HARMONIC INC
Form 10-Q
November 04, 2008

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark one)

[X] Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the Quarterly Period Ended September 26, 2008.

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File No. 000-25826

HARMONIC INC.

(Exact name of Registrant as specified in its charter)

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

549 Baltic Way
Sunnyvale, CA 94089
(408) 542-2500

(Address, including zip code, and telephone number, including area code, of Registrants s principal executive offices)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes [X] No [ ]

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

Large accelerated	Accelerated filer: [X]	Non-accelerated filer: [ ]	Smaller reporting company:[ ]

filer: [ ]

(Do not check if a smaller reporting company)

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

Yes [ ] No [X]

The number of shares outstanding of the Registrant s Common Stock, $.001 par value, was 95,013,945 on October 24, 2008.

TABLE OF CONTENTS

PART I
ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
ITEM 2. MANAGEMENT_S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK
ITEM 4. CONTROLS AND PROCEDURES
PART II
ITEM 1. LEGAL PROCEEDINGS
ITEM 1A. RISK FACTORS
ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS
ITEM 3. DEFAULTS UPON SENIOR SECURITIES
ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS
ITEM 5. OTHER INFORMATION
ITEM 6. EXHIBITS
SIGNATURES
EX-31.1
EX-31.2
EX-32.1
EX-32.2

Table of Contents

PART I

FINANCIAL INFORMATION

ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

HARMONIC INC.
CONDENSED CONSOLIDATED BALANCE SHEETS
(UNAUDITED)

(In thousands, except par value amounts)	September 26, 2008	December 31, 2007
ASSETS		
Current assets:		
Cash and cash equivalents	$ 169,593	$ 129,005
Short-term investments	123,816	140,255
Accounts receivable, net of allowances of $7,894 and $8,194	75,949	69,302
Inventories	32,530	34,251
Deferred income taxes	26,964	3,506
Prepaid expenses and other current assets	11,692	17,489
Total current assets	440,544	393,808
Property and equipment, net	14,894	14,082
Goodwill	42,613	45,793
Intangibles, net	13,598	17,844
Other assets	27,971	4,252
Total assets	$ 539,620	$ 475,779
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 12,688	$ 20,500
Income taxes payable	46	481
Deferred revenue	29,378	37,865
Accrued liabilities	40,589	51,686
Total current liabilities	82,701	110,532
Accrued excess facilities costs, long-term	6,584	9,907
Income taxes payable, long-term	40,773	8,908
Deferred taxes, long-term		3,454
Other non-current liabilities	8,511	8,565
Total liabilities	138,569	141,366

Commitments and contingencies (Notes 15 and 16)		
Stockholders equity:		
Preferred stock, $0.001 par value, 5,000 shares authorized; no shares issued or outstanding		
Common stock, $0.001 par value, 150,000 shares authorized; 94,998 and 93,772 shares issued and outstanding	95	94
Capital in excess of par value	2,263,679	2,246,875
Accumulated deficit	(1,861,603)	(1,912,386)
Accumulated other comprehensive loss	(1,120)	(170)
Total stockholders equity	401,051	334,413
Total liabilities and stockholders equity	$ 539,620	$ 475,779

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

Table of Contents

HARMONIC INC.
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

(In thousands, except per share amounts)	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Net sales	$91,455	$82,295	$268,071	$223,814
Cost of sales	47,259	46,652	138,744	130,454
Gross profit	44,196	35,643	129,327	93,360
Operating expenses:				
Research and development	13,724	11,018	40,264	31,615
Selling, general and administrative	19,254	14,911	56,725	46,357
Write-off of acquired in-process technology		700		700
Amortization of intangibles	160	143	479	365
Total operating expenses	33,138	26,772	97,468	79,037
Income from operations	11,058	8,871	31,859	14,323
Interest income, net	2,286	1,238	7,548	3,224
Other income (expense), net	(1,450)	58	(2,022)	42
Income before income taxes	11,894	10,167	37,385	17,589
Provision for (benefit from) income taxes	(71)	750	(13,398)	807
Net income	$11,965	$ 9,417	$ 50,783	$ 16,782
Net income per share				
Basic	$ 0.13	$ 0.12	$ 0.54	$ 0.21
Diluted	$ 0.12	$ 0.12	$ 0.53	$ 0.21

Weighted average shares				
Basic	94,805	80,371	94,365	79,570
Diluted	95,863	81,642	95,491	80,743

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

Table of Contents

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

(In thousands)	Nine Months Ended September 26, 2008	Nine Months Ended September 28, 2007
Cash flows from operating activities:		
Net income	$ 50,783	$ 16,782
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of intangibles	4,746	3,661
Write-off of acquired in-process technology		700
Depreciation	5,215	5,089
Stock-based compensation	5,470	4,475
Excess tax benefits from stock-based compensation	(2,864)	
Loss on impairment of investment	845	
Net loss (gain) on disposal and impairment of fixed assets	22	(31)
Deferred tax assets	(46,249)	
Other non-cash adjustments, net	(2,090)	(386)
Changes in assets and liabilities, net of effect of acquisition:		
Accounts receivable, net	(6,612)	(4,234)
Inventories	1,741	5,777
Prepaid expenses and other assets	5,755	1,108
Accounts payable	(7,812)	(18,217)
Deferred revenue	(6,967)	3,714
Income taxes payable	31,430	(271)
Accrued excess facilities costs	(4,808)	(5,661)
Accrued and other liabilities	(9,939)	(3,242)
Net cash provided by operating activities	18,666	9,264
Cash flows from investing activities:		
Purchases of investments	(91,868)	(70,507)
Proceeds from maturities and sales of investments	109,363	71,578
Acquisition of property and equipment	(6,049)	(4,193)
Acquisition of intellectual property	(500)	
Acquisition of Rhozet Corp, net of cash received	(2,828)	(1,370)
Redemption/(purchase) of Entone, Inc. convertible note	2,500	(2,500)
Acquisition costs related to the merger of Entone Technologies, Inc.		(2,466)
Net cash provided by (used in) investing activities	10,618	(9,458)

Cash flows from financing activities:		
Proceeds from issuance of common stock, net	8,367	8,292
Excess tax benefits from stock-based compensation	2,864	
Repayments under bank line and term loan		(460)
Repayments of capital lease obligations		(65)
Net cash provided by financing activities	11,231	7,767
Effect of exchange rate changes on cash and cash equivalents	73	(34)
Net increase in cash and cash equivalents	40,588	7,539
Cash and cash equivalents at beginning of period	129,005	33,454
Cash and cash equivalents at end of period	$169,593	$ 40,993
Supplemental disclosure of cash flow information:		
Income tax payments, net	$ 1,527	$ 1,132
Interest paid during the period	$	$ 66
Non-cash investing and financing activities		
Issuance of restricted common stock for Rhozet acquisition	$	$ 8,424
Liability for future issuance of common stock for Rhozet acquisition	$	$ 1,870

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

Table of Contents

HARMONIC INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1: BASIS OF PRESENTATION

Basis of Presentation. The accompanying unaudited condensed consolidated financial statements include all adjustments (consisting only of normal recurring adjustments) which Harmonic Inc. (Harmonic, the Company or we) considers necessary for a fair presentation of the results of operations for the interim periods covered and the consolidated financial condition of the Company at the date of the balance sheets. This Quarterly Report on Form 10-Q should be read in conjunction with the Company s audited consolidated financial statements contained in the Company s Annual Report on Form 10-K, which was filed with the Securities and Exchange Commission on March 17, 2008. The interim results presented herein are not necessarily indicative of the results of operations that may be expected for the full fiscal year ending December 31, 2008, or any other future period. The Company s fiscal quarters are based on 13-week periods, except for the fourth quarter which ends on December 31.

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

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

Reclassifications. The Company has reclassified certain prior period balances to conform to the current year presentation. These reclassifications have no material impact on previously reported total assets, total liabilities, stockholders equity, results of operations or cash flows.

NOTE 2: RECENT ACCOUNTING PRONOUNCEMENTS

In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards 157, Fair Value Measurements (SFAS 157). This statement clarifies the definition of fair value, establishes a framework for measuring fair value, and expands the disclosures on fair value measurements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB adopted FASB Staff Position SFAS No. 157-2 Effective Date of FASB Statement No. 157 delaying the effective date of SFAS No. 157 for one year for all non financial assets and non financial liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually).

Harmonic adopted SFAS No. 157 on January 1, 2008, except as it applies to those non-financial assets and non-financial liabilities as described in FSP FAS No. 157-2, and the adoption of SFAS 157 did not materially impact our financial condition, results of operations or cash flows. See Note 4, Fair Value.

In October 2008, the FASB issued FSP 157-3, Determining Fair Value of a Financial Asset in a Market That Is Not Active (FSP 157-3). FSP 157-3 clarified the application of SFAS No. 157 in an inactive market. It demonstrated how the fair value of a financial asset is determined when the market for that financial asset is inactive. FSP 157-3 was effective upon issuance, including prior periods for which financial statements had not been issued. The implementation of this standard did not have a material impact on our consolidated results of operations and financial condition for the period covered by this quarterly report on Form 10-Q.

In December 2007, the FASB issued SFAS 141 (revised 2007), Business Combinations (SFAS 141(R)). SFAS 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS 141(R) also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS 141(R) is effective for fiscal years beginning after December

Table of Contents

15, 2008, and will be adopted by us in the first quarter of fiscal 2009. We are currently evaluating the potential impact, if any, of the adoption of SFAS 141(R) on our consolidated results of operations, financial condition or cash flows.

In December 2007, the FASB issued SFAS 160, Noncontrolling Interests in Consolidated Financial Statements an amendment of Accounting Research Bulletin 51 (SFAS 160). SFAS 160 establishes accounting and reporting standards for ownership interests in subsidiaries held by parties other than the parent, the amount of consolidated net income attributable to the parent and to the noncontrolling interest, changes in a parent s ownership interest, and the valuation of retained noncontrolling equity investments when a subsidiary is deconsolidated. SFAS 160 also establishes disclosure requirements that clearly identify and distinguish between the interests of the parent and the interests of the noncontrolling owners. SFAS 160 is effective for fiscal years beginning after December 15, 2008, and will be adopted by us in the first quarter of fiscal 2009. We are currently evaluating the potential impact, if any, of the adoption of SFAS 160 on our consolidated results of operations, financial condition or cash flows.

In March 2008, the FASB issued SFAS 161, Disclosures about Derivative Instruments and Hedging Activities an amendment of FASB Statement No. 133 (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedge items are accounted for under Statement 133 and its related interpretations, and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We are currently evaluating the potential impact, if any, of the adoption of SFAS 161 on our consolidated results of operations, financial condition or cash flows.

In May 2008, the FASB issued SFAS 162, The Hierarchy of Generally Accepted Accounting Principles (SFAS No. 162). SFAS 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principles (the GAAP hierarchy). SFAS 162 will become effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. We do not expect the adoption of SFAS 162 to have a material effect on our consolidated results of operations and financial condition.

NOTE 3: RHOZET ACQUISITION

On July 31, 2007, Harmonic completed the acquisition of Rhozet Corporation, or Rhozet, a privately held company based in Santa Clara, California. Rhozet develops and markets software-based transcoding solutions that facilitate the creation of multi-format video for internet, mobile and broadcast applications. With Rhozet s products, and sometimes in conjunction with other Harmonic products, Harmonic s existing broadcast, cable, satellite and telco customers can deliver video programming over the internet and to mobile services, as well as expand the types of content delivered via their traditional networks to encompass web-based and user-generated content. Harmonic also believes that the acquisition opens up new customer opportunities for Harmonic with Rhozet s customer base of broadcast content creators and online video service providers and is complementary to Harmonic s video-on-demand networking software business acquired in December 2006 from Entone Technologies. These opportunities were significant factors to the establishment of the purchase price, which exceeded the fair value of Rhozet s net tangible and intangible assets acquired resulting in the amount of goodwill we have recorded with this transaction. Management has made an allocation of the purchase price to the tangible and intangible assets acquired and liabilities assumed.

The purchase price of $16.2 million included $15.5 million of total merger consideration and $0.7 million of transaction expenses. Under the terms of the merger agreement, Harmonic paid or will pay an aggregate of approximately $15.5 million in total merger consideration, comprised of approximately $2.5 million in cash, approximately $10.3 million of common stock issued and to be issued, consisting of approximately 1.1 million shares of Harmonic s common stock, in exchange for all of the outstanding shares of capital stock of Rhozet, and approximately $2.8 million of cash, which was paid in the first quarter of 2008, as provided in the merger agreement, to the holders of outstanding options to acquire Rhozet common stock. Pursuant to the merger agreement, approximately $2.3 million of the total merger consideration, consisting of cash and shares of Harmonic

Table of Contents

common stock, is being held back by Harmonic for at least 18 months following the closing of the acquisition to satisfy certain indemnification obligations of Rhozet s shareholders. As of September 26, 2008, approximately $2.3 million of purchase consideration, which based on the terms of the merger agreement will be settled through the issuance of approximately 0.2 million shares of Harmonic s common stock and has been recorded as a long-term liability, and the payment of $0.5 million in cash which has been recorded as a current liability.

