NEXT LEVEL COMMUNICATIONS INC
Form 10-K/A
April 16, 2003

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K/A

(Amendment No. 1)

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2002

OR

o TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 for the transition period from to

Commission File No. 0-27877

NEXT LEVEL COMMUNICATIONS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**95-3342408**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

6085 State Farm Drive
Rohnert Park, CA 94928
(Address of principal executive offices)

Registrant s telephone number, including area code: **(707) 584-6820**

Securities registered pursuant to Section 12(b) of the Act:

Title of Class	Name of Each Exchange on Which Registered
Common Stock, par value $0.01	Nasdaq National Market

Indicate by check mark whether 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 files such reports) and (2) has been subject to such filing requirements for the past 90 days. YES x NO o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K/A or any amendment to this Form 10-K/A. o

Indicate by checkmark whether the registrant is an accelerated filer (as defined in Exchange Act Rule 12b-2).

YES o NO x

The aggregate market value of our voting and non-voting common equity held by non-affiliates is $19,906,515 as of June 30, 2002.

As of March 31, 2003, we have 87,260,523 outstanding shares of common stock.

DOCUMENTS INCORPORATED BY REFERENCE

Documents	Form 10-K References
Our Definitive Proxy Statement for our 2003 Annual Meeting of Stockholders	Part II and Part III

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PART I

ITEM 1. BUSINESS

This Annual Report on Form 10-K of Next Level Communications, Inc. includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. We intend these forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and we are including this statement for purposes of complying with these safe harbor provisions. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions, including those in the section entitled Risk Factors in this annual report. Actual results may vary materially from these forward-looking statements as a result of these and other risks.

Words such as expect, anticipate, intend, plan, believe, estimate and variations of these words and similar expressions are intended to i forward-looking statements. We undertake no obligations to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, unless we are required to do so by law. In light of these risks, uncertainties and assumptions, the forward-looking events discussed below might not occur.

For detailed financial information, consult our financial statements beginning on page 43.

OVERVIEW

We design and market broadband communications equipment that enables telephone companies and other communications service providers to cost-effectively deliver a full suite of voice, high-speed data and digital video services over the existing copper telephone wire infrastructure. Service providers who deploy our equipment can either offer voice, data and video services in a single product offering or offer each service separately depending on subscriber demand and the service provider s objectives. We believe that by installing our equipment, telephone companies and other emerging communications service providers will be able to capitalize on, and compete effectively in, the emerging market for integrated voice, data and video services. Our products consist of equipment located at the telephone company s central office or exchange, in the field and at the subscriber s home or business.

We commenced operations in July 1994 and recorded our first sale in September 1997. From January 1998 until November 1999, we operated through Next Level Communications L.P., which was formed as the result of the transfer of all of the net assets, management and workforce of a wholly-owned subsidiary of General Instrument. In November 1999, the business and assets of that partnership were merged into Next Level Communications, Inc. as part of our recapitalization. In November 1999, we completed an initial public offering of our common stock, raising approximately $177.0 million in net proceeds. In January 2000, General Instrument was acquired by Motorola, Inc., making us an indirect subsidiary of Motorola. As a result of the transactions that occurred in connection with our recapitalization and subsequent borrowings, preferred stock and warrant issuances, Motorola owns 64.1 million shares of our common stock, warrants to acquire an additional 41.3 million shares of our common stock and 7.5 million shares of preferred stock convertible into 91.7 million shares of our common stock constituting approximately 79.3% of our outstanding common stock on a fully diluted basis as of December 31, 2002.

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In 2002, net loss was $78.5 million and net cash used in operating activities was $34.1 million. As of December 31, 2002, our accumulated deficit was $567.0 million. At March 31, 2003, we had cash and cash equivalents of $14.1 million, after making a final payment of $9.5 million to extinguish our Vendor Note Payable and paying approximately $5.0 million of non-recurring expenses related to the Motorola tender offer.

During 2002, we instituted the following measures to improve cash flow:

We reduced our workforce twice in 2001 and by approximately 120 employees or 33% in January 2002; these reductions, along with other cost saving measures implemented, helped us reduce cash overhead expenses by $37.2 million (39%) from 2001 to 2002; and

we reduced inventory by $22.4 million (36%) in 2002, generating net cash flow of approximately $16.5 million;

Since late 2000, we have been significantly dependent on Motorola for funding. Loans from Motorola totaled $15.0 million in 2000 and $97.3 million in 2001. Cash proceeds from preferred stock issuances totaled $65.0 million in 2002. We converted $42.0 million of debt due to Motorola to preferred stock in 2002. We have a remaining debt obligation to Motorola of $41.0 million; in October 2002 the maturity date of this debt was extended from May 2003 to May 2006.

In January 2003, Motorola initiated an unsolicited tender offer for all of the shares of our common stock not owned by Motorola. On April 14, 2003 Motorola announced that it had completed its cash tender offer and that as a result Motorola would own approximately 88.7 percent of our outstanding common stock. Motorola also stated that it intended to convert certain of its shares of our preferred stock into shares of our common stock to achieve a 90 percent ownership level and that it will then effect a short-form merger pursuant to which all of our remaining outstanding shares (other than dissenting shares) will be converted into the right to receive $1.18 per share. Once Motorola completes the short-form merger, we will no longer be a publicly traded company on the Nasdaq National Market or otherwise.

In the last three quarters of 2002, we reduced our average negative quarterly operating cash flow to approximately negative $4.8 million. Subject to the effect of a significant change in our revenues on working capital, we expect 2003 cash flow from operations to be consistent with this trend (excluding the approximately $5.0 million of tender offer expenses paid in the first quarter of 2003). Our ability to generate positive operating cash flow is dependent on our ability to increase sales, convert our inventory and accounts receivable to cash, negotiate favorable terms with our vendors, effectively manage our operating costs and continue to raise sufficient operating capital. We believe that the combination of cash on hand, the cash flows expected to be generated from operations and the cost savings generated by further planned expense reductions will be sufficient to enable us to meet our financial obligations and sustain our operations through the third quarter of 2003. We intend to aggressively pursue additional sources of financing to support our operations on a continuing basis.

Our equipment is designed to provide the following key benefits:

Flexible, Integrated Products. Our products are designed with the flexibility to allow our customers to deliver voice, data and video services in a single packaged offering or to offer them individually. This flexibility allows telephone companies to immediately serve the varying needs of their diverse end-user base, including residential, corporate and telecommuter customers. By offering the flexibility inherent in an integrated system, our products enable telephone companies to effectively time their network equipment expenditures and rapidly introduce new services as demand warrants.

Cost-Effective Product Deployment. Our product design reduces the cost and complexity often associated with deploying multiple services to end-users. Because telephone companies often

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use separate equipment for each communications service, they require multiple equipment purchases, installations, training procedures, maintenance procedures and network management packages. In contrast, our products deliver all services from a single system. By integrating many traditionally separate functions, our products allow telephone companies to add services incrementally by simply installing new modules into our existing equipment, rather than purchasing entirely new infrastructure equipment. Additionally, our products installed in the house or office deliver video and data services from a single networked set-top box, thus eliminating the need for set-top boxes or modems for different services or separately located TVs and PCs. We believe our products provide cost savings, reduce trouble calls and ease installation compared to other equipment that often consists of separate systems, each of which corresponds to one service and which may not operate effectively together.

Complete Solution For Delivery of Voice, Data and Video. By supplying equipment for the telephone company central office, the field and the subscriber s home or office, we offer a single integrated system for the delivery of voice, data and video services. With our products, telephone companies initially deploying voice service can subsequently activate data and/or video service with a simple addition and installation of equipment at the subscriber s home or office. We believe the flexibility found in our products cannot currently be accomplished by attempting to integrate multiple systems from multiple vendors.

Reliable and Compatible Technology. Because our products provide multiple services, including voice, they are engineered to comply with rigorous industry standards for reliability and safety. We have also designed our products to operate with existing telephone company switches and billing systems, thereby minimizing the cost of using our products.

Security. We believe that our products produce greater security compared to cable systems that are based on shared network design in which data is broadcast to all users simultaneously. Security has always been important to individuals and businesses in voice transmission and is becoming increasingly important as e-commerce applications and video-on-demand services become more prevalent.

PRODUCTS

Our products include equipment located at a telephone company s central office, in the field and at a subscriber s home or business.

Broadband Digital Terminal. The Broadband Digital Terminal is the central element of our product suite, providing centralized access to both broadband and narrowband core networks and related voice, data and video services. The Broadband Digital Terminal is typically located in a telephone company s central office, or at a remote building basement or hut where it connects with central office equipment including voice and data switches and billing systems. On the subscriber side, the Broadband Digital Terminal provides high-speed connections to remote Universal Service Access Multiplexers, Broadband Service Access Multiplexers or Broadband Network Units that can support several thousand telephone subscribers or combinations thereof. The Broadband Digital Terminal has the capacity for cable and satellite competitive broadband applications such as video-on-demand and high definition television. Also, because the Broadband Digital Terminal supports different remote terminals, changes to network layouts or transmission media, copper or fiber, do not require different Broadband Digital Terminals.

Universal Service Access Multiplexer. We designed the Universal Service Access Multiplexer to use existing copper wire to connect to a customer s home or office. This product can be connected with fiber optic cable to the Broadband Digital Terminal. Each Universal Service Access Multiplexer can support up to 32 video and/or data subscribers via Very High Bit Rate Digital Subscriber Line technology, up to 48 video and/or data subscribers via Asymmetric Digital

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Subscriber Line technology or up to 96 voice subscribers in each shelf. By using modular components, a single Universal Service Access Multiplexer enables multiple voice, data and video services. The Universal Service Access Multiplexer can be deployed in the telephone company s central office or remotely. Because the Universal Service Access Multiplexer is flexible in terms of where it can be located in the network, as well as the services it can support, its use can reduce both the costs and the complexity of deploying new high-speed data and video services. A specialized version, called the Universal Service Access Multiplexer Single Shelf Enclosure, further reduces these costs by providing a hardened, self-contained cabinet to easily overlay existing digital lop carrier equipment or cost-effectively service rural subscribers.

Broadband Service Access Multiplexer. The Broadband Service Access Multiplexer is our latest remote terminal solution enabling the intelligent transport of voice, video, and data over a single twisted pair to the home. This is the first commercially available Digital Subscriber Line service shelf that utilizes the global 998 standard for VDSL transport. The 998 standard provides an ADSL spectrally compatible spectrum plan and is designed to provide a means for multi-vendor equipment interoperability. The Broadband Service Access Multiplexer can also support ADSL services. The Broadband Service Access Multiplexer can be deployed in the telephone company s central office or remotely. The Broadband Service Access Multiplexer provides increased density of VDSL and/or ADSL ports per shelf, substantially decreasing the cost per subscriber, and supports both Very High Bit Rate Digital Subscriber Line and Asymmetric Digital Subscriber Line cards, with 12 ports per card. The capacity is 12 line cards per shelf, totaling 144 Digital Subscriber Line ports per Broadband Service Access Multiplexer. Transport from the Broadband Digital Terminal to the Broadband Service Access Multiplexer is over a 622 megabit per second Optical Distribution Unit. The high-speed transport coupled with multicasting capability, which provides the intelligence to share the bandwidth of a single video channel over multiple homes, reduces costs of deploying high-speed as well as providing digital cable television competitive broadcast services.

Broadband Network Unit. The Broadband Network Unit is used with Fiber to the Curb installations where fiber optic cable is deployed up to a location relatively close to the customer s home or office. The Broadband Network Unit supports voice, data and video services, and can be mounted on a telephone pole, a pedestal or a wall. The Broadband Network Unit provides voice, high-speed data and video service for clusters of 8 or 16 video and/or data and 24 or 36 voice subscribers. Our Broadband Network Unit is particularly suited to situations where a new network is being built, or where existing copper wire is being upgraded by the installation of fiber optic cable as the transmission medium for residences or larger apartment buildings or offices. The advanced design and environmentally secure housing of the Broadband Network Unit helps to reduce in-field trouble calls.

N3 Residential Gateway. Our N3 Residential Gateway product is a single set-top box that delivers integrated data and video services. One N3 Residential Gateway enables multiple televisions and PCs to be served from the same copper line coming into the customer s home or office. Traditionally, the high cost of customer home or office equipment for broadband services has been a limiting factor in the deployment of broadband services to multiple televisions or personal computers. Historically, a customer would have to obtain multiple modems or set-top boxes to support services to multiple televisions or personal computers. In contrast, our N3 Residential Gateway simultaneously provides two or three independent high quality digital video streams that can be distributed throughout a home or office using standard coaxial cable. The N3 Residential Gateway also supports enhanced telephone services, such as an indicator on the television that a message is waiting on the customer s answering machine or service as well as on-screen caller ID. The data port in our N3 Residential Gateway supports high-speed connectivity to the Internet or remote work-at-home access.

N3 ETHERset. Our N3 ETHERset is a data-only, desktop device that provides a powerful, low-cost solution for delivering high-speed Internet or data services to subscribers in residences, small businesses and branch offices and the like. Individual or multiple PCs can be connected to a single N3 ETHERset.

Element and Subscriber Management Systems and Middleware. Our products can be managed remotely by our N3 View-1 Element Management System and our N3 View-2 Service Manager. The View-1 Element Management System enables service providers to manage our equipment and their other systems and products. The View-2 Service Manager enables service providers to manage delivery of voice, data and video services to their customers. We also provide sophisticated Middleware that manages the applications which can be provided via the N3 Residential Gateway, such as network games, walled garden Internet browsing, and other interactive applications. An open applications interface exists to allow other applications providers to provide their interactive applications on the N3 Residential Gateway.

CUSTOMERS

We market and sell our products through our direct sales force to service providers. Our largest customer, Qwest (formerly US WEST) accounted for 24%, 41% and 56% of our revenues in 2002, 2001 and 2000. In addition, we sell to a steadily increasing number of other local, independent and international telephone companies. During 2002, 64 customers each had purchased at least $100,000 of our products.

