) per common share:</b>				
Basic	92,888	84,017	92,087	38,419

Edgar Filing: INFINERA CORP - Form 10-Q

Diluted	97,208	84,017	97,061	38,419
---------	--------	--------	--------	--------

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

**Table of Contents****INFINERA CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	<b>Nine Months Ended</b>	
	<b>September 27, 2008</b>	<b>September 29, 2007</b>
<b>Cash Flows from Operating Activities:</b>		
Net income (loss)	\$ 85,416	\$ (51,435)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	8,877	7,150
Amortization of debt discount		282
Accretion of investment discount	(881)	
Asset impairment charges		393
Stock-based compensation expense	17,843	5,973
Excess tax benefit from stock option transactions	(2,588)	
Tax benefit from stock option transactions	2,588	
Revaluation of warrant liabilities		19,761
Gain on disposal of assets	(1,006)	(2,409)
Other loss (gain)	7	(73)
Changes in assets and liabilities:		
Accounts receivable	(8,478)	1,147
Inventory	(701)	3,215
Prepaid expenses and other current assets	(3,142)	(1,234)
Deferred inventory costs	71,626	(12,764)
Other non-current assets	(1,964)	(1,266)
Accounts payable	7,777	(14,692)
Accrued liabilities and other expenses	(8,723)	(2,694)
Deferred revenue	(141,981)	46,197
Accrued warranty	684	6,653
Net cash provided by operating activities	25,354	4,204
<b>Cash Flows from Investing Activities:</b>		
Purchase of available-for-sale investments	(172,875)	(111,294)
Proceeds from sale of investments	103,190	12,000
Proceeds from maturities of investments and restricted cash	122,899	
Proceeds from disposal of assets	1,080	2,781
Purchase of property and equipment	(15,152)	(11,710)
Net cash provided by (used in) investing activities	39,142	(108,223)
<b>Cash Flows from Financing Activities:</b>		
Principal payments on loan obligation		(35,401)
Proceeds from loans		7,119
Proceeds from initial public offering, net of issuance costs		190,078
Proceeds from issuance of common stock	11,242	2,097
Excess tax benefit from stock option transactions	2,588	
Proceeds from exercise of warrants		45
Repurchase of common stock	(30)	(50)
Net cash provided by financing activities	13,800	163,888



Edgar Filing: INFINERA CORP - Form 10-Q

Effect of exchange rate changes	(66)	70
Net change in cash and cash equivalents	78,230	59,939
Cash and cash equivalents at beginning of period	91,209	28,884

Cash and cash equivalents at end of period	\$ 169,439	\$ 88,823
--	------------	-----------

**Supplemental disclosures of cash flow information:**

Cash paid for interest	\$ 3	\$ 2,473
Cash paid for income taxes	\$ 858	\$ 62

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

---

**Table of Contents**

**INFINERA CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Description of Business**

Infinera Corporation (Infinera or the Company), headquartered in Sunnyvale, California, was founded in December 2000 and incorporated in the State of Delaware. Infinera has developed a digital optical networking system (DTN System) and began commercial shipment of its DTN System in November 2004. Infinera's DTN System is unique in its use of a breakthrough semiconductor technology: the photonic integrated circuit (PIC). Infinera's DTN System and PIC technology are designed to provide optical networks with simpler and more flexible engineering and operations, faster time-to-service, and the ability to rapidly deliver differentiated services without reengineering their optical infrastructure.

In June 2007, the Company completed its initial public offering (IPO) of common stock in which it sold and issued 16.1 million shares of its common stock, including 2.1 million shares sold pursuant to the underwriters' full exercise of their over-allotment option, at an issue price of \$13.00 per share. The Company raised a total of \$209.3 million in gross proceeds from its IPO, or \$190.1 million in net proceeds after deducting underwriting discounts and commissions of \$14.7 million and other offering costs of \$4.5 million. Upon the closing of the IPO, all shares of convertible preferred stock outstanding automatically converted into 59.4 million shares of common stock.

In November 2007, the Company completed its follow-on offering of common stock in which it sold and issued 5.0 million shares of its common stock, at an issue price of \$22.00 per share. The Company raised a total of \$110.0 million in gross proceeds, or approximately \$104.0 million in net proceeds after deducting underwriting discounts of \$5.2 million and other offering costs of approximately \$0.8 million. Additionally, 5.0 million shares were sold by existing stockholders of the Company at a price of \$22.00 per share. The Company did not receive any of the proceeds from the shares sold by the selling stockholders.

**2. Basis of Presentation**

***Basis of Financial Statements***

The Company prepared its interim condensed consolidated financial statements that accompany these notes in conformity with U.S. generally accepted accounting principles (GAAP), consistent in all material respects with those applied in the Company's annual report on Form 10-K for the year ended December 29, 2007. The condensed consolidated balance sheet as of December 29, 2007 has been derived from the audited consolidated financial statements included in the company's Annual Report on Form 10-K for the year ended December 29, 2007. The interim financial information is unaudited, but reflects all normal adjustments that are, in management's opinion, necessary to provide a fair statement of results for the interim periods presented. This interim information should be read in conjunction with the audited consolidated financial statements and related notes contained in the Company's annual report on Form 10-K. The Company reclassified certain amounts reported in previous periods to conform to the current presentation.

***Use of Estimates***

The condensed consolidated financial statements are prepared in accordance with GAAP. These accounting principles require the Company to make certain estimates, assumptions and judgments that can affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the condensed consolidated financial statements, as well as the reported amounts of revenue and expenses during the periods presented. Significant estimates, assumptions and judgments made by management include revenue recognition, warranty reserve, cash, cash equivalents and short and long-term investments, inventory valuation, stock based compensation and accounting for income taxes. Management believes that the estimates and judgments upon which the Company relies are reasonable based upon information available to it at the time that these estimates and judgments are made. To the extent there are material differences between these estimates and actual results, the Company's condensed consolidated financial statements will be affected.

**3. Accounting Changes**

## Edgar Filing: INFINERA CORP - Form 10-Q

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities including an amendment of FASB Statement No. 115* ( SFAS No. 159 ). SFAS No. 159 expands the use of fair value accounting but does not affect existing standards which require assets or liabilities to be carried at fair value. The objective of SFAS No. 159 is to improve financial reporting by providing companies with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. Under SFAS No. 159, a company may elect to use fair value to measure eligible items at specified election dates and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. Eligible items include,

**Table of Contents**

but are not limited to, accounts and loans receivable, available-for-sale and held-to-maturity securities, equity method investments, accounts payable, guarantees, issued debt and firm commitments. If elected, SFAS No. 159 is effective for fiscal years beginning after November 15, 2007. The Company did not elect to use fair value to measure its eligible items.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework and gives guidance regarding the methods used for measuring fair value, and expands disclosures about fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods of those fiscal years. In February 2008, the FASB released a FASB Staff Position (FSP FAS 157-2 *Effective Date of FASB Statement No. 157*) which delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008. In October 2008, the FASB released a FASB Staff Position (FSP FAS 157-3 *Determining the fair value of a financial asset when the market for that asset is not active*) which clarifies the application of SFAS No. 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. The adoption of SFAS No. 157 for financial assets and liabilities had no impact on the Company's condensed consolidated financial position, results of operations or cash flows. See Note 5 Investments and Fair Value Measurements.

Commencing in June 2007, the Company elected to use the simplified method to estimate the expected term as permitted by U.S. Securities and Exchange Commission ( SEC ) Staff Accounting Bulletin 107 ( SAB 107 ) due to the unknown effect on option holder behavior of the increased liquidity of the underlying options following the Company's IPO. In December 2007, the SEC released Staff Accounting Bulletin No. 110 ( SAB 110 ). SAB 110 amends SAB 107 to allow for the continued use, under certain circumstances, of the simplified method in developing an estimate of the expected term of plain vanilla stock options accounted for under SFAS 123(R). As a result, the Company will continue to use the simplified method until it has sufficient historical data to provide a reasonable basis to estimate the expected term.

**4. Summary of Significant Accounting Policies**

The Company believes the following critical accounting policies reflect its more significant judgments and estimates used in the preparation of its condensed consolidated financial statements.

**Revenue Recognition**

The Company's networking products are generally integrated with software that is more than incidental to the functionality of the equipment. Accordingly, the Company accounts for revenue in accordance with Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*. The Company recognizes product revenue when all of the following have occurred: (1) it has entered into a legally binding arrangement with a customer; (2) delivery has occurred, which is when product title and risk of loss have transferred to the customer; (3) customer payment is deemed fixed or determinable; and (4) collectability is reasonably assured. Revenue is recognized net of cash discounts.

Substantially all of the Company's product sales are sold in combination with support services comprised of either software warranty or software subscription services. In addition, the Company periodically sells training and installation and deployment services with its product sales. Software warranty provides customers with maintenance releases and patches during the warranty support period. Software subscription includes software warranty support and in addition, provides customers with rights to receive unspecified software product upgrades released during the support period. Training services include the right to a specified number of training classes over the term of the arrangement. Installation and deployment services may include customer site assessments, equipment installation and testing.

Product revenue consists of products that are sold without services or bundled products that are sold with services for which VSOE of fair value has already been established and therefore, is recognized upfront under the residual method in accordance with Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transaction*. The Company uses the residual method to recognize revenue when a sales agreement includes one or more elements to be delivered at a future date and vendor specific objective evidence ( VSOE ) of fair value of all undelivered elements exists. VSOE of fair value for software warranty, software subscription, training and installation and deployment services is determined by reference to the price the customer will be required to pay when these services are sold separately.

Prior to the first quarter of 2008, the Company had not established VSOE of fair value for its support services, and therefore recognized all revenue for transactions bundled with these services ratably over the longest support period which ranges from one to five years. Revenue related to these arrangements is included in ratable product and related support and services revenue. The Company determined that it had

## Edgar Filing: INFINERA CORP - Form 10-Q

established VSOE of fair value for software subscription in the first quarter and for training and installation and deployment services in the second quarter of 2008. For arrangements with multiple elements which include product and software subscription services and or training and installation and deployment services, the Company allocates revenue to the

## **Table of Contents**

undelivered elements using the residual method based on VSOE of fair value for each such element and the remainder is recognized as product revenue. However, when these transactions also include undelivered services for which VSOE of fair value has not been established, revenue is deferred and recognized ratably over the longest remaining support period. Upon completion of the services for which VSOE of fair value has not been established, the difference between the VSOE of fair value for the remaining related service periods and the remaining unrecognized portion of the arrangement fee is recognized as ratable product and related support and services revenue.

Services revenue includes software subscription services, training, installation and deployment services and extended hardware warranty services. Revenue from software subscription and extended hardware warranty contracts is deferred and is recognized ratably over the contractual support period, which is generally one year. A majority of the Company's customers have exercised the option to purchase software subscription services on an ongoing basis. Revenue related to training and installation and deployment services is recognized as the services are completed.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. In addition, shipping documents and customer acceptance, when applicable, are used to verify delivery and transfer of title. Revenue is recognized only when title and risk of loss pass to customers. In instances where acceptance of the product is specified by the customer, revenue is deferred until all such customer-specific acceptance criteria have been met. The Company assesses whether the fee is fixed or determinable based on the payment terms associated with the transaction. Payment terms to customers generally range from net 30 to 120 days from invoice. In the event payment terms are provided that differ from the Company's standard business practices, the fees are deemed to not be fixed or determinable and, therefore, revenue is not recognized until the fees become fixed or determinable which the Company believes is when they are legally due and payable. The Company assesses the ability to collect from its customers based primarily on the creditworthiness and past payment history of the customer.

For sales to resellers, the same revenue recognition criteria apply. It is the Company's practice to identify an end user prior to shipment to a reseller. The Company does not offer rights of return or price protection to its resellers.

Shipping charges billed to customers are included in product revenue and in ratable product and related support and services revenue.

### ***Stock-Based Compensation***

Under SFAS 123(R), the Company estimated the fair value of the stock options granted and rights to acquire stock using the Black-Scholes option pricing formula and a single option award approach. For new-hire grants, options typically vest with respect to 25% of the shares one year after the option's vesting commencement date and the remainder ratably on a monthly basis over three years, commencing one year after the vesting commencement date. For annual refresh grants, options typically vest ratably on a monthly basis over five years after the vesting commencement date. The Company makes a number of estimates and assumptions related to SFAS 123(R) including forfeiture rate, expected life and volatility. The Company utilized its historical data as an estimate of the expected forfeiture rate and it recognized compensation costs only for those equity awards expected to vest. The effect of adjusting the forfeiture rate for all expense amortization is recognized in the period the forfeiture estimate is changed. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from the Company's estimates, such amounts will be recorded as an adjustment in the period estimates are revised. Actual results may differ substantially from these estimates.

The expected term of options granted represents the period of time that options granted are expected to be outstanding, which incorporates the contractual terms, grant vesting schedules and terms and expected employee and director behaviors. Commencing in June 2007, the Company elected to use the simplified method to estimate the expected term as permitted by SEC Staff Accounting Bulletin 107 (SAB 107) due to the unknown effect on option holder behavior of increased liquidity of the underlying options following the Company's IPO. In December 2007, the SEC released Staff Accounting Bulletin No. 110 (SAB 110). SAB 110 amends SAB 107 to allow for the continued use, under certain circumstances, of the simplified method in developing an estimate of the expected term of plain vanilla stock options accounted for under SFAS 123(R). As a result, the Company will continue to use the simplified method until it has sufficient historical data to provide a reasonable basis to estimate the expected term.

**Table of Contents**

Expected volatility of the stock is based on the Company's peer group in the industry in which the Company does business because the Company does not have sufficient historical volatility data for its own common stock. In the future, as the Company gains historical data for volatility in its own stock and more data on the actual term employees hold their options, the expected volatility and expected term may change, which could substantially change the grant-date fair value of future awards of stock options and ultimately the expense the Company records.

During the three and nine months ended September 27, 2008, the Company granted options to employees and directors to purchase an aggregate of 35,000 and 2.4 million shares of common stock at weighted average exercise prices of \$8.31 and \$12.84 per share, respectively. These options have exercise prices equal to the closing market value of the Company's common stock on the dates these options were granted. The Company's current practice is to grant options to senior directors and above, and restricted stock units (RSUs) to all employees except for executive officers.

The weighted average estimated values of employee stock option grants and rights granted under the 2000 Stock Plan and the 2007 Equity Incentive Plan, as well as the weighted average assumptions used in calculating these values during the three and nine months ended September 27, 2008 and September 29, 2007 were based on estimates at the date of grant as follows:

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
<b>Employee and Director Stock Options</b>				
Volatility	71%	79% - 81%	65% - 74%	62% - 84%
Risk-free interest rate	3.47%	4.7%	3.07% - 3.53%	4.5% - 4.9%
Expected Life	6.1 years	6.1 - 6.3 years	5.3 - 6.3 years	4.3 - 6.3 years
Estimated fair value	\$5.34 - \$5.55	\$13.67 - \$17.04	\$5.34 - \$9.44	\$2.12 - \$17.04

Concurrent with the IPO in June 2007, the Company established the 2007 Employee Stock Purchase Plan (ESPP). This plan provides for consecutive six-month offering periods, except for the first such offering period which commenced on June 7, 2007 and ended on February 15, 2008. The Black-Scholes option pricing model is used to estimate the fair value of rights to acquire stock granted under the ESPP. Compensation cost related to the ESPP under FAS123(R) was approximately \$1.0 million and \$2.0 million for the three and nine months ended September 27, 2008 and the fair value of the ESPP shares were estimated at the date of grant using the following assumptions:

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
<b>Employee Stock Purchase Plan</b>				
Volatility	55%	49%	55% - 65%	49%
Risk-free interest rate	1.92%	4.97%	1.92% - 2.12%	4.97%
Expected life	0.5 years	0.7 years	0.5 years	0.7 years
Estimated fair value	\$3.51	\$4.17	\$3.51 - \$4.42	\$4.17

The Company began issuing RSUs in the second quarter of 2007 pursuant to the Company's 2007 Equity Incentive Plan. An RSU is a right to receive a share of the Company's common stock when the unit vests, subject to continuing service with the Company on each vesting date. During the three and nine months ended September 27, 2008, the Company granted RSUs to employees to purchase an aggregate of 0.2 million shares and 1.7 million shares, respectively, of common stock at no cost, vesting annually over four or five years. The Company accounted for the fair value of the RSUs using the closing market price of the Company's common stock on the date of grant.

**Table of Contents**

The following table summarizes the effects of stock-based compensation related to employee and director awards, employee non-recourse notes and non-employee awards on the Company's condensed consolidated balance sheets and statements of operations for the three and nine months ended September 27, 2008 and September 29, 2007, respectively (in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 27, 2008</b>	<b>September 29, 2007</b>	<b>September 27, 2008</b>	<b>September 29, 2007</b>
<b>Stock-based compensation effects in inventory</b>				
Beginning balance	\$ 1,758	\$ 2,429	\$ 2,215	\$ 81
Stock-based compensation expense added to inventory	794	158	2,187	2,621
Stock-based compensation expense released from inventory to cost of revenue	(971)	(19)	(2,594)	(26)
Stock-based compensation expense released from inventory to deferred inventory costs	(26)	(307)	(253)	(415)
Closing balance	\$ 1,555	\$ 2,261	\$ 1,555	\$ 2,261
<b>Stock-based compensation effects in deferred inventory cost</b>				
Beginning balance	\$ 428	\$ 98	\$ 947	\$ 23
Stock-based compensation expense added from inventory	26	307	253	415
Stock-based compensation expense recognized released from inventory to cost of revenue	(209)	(70)	(955)	(103)
Closing balance	\$ 245	\$ 335	\$ 245	\$ 335
<b>Stock-based compensation effects in income (loss) before provision for income taxes</b>				
Cost of revenue	\$ 299	\$ 143	\$ 778	\$ 254
Research and development	1,870	1,113	4,722	2,436
Sales and marketing	1,250	689	3,264	1,122
General and administration	1,956	1,129	5,530	2,032
	5,375	3,074	14,294	5,844
Cost of revenue - amortization from balance sheet*	1,180	89	3,549	129
<b>Total stock-based compensation expense</b>	<b>\$ 6,555</b>	<b>\$ 3,163</b>	<b>\$ 17,843</b>	<b>\$ 5,973</b>

\* Represents stock-based compensation expense deferred to inventory and deferred inventory costs in prior periods and recognized in the current period.

**Inventory Valuation**

Inventories consist of raw materials, work-in-process and finished goods and are stated at standard cost adjusted to approximate the lower of actual cost (first-in, first-out method) or market. Market value is based upon an estimated selling price reduced by the estimated cost of disposal. The determination of market value involves numerous judgments including estimated average selling prices based upon recent sales volumes, industry trends, existing customer orders, current contract price, future demand and pricing for its products and technological obsolescence of the Company's products.

Inventory that is obsolete or in excess of the Company's forecasted demand or is anticipated to be sold at a loss is written down to its estimated net realizable value based on historical usage and expected demand. The Company's forecasted demand is an estimate that requires significant judgment. To the extent there are material differences between the estimated forecasted demand and actual demand and the Company cannot effectively respond to these changes, the Company's condensed consolidated financial statements may be materially affected.



## Edgar Filing: INFINERA CORP - Form 10-Q

The Company recorded inventory write-downs for excess and obsolete inventory in the three and nine months ended September 27, 2008 of \$0.9 million and \$4.5 million, respectively, and in the three and nine months ended September 29, 2007 of \$1.7 million and \$4.2 million, respectively. In addition, the Company recorded total inventory write-downs for lower of cost or market ( LCM ) adjustments in the three and nine months ended September 27, 2008 of \$3.0 million and \$3.5 million, respectively, and in the three and nine months ended September 29, 2007 of \$3.2 million and \$6.5 million, respectively. These write-downs for excess and obsolete inventory and LCM adjustments were reflected as cost of product and cost of ratable product and related support and services.

In valuing its deferred inventory costs, the Company considered the valuation of inventory using the guidance of Accounting Research Bulletin 43 *Restatement and Revision of Accounting Research Bulletins* ( ARB 43 ). In particular, the Company considered ARB 43, Chapter 4, Statement 5 and whether the utility of the products delivered or expected to be delivered at less than cost, primarily comprised of common equipment, had declined. The Company concluded that, in the instances where the utility of the products delivered or expected to be delivered were less than cost, it was appropriate to value the deferred inventory costs and

**Table of Contents**

inventory costs at cost or market, whichever is lower, thereby recognizing the cost of the reduction in utility in the period in which the reduction occurred or can be reasonably estimated. The Company has, therefore, recorded inventory write-downs as necessary in each period in order to reflect common equipment inventory at the lower of cost or market. In addition, the Company considered the guidance provided in ARB 43, Chapter 4, Statement 10 relating to losses on firm purchase commitments related to inventory items. Given that the expected selling price of common equipment in the future remains below cost, the Company has also recorded losses on these firm purchase commitments in the period in which the commitment is made. When the inventory parts related to these firm purchase commitments are received, that inventory is recorded at the purchase price less the accrual for the loss on the purchase commitment.

If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

***Warranty Reserve***

The Company warrants that its products will operate substantially in conformity with product specifications. Upon delivery of the Company's products, the Company provides for the estimated cost to repair or replace products or the related components that may be returned under warranty. The Company's hardware warranty periods range from 1 to 5 years from date of acceptance for hardware and 90 days to 60 months for software warranty. The hardware warranty reserve is based on actual historical returns experience and the impact of the returns rate on future estimated returns. The Company periodically assesses the adequacy of its recorded warranty liabilities and adjusts the amounts as necessary.

***Cash, Cash Equivalents and Short-term and Long-term Investments***

The Company considers all liquid instruments with an original maturity at the date of purchase of 90 days or less to be cash equivalents. The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits. The Company has not experienced any losses in such accounts.