The Rhozet acquisition was accounted for under SFAS No. 141 and certain specified provisions of SFAS No. 142. The results of operations of Rhozet are included in Harmonic s Consolidated Statements of Operations from July 31, 2007, the date of acquisition. The following table summarizes the allocation of the purchase price based on the fair value of the tangible assets acquired and the liabilities assumed at the date of acquisition:

	(in thousands)
Cash acquired	$ 657
Accounts receivable	457
Fixed assets	133
Other tangible assets acquired	59
Intangible assets:	
IP technology	169
Software license	80
Existing technology	4,000
In-process technology	700
Core technology	1,100
Customer contracts	300
Maintenance agreements	600
Tradenames/trademarks	300
Goodwill	8,980
Total assets acquired	17,535
Deferred revenue	(174)
Other accrued liabilities	(1,165)
Net assets acquired	$16,196

The purchase price was allocated as set forth in the table above. The Income Approach which includes an analysis of the markets, cash flows and risks associated with achieving such cash flows, was the primary method used in valuing the identified intangibles acquired. The Discounted Cash Flow method was used to estimate the fair value of the acquired existing technology, in-process technology, maintenance agreements and customer contracts. The Royalty Savings Method was used to estimate the fair value of the acquired core technology and trademarks/trade names. In the Royalty Savings Method, the value of an asset is estimated by capitalizing the royalties saved because the Company owns the asset. Expected cash flows were discounted at the Company s weighted average cost of capital of 18%. Identified intangible assets, including existing technology and core technology are being amortized over their useful lives of four years; trade name/trademarks are being amortized over their useful lives of five years; customer contracts are being amortized over its useful life of six years and maintenance agreements are being amortized over its useful life of seven years. In-process technology was written off due to the risk that the developments will not be completed or competitive with comparable products. Existing technology is being amortized using the double

declining method which reflects the future projected cash flows. The core technology, customer contracts, maintenance agreements and trade name/trademarks are being amortized using the straight-line method.

The residual purchase price of $9.0 million has been recorded as goodwill. The goodwill as a result of this acquisition is not expected to be deductible for tax purposes. In accordance with SFAS No. 142, Goodwill and Other Intangible Assets, goodwill relating to the acquisition of Rhozet is not being amortized and will be tested for impairment annually or whenever events indicate that an impairment may have occurred.

The following unaudited pro forma financial information presented below summarizes the combined results of operations as if the merger had been completed as of the beginning of January 1, 2007. The unaudited pro forma financial information for the three and nine months ended September 28, 2007 combines the results for Harmonic

Table of Contents

for the three and nine months ended September 28, 2007, and the historical results of Rhozet for the one and seven months ended July 31, 2007. The pro forma financial information is presented for informational purposes only and does not purport to be indicative of what would have occurred had the merger actually been completed on such date or of results which may occur in the future.

(in thousands, except per share data)	Three Months Ended September 28, 2007	Nine Months Ended September 28, 2007
Net sales	$ 82,553	$ 225,136
Net income	$ 8,603	$ 13,513
Net income per share basic	$ 0.11	$ 0.17
Net income per share diluted	$ 0.10	$ 0.17

NOTE 4: FAIR VALUE

In September 2006, FASB issued SFAS 157. This statement establishes a framework for measuring fair value and expands required disclosure about the fair value measurements of assets and liabilities. SFAS 157 for financial assets and liabilities is effective for fiscal years beginning after November 15, 2007. The Company adopted SFAS 157 as of January 1, 2008 and the impact was not significant.

SFAS 157 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under SFAS 157 must maximize the use of observable inputs and minimize use of unobservable inputs. The standard describes three levels of inputs that may be used to measure fair value:

Level 1 Quoted prices in active markets for identical assets or liabilities.

Level 2 Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. The Company s short-term investments primarily use broker quotes in a non-active market for valuation of these securities.

Level 3 Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company uses the market approach to measure fair value for its financial assets and liabilities. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

In accordance with SFAS 157, the following table represents Harmonic s fair value hierarchy for its financial assets and liabilities measured at fair value on a recurring basis as of September 26, 2008:

(in thousands)	Level 1	Level 2	Level 3	Total
Money market funds	$142,164	$	$	$142,164
U.S. corporate debt		73,526		73,526
U.S. government agencies		35,925		35,925
Auction rate securities			14,365	14,365
	$142,164	$109,451	$14,365	$265,980
Forward exchange contracts		5,666		5,666

Total assets	$142,164	$115,117	$14,365	$271,646

Our auction rate securities were measured at fair value on a recurring basis using significant Level 3 inputs as of September 26, 2008. The following table summarizes our fair value measurements using significant Level 3 inputs, and changes therein, for the nine month period ended September 26, 2008:

Table of Contents

(in thousands)	Level 3
Balance as of December 31, 2007	$
Transfers in to Level 3	34,863
Sales	(8,130)
Balance as of March 28, 2008	26,733
Sales	(12,289)
Unrealized gain recorded in Other comprehensive income	64
Balance as of June 27, 2008	14,508
Unrealized loss recorded in Other comprehensive income	(143)
Balance as of September 26, 2008	$ 14,365

The fair value of our auction rate securities at September 26, 2008 were measured using Level 3 inputs. The inputs to the valuation model could no longer be valued by observable market data as of September 26, 2008, and as a result, these securities were classified as Level 3 of the fair value hierarchy under the framework of SFAS 157. Significant inputs to our valuation model for auction rate securities as of September 26, 2008 were based on certain assumptions, including interest rate yield curves, credit quality, the estimated time until liquidity returns to the auction rate securities and valuation estimates.

The following is a summary of available-for-sale securities:

(in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
September 26, 2008				
U.S. government debt securities	$ 36,067	$	$ (142)	$ 35,925
Corporate debt securities	75,375	25	(1,874)	73,526
Auction rate securities	14,365			14,365
Total	$125,807	$ 25	$(2,016)	$123,816
December 31, 2007				
U.S. government debt securities	$ 15,886	$ 13	$ (12)	$ 15,887
Corporate debt securities	90,247	68	(134)	90,181
Auction rate securities	34,187			34,187
Total	$140,320	$ 81	$ (146)	$140,255

As of September 26, 2008, the fair value of certain of the Company s short-term investments was less than their cost basis. These unrealized losses as a result of the decline in the fair value of such investments were primarily due to the current credit crisis in addition to changes in interest rates. Management reviewed various factors to determine the fair market value of our investments and whether to recognize an impairment charge related to these unrealized losses including, the current financial and credit market environment, the financial condition and near term prospects of the issuer of the short-term investment, the magnitude of the unrealized loss compared to the cost of the investment, the length of time the investment has been in a loss position and the Company s intent and ability to hold the investment for a period of time sufficient to allow for any anticipated recovery of market value. Based on this analysis, the Company determined that a portion of the unrealized losses associated with the Company s portfolio of short-term investments were other-than-temporary and recorded an impairment charge for one security of $0.8 million for the three month period ended September 26, 2008, which is included in other income (expense), net, in the accompanying condensed consolidated statements of operations. The impairment charge recognized during the three-month period ended September 26, 2008 relates to a marketable security issued by Lehman Brothers Holdings, Inc., which filed for bankruptcy in September 2008. The Company determined that the remaining unrealized losses are temporary in nature and recorded them as a component of accumulated other comprehensive loss.

Table of Contents

As of September 26, 2008, we held approximately $14.4 million of auction rate securities, or ARSs, classified as short-term investments and we believe the fair value of these securities approximate their par value at the balance sheet date. These ARSs, which are invested in preferred securities in closed end funds, all have a credit rating of AA or better and the issuers are paying interest at the maximum contractual rate. During the first nine months of 2008, the Company was able to sell $20.4 million of auction rate securities through successful auctions and redemptions. The remaining $14.4 million in ARSs held by the Company as of September 26, 2008 all had failed auctions in the first nine months of 2008. Based on current market conditions, we believe that it is likely that future auctions related to these securities will be unsuccessful in the near term. Unsuccessful auctions will result in our holding these securities beyond their next scheduled auction reset dates, thus limiting the short-term liquidity of these investments. While these failures in the auction process have affected our ability to access these funds in the near term, we do not believe that the underlying securities or collateral have been affected. It is the Company s intent to realize the cash value of these securities during its normal operating cycle and accordingly the securities have been classified in short-term investments. During August 2008, we received notification from our investment manager who holds the ARSs that it had reached a settlement with certain regulatory authorities, pursuant to which the Company would be able to sell its outstanding ARSs to the investment manager at par, plus accrued interest and dividends at any time during the period from January 2, 2009 through January 15, 2010. While management believes that the Company will be able to liquidate our auction rate securities without significant loss during its normal annual operating cycle, the timing to realize the investments recorded value is uncertain. If the credit rating of the security issuers deteriorates or does not meet our investment criteria, the Company may be required to adjust the carrying value of these investments through an impairment charge or dispose of these securities, possibly at a loss.

Impairment of Investments

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

In the third quarter of 2008, we recorded an impairment of $0.8 million in other expense on an investment in the unsecured debt of Lehman Brothers Holdings, Inc., which filed for bankruptcy in September 2008.

In accordance with FASB Staff Position Nos. 115-1 and FAS 124-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments (FSP FAS 115-1), there is one available-for-sale security with a total fair market value at September 26, 2008 of $0.4 million that has been in a continuous unrealized loss position for more than 12 months, however the amount of unrealized losses on that security is insignificant as of September 26, 2008. The decline in the estimated fair value of the Company s these investments relative to amortized cost is primarily related to changes in interest rates and is considered to be temporary in nature.

NOTE 5: INVENTORIES

(In Thousands)	September 26, 2008	December 31, 2007
Raw materials	$ 8,192	$ 8,700
Work-in-process	2,315	1,574
Finished goods	22,023	23,977

$ 32,530	$ 34,251

NOTE 6: GOODWILL AND IDENTIFIED INTANGIBLES

The following is a summary of goodwill and intangible assets as of September 26, 2008 and December 31, 2007:

Table of Contents

(In Thousands)	September 26, 2008 Gross Carrying Amount	September 26, 2008 Accumulated Amortization	September 26, 2008 Net Carrying Amount	December 31, 2007 Gross Carrying Amount	December 31, 2007 Accumulated Amortization	December 31, 2007 Net Carrying Amount
Identified intangibles:						
Developed core technology	$ 49,745	$(38,934)	$10,811	$ 49,463	$(34,941)	$14,522
Customer relationships/contracts	33,908	(32,479)	1,429	33,912	(32,234)	1,678
Trademark and tradename	5,312	(4,572)	740	5,337	(4,432)	905
Supply agreement	3,501	(3,501)		3,543	(3,543)	
Maintenance agreements	600	(100)	500	600	(36)	564
Software license, intellectual property and assembled workforce	309	(191)	118	249	(74)	175
Subtotal of identified intangibles	93,375	(79,777)	13,598	93,104	(75,260)	17,844
Goodwill	42,613		42,613	45,793		45,793
Total goodwill and other intangibles	$135,988	$(79,777)	$56,211	$138,897	$(75,260)	$63,637

The changes in the carrying amount of goodwill for the nine months ended September 26, 2008 are as follows:

(In Thousands)	Goodwill
Balance as of December 31, 2007	$45,793
Deferred tax asset adjustment	(2,960)
Foreign currency translation adjustments	(220)
Balance as of September 26, 2008	$42,613

During the second quarter of 2008 an adjustment to goodwill of $3.0 million was recorded due to an adjustment of the tax valuation allowance from the Entone and Rhozet acquisitions.

During the third quarter of 2008, the Company purchased certain assets, including intellectual property for $0.5 million in cash. This intellectual property will be utilized in furthering the capabilities of the Company s IP-based video solutions over cable network infrastructures. The purchase price was allocated between developed technology and assembled workforce and both have a useful life of 2.5 years.

For the three and nine months ended September 26, 2008, the Company recorded a total of $1.5 million and $4.6 million of amortization expense for identified intangibles, of which $1.4 million and $4.2 million was included in cost of sales, respectively. For the three and nine months ended September 28, 2007, the Company recorded a total of $1.5 million and $3.7 million of amortization expense for identified intangibles, of which $1.3 million and $3.3 million was included in cost of sales, respectively. The estimated future amortization expense of purchased intangible assets with definite lives is as follows:

Table of Contents

(In Thousands)

Years Ending December 31,	Amounts
2008 (remaining 3 months)	$ 1,529
2009	6,012
2010	4,641
2011	815
2012	437
2013	115
2014	49
Total	$13,598

NOTE 7: RESTRUCTURING AND EXCESS FACILITIES

In 2001 and 2002, excess facilities charges totaling $44.3 million were recorded due to the Company s reduced headcount, difficult business conditions and a weak local commercial real estate market.

In the fourth quarter of 2005, the excess facilities liability was decreased by $1.1 million due to subleasing a portion of an unoccupied building for the remainder of the lease. During the third quarter of 2006, the Company recorded a charge in selling, general and administrative expenses for excess facilities of $3.9 million. In addition, during the third quarter of 2006 the Company revised its estimate of expected sublease income with respect to previously vacated facilities and recorded a credit of $1.7 million.

In the third quarter of 2007, the Company recorded a credit of $1.8 million in selling, general and administrative expenses from a revised estimate of expected sublease income due to the extension of a sublease of a Sunnyvale building to the lease expiration. In addition, in 2007 the Company recorded a restructuring charge of $0.4 million on a reduction in estimated sublease income for a Sunnyvale building.

During the first quarter of 2007, the Company recorded a charge in selling, general and administrative expenses for excess facilities of $0.4 million. This charge primarily relates to two buildings in the UK which were vacated in connection with the closure of the manufacturing and research and development activities of Broadcast Technology Limited, or BTL, in accordance with applicable provisions of FAS No. 146. In the fourth quarter of 2007, the Company recorded a charge in selling, general and administrative expenses of $0.1 million for the remaining building from the closure of BTL.