We recorded our first sale to Qwest in September 1997 for deployment of video and data service to Qwest s customers in Phoenix, Arizona. In October 1998, Qwest selected our product to provide voice applications in six of the 14 states that Qwest serves. Sales to Qwest were significantly reduced in late 2001 due to an overall reduction in capital spending by Qwest. Additionally, Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to Qwest in the future are dependent upon its decision regarding the deployment of our product and its overall capital spending plans. Qwest reported significant operating losses in 2002, and has reported that it will restate prior period financials for certain incorrectly recorded transactions. These factors may have a significant adverse impact on Qwest s decision regarding the deployment of our product.

Our customers also include Bell Canada, Ben Lomand Communication, Brandenburg Telephone Company, Cablevision, Cameron Telephone, CenturyTel, Chibardun Telephone, Clear Lake Telephone, Craw-Kan Telephone Cooperative, Frontier Communications, Horizon Telephone, Horry Telephone Cooperative, Hutchinson Telephone, MTS Communications, New ULM Telecom, Paul Bunyan Rural Telephone, South Central Rural Telephone Cooperative, Telenor, United Telephone, West Carolina Rural Telephone Cooperative, Warwick Valley Telephone and Wood County Telephone.

TECHNOLOGY

We believe the following key technologies have been instrumental in our ability to provide what we believe is the world s only integrated, complete solution for the delivery of integrated voice, high-speed data and digital video services over the existing telephone copper telephone wires and deep fiber architectures such as Fiber to the Curb and Fiber to the Home.

Advanced Application Specific Integrated Circuit (ASIC) Architecture. are custom-designed silicon circuits that are optimized for a specific task or set of tasks. These circuits are critical because they are performance-optimized to minimize complexity, packaging size, power dissipation and cost. In addition, one of these circuits may be the only way to provide a new or novel function that is not available in an off-the-shelf circuit. Our engineers have substantial experience in the design of these circuits and have developed a portfolio of over 50, which enables flexible delivery of voice, data and video from a single system. We will continue to pursue additional service and system level ASICs as a mechanism for protecting our intellectual property and to achieve ongoing cost reductions.

System Design and Integration Expertise. We employ a team of experienced system design and integration engineers in our research and development group. These individuals provide research, design and development resources and ensure that our products can be integrated by our customers. System integration expertise is critical to the successful deployment of new advanced full service telecommunications systems and services by our customers.

Wavelength Division Multiplexing Technology. Our system uses a technology known as wavelength division multiplexing. This technology allows multiple optical signals to be carried on the same optical fiber. In particular, this technology is used to communicate two-way voice, data and video over a single optical fiber. This enables our customers to save fiber costs and increase bandwidth.

Software and Protocol Stacks. Most of the system software in our products has been developed internally using modern design principles and processes. Where appropriate, various third-party software packages have been integrated into the access system. Some examples include the real-time operating system and various protocol stack software packages.

Standards-based Architecture. We support multiple industry standards to minimize interoperability issues and leverage industry hardware and software capabilities, and improve time to market. On the customer side of the network, we are working with industry standards for asymmetric digital subscriber line and very high-speed digital subscriber line standards to support various equipment at the customer s home or business. In addition, we are providing an open middleware environment for our family of Residential Gateway products that enable support for various third party interactive applications.

RESEARCH AND DEVELOPMENT

We believe that our future success depends on our ability to:

- adapt to the rapidly changing telecommunications environment;
- maintain our expertise in core technologies; and
- continue meeting and anticipating the evolving needs of telephone companies.

We continually review and evaluate technological changes affecting the telecommunications market and invest substantially in applications-based research and development. We are committed to an ongoing program of new product development that combines internal development efforts with strategic relationships and licensing or marketing arrangements relating to new products and technologies from outside sources.

We have focused our research and development expenditures for the past several years on creating a complete solution for the delivery of voice, data and video services using the existing infrastructure of telephone companies. We have also concentrated on developing the associated customer premises equipment, including our N3 Residential Gateway, and on developing our N3 View-1 Element Management Systems. In 2002, 2001 and 2000, research and development expenses were $25.3 million, $46.9 million and $55.8 million. We believe that our extensive experience in designing and implementing high-quality network components has enabled us to develop integrated systems solutions. We continually seek to improve our existing products, including developing additional home and office products and higher speed interfaces for our products.

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SALES AND MARKETING

We primarily market and sell our products through a direct sales force located in North America. Sales activities have been focused primarily on regional bell operating companies, and independent and international telephone network operators. Because of the potential importance of our products to our customers networks, we focus our selling efforts at many levels within each customer s organization.

We have a variety of marketing programs and initiatives to support the sale and distribution of our products. A key factor in building brand awareness for our products is promoting the success of our customers deploying our products. We seek to educate telephone companies regarding the benefits of deploying broadband-ready equipment across a diverse subscriber base. We also build our brand name through continued publicity and referral efforts in both media and industry-centered activities, including editorial presence in various trade magazines, press releases, public speaking opportunities, national and regional trade show participation, advertising, Internet-based communication and promotion, media sponsorships and participation in industry standards activities.

MANUFACTURING

We seek to deliver our products on time and defect-free by capitalizing on the experience and expertise and efficiencies of strategic contract manufacturers. Using contract manufacturers allows us to avoid costly investment in manufacturing facilities and processes. We established a new primary contract manufacturing relationship with Plexus Services Corporation in 2003.

We maintain only a limited in-house manufacturing capability for final assembly, testing and integration of our products. Our internal manufacturing expertise is focused on product design for testability, design for manufacturability and the transfer of products from development to manufacturing. Our contract manufacturers typically assemble an account team of personnel representing all the essential functions to deliver products from prototype through volume production. This team works with our design, test and manufacturing engineers, and our quality, materials, logistics and program management teams. Our primary contract manufacturer is certified under international quality standards. Although our contract manufacturers manage material procurement for the majority of the components that are incorporated in our products, we continue to manage the evaluation and selection of certain key components.

Our engineering team designs circuits and tests these designs using computer simulations. When the fundamental design is stable, our contract manufacturers make the circuits for testing. Upon completion of these tests, vendors such as Metalink, Oki Semiconductor, Broadcom, STMicroelectronics, VLSI (Philips) and Motorola manufacture the circuits in volume. Warranty and repair support is performed off-site by our contract manufacturers and by us at our Rohnert Park, California facility.

COMPETITION

The market for providing equipment for local telecommunications networks is extremely competitive. The principal competitive factors in this market include, or are likely to include:

- product performance and price;
- features and reliability;
- technical support and service;
- relationships with phone companies and systems integrators;
- compliance with industry standards;
- compatibility with the products of other suppliers;

- sales and distribution capabilities;
- strength of brand name;
- long-term cost of ownership and return on investment to communications providers; and
- general industry and economic conditions.

Many of our current and potential competitors have longer operating histories and greater name recognition and resources than we do. These competitors may undertake more extensive marketing campaigns, adopt more aggressive pricing policies, and/or devote substantially more resources to developing new products than we do. Many of our competitors have been consolidated with larger companies and now have even greater resources to compete with us.

Our significant current and potential competitors include Advanced Fibre Communications, Alcatel, Allied Telesyn, Calix Networks, Catena Networks, Cisco Systems, Lucent Technologies, Net-to-Net, Nokia, Nortel Networks, Occam Networks, Pace Electronics, Scientific Atlanta, Siemens and our largest stockholder, Motorola. Some of these competitors have existing relationships with our current and prospective customers, which could give them a competitive advantage over us as a preferred provider. In addition, we anticipate that other large companies, such as Matsushita Electric Industrial, which markets products under the Panasonic brand name, Microsoft, Network Computer, Philips, Sony, STMicroelectronics and Toshiba America, will likely introduce products that compete with our N3 Residential Gateway product in the future.

In addition, we are likely to face increasing competition from alternative technologies. In particular, cable operators are currently deploying products that deliver voice, high-speed data and video services over cable. Cable service providers that offer these packaged services will give subscribers the alternative of purchasing all communications services from a single service provider. If these services are implemented successfully, they will compete directly with the services offered by telephone companies using our products.

Consolidation in the telecommunications equipment industry may strengthen our competitors position in our market. Consolidation of our competitors has occurred, and we expect it to continue to occur in the foreseeable future. Acquisitions may further strengthen our competitors financial, technical and marketing resources.

INTELLECTUAL PROPERTY

We rely on a combination of patent, copyright and trademark laws, and on trade secrets, confidentiality provisions and other contractual provisions to protect our intellectual property. These measures afford only limited protection. We rely on patent, trademark, trade secret and copyright laws both to protect our proprietary technology and to protect us against claims from others. We believe that we have direct intellectual property rights or rights under cross-licensing arrangements covering substantially all of our material technologies. Given the technological complexity of our systems and products, however, we cannot assure that claims of infringement will not be asserted against us or against our customers in connection with their use of our systems and products, nor can we assure the outcome of any such claims.

As of March 31, 2003, we have 31 granted patents in the United States and 10 granted patents in various foreign countries. Additionally, we have 20 pending U.S. patent applications and 42 pending international and foreign patent applications.

We market our products primarily under our own name and mark. We consider our trademarks to be valuable assets.

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SOURCES AND AVAILABILITY OF MATERIALS

We contract for the manufacture of all of our products and have limited in-house manufacturing capabilities. During 2002, we relied primarily on two large contract manufacturers: Sanmina-SCI Systems and Flextronics Enclosures. Beginning in 2003, we will rely primarily on Plexus Services Corp. For a detailed discussion of these relationships and the risks associated with our dependence upon third-party manufacturers, see Business-Manufacturing and Risk Factors.

Some parts, components and equipment used in our products are obtained from sole sources of supply. If our sole source suppliers fail to provide or we fail to obtain components in sufficient quantities when required, delivery of our products could be delayed. Additional sole-sourced components may be incorporated into our equipment in the future. We do not have any long-term supply contracts to ensure sources of supply. In addition, our suppliers may enter into exclusive arrangements with our competitors, stop selling their products or components to us at commercially reasonable prices or refuse to sell their products or components to us at any price, which could harm our operating results.

ENVIRONMENTAL MATTERS

Our research and development operations are subject to certain federal, state, local and foreign environmental protection laws and regulations. These laws and regulations relate to the use, handling, storage, discharge and disposal of certain hazardous materials and wastes, the pre-treatment and discharge of process waste waters and the control of process air pollutants. We believe that we are in compliance in all material respects with applicable environmental regulations. Compliance with new laws and regulations could create significant compliance expenses, result in production suspension and delay, restrictions on expansion at present locations and require the acquisition of costly equipment. Non-compliance with laws and regulations could result in penalties and suspension of operations.

REGULATION OF CUSTOMERS

Although our products are not now directly subject to significant regulation by the Federal Communications Commission, (or FCC), or any other federal or state communications regulatory agency, our customers and their networks, into which our products are incorporated, are subject to government regulation. Accordingly, the effects of regulation on our customers may, in turn, affect our business, operating results and financial condition. FCC regulatory policies affecting either the willingness or the ability of telephone companies to offer certain services and to purchase and install our products in their networks, or the terms on which these companies offer the services and conduct their businesses, may impede sales of our products.

Several FCC regulatory policies may affect the degree to which or way in which incumbent local exchange carriers, which we refer to as incumbent carriers, principally the regional Bell operating companies, can or choose to make integrated voice, data and video offerings available. For example, the Telecommunications Act of 1996 requires incumbent carriers to offer their competitors cost-based access to certain parts of their networks to enable these competitors to provide telecommunications services. The FCC recently issued a decision under which incumbent carriers would no longer be required to provide competitors access to the elements of their networks used to provide broadband services. The FCC s order has not yet been released to the public so it is too early to determine the full impact of the decision. In addition, the order will be appealed at the FCC and in the courts. These legal challenges will not be resolved definitively for some time during which regulatory uncertainty may remain.

The Commission has tentatively concluded that it intends to develop a consistent framework for regulation of broadband services offered by cable and telephone companies. The Commission also has tentatively concluded that wireline broadband services are not subject to all the

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requirements that regulate the offerings of common carriers under Title II of the Communications Act of 1934. Finally, the Commission recently decided that broadband service provided by cable operators via a cable modem is not subject to regulation as a telecommunications service. This ruling, combined with the FCC s review of rules governing the incumbent carriers, indicates that change in the regulatory climate affecting incumbent carriers is possible. However, we will not know for certain the FCC s position until it issues orders in these proceedings and any legal challenges have been decided, which is not expected to occur until later this year at the earliest.

The Telecommunications Act of 1996 also requires incumbent carriers to offer for resale, at wholesale rates, any telecommunications services that incumbent carriers offer to customers. Existing regulations currently define Internet access services as telecommunications services, and thus incumbent carriers must offer such services for resale to competitors. This requirement also is implicated by on-going FCC proceedings, but the outcome is uncertain until the FCC issues orders in these proceedings and any legal challenges have been resolved.

Incumbent carriers can provide video services through a structurally separate subsidiary that is not subject to the unbundling and resale requirements. Our equipment is designed to allow carriers to provide video, high-speed data, and digital voice on an integrated basis. Because of the regulatory restrictions, if incumbent carriers choose to offer video or data services through a separate affiliate, incumbent carriers may prefer vendors whose equipment does not provide for integration of service offerings. A separate affiliate may choose to purchase less sophisticated equipment because it might not be able to utilize fully our equipment s integrated features. The FCC may change the separate subsidiary requirement, but we will not know for certain until the FCC issues an order and any legal challenges have been resolved.

In its order approving the merger of two Bell operating companies, SBC and Ameritech, the FCC permitted the merged entity to avoid its statutory resale obligations on advanced services provided that such services were offered through a separate subsidiary. Recently, however, the U.S. Court of Appeals for the D.C. Circuit vacated, in part, the FCC s order and held that the FCC may not permit an incumbent carrier to avoid its statutory obligations under the Telecommunications Act of 1996 by setting up an affiliate to offer such services.