The Company considers all debt instruments with remaining time to maturity of one year or less to be short-term investments. At September 27, 2008 and December 29, 2007, cash equivalents and short and long-term investments consisted primarily of money market funds, commercial paper, corporate bonds, U.S. agency notes, U.S. treasuries and adjustable rate securities. The Company's cash equivalents and short and long-term investments are classified as available-for-sale in accordance with the provisions of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

All cash, cash equivalents and short and long-term investments are stated at fair market value with unrealized gains and losses reported in accumulated comprehensive loss as a separate component of stockholders' equity. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity, both of which are included in interest income. Gains are recognized when realized in the Company's condensed consolidated statements of operations. Losses are recognized as realized or when the Company has determined that an other-than-temporary decline in fair value has occurred. Gains and losses are determined using the specific identification method.

In accordance with SFAS No. 115, it is the Company's policy to review its marketable debt securities classified as short or long-term investments on a regular basis to evaluate whether or not any security has experienced an other-than-temporary decline in fair value. The Company's policy includes, but is not limited to, reviewing the length of time and extent to which the market value has been less than amortized cost, the financial condition and near-term prospects of the issuer, and its intent and ability to retain its investment in the issuer for a sufficient period of time to allow for recovery in market value. If the Company believes that an other-than-temporary decline exists in one of its marketable debt securities, its policy is to write down these debt investments to the market value and record the related write-down as an investment loss on its condensed consolidated statements of operations. No other-than-temporary impairment charges were recorded for the three and nine months ended September 27, 2008 and September 29, 2007. See Note 5 to the Condensed Consolidated Financial Statements for further information regarding unrealized losses recorded as of September 27, 2008.

***Accounting for Income Taxes***

As part of the process of preparing the Company's condensed consolidated financial statements, the Company is required to estimate its taxes in each of the jurisdictions in which it operates. The Company estimates actual current tax expense together with assessing temporary differences resulting from differing treatment of items, such as accruals and allowances not currently deductible for tax purposes. These differences result in deferred tax assets and liabilities, which are included in the Company's condensed consolidated balance sheets. In general, deferred tax assets represent future tax benefits to be received when certain expenses previously recognized in the Company's condensed consolidated statements of operations become deductible expenses under applicable income tax laws or loss or credit carry-forwards are utilized. Accordingly, realization of the Company's deferred tax assets is dependent on future taxable income within the respective jurisdictions against which these deductions,

losses and credits can be utilized within the applicable future periods.

**Table of Contents**

The Company must assess the likelihood that some portion or all of its deferred tax assets will be recovered from future taxable income within the respective jurisdictions, and to the extent the Company believes that recovery does not meet the more-likely-than-not standard, it must establish a valuation allowance. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management judgment is required in determining the Company's provision for income taxes, its deferred tax assets and liabilities and any valuation allowance recorded against its net deferred tax assets. At September 27, 2008 and December 29, 2007, certain of the Company's deferred tax assets were fully reserved with a valuation allowance because, based on the available evidence, the Company believed at that time it was more likely than not that it would not be able to utilize those deferred tax assets in the future. The Company intends to maintain valuation allowances until sufficient evidence exists to support the reversal of the valuation allowances. The Company makes estimates and judgments about its future taxable income, by jurisdiction, based on assumptions that are consistent with its plans and estimates. Should the actual amounts differ from the Company's estimates, the amount of its valuation allowance could be materially impacted.

**5. Investments and Fair Value Measurements****Available-for-sale Investments**

The following is a summary of available-for-sale investments as of September 27, 2008 and December 29, 2007 (in thousands):

	September 27, 2008				December 29, 2007			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Money market funds	\$ 80,762	\$	\$	\$ 80,762	\$ 35,857	\$	\$	\$ 35,857
Commercial paper	36,928			36,928	74,352	12	(8)	74,356
Corporate bonds	24,453		(332)	24,121	49,796	47	(29)	49,814
U.S. agency notes	10,000		(16)	9,984	21,945	6	(5)	21,946
U.S. treasuries	72,491	84		72,575				
Adjustable rate securities	75,650		(6,818)	68,832	96,150			96,150
Total available-for-sale investments	\$ 300,284	\$ 84	\$ (7,166)	\$ 293,202	\$ 278,100	\$ 65	\$ (42)	\$ 278,123

The longest time that individual securities included in available-for-sale investments have been in a continuous unrealized loss position, is seven months.

The following is a summary of the carrying values and balance sheet classification as of September 27, 2008 and December 29, 2007 (in thousands):

	September 27, 2008	December 29, 2007
Available-for sale investments	\$ 293,202	\$ 278,123
Cash in banks	28,591	24,370
Restricted cash	2,799	3,337
Total	\$ 324,592	\$ 305,830
Reported as:		
Cash and cash equivalents	\$ 169,439	\$ 91,209
Short-term investments	78,551	181,168
Short-term restricted cash	840	743
Long-term investments	73,803	30,116

## Edgar Filing: INFINERA CORP - Form 10-Q

Long-term restricted cash	1,959	2,594
<b>Total</b>	<b>\$ 324,592</b>	<b>\$ 305,830</b>

As of September 27, 2008, the Company held approximately \$68.8 million at fair value of municipal note investments with an auction reset feature ( adjustable rate securities ) whose underlying assets are generally student loans which are substantially backed by the federal government under the Federal Family Education Loan Programs ( FFELP ) and are currently rated AAA by a rating agency. In February 2008, auctions began to fail for these securities and each auction since then has failed. The Company has since been unable to liquidate the securities. Based on the overall failure rate of these auctions, the frequency of the failures, and the underlying maturities of the securities, which range from 22 years to 39 years, the Company has classified these investments as

**Table of Contents**

long-term assets on the balance sheet. These investments were valued at fair value as of September 27, 2008, and the Company recorded an unrealized loss of \$6.8 million under Accumulated Other Comprehensive Income (Loss) in the accompanying condensed consolidated balance sheets under Stockholders' Equity as of September 27, 2008 related to these adjustable rate securities.

**Fair Value Measurement**

SFAS No. 157 clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. As such, fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. As a basis for considering such assumptions, SFAS No. 157 establishes a three-tier value hierarchy, which prioritizes the inputs used in measuring fair value as follows: (Level I) observable inputs such as quoted prices in active markets; (Level II) inputs other than the quoted prices in active markets that are observable either directly or indirectly; and (Level III) unobservable inputs in which there is little or no market data, which requires the Company to develop its own assumptions. This hierarchy requires the Company to use observable market data, when available, and to minimize the use of unobservable inputs when determining fair value. On a recurring basis, the Company measures its investments and marketable securities at fair value. The majority of the Company's cash and investment instruments are classified within Level I or Level II of the fair value hierarchy because they are valued using quoted market prices, market prices for similar securities, or alternative pricing sources with reasonable levels of price transparency. The types of instruments valued based on quoted market prices in active markets includes the Company's money market funds and U.S. treasuries. Such instruments are generally classified within Level I of the fair value hierarchy. The types of instruments valued based on other observable inputs includes the Company's U.S. government agency notes, corporate bonds and commercial paper. Such instruments are classified within Level II of the fair value hierarchy. The types of instruments valued based on unobservable inputs in which there is little or no market data and the unobservable inputs are significant to the fair value measurement includes the Company's adjustable rate securities, or ARS. As of December 29, 2007, these securities were valued at par value based on successful market auction data and were classified within Level II of the fair value hierarchy. However, as a result of auction failures related to these securities, these market inputs were not available as of September 27, 2008. A discounted cash flow model has therefore been used to determine the estimated fair value of the Company's investment in ARS as of September 27, 2008. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, discount rates and timing and amounts of cash flows, including assumptions about the expected holding periods of these securities. Such instruments are generally classified as Level III of the fair value hierarchy.

In accordance with SFAS 157, the following table represents the Company's fair value hierarchy for its marketable securities measured at fair value as of September 27, 2008 (in thousands):

	September 27, 2008			Total
	Level I	Level II	Level III	
Money market funds	\$ 80,762	\$	\$	\$ 80,762
Commercial paper		36,928		36,928
Corporate bonds		24,121		24,121
U.S. agency notes		9,984		9,984
U.S. treasuries	72,575			72,575
Adjustable rate securities			68,832	68,832
Total available-for-sale investments	\$ 153,337	\$ 71,033	\$ 68,832	\$ 293,202

Unrealized losses associated with Level III financial instruments were classified as Accumulated Other Comprehensive Income (Loss) in the accompanying condensed consolidated balance sheets under Stockholders' Equity. Unrealized losses associated with Level III financial instruments were approximately \$6.8 million as of September 27, 2008.

**Table of Contents**

The following table summarizes the change in balance sheet carrying value associated with Level III financial instruments carried at fair value during the three and nine months ended September 27, 2008 (in thousands):

	Three Months Ended September 27, 2008					September 27, 2008
	June 29, 2008	Payment, Purchases (Sales), Net	Transfers In (Out), Net	Gains (Losses)		
				Realized	Unrealized	
Adjustable Rate Securities	\$ 70,862	\$	\$	\$	\$ (2,030)	\$ 68,832

	Nine Months Ended September 27, 2008					September 27, 2008
	December 29, 2007	Payment, Purchases (Sales), Net	Transfers In (Out), Net	Gains (Losses)		
				Realized	Unrealized	
Adjustable Rate Securities	\$	\$ (20,500)	\$ 96,150	\$	\$ (6,818)	\$ 68,832

As a result of several states' Attorney General's actions, during August 2008, several large financial institutions/broker dealers announced programs to purchase adjustable rate securities from their clients at par value. On October 24, 2008, the Company entered into a contract with one of its broker dealers to sell back \$65.7 million of adjustable rate securities at par value at anytime during a two-year period beginning June 30, 2010 through July 2, 2012. These adjustable rate securities are recorded at fair value of \$60.0 million with an unrealized loss of \$5.7 million as of September 27, 2008 in the accompanying condensed consolidated balance sheets.

This contract represents a put option which will be valued at fair value, reflecting the Company's right to recover par value for these adjustable rate securities discounted for any underlying credit risk associated with the broker dealer and the timing of the cash flows. The difference between the fair value of this put option and any unrealized loss on these adjustable rate securities will be recorded in the Company's condensed consolidated statements of operations for the quarter ended December 27, 2008. The put option and the adjustable rate securities will be revalued to fair market value on a quarterly basis until the sale of these securities has been completed.

**6. Balance Sheet Components*****Restricted Cash***

As of September 27, 2008, the Company had short-term restricted cash of \$0.8 million and long-term restricted cash of \$2.0 million. As of December 29, 2007, the Company had short-term restricted cash of \$0.7 million and long-term restricted cash of \$2.6 million. The Company's restricted cash balances are comprised of certificates of deposit, of which the majority are not FDIC insured. These amounts primarily collateralize the Company's issuances of stand-by and commercial letters of credit.

***Inventory***

Inventory is comprised of the following (in thousands):

	September 27, 2008	December 29, 2007
Raw materials	\$ 10,045	\$ 10,475
Work in process	35,772	35,110
Finished goods	12,803	12,994
Total inventory	\$ 58,620	\$ 58,579

## Edgar Filing: INFINERA CORP - Form 10-Q

Included in finished goods inventory at September 27, 2008 and December 29, 2007 were \$5.5 million and \$1.5 million, respectively, of inventory at customer locations for which product acceptance had not occurred.



**Table of Contents*****Property, plant and Equipment, Net***

Property, plant and equipment, net, is comprised of the following (in thousands):

	September 27, 2008	December 29, 2007
Computer hardware	\$ 5,353	\$ 4,267
Computer software	3,635	3,111
Laboratory and manufacturing equipment	61,867	50,897
Furniture and fixtures	604	805
Leasehold improvements	13,949	12,438
	\$ 85,408	\$ 71,518
Less accumulated depreciation and amortization	(42,548)	(34,545)
Property, plant and equipment, net	\$ 42,860	\$ 36,973

Depreciation for the three and nine months ended September 27, 2008 was \$3.4 million and \$8.9 million, respectively, and depreciation for the three and nine months ended September 29, 2007 was \$2.7 million and \$6.7 million, respectively.

***Intangible Assets***

Other intangible assets, net are comprised of the following (in thousands):

	September 27, 2008			December 29, 2007		
	Gross Carrying Amount	Accumulated Amortization	Net	Gross Carrying Amount	Accumulated Amortization	Net
Patents & developed technology	\$ 1,628	\$ (454)	\$ 1,174	\$ 1,628	\$ (317)	\$ 1,311
Assembled workforce and other	370	(202)	168	370	(140)	230
Total intangible assets	\$ 1,998	\$ (656)	\$ 1,342	\$ 1,998	\$ (457)	\$ 1,541

***Accrued Expenses***

Accrued expenses are comprised of the following (in thousands):

	September 27, 2008	December 29, 2007
Loss contingency related to purchase commitments	\$ 1,399	\$ 1,880
Customer prepay liability	449	1,109
Tax payable	2,389	855
Other accrued expenses	5,923	5,653
Total accrued expenses	\$ 10,160	\$ 9,497



**Table of Contents****7. Comprehensive Income (Loss)**

Comprehensive income (loss) consists of other comprehensive income (loss) and net income (loss). Other comprehensive income (loss) includes certain changes in equity that are excluded from net income (loss). Specifically, cumulative foreign currency translation adjustments and unrealized holding gains (losses) on available-for-sale investments are included in accumulated other comprehensive income (loss) in the condensed consolidated balance sheets.

The components of accumulated other comprehensive income (loss) are as follows (in thousands):

	September 27, 2008	December 29, 2007
Accumulated net unrealized gain (loss) on foreign currency translation adjustment	\$ (549)	\$ 55
Net unrealized holding gain (loss) on available-for-sale investments	(7,082)	23
<b>Total accumulated other comprehensive income (loss)</b>	<b>\$ (7,631)</b>	<b>\$ 78</b>

The following table reconciles net income (loss) to comprehensive income (loss) for the three and nine month periods ended September 27, 2008 and September 29, 2007 (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Net income (loss)	\$ 14,937	\$ (5,526)	\$ 85,416	\$ (51,435)
Other comprehensive income (loss)	(2,496)	79	(7,709)	102
<b>Total comprehensive income (loss)</b>	<b>\$ 12,441</b>	<b>\$ (5,447)</b>	<b>\$ 77,707</b>	<b>\$ (51,333)</b>

**8. Basic and Diluted Net Income (Loss) Per Common Share**

Basic net income (loss) per common share is computed by dividing net income (loss) by the weighted average number of vested common shares outstanding during the period. Diluted net income (loss) per common share was computed using net income (loss) and the weighted average number of common shares outstanding plus potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include the assumed exercise of outstanding stock options, assumed vesting of outstanding restricted stock units, assumed exercise of outstanding warrants, and assumed issuance of stock under the stock purchase plan using the treasury stock method.

The following table sets forth the computation of net income (loss) per common share (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
<b>Numerator - Basic and Diluted</b>				
Net income (loss)	\$ 14,937	\$ (5,526)	\$ 85,416	\$ (51,435)
<b>Denominator</b>				
Basic weighted average common shares outstanding	92,888	84,017	92,087	38,419
Effect of dilutive securities:				
Employee equity plans	3,955		4,559	
Warrants to purchase common stock	365		415	
Diluted weighted average common shares outstanding	97,208	84,017	97,061	38,419

## Edgar Filing: INFINERA CORP - Form 10-Q

Net income (loss) per common share - basic	\$ 0.16	\$ (0.07)	\$ 0.93	\$ (1.34)
Net income (loss) per common share - dilutive	\$ 0.15	\$ (0.07)	\$ 0.88	\$ (1.34)

For the three months ended September 27, 2008 and September 29, 2007, the Company excluded 6.0 million shares and 0.1 million shares of outstanding stock options from the calculation of diluted earnings per common share, respectively, because the exercise prices of these stock options were greater than the average market value of the common stock shares. These options could be included in the calculation in the future if the average market value of the common stock shares increases and is greater than the exercise price of these options.

**Table of Contents****9. Deferred Revenue and Deferred Inventory Costs**

Deferred revenue and deferred inventory costs consist of the following (in thousands):

	September 27, 2008	December 29, 2007
Deferred product and ratable product and related support and services, current	\$ 19,036	\$ 167,031
Deferred service revenue, current	6,408	
<b>Deferred revenue - current</b>	<b>25,444</b>	<b>167,031</b>
Deferred product and ratable product and related support and services, non-current	7,012	7,406
<b>Deferred revenue - non-current</b>	<b>7,012</b>	<b>7,406</b>
<b>Total deferred revenue</b>	<b>\$ 32,456</b>	<b>\$ 174,437</b>
Deferred inventory costs, current	\$ 6,505	\$ 78,362
Deferred inventory costs, non-current	2,787	3,260
<b>Total deferred inventory costs</b>	<b>\$ 9,292</b>	<b>\$ 81,622</b>

Deferred ratable product and related support and services revenue primarily consists of revenue on transactions where VSOE of fair value of support and other services has not been established and, therefore, the entire arrangement is being recognized ratably over the longest bundled support or service period.

**10. Commitment and Contingencies*****Purchase Commitments***

The Company has purchase agreements with its major production suppliers where the Company is committed to purchase certain parts. As of September 27, 2008 and December 29, 2007, these non-cancelable purchase commitments were \$22.1 million and \$33.7 million, respectively. The contractual obligation table below excludes the Company's FIN48 liabilities because it cannot reliably estimate such liability obligations.

The following is a summary of the Company's contractual obligations as of September 27, 2008 (in thousands):

	Total	Payments Due by Period			More than 5 years
		Less than 1 year	1 - 3 years	3 - 5 years	
Purchase obligations	\$ 22,142	\$ 22,142	\$	\$	\$
Operating leases	12,739	4,240	6,433	2,066	
<b>Total contractual obligations</b>	<b>\$ 34,881</b>	<b>\$ 26,382</b>	<b>\$ 6,433</b>	<b>\$ 2,066</b>	<b>\$</b>

***Legal Matters***

On April 11, 2007, the Company, Level 3 and Cheetah Omni LLC ( "Cheetah" ) filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. Patent and Trademark Office as to whether it will reexamine U.S. Patent

## Edgar Filing: INFINERA CORP - Form 10-Q

Nos. 6,795,605 and 7,142,347; and (2) if the U.S. Patent and Trademark Office decides to reexamine either U.S. Patent No. 6,795,605 or 7,142,347, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. Patent and Trademark Office. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. On June 26, 2007 and August 1, 2007, the U.S. Patent and Trademark Office ordered reexamination of U.S. Patents 6,795,605 and 7,142,347, respectively. As a result, all proceedings in this lawsuit are stayed until the final resolution of these reexaminations.

On March 14, 2007, the Company submitted requests to the U.S. Patent and Trademark Office for inter parts reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347 asking the U.S. Patent and Trademark Office to reexamine the patents based on prior art in order to invalidate the patents or limit the scope of each patent's claims. On March 21, 2007, the Company and Level 3 filed a motion with the court to stay all proceedings in the lawsuit pending the reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347.

**Table of Contents**

On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, the Company and Level 3 filed responses to Cheetah's third amended complaint denying all infringement claims, and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims of the patents are invalid and that the DTN System does not infringe the patents.

On May 9, 2006, the Company and Level 3 were sued by Cheetah in the U.S. District Court for the Eastern District of Texas for alleged infringement of patent No. 6,795,605, and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of the Company's DTN System and to recover all damages caused by the alleged willful infringement including any and all compensatory damages available by law, such as actual and punitive damages, attorneys' fees, associated interest and Cheetah's costs incurred in the lawsuit. Cheetah's complaint does not request a specific dollar amount for these compensatory damages. The Company is contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent its product is found to infringe, and it has assumed the defense of this matter. On July 20, 2006, the Company and Level 3 filed an amended response denying all infringement claims under patent No. 6,795,605 and asserting that the claims of the patent are invalid and that the DTN System does not infringe the patent. On November 28, 2006, Cheetah filed a second amended complaint and added patent No. 7,142,347 to the lawsuit. On December 18, 2006, the Company and Level 3 filed responses to Cheetah's second amended complaint denying all infringement claims under patent No. 7,142,347 and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims are invalid and that the DTN System does not infringe the patents.

In addition to the matters described above, the Company is subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material effect on its results of operations, financial position or cash flows.

**11. Employee Equity Incentive Plans**

The following table summarizes the Company's stock award activity and related information for the nine months ended September 27, 2008 (in thousands, except per share data):

	Share Available for Grant <sup>(1)</sup>	Awards and Options Outstanding	Weighted- Average Exercise Price Per Share	Aggregate Intrinsic Value <sup>(2)</sup>
Balance at December 29, 2007	10,198	11,742	\$ 5.98	\$ 97,808
Additional options and RSUs authorized <sup>(3)</sup>	4,579		\$	
Options granted	(2,429)	2,429	\$ 12.84	
RSUs granted	(1,672)	1,672	\$	
Options exercised		(1,339)	\$ 2.19	\$ 13,486
RSUs released		(79)	\$	\$ 662
Options canceled	691	(691)	\$ 7.96	
RSUs canceled	79	(79)	\$	
Balance at September 27, 2008	11,446	13,655	\$ 6.81	\$ 65,648

(1) Shares available for grant under the 2000 plan and 2007 plan, as applicable. The Company does not intend to grant any additional options or other awards under the 2000 Plan.

(2) The aggregate intrinsic value of unexercised options and unvested RSUs is calculated as the difference between the exercise price of the underlying equity awards and the closing price of the Company's common stock at as of September 27, 2008. The aggregate intrinsic value of options which have been exercised is calculated as the difference between the fair market value of the common stock at the date of exercise and the exercise price of the underlying stock option awards.