During the second quarter of 2008, the Company recorded a charge in selling, general and administrative expenses for excess facilities of $1.2 million from a revised estimate of expected sublease income of a Sunnyvale building. The lease terminates in September 2010 and all sublease income has been eliminated from the estimated liability.

During the third quarter of 2008, the Company recorded a charge in selling, general and administrative expenses for excess facilities of $0.2 million from a revised estimate of expected sublease income of two buildings in England. The leases terminate in October 2010 and all sublease income has been eliminated from the estimated liability.

As of September 26, 2008, accrued excess facilities cost totaled $12.9 million, of which $6.4 million was included in current accrued liabilities and $6.5 million in other non-current liabilities. The Company incurred cash outlays of $4.8 million during the first nine months of 2008 principally for lease payments, property taxes, insurance and other maintenance fees related to vacated facilities. Harmonic expects to pay approximately $1.3 million of excess facility lease costs, net of estimated sublease income, for the remainder of 2008 and to pay the remaining $11.6 million, net of estimated sublease income, over the remaining lease terms through October 2010.

Harmonic reassesses this liability quarterly and adjusts as necessary based on changes in the timing and amounts of expected sublease rental income.

Table of Contents

The following table summarizes restructuring activities:

(In Thousands)	Excess Facilities	Campus Consolidation	BTL Closure	Total
Balance at December 31, 2007	$11,150	$ 4,493	$ 370	$16,013
Provisions/(recoveries)	(10)	1,463	263	1,716
Cash payments, net of sublease income	(2,949)	(1,639)	(197)	(4,785)
Balance at September 26, 2008	$ 8,191	$ 4,317	$ 436	$12,944

NOTE 8: CREDIT FACILITIES AND LONG-TERM DEBT

Harmonic has a bank line of credit facility with Silicon Valley Bank, which provides for borrowings of up to $10.0 million that matures on March 4, 2009. As of September 26, 2008, other than standby letters of credit and guarantees (Note 15), there were no amounts outstanding under the line of credit facility and there were no borrowings in 2007 or 2008. This facility, which was amended and restated in March 2008, contains a financial covenant with the requirement for Harmonic to maintain cash, cash equivalents and short-term investments, net of credit extensions, of not less than $40.0 million. If Harmonic is unable to maintain this cash, cash equivalents and short-term investments balance or satisfy the affirmative covenant requirement, Harmonic would be in noncompliance with the facility. In the event of noncompliance by Harmonic with the covenant under the facility, Silicon Valley Bank would be entitled to exercise its remedies under the facility which include declaring all obligations immediately due and payable if obligations were not repaid. At September 26, 2008, Harmonic was in compliance with the covenant under this line of credit facility. The March 2008 amendment requires payment of approximately $20,000 of additional fees if the Company does not maintain an unrestricted deposit of $30.0 million with the bank for 10 consecutive days. Future borrowings pursuant to the line bear interest at the bank s prime rate (5.0% at September 26, 2008). Borrowings are payable monthly and are not collateralized.

NOTE 9: BENEFIT PLANS

Stock Option Plans. Harmonic has reserved 17,554,000 shares of Common Stock for issuance under various employee stock option plans, which includes an amendment to the 1995 Plan approved by Harmonic s stockholders in May 2008 and increased the number of shares of common stock reserved for issuance under this plan by 7,500,000. The options are granted for periods not exceeding ten years and generally vest 25% at one year from date of grant, and an additional 1/48 per month thereafter. Stock options are granted at the fair market value of the stock at the date of grant. Beginning on February 27, 2006, option grants had a term of seven years. Certain option awards provide for accelerated vesting if there is a change in control.

Director Option Plans. In May 2002, Harmonic s stockholders approved the 2002 Director Stock Plan (the Plan), replacing the 1995 Director Option Plan. In June 2006, Harmonic s stockholders approved an amendment to the Plan and increased the maximum number of shares of common stock authorized for issuance over the term of the Plan by an additional 300,000 shares to 700,000 shares and reduced the term of future options granted under the Plan to seven years. In May 2008, Harmonic stockholders approved amendments to the Plan and increased the maximum number of shares of common stock authorized for issuance by an additional 100,000 shares to 800,000 shares. Harmonic has a total of 667,000 shares of Common Stock reserved for issuance under the Plan. The Plan provides for the grant of non-statutory stock options or restricted stock units to certain non-employee directors of Harmonic. Restricted stock units, or RSUs, are granted at fair market value of the stock at the date of grant and vest after one year. Stock options are granted at fair market value of the stock at the date of grant for periods not exceeding ten years. Initial option grants generally vest monthly over three years, and subsequent grants generally vest monthly over one year. In the third quarter of 2008, each non-employee director received restricted stock units valued at $80,000 on July 31, 2008, which will vest on May 15, 2009.

13

Table of Contents

The following table summarizes activities under the Plans:

(In thousands except exercise price)	Shares Available for Grant	Outstanding Options: Number of Shares	Outstanding Options: Weighted Average Exercise Price
Balance at December 31, 2007	2,051	9,469	$ 11.31
Shares authorized	7,600		
Restricted stock units granted	(144)		
Options granted	(2,861)	2,861	8.21
Options exercised		(757)	6.17
Options canceled	701	(701)	14.02
Options expired		(70)	25.66
Balance at September 26, 2008	7,347	10,802	$ 10.58
Options vested and exercisable as of September 26, 2008		5,717	$ 12.85
Options vested and expected-to-vest as of September 26, 2008		10,417	$ 10.67

The weighted-average fair value of options granted for the nine months ended September 26, 2008 was $3.79.
The following table summarizes information regarding stock options outstanding at September 26, 2008:

	Stock Options Outstanding			Stock Options Exercisable	
Range of Exercise Prices	Number Outstanding at September 26, 2008	Weighted-Average Remaining Contractual Life (Years)	Weighted-Average Exercise Price	Number Exercisable at September 26, 2008	Weighted Average Exercise Price
	(In thousands, except exercise price and life)				
$ 0.19 -- 5.86	1,355	5.4	$ 4.68	1,103	$ 4.63
5.87 -- 7.60	1,165	4.5	6.05	772	6.06
7.67 -- 8.17	2,739	6.6	8.16	67	8.00
8.20 -- 8.93	2,375	5.4	8.37	1,077	8.50

8.95 -- 11.33	1,972	3.9	9.76	1,502	9.68
11.45 -- 22.34	117	2.7	13.51	117	13.52
22.78 -- 121.68	1,079	1.5	35.08	1,079	35.08
	10,802	4.9	$ 10.58	5,717	$ 12.85

The weighted-average remaining contractual life for all exercisable stock options at September 26, 2008 was 3.8 years. The weighted-average remaining contractual life of all vested and expected-to-vest stock options at September 26, 2008 was 4.8 years.

Aggregate pre-tax intrinsic value of options exercisable at September 26, 2008 was $6.9 million. The aggregate intrinsic value of stock options vested and expected-to-vest net of estimated forfeitures was $10.9 million at September 26, 2008. Aggregate pre-tax intrinsic value represents the difference between our closing price on the last trading day of the fiscal period, which was $8.73 as of September 26, 2008, and the exercise price multiplied by the number of options outstanding or exercisable. The intrinsic value of exercised stock options is calculated based on the difference between the exercise price and the current market value at the time of exercise. The aggregate intrinsic value of exercised stock options was $0.9 million and $2.3 million during the three and nine months ended September 26, 2008, respectively.

Shares of RSUs granted have been deducted from the shares available for grant under the Company s stock option plans using a factor of two times the number of RSUs granted. Outstanding RSU balances were not included in the outstanding options balances in the above table. A summary of the Company s RSU activity and related information for the three months ended September 26, 2008 is set forth in the following table:

Table of Contents

(In thousands except exercise price)	Number of Shares	Weighted Average Grant Date Fair Value	Aggregate Intrinsic Value
Balance at June 27, 2008		$	
Restricted stock units granted	72	7.79	
Restricted stock units vested			
Restricted stock units cancelled			
Balance at September 26, 2008	72	$ 7.79	$ 628

Employee Stock Purchase Plan. In May 2002, Harmonic s stockholders approved the 2002 Employee Stock Purchase Plan (the 2002 Purchase Plan) replacing the 1995 Employee Stock Purchase Plan effective for the offering period beginning on July 1, 2002. In May 2004, Harmonic s stockholders approved an amendment to the 2002 Purchase Plan and increased the maximum number of shares of common stock authorized for issuance over the term of the 2002 Purchase Plan by an additional 2,000,000 shares. In June 2006, Harmonic s stockholders approved an amendment to the 2002 Purchase Plan to increase the maximum number of shares of common stock available for issuance under the 2002 Purchase Plan by an additional 2,000,000 shares to 5,500,000 shares and reduce the term of future offering periods to six months, which became effective for the offering period beginning January 1, 2007. The 2002 Purchase Plan enables employees to purchase shares at 85% of the fair market value of the Common Stock at the beginning of the offering period or end of the purchase period, whichever is lower. Offering periods and purchase periods generally begin on the first trading day on or after January 1 and July 1 of each year. The 2002 Purchase Plan is intended to qualify as an employee stock purchase plan under Section 423 of the Internal Revenue Code. During the first nine months of 2008 and 2007, the number of shares of stock issued under the purchase plans were 468,545 and 669,871 shares at weighted average prices of $7.88 and $4.82, respectively. The weighted-average fair value of each right to purchase shares of common stock granted under the purchase plans were $2.86 and $2.38 for the first nine months of 2008 and 2007, respectively. At September 26, 2008, 1,345,079 shares were reserved for future issuances under the 2002 Purchase Plan.

Retirement/Savings Plan. Harmonic has a retirement/savings plan which qualifies as a thrift plan under Section 401(k) of the Internal Revenue Code. This plan allows participants to contribute up to 20% of total compensation, subject to applicable Internal Revenue Service limitations. Harmonic makes discretionary contributions to the plan of 25% of the first 4% contributed by eligible participants up to a maximum contribution per participant of $1,000 per year. Such amounts totaled $0.1 million and $0.3 million in the three and nine months periods ended September 26, 2008.

Stock-based Compensation

The following table summarizes stock-based compensation costs on our Condensed Consolidated Statements of Operations for the three and nine months ended September 26, 2008 and September 28, 2007:

	Three Months Ended		Nine Months Ended	
(In Thousands)	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Employee stock-based compensation in:				
Cost of sales	$ 325	$ 255	$ 819	$ 719

Research and development expense	785	563	2,021	1,438
Sales, general and administrative expense	1,110	822	2,630	1,979
Total employee stock-based compensation in operating expense	1,895	1,385	4,651	3,417
Total employee stock-based compensation	2,220	1,640	5,470	4,136
Amount capitalized as inventory	10	(5)	16	9
Total other stock-based compensation(1)		48		339
Total stock-based compensation	$2,230	$ 1,683	$5,486	$ 4,484

(1) Other stock-based compensation represents charges related to non-employee stock options.

Table of Contents

The fair value of each option grant is estimated on the date of grant using the Black-Scholes multiple option pricing model with the following weighted average assumptions:

	Employee Stock Options			
	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Expected life (years)	4.75	4.75	4.75	4.75
Volatility	52%	56%	51%	59%
Risk-free interest rate	3.3%	4.6%	3.1%	4.7%
Dividend yield	0.0%	0.0%	0.0%	0.0%

	Employee Stock Purchase Plan			
	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Expected life (years)	0.5	0.5	0.5	0.5
Volatility	46%	50%	46%	51%
Risk-free interest rate	2.1%	4.9%	2.3%	4.9%
Dividend yield	0.0%	0.0%	0.0%	0.0%

The expected term for stock options and the 2002 Purchase Plan represents the weighted-average period that the stock options are expected to remain outstanding. Our computation of expected life was determined based on historical experience of similar awards, giving consideration to the contractual terms of the stock-based awards, vesting schedules and expectations of future employee behavior.

We use the historical volatility over the expected term of the options and the 2002 Purchase Plan offering period to estimate the expected volatility. We believe that the historical volatility, at this time, represents fairly the future volatility of its common stock. We will continue to monitor relevant information to measure expected volatility for future option grants and 2002 Purchase Plan offering periods.

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

NOTE 10: INCOME TAXES

The income tax provision includes U.S. federal, state and local, and foreign income taxes and is based on the application of a forecasted annual income tax rate applied to the current quarter s year-to-date pre-tax income. In determining the estimated annual effective income tax rate, the Company analyzes various factors, including projections of the Company s annual earnings, taxing jurisdictions in which the earnings will be generated, the impact of state and local income taxes, the Company s ability to use tax credits and net operating loss carryforwards, the current year accrual for unrecognized tax benefits and available tax planning alternatives. Discrete items, including the effect of changes in tax laws, tax rates, changes in liabilities for previous years uncertain tax positions and certain circumstances with respect to valuation allowances or other unusual or non-recurring tax adjustments are reflected in the period in which they occur as an addition to, or reduction from, the income tax provision, rather than included in the estimated effective annual income tax rate.

For the nine months ended September 26, 2008, our tax rate benefit, which includes discrete items, was 35.8% compared to a tax provision of 4.6% for the same period a year ago. The 35.8% tax rate benefit for the nine months ended is comprised of discrete items of 41.4%, primarily due to our discrete valuation allowance release and an underlying effective tax rate of 5.6%. The difference between the underlying effective tax rate for the nine months ended September 26, 2008 and the federal statutory rate of 35% is primarily attributable to charges due to the

Table of Contents

differential in foreign tax rates, intercompany license payment and non-deductible SFAS 123(R) stock compensation expense, offset by benefits due to the utilization of net operating loss carryforwards, alternative minimum tax credits, research tax credits and the release of the valuation allowance attributable to current year income.