Distribution of our N3 Residential Gateway could be adversely affected by the FCC s navigation devices rules. Those rules require video program distributors, including those who use our system to deliver video, to allow set-top boxes and other navigation devices owned by customers or manufactured by third parties to be connected to the video program distributor s system. The rules require video program distributors to disclose technical details of their interfaces so as to permit third parties to manufacture the navigation devices and retail customers to connect them. We believe these rules are not readily applicable to our system because our N3 Residential Gateway is in many ways different from a cable set-top box, and currently there is little likelihood of an independent market for our N3 Residential Gateway separate from our entire system. However, if these rules could be applied to our N3 Residential Gateway or other parts of our system, our customers might be required to disclose proprietary technical information including patented data about our technology, to allow competing vendors to access the system.

The uncertainties caused by pending regulatory proceedings and possible appeals of FCC decisions, and by pending legislation, could cause potential customers to delay purchasing decisions. In addition, the outcomes of the various regulatory proceedings and legislation may cause potential customers not to deploy all of the services for which our products are designed or to delay the widespread introduction of one or more of these services.

BACKLOG

Our backlog primarily consists of purchase orders for products to ship within the next six months. At December 31, 2001 and 2002, backlog was approximately $3.2 million and $7.9 million,

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respectively. We consider backlog to be an indicator, but not the sole predictor, of future sales because our customers may cancel or defer orders without penalty. Cancellation or reduction of pending purchase orders could seriously harm our future revenues.

EMPLOYEES

As of March 31, 2003, we have a total of 249 full-time employees and 23 independent contractors. The total number of employees consists of 120 in research and development, 10 in marketing, 33 in operations, 49 in sales and sales support and 37 in administration. The total number of contractors consists of two in research and development, 13 in operations, five in marketing and sales and three in administration. Our employees are not represented by any collective bargaining agreement with respect to their employment, and we have never experienced an organized work stoppage. Satisfactory relations have generally prevailed between our employees and us. Our future success is heavily dependent upon our ability to hire and retain qualified technical, marketing and management personnel.

ITEM 2. PROPERTIES

Our principal corporate offices are located in a company-owned building in Rohnert Park, California. We lease one sales office, in Englewood, Colorado. We also lease a sales support office in Englewood, Colorado and one administrative office in Schaumburg, Illinois.

We continually evaluate our occupancy needs, particularly with respect to the force reductions we have experienced in the past several quarters. In 2002 we incurred facility consolidation charges totaling $1.9 million: $0.9 million related to the present value of future minimum lease payments and impaired leasehold improvements on vacated premises and $1.0 million related to cancellation charges on a facility expansion project. If, in the future, we decide to further consolidate our facilities, we may incur related termination costs.

We believe our current facilities are suitable and adequate and have sufficient capacity to meet our current needs.

ITEM 3. LEGAL PROCEEDINGS

Securities Litigation.

Next Level and certain of its current or former officers and directors (the Next Level defendants) were named as defendants in a securities class action lawsuit filed in the United States District Court for the Southern District of New York. This action, captioned Next Level, Inc. Initial Public Offering Securities Litigation, also names several of the underwriters involved in Next Level s initial public offering (IPO) as defendants. This class action is brought on behalf of a purported class of purchasers of Next Level common stock from the time of Next Level s IPO (November 9, 1999) through December 6, 2000. The central allegation in this action is that the underwriters in the Next Level IPO solicited and received undisclosed commissions from, and entered into undisclosed arrangements with, certain investors who purchased Next Level stock in the IPO and the after-market. The complaint also alleges that the Next Level defendants violated the federal securities laws by failing to disclose in the IPO prospectus that the underwriters had engaged in these allegedly undisclosed arrangements. (More than 300 issuers have been named in similar lawsuits.)

In July 2002, an omnibus motion to dismiss all complaints against issuers and individual defendants affiliated with issuers (including the Next Level defendants) was filed by the entire group of issuer defendants in these similar actions. In October 2002, the Next Level individual defendants named in this action were dismissed without prejudice. On February 19, 2003, the Court in this action issued its decision on Defendants omnibus motion to dismiss. This decision denied the motion to dismiss the Section 10(b) claim as to Next Level (and numerous other issuer defendants), and denied the motion to dismiss the Section 11 claim as to Next Level and virtually all of the other issuer-defendants. Next Level believes it has meritorious defenses and intends to vigorously defend itself against this suit. As a result of this belief, no liability for this suit has been recorded in the accompanying financial statements. However, we could be forced to incur significant expenses in the litigation, and in the event there is an adverse outcome, our business could be harmed.

On January 28, 2002, a complaint entitled Next Level Communications, Inc. v. Virtual Access plc was filed by us in the Superior Court of the State of California, County of Sonoma. The complaint relates to a demand made by Virtual Access that Next Level invest an additional $2.0 million in Virtual Access pursuant to various investment and settlement agreements between the two companies. The complaint by Next Level seeks declaratory relief that Next Level has no obligation to make any further payments to Virtual Access, as well as restitution and rescission. Virtual Access did not file a timely response to the lawsuit and the court entered a Notice of Default in favor of Next Level. Default judgment has not yet been sought or entered.

On May 1, 2002, the Company filed two complaints both entitled Next Level Communications, Inc. v. CMC Mississippi, Inc. as adversary proceedings in the Chapter 11 Bankruptcy of CMC s corporate parent: ACT Manufacturing, Inc. These complaints allege that CMC, a former contract manufacturer of Next Level products, sold us defective products and also misappropriated Next Level-owned raw materials, all of which resulted in damages to us of over $5.0 million. We seek to offset these damages against CMC s claim of over $2.4 million owing from Next Level to CMC under a Promissory Note issued in conjunction with an October 2001 settlement agreement. CMC has counterclaimed for the amount remaining due under the promissory note, plus interest and legal fees. On March 7, 2003, CMC filed several motions for summary judgment which, if successful, could result in an award requiring Next Level to pay the $2.4 million balance under the promissory note, plus interest and fees. While we believe that our arguments for set off and/or recoupment of our losses from CMC are strong, and that we, not CMC, should be the eventual net recipient of an award in this dispute, and while we would likely seek to appeal any adverse ruling, we cannot guarantee the outcome of this litigation.

Delaware Stockholder Litigation

On January 14, 2003, alleged stockholders of Next Level filed four separate class action complaints in the Court of Chancery of the State of Delaware, in and for New Castle County, against Motorola, Next Level and various directors of Next Level, captioned: (i) Barry Feldman v. J. Michael Norris, et al., Civil Action No. 20114; (ii) Robert Bruckner v. Next Level Communications, Inc., et al., Civil Action No. 20115; (iii) Fishoff Family Foundation v. Michael J. Norris, et al., Civil Action No. 20118; and (iv) Mary Gorton v. J. Michael Norris, et al., Civil Action No. 20119. Each of these actions was brought as a putative class action on behalf of all holders of Next Level Shares other than the defendants and persons related to or affiliated with the defendants. The complaints in the four actions generally allege that:

- Motorola, Next Level and the individual Next Level directors breached their fiduciary duties as a result of the Motorola Offer;
- The Motorola Offer price is inadequate; and
- Motorola is engaging in unfair self-dealing, not acting in good faith towards Next Level s minority stockholders and that the Motorola Offer is a product of the conflict of interest between Motorola and Next Level s minority stockholders.

The lawsuits seek, among other things, to recover unspecified damages and costs and to enjoin or rescind the transactions contemplated by the Motorola Offer.

On February 4, 2003, alleged stockholders of Next Level filed an amended complaint in the Court of Chancery of the State of Delaware, in and for New Castle County, against Motorola, Next Level and various directors of Next Level, captioned: Barry Feldman v. J. Michael Norris, et al., Civil

Action No. 20114. The amendment dismisses the members of the Independent Committee as defendants, and, in addition to the allegations to the original complaint, generally alleges that:

Motorola has engaged in disclosure violations in its Schedule TO;

the Motorola Offer is coercive in light of Motorola s position on financing for Next Level;

the Motorola Offer price is inadequate for additional reasons specified in the complaint; and

Motorola, Next Level and the individual Next Level directors breached their fiduciary duties as a result of the Motorola Offer by refusing to allow the Board to adopt a stockholder rights plan.

On February 6, 2003, the four class action complaints originally filed on January 13, 2003 or January 14, 2003 in the Court of Chancery of the State of Delaware, in and for New Castle County, against Motorola, Next Level and various directors of Next Level were consolidated under the caption: In re: Next Level Communications Shareholders Litigation, Consolidated Civil Action No. 20114 NC .

On March 14, 2003, Barry Feldman, for himself and on behalf of a putative class of Next Level stockholders, filed a complaint in the Delaware Court of Chancery in and for New Castle County, against Walter C. Clay, Alex Good, Craig Kornblau, John McCartney, Richard D. Severns and Paul Latchford, Civil Action No. 20195. The complaint seeks to certify a class of Next Level stockholders and alleges the stockholders were harmed by the defendants conduct in adopting the retention agreements with Messrs. Ide, St. Cyr, Sheppard, Weeks, Wiley and Zar which are attached as exhibits to Next Level s Schedule 14D-9 (the Retention Agreements). The complaint seeks injunctive relief to rescind the Retention Agreements, damages and attorneys fees.

On March 24, 2003, Motorola and Next Level reached agreements in principle, subject to court approval, with the class action plaintiffs to settle the lawsuits that had been filed on behalf of Next Level s shareholders in both Delaware and California relating to the Motorola Offer and the Retention Agreements.

California Stockholder Litigation

On January 14, 2003, Scott Sebastian, allegedly a stockholder of Next Level, filed a putative class action complaint in the California Superior Court, Sonoma County, against Next Level and various Next Level directors. The action alleges, among other claims, that: (i) Next Level s directors breached their fiduciary duty of care by failing to properly value Next Level; (ii) Next Level s directors would personally benefit from the success of the Motorola Offer and, thus, their approval would constitute self-dealing; (iii) Next Level s directors have superior information about the Motorola Offer which enables them to profit disproportionately from it; (iv) Next Level s directors should engage in arm s-length negotiations as to the terms of the Motorola Offer; and (v) Next Level s directors should disclose such superior information to Next Level s stockholders. Plaintiff seeks declaratory relief, an injunction against the consummation of the Motorola Offer, rescission of any resultant transaction and an injunction requiring Next Level s directors to obtain a transaction that is in the best interests of Next Level s stockholders.

Next Level Litigation

On February 4, 2003, Next Level, Next Level Partners, LLC (the owner of more than 1.8 million Shares and the largest stockholder of Next Level other than Motorola), Spencer Segura and Jacqueline Segura (the respective owners of approximately 400,000 and approximately 200,000 Shares) filed suit against Motorola in the Court of Chancery of the State of Delaware, in and for New Castle County. Plaintiffs allege among other things that: (i) Motorola violated the non-disclosure agreement between Next Level and Motorola by using confidential information from Next Level to plan, launch and carry out the Motorola Offer; (ii) Motorola breached its fiduciary duty as a controlling stockholder of Next Level by using inside information to plan, launch and carry out the Motorola Offer; (iii) the Motorola Offer is substantively coercive because the Minority Stockholders are not, and cannot be informed of, material information that would affect Next Level s market value and the economic decision whether to tender; (iv) the Motorola Offer is structurally coercive because Motorola has not explicitly committed to purchasing Shares not tendered in a second step short form merger; (v) the Motorola Offer is coercive because Motorola, having ensured that Next Level has no outside financial support, has threatened that it will no longer support Next Level as an independent company; (vi) the Motorola Offer is subject to entire fairness review and fails that test because the offer is not made at an adequate price and Motorola did not follow a fair process; (vii) Motorola s refusal to consent to the Independent Committee adopting a stockholder rights plan was a breach of fiduciary duty; (viii) Motorola breached its fiduciary duty of disclosure by materially misstating and omitting certain facts in the Schedule TO; (ix) certain provisions in preferred stock held by Motorola which allegedly prevent Next Level from adopting a stockholder rights plan (the Blocking Preferred) conflict with Section 141(a) of the Delaware General Corporation Law and are thus invalid; and (x) the Shares held by Next Level s officers are properly included in determining whether the Motorola Offer meets the Minimum Tender Condition. Plaintiffs have asked the Court of Chancery to preliminarily and permanently enjoin the Motorola Offer, to rescind the Motorola Offer and any related transactions to the extent they are completed, to compel Motorola to correct its defective disclosures, to require Motorola to pay a fair price to the Next Level stockholders of its proceeds with the Motorola Offer, to require Motorola to pay substantial damages to Next Level, to invalidate the Blocking Preferred and to declare that the Shares held by Next Level s officers be included in determining whether the Motorola Offer meets the Minimum Tender Condition. On February 25, 2003, the Court of Chancery of the State of Delaware denied Next Level Communication s request for a preliminary injunction of the Motorola Offer. Next Level intends to pursue an expedited appeal with respect to the ruling. On February 27, 2003, the Supreme Court of the State of Delaware declined to hear Next Level Communication s application for an interlocutory appeal with respect to the Delaware Chancery Court s ruling on February 25, 2003. On March 24, 2003, Next Level, Next Level Partners, LLC, and Spencer and Jacquelyn Segura dismissed this complaint with prejudice and entered into a settlement agreement with Motorola.

Other Matters.

From time to time, we are a party to other actions which arise in the normal course of business. In our opinion, the ultimate disposition of these other matters will not have a material adverse effect on our business.

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

No matters were submitted to a vote of our stockholders during the quarter ended December 31, 2002.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY AND RELATED STOCKHOLDERS MATTERS

During November 1999, we completed our initial public offering in which we sold 9,775,000 shares of our common stock at a price of $20.00 per share pursuant to a Registration Statement on Form S-1 (File No. 333-85999). Our common stock is listed on The NASDAQ Stock Market s National Market under the symbol NXTV. The following table sets forth the high and low closing prices for our common stock for the periods indicated as reported on The NASDAQ National Market.

Year		High	Low
2002	Fourth Quarter	$ 1.10	$ 0.58
	Third Quarter	$ 1.47	$ 0.72
	Second Quarter	$ 1.91	$ 0.83
	First Quarter	$ 3.56	$ 1.38
2001	Fourth Quarter	$ 6.44	$ 2.60
	Third Quarter	$ 6.45	$ 1.40
	Second Quarter	$ 12.18	$ 3.16
	First Quarter	$ 14.69	$ 5.02
2000	Fourth Quarter	$ 71.50	$10.38
	Third Quarter	$125.56	$40.63
	Second Quarter	$128.13	$50.00
	First Quarter	$195.75	$60.75

On March 31, 2003, the last reported sale price for our common stock on the NASDAQ National Market was $1.17 per share. At March 31, 2003, the number of record holders of our common stock was 300.