- (3) Pursuant to the evergreen provision of the Company's 2007 Equity Incentive Plan, the number of shares reserved for issuance under the Company's 2007 Equity Incentive Plan was increased by 4.6 million shares in the first quarter of 2008 as approved by the Board of Directors.



**Table of Contents**

Options outstanding that have vested and are expected to vest as of September 27, 2008 are as follows (in thousands, except per share data and contractual term):

	Number of shares	Weighted-Average Exercise Price Per Share	Weighted-Average remaining contractual term (In years)	Aggregate Intrinsic Value <sup>(1)</sup>
Vested	4,379	\$ 5.03	7.44	\$ 26,187
Expected to vest <sup>(2)</sup>	6,932	\$ 9.93	8.65	17,731
Total vested and expected to vest	11,311	\$ 8.03	18.18	\$ 43,918
Not expected to vest	214			
Total options outstanding	11,525			

<sup>(1)</sup> These amounts represent the difference between the exercise price and the Company's closing stock price as of September 27, 2008.

<sup>(2)</sup> Options outstanding that are expected to vest are net of estimated future option forfeitures in accordance with the provisions of SFAS No. 123(R).

Information with respect to restricted stock units as of September 27, 2008 is as follows (in thousands, except per share data):

	Number of Shares	Weighted Average Grant-Date Fair Value	Aggregate Fair Value <sup>(1)</sup>
Outstanding at December 29, 2007	616	\$ 20.08	
Granted	1,672	\$ 12.54	
Vested	(79)	\$ 19.71	\$ 662
Canceled	(79)	\$ 15.52	
Outstanding at September 27, 2008	2,130	\$ 14.34	

<sup>(1)</sup> Represents the value of Infinera stock on the date that the restricted stock units vest.

As of September 27, 2008, there were 2.1 million RSUs outstanding; 1.8 million RSUs are expected to vest and 0.3 million RSUs are not expected to vest. As of September 27, 2008, 79,000 RSUs were vested.

**12. Income Taxes**

The effective tax rate of 3.82% for the nine months ended September 27, 2008 differs from the statutory rate of 35% primarily due to the tax benefits resulting from the release of valuation allowances on tax attribute carry-forwards which was partially offset by the impact of certain stock compensation charges under SFAS 123(R), alternative minimum tax and state income taxes. During the quarter ended September 27,

## Edgar Filing: INFINERA CORP - Form 10-Q

2008, the Company recorded a one-time anticipated benefit of \$290,000 related to refundable research and development tax credits due to the enactment of the Housing and Economic Recovery Act of 2008, signed into law on July 30, 2008.

Tax deductions associated with stock option exercises related to grants vesting prior to January 1, 2006 are credited to stockholders' equity. Tax deductions in excess of prior book expenses under SFAS 123(R) associated with stock option exercises related to grants vesting on or after January 1, 2006 are also credited to stockholders' equity. The reductions of income taxes payable resulting from the exercise of employee stock options and other employee stock programs that were credited to stockholders' equity were approximately \$2.6 million for the nine months ended September 27, 2008.

**Table of Contents**

During the three months ended March 29, 2008, the Company received an assessment resulting from an examination in India for the 2006 tax year. The Company is appealing the assessment. All uncertain tax positions have been fully reserved. The Company does not expect a material adjustment to the financial statements as a result of this inquiry.

As of September 27, 2008, the Company's U.S. regular tax expense was equally offset by U.S. income tax benefits from the utilization of Net Operating Loss ( NOL ) carry-forwards which were previously reserved with a valuation allowance. The Company also reversed approximately \$1.6 million of valuation allowance that is supportable by refundable income taxes. The Company recorded a full valuation allowance against the remainder of its net deferred tax assets due to operating losses incurred since inception. Realization of future deferred tax assets is dependent upon future earnings, if any, the timing and amount of which are uncertain. Accordingly, certain of the net deferred tax assets were fully offset by a valuation allowance. If not utilized, the federal and state net operating loss and tax credit carry-forwards will expire between 2013 and 2028. Utilization of these net operating losses and credit carry-forwards may be subject to an annual limitation due to provisions of the Internal Revenue Code of 1986, as amended, that are applicable if the Company experiences an ownership change that may occur, for example, by a change in significant stockholder allocation or equity structure. In 2007, the Company performed an analysis of these changes in ownership rules and determined that changes in ownership have occurred that would limit tax attribute carry-forwards. However, based on the work performed, the Company believes the limitations are not significant enough to materially impact future utilization of tax attributes against future taxable income.

In determining future taxable income, the Company makes assumptions to forecast federal, state and international operating income, the reversal of temporary differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with the Company's forecasts used to manage its business. The Company intends to maintain the remaining valuation allowance until sufficient further positive evidence exists to support a reversal of, or decrease, in the valuation allowance.

At September 27, 2008, the cumulative unrecognized tax benefit was \$4.8 million compared to \$6.7 million at December 29, 2007 that was substantially netted against deferred tax assets which were previously offset with a full valuation allowance. Included in the \$4.8 million of cumulative unrecognized tax benefit, approximately \$0.2 million impacted the Company's effective tax rate during the quarter ended September 27, 2008. At September 27, 2008, the Company had \$0.3 million of unrecognized tax benefits related to uncertain tax positions recorded within current and other long-term tax liabilities. In the quarter ended September 27, 2008, the Company reduced its cumulative unrecognized tax benefit related to prior years by \$2.6 million due to the completion of a research and development tax credit study for tax years 2000 to 2007. There are minimal penalties and interest associated with these tax positions and are immaterial to the financial statements. The Company files income tax returns in the United States on a federal basis and in many U.S. state and foreign jurisdictions. The tax years 2000 to 2007 remain open to examination by the major taxing jurisdictions in which the Company is subject to tax. Over the next twelve months, the Company's existing tax positions are expected to generate an increase in total unrecognized tax benefits.

For FIN 48 purposes, the Company recognizes interest and penalties related to uncertain tax positions as part of its provision for federal, state and foreign income taxes.

**13. Segment Information**

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, establishes standards for reporting information about operating segments. Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is the Company's chief executive officer. The Company's chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. The Company has one business activity, and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, the Company is considered to be in a single reporting segment and operating unit structure.

**Table of Contents**

Revenue by geographic region is based on the shipping address of the customer. The following table sets forth revenue and long-lived assets by geographic region (in thousands):

**Revenue**

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
North America	\$ 97,833	\$ 50,473	\$ 339,865	\$ 137,708
Europe, Middle East and Africa	19,179	10,967	68,488	30,393
Asia Pacific	3,494	715	11,515	1,662
Total revenue	\$ 120,506	\$ 62,155	\$ 419,868	\$ 169,763

**Property, plant and equipment, net**

	September 27, 2008	December 29, 2007
North America	\$ 41,941	\$ 36,270
Europe, Middle East and Africa		
Asia Pacific	919	703
Total property, plant and equipment, net	\$ 42,860	\$ 36,973

**14. Guarantees****Product Warranties**

Upon delivery of products, the Company provides for the estimated cost to repair or replace products or the related components that may be returned under the hardware warranty. In general, hardware warranty periods range from 1 to 5 years. Hardware warranties provide the purchaser with protection in the event that the product does not perform to product specifications. During the warranty period, the purchaser's sole and exclusive remedy in the event of such defect or failure to perform is limited to the correction of the defect or failure by repair, refurbishment or replacement, at the Company's sole option and expense. The Company estimates the fair value of the Company's hardware warranty obligations based on the Company's historical experience of known product failure rates, use of materials to repair or replace defective products, and service delivery costs incurred in correcting product failures. In addition, from time to time, specific hardware warranty accruals may be made if unforeseen technical problems arise with specific products. Management periodically assesses the adequacy of the Company's recorded warranty liabilities and adjusts the amounts as necessary. Changes in hardware warranty liability for the three and nine months ended September 27, 2008 and September 29, 2007, respectively, are summarized below (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Balance at the beginning of the period	\$ 10,560	\$ 10,036	\$ 9,992	\$ 2,718
Charges to operations	3,037	2,654	8,502	8,324
Utilization	(1,875)	(1,387)	(5,505)	(3,122)
Changes in estimate	(1,046) <sup>(2)</sup>	(1,932) <sup>(1)</sup>	(2,313) <sup>(2)</sup>	1,451 <sup>(3)</sup>
Balance at the end of the period	\$ 10,676	\$ 9,371	\$ 10,676	\$ 9,371

- (1) The favorable change in estimate was primarily due to continued improvements in overall actual failure rates and impact of these improvements on the Company's estimate of expected future returns.
- (2) Change in estimate is primarily due to continued improvements in average return rates and reductions in the cost of replacement.
- (3) This unfavorable change in estimate primarily represented higher than expected costs of replacing defective products due to reduced usage of repaired products in the repair process. In addition, there was a specific increase in expected return rates related to a component quality issue on one specific product that ceased shipping in June 2006. This increase was based on new quality data related to that component that became available in the first quarter of 2007.

**Table of Contents**

**15. Subsequent Events**

*Emergency Economic Stabilization Act of 2008*

On October 3, 2008, the Emergency Economic Stabilization Act of 2008, which included a retroactive reinstatement of the federal research and development credit, was signed into law. The Company anticipates any tax benefit, net of FIN 48 tax liabilities, from this law will be offset by a valuation allowance and will be recorded in the fourth quarter of fiscal year 2008.

*California Assembly Bill 1452*

On September 30, 2008, California enacted Assembly Bill 1452 which among other provisions, suspends net operating loss deductions carried forward from prior years for fiscal years 2008 and 2009 and extends the carry-forward period of any net operating losses not utilized due to such suspension; adopts the federal 20-year net operating loss carry-forward period; phases-in the federal two-year net operating loss carry-back periods beginning in 2011 and limits the utilization of tax credits to 50 percent of a taxpayer's taxable income. The Company expects to record additional state tax provision, net of federal benefits as a result of this law change in the fourth quarter of fiscal year 2008.

*Adjustable Rate Securities*

As of September 27, 2008, the Company held \$75.7 million of adjustable rate securities which are recorded on the accompanying condensed consolidated balance sheet at fair value of \$68.8 million. On October 24, 2008, the Company entered into a contract with one of its broker dealers to sell back \$65.7 million of adjustable rate securities at par value at anytime during a two-year period beginning June 30, 2010 through July 2, 2012. These adjustable rate securities are recorded at fair value of \$60.0 million with an unrealized loss of \$5.7 million as of September 27, 2008 in the accompanying condensed consolidated balance sheets.

This contract represents a put option which will be valued at fair value, reflecting the Company's right to recover par value for these adjustable rate securities discounted for any underlying credit risk associated with the broker dealer and the timing of the cash flows. The difference between the fair value of this put option and any unrealized loss on these adjustable rate securities will be recorded in the Company's condensed consolidated statements of operations for the quarter ended December 27, 2008. The put option and the adjustable rate securities will be revalued to fair market value on a quarterly basis until the sale of these securities has been completed.

**Table of Contents****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 that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include any expectation of earnings, revenues or other financial items; any statements of the plans, strategies and objectives of management for future operations and personnel; factors that may affect our operating results; statements concerning new products or services; statements related to future statements regarding capital expenditures; statements related to future economic conditions or performance; market growth; statements related to repayment of our adjustable rate securities, statements related to the timing of achieving vendor specific objective evidence; statements as to industry trends and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. These statements are often identified by the use of words such as anticipate, believe, continue, could, estimate, expect, intend, may, or will, and similar expressions or variations. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included elsewhere in this Form 10-Q and in our other Securities and Exchange Commission filings, including our annual report on Form 10-K for the year ended December 29, 2007 filed on February 19, 2008. Such forward-looking statements speak only as of the date of this report. We disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. The following discussion and analysis should be read in conjunction with our Selected Condensed Consolidated Financial Data and condensed consolidated financial statements and notes thereto included elsewhere in this quarterly report on Form 10-Q.*

**Executive Overview**

Infinera was founded in December 2000 with a unique vision for optical networking. Prior to Infinera, service provider optical networks were built from fairly commoditized products, broadly known as dense wavelength division multiplexing ( DWDM ) systems. The pace of bandwidth growth in service provider networks has been significant over the last few years. Thus each year, service providers generally have been consuming more space, more power, and more of their human resources to deploy and manage their optical networks. The Infinera vision is that photonic integration offers a solution to this problem. Photonic integration is predicated upon the belief that, it is possible to generate a Moore's Law-like continuous improvement in capacity per device (or chip) to help service providers scale their network bandwidth without significant increases in space, power or operational workload.

Infinera's product offering is a digital optical networking system ( DTN System ). The DTN System uses photonic integrated circuits, or PICs, to generate 100G of optical capacity per line card. This capacity is then digitally virtualized so that it can be allocated, using software, to a variety of service types. The DTN System includes intelligent software that is designed to simplify and speed the delivery and control of optical services, and to enable advanced feature capabilities. Photonic integration provides the basis for the DTN System's power and space advantages relative to conventional DWDM systems, while the DTN System's bandwidth virtualization capability and software intelligence are architected to allow Infinera customers to simplify and speed their operations tasks, and ultimately to improve operational efficiency.

Infinera's digital optical networking architecture is made possible by what we believe to be the world's only commercially-deployed, large-scale PIC. Our PICs transmit and receive 100 Gbps of optical capacity and incorporate the functionality of over 60 discrete optical components into a pair of indium phosphide chips. Their function is to convert 100 Gbps of optical capacity into electronic signals. Once electronic, these signals can be virtualized and allocated to a number of services using digital technology. The PICs are in effect the heart of the DTN System, as they are the key to its ability to deliver a wide range of transport services, with optional advanced features, quickly and easily. By contrast, competitive DWDM platforms, which do not have access to PIC technology, generally require photonics equipment to add new services to the network. Photonic engineering can be considerably slower and more difficult than digital engineering; as a result, we believe competitive platforms have less flexibility, take longer to provision, and are harder to operate than the DTN System.

Our goal is to be a leading provider of optical communications systems to operators of optical networks, including telecom carriers, cable operators, internet or content service providers, and others. Our revenue growth will depend on the continued acceptance of our DTN System, growth of communications traffic and the proliferation of next-generation bandwidth-intensive services, which are expected to drive the need for increased levels of bandwidth. Our ability to increase revenue and achieve profitability will be directly affected by the level of acceptance of our products in the long-haul and metro DWDM markets and by our ability to cost-effectively develop and sell innovative products that leverage our technology advantages.

**Table of Contents**

We are headquartered in Sunnyvale, California, with employees located throughout the United States, Europe and the Asia Pacific region. We expect to continue to add personnel in the United States and internationally to develop our product and provide additional geographic sales and technical support coverage. We primarily sell our products through our direct sales force, with a small portion sold indirectly through resellers. We derived 96% and 97% of our revenue from direct sales to customers for the three and nine months ended September 27, 2008, respectively. We derived 97% of our revenue from direct sales to customers for the three and nine months ended September 29, 2007, respectively. We expect to continue generating a substantial majority of our revenue from direct sales in the future.

Our revenue growth is directly impacted by underlying growth in invoiced shipments. Although we expect growth in invoiced shipments to continue on a year-over-year basis, quarter-over-quarter growth may be impacted by several factors including the timing of large product deployments, acquisitions of new customers, new product introductions and general market conditions. Therefore, quarter-over-quarter revenue growth could be somewhat volatile and growth may not always occur in a linear manner.

In addition, the timing at which we recognize revenue is directly impacted by our ability to establish VSOE of fair value for our services offerings. The attainment of VSOE of fair value on software subscription services in the first quarter of 2008 and for training and installation and deployment services in the second quarter of 2008 resulted in an increased portion of our shipments for the period being recognized as product and service revenue at the time of acceptance. This change resulted in a significant increase in the amount of revenue recognized from current period shipments and a significant reduction in additions to deferred revenue and in the deferred revenue balance. This increase in the recognition of revenue from the current period's shipments, combined with the recognition of \$39.6 million and \$152.7 million of deferred revenue from the periods prior to the attainment of VSOE of fair value for most of our services, in the three and nine months ended September 27, 2008 resulted in elevated revenues in those periods. We expect this to continue in the fourth quarter of 2008 with the recognition of approximately \$14.3 million of deferred revenue from periods prior to the second quarter of 2008 and the attainment of VSOE of fair value for most of our services. We expect revenues in 2009 and future periods to more closely approximate the underlying invoiced shipment levels for those periods.

We have established VSOE for our training and installation and deployment services effective in the second quarter of 2008. This allowed us to recognize most of our shipments as revenue at the time of acceptance and to allocate that revenue to the appropriate revenue category in our condensed consolidated statements of operations. This resulted in increased levels of product and services revenue offset by a reduction in ratable revenue. Ratable revenue for the remainder of 2008 will result primarily from the recognition of deferred revenue from periods prior to the second quarter of 2008 and the attainment of VSOE for most of our services. It will also include a small portion of current period revenues related to products sold in combination with software warranty services for which VSOE has not yet been established. We have and will continue to offer new and incremental services to our customers in the future and we will need to establish VSOE of fair value for those services. This may result in shipments to those customers being recognized as ratable revenue until VSOE of fair value is achieved.

As of September 27, 2008, we had \$13.6 million of deferred margin on our balance sheet related to invoiced shipments of bundled products from periods prior to the second quarter of 2008 and the attainment of VSOE of fair value for most of our services. We expect \$9.4 million of this deferred margin to be recognized in the fourth quarter of 2008 and we do not expect to continue to defer significant amounts of margin from new invoiced shipments in the future. We expect gross profits in 2009 and future periods to more closely approximate the gross margin generated on the underlying invoiced shipments for those periods. It remains difficult to predict future improvements in invoiced shipment gross margins due to changes in product and customer mix and the timing of new customer deployments.

**Overview of Condensed Consolidated Financial Data***Revenue*

We derive our revenue from sales of our products, support and services. Our revenue is comprised of three components: (1) ratable product and related support and services revenue, or ratable revenue, (2) product revenue and (3) services revenue. Our DTN System is integrated with software that is more than incidental to the functionality of our equipment. We refer to the integration of our DTN System with our software and related support and services as a bundled product. We recognize the majority of our revenue pursuant to Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*, or SOP 97-2. For arrangements with multiple elements which include product and services for which VSOE of fair value has been established, we allocate revenue to the undelivered element using the residual method based on VSOE of fair value for each of the elements. However, when these transactions also include undelivered services for which VSOE has not been established, product revenue is deferred and recognized ratably over the longest remaining support period.

Product revenue consists of sales of products where software is considered incidental and is recognized under Staff Accounting Bulletin No. 104, *Revenue Recognition*, or SAB 104. In addition, product revenue consists of products that are sold without services or bundled products that are sold only with services for which VSOE of fair value has already been established and therefore, is recognized upfront under the residual



## Edgar Filing: INFINERA CORP - Form 10-Q

method in accordance with Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transaction*.

**Table of Contents**

Services revenue is comprised of (1) revenue related to services for which VSOE of fair value has been established, (2) revenue related to services which were sold standalone or (3) revenue related to extended hardware warranty.

The following table illustrates our revenue for the three months and nine months ended September 27, 2008 and September 29, 2007 (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Revenue:				
Product	\$ 76,130	\$ 25	\$ 226,763	\$ 7,275
Ratable product and related support and services	39,495	62,130	181,462	162,488
Services	4,881		11,643	
<b>Total of revenue</b>	<b>\$ 120,506</b>	<b>\$ 62,155</b>	<b>\$ 419,868</b>	<b>\$ 169,763</b>

*Product Revenue.* Product revenue consists of products that are sold without services or bundled products that are sold with services for which VSOE of fair value has already been established and therefore, is recognized upfront under the residual method in accordance with Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transaction*. We use the residual method to recognize revenue when a sales agreement includes one or more elements to be delivered at a future date and vendor specific objective evidence ( VSOE ) of fair value of all undelivered elements exists. VSOE of fair value for software warranty, software subscription, training and installation and deployment services is determined by reference to the price the customer will be required to pay when these services are sold separately. As discussed above, following the attainment of VSOE of fair value for software subscription services in the first quarter of 2008 and for training and installation and deployment services in the second quarter of 2008, product revenue increased significantly due to the inclusion of product revenue from sales of bundled products and services where software subscription or training and installation and deployment services was the only undelivered element. In 2007, product revenue consisted primarily of a small number of sales of our networking products to customers who did not require support services and sales of an end of life product line that did not require significant customization and with regard to which software was considered incidental.

*Ratable Revenue.* Substantially all of our product sales are sold in combination with support services, which consist of software warranty or software subscription services. In addition, we have sold training and installation and deployment services with a significant number of these bundled sales.

VSOE of fair value for support services, training and installation and deployment services is determined by reference to the price the customer is required to pay when these services are sold separately. Support services are comprised of software warranty and software subscription services. Software warranty provides customers with maintenance releases and patches during the warranty support period. Software subscription includes software warranty support and in addition, provides customers with rights to receive unspecified software product upgrades released during the support period. In order to establish VSOE for these services, we were required to establish a history of selling these services separately at a consistent price. Prior to December 29, 2007, we had not established VSOE of fair value for support services, training or installation and deployment services. As a result, prior to that date, when all other revenue recognition criteria had been met and the only undelivered element was support services, training or installation and deployment services, revenue was deferred and recognized ratably over the longest undelivered service period. The undelivered service period for these services ranged from one to five years and averaged 14 months in the fourth quarter of 2007. This resulted in the majority of our invoiced shipments in 2007 being deferred and recognized over an average period of 14 months. Revenue related to these arrangements is included in ratable product and related support and services revenue.

In the first quarter of 2008, we established VSOE for software subscription services. As a result, we are no longer required to ratably recognize product revenue for sales transactions where products were sold with software subscription. Product revenue from these transactions is recognized upon acceptance, and software subscription service revenue is deferred and recognized over the term of the arrangement which is generally 12 months. Revenue allocated to product sales is included in product revenue, revenue allocated to services is included in services revenue. However, when these transactions also included undelivered training or installation and deployment services prior to the second quarter of 2008, product revenue was deferred and recognized ratably over the longest remaining support period until the training or installation and deployment services were complete. Upon completion of these services, the difference between the VSOE of fair value for the remaining software subscription period and the remaining unrecognized portion of the arrangement fee was recognized as ratable product and related support and services revenue.