On October 3, 2008, the President signed into law the Emergency Economic Stabilization Act of 2008, which reinstated the federal research tax credit and is effective retroactively to January 1, 2008. The effect of the reinstatement of this tax credit will be recorded in the fourth quarter of 2008.

In accordance with SFAS 109, we have evaluated the need for a valuation allowance based on historical evidence, trends in profitability, expectations of future taxable income and implemented tax planning strategies. In the second quarter of 2008 the company determined that a valuation allowance was no longer necessary for a portion of its net deferred tax assets because based on the available evidence it determined that realization of these net deferred tax assets was more likely than not. In addition, SFAS 109 requires that the portion of the valuation allowance release that is based on income projections in future years be recorded as a discrete item. In the first nine months of 2008 our discrete valuation release totaled $19.0 million, of which $16.1 million was recorded as a benefit to the provision for income taxes and $2.9 million as a reduction to goodwill. In addition, during the first nine months of 2008 an adjustment of $2.9 million was recorded to Additional Paid in Capital due to the realization of excess tax benefits from stock-based compensation.

In compliance with FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48), the Company had gross unrecognized tax benefits, which exclude interest and penalties of approximately $12.1 million as of December 31, 2007, and approximately $43.2 million as of September 26, 2008. We anticipate the unrecognized tax benefits to increase by approximately $2 million to $6 million in the next 12 months.

We record interest and penalties related to uncertain tax positions in income tax expense. During the third quarter and first nine months ended September 26, 2008, we recorded $0.2 million and $0.6 million, respectively, for interest and penalties related to uncertain tax positions resulting in a balance at September 26, 2008 of $3.7 million.

The tax years 2001-2007 remain open to examination by various federal, state and foreign taxing jurisdictions to which we are subject.

NOTE 11: NET INCOME PER SHARE

Basic net income per share is computed by dividing the net income attributable to common stockholders for the period by the weighted average number of the common shares outstanding during the period.

The following table shows the potentially dilutive shares, consisting of options, for the periods presented that were excluded from the net income computations because their effect was antidilutive:

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Potentially dilutive options outstanding	8,790	5,464	9,249	7,196

Table of Contents

Following is a reconciliation of the numerators and denominators of the basic and diluted net income per share computations:

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Net income (numerator)	$11,965	$ 9,417	$50,783	$ 16,782
Shares calculation (denominator):				
Weighted average shares outstanding basic	94,805	80,371	94,365	79,570
Effect of dilutive securities:				
Future issued common stock related to acquisitions	201	132	201	44
Potential common stock relating to stock options, restricted stock units and ESPP	857	1,139	925	1,129
Average shares outstanding diluted	95,863	81,642	95,491	80,743
Net income per share basic	$ 0.13	$ 0.12	$ 0.54	$ 0.21
Net income per share diluted	$ 0.12	$ 0.12	$ 0.53	$ 0.21

NOTE 12: COMPREHENSIVE INCOME

The Company s total comprehensive income was as follows:

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Net income	$11,965	$ 9,417	$50,783	$ 16,782
Change in unrealized gain (loss) on investments, net	(1,024)	92	(1,194)	71
Foreign currency translation	84	(11)	245	(78)

Total comprehensive income	$11,025	$ 9,498	$49,834	$ 16,775

NOTE 13: SEGMENT INFORMATION

We operate our business in one reportable segment, which is the design, manufacture and sales of products and systems that enable network operators to efficiently deliver broadcast and on-demand video services that include digital audio, video-on-demand and high definition television as well as high-speed internet access and telephony. Operating segments are defined as components of an enterprise that engage in business activities for which separate financial information is available and evaluated by the chief operating decision maker in deciding how to allocate resources and assessing performance. Our chief operating decision maker is our Chief Executive Officer.

Our revenue by geographic region, based on the location at which each sale originates, is summarized as follows:

Geographic Information:

	Three Months Ended		**Nine Months Ended**	
	September 26, 2008	**September 28, 2007**	**September 26, 2008**	**September 28, 2007**
Net sales:				
United States	$55,669	$ 44,638	$153,565	$ 125,447
International	35,786	37,657	114,506	98,367
Total	$91,455	$ 82,295	$268,071	$ 223,814

Table of Contents

For the three months ended September 26, 2008, sales to Comcast and EchoStar accounted for 24% and 10% of net sales, respectively. For the nine months ended September 26, 2008, sales to Comcast and EchoStar accounted for 20% and 12% of net sales, respectively. For the three months ended September 28, 2007, sales to Comcast and EchoStar accounted for 16% and 15% of net sales, respectively. For the nine months ended September 28, 2007, sales to Comcast accounted for 18% of net sales. As of September 26, 2008, two customers had a balance of 27% and 13% of our net accounts receivable.

The Company s assets are primarily located within the United States of America.

NOTE 14: RELATED PARTY

A director of Harmonic is also a director of JDS Uniphase Corporation, from whom the Company purchases products used in the manufacture of our products. Product purchases from JDS Uniphase were approximately $0.3 million and $0.6 million for the three and nine months ended September 26, 2008, respectively. As of September 26, 2008, Harmonic had liabilities to JDS Uniphase of an insignificant amount.

NOTE 15: GUARANTEES

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

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Balance at beginning of the period	$ 5,634	$ 6,056	$ 5,786	$ 6,061
Accrual for current period warranties.	937	1,120	2,703	2,700
Adjustments for preexisting warranties	556	(148)	1,142	274
Warranty costs incurred	(1,431)	(1,208)	(3,935)	(3,215)
Balance at end of the period	$ 5,696	$ 5,820	$ 5,696	$ 5,820

Standby Letters of Credit. As of September 26, 2008, the Company s financial guarantees consisted of standby letters of credit outstanding, which were principally related to performance bonds. The maximum amount of potential future payments under these arrangements was $0.3 million.

Indemnification. Harmonic is obligated to indemnify its officers and the members of its Board of Directors pursuant to its bylaws and contractual indemnity agreements. Harmonic also indemnifies some of its suppliers and customers for specified intellectual property matters pursuant to certain contractual arrangements, subject to certain limitations. The scope of these indemnities varies, but in some instances, includes indemnification for damages and expenses (including reasonable attorneys fees). There have been no claims against us for indemnification pursuant to any of these arrangements and, accordingly, no amounts have been accrued in respect of the indemnification provisions through September 26, 2008.

Guarantees. As of September 26, 2008, Harmonic had no other guarantees outstanding.

NOTE 16: LEGAL PROCEEDINGS

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

A consolidated complaint, filed on December 7, 2000, was brought on behalf of a purported class of persons who purchased Harmonic s publicly traded securities between January 19, 2000 and June 26, 2000. The complaint also

Table of Contents

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

Following a series of procedural actions at the District Court and at the United States Court of Appeals for the Ninth Circuit, a significant number of the claims alleged in the plaintiffs amended complaint were dismissed, including all claims against C-Cube and its officers and directors. However, certain of the plaintiffs claims survived dismissal. In January 2007, the District Court set a trial date for August 2008, and also ordered the parties to participate in mediation.

A derivative action purporting to be on our behalf was filed in the Superior Court for the County of Santa Clara against certain current and former officers and directors on May 15, 2003. It alleges facts similar to those alleged in the securities class action and names Harmonic as a nominal defendant. The action remains pending with no trial date set.

As a result of discussions and negotiations between plaintiffs counsel and Harmonic, and Harmonic and its insurance carriers, an agreement was reached in March 2008 to resolve the securities class action lawsuit. This agreement releases Harmonic, its officers, directors and insurance carriers from all claims brought in the lawsuit by the plaintiffs against Harmonic or its officers and directors, without any admission of fault on the part of Harmonic or its officers and directors. On October 29, 2008, the District Court issued a final order granting approval of the settlement agreement.

In the derivative action, recent discussions between the plaintiffs counsel and Harmonic have resulted in a tentative settlement which will require no payments by the Company or its officers and directors. If finalized, this tentative agreement will release Harmonic s officers and directors from all claims brought in the derivative lawsuit. This tentative agreement remains subject to certain contingencies, including negotiation and execution by the parties of a written settlement agreement, and final approval by the District Court. A hearing to grant final approval is scheduled for December 19, 2008.

Under the terms of the agreement to settle the securities class action lawsuit, Harmonic and its insurance carriers will pay $15.0 million in consideration to the plaintiffs in the securities class action. Of this amount, Harmonic will pay $5.0 million, and Harmonic s insurance carriers, in addition to having funded most litigation costs, will contribute the remaining $10.0 million on behalf of the individual defendants. The plaintiffs lawyers have applied for an award of fees and costs in an unspecified amount to be paid from the $15.0 million in consideration and subject to the approval of the District Court. In addition, Harmonic estimates that it has paid or will pay approximately $1.4 million in related legal fees and expenses in connection with proceedings in the securities class action and derivative lawsuits. The Company recorded a provision of $6.4 million in its selling, general and administrative expenses in the year ended December 31, 2007. Harmonic paid its share of the settlement consideration into escrow on August 5, 2008. As of September 26, 2008, we had $0.6 million recorded in accrued liabilities for the settlement of remaining obligations.

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of Harmonic s products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint sought injunctive relief, royalties and damages. On August 6, 2007, the District Court granted our motion to dismiss. The plaintiffs appealed this motion and on June 19, 2008 the U.S. Court of Appeals for the Federal Circuit issued a decision which vacated the District Court s decision and remanded for further proceedings. At a scheduling conference on October 6, 2008 the judge ordered the parties to mediation. A mediation session is scheduled for November 4, 2008. An unfavorable outcome on any of these litigation matters could require that Harmonic pay substantial damages, or, in connection with any intellectual property infringement claims, could require that we pay ongoing royalty payments or could prevent us from selling certain of our products. A settlement or an unfavorable outcome on these or any other

Table of Contents

litigation matters could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

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

ITEM 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended, including statements related to:

Our expectation that customer concentration will continue for the foreseeable future;

Our expectation that international sales will continue to account for a significant portion of our net sales for the foreseeable future;

Our expectation that we will experience a substantial increase in our effective tax rate in 2009 and future years;

Our expectation that auctions for our auction rate securities held by us will be unsuccessful in the near term;

Our belief that we will be able to liquidate auction rate securities held by us without significant loss;

Our belief that adverse economic conditions and tight credit markets may reduce capital spending by our customers, which could have a material and adverse affect on sales of our products;

Our expectation that we will record a total of approximately $1.3 million in amortization of intangibles expense in cost of sales in the remaining three months of 2008;

Our expectation that we will record a total of approximately $0.2 million in amortization of intangibles expense in operating expenses in the remaining three months of 2008;

Our expectation that our capital expenditures will be in the range of $7 million to $8 million during 2008;

Our belief that the net proceeds from our recently completed public offering of common stock will be used for general corporate purposes, including payment of existing liabilities, research and development, the development or acquisition of new products or technologies, equipment acquisitions, strategic acquisitions of businesses, general working capital and operating expenses;

Our belief that our existing liquidity sources, including our bank line of credit facility, will satisfy our requirements for at least the next twelve months;

Our belief that near-term changes in exchange rates will not have a material impact on our operating results, financial position and liquidity;

Our expectation that sales to cable television, satellite and telecommunications operators will constitute a significant portion of net sales for the foreseeable future;

Our expectation regarding the ultimate settlement or resolution of outstanding litigation;

Our expectation that we will make acquisitions in the future;

Our expectation that our operations will be affected by new environmental laws and regulations on an ongoing basis;

Our expectation that an increasing percentage of our consolidated, pre-tax income will be derived from and reinvested in our international operations and our expectations regarding the associated tax rates;

Table of Contents

Our expectation that any ultimate liability of Harmonic with respect to certain litigation arising in the normal course of business will not, in the aggregate, have a material adverse effect on us or our operating results, financial position or cash flows; and

Our expectation that operating results are likely to fluctuate in the future.

These statements involve risks and uncertainties as well as assumptions that, if they were to never materialize or prove incorrect, could cause actual results to differ materially from those projected, expressed or implied in the forward-looking statements. These risks and uncertainties include those set forth under Risk Factors below and elsewhere in this Quarterly Report on Form 10-Q and that are otherwise described from time to time in Harmonic s filings with the Securities and Exchange Commission. We undertake no obligation to update or correct these forward-looking statements.

Overview

Harmonic designs, manufactures and sells versatile and high performance video products and system solutions that enable service providers to efficiently deliver the next generation of broadcast and on-demand services, including high-definition television, or HDTV, video-on-demand, or VOD, network personal video recording and time-shifted TV. Historically, the majority of our sales have been derived from sales of video processing solutions and edge and access systems to cable television operators and from sales of video processing solutions to direct-to-home satellite operators. We also provide our video processing solutions to telecommunications companies, or telcos, broadcasters and Internet companies that offer video services to their customers.

In the third quarter and first nine months of 2008, Harmonic had net sales of $91.5 million and $268.1 million, respectively, which represented increases of 11% and 20%, respectively, in each period, compared to the third quarter and first nine months of 2007. The increase in sales in the third quarter of 2008 compared to the corresponding periods in 2007 was primarily due to stronger demand from our domestic satellite and cable customers for products and solutions related to VOD and HDTV. The increase in sales in the first nine months of 2008 compared to the corresponding periods in 2007 was primarily due to stronger demand from our domestic and international satellite and cable customers for products and solutions related to VOD and HDTV, and sales to new customers worldwide. Gross margins increased in the third quarter and first nine months of 2008 compared to the corresponding periods in 2007 due to favorable margins from lower average product costs due to increased manufacturing volumes and product design innovations and lower expenses for excess and obsolete inventories.