We have never declared or paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. We intend to retain all available funds and any future earnings for use in the operation of our business. In addition, we are party to several agreements with Motorola which restrict our ability to pay dividends on our common stock.

EQUITY COMPENSATION PLAN INFORMATION

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	69,917,868	$5.83	4,675,704
Equity compensation plans not approved by security holders	0	0	0
Total	69,917,868	$5.83	4,675,704

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On December 18, 2002, we and Motorola, Inc. (Motorola) entered into a Securities Purchase Agreement whereby Motorola purchased 26,506 shares of our Series A-2 Convertible Preferred Stock (Series A-2 Preferred) at a per share purchase price of $830.00, for a total purchase price of approximately $22 million; these shares were issued under Regulation D of the Securities Act. The total purchase price consisted of (i) the cancellation of $10 million under the Credit Agreement (Multi-Draw Term Loan Facility), dated as of May 16, 2001 between us and Motorola, as amended, and (ii) cash in the amount of $12 million. Each share of Series A-2 Preferred is initially convertible into 1,000 shares of our common stock; is entitled to cumulative dividends at an annual rate of 7.5%, payable in cash or additional shares of Series A-2 Preferred; and is entitled to a liquidation preference of $2,075.00 per share in the event of insolvency or dissolution of the Company, in the event of certain change in control, merger or consolidation events and in the event of sales or transfers of a material portion of our assets outside the ordinary course of business. Holders of Series A-2 Preferred may vote their shares together with holders of Common Stock on an as-converted to common stock basis, and certain material actions require the consent of holders of a majority of the Series A-2 Preferred. In connection with the issuance of the Series A-2 Preferred, we granted Motorola a warrant to purchase 7,951,807 shares of our common stock which is currently exercisable with an exercise price of $0.83 per share and a warrant to purchase 220,000 shares of our common stock which is exercisable after December 18, 2007 with an exercise price of $2.00 per share. The warrants expire on December 17, 2007 and December 17, 2012, respectively.

Also on December 18, 2002, we amended the terms of our outstanding Series A Convertible Preferred Stock (Series A Preferred) and Series A-1 Convertible Preferred Stock (Series A-1 Preferred) to (i) remove the provision allowing for redemption at the option of the holder of Series A Preferred or Series A-1 Preferred, as the case may be, after June 25, 2007, and (ii) amend the events under which the holder of Series A Preferred or Series A-1 Preferred, as the case may be, is entitled to a liquidation preference. As amended, the Series A Preferred and Series A-1 Preferred contain substantially identical terms as the Series A-2 Preferred.

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ITEM 6. SELECTED FINANCIAL DATA

The selected financial data set forth below should be read in conjunction with Management s Discussion and Analysis of Financial Condition and Results of Operations and the historical consolidated financial statements and notes included in this annual report.

	2002	2001	2000	1999	1998
			(In thousands, except share data)		
Statement of Operations Data:					
Revenues	$ 57,352	$ 93,245	$ 150,091	$ 57,597	$ 43,830
Cost of revenues	51,444	157,964	125,231	51,557	43,433
Gross profit (loss)	5,908	(64,719)	24,860	6,040	397
Operating Expenses:					
Research and development	25,307	46,868	55,834	48,454	47,086
Selling, general and administrative	33,574	53,349	46,907	30,511	26,248
Asset impairments and disposals, net	2,208	8,431			
Litigation					5,000
Non-cash compensation charge			2,384	128,284	
Total operating expenses	61,089	108,648	105,125	207,249	78,334
Operating loss	(55,181)	(173,367)	(80,265)	(201,209)	(77,937)
Interest income (expense), net	(22,793)	(14,454)	5,575	(3,564)	(3,776)
Other expense, net	(537)	(20,785)	(148)	(299)	(18)
Net loss	(78,511)	(208,606)	(74,838)	(205,072)	(81,731)
Preferred stock accretion and dividends	(23,406)				
Net loss available to common shareholders	(101,917)	(208,606)	(74,838)	(205,072)	(81,731)
Basic and diluted net loss per common share (pro forma in 1999 and 1998)	$ (1.18)	$ (2.45)	$ (0.91)	$ (2.78)	$ (1.08)
Shares used to compute basic and diluted net loss per common share (pro forma in 1999 and 1998)	86,368,288	85,277,764	81,929,663	71,597,834	69,967,053

	December 31,				
	2002	2001	2000	1999	1998
			(In thousands)		
Balance Sheet Data:					
Cash and cash equivalents	$ 33,394	$ 20,580	$ 35,863	$128,752	$ 28,983
Working capital	58,611	47,785	85,265	147,948	38,564
Total assets	132,031	154,035	275,716	267,811	97,771
Long-term obligations, net of current portion	87,213	104,428	15,000	25,199	81,275
Total stockholders equity (deficit) / partners capital (deficit)	11,251	(8,299)	158,749	206,228	(14,769)

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The following table sets forth unaudited statement of operations data for our eight most recent quarters in the period ended December 31, 2002. This unaudited information has been prepared on the same basis as the annual financial statements and includes all adjustments, consisting of normal recurring items (In thousands, except per share data)

	Three Months Ended				Year Ended
	March 31, 2002	June 30, 2002	September 30, 2002	December 31, 2002	December 31, 2002
Total revenues	$ 14,078	$ 16,778	$ 12,344	$ 14,152	$ 57,352
Gross profit (loss)	1,833	2,666	987	422	5,908
R&D	8,211	5,319	5,545	6,232	25,307
SG&A	9,233	8,686	7,693	7,962	33,574
Impairments and asset disposals			1,934	274	2,208
Total operating expenses	17,444	14,005	15,172	14,468	61,089
Operating loss	(15,611)	(11,339)	(14,185)	(14,046)	(55,181)
Interest income (expense), net	(5,617)	(9,231)	(6,218)	(1,727)	(22,793)
Other income (expense), net	(290)	(548)	(53)	355	(537)
Net loss	(21,518)	(21,118)	(20,456)	(15,418)	(78,511)
Preferred stock accretion and dividends	(463)	(1,160)	(2,218)	(19,565)	(23,406)
Net loss available to common shareholders	$(21,981)	$(22,278)	$(22,674)	$(34,983)	$(101,917)
Shares outstanding	85,933	86,255	86,436	86,838	86,368
Basic and diluted					
Net loss per share	$ (0.26)	$ (0.26)	$ (0.26)	$ (0.40)	$ (1.18)

[Additional columns below]

[Continued from above table, first column(s) repeated]

	Three Months Ended				Year Ended
	March 31, 2001	June 30, 2001	September 30, 2001	December 31, 2001	December 31, 2001
Total revenues	$ 28,738	$ 31,904	$ 20,198	$ 12,406	$ 93,245
Gross profit (loss)	6,098	(66,038)	2,629	(7,407)	(64,719)
R&D	14,095	12,858	11,788	8,126	46,868
SG&A	14,510	14,838	12,932	11,070	53,349
Impairments and asset disposals		796		7,635	8,431

Total operating expenses	28,605	28,492	24,720	26,831	108,648
Operating loss	(22,507)	(94,530)	(22,091)	(34,238)	(173,367)
Interest income (expense), net	108	(3,192)	(5,441)	(5,929)	(14,454)
Other income (expense), net	1	(4,413)	(236)	(16,136)	(20,785)
Net loss	(22,398)	(102,135)	(27,768)	(56,303)	(208,606)
Preferred stock accretion and dividends					
Net loss available to common shareholders	$(22,398)	$(102,135)	$(27,768)	$(56,303)	$(208,606)
Shares outstanding	84,628	85,233	85,473	85,762	85,278
Basic and diluted					
Net loss per share	$ (0.26)	$ (1.20)	$ (0.32)	$ (0.66)	$ (2.45)

Item 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

We design and market broadband communications equipment that enables telephone companies and other communications service providers to cost-effectively deliver a full suite of voice, data and video services over the existing copper wire telephone infrastructure. We commenced operations in July 1994 and recorded our first sale in September 1997. From January 1998 until November 1999, we operated through Next Level Communications L.P., which was formed in connection with the transfer of all of the net assets, management and workforce of a wholly-owned subsidiary of General Instrument. In November 1999, the business and assets of that partnership were merged into Next Level Communications, Inc. as part of our recapitalization. In January 2000, General Instrument was acquired by Motorola, Inc., making us an indirect subsidiary of Motorola.

We generate our revenues primarily from sales of our equipment. A small number of customers have accounted for a large part of our revenues to date, and we expect this concentration to continue in the future. Qwest accounted for 24%, 41% and 56% of our total revenues in 2002, 2001 and 2000, respectively. Our agreements with our largest customers do not obligate the customers to purchase any products. In addition, our significant customer agreements generally contain fixed-price provisions. As a result, our ability to generate a profit on these contracts depends upon our ability to produce and market our products at costs lower than these fixed prices.

The timing of our revenues is difficult to predict because of the length and variability of the sales cycle for our products. Customers view the purchase of our products as a significant and strategic decision. As a result, customers typically undertake significant evaluation, testing and trial of our products before deploying them. This evaluation process frequently results in a lengthy sales cycle, typically ranging from nine months to more than a year. While our customers are evaluating our products and before they place an order, if at all, we may incur substantial sales and marketing expenses and expend significant management efforts.

Beginning in 2001, the global telecommunications market deteriorated, resulting in a reduction in capital spending by our customers. This trend continued in 2002. Additional capital spending reductions may occur during 2003. Reasons for this reduction include the general economic slowdown, network overcapacity, customer bankruptcies, network build-out delay and limited capital availability. As a result, our sales and results of operations have been and may continue to be adversely affected. The significant slowdown in capital spending has created uncertainty as to the level of demand in our target markets. As a result of the uncertainty and variations in our markets, accurately forecasting future results, earnings and cash flow is increasingly difficult.

In January 2003, Motorola initiated an unsolicited tender offer for all of the shares of our common stock not owned by Motorola. On April 14, 2003 Motorola announced that it had completed its cash tender offer and that as a result Motorola would own approximately 88.7 percent of our outstanding common stock. Motorola also stated that it intended to convert certain of its shares of our preferred stock into shares of our common stock to achieve a 90 percent ownership level and that it will then effect a short-form merger pursuant to which all of our remaining outstanding shares (other than dissenting shares) will be converted into the right to receive $1.18 per share. Once Motorola completes the short-form merger, we will no longer be a publicly traded company on the Nasdaq National Market or otherwise.

APPLICATION OF CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Our discussion and analysis of our financial condition and results of operations are based on our consolidated financial statements, which have been prepared in conformity with accounting principles generally accepted in the United States of America. Our preparation of these consolidated financial statements requires us to make judgments and estimates that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Actual results may differ from such estimates under different assumptions or conditions. The following summarizes our critical accounting policies and significant estimates used in preparing our consolidated financial statements:

Revenue Recognition We recognize revenue when contractual obligations have been satisfied, title and risk of loss have been transferred to the customer and collection of the resulting receivable is reasonably assured. Generally, we recognize revenue from equipment sales upon shipment. In cases where title and risk of loss pass upon delivery, we recognize revenue from equipment sales upon receipt by the customer. Revenue from installation services is recognized when the services have been completed and acceptance by the customer has occurred. Typically (over 85% of our sales transactions), customers do not purchase our installation services. However, in circumstances where customers purchase our installation services, those services are included with equipment purchases as part of a multiple element arrangement. Fair value of equipment is based on the sales prices offered to customers that purchase only equipment and revenue is generally recognized upon shipment. The installation services are separately priced at a rate approximately equivalent to that charged by third party vendors (i.e. outside parties that provide similar installation services) and the portion of the contract price relating to installation services is deferred until the installation is complete and accepted by the customer. Installation services do not involve a significant change to the features or capabilities of the equipment or building complex interfaces or connections; the equipment is a standard product (i.e. does not require customer specific modification); and installation does not significantly alter the equipment s capabilities. Revenue from field trials is recognized when the trial has been completed and full payment has been received. We accrue a provision for estimated sales returns as a reduction of revenue at the time of revenue recognition.

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Accrued Warranty We accrue the estimated cost of product warranties at the time revenues are recognized. While we engage in product quality programs and processes, including actively monitoring and evaluating the quality of our contract manufacturers, our warranty obligation is affected by actual warranty costs including material usage and service delivery costs incurred in correcting a product failure. If actual product failure rates, material usage or service delivery costs differ from our estimates, revisions to the estimated warranty liability will be required. We perform ongoing evaluations of the adequacy of our product warranty reserve. Warranty reserve activity is detailed as follows (in millions):

	Beginning of year	Accruals	Actual Costs	End of year
Year ended December 31:				
2000	2.8	5.7	2.9	5.6
2001	5.7	3.8	4.6	4.9
2002	4.8	2.6	3.1	4.3

Employee Stock-based Compensation We grant stock options for a fixed number of shares to employees with an exercise price equal to the fair value of the shares at the date of grant. We account for employee stock-based compensation in accordance with Accounting Principles Board Opinion No. 25 (APB 25), Accounting for Stock Issued to Employees and Financial Accounting Standards Board interpretation No. 44, Accounting for Certain Transactions Involving Stock Compensation (FIN 44). We account for stock-based awards to nonemployees in accordance with Statement of Financial Accounting Standards No. 123 (SFAS 123), Accounting for Stock-Based Compensation and Emerging Issues Task Force (EITF) Issue No. 96-18, Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services.

Under SFAS No. 123, had the Company recorded compensation expense based on the estimated grant date fair value for awards based on grants under the Plans and the tandem stock grant, the Company s net loss and net loss per share would have changed.