## Table of Contents

The attainment of VSOE of fair value on software subscription services in the first quarter of 2008 resulted in a significant increase in the proportion of total revenue recognized from the underlying invoiced shipments in that quarter. Product revenue increased due to our ability to recognize and allocate revenue related to bundled shipments where software subscription was the only undelivered element. In addition, the weighted average revenue deferral period for current period shipments of bundled products and services was reduced to approximately 90 days as compared to 14 months in the fourth quarter of 2007. This change resulted in a significant increase in the amount of ratable revenue recognized from invoiced shipments in the first quarter of 2008 and a significant reduction in additions to deferred revenue and in the deferred revenue balance for the period.

We established VSOE for our training and installation and deployment services in the second quarter of 2008. This allowed us to recognize most of our shipments as revenue at the time of acceptance and to allocate that revenue to the appropriate revenue category in our condensed consolidated statements of operations. This resulted in increased levels of product and services revenue in the second quarter of 2008 offset by a reduction in ratable revenue. Ratable revenue for the remainder of 2008 will result primarily from the recognition of deferred revenue from prior periods and a small portion of current period revenue related to products sold in combination with software warranty and other services for which VSOE has not yet been established.

The attainment of VSOE of fair value on most of our services significantly increased total revenues for the first nine months of 2008. This increase resulted from an increase in the recognition of revenue from invoiced shipments in the current period, combined with the recognition of \$152.7 million of deferred revenue from periods prior to the attainment of VSOE on most of our services.

We have and will continue to offer new and incremental services to our customers in the future and we will need to establish VSOE of fair value for those services. This may result in shipments to those customers being recognized as ratable revenue until VSOE of fair value is achieved.

*Services Revenue.* Services revenue is comprised of (1) revenue related to services for which VSOE of fair value has been established, (2) revenue related to services which were sold on a standalone basis or (3) revenue related to extended hardware warranty and other non-bundled services. Following the attainment of VSOE of fair value for software subscription services in the first quarter of 2008 and attainment of VSOE of fair value for training and installation and deployment services in the second quarter of 2008, we have recognized revenue from delivered training and installation and deployment services and software subscription revenues as services revenue in our condensed consolidated statements of operations.

*Deferred Revenue.* Prior to December 29, 2007 a portion of our invoiced shipments of bundled products and services were recognized as revenue in such quarter and the remainder was recorded as deferred revenue. Deferred revenue increased each quarter by the amount of invoiced shipments of bundled products and services in that quarter and decreased by the amount of ratable revenue recognized from invoiced shipments of bundled products and services. Following the attainment of VSOE of fair value on software subscription in the first quarter of 2008 and attainment of VSOE of fair value for training and installation and deployment services in the second quarter of 2008, an increased portion of our invoiced shipments are recognized as revenue in the same period in which they are invoiced. As a result, we expect our ratable deferred revenue balance to continue to decline throughout 2008.

The additions to the product and ratable deferred revenue balances relate to invoiced shipments bundled with services for which we have not established VSOE of fair value or invoiced shipments for which basic revenue recognition has not been met. Our services deferred revenue balance relates to deferred software subscription and extended hardware warranty which will be recognized as service revenue on a ratable basis over the service delivery period and also relates to deferred training and deployment and installation services which will be recognized as services revenue upon delivery of services.

**Table of Contents**

The following table illustrates the increase (decrease) in deferred revenue for the specified periods (in thousands):

	Three Months Ended September 27, 2008			
	Pre Mar. 29, 2008 Product / Ratable Revenue <sup>(1)</sup>	Post Mar. 29, 2008 Product / Ratable Revenue <sup>(2)</sup>	Services Revenue	Total
Beginning balance	\$ 61,340	\$ 3,113	\$ 5,456	\$ 69,909
Additions to deferred revenue		2,075	3,567	5,642
Amortization to revenue	(39,588)	(891)	(2,616)	(43,095)
Ending balance	\$ 21,752	\$ 4,297	\$ 6,407	\$ 32,456
<b>Increase (decrease) in deferred revenue balance</b>	<b>\$ (39,588)</b>	<b>\$ 1,184</b>	<b>\$ 951</b>	<b>\$ (37,453)</b>

	Nine Months Ended September 27, 2008			
	Pre Mar. 29, 2008 Product / Ratable Revenue <sup>(1)</sup>	Post Mar. 29, 2008 Product / Ratable Revenue <sup>(2)</sup>	Services Revenue	Total
Beginning balance	\$ 174,437	\$	\$	\$ 174,437
Additions to deferred revenue	29,639	7,054	11,779	48,472
Amortization to revenue	(182,324)	(2,757)	(5,372)	(190,453)
Ending balance	\$ 21,752	\$ 4,297	\$ 6,407	\$ 32,456
<b>Increase (decrease) in deferred revenue balance</b>	<b>\$ (152,685)</b>	<b>\$ 4,297</b>	<b>\$ 6,407</b>	<b>\$ (141,981)</b>

<sup>(1)</sup> Represents changes in deferred revenue related to periods prior to the attainment of VSOE of fair value for most of our services.

<sup>(2)</sup> Represents changes in deferred revenue related to periods after the attainment of VSOE of fair value for most of our services.  
*Cost of Revenue*

Our cost of revenue is comprised of three components: cost of ratable revenue, cost of product revenue and cost of services revenue.

The following table illustrates our cost of revenue for the specified periods (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Cost of revenue:				
Cost of product	\$ 45,139	\$ 18	\$ 131,928	\$ 3,869
Cost of ratable product and related support and services	18,537	40,804	86,537	116,462
Cost of service	2,592		5,814	
<b>Total cost of revenue</b>	<b>\$ 66,268</b>	<b>\$ 40,822</b>	<b>\$ 224,279</b>	<b>\$ 120,331</b>

*Cost of Product Revenue.* Cost of product revenue consists primarily of the costs of manufacturing network components, such as personnel costs, raw materials, overhead and period costs. Included in cost of product revenue for the three and nine months ended September 27, 2008 are

## Edgar Filing: INFINERA CORP - Form 10-Q

inventory write-downs for excess and obsolete inventory of \$0.9 million and \$4.5 million, respectively. We may experience some increase in inventory write downs in future periods as we complete a number of major product transitions. In addition, the cost of some of our products will increase in the future due to changes in yields and production volumes for those products.

Losses associated with products which are sold or anticipated to be sold at a loss are recognized in the period in which they are incurred or can be reasonably estimated. The initial deployment of our DTN System at a customer involves the installation of common equipment, including a chassis, optical line amplifiers and related equipment. This common equipment is typically sold at low or negative gross margins. When we sell equipment at a loss, the losses are recognized in the period in which they are incurred or are reasonably estimatable. We refer to this loss as a lower of cost or market adjustment, or LCM adjustment. We recorded \$3.0 million of LCM adjustments in cost of product revenue in the three months ended September 27, 2008.

**Table of Contents**

*Cost of Ratable Revenue.* Cost of ratable revenue consists primarily of the costs of manufacturing our network equipment, including personnel costs, stock-based compensation, raw materials, overhead and period costs. Period costs consist primarily of shipping fees, logistics costs, manufacturing ramp-up costs, expenses for inventory obsolescence, lower of cost or market adjustment, and warranty obligations, and are recognized in the period in which they are incurred or can be reasonably estimated. All other costs of ratable revenue are initially recorded as deferred inventory costs and are subsequently recognized in the same period as the corresponding revenue.

*Cost of Services Revenue.* Cost of service revenue consists primarily of the costs of providing our service offerings, including personnel costs, stock-based compensation and costs associated with third party service providers.

*Deferred Inventory Cost*

Deferred inventory cost increases by the cost of invoiced shipments of bundled products and services in a period and decreases as cost of ratable revenue is amortized in that period.

The following table illustrates the increase (decrease) in our deferred inventory cost for the specified periods (in thousands):

	Pre Mar. 29, 2008 Product / Ratable Cost <sup>(1)</sup>	Three Months Ended September 27, 2008 Post Mar. 29, 2008 Product / Ratable Cost <sup>(2)</sup>	Total
Beginning balance	\$ 26,510	\$ 450	\$ 26,960
Additions to deferred inventory cost		710	710
Amortization to cost of revenue	(18,338)	(40)	(18,378)
Ending balance	\$ 8,172	\$ 1,120	\$ 9,292
<b>Increase (decrease) in deferred inventory cost balance</b>	<b>\$ (18,338)</b>	<b>\$ 670</b>	<b>\$ (17,668)</b>

	Pre Mar. 29, 2008 Product / Ratable Cost <sup>(1)</sup>	Nine Months Ended September 27, 2008 Post Mar. 29, 2008 Product / Ratable Cost <sup>(2)</sup>	Total
Beginning balance	\$ 81,622	\$	\$ 81,622
Additions to deferred inventory cost	11,162	1,169	12,331
Amortization to cost of revenue	(84,612)	(49)	(84,661)
Ending balance	\$ 8,172	\$ 1,120	\$ 9,292
<b>Increase (decrease) in deferred inventory cost balance</b>	<b>\$ (73,450)</b>	<b>\$ 1,120</b>	<b>\$ (72,330)</b>

<sup>(1)</sup> Represents changes in deferred inventory cost related to periods prior to the attainment of VSOE of fair value for most of our services.

<sup>(2)</sup> Represents changes in deferred inventory cost related to periods after the attainment of VSOE of fair value for most of our services.  
*Gross Margin*

Gross margins have been and will continue to be affected by a variety of factors, including the product mix, average selling prices of our products, new product introductions and enhancements, changes to our manufacturing costs, including the impact of fluctuations in yields and production volumes, the amount of revenue that is recognized up front versus ratably and the period over which that revenue is recognized ratably, and the amount of common equipment sold at a loss causing an LCM adjustment.

## Edgar Filing: INFINERA CORP - Form 10-Q

To satisfy our customers' requirement of transmitting optical signals, our customers must purchase a combination of common equipment and some limited number of Digital Line Modules ( DLMs ), Tributary Adapter Modules ( TAMs ), and Tributary Optical Modules ( TOMs ). If a customer wishes to add capacity to our DTN System after their initial deployment to satisfy their additional demands, they may purchase additional DLMs, TAMs and TOMs. When a customer wishes to expand the reach of the DTN System or deploy another DTN System on a route, they may purchase a combination of additional common equipment and additional DLMs, TAMs and TOMs. Pricing for optical communications systems, such as our DTN System, is very competitive and we must often respond to these competitive pressures by decreasing the initial purchase price of our product. As a result of these competitive pressures and in order to gain new customers, our common equipment is typically sold at low margins or at a loss. Our DLMs, TAMs or TOMs are typically sold at higher gross margins. These higher margin sales positively impact overall gross margin over the revenue recognition period.



**Table of Contents**

The following table illustrates our gross margin for the specified periods (in thousands, except gross margin):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Revenue	\$ 120,506	\$ 62,155	\$ 419,868	\$ 169,763
Cost of revenue	66,268	40,822	224,279	120,331
Gross profit	\$ 54,238	\$ 21,333	\$ 195,589	\$ 49,432
Gross margin	45%	34%	47%	29%

The improved gross margin for the three months ended September 27, 2008 compared to the corresponding period of 2007 reflects the impact of the recognition of \$21.3 million of deferred gross margin related to invoiced shipments from periods prior to the second quarter of 2008 and the attainment of VSOE of fair value for the most of our services. In addition, we recognized increased revenue amounts from higher margin invoiced shipments in the current period. This increase in the recognition of revenue and gross profit from the current period was due to the attainment of VSOE of fair value for software subscription services in the first quarter of 2008 and for training and installation and deployment services in the second quarter of 2008.

The improved gross margin for the nine months ended September 27, 2008 compared to the corresponding period of 2007 reflects the impact of the recognition of \$79.2 million of deferred gross margin related to invoiced shipments in prior periods before the attainment of VSOE of fair value for most of our services. In addition, we recognized increased revenue amounts from higher margin invoiced shipments in the current period. These higher margins reflect improved customer and product mix. This increase in the recognition of revenue and margin was due to the attainment of VSOE of fair value for software subscription services in the first quarter of 2008 and for our training and installation and deployment services in the second quarter of 2008.

The prices paid for our DTN System vary by customer. In addition, the quantity of DTN Systems purchased by each of our customers varies from quarter-to-quarter depending on our customers' needs for optical transport equipment. To the extent that a customer with lower contractual prices purchases significant quantities of our DTN System that comprise a significant portion of the DTN Systems we sell within a quarter, our gross margin for such quarter and for future quarters in which that revenue is ratably recognized would be lower. In addition, substituting or adding a new customer with a higher requirement for common equipment could result in an increased inventory write-down in a given quarter or lower gross margins in that quarter.

As of September 27, 2008, deferred revenue related to bundled product sales from periods prior to the second quarter of 2008 and the attainment of VSOE of fair value for most of our services was \$21.8 million, and deferred inventory cost was \$8.2 million. We expect \$9.4 million of this \$13.6 million of deferred margin to be recognized during the fourth quarter of 2008 and we do not expect to continue to defer significant amounts of margin from new invoiced shipments in the future, resulting in continued elevated gross profit in 2008. We expect gross margins in 2009 and future periods to more closely approximate the margin generated on the underlying invoiced shipments for those periods.

The table below, which only represents a portion of our results for the projected periods presented and may not be indicative of our future results, shows the expected future impact of the recognition of these deferred amounts related to invoiced shipments of bundled product and services from periods prior to the second quarter of 2008 and prior to the attainment of VSOE of fair value for most of our services on our condensed consolidated statements of operations (in thousands):

	Deferred Balance as of September 27, 2008	For the Three Months Ended December 27, 2008	Future Periods
Revenue	\$ 21,752	\$ 14,315	\$ 7,437
Cost of inventory	8,172	4,871	3,301
Gross profit	\$ 13,580	\$ 9,444	\$ 4,136



## **Table of Contents**

### *Operating Expenses*

Operating expenses consist of sales and marketing, research and development and general and administrative expenses, and are recognized as incurred. Personnel-related costs are the most significant component of each of these expense categories. We expect personnel costs to continue to increase as we hire new employees to support our anticipated growth. We expect that each of the categories of operating expenses discussed below will increase in absolute dollars, but will decline as a percentage of total revenue in the long term.

Research and development expenses are the largest component of our operating expenses and primarily include salary and related benefit costs, including stock-based compensation expense, and facilities costs and other related expenses. We expense research and development expenses as incurred. We are devoting substantial resources to the continued development of additional functionality for existing products and the development of new products. We intend to continue to invest significantly in our research and development efforts both in the United States and internationally because we believe that they are essential to maintaining our competitive position.

Sales and marketing expenses primarily include salary and related benefit costs, including stock-based compensation expense, sales commissions, marketing and facilities costs. We expect sales and marketing expenses to increase as we hire additional personnel both in the United States and internationally to support our expected revenue growth.

General and administrative expenses consist primarily of salary and related benefit costs, including stock-based compensation expense and facilities related to our executive, finance, human resource, information technology and legal organizations, and fees for professional services. Professional services principally consist of outside legal, audit and information technology consulting costs.

### *Other Income (expense), net*

During the first nine months of 2008, other income (expense), net includes interest income on our cash and short and long-term investment balances, gains on sale of assets, realized losses or gains on investments, losses or gains on conversion of foreign currency transactions. During the first nine months of 2007, other income (expense), net, also included an adjustment to record our convertible preferred stock warrants at fair value as required by Staff Position 150-5, *Issuer's Accounting under FASB Statement No. 150 for Freestanding Warrants and Other Similar Instruments on Shares That Are Redeemable*, or FSP 150-5 and interest expense. In addition, if interest rates continue to decline due to current global market conditions, we will experience reductions in future interest income from our cash and short and long-term investment balances, assuming consistent investment levels.

### *Provision for income taxes*

The effective tax rate of 3.82% for the nine months ended September 27, 2008, differs from the statutory rate of 35% primarily due to the tax benefits resulting from the release of valuation allowances on tax attribute carry-forwards which was partially offset by the impact of certain stock compensation charges under SFAS No. 123(R), alternative minimum tax and state income taxes.

## **Critical Accounting Policies and Estimates**

Our condensed consolidated financial statements are prepared in accordance with United States generally accepted accounting principles, or GAAP. These accounting principles require us to make certain estimates and judgments that can affect the reported amounts of assets and liabilities as of the date of the condensed consolidated financial statements, as well as the reported amounts of revenue and expenses during the periods presented. Significant estimates and assumptions made by management include revenue recognition, valuation of financial instruments, warranty reserve, cash, cash equivalents and short and long-term investments, inventory valuation, stock based compensation and accounting for income taxes. By their nature, these estimates and judgments are subject to an inherent degree of uncertainty. We believe that the estimates and judgments upon which we rely are reasonable based upon information available to us at the time that these estimates and judgments are made. To the extent there are material differences between these estimates and actual results, our condensed consolidated financial statements will be affected.

### *Revenue Recognition*

Our networking products are generally integrated with software that is more than incidental to the functionality of the equipment. Accordingly, we account for revenue in accordance with Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transactions*. We recognize product revenue when all of the following have occurred: (1) We have entered into a legally binding arrangement with a customer; (2) delivery has occurred, which is when product title and risk of loss have transferred to the customer; (3) customer payment is deemed fixed or determinable; and (4) collectability is

reasonably assured. Revenue is recognized net of cash discounts.

## **Table of Contents**

Substantially all of our product sales are sold in combination with support services comprised of either software warranty or software subscription services. In addition, we periodically sell training and installation and deployment services with our product sales. Software warranty provides customers with maintenance releases and patches during the warranty support period. Software subscription includes software warranty support and in addition, provides customers with rights to receive unspecified software product upgrades released during the support period. Training services include the right to a specified number of training classes over the term of the arrangement. Installation and deployment services may include customer site assessments, equipment installation and testing.

Product revenue consists of products that are sold without services or bundled products that are sold with services for which VSOE of fair value has already been established and therefore, is recognized upfront under the residual method in accordance with Statement of Position No. 97-2, *Software Revenue Recognition*, as amended by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition, with Respect to Certain Transaction*. We use the residual method to recognize revenue when a sales agreement includes one or more elements to be delivered at a future date and vendor specific objective evidence ( VSOE ) of fair value of all undelivered elements exists. VSOE of fair value for software warranty, software subscription, training and installation and deployment services is determined by reference to the price the customer will be required to pay when these services are sold separately.

Prior to the first quarter of 2008, we had not established VSOE of fair value for its support services, and therefore recognized all revenue for transactions bundled with these services ratably over the longest support period which ranges from one to five years. Revenue related to these arrangements is included in ratable product and related support and services revenue. We determined that we had established VSOE of fair value for software subscription in the first quarter and for training and installation and deployment services in the second quarter of 2008. For arrangements with multiple elements which include product and software subscription services and or training and installation and deployment services, we allocate revenue to the undelivered elements using the residual method based on VSOE of fair value for each such element and the remainder is recognized as product revenue. However, when these transactions also include undelivered services for which VSOE of fair value has not been established, revenue is deferred and recognized ratably over the longest remaining support period. Upon completion of the services for which VSOE of fair value has not been established, the difference between the VSOE of fair value for the remaining software subscription period and the remaining related service periods and the unrecognized portion of the arrangement fee is recognized as ratable product and related support and services revenue.

Services revenue includes software subscription services, training, installation and deployment services and extended hardware warranty services. Revenue from software subscription and extended hardware warranty contracts is deferred and is recognized ratably over the contractual support period, which is generally one year. A majority of our customers have exercised the option to purchase software subscription services on an ongoing basis. Revenue related to training and installation and deployment services is recognized as the services are completed.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. In addition, shipping documents and customer acceptance, when applicable, are used to verify delivery and transfer of title. Revenue is recognized only when title and risk of loss pass to customers. In instances where acceptance of the product is specified by the customer, revenue is deferred until all such customer-specific acceptance criteria have been met. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction. Payment terms to customers generally range from net 30 to 120 days from invoice. In the event payment terms are provided that differ from our standard business practices, the fees are deemed to not be fixed or determinable and, therefore, revenue is not recognized until the fees become fixed or determinable which we believe is when they are legally due and payable. We assess the ability to collect from its customers based primarily on the creditworthiness and past payment history of the customer.

For sales to resellers, the same revenue recognition criteria apply. It is our practice to identify an end-user prior to shipment to a reseller. We do not now offer rights of return or price protection to its resellers.

Revenue for products that do not require significant customization, and with respect to which any software is considered incidental, is recognized under Staff Accounting Bulletin No. 104, *Revenue Recognition* ( SAB 104 ). Under SAB 104, revenue is recognized only when persuasive evidence of an arrangement exists, delivery has occurred or services have been rendered, the fee is fixed or determinable and collectability is reasonably assured. Revenue related to these arrangements is included in product revenue.

Shipping charges billed to customers are included in product revenue and in ratable product and related support and services revenue.

### ***Stock-Based Compensation***

Under SFAS 123(R), we estimated the fair value of the stock options granted and rights to acquire stock using the Black-Scholes option pricing formula and a single option award approach. For new-hire grants, options typically vest with respect to 25% of the shares one year after the option s vesting commencement date and the remainder ratably on a monthly basis over three years, commencing one year after the vesting

commencement date. For annual refresh grants, options typically vest ratably on a monthly

**Table of Contents**

basis over five years after the vesting commencement date. We make a number of estimates and assumptions related to SFAS 123(R) including forfeiture rate, expected life and volatility. We utilized our historical data as an estimate of the expected forfeiture rate and we recognized compensation costs only for those equity awards expected to vest. The effect of adjusting the forfeiture rate for all expense amortization is recognized in the period the forfeiture estimate is changed. The estimation of stock awards that will ultimately vest requires judgment, and to the extent actual results differ from our estimates, such amounts will be recorded as an adjustment in the period estimates are revised. Actual results may differ substantially from these estimates.