Historically, a majority of our net sales have been to relatively few customers, and due in part to the consolidation of ownership of cable television and direct broadcast satellite systems, and we expect this customer concentration to continue for the foreseeable future. In the third quarter of 2008 sales to Comcast and EchoStar accounted for 24% and 10% of net sales, respectively. In the third quarter of 2007, sales to Comcast and EchoStar accounted for 16% and 15% of net sales, respectively. In the first nine months of 2008, sales to Comcast and EchoStar accounted for 20% and 12% of net sales, respectively. In the first nine months of 2007, sales to Comcast accounted for 18% of net sales.

Sales to customers outside of the U.S. in the third quarter and first nine months of 2008 represented 39% and 43% of net sales, respectively, compared to 46% and 44% for the comparable periods in 2007. A significant portion of our international sales are made to distributors and system integrators, which are generally responsible for importing the products and providing installation and technical support and service to customers within their territory. Sales denominated in foreign currencies were approximately 5% of net sales in the first nine months of 2008 compared to 7% for the comparable period of 2007. We expect international sales to continue to account for a significant portion of our net sales for the foreseeable future.

Harmonic historically has recognized a significant portion, or the majority, of its revenues in the last month of the quarter. Harmonic establishes its expenditure levels for product development and other operating expenses based on projected sales levels, and expenses are relatively fixed in the short term. Accordingly, variations in timing of sales can cause significant fluctuations in operating results. Harmonic s expenses for any given quarter are typically based on expected sales and if sales are below expectations, our operating results may be adversely impacted by our

Table of Contents

inability to adjust spending to compensate for the shortfall. In addition, because a significant portion of Harmonic s business is derived from orders placed by a limited number of large customers, the timing of such orders can also cause significant fluctuations in our operating results.

On December 8, 2006, Harmonic completed its acquisition of the video networking software business of Entone Technologies, Inc. for a total purchase price of $49.0 million. The purchase price consisted of a payment of $26.2 million, the issuance of 3,579,715 shares of Harmonic common stock with a value of $20.1 million, the issuance of 175,342 options to purchase Harmonic common stock with a value of $0.2 million, and $2.5 million of transaction costs. Prior to the closing of the acquisition, Entone spun off its consumer premises equipment, or CPE, business into a separate private company.

On July 31, 2007, Harmonic completed its acquisition of Rhozet Corporation, pursuant to the terms of the Agreement and Plan of Merger, or Rhozet Agreement, dated July 25, 2007. Under the Rhozet Agreement, Harmonic paid or will pay an aggregate of approximately $15.5 million in total merger consideration, comprised of approximately $2.5 million in cash, 1,105,656 shares of Harmonic s common stock in exchange for all of the outstanding shares of capital stock of Rhozet, and approximately $2.8 million of cash which was paid in the first quarter of 2008, as provided in the Rhozet Agreement, to the holders of outstanding options to acquire Rhozet common stock. In addition, in connection with the acquisition, Harmonic incurred approximately $0.7 million in transaction costs. Pursuant to the Rhozet Agreement, approximately $2.3 million of the total merger consideration, consisting of cash and shares of Harmonic common stock, are being held back by Harmonic for at least 18 months following the closing of the acquisition to satisfy certain indemnification obligations of Rhozet s shareholders pursuant to the terms of the Rhozet Agreement.

In the fourth quarter of 2007, we sold and issued 12,500,000 shares of common stock in a public offering at a price of $12.00 per share. Our net proceeds from the offering were approximately $141.8 million, which was net of underwriters discounts and commissions of approximately $7.4 million and related legal, accounting, printing and other costs totaling approximately $0.7 million. The net proceeds from the offering have been or may in the future be used for general corporate purposes, including payment of existing liabilities, research and development, the development or acquisition of new products or technologies, equipment acquisitions, strategic acquisitions of businesses, general working capital and operating expenses. The offering was made pursuant to our Registration Statement on Form S-3 (File No. 333-123823) filed with the SEC on April 4, 2005, and declared effective by the SEC on April 22, 2005, and the related prospectus supplement filed with the SEC on October 31, 2007.

In 2001 and 2002, excess facilities and fixed asset impairment charges totaling $52.6 million were recorded due to the Company s reduced headcount, difficult business conditions and a weak local commercial real estate market. In the fourth quarter of 2005, the excess facilities liability was decreased by $1.1 million due to subleasing a portion of the unoccupied portion of one building for the remainder of the lease. In the third quarter of 2006, we completed our facilities rationalization plan resulting in more efficient use of our Sunnyvale campus and vacated several buildings, some of which were subsequently subleased. This resulted in a net charge for excess facilities of $2.1 million in the third quarter of 2006. In the third quarter of 2007, we recorded a net credit of $1.4 million resulting primarily from an extension of a subleased building to the lease expiration. During the second quarter of 2008, the Company recorded a charge in selling, general and administrative expenses for excess facilities of $1.2 million from a revised estimate of expected sublease income of a Sunnyvale building. The lease terminates in September 2010 and all sublease income from this building has been eliminated from the calculation of the estimated liability. During the third quarter of 2008, the Company recorded a charge in selling, general and administrative expenses for excess facilities of $0.2 million from a revised estimate of expected sublease income of two buildings in England. The leases terminate in October 2010 and all sublease income has been eliminated from the estimated liability. In the event we are unable to achieve expected levels of sublease rental income, we will need to revise our estimate of the liability, which could materially impact our financial position, liquidity, cash flows and results of operations.

Adverse economic conditions in markets in which we operate and into which we sell our products can harm our business. Recently, economic conditions in the countries in which we operate and sell products have become increasingly negative, and global financial markets have experienced a severe downturn stemming from a multitude of factors, including adverse credit conditions impacted by the subprime-mortgage crisis, slower economic activity,

concerns about inflation and deflation, increased energy costs, decreased consumer confidence, reduced corporate

Table of Contents

profits and capital spending, adverse business conditions and liquidity concerns and other factors. Economic growth in the U.S. and in many other countries slowed in the fourth quarter of 2007, remained slow for the first three quarters of 2008, and is expected to slow further or recede in the fourth quarter of 2008 in the U.S. and internationally. During challenging economic times, and in tight credit markets, many customers may delay or reduce capital expenditures. This could result in reductions in sales of our products, longer sales cycles, difficulties in collection of accounts receivable, excess and obsolete inventory, gross margin deterioration, slower adoption of new technologies, increased price competition and supplier difficulties.

The Company is in the process of expanding its international operations and staff to better support its expansion into international markets. This expansion includes the implementation of an international structure that includes, among other things, a research and development cost-sharing arrangement, certain licenses and other contractual arrangements by and among the Company and its wholly-owned domestic and foreign subsidiaries. The Company s foreign subsidiaries have acquired certain rights to sell the Company s existing intellectual property and intellectual property that will be developed or licensed in the future. As a result of these changes and an expanding customer base internationally, the Company expects that an increasing percentage of its consolidated pre-tax income will be derived from, and reinvested in, its international operations. The Company anticipates that this pre-tax income will be subject to foreign tax at relatively lower tax rates when compared to the United States federal statutory tax rate.

Critical Accounting Policies, Judgments and Estimates

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

Our significant accounting policies are described in Note 1 to the annual consolidated financial statements as of and for the year ended December 31, 2007, included in our Annual Report on Form 10-K filed with the SEC on March 17, 2008 and notes to condensed consolidated financial statements as of and for the three and nine month periods ended September 26, 2008, included herein. Our most critical accounting policies have not changed since December 31, 2007, except that in the second quarter of 2008 we revised our critical accounting policy related to the accounting for income taxes, and includes the following:

Revenue recognition;

Allowances for doubtful accounts, returns and discounts;

Valuation of inventories;

Impairment of long-lived assets;

Restructuring costs and accruals for excess facilities;

Assessment of the probability of the outcome of current litigation;

Accounting for income taxes, and

Stock-based compensation.

In preparing our financial statements, we estimate our income taxes for each of the jurisdictions in which we operate. This involves estimating our actual current tax exposures and assessing temporary and permanent differences resulting from differing treatment of items, such as reserves and accruals, for tax and accounting purposes.

Table of Contents

Our income tax policy is to record the estimated future tax effects of temporary differences between the tax bases of assets and liabilities and amounts reported in our accompanying condensed consolidated balance sheets, as well as operating loss and tax credit carryforwards. We follow the guidelines set forth in Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes, or SFAS 109, regarding the recoverability of any tax assets recorded on the balance sheet and provide any necessary allowances as required. Determining necessary allowances requires us to make assessments about the timing of future events, including the probability of expected future taxable income and available tax planning opportunities. In the first nine months of 2008, our discrete valuation release totaled $19.0 million, of which $16.1 million was recorded as a benefit to the provision for income taxes and $2.9 million as a reduction to goodwill. In addition, during the first nine months of 2008, an adjustment of $2.9 million was recorded to Additional Paid in Capital due to the realization of excess tax benefits from stock-based compensation. In accordance with SFAS 109, we have evaluated our need for a valuation allowance based on historical evidence, trends in profitability, expectations of future taxable income and implemented tax planning strategies. In periods following the release of our valuation allowance our expectation is that the Company will experience a substantial increase in our effective tax rate.

We are subject to examination of our income tax returns by various tax authorities on a periodic basis. We regularly assess the likelihood of adverse outcomes resulting from such examinations to determine the adequacy of our provision for income taxes. We adopted the provisions of FIN 48 as of the beginning of 2007. Prior to adoption, our policy was to establish reserves that reflected the probable outcome of known tax contingencies. The effects of final resolution, if any, were recognized as changes to the effective income tax rate in the period of resolution. FIN 48 requires application of a more-likely-than-not threshold to the recognition and de-recognition of uncertain tax positions. If the recognition threshold is met, FIN 48 permits us to recognize a tax benefit measured at the largest amount of tax benefit that, in our judgment, is more than 50 percent likely to be realized upon settlement. If further requires that a change in judgment related to the expected ultimate resolution of uncertain tax positions be recognized in earnings in the quarter of such change.

We file annual income tax returns in multiple taxing jurisdictions around the world. A number of years may elapse before an uncertain tax position is audited and finally resolved. While it is often difficult to predict the final outcome or the timing of resolution of any particular uncertain tax position, we believe that our reserves for income taxes reflect the most likely outcome. We adjust these reserves and penalties as well as the related interest, in light of changing facts and circumstances. Changes in our assessment of our uncertain tax positions or settlement of any particular position could materially impact our income tax rate, financial position and cashflows.

Results of Operations

Harmonic s historical consolidated statements of operations data for the third quarter and first nine months of 2008 and the third quarter and first nine months of 2007 as a percentage of net sales, are as follows:

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Net sales	100	100	100	100
Cost of sales	52	57	52	58
Gross profit	48	43	48	42
Operating expenses:				
Research and development	15	13	15	14
Selling, general and administrative	21	18	21	21

Write-off of acquired in-process technology		1		
Amortization of intangibles				
Total operating expenses	36	32	36	35
Income from operations	12	11	12	7
Interest income, net	3	1	3	1
Other income (expense), net	(2)		(1)	
Income before income taxes	13	12	14	8
Provision for (benefit from) income taxes		1	(5)	
Net income	13%	11%	19%	8%

Table of Contents

Service revenue and service cost of sales were each below 10% of net sales in the third quarter and first nine months of 2008 and, therefore, were included in product sales and product cost of sales.

Net Sales Consolidated

Harmonic s consolidated net sales in the third quarter and first nine months of 2008 compared with the corresponding periods in 2007 are presented in the table below. Also presented are the related dollar and percentage change in consolidated net sales in the third quarter and first nine months of 2008 compared with the corresponding periods in 2007.

Sales Data:

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Video Processing	$32,284	$ 38,623	$101,152	$ 92,790
Edge and Access	43,029	29,156	124,191	95,891
Software, Support and Other	16,142	14,516	42,728	35,133
Net sales	$91,455	$ 82,295	$268,071	$ 223,814
Video Processing increase (decrease)	$ (6,339)		$ 8,362	
Edge and Access increase	13,873		28,300	
Software, Support and Other increase	1,626		7,595	
Total increase	$ 9,160		$ 44,257	
Video Processing percent change	(16.4)%		9.0%	
Edge and Access percent change	47.6%		29.5%	
Software, Support and Other percent change	11.2%		21.6%	
Total percent change	11.1%		19.8%	

Net sales increased in the third quarter of 2008 compared to the third quarter of 2007 principally due to stronger demand for our products from our domestic satellite and cable customers for their VOD and HDTV deployments. The sales of products of the video processing product line were lower in the third quarter of 2008 compared to the same period in the prior year due primarily to decreased spending from international customers. The increase in sales of products of the edge and access products line in the third quarter of 2008 compared to the same period in 2007 was primarily due to an increase in sales of the Company s NSG edgeQAM devices for VOD, switched digital and Cable Modem Termination System, or CMTS, deployments by domestic cable operators.

Net sales increased in the first nine months of 2008 compared to the first nine months of 2007 principally due to stronger demand for our products from our domestic satellite and cable customers for VOD and HDTV deployments, and an increase in sales to new customers internationally. The sales of products of the video processing product line

were higher in the first nine months of 2008 compared to the same period in the prior year due primarily to increased purchases of our products from domestic satellite customers. The increase in sales of products of the edge and access products line in the first nine months of 2008 compared to the same period in 2007 was primarily due to an increase in sales of the Company s NSG edgeQAM devices for VOD, switched digital and Cable Modem Termination System, or CMTS, deployments by domestic and international cable operators. The sales of software, support and other products was higher in the first nine months of 2008 compared to the same period in the prior year primarily from software sales of new products and revenue from system integration projects.