Inventories We are required to state our inventories at the lower of cost or market. In assessing the ultimate realization of inventories, we are required to make judgments as to future demand requirements and compare these with the current or committed inventory levels. Our reserve requirements generally increase as our projected demand requirements decrease due to market conditions, technological and product life cycle changes, and strategic direction, such as discontinuances of product lines, as well as declining market conditions. As a result, we incurred inventory charges of approximately $5.9 million, $76.8 million and $9.0 million during fiscal 2002, 2001 and 2000, respectively. Additionally, during the first quarter of 2003, as we began to consolidate inventories and production to a new primary contract manufacturer, we initiated a thorough quality review of our raw materials on hand, the results of which have not yet been finalized. At December 31, 2002 and 2001, inventories were $40.3 million and $62.6 million, respectively. It is possible that additional inventory charges may occur in the future if there is a further decline in market conditions or if additional restructuring actions are taken.

NEW ACCOUNTING PRONOUNCEMENTS

Accounting for Costs Associated with Exit or Disposal Activities. In June 2002, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 146, or SFAS 146, Accounting for Costs Associated with Exit or Disposal Activities, which addresses accounting for restructuring and similar costs. SFAS 146 supersedes previous accounting guidance, principally Emerging Issues Task Force Issue (EITF) No. 94-3. We adopted the provisions of SFAS 146 for restructuring activities initiated after December 31, 2002. SFAS 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF No. 94-3, a liability for an exit cost was recognized at the date of our commitment to an exit plan. SFAS 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized.

Accounting for Stock-Based Compensation. In December 2002, the FASB issued Statement of Financial Accounting Standards No. 148, or SFAS 148, Accounting for Stock-Based Compensation-Transition and Disclosure an Amendment of FASB Statement No. 123, which provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. In addition, SFAS 148 amends the disclosure requirements of SFAS No. 123 to require prominent disclosures in both annual and interim financial statements about the method of accounting for stock-based employee compensation and the effect of the method used on reported results. In the fourth quarter of 2002, we adopted the disclosure provisions of SFAS 148.

Accounting and Disclosure Requirements for Guarantees. In November 2002, the FASB issued FASB Interpretation No. 45, or FIN 45, Guarantor s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. FIN 45 requires that upon issuance of a guarantee, the guarantor must recognize a liability for the fair value of the obligation it assumes under that guarantee. The disclosure provisions of FIN 45 are effective for financial statements of interim or annual periods that end after December 15, 2002. The provisions for initial recognition and measurement are effective on a prospective basis for guarantees that are issued or modified after December 31, 2002, irrespective of a guarantor s year-end. We do not believe the adoption of FIN No. 45 will have a material impact on our consolidated financial condition.

Revenue Arrangements with Multiple Deliverables. In November 2002, the EITF reached a consensus on EITF Issue No. 00-21, or EITF No. 00-21, Revenue Arrangements with Multiple Deliverables. EITF No. 00-21 will be effective for fiscal periods beginning after June 15, 2003. We have not yet determined the impact of the adoption of EITF No. 00-21 on our results of operations or financial position.

RESULTS OF OPERATIONS

Comparison of 2002 to 2001

Revenues. Total revenues in 2002 decreased to $57.4 million from $93.2 million in 2001. The decrease was primarily due to a decrease in equipment sales to Qwest. An equipment revenue analysis by channel is detailed in the following chart. Our equipment revenue is analyzed using three channels: Independent operating companies (IOC), major carriers which currently include Qwest and other North American regional bell operating companies (MAJOR CARRIERS) and other customers which include, among others, multiple service organizations and international customers (OTHER).

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CHANNEL	2002	2001
IOC	$40.7	$48.1
MAJOR CARRIERS (PRIMARILY QWEST)	16.2	38.3
OTHER EQUIPMENT	0.5	4.6
SOFTWARE		2.2
TOTAL EQUIPMENT REVENUE	$57.4	$93.2

Sales to Qwest were significantly reduced in 2002 due to an overall reduction in capital spending by Qwest. Additionally, Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to Qwest in the future are dependent upon its decision regarding the deployment of our product and its overall capital spending plans. Qwest reported significant operating losses in 2002, and has reported that it will restate prior period financials for certain incorrectly recorded transactions. These factors may have a significant adverse impact on Qwest s decision regarding the deployment of our product.

Sales to IOCs and our other customers decreased in 2002 due to a general slowdown in the telecommunications industry and the resulting reduction of our customers capital expenditures.

We expect to continue to derive substantially all of our revenues from sales of equipment to regional bell operating companies and local, foreign and independent telephone companies for the foreseeable future. Revenue levels in future quarters will depend significantly upon Qwest s and other major carriers future decisions and general economic conditions, as well as whether and how quickly our existing customers roll out broadband services in their coverage areas and whether and how quickly we obtain new customers.

Cost of Revenues. Total cost of revenues decreased to $51.4 million in 2002 from $158.0 million in 2001. The decrease in our cost of revenues in 2002 was primarily attributable to reduced sales of equipment in 2002 and inventory charges taken in the prior year totaling $76.8 million related to excess inventory, obsolescence and lower of cost or market adjustments. Excluding the inventory charges in 2001, cost of revenues in 2001 were $81.2 million.

At December 31, 2002, we had inventories of $40.3 million. At each reporting period we perform a detailed review of raw material and finished goods inventories on hand, components under purchase commitments, and a detailed analysis of our sales forecasts and product end-of-life estimates, to determine whether any inventory charges are required. During 2002, we recorded inventory charges totaling $5.9 million based upon our analysis.

Our gross margin decreased to 10.3% in 2002 from 13.0% in 2001 (excluding inventory write-down related charges). The decline in our gross margin percentage was primarily related to spreading the manufacturing overhead elements of product cost over reduced sales volumes.

Our gross margins are affected by a number of factors including, but not limited to, overall sales volume, customer mix, volume discounts, product mix, excess inventory, obsolete inventory, the timing and size of orders received, the availability of adequate supplies of key components and assemblies and cost reduction programs. Because various customer groups order different product mixes and have different volume pricing discounts, gross profit will vary as a result of changes in our customer order flow. Individual products have different profit margins and, therefore, the mix of products sold has an impact on the margins generated by those sales. The size of discounts given to a customer may vary depending on the type and size of the sales order. Our ability to successfully implement cost reduction programs affects fixed and variable costs that impact profit

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margins. In a rapidly changing industry, introduction of new products using new technologies may result in existing inventory becoming obsolete, requiring such obsolete inventory to be expensed.

Research and development. Research and development expenses decreased to $25.3 million in 2002 from $46.9 million in 2001. The decrease in the research and development expenses was primarily due to cost cutting measures, including a reduction in research and development personnel, implemented in the current year. In the near term, research and development expenses could increase slightly, primarily due to costs associated with new product introductions.

Selling, general and administrative. Selling, general and administrative expenses decreased to $33.6 million in 2002 from $53.3 million in 2001. The decrease was primarily due to cost-cutting measures, including a reduction in selling, general and administrative personnel. In addition, the 2001 period included $6.5 million in goodwill amortization of which there was none in 2002.

Asset impairments and disposals, net. Asset impairment and disposals, net, was $2.2 million in 2002 and related primarily to facility consolidation charges. Charges of $0.9 million represented the present value of future minimum lease payments and impaired leasehold improvements on vacated premises and $1.1 million related to cancellation charges on a facility expansion project.

Asset impairments and disposals in 2001 were $8.4 million and consisted of (i) the write-off of goodwill related to SoftProse of $8.4 million, (ii) loss on disposal of property, plant and equipment of $2.6 million and (iii) the gain on sale of our software product line of $2.6 million.

Interest income (expense), net. Interest expense, net increased to $22.8 million in 2002 from $14.5 million in 2001. The increase is primarily attributable to an increase in cash and non-cash interest related to our credit agreement with Motorola and is detailed in the following table.

(In millions)	**Fiscal Year Ended December 31,**	
	2002	**2001**
Motorola Credit Facility Cash interest	$ (3.7)	$ (2.5)
Noncash interest recurring	(11.2)	(10.5)
Noncash interest non-recurring (1)	(5.3)	
Mortgage interest	(1.5)	(0.3)
Vendor note payable interest	(1.5)	(1.8)
Other interest income (expense)	0.4	0.6
	$(22.8)	$(14.5)

(1) Non-recurring noncash interest is related to conversions of debt to equity that took place in June and September 2002 (See Note 7 to the consolidated financial statements). Noncash interest is expected to decrease in future periods as the entire remaining warrant discount of $6.5 million related to the Motorola credit facility was treated as a dividend upon extension of the facility s maturity date from May 16, 2003 to May 16, 2006 (see Note 5 to the consolidated financial statements). This extension occurred on October 22, 2002.

Investment impairments and other expense, net. Investment impairments and other expense were $0.5 in 2002 and primarily related to $0.4 million in warrant issuance expense (see Note 8 to the consolidated financial statements). Investment impairments and other expense in 2001 was $20.8 million, and was primarily related to the write-down of certain long-term investments in Virtual Access of $13.0 million, $4.0 million in Outreach Communications and $3.0 million in Expanse Networks, Inc.

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Preferred stock accretion and dividends. Preferred stock accretion and dividends in 2002 was $23.4 million and related to the issuance of Preferred Stock to Motorola in February 2002, June 2002, September 2002 and December 2002 and the fourth quarter restructuring of such preferred stock in December 2002 (see Note 7 to the consolidated financial statements). There was no accretion or dividends payable on preferred stock in 2001 as there was no preferred stock outstanding in that period.

Comparison of 2001 to 2000

Revenues. Total revenues in 2001 decreased to $93.2 million from $150.1 million in 2000. The decrease was primarily due to a decrease in equipment sales to Qwest. An equipment revenue analysis by channel is detailed in the following chart. Our equipment revenue is analyzed using three channels: Independent operating companies (IOC), major carriers which currently include Qwest and other North American regional bell operating companies (MAJOR CARRIERS) and other customers which include, among others, multiple service organizations and international customers (OTHER).

CHANNEL	2001	2000
IOC	$48.1	$ 56.0
MAJOR CARRIERS (PRIMARILY QWEST)	38.3	84.8
OTHER	4.6	5.5
SOFTWARE	2.2	3.8
TOTAL EQUIPMENT REVENUE	$93.2	$150.1

Sales to Qwest were significantly reduced in 2001 due to an overall reduction in capital spending by Qwest. Additionally, Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to IOCs and our other customers decreased in 2001 due to a general slowdown in the telecommunications industry and the resulting reduction of our customers capital expenditures.

Cost of Revenues. Total cost of revenues increased to $158.0 million in 2001 from $125.2 million in 2000. The increase in our cost of revenues in 2001 was primarily attributable to inventory charges taken in the year totaling $76.8 million related to excess inventory, obsolescence and lower of cost or market adjustments. Included in 2001 and 2000 cost of revenues are inventory charges totaling $76.8 million and $9.0 million. Excluding the inventory charges, cost of revenues were $81.2 million and $116.2 million in 2001 and 2000. The 2001 decrease was primarily due to lower sales of equipment.

2001 Inventory Write-down.

To meet forecasted demand and reduce the anticipated component supply constraints that had existed in the past, in late 2000 we increased inventory levels for certain components and entered into purchase commitments for certain components with long lead times. However, in the quarter ended June 30, 2001, our actual sales, as well as our estimates of forecasted sales in 2001 and 2002 for our current generation of products declined significantly. As a result, inventory related charges were required and were calculated based upon (i) the substantial completion of the negotiation process with our contract manufacturers and their suppliers and our other vendors regarding purchase commitments and cancellations made by us, (ii) the inventory levels in excess of forecasted demand and (iii) our estimates of salvage or recovery value for each raw material or finished good on an item by item basis. We do not currently anticipate that the excess inventory included in this provision will be used based on our current demand forecast. At December 31,

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2001, we updated our estimates and recorded an additional inventory charge. These write-downs were included in cost of revenues in 2001 and consisted of the following (in millions):

Excess quantities of raw materials on hand or under purchase commitments, net of salvage	$36.9
Excess quantities of finished goods on hand, net of salvage	10.8
Obsolescence	14.5
Cancellation charges on purchase commitments	5.2
Lower of cost or market write-down on current generation product platform	9.4
Total	$76.8

Significant estimates included in the calculation of the inventory write-downs above include forecasted demand for our products, sales prices for residential gateways and other finished goods and estimated salvage or recovery value for excess raw materials and finished goods. Actual results could differ from those estimates, and therefore additional inventory write-downs may be necessary in future periods.

2000 Inventory Write-down.

During 2000, we recorded a $9.0 million inventory write-down primarily related to a lower of cost or market adjustment to certain residential gateway products and other obsolescence provisions.

Excluding the inventory charges in both 2001 and 2000, our gross margin percentage decreased to 13% in 2001 from 23% in 2000. The decline in our gross margin percentage was primarily related to spreading the manufacturing overhead elements of product cost over reduced sales volumes.

Research and development. Research and development expenses decreased to $46.9 million in 2001 from $55.8 million in 2000. The decrease in the research and development expenses was primarily due to cost cutting measures, including a reduction in research and development personnel, implemented in 2001. We reduced our workforce in October 2001 by approximately 15%.

Selling, general and administrative. Selling, general and administrative expenses increased to $53.3 million in 2001 from $46.9 million in 2000. The increase was attributable to increased goodwill amortization arising from the purchase of SoftProse in July 2000 and higher recruiting and relocation expenses in the first half of 2001. We reduced our workforce in October 2001 by approximately 15%.

Non-cash compensation charge. Substantially all of our employees in 1999 were granted contingently exercisable stock options that became options to purchase our common stock upon our recapitalization in 1999. In addition, tandem stock options were granted in January 1997 to some of our employees. As a result, non-cash compensation expense was recognized upon the completion of our initial public offering based on the difference between the exercise price of these options and the initial public offering price of our common stock. The non-cash compensation expense related to these option grants in 2000 was $2.4 million. There was no such expense in 2001.

Asset impairments and disposals, net. Asset impairment and disposals, net, of $8.4 million in 2001 consisted of (i) the write-off of goodwill related to SoftProse of $8.4 million, (ii) loss on disposal of property, plant and equipment of $2.6 million and (iii) the gain on sale of our software product line of $2.6 million.