The expected term of options granted represents the period of time that options granted are expected to be outstanding, which incorporates the contractual terms, grant vesting schedules and terms and expected employee and director behaviors. Commencing in June 2007, we elected to use the simplified method to estimate the expected term as permitted by SEC Staff Accounting Bulletin 107 ( SAB 107 ) due to the unknown effect on option holder behavior of the increased liquidity of the underlying options following our IPO. In December 2007, the SEC released Staff Accounting Bulletin No. 110 ( SAB 110 ). SAB 110 amends SAB 107 to allow for the continued use, under certain circumstances, of the simplified method in developing an estimate of the expected term of plain vanilla stock options accounted for under SFAS 123(R). As a result, we will continue to use the simplified method until we have sufficient historical data to provide a reasonable basis to estimate the expected term.

Expected volatility of the stock is based on our peer group in the industry in which we do business because we don't have sufficient historical volatility data for our own common stock. In the future, as Infinera gains historical data for volatility in our own stock and more data on the actual term employees hold their options, the expected volatility and expected term may change, which could substantially change the grant-date fair value of future awards of stock options and ultimately the expense we record.

***Inventory Valuation***

Inventories consist of raw materials, work-in-process and finished goods and are stated at standard cost adjusted to approximate the lower of actual cost (first-in, first-out method) or market. Market value is based upon an estimated selling price reduced by the estimated cost of disposal. The determination of market value involves numerous judgments including estimated average selling prices based upon recent sales volumes, industry trends, existing customer orders, current contract price, future demand and pricing for our products and technological obsolescence of our products.

Inventory that is obsolete or in excess of our forecasted demand or is anticipated to be sold at a loss is written down to its estimated net realizable value based on historical usage and expected demand. If our demand forecast for specific products is greater than actual demand and we are not able to reduce manufacturing output accordingly, we could be required to write off inventory, which would negatively impact our gross margin.

We recorded inventory write-downs for excess and obsolete inventory in the three and nine months ended September 27, 2008 of \$0.9 million and \$4.5 million, respectively, and in the three and nine months ended September 29, 2007 of \$1.7 million and \$4.2 million, respectively. In addition, we recorded total inventory write-downs for lower of cost or market ( LCM ) adjustments in the three and nine months ended September 27, 2008 of \$3.0 million and \$3.5 million and in the three and nine months ended September 29, 2007 of \$3.2 million and \$6.5 million, respectively. These write-downs for excess and obsolete inventory and LCM adjustments were reflected as cost of product and cost of ratable product and related support and services.

In valuing our deferred inventory costs, we considered the valuation of inventory using the guidance of Accounting Research Bulletin 43 *Restatement and Revision of Accounting Research Bulletins* ( ARB 43 ). In particular, we considered ARB 43, Chapter 4, Statement 5 and whether the utility of the products delivered or expected to be delivered at less than cost, primarily comprised of common equipment, had declined. We concluded that, in the instances where the utility of the products delivered or expected to be delivered were less than cost, it was appropriate to value the deferred inventory costs and inventory costs at cost or market, whichever is lower, thereby recognizing the cost of the reduction in utility in the period in which the reduction occurred or can be reasonably estimated. We have, therefore, recorded inventory write-downs as necessary in each period in order to reflect common equipment inventory at the lower of cost or market. In addition, we considered the guidance provided in ARB 43, Chapter 4, Statement 10 relating to losses on firm purchase commitments related to inventory items. In instances where the expected selling price of common equipment in the future is below cost, we have recorded losses on these firm purchase commitments in the period in which the commitment is made. When the inventory parts related to these firm purchase commitments are received, that inventory is recorded at the purchase price less the accrual for the loss on the purchase commitment.

If actual market conditions are less favorable than those projected by management, additional inventory write-downs may be required.

***Warranty Reserve***

## Edgar Filing: INFINERA CORP - Form 10-Q

We warrant that our products will operate substantially in conformity with product specifications. Upon delivery of our products, we provide for the estimated cost to repair or replace products or the related components that may be returned under warranty. Our hardware warranty periods range from 1 to 5 years from date of acceptance for hardware and 90 days to 60 months for software warranty. The hardware warranty reserve is based on actual historical returns experience and the impact of the returns rate on future estimated returns. We periodically assess the adequacy of the recorded warranty liabilities and adjust the amounts as necessary.



---

**Table of Contents**

***Cash, Cash Equivalents and Short-term and Long-term Investments***

We consider all liquid instruments with an original maturity at the date of purchase of 90 days or less to be cash equivalents. We maintain our cash in bank deposit accounts which, at times, may exceed federally insured limits. We have not experienced any losses in such accounts.

We consider all debt instruments with remaining time to maturity of one year or less to be short-term investments. At September 27, 2008 and December 29, 2007, cash equivalents and short and long-term investments consisted primarily of money market funds, commercial paper, corporate bonds, U.S. agency notes, U.S. treasuries and adjustable rate securities. Our cash equivalents and short and long-term investments are classified as available-for-sale in accordance with the provisions of SFAS No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.

All cash, cash equivalents and short and long-term investments are stated at fair market value with unrealized gains and losses reported in accumulated comprehensive loss as a separate component of stockholders' equity. The amortized cost of debt securities is adjusted for amortization of premiums and accretion of discounts to maturity, both of which are included in interest income. Gains are recognized when realized in our condensed consolidated statements of operations. Losses are recognized as realized or when we have determined that an other-than-temporary decline in fair value has occurred. Gains and losses are determined using the specific identification method.

In accordance with SFAS No. 115, it is our policy to review our marketable debt securities classified as short or long-term investments on a regular basis to evaluate whether or not any security has experienced an other-than-temporary decline in fair value. Our policy includes, but is not limited to, reviewing the length of time and extent to which the market value has been less than the amortized cost, the financial condition and near-term prospects of the issuer, and our intent and ability to retain our investment in the issuer for a sufficient period of time to allow for recovery in the market value of such security. If we believe that an other-than-temporary decline exists in one of our marketable debt securities, our policy is to write down these debt investments to the market value and record the related write-down as an investment loss on our condensed consolidated statements of operations. No other-than-temporary impairment charges were recorded for the nine months ended September 27, 2008 and September 29, 2007. See Note 5 to the Condensed Consolidated Financial Statements for further information regarding unrealized losses recorded as of September 27, 2008.

***Accounting for Income Taxes***

As part of the process of preparing our condensed consolidated financial statements, we are required to estimate our taxes in each of the jurisdictions in which we operate. We estimate actual current tax expense together with assessing temporary differences resulting from differing treatment of items, such as accruals and allowances not currently deductible for tax purposes. These differences result in deferred tax assets and liabilities, which are included in our condensed consolidated balance sheets. In general, deferred tax assets represent future tax benefits to be received when certain expenses previously recognized in our condensed consolidated statements of operations become deductible expenses under applicable income tax laws or loss or credit carry-forwards are utilized. Accordingly, realization of our deferred tax assets is dependent on future taxable income within the respective jurisdictions against which these deductions, losses and credits can be utilized within the applicable future periods.

We must assess the likelihood that some portion or all of our deferred tax assets will be recovered from future taxable income within the respective jurisdictions, and to the extent we believe that recovery does not meet the more-likely-than-not standard, we must establish a valuation allowance. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. At September 27, 2008 and December 29, 2007, certain of our deferred tax assets were fully reserved with a valuation allowance because, based on the available evidence, we believed at that time it was more likely than not that it would not be able to utilize those deferred tax assets in the future. We intend to maintain valuation allowances until sufficient evidence exists to support the reversal of the valuation allowances. We make estimates and judgments about our future taxable income, by jurisdiction, based on assumptions that are consistent with our plans and estimates. Should the actual amounts differ from our estimates, the amount of our valuation allowance could be materially impacted.

**Table of Contents****Results of Operations***Revenue*

The following table presents our revenue by type, geography and sales channel for the three and nine months ended September 27, 2008 and September 29, 2007 (in thousands, except %):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
<b>Statements of Operations Data:</b>				
Total revenue	\$ 120,506	\$ 62,155	\$ 419,868	\$ 169,763
Total revenue by type				
Product	\$ 76,130	\$ 25	\$ 226,763	\$ 7,275
Ratable product and related support and services	39,495	62,130	181,462	162,488
Service	4,881		11,643	
% Revenue by type				
Product	63%	0%	54%	4%
Ratable product and related support and services	33%	100%	43%	96%
Service	4%	0%	3%	0%
Total revenue by geography				
Domestic	\$ 97,833	50,473	\$ 339,865	\$ 137,708
International	22,673	11,682	80,003	32,055
% Revenue by geography				
Domestic	81%	81%	81%	81%
International	19%	19%	19%	19%
Total revenue by sales channel				
Direct	\$ 116,108	60,518	\$ 406,721	\$ 165,516
Indirect	4,398	1,637	13,147	4,247
% Revenue by sales channel				
Direct	96%	97%	97%	98%
Indirect	4%	3%	3%	2%

*Three Months Ended September 27, 2008 Compared to Three Months Ended September 29, 2007.*

Total revenue increased from \$62.2 million in the three months ended September 29, 2007 to \$120.5 million in the three months ended September 27, 2008. This overall growth reflects the recognition of \$39.6 million of deferred revenue from prior periods and the recognition of \$80.9 million from the current period. Total invoiced shipments for the period decreased from \$80.3 million in the three months ended September 29, 2007 compared to \$79.4 million in the three months ended September 27, 2008. The lack of growth in invoiced shipments in the period mainly reflects the timing of purchases of our DTN System by existing customers. Invoiced shipment growth was also impacted to a lesser extent by a relative slow down in the addition of new customers in the first half of 2008, with 3 new customers added in that period. However, we experienced resumption in new customer growth in the third quarter of 2008 and we added 5 new customers between June 28, 2008 and September 27, 2008 and had a total of 49 customers as of September 27, 2008.

In the three months ended September 27, 2008, we recognized \$76.1 million of product revenue compared to \$25,000 in the corresponding period of 2007. This reflects an increase in the upfront recognition of product revenue following the attainment of VSOE on software subscription services and training and installation and deployment services in 2008 and we expect to continue to generate significant amounts of product revenue in the future. The \$25,000 of product revenue recognized in the third quarter of 2007 was related to a product sale to customers that did not require support services.

Ratable revenue decreased from \$62.1 million in the three months ended September 29, 2007 to \$39.5 million in the corresponding period in 2008. The decrease reflected the recognition of revenue amortized from prior periods of \$38.6 million in the three months ended September 27, 2008 compared to \$54.8 million in the corresponding period of 2007. The decrease reflected the recognition of revenue from the current period invoiced shipments of \$0.9 million in the three months ended September 27, 2008 compared to \$7.3 million of invoiced shipments of bundled products and services in the corresponding period in 2007.

## Edgar Filing: INFINERA CORP - Form 10-Q

In the three months ended September 27, 2008, we recorded \$4.9 million of services revenue related to software subscription services and training and installation and deployment services provided during the period.

**Table of Contents***Nine Months Ended September 27, 2008 Compared to Nine Months Ended September 29, 2007.*

Total revenue increased from \$169.8 million in the nine months ended September 29, 2007 to \$419.9 million in the nine months ended September 27, 2008. This overall growth reflects the recognition of \$152.7 million of deferred revenue from periods prior to the attainment of VSOE of fair value for most of our services and the recognition of \$267.2 million from the current period. Total invoiced shipments for the period increased from \$215.8 million in the nine months ended September 29, 2007 to \$267.3 million in the nine months ended September 27, 2008. The increase in invoiced shipments was due to increased purchases of our DTN System by existing customers and the addition of new customers. We added a net of 8 new customers between December 29, 2007 and September 27, 2008 and had a total of 49 customers as of September 27, 2008.

In the nine months ended September 27, 2008, we recognized \$226.8 million of product revenue compared to \$7.3 million in the corresponding period of 2007. This reflects an increase in the upfront recognition of product revenue following the attainment of VSOE on software subscription services and training and installation and deployment services in 2008 and we expect to continue to generate significant amounts of product revenue in the future. The \$7.3 million of product revenue recognized in the first nine months of 2007 was comprised of \$5.3 million related to the sale of 10 Gbps cards not for use in our DTN System and \$2.0 million related to product sales to customers that did not require support services.

Total ratable revenue increased from \$162.5 million in the nine months ended September 29, 2007 to \$181.5 million in the corresponding period in 2008. The increase reflected revenue amortized from our deferred revenue balance which significantly increased in 2007. Due to our attainment of VSOE of fair value on software subscription services, deployment and installation services and training in 2008, we expect ratable revenue to decrease over time.

Total service revenue increased from \$0 million in the nine months ended September 29, 2007 to \$11.6 million in the corresponding period in 2008. The increase is due to the achievement of VSOE of fair value for software subscription, training and installation and deployment services during the first nine months of 2008.

*Cost of Revenue and Gross Margin*

The following table presents our revenue, cost of revenue by revenue source, gross profit and gross margin for the three and nine months ended September 27, 2008 and September 29, 2007 (in thousands, except gross margin):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Total revenue	\$ 120,506	\$ 62,155	\$ 419,868	\$ 169,763
Total cost of revenue:				
Cost of product	45,139	18	131,928	3,869
Cost of ratable product and related support and services	18,537	40,804	86,537	116,462
Cost of service	2,592		5,814	
Gross profit	\$ 54,238	\$ 21,333	\$ 195,589	\$ 49,432
Gross margin	45%	34%	47%	29%

*Three Months Ended September 27, 2008 Compared to Three Months Ended September 29, 2007.*

Gross margins improved from 34% in the three months ended September 29, 2007 to 45% in the corresponding period in 2008. This improvement was partially due to the impact of the recognition of \$21.3 million of deferred gross profit related to invoiced shipments from periods prior to the second quarter of 2008 and the attainment of VSOE of fair value for most of our services. Gross margin on this release was 54% resulting in overall improved margins for the period.

**Table of Contents**

*Nine Months Ended September 27, 2008 Compared to Nine Months Ended September 29, 2007.*

Gross margins improved from the nine months ended September 29, 2007 to the corresponding period in 2008 due primarily to the impact of the recognition of \$79.2 million of deferred gross margin related to invoiced shipments in prior periods before the attainment of VSOE on most of our services. In addition, there was significant improvement in gross margins on current period invoiced shipments reflecting improved pricing product mix and cost structures. In addition, we experienced a reduction in our warranty expense from \$6.1 million in the nine months ended September 27, 2007 to \$0.7 million for the same period in 2008. This improvement reflects improved failure rates and reduced cost of replacing defective units.

*Research and Development Expenses*

The following table presents our research and development expenses in absolute dollars and as a percent of total revenue for the three and nine months ended September 27, 2008 and September 29, 2007 (in thousands, except %):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Research and development expenses	\$ 21,092	\$ 14,621	\$ 57,172	\$ 44,758
Percent of total revenue <sup>(1)</sup>	18%	24%	14%	26%

<sup>(1)</sup> Research and development expenses as a percent of total revenue is not a meaningful trend indicator because our revenue recognition policy has historically required the deferral of a significant portion of our revenues over future periods.

*Three Months Ended September 27, 2008 Compared to Three Months Ended September 29, 2007.* Research and development expenses increased by \$6.5 million primarily due to a \$2.9 million increase in personnel related costs and a \$2.8 million increase in new product development, prototypes, consulting and non-recurring engineering expenses. In addition, the increase resulted from a \$0.8 million increase in stock-based compensation.

*Nine Months Ended September 27, 2008 Compared to Nine Months Ended September 29, 2007.* Research and development expenses increased \$12.4 million from the nine months ended September 29, 2007 to the corresponding period in 2008 primarily due to \$7.9 million in incremental headcount expenses and \$6.9 million in increased prototype and non-recurring engineering spending. These increases were offset by \$4.7 million of expense in 2007 related to software development services that we purchased from a third party to enable our product to operate in a regional bell operating company infrastructure. In addition, the increase resulted from a \$2.3 million increase in stock-based compensation.

*Sales and Marketing Expenses*

The following table presents our sales and marketing expenses in absolute dollars and as a percent of total revenue for the three and nine months ended September 27, 2008 and September 29, 2007 (in thousands, except %):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Sales and marketing expenses	\$ 11,171	\$ 7,995	\$ 32,277	\$ 22,032
Percent of total revenue <sup>(1)</sup>	9%	13%	8%	13%

<sup>(1)</sup> Sales and marketing expenses as a percent of total revenue is not a meaningful trend indicator because our revenue recognition policy has historically required the deferral of a significant portion of our revenues over future periods.

*Three Months Ended September 27, 2008 Compared to Three Months Ended September 29, 2007.* Sales and marketing expenses increased by \$3.2 million from the three months ended September 29, 2007 to the corresponding period in 2008 due primarily to an increase of \$1.5 million in personnel related expenses, \$0.9 million of increased expenses related to demonstration units used in potential customer lab trials and \$0.2 million of increased international facility expenses. In addition, the increase resulted from a \$0.6 million increase in stock-based compensation.

## Edgar Filing: INFINERA CORP - Form 10-Q

*Nine Months Ended September 27, 2008 Compared to Nine Months Ended September 29, 2007.* Sales and marketing expenses increased by \$10.2 million from the nine months ended September 29, 2007 to the corresponding period in 2008 due primarily to an increase of \$4.3 million in personnel related expenses, including salaries and commission, \$2.6 million of expenses related to demonstration units used in potential customer lab trials and trade shows and \$1.2 million of increased international facility expenses. In addition, there was a \$2.1 million increase in stock-based compensation.

**Table of Contents***General and Administrative Expenses*

The following table presents our general and administrative expenses in absolute dollars and as a percent of total revenue for the three and nine months ended September 27, 2008 and September 29, 2007 (in thousands, except %):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
General and administrative expenses	\$ 8,713	\$ 7,069	\$ 25,632	\$ 17,984
Percent of total revenue <sup>(1)</sup>	7%	11%	6%	11%

<sup>(1)</sup> General and administrative expenses as a percent of total revenue is not a meaningful trend indicator because our revenue recognition policy has historically required the deferral of a significant portion of our revenues over future periods.

*Three Months Ended September 27, 2008 Compared to Three Months Ended September 29, 2007.* General and administrative expenses increased by \$1.6 million from the three months ended September 27, 2007 to the corresponding period in 2008 due primarily to a \$0.8 million increase in stock-based compensation, increased accounting, legal and tax expenses of \$0.4 million, increased facilities related expenses of \$0.3 million and increased personnel related costs of \$0.1 million.

*Nine Months Ended September 27, 2008 Compared to Nine Months Ended September 29, 2007.* General and administrative expenses increased by \$7.6 million from the nine months ended September 27, 2007 to the corresponding period in 2008 due primarily to a \$3.5 million increase in stock-based compensation expense, increased personnel related costs of \$2.4 million, increased facility related expenses of \$1.3 million and an increase of \$0.4 million in accounting and legal expenses.

*Other Income (Expense), Net*

The following table presents our interest income, interest expense and other gain (loss) for the three and nine months ended September 27, 2008 and September 29, 2007 (in thousands):

	Three Months Ended		Nine Months Ended	
	September 27, 2008	September 29, 2007	September 27, 2008	September 29, 2007
Interest income	\$ 1,675	\$ 2,459	\$ 7,236	\$ 3,373
Interest expense		(67)	(3)	(2,249)
Other gain (loss), net	37	533	1,213	(16,982)
Total other income (expense), net	\$ 1,712	\$ 2,925	\$ 8,446	\$ (15,858)

*Three Months Ended September 27, 2008 Compared to Three Months Ended September 29, 2007.* Interest income for the period decreased by \$0.8 million primarily due to the impact of lower interest rates. The decrease in interest expense is due to the payoff of our outstanding debt following our initial public offering (IPO). Other gain (loss), net for the three months ended September 27, 2008 is comprised of a gain of \$0.3 million related to the sale of assets offset by a realized loss of \$0.2 million on the sale of investments. Other gain (loss), net for the three months ended September 29, 2007 primarily consisted of a \$0.4 million gain related to the sale of assets and \$0.1 million of foreign exchange gain.

*Nine Months Ended September 27, 2008 Compared to Nine Months Ended September 29, 2007.* The \$3.9 million increase in interest income was primarily due to increased cash and investment fund balances offset by lower interest rates in the second and third quarter of 2008. The decrease in interest expense was due to the pay off of our outstanding debt following our IPO. Other gain (loss), net for the nine months ended September 27, 2008 primarily consisted of a gain of \$1.0 million related to sale of asset and a gain of \$0.3 million on our foreign currency receivables and transactions. Other gain (loss), net for the nine months ended September 29, 2007 primarily consisted of \$19.8 million charge related to the revaluation of preferred stock warrant liabilities at fair market value. Subsequent to the IPO and the associated conversion of our outstanding convertible preferred stock to common stock, the warrants were reclassified to common stock and additional paid-in-capital and are

## Edgar Filing: INFINERA CORP - Form 10-Q

no longer subject to re-measurement. This loss was partially offset by a \$2.4 million gain related to the sale of assets acquired under an asset purchase agreement and \$0.2 million related to a subletting transaction.



**Table of Contents***Income Tax Provision*

The effective tax rate of 3.82% for the nine months ended September 27, 2008 differs from the statutory rate of 35% primarily due to the tax benefits resulted from the release of valuation allowance on tax attribute carry-forwards which was partially offset by the impact of certain stock compensation charges under SFAS No. 123(R), alternative minimum and state income taxes.