Net Sales Geographic

Harmonic s domestic and international net sales in the third quarter and first nine months of 2008 compared with the corresponding periods in 2007 are presented in the table below. Also presented are the related dollar and percentage change in domestic and international net sales in the third quarter and first nine months of 2008 compared with the corresponding periods in 2007.

Table of Contents

Geographic Sales Data:

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
U.S.	$55,669	$ 44,638	$153,565	$ 125,447
International	35,786	37,657	114,506	98,367
Net sales	$91,455	$ 82,295	$268,071	$ 223,814
U.S. increase	$11,031		$ 28,118	
International increase (decrease)	(1,871)		16,139	
Total increase	$ 9,160		$ 44,257	
U.S. percent change	24.7%		22.4%	
International percent change	(5.0)%		16.4%	
Total percent change	11.1%		19.8%	

The increase in U.S. sales in the third quarter and first nine months of 2008 compared to the corresponding periods in 2007 was principally due to stronger demand for our products from our domestic satellite and cable customers for VOD and HDTV deployments.

International sales in the third quarter of 2008 decreased compared to the corresponding period in 2007 primarily due to weaker demand for our products from international customers, primarily in the Latin American and Canadian markets. International sales in the first nine months of 2008 increased compared to the corresponding period in 2007 primarily due to stronger demand for our products from international cable operators and an increase in the number of international customers, particularly in the European and Asian markets. We expect that international sales will continue to account for a significant portion of our net sales for the foreseeable future.

Gross Profit

Harmonic s gross profit and gross profit as a percentage of consolidated net sales in the third quarter and first nine months of 2008 as compared with the corresponding periods of 2007 are presented in the tables below. Also presented are the related dollar and percentage change in gross profit in the third quarter and first nine months of 2008 as compared with the corresponding periods of 2007.

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Gross profit	$44,196	$ 35,643	$129,327	$ 93,360
As a % of net sales	48.3%	43.3%	48.2%	41.7%
Increase	$ 8,553		$ 35,967	

Percent change	24.0%	38.5%

The increase in gross profit in the third quarter of 2008 as compared to the third quarter of 2007 was primarily due to higher sales of $9.2 million and lower expense for excess and obsolete inventories of $3.8 million. The gross margin percentage of 48.3% in the third quarter of 2008 compared to 43.3% in the third quarter of 2007 was higher primarily due to increased sales of Harmonic s new NSG edgeQAM products for VOD, switched digital and CMTS deployments worldwide, as well as lower manufacturing costs resulting from higher volumes and product design cost reductions, which increases were partially offset by increased expense from amortization of intangibles.

The increase in gross profit in the first nine months of 2008 as compared to the first nine months of 2007 was primarily due to higher sales of $44.3 million and lower expense for excess and obsolete inventories of $5.5 million, which was partially offset by increases in unfavorable material and overhead variances of $3.1 million and $0.9 million in amortization of intangibles expenses in the first nine months of 2008 compared to the corresponding period of 2007. The gross margin percentage of 48.2% in the first nine months of 2008 compared to 41.7% in the first nine months of 2007 was higher primarily due to increased purchases of Harmonic s new NSG edgeQAM products for VOD, switched digital and CMTS deployments worldwide, as well as lower manufacturing costs resulting from higher volumes and product design cost reductions and lower expense for excess and obsolete inventories. These improvements to gross margin percentage were partially offset by increased expense from amortization of intangibles.

Table of Contents

In the first nine months of 2008, $4.2 million of amortization of intangibles expense was included in cost of sales compared to $3.3 million in the first nine months of 2007. The higher amortization of intangible expense in the first nine months of 2008 was due to the amortization of intangibles arising from the Rhozet acquisition which was completed in the third quarter of 2007. We expect to record approximately $1.3 million in amortization of intangibles expenses in cost of sales in the remaining three months of 2008 related to the acquisitions of Entone and Rhozet.

Research and Development

Harmonic s research and development expense and the expense as a percentage of consolidated net sales in the third quarter and first nine months of 2008, as compared with the corresponding periods of 2007, are presented in the table below. Also presented are the related dollar and percentage change in research and development expense in the third quarter and first nine months of 2008 as compared with the corresponding periods of 2007.

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Research and development expense	$13,724	$ 11,018	$40,264	$ 31,615
As a % of net sales	15.0%	13.4%	15.0%	14.1%
Increase	$ 2,706		$ 8,649	
Percent change	24.6%		27.4%	

The increase in research and development expense in the third quarter of 2008 as compared to the third quarter of 2007 was primarily the result of increased compensation costs of $1.4 million, increased facilities expenses of $0.4 million, increased consulting and outside services expenses of $0.3 million and increased stock-based compensation expenses of $0.2 million. Higher compensation costs in the third quarter of 2008 was due to increased headcount which was partially related to the additional personnel that we hired upon the acquisition of Rhozet in July 2007, increased payroll taxes and higher incentive compensation expenses.

The increase in research and development expense in the first nine months of 2008 as compared to the first nine months of 2007 was primarily the result of increased compensation costs of $5.1 million, increased facilities expenses of $1.4 million, increased stock-based compensation expenses of $0.6 million, increased prototype material expense of $0.4 million, increased recruiting and relocation expenses of $0.2 million, increased consulting and outside services expenses of $0.2 million and increased depreciation expense of $0.2 million. The increased compensation costs in the first nine months of 2008 was related to increased headcount which is partially related to the additional personnel that we hired upon the acquisition of Rhozet in July 2007, increased payroll taxes and higher incentive compensation

Selling, General and Administrative

Harmonic s selling, general and administrative expense and the expense as a percentage of consolidated net sales in the third quarter and first nine months of 2008, as compared with the corresponding periods of 2007, are presented in the table below. Also presented are the related dollar and percentage change in selling, general and administrative expense in the third quarter and first nine months of 2008 as compared with the corresponding periods of 2007.

Three Months Ended		Nine Months Ended	
September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
$19,254	$ 14,911	$56,725	$ 46,357

Selling, general and administrative expense				
As a % of net sales	21.1%	18.1%	21.2%	20.7%
Increase	$ 4,343		$10,368	
Percent change	29.1%		22.4%	

Table of Contents

The increase in selling, general and administrative expense in the third quarter of 2008 compared to the third quarter of 2007 was primarily a result of higher compensation expense of $1.3 million primarily related to increased headcount, higher incentive compensation and management changes, higher excess facilities charges of $1.7 million primarily related to a credit of $1.4 million recorded in the third quarter of 2007, higher marketing expenses of $0.3 million primarily related to trade shows, higher professional services expenses of $0.2 million, higher stock-based compensation expense of $0.2 million and higher travel and entertainment expenses of $0.2 million. Higher professional services expenses in the third quarter of 2008 were primarily due to costs related to the establishment of an international support center in Europe.

The increase in selling, general and administrative expense in the first nine months of 2008 compared to the first nine months of 2007 was primarily a result of higher excess facilities charges of $2.7 million primarily resulting from a $1.4 million charge in the first nine months related to a change in estimate in sublease income and a net credit of $1.4 million recorded in the first nine months of 2007 from extensions of subleased facilities, higher compensation expense of $4.4 million primarily related to increased headcount and incentive compensation, higher marketing expenses of $1.0 million primarily related to trade shows, higher professional services expenses of $0.8 million, higher travel and entertainment expenses of $0.7 million and higher stock-based compensation expense of $0.3 million. Higher professional services fees in the first nine months of 2008 were primarily due to legal costs related to patents and licensing and costs related to the establishment of an international support center in Europe. The increase in travel and entertainment expenses in the first nine months of 2008 were primarily due to higher travel costs associated with selling activities, trade shows and the establishment of an international support center.

Amortization of Intangibles

Harmonic s amortization of intangible assets and the expense as a percentage of consolidated net sales in the third quarter and first nine months of 2008 as compared with the corresponding periods of 2007 are presented in the table below. Also presented are the related dollar and percentage change in amortization of intangible in the third quarter and first nine months of 2008 as compared with the corresponding periods of 2007.

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Amortization of intangibles	$ 160	$ 143	$ 479	$ 365
As a % of net sales	0.2%	0.2%	0.2%	0.2%
Increase	$ 17		$ 114	
Percent change	11.9%		31.2%	

The increase in the amortization of intangibles in the third quarter and first nine months of 2008 compared to the corresponding periods of 2007 was primarily due to the acquisition of Rhozet s intangible assets during the third quarter of 2007. Harmonic expects to record a total of approximately $0.2 million in amortization of intangibles in operating expenses in the remaining three months of 2008.

Interest Income, Net

Harmonic s interest income, net, and interest income, net, as a percentage of consolidated net sales in the third quarter and first nine months of 2008 as compared with the corresponding periods of 2007, are presented in the table below. Also presented are the related dollar and percentage change in interest income, net, in the third quarter and first nine months of 2008 as compared with the corresponding periods of 2007.

	Three Months Ended	Nine Months Ended

	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Interest income, net	$2,286	$ 1,238	$7,548	$ 3,224
As a % of net sales.	2.5%	1.5%	2.8%	1.4%
Increase	$1,048		$4,324	
Percent change	84.7%		134.1%	

Table of Contents

The increase in interest income, net, in the third quarter and first nine months of 2008 compared to the corresponding periods of 2007, was due primarily to a higher portfolio balance during the third quarter and first nine months of 2008, which was partially offset by lower interest rates on the investment portfolio. The higher investment balance in the third quarter and first nine months of 2008 was primarily due to the stock offering completed in the fourth quarter of 2007 which resulted in net proceeds to Harmonic of approximately $141.8 million.

Other Income (Expense), Net

Harmonic s other income (expense), net, and other income (expense), net, as a percentage of consolidated net sales in the third quarter and first nine months of 2008 as compared with the corresponding periods of 2007, are presented in the table below. Also presented is the related dollar and percentage change in other income (expense), net, in the third quarter and first nine months of 2008 as compared with the corresponding periods of 2007.

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Other income (expense)	$ (1,450)	$ 58	$ (2,022)	$ 42
As a % of net sales	(1.6)%	0.1%	(0.8)%	%
Decrease	$ (1,508)		$ (2,064)	
Percent change	(2,600.0)%		(4,914.3)%	

The increase in other expense, net, in the third quarter of 2008 compared to the corresponding period of 2007 was primarily due to an impairment charge on an investment of $0.8 million and higher foreign exchange losses on intercompany balances of $0.6 million.

The increase in other expense, net, in the first nine months of 2008 compared to the corresponding period of 2007 was primarily due to the impairment expense on an investment of $0.8 million, higher foreign exchange losses on intercompany balances of $1.0 million and higher indirect tax expenses of $0.1 million.

Income Taxes

Harmonic s provision for (benefit from) income taxes, and provision for (benefit from) income taxes as a percentage of income before income taxes in the third quarter and first nine months of 2008, as compared with the corresponding periods of 2007, are presented in the tables below. Also presented is the related dollar and percentage change in income taxes in the third quarter and first nine months of 2008 as compared with the corresponding periods of 2007.

	Three Months Ended		Nine Months Ended	
	September 26, 2008	September 28, 2007	September 26, 2008	September 28, 2007
Provision for (benefit from) income taxes	$ (71)	$ 750	$ (13,398)	$ 807
As a % of income before income taxes	(0.6)%	7.4%	(35.8)%	4.6%
Decrease	$ (821)		$ (14,205)	
Percent change	(109.5)%		(1,760.2)%	

For the nine months ended September 26, 2008, our tax rate benefit, which includes discrete items, was 35.8% compared to a tax provision of 4.6% for the same period a year ago. The 35.8% tax rate benefit for the nine months

ended September 26, 2008 is comprised of discrete items of 41.4%, primarily due to our discrete valuation allowance release and an underlying effective tax rate of 5.6%. The difference between the underlying effective tax rate for the nine months ended September 26, 2008 and the federal statutory rate of 35% is primarily attributable to charges due to the differential in foreign tax rates, intercompany nonexclusive license payment and non-deductible SFAS 123(R) stock compensation expense, offset by benefits due to the utilization of net operating loss carryforwards, alternative minimum tax credits, research tax credits and the release of the valuation allowance attributable to current year income.

Table of Contents

In the second quarter of 2008, the Company determined that a valuation allowance was no longer necessary for a portion of its net deferred tax assets because based on the available evidence it determined that realization of these net assets was more likely than not. In addition, SFAS 109 requires that the portion of the valuation allowance release that is based on income projections in future years be recorded as a discrete item. In the first nine months of 2008, our discrete valuation release totaled $19.0 million, of which $16.1 million was recorded as a benefit to the provision for income taxes and $2.9 million as a reduction to goodwill. In addition, during the first nine months of 2009 an adjustment of $2.9 million was recorded to Additional Paid in Capital due to the realization of excess tax benefits from stock-based compensation.

In addition, the U.S. federal government approved an extension of the R&D tax credit for 2008, effective October 2008; therefore that credit has not been factored into our effective tax rate for the period ended September 26, 2008.

We currently expect to experience a substantial increase in our effective tax rate in 2009 and future years.