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Interest income (expense), net. Interest expense, net was $14.5 million in 2001. Interest income, net was $5.6 million in 2000. Interest expense in 2001 included non-cash interest expense of $10.4 million related to our loan agreement with Motorola. Interest income, net in 2000 related primarily to interest earned on our initial public offering proceeds.

Investment impairments and other expense, net. Investment impairments and other expense, net in 2001 was $20.8 million, and was primarily related to the write-down of certain long-term investments in Virtual Access of $13.0 million, $4.0 million in Outreach Communications and $3.0 million in Expanse Networks, Inc.

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LIQUIDITY AND CAPITAL RESOURCES

Net cash used in operating activities decreased to $34.1 million in 2002, from $127.8 million in 2001 and $103.3 million in 2000. The improvement of cash used in operating activities reflects the favorable impact on cash flow of our operating expense reductions, which decreased from $108.6 million in 2001 and $105.1 million in 2000 to $61.1 million in 2002, serving to more than offset the unfavorable impact of the reduction in revenues of $35.9 million from 2001 to 2002 and $92.7 million from 2000 to 2002. Cash flows of $10.1 million generated by positive working capital changes in 2002 primarily related to a $16.5 million reduction in inventories. The use of cash in 2001 primarily related to a $42.7 million increase in inventories and a $25.1 million reduction in accounts payable, partially off-set by a $17.0 million decrease in accounts receivable. Noncash changes in the 2001 period included the conversion of $14.3 million in vendor payables and $10.0 million in vendor purchase commitments into a note payable. The use of cash in 2000 was primarily due to a $73.2 million increase in inventories and a $20.6 million increase in accounts receivable, partially off-set by a $40.1 million increase in accounts payable.

Net cash used in investing activities was $2.0 million in 2002 and related entirely to capital expenditures. Net cash provided by investing activities in 2001 was $17.8 million; this amount was primarily attributable to the sale of marketable securities, partially off-set by capital expenditures as well as an additional $8.0 million investment in Virtual Access. In 2001, we also received $4.9 million for the sale of our software product line. Net cash used by investing activities was $12.5 million in 2000 and primarily related to $15.5 million in capital expenditures and $15.0 million in investments in Expanse Networks, Inc., OutReach Communications L.L.C. and Virtual Access, partially off-set by the sale of $18.0 million in marketable securities.

Net cash provided by financing activities was $48.9 million in 2002, $94.7 million in 2001 and $22.9 million in 2000. The 2002 amount primarily related to the proceeds received in connection with the issuance of $65.0 million of preferred stock to Motorola in February, June, September and December 2002. This amount was partially off-set by $15.6 million of repayments on borrowings that related to our vendor note payable and our mortgage note payable. The 2001 amount is primarily related to borrowings of $83.0 million from Motorola, mortgage proceeds of $20.0 million and $14.3 million in proceeds related to our Tax Sharing Agreement with Motorola. The 2001 amount was partially off-set by the repayment of a $25.0 million note. The 2000 amount was primarily related to $15.0 million in proceeds related to the Tax Sharing Agreement with Motorola and $9.3 million related to the issuance of common stock in connection with the exercise of stock options.

Vendor Note Payable During the year ended December 31, 2002, we made principal and interest payments totaling $18.0 million under our vendor note payable. The remaining principal and interest payment of $9.5 million was paid on March 31, 2003.

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Contractual Obligations - The following table sets forth our contractual obligations, including interest, as of December 31, 2002 (in millions):

	Payments Due by Period						
	2003	2004	2005	2006	2007	Thereafter	Total
Vendor Note Payable (1)	$ 9.5						$ 9.5
Motorola Debt							
Note Payable (2)	2.2	$2.2	$2.2	$41.8			48.4
Tax Sharing Liability (3)				29.3			29.3
Mortgage Debt (4)	2.5	2.5	2.5	2.5	$2.5	$ 14.6	27.1
Off-Balance Sheet Commitments							
Vendor Purchase Commitments (5) (6)	10.0						10.0
Operating Leases (7)	1.2	1.2	1.2	0.8			4.4
Total Contractual Obligations	$25.4	$5.9	$5.9	$74.4	$2.5	$ 14.6	$128.7

(1) Due (and paid) March 31, 2003.

(2) On October 22, 2002, maturity was extended from May 16, 2003 to May 16, 2006.

(3) Due in 2006 if Motorola does not achieve expected tax benefits. Maturity will be accelerated in whole or in part if certain conditions (such as our completion of a debt or equity offering greater than $25.0 million) are met.

(4) Annual principal and interest payments required plus $4.9 million balloon payment due in 2011.

(5) Represents commitments as of December 31, 2002, with various suppliers to purchase certain raw materials and finished goods.

(6) In addition to the amounts in the table, we have recently entered negotiations with a vendor to settle or eliminate a long-standing purchase commitment with a maximum exposure of approximately $7.0 million.

(7) Future minimum lease payments under non-cancelable operating leases for certain facilities and equipment.

In 2002, net loss was $78.5 million and net cash used in operating activities was $34.1 million. As of December 31, 2002, our accumulated deficit was $567.0 million. At March 31, 2003, we had cash and cash equivalents of $14.1 million, after making a final payment of $9.5 million to extinguish our Vendor Note Payable and paying approximately $5.0 million of non-recurring expenses related to the Motorola tender offer.

During 2002, we instituted the following measures to improve cash flow:

We reduced our workforce by approximately 120 employees or 33% in January 2002; this reduction, along with other cost saving measures implemented, helped us reduce cash overhead expenses by $37.2 million (39%) from 2001 to 2002; and

we reduced inventory by $22.4 million (36%) in 2002, generating net cash flow of approximately $16.5 million;

Since late 2000, we have been significantly dependent on Motorola for funding. Loans from Motorola totaled $15.0 million in 2000 and $97.3 million in 2001. Cash proceeds from preferred stock issuances totaled $65.0 million in 2002. We converted $42.0 million of debt due to Motorola to preferred stock in 2002. We have a remaining debt obligation to Motorola of $41.0 million; in October 2002 the maturity date of this debt was extended from May 2003 to May 2006.

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In January 2003, Motorola initiated an unsolicited tender offer for all of the shares of our common stock not owned by Motorola. On April 14, 2003 Motorola announced that it had completed its cash tender offer and that as a result Motorola would own approximately 88.7 percent of our outstanding common stock. Motorola also stated that it intended to convert certain of its shares of our preferred stock into shares of our common stock to achieve a 90 percent ownership level and that it will then effect a short-form merger pursuant to which all of our remaining outstanding shares (other than dissenting shares) will be converted into the right to receive $1.18 per share. Once Motorola completes the short-form merger, we will no longer be a publicly traded company on the Nasdaq National Market or otherwise.

In the last three quarters of 2002, we reduced our average quarterly negative operating cash flow to approximately negative $4.8 million. Subject to the effect of a significant change in our revenues on working capital, we expect 2003 cash flow from operations to be consistent with this trend (excluding the approximately $5.0 million of tender offer expenses paid in the first quarter of 2003). Our ability to generate positive operating cash flow is dependent on our ability to increase sales, convert our inventory and accounts receivable to cash, negotiate favorable terms with our vendors, effectively manage our operating costs and continue to raise sufficient operating capital. We believe that the combination of cash on hand, the cash flows expected to be generated from operations and the cost savings generated by further planned expense reductions will be sufficient to enable us to meet our financial obligations and sustain our operations through the third quarter of 2003. We intend to aggressively pursue additional sources of financing to support our operations on a continuing basis.

RISK FACTORS IF MOTOROLA DOES NOT COMPLETE THE MERGER

In January 2003, Motorola initiated an unsolicited tender offer for all of the shares of our common stock not owned by Motorola. On April 14, 2003 Motorola announced that it had completed its cash tender offer and that as a result Motorola would own approximately 88.7 percent of our outstanding common stock. Motorola also stated that it intended to convert certain of its shares of our preferred stock into shares of our common stock to achieve a 90 percent ownership level and that it will then effect a short-form merger pursuant to which all of our remaining outstanding shares (other than dissenting shares) will be converted into the right to receive $1.18 per share. Once Motorola completes the short-form merger, we will no longer be a publicly traded company on the Nasdaq National Market or otherwise.

If Motorola does not complete the merger, we will be subject to the following risks, which you should carefully consider.

Our 2002 financial statements include a going concern opinion from our independent accountants; this going concern opinion could have a significant adverse effect on our ability to sell our products to existing customers and to gain new customers for our products.

The opinion of our independent accountants on our financial statements is subject to a going concern qualification and states that our operations and cash position raise substantial doubt about our ability to continue as a going concern through 2003. Our existing customers may be unwilling to continue to purchase products from a company the financial statements of which are subject to a going concern qualification. Potential new customers may also be unwilling to even discuss purchases of products with a company the financial statements of which are subject to a going concern qualification. For these reasons, the going concern qualification may have a material adverse effect on our existing business and prospects for the future.

We have been financially dependent on Motorola and any change in their level of commitment could have an adverse impact on us.

Since late 2000, we have been significantly dependent on Motorola for funding. Loans from Motorola totaled $15.0 million in 2000 and $97.3 million in 2001. Preferred stock issuances for cash proceeds totaled $65.0 million in 2002. We have a remaining debt obligation to Motorola of $41.0 million; in October 2002 the maturity date of this debt was extended from May 2003 to May 2006.

In January 2003, Motorola initiated an unsolicited tender offer for all of the shares of our common stock not owned by Motorola. While the tender offer has been outstanding, our ability to secure outside financing has been significantly inhibited. In the event that the short-form merger is not consummated, we intend to actively seek additional financing, but there can be no assurance that we will be successful in our efforts to obtain additional funding sources. In this regard, Motorola has certain veto rights and other rights and preferences with respect to its debt and equity holdings in us that Motorola will need to waive or amend in order for us to complete any such financing, and there can be no assurance that Motorola will continue to fund our operations or agree to waive or amend any of such rights. In addition, any financing that may be obtained by us may be significantly dilutive to our existing stockholders.

If we do not obtain additional capital funding, we may not be able to continue operations.

In 2002, net loss was $78.5 million and net cash used in operating activities was $34.1 million. As of December 31, 2002, our accumulated deficit was $567.0 million. At March 31, 2003, we had cash and cash equivalents of $14.1 million, after making a final payment of $9.5 million to extinguish our Vendor Note Payable and paying approximately $5.0 million of non-recurring expenses related to the Motorola tender offer.

In the last three quarters of 2002, we reduced our average quarterly negative operating cash flow to approximately negative $4.8 million. Subject to the effect of a significant change in our revenues on working capital, we expect 2003 cash flow from operations to be consistent with this trend (excluding the approximately $5.0 million of tender offer expenses paid in the first quarter of 2003). Our ability to generate positive operating cash flow is dependent on our ability to increase sales, convert our inventory and accounts receivable to cash, negotiate favorable terms with our vendors, effectively manage our operating costs and continue to raise sufficient operating capital. We believe that the combination of cash on hand, the cash flows expected to be generated from operations and the cost savings generated by further planned expense reductions will be sufficient to enable us to meet our financial obligations and sustain our operations through the third quarter of 2003. We intend to aggressively pursue additional sources of financing to support our operations on a continuing basis.

Motorola may exercise significant influence over our business and affairs and our stockholder votes and, for its own reasons, could prevent transactions which our other stockholders may view as favorable.

Prior to the consummation of its tender offer, Motorola beneficially owned (as defined in Rule 13d-3 under the Securities Exchange Act of 1934, as amended (the Exchange Act)) approximately 89.5% of the outstanding shares of our common stock as of March 31, 2003; and it announced that an additional 13.3 million shares were tendered to Motorola in the tender offer. Motorola also has designated two directors on our board. As a result, Motorola will be able to exercise significant influence over all matters relating to our business and affairs, including approval of significant corporate transactions, which could delay or prevent someone from acquiring or merging with us and could prevent you from receiving a premium for your shares.

In the event that the merger is not consummated, we do not know whether Motorola s plans for our business and affairs will be different than our existing plans and whether any changes that may be implemented under Motorola s control will be beneficial or detrimental to our other stockholders.

Motorola may have interests that conflict with the best interests of our other stockholders and us and may cause us to forgo opportunities or take actions that disproportionately benefit Motorola as our principal stockholder.

It is possible that Motorola could be in a position involving a conflict of interest with us. In addition, individuals who are officers or directors of Motorola and of us may have fiduciary duties to both companies. For example, a conflict may arise if Motorola were to engage in activities or pursue corporate opportunities that may overlap with our business. These conflicts could harm our business and operating results. Our certificate of incorporation contains provisions intended to protect Motorola as our principal stockholder in these situations. These provisions limit the legal remedies of other stockholders.

If we fail to meet the continued listing requirements of the Nasdaq Stock Market, our stock could be delisted.

Our stock is currently listed on the Nasdaq National Market. The Nasdaq Stock Market s Marketplace Rules impose certain minimum financial requirements on us for the continued listing of our stock.

Currently we are in compliance with all Nasdaq National Market listing requirements. If we are out of compliance in the future with Nasdaq listing requirements, we may take actions in order to achieve compliance, which may include a transfer to the Nasdaq Small Cap Market and/or a reverse split of our common stock. If we are delisted and cannot obtain listing on another major market or exchange, our stock s liquidity would suffer, and we would likely experience reduced analyst coverage and investor interest. Such factors may result in a decrease in our stock s trading price. Delisting also may restrict us from issuing additional securities or securing additional financing.

We have incurred net losses and negative cash flow for our entire history and we expect to incur future losses and negative cash flow.

We incurred net losses of $78.5 million in 2002, and we expect to continue to incur net losses in future quarters. Our ability to achieve profitability will depend on the successful design, development, testing, introduction, marketing and sale of our broadband equipment products. We expect to continue to incur significant product development, sales and marketing, and administrative expenses. In addition, we depend in part on cost reductions to improve gross profit margins because the fixed-price nature of most of our long-term customer agreements prevents us from increasing prices. We may not be successful in reducing our costs or in selling our products in sufficient volumes to realize cost benefits from our manufacturers. There is no guarantee that we can achieve sufficient revenues or gross profit margin improvements to achieve profitability.