**Liquidity and Capital Resources**

(In thousands)

	September 27, 2008	December 29, 2007
Working capital	\$ 294,462	\$ 237,590
Cash and cash equivalents	\$ 169,439	\$ 91,209
Short and long-term investments	152,354	211,284
Short and long-term restricted cash	2,799	3,337
<b>Total cash, cash equivalents, investments and restricted cash</b>	<b>\$ 324,592</b>	<b>\$ 305,830</b>

	Nine Months Ended	
	September 27, 2008	September 29, 2007
Cash provided by operating activities	\$ 25,354	\$ 4,204
Cash provided by (used in) investing activities	39,142	(108,223)
Cash provided by financing activities	13,800	163,888

Prior to our IPO in June 2007, we had financed our operations primarily through private sales of equity and from borrowings under credit facilities and more recently from cash collections on the sales of our DTN System. In June 2007, we completed our IPO and raised net proceeds of \$190.1 million. In November 2007, we completed our follow-on offering and raised net proceeds of \$104.0 million.

At December 29, 2007, we had \$91.2 million in cash and cash equivalents, \$211.3 million in short and long-term investments and \$3.3 million in restricted cash. In comparison, at September 27, 2008, we had \$169.4 million in cash and cash equivalents and \$152.4 million in short-term and long term investments and \$2.8 million in restricted cash. Cash, cash equivalents restricted cash and short and long-term investments consist of highly liquid investments in money market funds, commercial paper, corporate bonds, U.S. agency notes, U.S. treasuries and adjustable rate securities. The restricted cash balance amounts are pledged as collateral for certain stand-by and commercial letters of credit.

Auctions related to our adjustable rate securities began failing in February of 2008 and we have since been unable to sell these securities and they have therefore been classified as long-term assets on the balance sheet. As of September 27, 2008, we held \$75.7 million of adjustable rate securities which are recorded on the accompanying balance sheet at fair value of \$68.8 million.

As a result of several states' Attorney General's actions, during August 2008, several large financial institutions/broker dealers announced programs to purchase adjustable rate securities from their clients at par value. On October 24, 2008, we entered into a contract with one of our broker dealers to sell back \$65.7 million of adjustable rate securities at par value at anytime during a two-year period beginning June 30, 2010 through July 2, 2012. These adjustable rate securities are recorded at fair value of \$60.0 million with an unrealized loss of \$5.7 million as of September 27, 2008 in the accompanying condensed consolidated balance sheets.

This contract represents a put option which will be valued at fair value, reflecting our right to recover par value for these adjustable rate securities discounted for any underlying credit risk associated with the broker dealer and the timing of the cash flows. The difference between the fair value of this put option and any unrealized loss on these adjustable rate securities will be recorded in our condensed consolidated statements of operations for the quarter ended December 27, 2008. The put option and the adjustable rate securities will be revalued to fair market value on a quarterly basis until the sale of these securities has been completed.

*Operating Activities*

We experienced positive cash flows from operations of \$25.4 million in the first nine months of 2008. We generated net income for the period of \$85.4 million, and we had total non-cash charges of \$24.8 million consisting primarily of depreciation and amortization expenses of \$8.9 million and stock-based compensation expense of \$17.8 million offset by investment discount accretion of \$0.9 million. The net income also reflects the release of \$142.0 million of deferred revenue and \$71.6 million of deferred inventory cost to the balance sheet in the period. Accounts receivable increased by \$8.5 million due to the non-linearity of invoicing and a delay in receipt of payment for one large deployment until after the end of the quarter. This was offset by an increase in accounts payable of \$7.8 million. Accrued liabilities and other expenses decreased by \$8.7 million due to payments made during the period. We also continued to invest in the development of our DTN System and in the expansion of our sales and marketing presence in the United States and internationally.

**Table of Contents**

We experienced positive cash flows from operations of \$4.2 million in the nine months ended September 29, 2007. We generated a net loss for the period of \$51.4 million, and we had non-cash charges of \$31.1 million consisting primarily of warrant expense of \$19.8 million and depreciation of \$7.2 million and stock-based compensation expense of \$6.0 million. The net loss also reflects the non-cash deferral of \$46.2 million of deferred revenue and \$12.8 million of deferred inventory cost to the balance sheet in the period. We experienced improved collections in the period offset by reductions in accounts payable terms.

*Investing Activities*

Net cash provided by investing activities in the first nine months of 2008 was \$39.1 million, primarily comprised of net proceeds from the purchase, maturity and sale of investments in the period of \$53.2 million, reflecting our continued switch to money market funds during the period. This was offset by additions to property, plant and equipment for the period of \$15.2 million.

Cash used in investing activities was \$108.2 million in the nine months ended September 29, 2007, consisting of \$111.3 million of purchase of investments reflecting the investment of cash raised from our IPO in June 2007, \$11.7 million for the purchase of property, plant and equipment, primarily offset by \$12.0 million of proceeds from maturities and sale of investments and \$2.7 million of proceeds from the subsequent sale of some of the purchased assets.

*Financing Activities*

Net proceeds from financing activities in the first nine months of 2008 were \$13.8 million due to \$11.2 million in proceeds from the issuance of common stock under our ESPP and other equity plans and \$2.6 million related to excess tax benefit from stock option transactions.

Net proceeds from financing activities in the nine months ended September 29, 2007 were \$163.9 million. We completed our IPO in June 2007 and generated net proceeds of \$190.1 million. We used \$35.4 million to pay off our outstanding debt, including \$7.1 million which we had borrowed under an existing facility in the first quarter of 2007. In addition, we received \$2.1 million from employee stock options exercised in the period.

*Credit Facilities*

As of September 27, 2008, we held approximately \$68.8 million of municipal note investments at fair value with an auction reset feature (adjustable rate securities) whose underlying assets are generally student loans which are substantially backed by the federal government under the Federal Family Education Loan Programs (FFELP). In February 2008, auctions began to fail for these securities and each auction since then has failed. We have since been unable to liquidate the securities. Based on the overall failure rate of these auctions, the frequency of the failures, and the underlying maturities of the securities, which range from 22 years to 39 years, we have classified these investments as long-term assets on the balance sheet. These investments were valued at fair value as of September 27, 2008, and we recorded an unrealized loss of \$6.8 million under Accumulated Other Comprehensive Income (Loss) on the accompanying condensed consolidated balance sheets under Stockholders Equity as of September 27, 2008 related to these adjustable rate securities.

All of Infinera's adjustable rate securities are currently rated AAA, the highest rating, by a rating agency. If the issuers of the adjustable rate securities are unable to successfully close future auctions or refinance their debt in the near term and their credit ratings deteriorate, we may in the future be required to record an impairment charge on these investments. Based on the expected operating cash flows and other sources of cash, we do not anticipate the current lack of liquidity on these investments will affect our ability to execute our current business plan.

As a result of several states' Attorney General's actions, during August 2008, several large financial institutions/broker dealers announced programs to purchase adjustable rate securities from their clients at par value, beginning in September 2008 through June 2010. As of September 27, 2008, we held \$75.7 million of adjustable rate securities which are recorded on the accompanying condensed consolidated balance sheets at fair value of \$68.8 million.

On October 24, 2008, we entered into a contract with one of our broker dealers to sell back \$65.7 million of adjustable rate securities at par value at anytime during a two-year period beginning June 30, 2010 through July 2, 2012. These adjustable rate securities are recorded at fair value of \$60.0 million with an unrealized loss of \$5.7 million as of September 27, 2008 in the accompanying condensed consolidated balance sheets.

This contract represents a put option which will be valued at fair value, reflecting our right to recover par value for these adjustable rate securities discounted for any underlying credit risk associated with the broker dealer and the timing of the cash flows. The difference between the fair value of this put option and any unrealized loss on these adjustable rate securities will be recorded in our condensed consolidated

## Edgar Filing: INFINERA CORP - Form 10-Q

statements of operations for the quarter ended December 27, 2008. The put option and the adjustable rate securities will be revalued to fair market value on a quarterly basis until the sale of these securities has been completed.

**Table of Contents**

In the next twelve months, capital expenditures are expected to be in the range of approximately \$25 to \$30 million, primarily for product development and manufacturing expansion and upgrades. We believe our current cash and cash equivalents along with the cash we expect to generate from operations, will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least 12 months. If these sources of cash are insufficient to satisfy our liquidity requirements beyond 12 months, we may require additional capital from equity or debt financings to fund our operations, respond to competitive pressures or strategic opportunities or otherwise. We may not be able to secure timely additional financing on favorable terms, or at all. The terms of any additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer dilution in their percentage ownership of us, and any new securities we issue could have rights, preferences and privileges senior to those of holders of our common stock.

*Fair Value Inputs*

We adopted SFAS No. 157 as of the beginning of fiscal year 2008. See Notes 3 and Note 5 to the Condensed Consolidated Financial Statements. Fair value is a market-based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. The use of fair value to measure investment instruments, with related unrealized and realized gains or losses on investment is a component to our condensed consolidated financial statements.

We value the majority of our cash and investment instruments by using quoted market prices and alternative pricing sources with reasonable levels of price transparency. The types of instruments valued based on quoted market prices in active markets include our money market funds and U.S. treasuries. The types of instruments valued based on quoted prices in markets that are not active and alternative pricing sources with reasonable levels of price transparency include U.S. agency notes, corporate bonds and commercial paper products. The price for each security at the measurement date is sourced from an independent pricing vendor. Periodically, management assesses the reasonableness of these sourced prices by comparing a sample of items to the prices provided by our portfolio managers to derive the fair value of these financial instruments. Historically, we did not experience significant deviation between the prices from the independent pricing vendor and our portfolio managers. The types of instruments valued based on unobservable inputs for which there is little or no market data and the unobservable inputs are significant to the fair value measurement includes our adjustable rate securities or ARS. A discounted cash flow model has been used to determine the estimated fair value of our investment in ARS as of September 27, 2008. The assumptions used in preparing the discounted cash flow model include estimates for interest rates, discount rates and the timing and amount of cash flows, including assumptions about the expected holding periods of these securities. Management expects changing conditions in the ARS market to have a significant impact on these underlying assumptions, which in turn can have a significant impact on the fair value of these securities.

**Contractual Obligations**

The following is a summary of our contractual obligations as of September 27, 2008 (in thousands):

	Total	Payments Due by Period			More than 5 years
		Less than 1 year	1 - 3 years	3 - 5 years	
Purchase obligations <sup>(1)</sup>	\$ 22,142	\$ 22,142	\$	\$	\$
Operating leases	12,739	4,240	6,433	2,066	
<b>Total contractual obligations</b>	<b>\$ 34,881</b>	<b>\$ 26,382</b>	<b>\$ 6,433</b>	<b>\$ 2,066</b>	<b>\$</b>

<sup>(1)</sup> We have purchase agreements with our major production suppliers under which we are committed to purchase certain parts. The contractual obligation table above excludes our FIN48 liabilities because we cannot reliably estimate such liability obligations.

**Off-Balance Sheet Arrangements**

As of September 27, 2008, we did not have any relationships with unconsolidated entities or financial partnerships, such as entities often referred to as structured finance or special purpose entities, which would have been established for the purpose of facilitating off-balance sheet arrangements or other contractually narrow or limited purposes.



**Table of Contents****Item 3. Quantitative and Qualitative Disclosures about Market Risk***Foreign Currency Risk*

A majority of our revenue, expense and capital purchasing activities are transacted in U.S. dollars. However, we do incur certain insignificant operating costs in other currencies. In addition, certain of our sales contracts are priced in Euros and, therefore, a portion of our revenue is subject to foreign currency risks. Our operating expenses and cash flows are subject to fluctuations due to changes in foreign currency exchange rates, particularly changes in the India Rupee, British pound and the Euro. The effect of an immediate 10% adverse change in exchange rates on foreign denominated transactions as of September 27, 2008 would result in a loss of approximately \$0.7 million. To date, we have not entered into any hedging contracts although we may do so in the future. Fluctuations in currency exchange rates could harm our business in the future.

*Interest Rate Sensitivity*

We had cash, cash equivalents, short and long-term investments and short and long-term restricted cash totaling \$324.6 million at September 27, 2008. These amounts were invested primarily in certificates of deposit, money market funds, commercial paper, corporate bonds, U.S. agency notes, U.S. treasuries and adjustable rate securities. The unrestricted cash and cash equivalents are held for working capital purposes. We do not enter into investments for trading or speculative purposes. We believe that we do not have any material exposure to changes in the fair value as a result of changes in interest rates. Declines in interest rates, however, will reduce future investment income. If overall interest rates fell by 10% in the three months ended September 27, 2008, our interest income would have declined approximately \$0.7 million, assuming consistent investment levels.

*Adjustable Rate Securities*

As of September 27, 2008, we held \$68.8 million at fair value of municipal notes investments, with an auction reset feature ( adjustable rate securities ) whose underlying assets were in student loans with a credit rating of AAA. In February 2008, auctions related to these adjustable rate securities began to fail and each auction since then has similarly failed. As a result, our ability to liquidate and fully recover the carrying value of our remaining adjustable rate securities in the near term may be limited or not exist. These developments have resulted in the reclassification of these securities as long-term investments in our condensed consolidated financial statements as of September 27, 2008. In addition, we have recorded an unrealized loss of \$6.8 million under Accumulated Other Comprehensive Income (Loss) in the accompanying condensed consolidated balance sheets under Stockholders' Equity as of September 27, 2008. This unrealized loss reflects the current lack of liquidity for these securities in the market place and does not reflect any deterioration in the credit worthiness of the securities or their issuers. However, while all of our adjustable rate securities are currently rated AAA, if the issuers are unable to successfully close future auctions or their credit ratings deteriorate, we may in the future be required to record a realized impairment charge on these investments.

As a result of several states' Attorney General's actions, during August 2008, several large financial institutions/broker dealers announced programs to purchase adjustable rate securities from their clients at par value. As of September 27, 2008, we held \$75.7 million of adjustable rate securities which are recorded on the accompanying condensed consolidated balance sheets at fair value of \$68.8 million.

On October 24, 2008, we entered into a contract with one of our broker dealers to sell back \$65.7 million of adjustable rate securities at par value at anytime during a two-year period beginning June 30, 2010 through July 2, 2012. These adjustable rate securities are recorded at fair value of \$60.0 million with an unrealized loss of \$5.7 million as of September 27, 2008 in the accompanying condensed consolidated balance sheets.

This contract represents a put option which will be valued at fair value, reflecting our right to recover par value for these adjustable rate securities discounted for any underlying credit risk associated with the broker dealer and the timing of the cash flows. The difference between the fair value of this put option and any unrealized loss on these adjustable rate securities will be recorded in our condensed consolidated statements of operations for the quarter ended December 27, 2008. The put option and the adjustable rate securities will be revalued to fair market value on a quarterly basis until the sale of these securities has been completed.

---

**Table of Contents****Item 4. Controls and Procedures**  
**Evaluation of Disclosure Controls and Procedures**

As of September 27, 2008, an evaluation was performed by management, with the participation of our Chief Executive Officer ( CEO ) and our Chief Financial Officer ( CFO ), of the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15-d and 15(e) under the Securities Exchange Act of 1934, as amended). Disclosure controls and procedures are controls and procedures that are designed to ensure that information required to be disclosed in our reports filed or submitted under the 1934 Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Based on this evaluation, our CEO and CFO have concluded that, as of the end of the fiscal period covered by this quarterly report on Form 10-Q, our disclosure controls and procedures were effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified by the U.S. Securities and Exchange Commission's rules and forms and that such information is accumulated and communicated to management, including the CEO and CFO, as appropriate, to allow timely decisions regarding required disclosures.

We are required to comply with Section 404 of the Sarbanes-Oxley Act of 2002 by our fiscal year ending December 27, 2008. The notification of such compliance is due no later than the time we file our annual report for the fiscal year ending December 27, 2008. We believe we will have adequate resources and expertise, both internal and external, in place to meet this requirement. However, there is no guarantee that our efforts will result in a management assurance, or an attestation by the independent auditors, that internal controls over financial reporting were adequate in their design and/or operation.

**Changes in Internal Control over Financial Reporting:**

There were no changes in our internal control over financial reporting, during our most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

**Inherent Limitations of Internal Controls**

Our management, including our CEO and CFO, does not expect that our disclosure controls and procedures or our internal controls will prevent all error and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and that breakdowns can occur because of a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. 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 cost-effective control system, misstatements due to error or fraud may occur and not be detected.

**PART II. OTHER INFORMATION****Item 1. Legal Proceedings**

On April 11, 2007, the Company, Level 3 and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. Patent and Trademark Office as to whether it will reexamine U.S. Patent Nos. 6,795,605 and 7,142,347; and (2) if the U.S. Patent and Trademark Office decides to reexamine either U.S. Patent No. 6,795,605 or 7,142,347, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. Patent and Trademark Office. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. On June 26, 2007, the U.S. Patent and Trademark Office ordered reexamination of U.S. Patent No. 6,795,605. On August 1, 2007, the U.S. Patent and Trademark Office ordered reexamination of U.S. Patent No. 7,142,347. As a result, all proceedings in this lawsuit are stayed until the final resolution of these reexaminations. The Company believes the suit is without merit and intends to defend itself vigorously, but it is unable to predict the likelihood of an unfavorable outcome.

On March 14, 2007, the Company submitted requests to the U.S. Patent and Trademark Office for inter parts reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347 asking the U.S. Patent and Trademark Office to reexamine the patents based on prior art in order to invalidate the patents or limit the scope of each patent's claims. On March 21, 2007, the Company and Level 3 filed a motion with the court to stay all proceedings in the lawsuit pending the reexamination of U.S. Patent Nos. 6,795,605 and 7,142,347.



## Edgar Filing: INFINERA CORP - Form 10-Q

On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, the Company and Level 3 filed responses to Cheetah's third amended complaint denying all infringement claims, and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims of the patents are invalid and that the DTN System does not infringe the patents.

**Table of Contents**

On May 9, 2006, the Company and Level 3 were sued by Cheetah in the U.S. District Court for the Eastern District of Texas for alleged infringement of patent No. 6,795,605, and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of the Company's DTN System and to recover all damages caused by the alleged willful infringement including any and all compensatory damages available by law, such as actual and punitive damages, attorneys' fees, associated interest and Cheetah's costs incurred in the lawsuit. Cheetah's complaint does not request a specific dollar amount for these compensatory damages. The Company is contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent its product is found to infringe, and it has assumed the defense of this matter. On July 20, 2006, the Company and Level 3 filed an amended response denying all infringement claims under patent No. 6,795,605 and asserting that the claims of the patent are invalid and that the DTN System does not infringe the patent. On November 28, 2006, Cheetah filed a second amended complaint and added patent No. 7,142,347 to the lawsuit. On December 18, 2006, the Company and Level 3 filed responses to Cheetah's second amended complaint denying all infringement claims under patent No. 7,142,347 and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims are invalid and that the DTN System does not infringe the patents.

In addition to the matters described above, the Company is subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material effect on its results of operations, financial position or cash flows.

---

## **Table of Contents**

### **Item 1A. Risk Factors**

*A description of the risks and uncertainties associated with our business is set forth below. This description includes any material changes to and supersedes the description of the risks and uncertainties associated with our business previously disclosed in Part I, Item 1A of our Annual Report on Form 10-K for the fiscal year ended December 29, 2007. You should carefully consider such risks and uncertainties, together with the other information contained in this report, our Annual Report on Form 10-K for the fiscal year ended December 29, 2007 and in our other public filings. If any of such risks and uncertainties actually occurs, our business, financial condition or operating results could differ materially from the plans, projections and other forward-looking statements included in the section titled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and elsewhere in this report and in our other public filings. In addition, if any of the following risks and uncertainties, or if any other risks and uncertainties, actually occurs, our business, financial condition or operating results could be harmed substantially, which could cause the market price of our stock to decline, perhaps significantly.*

#### **We have a limited operating history and limited history of selling our DTN System, both of which make it difficult to predict our future operating results.**

We were incorporated in December 2000 and shipped our first DTN System in November 2004. Our limited operating history gives you very little basis upon which to evaluate our ability to accomplish our business objectives. In making an investment decision, you should evaluate our business in light of the risks, expenses and difficulties frequently encountered by companies in early stages of development, particularly companies in the rapidly changing optical communications market. We may not be successful in addressing these risks. It is difficult to accurately forecast our future revenue and plan expenses accordingly and, therefore, predict our future operating results.

#### **We have a history of significant operating losses and may not achieve or maintain profitability on an annual basis in the future.**

We have not achieved profitability on an annual basis. We experienced a net loss of \$55.3 million for the year ended December 29, 2007. As of September 27, 2008, our accumulated deficit was \$284.1 million. We expect to continue to make significant expenditures related to the development of our business, including expenditures to hire additional personnel related to the sales, marketing and development of our DTN System and to maintain and expand our manufacturing facilities and research and development operations. In addition, as a newly public company, we have incurred and will continue to incur significant legal, accounting and other expenses. We will have to sustain significant increased revenue and product gross margins to achieve profitability on an annual basis.

#### **Our operating results may fluctuate significantly, which could make our future results difficult to predict and could cause our operating results to fall below investor or analyst expectations.**

Our operating results may fluctuate due to a variety of factors, many of which are outside of our control. As a result, comparing our operating results on a period-to-period basis may not be meaningful. You should not rely on past results, in particular the recent growth in our revenue, as an indicator of our future performance. Fluctuations in our revenue can lead to even greater fluctuations in our operating results. Our budgeted expense levels depend in part on our expectations of long-term future revenue. Given relatively fixed operating costs related to our personnel and facilities, any substantial adjustment to our expenses to account for lower levels of revenue will be difficult and take time. Consequently, if our revenue does not meet projected levels, our inventory levels and operating expenses would be high relative to revenue, resulting in additional operating losses.