Liquidity and Capital Resources

	Nine months Ended	
(In Thousands)	**September 26, 2008**	**September 28, 2007**
Cash, cash equivalents and short-term investments	$293,409	$ 99,031
Net cash provided by operating activities	$ 18,666	$ 9,264
Net cash provided by (used in) investing activities	$ 10,618	$ (9,458)
Net cash provided by financing activities	$ 11,231	$ 7,767

As of September 26, 2008, cash, cash equivalents and short-term investments totaled $293.4 million, compared to $269.3 million as of December 31, 2007. Cash provided by operations in the first nine months of 2008 was $18.7 million, resulting from net income of $50.8 million, adjusted for $34.9 million in non-cash adjustments and a $2.8 million net change in assets and liabilities. The significant non-cash adjustments included the increase in deferred tax assets, stock-based compensation expense, depreciation expense and amortization of intangibles expense. The increase in deferred tax assets is primarily due to the release of our valuation allowance against certain deferred tax assets. The net change in assets and liabilities included a decrease in accrued liabilities, accounts payable, deferred revenue and excess facilities liabilities, and an increase in accounts receivable, which was partially offset by an increase in long-term income taxes payable and a decrease in prepaid expenses and other assets. The decrease in the accrued liabilities was primarily due to the $5.0 million escrow payment in connection with the settlement of the securities litigation, and payments of $4.8 million of pre-merger liabilities under the terms of the merger agreement with C-Cube. Accounts payable decreased due to the timing of payments primarily for inventory purchases. The higher accounts receivable was primarily due to the increase and timing in sales in the third quarter of 2008. The increase in long-term income taxes payable is due to an increase in uncertain tax positions and associated accrued interest and penalties, primarily due to tax uncertainties relating to the implementation of our international operations center. We are unable to predict when these uncertainties will be resolved.

To the extent that non-cash items impact our future operating results, there will be no corresponding impact on our cash flows. After excluding the effects of these non-cash charges, the primary changes in cash flows relating to operating activities resulted from changes in working capital. Our primary source of operating cash flows is the collection of accounts receivable from our customers. Our operating cash flows are also impacted by the timing of payments to our vendors for accounts payable and other liabilities. We generally pay our vendors and service providers in accordance with the invoice terms and conditions.

Net cash provided by investing activities was $10.6 million for the nine months ended September 26, 2008, resulting primarily from the maturity of investments and the redemption of a convertible note for $2.5 million, which was partially offset by the payment of $2.8 million to optionholders of Rhozet as part of the acquisition in July 2007 and

by $6.0 million of capital expenditures primarily for test equipment. Harmonic currently expects capital expenditures to be in the range of $7 million to $8 million during 2008.

Table of Contents

Net cash provided by financing activities was $11.2 million for the nine months ended September 26, 2008, primarily resulting from proceeds received from the exercise of stock options and the sale of our common stock of $8.4 million under our 2002 Purchase Plan and the excess tax benefits from stock-based compensation of $2.9 million.

Under the terms of the merger agreement with C-Cube, Harmonic is generally liable for C-Cube s pre-merger liabilities. As of September 26, 2008, approximately $1.8 million of pre-merger liabilities remained outstanding and are included in accrued liabilities. We are working with LSI Logic, which acquired C-Cube s spun-off semiconductor business in June 2001 and assumed its obligations, to develop an approach to settle these obligations, a process which has been underway since the merger in 2000. These liabilities represent estimates of C-Cube s pre-merger obligations to various authorities in six countries. Harmonic paid $4.8 million in the first quarter of 2008, but is unable to predict when the remaining obligations will be paid. The full amount of the estimated obligations has been classified as a current liability. To the extent that these obligations are finally settled for less than the amounts provided, Harmonic is required, under the terms of the merger agreement, to refund the difference to LSI Logic. Conversely, if the settlements are more than the remaining $1.8 million pre-merger liability, LSI Logic is obligated to reimburse Harmonic.

Harmonic has a bank line of credit facility with Silicon Valley Bank, which provides for borrowings of up to $10.0 million that matures on March 4, 2009. As of September 26, 2008, other than standby letters of credit and guarantees, there were no amounts outstanding under the line of credit facility and there were no borrowings in 2007 or 2008. This facility, which was amended and restated in March 2008, contains a financial covenant with the requirement for Harmonic to maintain cash, cash equivalents and short-term investments, net of credit extensions, of not less than $40.0 million. If Harmonic is unable to maintain this cash, cash equivalents and short-term investments balance or satisfy the affirmative covenant requirement, Harmonic would be in noncompliance with the facility. In the event of noncompliance by Harmonic with the covenant under the facility, Silicon Valley Bank would be entitled to exercise its remedies under the facility which include declaring all obligations immediately due and payable, if obligations were not repaid. At September 26, 2008, Harmonic was in compliance with the covenant under this line of credit facility. The March 2008 amendment requires payment of approximately $20,000 of additional fees if the Company does not maintain an unrestricted deposit of $30.0 million with the bank for 10 consecutive days. Future borrowings pursuant to the line bear interest at the bank s prime rate (5.0% at September 26, 2008). Borrowings are payable monthly and are not collateralized.

Harmonic s cash, cash equivalents and short-term investments at September 26, 2008 were $293.4 million. As of September 26, 2008, we held approximately $14.4 million of auction rate securities, or ARSs, classified as short-term investments and the fair value of these securities approximate their par value at the balance sheet date. These ARSs which are invested in preferred securities in closed end funds, all have a credit rating of AA or better and the issuers are paying interest at the maximum contractual rate. During the first nine months of 2008, the Company was able to sell $20.4 million of ARSs through successful auctions and redemptions. The remaining balance of $14.4 million in ARSs that we held as of September 26, 2008 all had failed auctions in the first nine months of 2008. Based on current market conditions, we believe that it is likely that future auctions related to these securities will be unsuccessful in the near term. Unsuccessful auctions will result in our holding these securities beyond their next scheduled auction reset dates and limiting the short-term liquidity of these investments. While these failures in the auction process have affected our ability to access these funds in the near term, we do not believe that the underlying securities or collateral have been affected. It is our intent to realize the cash value of these securities during our normal annual operating cycle and accordingly the securities have been classified in short-term investments. During August 2008, we received notification from our investment manager who holds the ARSs that it had reached a settlement with certain regulatory authorities, pursuant to which the Company would be able to sell its outstanding ARSs to the investment manager at par, plus accrued interest and dividends at any time during the period from January 2, 2009 through January 15, 2010. While management believes that we will be able to liquidate our ARSs without significant loss, the timing to realize the investments recorded value is uncertain. If the credit rating of the security issuers deteriorates or does not meet our investment criteria, we may be required to adjust the carrying value of these investments through an impairment charge or dispose of these securities, possibly at a loss. Nevertheless, we believe that our existing liquidity sources will satisfy our cash requirements for at least the next twelve months. However, if our expectations are incorrect, we

may need to raise additional funds to fund our operations, to take advantage of unanticipated strategic opportunities or to strengthen our financial position.

In addition, we actively review potential acquisitions that would complement our existing product offerings, enhance our technical capabilities or expand our marketing and sales presence. Any future transaction of this nature

Table of Contents

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

Our ability to raise funds may be adversely affected by a number of factors relating to Harmonic, as well as factors beyond our control, including weakness in the economic conditions in markets in which we operate and into which we sell our products, increased uncertainty in the financial, capital and credit markets, as well as conditions in the cable and satellite industries. In particular, companies are experiencing difficulty raising capital from issuances of debt or equity securities in the current capital market environment, and may also have difficulty securing credit financing. There can be no assurance that any financing will be available on terms acceptable to us, if at all.

Off-Balance Sheet Arrangements

None as of September 26, 2008.

Contractual Obligations and Commitments

As of September 26, 2008, we had a liability for unrecognized tax benefits and an accrual for the payment of related interest and penalties totaling $41 million, none of which is expected to be paid within one year. We are unable to make a reasonably reliable estimate of when cash settlement with a taxing authority will occur.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

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

Foreign Currency Exchange Risk

Harmonic has a number of international customers whose sales are generally denominated in U.S. dollars. Recently, the value of the U.S. dollar has appreciated against many foreign currencies, including the local currencies of many of our international customers. As the U.S. dollar appreciates relative to the local currencies of our customers, the price of our products correspondingly increases for such customers. Sales denominated in foreign currencies were approximately 5% and 7% of net sales in the first nine months of 2008 and 2007, respectively. In addition, the Company has various international branch offices that provide sales support and systems integration services. Periodically, Harmonic enters into foreign currency forward exchange contracts, or forward contracts, to manage exposure related to accounts receivable denominated in foreign currencies. Harmonic does not enter into derivative financial instruments for trading purposes. At September 26, 2008, we had a forward contract to sell Euros totaling $5.7 million that matures during the fourth quarter of 2008. While Harmonic does not anticipate that near-term changes in exchange rates will have a material impact on Harmonic s operating results, financial position and liquidity, Harmonic cannot assure you that a sudden and significant change in the value of local currencies would not harm Harmonic s operating results, financial position and liquidity.

Interest Rate and Credit Risk

Exposure to market risk for changes in interest rates relates primarily to Harmonic s investment portfolio of marketable debt securities of various issuers, types and maturities and to Harmonic s borrowings under its bank line of credit facility. Harmonic does not use derivative instruments in its investment portfolio, and its investment portfolio primarily includes highly liquid instruments. These investments are classified as available for sale and are carried at estimated fair value, with material unrealized gains and losses reported in other comprehensive income. As of September 26, 2008, we had gross unrealized losses of $2.0 million that were determined by management to be temporary in nature. If the credit market continues to deteriorate, we may conclude that the decline in value is other than temporary and we may also incur realized losses, which could adversely affect our financial condition or results of operations. There is risk that losses could be incurred if Harmonic were to sell any of its securities prior to stated maturity. As of September 26, 2008, our cash, cash equivalents and short-term investments balance was $293.4 million. In a declining interest rate environment, as short term investments mature, reinvestment occurs at less favorable market rates. Given the short term nature of certain investments, declining interest rates would

Table of Contents

negatively impact investment income. Based on our estimates, a 100 basis point, or 1%, change in interest rates would have increased or decreased the fair value of our investments by approximately $1.1 million.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of disclosure controls and procedures.

We maintain disclosure controls and procedures, as such term is defined in Rule 13a-15(e) under the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures were effective.

Changes in internal controls.

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Shareholder Litigation

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

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

Table of Contents

Following a series of procedural actions at the District Court and at the United States Court of Appeals for the Ninth Circuit, a significant number of the claims alleged in the plaintiffs amended complaint were dismissed, including all claims against C-Cube and its officers and directors. However, certain of the plaintiffs claims survived dismissal. In January 2007, the District Court set a trial date for August 2008, and also ordered the parties to participate in mediation.

A derivative action purporting to be on our behalf was filed in the Superior Court for the County of Santa Clara against certain current and former officers and directors on May 15, 2003. It alleges facts similar to those alleged in the securities class action and names Harmonic as a nominal defendant. The action remains pending with no trial date set.

As a result of discussions and negotiations between plaintiffs counsel and Harmonic, and Harmonic and its insurance carriers, an agreement was reached in March 2008 to resolve the securities class action lawsuit. This agreement releases Harmonic, its officers, directors and insurance carriers from all claims brought in the lawsuit by the plaintiffs against Harmonic or its officers and directors, without any admission of fault on the part of Harmonic or its officers and directors. On October 29, 2008, the District Court issued a final order granting approval of the settlement agreement.

In the derivative action, recent discussions between the plaintiffs counsel and Harmonic have resulted in a tentative settlement which will require no payments by the Company or its officers and directors. If finalized, this tentative agreement will release Harmonic s officers and directors from all claims brought in the derivative lawsuit. This tentative agreement remains subject to certain contingencies, including negotiation and execution by the parties of a written settlement agreement, and final approval by the District Court. A hearing to grant final approval is scheduled for December 19, 2008.

Under the terms of the agreement to settle the securities class action lawsuit, Harmonic and its insurance carriers will pay $15.0 million in consideration to the plaintiffs in the securities class action. Of this amount, Harmonic will pay $5.0 million, and Harmonic s insurance carriers, in addition to having funded most litigation costs, will contribute the remaining $10.0 million on behalf of the individual defendants. The plaintiffs lawyers have applied for an award of fees and costs in an unspecified amount to be paid from the $15.0 million in consideration and subject to the approval of the District Court. In addition, Harmonic estimates that it has paid or will pay approximately $1.4 million in related legal fees and expenses in connection with proceedings in the securities class action and derivative lawsuits. Harmonic paid its share of the settlement consideration into escrow on August 5, 2008.

Other Litigation

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of Harmonic s products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint sought injunctive relief, royalties and damages. On August 6, 2007, the District Court granted our motion to dismiss. The plaintiffs appealed this motion and on June 19, 2008 the U.S. Court of Appeals for the Federal Circuit issued a decision which vacated the District Court s decision and remanded for further proceedings. At a scheduling conference on September 6, 2008, the judge ordered the parties to mediation. A mediation session is scheduled for November 4, 2008. An unfavorable outcome on this or any other litigation matter could require that Harmonic pay substantial damages, or, in connection with any intellectual property infringement claims, could require that we pay ongoing royalty payments or could prevent us from selling certain of our products. A settlement or an unfavorable outcome on this or any other litigation matter could have a material adverse effect on Harmonic s business, operating results, financial position or cash flows.

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

Table of Contents

ITEM 1A. RISK FACTORS

We depend on cable, satellite and telecom industry capital spending for a substantial portion of our revenue and any decrease or delay in capital spending in these industries would negatively impact our operating results and financial condition or cash flows.

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

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

access to financing;

annual budget cycles;

the impact of industry consolidation;

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

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

evolving industry standards and network architectures;

competitive pressures, including pricing pressures;

discretionary customer spending patterns; and

general economic conditions.

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

uncertainty related to development of digital video industry standards;

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

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

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

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

economic and financial conditions in domestic and international markets; and

bankruptcies and financial restructuring of major customers.