The loss of or reduction in business from Qwest could cause our sales to fall significantly.

Qwest accounted for 24% and 41% of total revenues in 2002 and 2001. Our agreements with our customers are cancelable by these customers on short notice, without penalty, do not obligate the customers to purchase any products and are not exclusive. Sales to Qwest have been reduced from 2001 to 2002 due to an overall reduction in capital spending by Qwest. Additionally,

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Qwest has slowed its purchases of our equipment while it re-evaluates its plans regarding the deployment of VDSL across its network. Sales to Qwest in the future are dependent upon its decision regarding the deployment of our product and its overall capital spending plans. Qwest reported significant operating losses in 2002, and has reported that it will restate prior period financials for certain incorrectly recorded transactions. These factors may have an adverse impact on Qwest s decision regarding the deployment of our product. Any continued significant reduction in purchases of our equipment by Qwest could have a material adverse effect on us.

A significant market for our products may not develop if telephone companies do not successfully deploy broadband services such as high-speed data and video.

Telephone companies have only recently begun widely offering high-speed data services, and most telephone companies have not offered video services at all. Sales of our products largely depend on the increased use and widespread adoption of broadband services and the ability of our customers to market and sell broadband services, including video services, to their customers. Certain critical issues concerning use of broadband services are unresolved and will likely affect their use. These issues include security, reliability, speed and volume, cost, government regulation and the ability to operate with existing and new equipment. Unless more large telephone companies make the strategic decision to enter the market for providing broadband services, a significant market for our products may not develop. In this regard, announced capital expenditures by most telephone companies decreased from 2001 to 2002.

A number of factors may lead customers to delay or forego deployment, which would hinder our ability to meet our business objectives.

Our customers have delayed deployments in the past and may delay deployments in the future. Factors that could cause telephone companies not to deploy, to delay deployment of, or to fail to deploy successfully the services for which our products are designed include the following:

- general economic conditions and telephone company capital spending plans;
- industry consolidation;
- regulatory uncertainties and delays;
- varying quality of telephone companies network infrastructure and cost of infrastructure upgrades and maintenance;
- inexperience of telephone companies in obtaining access to video programming content from third-party providers;
- inexperience of telephone companies in providing broadband services and the lack of sufficient technical expertise and personnel to install products and implement services effectively;
- uncertain subscriber demand for broadband services; and
- inability of telephone companies to predict return on their investment in broadband capable infrastructure and equipment.

Unless our products are successfully deployed by telephone companies in the near term, we will not be able to achieve our business objectives and increase our revenues.

We expect our quarterly revenues and operating results to fluctuate, and these fluctuations may make our stock price volatile.

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Our quarterly revenues and operating results have fluctuated in the past and are likely to fluctuate significantly in the future. As a result, we believe that quarter-to-quarter comparisons of our operating results may not be meaningful. Fluctuations in our quarterly revenues or operating results may cause volatility in the price of our stock. It is likely that in some future quarter our operating results may be below the expectations of public market analysts and investors, which may cause the price of our stock to fall. Factors likely to cause variations in our quarterly revenues and operating results include:

- delays or cancellations of any orders by Qwest, which accounted for approximately 24% of our revenues in 2002, or by any other customer accounting for a significant portion of our revenues;
- variations in the timing, mix and size of orders and shipments of our products throughout a quarter or year;
- new product introductions by us or by our competitors;
- the timing of upgrades of telephone companies infrastructure;
- general economic conditions and variations in capital spending budgets of telephone companies; and
- increased expenses, whether related to sales and marketing, product development or administration.

Because most of our operating expenses are fixed in the short term, we may not be able to quickly reduce spending if our revenues are lower than we had projected and our results of operations could be harmed.

Consolidation among telephone companies may reduce our sales.

Consolidation in the telecommunications industry may cause delays in the purchase of our products and cause a reexamination of strategic and purchasing decisions by our customers. In addition, we may lose relationships with key personnel within a customer s organization due to budget cuts, layoffs, or other disruptions following a consolidation.

Because our sales cycle is lengthy and variable, the timing of our revenue is difficult to predict, and we may incur sales and marketing expenses with no guarantee of a future sale.

Customers view the purchase of our products as a significant and strategic decision. As a result, customers typically undertake significant evaluation, testing and trial of our products before deployment. This evaluation process frequently results in a lengthy sales cycle, typically ranging from nine months to more than a year. Before a customer places an order, we may incur substantial sales and marketing expenses and expend significant management efforts. In addition, product purchases are frequently subject to unexpected administrative, processing and other delays on the part of our customers. This is particularly true for customers for whom our products represent a very small percentage of their overall purchasing activities. As a result, sales forecasted to be made to a specific customer for a particular quarter may not be realized in that quarter; and this could result in lower than expected revenues in that quarter.

Government regulation of our customers and related uncertainty could cause our customers to delay the purchase of our products.

The Federal Communications Commission (FCC) has announced that, except in limited circumstances, it will not require incumbent carriers to offer their competitors access to the facilities

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and equipment used to provide high-speed data services. Nevertheless, other regulatory and judicial proceedings relating to telephone companies obligations to provide elements of their network to competitors are pending. The FCC also requires incumbent carriers to permit competitive carriers to collocate certain of their equipment with the local switching equipment of the incumbents.

Despite the FCC s recent decision to deregulate the facilities and equipment used to provide high-speed data and video services, telephone companies may not wish to make expenditures for infrastructure and equipment required to provide broadband services until the FCC s decision becomes final, which may not be for several years.

The FCC has also issued a ruling that classified cable modem service as an interstate information service that is subject to FCC jurisdiction but not subject to common carrier regulation. As a result, such services are not currently regulated by the FCC and should not be subject to separate state and local regulation. This ruling may improve the competitive position of cable providers who compete with our customers who provide wireline-based broadband services. There is also currently a pending rulemaking proceeding in which the FCC proposes to classify broadband Internet access services provided by wireline-based telephone companies as interstate information services.

We cannot predict when or how these various regulatory issues will be decided. The uncertainties caused by the above described regulatory proceedings may cause telephone companies to delay purchasing decisions at least until the proceedings and any related judicial appeals are completed. The outcomes of these regulatory proceedings, as well as other FCC regulation, may cause telephone companies not to deploy services for which our products are designed or to further delay deployment.

Our customers and potential customers will not purchase our products if they do not have the infrastructure necessary to use our products.

The copper wire infrastructures over which telephone companies may deliver voice, data and video services using our products vary in quality and reliability. As a result, some of these telephone companies may not be able to deliver a full set of voice, data and video services to their customers, despite their intention to do so, and this could harm our sales. Even after installation of our products, we remain highly dependent on telephone companies to continue to maintain their infrastructure so that our products will operate at a consistently high performance level. Infrastructure upgrades and maintenance may be costly, and telephone companies may not have the necessary financial resources. This may be particularly true for our smaller customers and potential customers such as independent telephone companies and domestic local telephone companies. If our current and potential customers infrastructure is inadequate, we may not be able to generate anticipated revenues from them.

If competing technologies that offer alternative solutions to our products achieve widespread acceptance, the demand for our products may not develop.

Technologies that compete with our products include other telecommunications-related wireline technologies, cable-based technologies, fixed wireless technologies and satellite technologies. If these alternative technologies are chosen by our existing and potential customers, our business, financial condition and results of operations could be harmed. In particular, cable operators are currently deploying products that will be capable of delivering voice, high-speed data and video services over cable, including products from Motorola, our principal stockholder. Our technology may not be able to compete effectively against these technologies on price, performance or reliability.

Our customers or potential customers that also offer cable-based services may choose to purchase cable-based technologies. Cable service providers that offer not only data and video but also telephony over cable systems will give subscribers the alternative of purchasing all communications services from a single communications service provider, allowing the potential for more favorable pricing and a single point of contact for bill payment and customer service. If these services are implemented successfully over cable connections, they will compete directly with the services offered by telephone companies using our products. In addition, several telephone companies have commenced the marketing of video services over direct broadcast satellite while continuing to provide voice and data services over their existing copper wire infrastructure. If any of these services are accepted by consumers, the demand for our products may not develop and our ability to generate revenues will be harmed.

We face intense competition in providing equipment for telecommunications networks from larger and more established companies, and we may not be able to compete effectively with these companies.

Many of our current and potential competitors have longer operating histories, greater name recognition and significantly greater financial, technical, marketing and distribution resources than we do. These competitors may undertake more extensive marketing campaigns, adopt more aggressive pricing policies and devote substantially more resources to developing new products than we are able to, which could result in the loss of current customers and impair our ability to attract potential customers.

Our significant current competitors include Advanced Fibre Communications, Alcatel, Cisco Systems, Efficient Networks, Ericsson, Lucent Technologies, Nokia, Nortel Networks, BAE Systems, Scientific Atlanta, Siemens and our largest stockholder, Motorola, as well as emerging companies that are developing new technologies. Some of these competitors have existing relationships with our current and prospective customers. In addition, we anticipate that other large companies, such as Matsushita Electric Industrial which markets products under the Panasonic brand name, Microsoft, Network Computer, Philips, Sony, STMicroelectronics and Toshiba America will likely introduce products that compete with our N(3) Residential Gateway product in the future. Our customer base may be attracted by the names and resources of these large, well-known companies and may prefer to purchase products from them instead of us.

Consolidation of our competitors may cause us to lose customers and negatively affect our sales.

Consolidation in the telecommunications equipment industry may strengthen our competitors positions in our market, cause us to lose customers and hurt our sales. For example, Alcatel acquired DSC Communications, Lucent acquired Ascend Communications and BAE Systems, CNI Division, formerly GEC Marconi, acquired RELTEC. Acquisitions such as these may strengthen our competitors financial, technical and marketing resources and provide them access to regional Bell operating companies and other potential customers. Consolidation may also allow some of our competitors to penetrate new markets that we have targeted, such as domestic local, independent and international telephone companies. This consolidation may negatively affect our ability to increase revenues.

If we do not respond quickly to changing customer needs and frequent new product introductions by our competitors, our products may become obsolete.

Our position in existing markets or potential markets could be eroded rapidly by product advances. The life cycles of our products are difficult to estimate. Our growth and future financial performance will depend in part upon our ability to enhance existing products and develop and introduce new products that keep pace with:

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- the increasing use of the Internet;
- the growth in remote access by telecommuters;
- the increasingly diverse distribution sources for high quality digital video; and
- other industry and technological trends.

We expect that our product development efforts will continue to require substantial investments. We may not have sufficient resources to make the necessary investments. If we fail to timely and cost-effectively develop new products that respond to new technologies and customer needs, the demand for our products may fall and we could lose revenues.

Certain key personnel are critical to our business and the loss of their services could disrupt our operations and our customer relationships.

Our engineering and product development teams are critical in developing our products and have developed important relationships with our regional Bell operating company customers and their technical staffs. The loss of any of these key personnel could harm our operations and customer relationships.

Our limited ability to protect our intellectual property may affect our ability to compete, and we could lose customers.

We rely on a combination of patent, copyright and trademark laws, and on trade secrets and confidentiality provisions and other contractual provisions to protect our intellectual property. There is no guarantee that these safeguards will protect our intellectual property and other valuable confidential information. If our methods of protecting our intellectual property in the United States or abroad are not adequate, our competitors may copy our technology or independently develop similar technologies and we could lose customers. In addition, the laws of some foreign countries do not protect our proprietary rights as fully as do the laws of the United States. If we fail to adequately protect our intellectual property, it would be easier for our competitors to sell competing products, which could harm our business.

Third-party claims regarding intellectual property matters could cause us to stop selling our products, license additional technology or pay monetary damages.

From time to time, third parties, including our competitors and customers, have asserted patent, copyright and other intellectual property rights to technologies that are important to us. We expect that we will increasingly be subject to infringement claims as the number of products and competitors in our market grows and the functionality of products overlaps, and our products may currently infringe on one or more United States or international patents. The results of any litigation are inherently uncertain. In the event of an adverse result in any litigation with third parties that could arise in the future, we could be required:

- to pay substantial damages, including paying treble damages if we are held to have willfully infringed;
- to halt the manufacture, use and sale of infringing products;
- to expend significant resources to develop non-infringing technology; and/or
- to pay significant sums to obtain licenses to the infringing technology.

Licenses may not be available from any third party that asserts intellectual property claims against us, on commercially reasonable terms, or at all. In addition, litigation frequently involves substantial expenditures and can require significant management attention, even if we ultimately prevail. In addition, we indemnify our customers for patent infringement claims, and we may be required to obtain licenses on their behalf, which could subject us to significant additional costs.

We depend on third-party manufacturers and any disruption in their manufacture of our products would harm our operating results.

We contract for the manufacture of all of our products and have limited in-house manufacturing capabilities. We currently rely primarily on one large contract manufacturer: Plexus Services Corp. The efficient operation of our business will depend, in large part, on our ability to have Plexus and other companies manufacture our products in a timely manner, cost-effectively and in sufficient volumes, while maintaining consistent quality. As our business grows, Plexus and other contract manufacturing companies may not have the capacity to keep up with the increased demand. Any manufacturing disruption could impair our ability to fulfill orders and could cause us to lose revenue and/or customers.

We may be required to write down the value of our inventories in the future, which could be harmful to our operating results.

In assessing the ultimate realization of inventories, we are required to make judgments as to future demand requirements and compare these with the current or committed inventory levels. Our reserve requirements generally increase as our projected demand requirements decrease due to market conditions, technological and product life cycle changes, and strategic direction, such as discontinuances of product lines. As a result, we incurred inventory charges of approximately $5.9 million, $76.8 million and $9.0 million during fiscal 2002, 2001, and 2000, respectively. Additionally, during the first quarter of 2003, as we began to consolidate inventories and production to a new primary contract manufacturer, we initiated a thorough quality review of our raw materials on hand, the results of which have not yet been finalized. At December 31, 2002 and 2001, inventories were $40.3 million and $62.6 million, respectively. It is possible that significant changes in required inventory reserves may continue to occur in the future, especially if there is a further decline in market conditions or a change in product transition plans.