In addition to other risks discussed in this section, factors that may contribute to fluctuations in our revenue and our operating results include:

fluctuations in demand, sales cycles, product mix and prices for our DTN System and our services;

reductions in customers' budgets for optical communications purchases and delays in their purchasing cycles;

order cancellations or reductions or delays in delivery schedules by our customers;

timeliness of our customers' payments for their purchases;

## Edgar Filing: INFINERA CORP - Form 10-Q

readiness of customer sites for installation of our DTN System;

the timing of product releases or upgrades by us or by our competitors;

our ability to establish vendor specific objective evidence, or VSOE, for any future service that we may offer to a customer and to recognize revenue once the other revenue recognition criteria have been met, rather than ratably over the longest undelivered service period;

availability of third party suppliers to provide contract engineering and installation services for us;

**Table of Contents**

any significant changes in the competitive dynamics of our market, including any new entrants, technological advances or substantial discounting of products;

the timing of recognizing revenue in any given quarter as a result of software revenue recognition requirements and any changes in U.S. generally accepted accounting principles or new interpretations of existing accounting rules;

our ability to control costs, including our operating expenses and the costs of components we purchase; and

general economic conditions in domestic and international markets.

If our revenue or operating results fall below the expectations of investors or securities analysts or below any guidance we may in the future provide to the market, the price of our common stock may decline substantially.

**Our gross margin may fluctuate from quarter to quarter and may be adversely affected by a number of factors, some of which are beyond our control.**

Our gross margin fluctuates from period to period and varies by customer and by product specification. Our gross margin may continue to be adversely affected by a number of factors, including:

the mix in any period of higher and lower margin products and services;

price discounts negotiated by our customers;

sales volume from each customer during the period;

the period of time over which ratable recognition of revenue occurs;

the amount of equipment we sell for a loss in a given quarter;

charges for excess or obsolete inventory;

changes in the price or availability of components for our DTN System;

changes in our manufacturing costs, including fluctuations in yields and production volumes;

introduction of new products, with initial sales at relatively small volumes with resulting higher product costs;

increased price competition, including competition from low-cost producers in China; and

## Edgar Filing: INFINERA CORP - Form 10-Q

increased warranty or repair costs.

It is likely that the average unit prices of our DTN System will decrease over time in response to competitive pricing pressures, increased negotiated sales discounts, new product introductions by us or our competitors or other factors. In addition, some of our customer contracts contain annual technology discounts that require us to decrease the sales price of our DTN System to these customers. In response, we will need to reduce the cost of our DTN System through manufacturing efficiencies, design improvements and cost reductions or change the mix of the DTN Systems we sell. If these efforts are not successful or if we are unable to reduce our costs to a greater extent than the reduction in the price of our DTN System, our revenue and gross margin will decline, causing our operating results to decline. Fluctuations in gross margin may make it difficult to manage our business and achieve or maintain profitability.

### **Aggressive business tactics by our competitors may harm our business.**

Increased competition in our markets has resulted in aggressive business tactics by our competitors, including:

selling at a discount used equipment or inventory that a competitor had previously written down or written off;

announcing competing products prior to market availability combined with extensive marketing efforts;

offering to repurchase our equipment from existing customers;

providing financing, marketing and advertising assistance to customers; and

asserting intellectual property rights.

If we fail to compete successfully against our current and future competitors, or if our current or future competitors continue or expand aggressive business tactics, including those described above, demand for our DTN System could decline, we could experience delays or cancellations of customer orders, or we could be required to reduce our prices or increase our expenses.

---

## **Table of Contents**

### **Our ability to increase our revenue will depend upon continued growth of demand by consumers and businesses for additional network capacity.**

Our future success depends on factors such as the continued growth of the Internet and internet protocol traffic and the continuing adoption of high capacity, revenue-generating services to increase the amount of data transmitted over communications networks and the growth of optical communications networks to meet the increased demand for bandwidth. If demand for such bandwidth does not continue, or slows down, the need for increased bandwidth across networks and the market for optical communications network products may not continue to grow. If this growth does not continue or slows down, our DTN System sales would be negatively impacted. In addition, if general economic conditions weaken, this may cause our customers and potential customers to slow or delay their purchase decisions, which would have an adverse affect on our business and financial condition.

### **Recent turmoil in the financial markets and in the general economy has adversely affected and may continue to adversely affect our customers' ability to purchase our products, which would harm our business, financial condition and results of operations.**

Due to the recent tightening of credit markets and disruptions in the financial system, our customers may be delayed in obtaining, or may not be able to obtain, necessary financing for their purchases of our products. A lack of liquidity in the capital markets or the continued general economic uncertainty may cause our customers to delay or cancel their purchases, delay the time they take to pay for our DTN product or default in their payments for our DTN products, each of which would negatively affect our revenue. Continued weakness in the economy could cause some of our customers to become illiquid or further delay payments on their accounts, which could result in a higher level of bad debts. In addition, currency fluctuations relating to the financial crisis could negatively affect our international customers' ability or desire to purchase our products.

This lack of liquidity or general economic uncertainty may adversely affect our suppliers or the terms on which we purchase products from these suppliers. It may also cause some of our suppliers to become illiquid. Any of these impacts could limit our ability to obtain components for our products from these suppliers and could adversely impact our supply chain or the delivery schedule to our customers. This also could require us to re-design our DTN System, which could cause delays in the manufacturing and delivery of our systems. Such events could harm our reputation and our customer relationships, either of which could harm our business and operating results.

### **The markets in which we compete are highly competitive and dominated by large corporations, and we may not be able to compete effectively.**

Competition in the optical communications equipment market is intense, and we expect such competition to increase. A number of very large companies historically have dominated the optical communications network equipment industry. Our competitors include current wavelength division multiplexing suppliers, such as Alcatel-Lucent, Ciena Corporation, Cisco Systems, Ericsson, Fujitsu Limited, Huawei Technologies Co., LM Ericsson Telephone Co., NEC Corporation, Nokia-Siemens Networks, Nortel Networks, Tellabs and ZTE Corporation. Competition in these markets is based on price, functionality, manufacturing capability, pre-existing installation, services, existing business and customer relationships, scalability and the ability of products and breadth and quality of services to meet our customers' immediate and future network requirements. Other companies have, or may in the future develop, products that are or could be competitive with our DTN System. In particular, if a competitor develops a photonic integrated circuit with similar functionality, our business could be harmed. Recent mergers from our competitors and any future acquisitions or combinations between or among our competitors may adversely affect our competitive position by strengthening our competitors.

Many of our competitors have substantially greater name recognition and technical, financial and marketing resources, greater manufacturing capacity and better established relationships with incumbent carriers and other potential customers than we have. Many of our competitors have more resources to develop or acquire, and more experience in developing or acquiring, new products and technologies and in creating market awareness for those products and technologies. In addition, many of our competitors have the financial resources to offer competitive products at below market pricing levels that could prevent us from competing effectively. Further, many of our competitors have built long-standing relationships with some of our prospective customers and have the ability to provide financing to customers and could, therefore, have an inherent advantage in selling products to those customers.

We also compete with low-cost producers in China that can increase pricing pressure on us and a number of smaller companies that provide competition for a specific product, customer segment or geographic market. These competitors often base their products on the latest available technologies. Due to the narrower focus of their efforts, these competitors may achieve commercial availability of their products more quickly than we can and may provide attractive alternatives to our customers.

**We are dependent on Level 3 Communications for a significant portion of our revenue and the loss of, or a significant reduction in orders from, Level 3 or one or more of our key customers would reduce our revenue and harm our operating results.**

A relatively small number of customers account for a large percentage of our net revenue. In particular, for the nine months of 2008, Level 3 Communications, or Level 3, accounted for approximately 26% of our revenue. We expect Level 3 to continue to represent a significant percentage of our revenue for the foreseeable future. Our business will be harmed if we do not generate as much revenue as we expect from our key customers, particularly from Level 3, if we experience a loss of Level 3 or of any of our other key customers or if we suffer a substantial reduction in orders from these customers. Our ability to continue to generate revenue from our key customers will depend on our ability to maintain strong relationships with these customers and introduce new products that are desirable to these customers at competitive prices, and we may not be successful doing so. Because, in most cases, our sales are made to these customers pursuant to standard purchase agreements rather than long-term purchase commitments, orders may be cancelled or reduced readily. In the event of a cancellation or reduction of an order, we may not have enough time to reduce operating expenses to minimize the effect of the lost revenue on our business. Our operating results will continue to depend on our ability to sell our DTN System to Level 3 and other large customers.



## **Table of Contents**

**Our large customers have substantial negotiating leverage, which may require that we agree to terms and conditions that result in increased cost of sales, decreased revenue and lower average selling prices and gross margins, all of which would harm our operating results.**

Substantial changes in the optical communications industry have occurred over the last few years. Many potential customers have confronted static or declining revenue. Many of our customers have substantial debt burdens, many have experienced financial distress, and some have gone out of business or have been acquired by other service providers or announced their withdrawal from segments of the business. Consolidation in the markets in which we compete has resulted in the changes in the structure of the communications networking industry, with greater concentration of purchasing power in a small number of large service providers, cable operators and government agencies. In addition, it has resulted in a substantial reduction in the number of our potential customers. For example, service providers, such as Level 3, have acquired a number of other communications service providers, including one of our other customers. This increased concentration among our customer base may also lead to increased negotiating power for our customers and may require us to decrease our average selling prices.

Further, many of our customers are large communications service providers that have substantial purchasing power and leverage in negotiating contractual arrangements with us. These customers have and may continue to seek advantageous pricing and other commercial terms and may require us to develop additional features in the products we sell to them. We have and may continue to be required to agree to unfavorable commercial terms with these customers, including reducing the average selling price of our DTN System in response to these commercial requirements or competitive pricing pressures. To maintain acceptable operating results, we will need to comply with these commercial terms, develop and introduce new products and product enhancements on a timely basis and continue to reduce our costs.

We expect the factors described above to continue to affect our business and operating results for an indeterminate period, in several ways, including:

overall capital expenditures by many of our customers or potential customers may be flat or reduced;

we will continue to have only limited ability to forecast the volume and product mix of our sales;

managing expenditures and inventory will be difficult in light of the uncertainties surrounding our business; and

increased competition will enable customers to insist on more favorable terms and conditions for sales, including product discounts, extended payment terms or financing assistance, as a condition of procuring their business.

If we are unable to offset any reductions in our average selling prices or increases in our average costs with increased sales volumes and reduced production costs, or if we fail to develop and introduce new products and enhancements on a timely basis, or if we disagree on our interpretation and compliance with the commercial terms of our customer agreements, our relationships with our customers and our operating results would be harmed.

**We are dependent on a single product, and the lack of continued market acceptance of our DTN System would harm our business.**

Our DTN System accounts for substantially all of our revenue and will continue to do so for the foreseeable future. As a result, our business could be harmed by:

any decline in demand for our DTN System;

the failure of our existing DTN System to achieve continued market acceptance;

## Edgar Filing: INFINERA CORP - Form 10-Q

the introduction of products and technologies that serve as a replacement or substitute for, or represent an improvement over, our DTN System;

technological innovations or new communications standards that our DTN System does not address; and

our inability to release enhanced versions of our DTN System on a timely basis.

**If we fail to expand sales of our DTN System into international markets or to sell our products to new types of customers, such as U.S. regional bell operating companies and international postal, telephone and telegraph companies, our revenue will be harmed.**

We believe that, in order to grow our revenue and business and to build a large and diverse customer base, we must successfully sell our DTN System in international markets and to new types of customers, such as U.S. regional bell operating companies and international postal, telephone and telegraph companies. We have limited experience selling our DTN System internationally and to U.S. regional bell operating companies and international postal, telephone and telegraph companies. To succeed in these sales efforts, we believe we must hire additional sales personnel and develop and manage new sales channels through resellers, distributors and systems integrators. If we do not succeed in our efforts to sell to these target markets and customers, the size of our total addressable market will be limited. This, in turn, would harm our ability to grow our customer base and revenue.

---

**Table of Contents****If we fail to protect our intellectual property rights, our competitive position could be harmed or we could incur significant expense to enforce our rights.**

We depend on our ability to protect our proprietary technology. We rely on a combination of trade secret, patent, copyright and trademark laws and confidentiality agreements with employees and third parties, all of which offer only limited protection. The steps we have taken to protect our proprietary rights may be inadequate to preclude misappropriation of our proprietary information or infringement of our intellectual property rights, and our ability to police such misappropriation or infringement is uncertain, particularly in countries outside of the United States. This is likely to become an increasingly important issue as we expand our operations and product development into countries that provide a lower level of intellectual property protection. We do not know whether any of our pending patent applications will result in the issuance of patents or whether the examination process will require us to narrow our claims, and even if patents are issued, they may be contested, circumvented or invalidated. Moreover, the rights granted under any issued patents may not provide us with a competitive advantage, and, as with any technology, competitors may be able to develop similar or superior technologies to our own now or in the future.

Protecting against the unauthorized use of our DTN System, trademarks and other proprietary rights is expensive, difficult, time consuming and, in some cases, impossible. Litigation may be necessary in the future to enforce or defend our intellectual property rights, to protect our trade secrets or to determine the validity or scope of the proprietary rights of others. Such litigation could result in substantial cost and diversion of management resources, either of which could harm our business, financial condition and operating results. Furthermore, many of our current and potential competitors have the ability to dedicate substantially greater resources to enforce their intellectual property rights than we do. Accordingly, despite our efforts, we may not be able to prevent third parties from infringing upon or misappropriating our intellectual property.

**Claims by others that we infringe their intellectual property could harm our business.**

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In particular, many leading companies in the optical communications industry, including our competitors, have extensive patent portfolios with respect to optical communications technology. We expect that infringement claims may increase as the number of products and competitors in our market increases and overlaps occur. From time to time, third parties may assert exclusive patent, copyright, trademark and other intellectual property rights to technologies and related standards that are important to our business or seek to invalidate the proprietary rights that we hold. Competitors or other third parties have, and may continue to assert claims or initiate litigation or other proceedings against us or our manufacturers, suppliers or customers alleging infringement of their proprietary rights, or seeking to invalidate our proprietary rights, with respect to our DTN System and technology. In the event that we are unsuccessful in defending against any such claims, or any resulting lawsuit or proceedings, we could incur liability for damages and/or have valuable proprietary rights invalidated.

Any claim of infringement from a third party, even one without merit, could cause us to incur substantial costs defending against the claim, and could distract our management from running our business. Furthermore, a party making such a claim, if successful, could secure a judgment that requires us to pay substantial damages. A judgment could also include an injunction or other court order that could prevent us from offering our DTN System. In addition, we might be required to seek a license for the use of such intellectual property, which may not be available on commercially reasonable terms or at all. Alternatively, we may be required to develop non-infringing technology, which would require significant effort and expense and may ultimately not be successful. Any of these events could harm our business, financial condition and operating results. Competitors and other third parties have and may continue to assert infringement claims against our customers and sales partners. Any of these claims would require us to initiate or defend potentially protracted and costly litigation on their behalf, regardless of the merits of these claims, because we generally indemnify our customers and sales partners from claims of infringement of proprietary rights of third parties. If any of these claims succeed, we may be forced to pay damages on behalf of our customers or sales partners, which could have an adverse effect on our business, financial condition and operating results.

On May 9, 2006, we and Level 3 were sued by Cheetah in the United States District Court for the Eastern District of Texas Texarkana Division for alleged infringement of patent No. 6,795,605, and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of our DTN System, recovery of all damages caused by the alleged infringement and an award of any and all compensatory damages available by law, including damages, attorneys' fees, associated interest and Cheetah's costs incurred in the lawsuit. Cheetah's complaint does not request a specific dollar amount of damages. We are contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent our product is found to infringe the rights of a third party, and we have assumed the defense of this matter. On July 20, 2006, we and Level 3 filed an amended response. On November 28, 2006, Cheetah filed a second amended complaint and added patent No. 7,142,347 to the lawsuit. On December 18, 2006, we and Level 3 filed responses to Cheetah's second amended complaint. On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, we and Level 3 filed responses to Cheetah's third amended complaint.



---

**Table of Contents**

On April 11, 2007, we, Level 3 and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. Patent and Trademark Office as to whether it will reexamine U.S. Patent Nos. 6,795,605 and 7,142,347; and (2) if the U.S. Patent and Trademark Office decides to reexamine either U.S. Patent No. 6,795,605 or 7,142,347, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. Patent and Trademark Office. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. On June 26, 2007, the U.S. Patent and Trademark Office ordered reexamination of U.S. Patent No. 6,795,605. On August 1, 2007, the U.S. Patent and Trademark Office ordered reexamination of U.S. Patent No. 7,142,347. As a result, all proceedings in this lawsuit are stayed until the final resolution of these reexaminations. We do not know when the U.S. Patent and Trademark Office reexamination process will be completed. In the event that Cheetah is successful in obtaining a judgment requiring us to pay damages or obtains an injunction preventing the sale of our DTN System, our business could be harmed.

**Our manufacturing process is very complex and the partial or complete loss of our manufacturing facility, or a reduction in yields or an inability to scale capacity to meet customer demands could harm our business.**

The manufacturing process for certain components of our DTN product, including our PIC, and for our DTN System is technically challenging. In the event that any of these manufacturing facilities was fully or partially destroyed, as a result of fire, water damage, or otherwise, it would limit our ability to produce our DTN System. Because of the complex nature of our manufacturing facilities, such loss would take a considerable amount of time to repair or rebuild. The partial or complete loss of any of our manufacturing facilities, or an event causing the interruption in our use of such facility for any extended period of time would cause our business, financial condition and operating results to be harmed.

Minor deviations in the manufacturing process can cause substantial decreases in yields and, in some cases, cause production to be suspended. We have had production interruptions and suspensions in the past and may have additional interruptions or suspensions in the future. We expect our manufacturing yield for our next generation PICs to be lower initially and increase as we achieve full production. Poor yields from our PIC manufacturing process or defects, integration issues or other performance problems in our DTN System could cause us customer relations and business reputation problems, harming our business and operating results.

In addition, our manufacturing facilities may not have adequate capacity to meet the demand for our DTN System or we may not be able to increase our capacity to meet potential increases in demand for our DTN System. Our inability to obtain sufficient manufacturing capacity to meet demand, either in our own facilities or through foundry or similar arrangements with third parties, could harm our relationships with customers, our business and our operating results.

**If we fail to accurately forecast demand for our DTN System, we may have excess or insufficient inventory, which may increase our operating costs, decrease our revenue and harm our business.**

We are required to generate forecasts of future demands for our DTN System several months prior to the scheduled delivery to our prospective customers, which requires us to make significant investments before we know if corresponding revenue will be recognized. If we overestimate demand for our DTN System or particular elements of our DTN System and increase our inventory in anticipation of customer orders that do not materialize, we will have excess inventory, we will face a risk of obsolescence and significant inventory write-downs and our capital infrastructure will be depreciated across fewer units raising our per unit costs. If we underestimate demand for our DTN System, we will have inadequate inventory, which could slow down or interrupt the manufacturing of our DTN System and result in delays in shipments and our ability to recognize revenue. In addition, we may be unable to meet our supply commitments to customers which could result in a breach of our customer agreements and require us to pay damages. Lead times for materials and components, including application-specific integrated circuits, that we need to order for the manufacturing of our DTN System vary significantly and depend on factors such as the specific supplier, contract terms and demand for each component at a given time.

**Product performance problems, including undetected errors in our hardware or software, could harm our business and reputation.**

The development and production of new products with high technology content, such as our DTN System, is complicated and often involves problems with software, components and manufacturing methods. Complex hardware and software products, such as our DTN System, can often contain undetected errors when first introduced or as new versions are released. We have experienced errors in the past in connection with our DTN System, including failures due to the receipt of faulty components from our suppliers. We suspect that errors, including potentially serious errors, will be found from time to time in our DTN System. We have been shipping our DTN System since November 2004, which provides us with limited information on which to judge its reliability. Our DTN System may suffer degradation of performance and reliability over time.

## Table of Contents

If reliability, quality or network monitoring problems develop, a number of negative effects on our business could result, including:

delays in our ability to recognize revenue;

costs associated with fixing software or hardware defects or replacing products;

high service and warranty expenses;

delays in shipments;

high inventory excess and obsolescence expense;

high levels of product returns;

diversion of our engineering personnel from our product development efforts;

delays in collecting accounts receivable;

payment of damages for performance failures;

reduced orders from existing customers; and

declining interest from potential customers.

Because we outsource the manufacturing of certain components of our DTN System, we may also be subject to product performance problems as a result of the acts or omissions of these third parties.

From time to time, we encounter interruptions or delays in the activation of our DTN System at a customers' site. These interruptions or delays may result from product performance problems or from issues with installation and activation, some of which are outside our control. If we experience significant interruptions or delays that we cannot promptly resolve, confidence in our DTN System could be undermined, which could cause us to lose customers and fail to add new customers.

**We are dependent on sole source and limited source suppliers for several key components, and if we fail to obtain these components on a timely basis, we will not meet our customers' product delivery requirements.**

We currently purchase several key components from single or limited sources. In particular, we rely on our own production of certain components of our DTN System, such as PICs, and on third parties as sole source suppliers for certain of the components of our system, including: application-specific integrated circuits, field-programmable gate arrays, processors, and other semiconductor and optical components. We purchase these items on a purchase order basis and have no long-term contracts with most of these sole source suppliers. If any of our sole or limited source suppliers suffer from capacity constraints, lower than expected yields, work stoppages or any other reduction or disruption in output, they may be unable to meet our delivery schedule. Further, our suppliers could enter into exclusive arrangements with our competitors, refuse to sell their products or components to us at commercially reasonable prices or at all, go out of business or discontinue their relationships

with us. We may be unable to develop alternative sources for these components.