Our manufacturers may not be able to deliver our products on time, at favorable prices, or in sufficient quantities.

Although we currently have a one-year contracts in place with Plexus Services Corp., that contract does not absolutely guarantee product availability, firmly fix product costs or ensure the extension of credit. If Plexus and/or our other manufacturers are unable or unwilling to continue manufacturing our products in required volumes, we will have to identify acceptable alternative manufacturers, which could take in excess of three months. It is possible that a source may not be available to us when needed or be in a position to satisfy our production requirements at acceptable prices and on a timely basis. If we cannot find alternative sources for the manufacture of our products, we will not be able to meet existing demand. As a result, we may lose existing customers, and our ability to gain new customers may be significantly constrained.

Our inability to produce sufficient quantities of our products because of our dependence on components from key sole suppliers could result in delays in the delivery of our products and could harm our revenues.

Some parts, components and equipment used in our products are obtained from sole sources of supply. If our sole source suppliers fail to provide or we fail to obtain components in sufficient quantities when required, delivery of our products could be delayed resulting in decreased revenues. Additional sole-sourced components may be incorporated into our equipment in the future. We do not currently have any long-term supply contracts to ensure sources of supply. In addition, our suppliers may enter into exclusive arrangements with our competitors, stop selling their products or components to us at commercially reasonable prices or refuse to sell their products or components to us at any price, which could harm our operating results.

The occurrence of any defects, errors or failures in our products could result in delays in installation, product returns and other losses to us or to our customers or end users.

Our products are complex and may contain undetected defects, errors or failures. These problems have occurred in our products in the past and additional problems may occur in our products in the future and could result in the loss of or delay in market acceptance of our products. In addition, we expect additional defects, errors and failures as our business expands from trials to commercial deployment at certain customers. We will have limited experience with the problems that could arise with any new products that we introduce. Further, our customer agreements

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generally include a longer warranty for defects than our manufacturing agreements. These defects could result in a loss of sales and additional costs and liabilities to us as well as damage to our reputation and the loss of our customers.

We do not have significant experience in international markets and may have unexpected costs and difficulties in developing international revenues.

We hope to increase the marketing and sales of our products internationally. International operations are generally subject to inherent risks and challenges that could harm our operating results, including:

- unexpected changes in telecommunications regulatory requirements;
- limited number of telephone companies operating internationally;
- expenses associated with developing and customizing our products for foreign countries;
- tariffs, quotas and other import restrictions on telecommunications equipment;
- longer sales cycles for our products;
- fluctuating exchange rates affecting costs, pricing and revenues; and
- compliance with international standards that differ from domestic standards.

To the extent that we generate international sales in the future, any negative effects on our international business could harm our business, operating results and financial condition.

The price of our common stock has been and may continue to be highly volatile.

The stock markets have in general, and with respect to high technology companies, including us, in particular, recently experienced extreme stock price and volume volatility, often unrelated to the financial performance of particular companies. The price at which our common stock will trade in the future is likely to also be highly volatile and may fluctuate substantially due to factors such as:

- actual or anticipated fluctuations in our operating results;
- changes in or our failure to meet securities analysts expectations;
- announcements of technological innovations by us or our competitors;
- introduction of new products and services by us or our competitors;
- limited public float of our common stock;
- conditions and trends in the telecommunications and other technology industries; and
- general economic and market conditions.

Sales of shares of our common stock by existing stockholders could cause the market price of our common stock to drop significantly.

As of March 31, 2003, Motorola owned 64.1 million shares of our common stock, 7.5 million shares of preferred stock convertible into 91.7 million shares of common stock and warrants to purchase an additional 41.3 million shares of our common stock. In addition, Motorola has announced that an additional 13.3 million shares were tendered to Motorola in its tender offer. If Motorola or any of our other stockholders sells substantial amounts of common stock, including shares issued upon exercise of outstanding options and warrants, in the public market, the market price of the common stock could fall. In addition, any distribution of shares of our common stock by Motorola to its stockholders could also have an adverse effect on the market price.

Motorola and its transferees are entitled to registration rights pursuant to which they may require that we register their shares under the Securities Act of 1933.

In addition, as of March 31, 2003, there were outstanding options to purchase approximately 20.0 million shares of our common stock. Subject to vesting provisions and, in the case of our affiliates, volume and manner of sale restrictions, the shares of common stock issuable upon the exercise of our outstanding employee options will be eligible for sale into the public market at various times.

Anti-takeover provisions in our charter documents and Delaware law, along with retention agreements with certain key employees, could prevent or delay a change in control of our company that a stockholder may consider favorable.

Several provisions of our certificate of incorporation and bylaws and Delaware law may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable. These provisions include:

- authorizing the issuance of preferred stock without stockholder approval;
- providing for a classified board of directors with staggered, three-year terms;
- prohibiting cumulative voting in the election of directors;
- restricting business combinations with interested stockholders;
- limiting the persons who may call special meetings of stockholders;
- prohibiting stockholder action by written consent;
- establishing advance notice requirements for nominations for election to the board of directors and for proposing matters that can be acted on by stockholders at stockholder meetings; and
- requiring super-majority voting to effect amendments to our certificate of incorporation and bylaws.

Some of these provisions do not currently apply to Motorola and its affiliates.

In addition, certain key employees, including President and CEO J. Michael Norris and his six direct reports, have employment contracts and/or retention agreements containing change-of-control provisions which potential acquirers may find unfavorable.

Any or all of the above could prevent or delay a change in control of our company that a stockholder may consider favorable.

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ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk is limited to interest rate fluctuation. Interest on our debt to Motorola is variable, payable monthly and is determined on either the base rate, as defined in the agreement, plus 2% or the Eurodollar rate plus 3 1/2% (4.9% at December 31, 2002). If interest rates increased by 10% (0.5% change in interest rate), our interest expense on this debt would increase by approximately $0.2 million. We do not engage in any hedging activities, and we do not use derivatives or equity investments for cash investment purposes.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

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INDEPENDENT AUDITORS REPORT

To the Board of Directors and Stockholders of Next Level Communications, Inc.:

We have audited the accompanying consolidated balance sheets of Next Level Communications, Inc. and subsidiary (the Company) (a majority-owned subsidiary of Motorola, Inc.) as of December 31, 2002 and 2001 and the related consolidated statements of operations, redeemable convertible preferred stock, stockholders equity (deficit) and cash flows for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of Next Level Communications, Inc. and subsidiary as of December 31, 2002 and 2001 and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 1 to the financial statements, the Company s recurring losses from operations raise substantial doubt about its ability to continue as a going concern. Management s plans concerning these matters are also described in Note 1. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Deloitte & Touche LLP

San Francisco, California
April 15, 2003

Next Level Communications, Inc.
Consolidated Statements of Operations
Years Ended December 31, 2002, 2001 and 2000
(In Thousands, except per share data)

	Year Ended December 31,		
	2002	**2001**	**2000**
Revenues			
Equipment	$ 57,352	$ 91,030	$ 146,314
Software		2,215	3,777
Total Revenues	57,352	93,245	150,091
Cost of Revenues			
Equipment	51,444	157,837	125,090
Software		127	141
Total Cost of Revenues	51,444	157,964	125,231
GROSS PROFIT (LOSS)	5,908	(64,719)	24,860
OPERATING EXPENSES			
Research & development	25,307	46,868	55,834
Selling, general and administrative	33,574	53,349	46,907
Asset impairments and disposals, net	2,208	8,431	
Non-cash compensation charge			2,384
Total operating expenses	61,089	108,648	105,125
OPERATING LOSS	(55,181)	(173,367)	(80,265)
INTEREST INCOME (EXPENSE), NET	(22,793)	(14,454)	5,575
INVESTMENT IMPAIRMENTS		(20,000)	
OTHER EXPENSE, NET	(537)	(785)	(148)
NET LOSS	(78,511)	(208,606)	(74,838)
PREFERRED STOCK ACCRETION AND DIVIDENDS	(23,406)		
NET LOSS AVAILABLE TO COMMON SHAREHOLDERS	$ (101,917)	$ (208,606)	$ (74,838)
BASIC AND DILUTED NET LOSS PER COMMON SHARE	$ (1.18)	$ (2.45)	$ (0.91)
SHARES USED TO COMPUTE BASIC AND DILUTED NET LOSS PER COMMON SHARE	86,368	85,278	81,930

See notes to consolidated financial statements.

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Next Level Communications, Inc.
Consolidated Balance Sheets
December 31, 2002 and 2001
(In Thousands, except share data)

	December 31,	
	2002	**2001**
ASSETS		
Current Assets		
Cash and cash equivalents	$ 33,394	$ 20,580
Trade receivables, less allowance for doubtful accounts of $1,028 and $1,332, respectively	9,799	15,989
Other receivables	3,852	3,373
Inventories	40,267	62,645
Prepaid expenses and other	4,866	3,104
Total current assets	92,178	105,691
Property and equipment, net	38,249	46,740
Long-term investments and other assets	1,604	1,604
Total Assets	$ 132,031	$ 154,035
LIABILITIES AND STOCKHOLDERS EQUITY (DEFICIT)		
Current Liabilities		
Accounts payable	$ 8,832	$ 13,938
Accrued liabilities	14,361	19,213
Notes and loans payable		

See notes to consolidated financial statements.

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Consolidated Statements of Redeemable Convertible Preferred Stock and Stockholders Equity (Deficit)
Years Ended December 31, 2002, 2001 and 2000
(In Thousands)

	Redeemable Convertible Preferred Stock	Common Shares	Stock Amount	Preferred Shares	Stock Amount	Additional Paid-In Capital	Deferred Compensation	Accumulated Deficit	Total
Balance, December 31, 1999		79,752	$ 754			$ 412,930	$ (2,384)	$ (205,072)	$ 206,228
Issuance of common stock in connection with:									
Exercise of stock options and employee stock purchase plan		2,183	21			9,230			9,251
Exercise of warrants		2,369							
Acquisition of SoftProse		139	1			16,861	(365)		16,497
Additional initial public offering expenses						(898)			(898)
Amortization of deferred compensation							2,509		2,509
Net loss								(74,838)	(74,838)
Balance, December 31, 2000		84,443	776			438,123	(240)	(279,910)	158,749
Issuance of common stock in connection with:									
Exercise of stock options and employee stock purchase plan		1,426	15			2,774			2,789
Issuance of warrants to Motorola						38,123			38,123
Stock-based compensation and other						406			406
Amortization of deferred compensation							240		240
Net loss								(208,606)	(208,606)
Balance, December 31, 2001		85,869	791			479,426		(488,516)	(8,299)
Issuance of common stock in connection with:									
Exercise of stock options, 401(K) Stock Match and employee stock purchase plan		1,186	12			1,001			1,013
Issuance of redeemable convertible preferred stock	$ 64,931								
Issuance of warrants to Motorola- redeemable convertible preferred stock						13,709			13,709
Beneficial Conversion Feature-redeemable convertible Preferred Stock	6,360								
Preferred stock accretion	2,933								0
Dividend of Beneficial Conversion Feature	5,923								0

Dividends on redeemable convertible preferred stock	3,460								0
Conversion on elimination of redemption feature	(83,607)			7,426	$ 83,607				83,607
Issuance of preferred stock to Motorola				27	15,915				15,915
Beneficial Conversion Feature- Preferred Stock					2,575				2,575
Dividends on preferred stock						290			290
Issuance of warrants to Motorola- Preferred Stock						3,510			3,510
Dividend of Beneficial Conversion Feature						2,575			2,575
Revaluation of warrants on Motorola note payable						(3,987)			(3,987)
Warrants issued on extension of Motorola note payable						1,706			1,706
Stock-based compensation and other						554			554
Dividends to preferred stockholder						(23,406)			(23,406)
Net loss								(78,511)	(78,511)
Balance, December 31, 2002	$	87,055	$ 803	7,453	$ 102,097	$ 475,378	$	$ (567,027)	$ 11,251

See notes to consolidated financial statements.

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Next Level Communications, Inc.
Consolidated Statements of Cash Flows
Years Ended December 31, 2002, 2001 and 2000

(In Thousands)	Years ended December 31,		
	2002	2001	2000
OPERATING ACTIVITIES			
Net loss	$(78,511)	$(208,606)	$ (74,838)
Adjustments to reconcile net loss to net cash used in operating activities:			
Inventory charges	5,885	76,816	9,000
Impairment of investments and property and equipment	1,371	24,094	
Impairment of goodwill		8,452	
Other	579	536	2,624
Depreciation and amortization	9,509	17,649	13,813
Amortization of discount on note payable to Motorola	16,526	10,427	
Stock issued in connection with 401(k) Plan	404		
Equity in net loss of investee		635	
Gain on sale of software product line		(2,576)	
Changes in assets and liabilities:			
Trade receivables	6,170	17,004	(20,558)
Inventories	16,493	(42,697)	(73,211)
Other assets	(2,241)	(809)	(782)
Accounts payable	(5,106)	(25,089)	40,106
Accrued liabilities and deferred revenue	(5,224)	(3,642)	532
Net cash used in operating activities	(34,145)	(127,806)	(103,314)
INVESTING ACTIVITIES			
Purchases of property and equipment	(1,950)	(5,045)	(15,515)
Proceeds from sale (purchases) of marketable securities, net		25,000	18,044
Purchase of long-term investments		(8,000)	(14,988)
Proceeds from sale of software product line		4,875	
Return of capital from long-term investment		1,000	
Net cash (used in) provided by investing activities	(1,950)	17,830	(12,459)
FINANCING ACTIVITIES			
Proceeds from Motorola financings:			
Proceeds from issuance of redeemable convertible preferred stock and warrants	53,000		
Proceeds from issuance of preferred stock and warrants	12,000		
Note payable and warrants		82,954	
Tax sharing agreement		14,346	15,000
Proceeds from mortgage		20,000	
Repayment of mortgage	(1,089)	(176)	
Repayment of capital lease obligations		(330)	(617)
(Repayment of) proceeds from borrowings	(15,605)	(25,000)	148
Issuance of common stock and other	603	2,899	9,251
Initial public offering expenses, net			(898)
Net cash provided by financing activities	48,909	94,693	22,884