If we do not receive critical components for our DTN System in a timely manner, we will be unable to deliver those components to our manufacturer in a timely manner and would, therefore, be unable to meet our prospective customers' product delivery requirements. In addition, the sourcing from new suppliers may require us to re-design our DTN System, which could cause delays in the manufacturing and delivery of our systems. In the past, we have experienced delivery delays because of lack of availability of components or reliability issues with components that we were purchasing. In addition, some of our sole suppliers have gone out of business, limited their supply of components to us, or indicated that they may be going out of business. These supplier disruptions may continue to occur in the future, which could limit our ability to produce the DTN System and cause us to fail to meet a customer's delivery requirements. Such events could harm our reputation and our customer relationships, either of which could harm our business and operating results.

**We have experienced delays in the development and introduction of our DTN System, and any future delays in releasing new products or in releasing enhancements to our DTN System may harm our business.**

Since our DTN System is based on complex technology, we may experience unanticipated delays in developing, improving, manufacturing or deploying it. Any modification to our PIC and to our DTN System entails similar development risks. At any given time, various new product introductions and enhancements to our DTN System are in the development phase and are not yet ready for commercial manufacturing or deployment. The maturing process from laboratory prototype to customer trials, and subsequently to general availability, involves a number of steps, including:

completion of product development;

the qualification and multiple sourcing of critical components;

validation of manufacturing methods and processes;

---

**Table of Contents**

extensive quality assurance and reliability testing, and staffing of testing infrastructure;

validation of software; and

establishment of systems integration and systems test validation requirements.

Each of these steps, in turn, presents risks of failure, rework or delay, any one of which could decrease the speed and scope of product introduction and marketplace acceptance of our products. New versions of our PICs, specialized application-specific integrated circuits and intensive software testing and validation are important to the timely introduction of new product introductions and enhancements to our DTN System and to our ability to enter new markets, and schedule delays are common. In addition, unexpected intellectual property disputes, failure of critical design elements, and a host of other execution risks may delay or even prevent the introduction of enhancements to our DTN System. If we do not develop and successfully introduce products in a timely manner, our competitive position may suffer.

**Our investments in adjustable rate securities are subject to risks which may cause losses and affect the liquidity of these investments.**

As of September 27, 2008, we held \$68.8 million of municipal note investments at fair value, classified as long-term investments, with an auction reset feature whose underlying assets were in student loans that had an AAA credit rating. In February 2008, auctions began to fail for these securities and each auction since then has failed. As a result, our ability to liquidate and fully recover the carrying value of our adjustable rate securities in the near term does not exist.

On October 24, 2008, we entered into a contract with one of our broker dealers to sell back \$65.7 million of adjustable rate securities at par value at anytime during a two-year period beginning June 30, 2010 through July 2, 2012. As part of this contract, we agreed to give the broker dealer sole discretion to sell these securities and agreed to release the broker dealer from liability associated with the marketing and sale of these securities. These adjustable rate securities are recorded at fair value of \$60.0 million with an unrealized loss of \$5.7 million as of September 27, 2008 in the accompanying condensed consolidated balance sheets.

This contract represents a put option which will be valued at fair value, reflecting our right to recover par value for these adjustable rate securities discounted for any underlying credit risk associated with the broker dealer and the timing of the cash flows. The difference between the fair value of this put option and any unrealized loss on these adjustable rate securities will be recorded in our condensed consolidated statements of operations for the quarter ended December 27, 2008. The put option and the adjustable rate securities will be revalued to fair market value on a quarterly basis until the sale of these securities has been completed. We cannot be certain that the purchase will be completed or that the broker dealer will have the financial resources to satisfy its obligations under our contract. If the broker dealer is unable to perform its obligations under the contract, our ability to liquidate the securities or fully recover the value of the securities may be further limited.

In the first nine months of 2008, we recorded an unrealized loss of \$6.8 million in our condensed consolidated balance sheet related to our adjustable rate securities. If the issuers of the adjustable rate securities are unable to successfully close future auctions or refinance their debt in the near term and their credit ratings deteriorate, or if the purchase is not completed, we may be required to record an impairment charge on these investments and may liquidate these investments for less than their face value. Such an impairment charge would have an adverse effect on our financial condition and operating results.

**We must respond to rapid technological change and comply with evolving industry standards and requirements for our DTN System to be successful.**

The optical communications equipment market is characterized by rapid technological change, changes in customer requirements and evolving industry standards. The introduction of new communications technologies and the emergence of new industry standards or requirements could render our DTN System obsolete. Further, in developing our DTN System, we have made, and will continue to make, assumptions with respect to which standards or requirements will be adopted by our customers and competitors. If the standards or requirements adopted by our prospective customers are different from those on which we have focused our efforts, market acceptance of our DTN System would be reduced or delayed and our business would be harmed.

We expect our competitors to continue to improve the performance of their existing products and to introduce new products and technologies. To be competitive, we must continue to invest significant resources in research and development, sales and marketing and customer support. We may not have sufficient resources to make these investments, we may not be able to make the technological advances necessary to be competitive and we may not be able to effectively sell our DTN System to customers who have prior relationships with our competitors.



**If we fail to maintain effective internal control over financial reporting in the future, the accuracy and timing of our financial reporting may be adversely affected.**

Assessing our processes, procedures and staffing in order to improve our internal control over financial reporting is an ongoing process. For the year ending December 27, 2008, pursuant to Section 404 of the Sarbanes-Oxley Act, management will be required for the first time to deliver a report that assesses the effectiveness of our internal control over financial reporting. Also, beginning with the year ending December 27, 2008, our auditors will be required to deliver an attestation report on the operating effectiveness of our internal control over financial reporting.

---

## **Table of Contents**

Preparing our financial statements involves a number of complex processes, many of which are done manually and are dependent upon individual data input or review. These processes include, but are not limited to, calculating revenue, deferred revenue and inventory costs. While we continue to automate our processes and enhance our review and put in place controls to reduce the likelihood for errors, we expect that for the foreseeable future many of our processes will remain manually intensive and thus subject to human error.

We have a substantial effort ahead of us to implement appropriate processes, document the system of internal control over key processes, assess their design, remediate any deficiencies identified and test their operation. In the past, we have identified several material weaknesses in our internal control over financial reporting. We have remediated these identified material weaknesses, but we cannot give any assurances that all material weaknesses have been identified or that additional material weaknesses will not be identified in the future in connection with our compliance with the provisions of Section 404 of the Sarbanes-Oxley Act of 2002 beginning in the year ending December 27, 2008. The existence of one or more material weaknesses would preclude a conclusion by management that we maintained effective internal control over financial reporting.

We cannot be certain at this time that we will be able to successfully complete the procedures, certification and attestation requirements of Section 404 or that we or our independent registered public accounting firm will not identify additional material weaknesses in our internal control over financial reporting. If we fail to comply with the requirements of Section 404 or if we or our independent registered public accounting firm identify and report a material weakness, it may affect the reliability of our internal control over financial reporting. Moreover, the market price of our stock could decline and we could be subject to potential delisting by the NASDAQ Stock Market and review by the NASDAQ Stock Market, the SEC, or other regulatory authorities, which would require additional financial and management resources.

### **If we lose key personnel or fail to attract and retain additional qualified personnel when needed, our business may be harmed.**

Our success depends to a significant degree upon the continued contributions of our key management, engineering, sales and marketing, and finance personnel, many of whom would be difficult to replace. For example, senior members of our engineering team have unique technical experience that would be difficult to replace. We do not have long-term employment contracts or key person life insurance covering any of our key personnel. Because our DTN System is complex, we must hire and retain a large number of highly trained customer service and support personnel to ensure that the deployment of our DTN System does not result in network disruption for our customers. We believe our future success will depend in large part upon our ability to identify, attract and retain highly skilled managerial, engineering, sales, marketing, finance and customer service and support personnel. Competition for these individuals is intense in our industry, especially in the San Francisco Bay Area. We may not succeed in identifying, attracting and retaining appropriate personnel. Further, competitors and other entities have in the past attempted, and may in the future attempt, to recruit our employees. The loss of the services of any of our key personnel, the inability to identify, attract or retain qualified personnel in the future or delays in hiring qualified personnel, particularly engineers and sales personnel, could make it difficult for us to manage our business and meet key objectives, such as timely product introductions.

### **Our sales cycle can be long and unpredictable, which could result in an unexpected revenue shortfall in any given quarter.**

Our DTN System has a lengthy sales cycle, which can extend from six to twelve months and may take even longer for larger prospective customers such as U.S. regional bell operating companies, international postal, telephone and telegraph companies and U.S. competitive local exchange carriers. Our prospective customers conduct significant evaluation, testing, implementation and acceptance procedures before they purchase our DTN System. We incur substantial sales and marketing expenses and expend significant management effort during this time, regardless of whether we make a sale.

Because the purchase of our equipment involves substantial cost, most of our customers wait to purchase our equipment until they are ready to deploy it in their network. As a result, it is difficult for us to accurately predict the timing of future purchases by our customers. In addition, product purchases are often subject to budget constraints, multiple approvals and unplanned administrative processing and other delays. If sales expected from customers for a particular quarter are not realized in that quarter or at all, our revenue will be negatively impacted.

### **Our international sales and operations subject us to additional risks that may harm our operating results.**

We market, sell and service our DTN System globally. In 2007, 2006 and 2005, we derived approximately 19%, 14% and 36%, respectively, of our revenue from customers outside of the United States. We have sales and support personnel in numerous countries worldwide. In addition, we have a large group of software development personnel located in Bangalore, India. We expect that significant management attention and financial resources will be required for our international activities over the foreseeable future as we enter new international markets. In some countries, our success will depend in part on our ability to form relationships with local partners. Our inability to identify appropriate partners or reach mutually satisfactory arrangements for international sales of our DTN System could impact our ability to maintain or increase international market demand for our DTN System.



## Table of Contents

Our international operations are subject to inherent risks, and our future results could be adversely affected by a variety of factors, many of which are outside of our control, including:

greater difficulty in collecting accounts receivable and longer collection periods;

difficulties of managing and staffing international offices, and the increased travel, infrastructure and legal compliance costs associated with multiple international locations;

the impact of recessions in economies outside the United States;

tariff and trade barriers and other regulatory requirements or contractual limitations on our ability to sell or develop our DTN System in certain foreign markets;

certification requirements;

greater difficulty documenting and testing our internal controls;

reduced protection for intellectual property rights in some countries;

potentially adverse tax consequences;

political and economic instability;

effects of changes in currency exchange rates; and

service provider and government spending patterns.

International customers may also require that we comply with certain testing or customization of our DTN System to conform to local standards. The product development costs to test or customize our DTN System could be extensive and a material expense for us.

As we continue to expand our business globally, our success will depend, in large part, on our ability to anticipate and effectively manage these and other risks associated with our international operations. Our failure to manage any of these risks could harm our international operations and reduce our international sales.

### **If our contract manufacturers do not perform as we expect, our business may be harmed.**

Our future success will depend on our ability to have sufficient volumes of our DTN System manufactured in a cost-effective and quality-controlled manner. We have engaged third parties to manufacture certain elements of our DTN System and are in the process of qualifying non-U.S. contract manufacturing sites. There are a number of risks associated with our dependence on contract manufacturers, including:

reduced control over delivery schedules, particularly for international contract manufacturing sites;

reliance on the quality assurance procedures of third parties;

potential uncertainty regarding manufacturing yields and costs;

potential lack of adequate capacity during periods of excess demand;

potential uncertainty related to the use of international contract manufacturing sites;

limited warranties on components supplied to us;

potential misappropriation of our intellectual property; and

potential manufacturing disruptions.

Any of these risks could impair our ability to fulfill orders. Our contract manufacturers may not be able to meet the delivery requirements of our customers, which could decrease customer satisfaction and harm our DTN System sales. We do not have long-term contracts or arrangements with our contract manufacturers that will guarantee product availability, or the continuation of particular pricing or payment terms. If our contract manufacturers are unable or unwilling to continue manufacturing our DTN System in required volumes or our relationship with any of our contract manufacturers is discontinued for any reason, we would be required to identify and qualify alternative manufacturers, which could cause us to be unable to meet our supply requirements to our customers and result in the breach of our customer agreements. Qualifying a new contract manufacturer and commencing volume production is expensive and time-consuming and if we are required to change or qualify a new contract manufacturer, we would likely lose sales revenue and damage our existing customer relationships.

## **Table of Contents**

### **Any acquisitions we make could disrupt our business and harm our financial condition and operations.**

We have made strategic acquisitions of businesses, technologies and other assets in the past. While we have no current agreements or commitments, we may in the future acquire businesses, product lines or technologies. In the event of any future acquisitions, we may not ultimately strengthen our competitive position or achieve our goals, or they may be viewed negatively by customers, financial markets or investors and we could:

issue stock that would dilute our current stockholders' percentage ownership;

incur debt and assume other liabilities; or

incur amortization expenses related to goodwill and other intangible assets and/or incur large and immediate write-offs. Acquisitions also involve numerous risks, including:

problems integrating the acquired operations, technologies or products with our own;

diversion of management's attention from our core business;

assumption of unknown liabilities;

adverse effects on existing business relationships with suppliers and customers;

increased accounting compliance risk;

risks associated with entering new markets; and

potential loss of key employees.

We may not be able to successfully integrate any businesses, products, technologies or personnel that we might acquire in the future. Our failure to do so could have an adverse effect on our business, financial condition and operating results.

### **Our use and reliance upon development resources in India may expose us to unanticipated costs or liabilities.**

We have established a development center in India and expect to continue to increase hiring of personnel for this facility. There is no assurance that our reliance upon development resources in India will enable us to achieve meaningful cost reductions or greater resource efficiency. Further, our development efforts and other operations in India involve significant risks, including:

difficulty hiring and retaining appropriate engineering resources due to intense competition for such resources and resulting wage inflation;

the knowledge transfer related to our technology and exposure to misappropriation of intellectual property or confidential information, including information that is proprietary to us, our customers and other third parties;

heightened exposure to changes in the economic, security and political conditions of India;

fluctuation in currency exchange rates and tax risks associated with international operations; and

development efforts that do not meet our requirements because of language, cultural or other differences associated with international operations, resulting in errors or delays.

Difficulties resulting from the factors above and other risks related to our operations in India could expose us to increased expense, impair our development efforts, harm our competitive position and damage our reputation.

**Unforeseen health, safety and environmental costs could harm our business.**

Our manufacturing operations use substances that are regulated by various federal, state and international laws governing health, safety and the environment. If we experience a problem with these substances, it could cause an interruption or delay in our manufacturing operations or could cause us to incur liabilities for any costs related to health, safety or environmental remediation. We could also be subject to liability if we do not handle these substances in compliance with safety standards for storage and transportation and applicable laws. If we experience a problem or fail to comply with such safety standards, our business, financial condition and operating results may be harmed.

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

We are subject to export control laws that limit which products we sell and where and to whom we sell our DTN System. In addition, various countries regulate the import of certain technologies and have enacted laws that could limit our ability to distribute our DTN System or could limit our customers' ability to implement our DTN System in those countries. Changes in our DTN System or changes in export and import regulations may create delays in the introduction of our DTN System in international markets, prevent our customers with international operations from deploying our DTN System throughout their global systems or, in some cases, prevent the export or import of our DTN System to certain countries altogether. Any change in export or import regulations or related legislation, shift in approach to the enforcement or scope of existing regulations, or change in the countries, persons or technologies targeted by such regulations, could result in decreased use of our DTN System by, or in our decreased ability to export or sell our

---

## **Table of Contents**

DTN System to, existing or potential customers with international operations. For example, we need to comply with Waste from Electrical and Electronic Equipment and Restriction of Hazardous Substances laws, which have been adopted by certain European Economic Area countries on a country-by-country basis. Failure to comply with these and similar laws on a timely basis, or at all, decreased use of our DTN System or any limitation on our ability to export or sell our products would adversely affect our business, financial condition and operating results.

### **If we need additional capital in the future, it may not be available to us on favorable terms, or at all.**

Our business requires significant capital. We have historically relied on significant outside debt and equity financing as well as cash flow from operations to fund our operations, capital expenditures and expansion. We may require additional capital from equity or debt financings in the future to fund our operations or respond to competitive pressures or strategic opportunities in the event that we continue to incur significant losses, we are unable to liquidate our auction rate securities or otherwise. We may not be able to secure timely additional financing on favorable terms, or at all. The terms of any additional financing may place limits on our financial and operating flexibility. If we raise additional funds through further issuances of equity, convertible debt securities or other securities convertible into equity, our existing stockholders could suffer dilution in their percentage ownership of our company, and any new securities we issue could have rights, preferences and privileges senior to those of holders of our common stock. If we are unable to obtain adequate financing or financing on terms satisfactory to us, if and when we require it, our ability to grow or support our business and to respond to business challenges could be limited and our business will be harmed.

### **We are subject to government regulations that could adversely impact our business.**

The Federal Communications Commission, or FCC, has jurisdiction over the entire U.S. communications industry and, as a result, our DTN System and our North American customers are subject to FCC rules and regulations. Current and future FCC regulations affecting communications services, our DTN System or our customers' businesses could negatively affect our business. In addition, international regulatory standards could impair our ability to develop products for international customers in the future. Delays caused by our compliance with regulatory requirements could result in postponements or cancellations of product orders. Further, we may not be successful in obtaining or maintaining any regulatory approvals that may, in the future, be required to operate our business. Any failure to obtain such approvals could harm our business and operating results.

### **Natural disasters, terrorist attacks or other catastrophic events could harm our operations.**

Our headquarters and the majority of our infrastructure, including our PIC manufacturing facility, are located in Northern California, an area that is susceptible to earthquakes and other natural disasters. Further, a terrorist attack aimed at Northern California or at our nation's energy or telecommunications infrastructure could hinder or delay the development and sale of our DTN System. In the event that an earthquake, terrorist attack or other catastrophe were to destroy any part of our facilities, or certain of our contract manufacturers' facilities, destroy or disrupt vital infrastructure systems or interrupt our operations for any extended period of time, our business, financial condition and operating results would be harmed.

### **The trading price of our common stock has been volatile and is likely to be volatile in the future.**

The trading prices of our common stock and the securities of other technology companies have been and may continue to be highly volatile. Further, our common stock has limited prior trading history. Factors affecting the trading price of our common stock include:

variations in our operating results;

announcements of technological innovations, new services or service enhancements, strategic alliances or agreements by us or by our competitors;

the gain or loss of customers;

recruitment or departure of key personnel;



changes in the estimates of our operating results or changes in recommendations by any securities analysts that elect to follow our common stock;

market conditions in our industry, the industries of our customers and the economy as a whole; and

adoption or modification of regulations, policies, procedures or programs applicable to our business.

In addition, if the market for technology stocks or the stock market in general experiences loss of investor confidence, the trading price of our common stock could decline for reasons unrelated to our business, financial condition or operating results. The trading price of our common stock might also decline in reaction to events that affect other companies in our industry even if these events do not directly affect us. Each of these factors, among others, could harm the value of your investment in our common stock. Some companies that have had volatile market prices for their securities have had securities class action lawsuits filed against them. If a suit were filed against us, regardless of its merits or outcome, it could result in substantial costs and divert management's attention and resources.

**Table of Contents**

**If securities or industry analysts do not publish research or publish misleading or unfavorable research about our business, our stock price and trading volume could decline.**

The trading market for our common stock depends in part on the research and reports that securities or industry analysts publish about us or our business. If no or few securities or industry analysts cover our company, the trading price for our stock would be negatively impacted. If one or more of the analysts who covers us downgrades our stock or publishes misleading or unfavorable research about our business, our stock price would likely decline. If one or more of these analysts ceases coverage of our company or fails to publish reports on us regularly, demand for our stock could decrease, which could cause our stock price or trading volume to decline.

**Anti-takeover provisions in our charter documents and Delaware law could discourage, delay or prevent a change in control of our company and may affect the trading price of our common stock.**

We are a Delaware corporation and the anti-takeover provisions of the Delaware General Corporation Law, which apply to us, may discourage, delay or prevent a change in control by prohibiting us from engaging in a business combination with an interested stockholder for a period of three years after the person becomes an interested stockholder, even if a change of control would be beneficial to our existing stockholders. In addition, our amended and restated certificate of incorporation and amended and restated bylaws may discourage, delay or prevent a change in our management or control over us that stockholders may consider favorable. Our amended and restated certificate of incorporation and amended and restated bylaws:

authorize the issuance of blank check convertible preferred stock that could be issued by our board of directors to thwart a takeover attempt;

establish a classified board of directors, as a result of which the successors to the directors whose terms have expired will be elected to serve from the time of election and qualification until the third annual meeting following their election;

require that directors only be removed from office for cause and only upon a supermajority stockholder vote;

provide that vacancies on the board of directors, including newly-created directorships, may be filled only by a majority vote of directors then in office rather than by stockholders;

prevent stockholders from calling special meetings; and

prohibit stockholder action by written consent, requiring all actions to be taken at a meeting of the stockholders.

**Table of Contents**

**Item 6. Exhibits**

<b>Exhibit No.</b>	<b>Description</b>
31.1	Certification of Chief Executive Officer, pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Rule 13a-14(a) and Rule 15d-14(a) of the Securities Exchange Act, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

The certification attached as Exhibit 32.1 that accompanies this Quarterly Report on Form 10-Q is not deemed filed with the Securities and Exchange Commission and is not to be incorporated by reference into any filing of Infinera Corporation under the Securities Act of 1933 or the Securities Exchange Act of 1934, whether made before or after the date of this Quarterly Report on Form 10-Q, irrespective of any general incorporation language contained in such filing.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**Infinera Corporation**

By: /s/ Duston M. Williams  
*Duston M. Williams*  
*Chief Financial Officer*

(Duly Authorized Officer and Principal Financial  
Officer)

Date: October 31, 2008