The financial difficulties of certain of our customers and changes in our customers deployment plans adversely affected our business in recent years. Recently, economic conditions in the countries in which we operate and sell products have become increasingly negative, and global financial markets have experienced a severe downturn stemming from a multitude of factors, including adverse credit conditions impacted by the subprime-mortgage crisis, slower economic activity, concerns about inflation and deflation, increased energy costs, decreased consumer

Table of Contents

confidence, reduced corporate profits and capital spending, adverse business conditions and liquidity concerns and other factors. Economic growth in the U.S. and in many other countries has slowed significantly recently, and is expected by many to slow further or recede in the fourth quarter of 2008. During challenging economic times, and in tight credit markets, many customers may delay or reduce capital expenditures. Further, we have a number of customers internationally to whom sales are denominated in U.S. dollars. The value of the U.S. dollar also has appreciated against many foreign currencies, including the local currencies of many of our international customers. As the U.S. dollar appreciates relative to the local currencies of our customers, the price of our products correspondingly increase for such customers. These factors could result in reductions in sales of our products, longer sales cycles, difficulties in collection of accounts receivable, slower adoption of new technologies and increased price competition. Financial difficulties among our customers could adversely affect our operating results and financial condition.

In addition, industry consolidation has, in the past and may in the future, constrained capital spending among our customers. As a result, we cannot assure you that we will maintain or increase our net sales in the future. If our product portfolio and product development plans do not position us well to capture an increased portion of the capital spending of U.S. cable operators, our revenue may decline and our operating results would be adversely affected.

Our customer base is concentrated and the loss of one or more of our key customers, or a failure to diversify our customer base, could harm our business.

Historically, a majority of our sales have been to relatively few customers, and due in part to the consolidation of ownership of cable television and direct broadcast satellite systems, we expect this customer concentration to continue in the foreseeable future. Sales to our ten largest customers in the first nine months of 2008 and the fiscal years 2007 and 2006 accounted for approximately 58%, 53% and 50% of net sales, respectively. Although we are attempting to broaden our customer base by penetrating new markets, such as the telecommunications and broadcast markets, and to expand internationally, we expect to see continuing industry consolidation and customer concentration due in part to the significant capital costs of constructing broadband networks. For example, Comcast acquired AT&T Broadband in 2002, thereby creating the largest U.S. cable operator, reaching approximately 24 million subscribers. The sale of Adelphia Communications cable systems to Comcast and Time Warner Cable has led to further industry consolidation. NTL and Telewest, the two largest cable operators in the UK, completed their merger in 2006. In the direct broadcast satellite, or DBS, market, The News Corporation Ltd. acquired an indirect controlling interest in Hughes Electronics, the parent company of DIRECTV, in 2003. News Corporation sold its interest in DIRECTV to Liberty Media in February 2008. In the telco market, AT&T completed its acquisition of Bell South in December 2006.

In the first nine months of 2008, sales to Comcast and EchoStar accounted for 20% and 12%, respectively, of our net sales. In the fiscal year 2007, sales to Comcast and EchoStar accounted for 16% and 12%, respectively, of our net sales. In the fiscal year 2006, sales to Comcast accounted for 12% of our net sales. The loss of Comcast, EchoStar or any other significant customer or any reduction in orders by Comcast, EchoStar or any significant customer, or our failure to qualify our products with a significant customer could adversely affect our business, operating results and liquidity. In this regard, sales to Comcast declined in 2006 compared to 2005, both in absolute dollars and as a percentage of revenues. The loss of, or any reduction in orders from, a significant customer would harm our business if we were not able to offset any such loss or reduction with increased orders from other customers.

In addition, historically we have been dependent upon capital spending in the cable and satellite industry. We are attempting to diversify our customer base beyond cable and satellite customers, principally into the telco market. Major telcos have begun to implement plans to rebuild or upgrade their networks to offer bundled video, voice and data services. While we have recently increased our revenue from telco customers, we are relatively new to this market. In order to be successful in this market, we may need to build alliances with telco equipment manufacturers, adapt our products for telco applications, take orders at prices resulting in lower margins, and build internal expertise to handle the particular contractual and technical demands of the telco industry. In addition, telco video deployments are subject to delays in completion, as video processing technologies and video business models are new to most telcos and many of their largest suppliers. Implementation issues with our products or those of other vendors have caused, and may continue to cause, delays in project completion for our customers and delay the recognition of revenue by Harmonic. Further, during challenging economic times, and in tight credit markets, many customers,

including telcos, may delay or reduce capital expenditures. This could result in reductions in sales of our products, longer sales cycles, difficulties in collection of accounts receivable, slower adoption of new technologies and increased price competition. As a result of these and other factors, we cannot assure you that we will be able to

Table of Contents

increase our revenues from the telco market, or that we can do so profitably, and any failure to increase revenues and profits from telco customers could adversely affect our business.

Our operating results are likely to fluctuate significantly and may fail to meet or exceed the expectations of securities analysts or investors, causing our stock price to decline.

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

- the level and timing of capital spending of our customers, both in the U.S. and in foreign markets;
- access to financing for capital spending by our customers;
- changes in market demand;
- the timing and amount of orders, especially from significant customers;
- the timing of revenue recognition from solution contracts, which may span several quarters;
- the timing of revenue recognition on sales arrangements, which may include multiple deliverables;
- the timing of completion of projects;
- competitive market conditions, including pricing actions by our competitors;
- seasonality, with fewer construction and upgrade projects typically occurring in winter months and otherwise being affected by inclement weather;
- our unpredictable sales cycles;
- the amount and timing of sales to telcos, which are particularly difficult to predict;
- new product introductions by our competitors or by us;
- changes in domestic and international regulatory environments;
- market acceptance of new or existing products;
- the cost and availability of components, subassemblies and modules;
- the mix of our customer base and sales channels;
- the mix of products sold and the effect it has on gross margins;
- changes in our operating expenses and extraordinary expenses;
- impairment of goodwill and intangibles;
- the outcome of litigation;
- write-downs of inventory;

the impact of SFAS 123(R), an accounting standard which requires us to record the fair value of stock options as compensation expense;

changes in our tax rate, including as a result of changes in our valuation allowance against our deferred tax assets and our expectation that we would experience a substantial increase in our effective tax rate in periods following a potential release of our valuation allowance;

the impact of FIN 48, a recently adopted accounting interpretation which requires us to establish reserves for uncertain tax positions and accrue potential tax penalties and interest;

our development of custom products and software;

the level of international sales;

economic and financial conditions specific to the cable, satellite and telco industries; and

Table of Contents

general economic conditions.

The timing of deployment of our equipment can be subject to a number of other risks, including the availability of skilled engineering and technical personnel, the availability of other equipment such as compatible set top boxes, and our customers need for local franchise and licensing approvals.

In addition, we often recognize a substantial portion, or majority, of our revenues in the last month of the quarter. We establish our expenditure levels for product development and other operating expenses based on projected sales levels, and expenses are relatively fixed in the short term. Accordingly, variations in timing of sales can cause significant fluctuations in operating results. As a result of all these factors, our operating results in one or more future periods may fail to meet or exceed the expectations of securities analysts or investors. In that event, the trading price of our common stock would likely decline.

Our future growth depends on market acceptance of several emerging broadband services, on the adoption of new broadband technologies and on several other broadband industry trends.

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

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

new video compression standards such as MPEG-4 ACV/H.264 for both standard definition and high definition services;

fiber to the premises, or FTTP, and digital subscriber line, or DSL, networks designed to facilitate the delivery of video services by telcos;

the greater use of protocols such as IP;

the adoption of switched digital video; and

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

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

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

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

the entry of telcos into the video business;

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

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

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

Table of Contents

We need to develop and introduce new and enhanced products in a timely manner to remain competitive.

Broadband communications markets are characterized by continuing technological advancement, changes in customer requirements and evolving industry standards. To compete successfully, we must design, develop, manufacture and sell new or enhanced products that provide increasingly higher levels of performance and reliability. However, we may not be able to successfully develop or introduce these products if our products:

are not cost effective;

are not brought to market in a timely manner;

are not in accordance with evolving industry standards and architectures;

fail to achieve market acceptance; or

are ahead of the market.

We are currently developing and marketing products based on new video compression standards. Encoding products based on the MPEG-2 compression standards have represented a significant portion of our sales since our acquisition of DiviCom in 2000. New standards, such as MPEG-4 ACV/H.264 have been adopted which provide significantly greater compression efficiency, thereby making more bandwidth available to operators. The availability of more bandwidth is particularly important to those DBS and telco operators seeking to launch, or expand, HDTV services. We have developed and launched products, including HD encoders, based on these new standards in order to remain competitive and are devoting considerable resources to this effort. There can be no assurance that these efforts will be successful in the near future, or at all, or that competitors will not take significant market share in HD encoding. At the same time, we need to devote development resources to the existing MPEG-2 product line which our cable customers continue to require.

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

Conditions and changes in the national and global economic environments may adversely affect our business and financial results.

Adverse economic conditions in markets in which we operate may harm our business. Recently, economic conditions in the countries in which we operate and sell products have become increasingly negative, and global financial markets have experienced a severe downturn stemming from a multitude of factors, including adverse credit conditions impacted by the subprime-mortgage crisis, slower economic activity, concerns about inflation and deflation, increased energy costs, decreased consumer confidence, reduced corporate profits and capital spending, adverse business conditions and liquidity concerns and other factors. Economic growth in the U.S. and in many other countries slowed in the fourth quarter of 2007, remained slow for the first three quarters of 2008, and is expected to slow further or recede in the fourth quarter of 2008 in the U.S. and internationally. During challenging economic times, and in tight credit markets, many customers may delay or reduce capital expenditures. This could result in reductions in sales of our products, longer sales cycles, difficulties in collection of accounts receivable, slower adoption of new technologies and increased price competition. If global economic and market conditions, or economic conditions in the United States or other key markets deteriorate, we may experience a material and adverse impact on our business, results of operations and financial condition.

Broadband communications markets are characterized by rapid technological change.

Broadband communications markets are relatively immature, making it difficult to accurately predict the markets future growth rates, sizes or technological directions. In view of the evolving nature of these markets, it is possible

Table of Contents

that cable television operators, telcos or other suppliers of broadband wireless and satellite services will decide to adopt alternative architectures or technologies that are incompatible with our current or future products. Also, decisions by customers to adopt new technologies or products are often delayed by extensive evaluation and qualification processes and can result in delays in sales of current products. If we are unable to design, develop, manufacture and sell products that incorporate or are compatible with these new architectures or technologies, our business will suffer.

The markets in which we operate are intensely competitive.

The markets for digital video systems are extremely competitive and have been characterized by rapid technological change and declining average selling prices. Pressure on average selling prices was particularly severe during economic downturns as equipment suppliers compete aggressively for customers reduced capital spending. Our competitors for fiber optic access and edge products include corporations such as Motorola, Cisco Systems and Arris. In our video processing products, we compete broadly with products from vertically integrated system suppliers including Motorola, Cisco Systems, Thomson Multimedia and Ericsson, and, in certain product lines, with a number of smaller companies.

Many of our competitors are substantially larger and have greater financial, technical, marketing and other resources than us. Many of these large organizations are in a better position to withstand any significant reduction in capital spending by customers in these markets. They often have broader product lines and market focus and may not be as susceptible to downturns in a particular market. These competitors may also be able to bundle their products together to meet the needs of a particular customer and may be capable of delivering more complete solutions than we are able to provide. Further, some of our competitors have greater financial resources than we do, and they have offered and in the future may offer their products at lower prices than we do, which has in the past and may in the future cause us to lose sales or to reduce our prices in response to competition. In addition, many of our competitors have been in operation longer than we have and therefore have more long-standing and established relationships with domestic and foreign customers. We may not be able to compete successfully in the future, which would harm our business.

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

If sales forecasted for a particular period are not realized in that period due to the unpredictable sales cycles of our products, our operating results for that period will be harmed.

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

- a significant technical evaluation;
- a commitment of capital and other resources by cable, satellite, and other network operators;
- time required to engineer the deployment of new technologies or new broadband services;
- testing and acceptance of new technologies that affect key operations; and
- test marketing of new services with subscribers.

For these and other reasons, our sales cycles generally last three to nine months, but can last up to 12 months. If

Table of Contents

orders forecasted for a specific customer for a particular quarter do not occur in that quarter, our operating results for that quarter could be substantially lower than anticipated. In this regard, our sales cycles with our current and potential satellite and telco customers are particularly unpredictable. Orders may include multiple elements, the timing of delivery of which may impact the timing of revenue recognition. Additionally, our sales arrangements may include testing and acceptance of new technologies and the timing of completion of acceptance testing is difficult to predict and may impact the timing of revenue recognition. Quarterly and annual results may fluctuate significantly due to revenue recognition policies and the timing of the receipt of orders.

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

We must be able to manage expenses and inventory risks associated with meeting the demand of our customers.

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

In addition, we must carefully manage the introduction of next generation products in order to balance potential inventory risks associated with excess quantities of older product lines and forecasts of customer demand for new products. For example, in 2007, we wrote down approximately $7.6 million of net obsolete and excess inventory, with a significant portion of the write-down being due to product transitions. We also wrote down $1.1 million in 2006 as a result of the end of life of a product line. There can be no assurance that we will be able to manage these product transitions in the future without incurring write-downs for excess inventory or having inadequate supplies of new products to meet customer expectations.

We may be subject to risks associated with acquisitions.

As part of our business strategy, from time to time, we have acquired, and continue to consider acquiring, businesses, technologies, assets and product lines that we believe complement or expand our existing business. For example, on December 8, 2006, we acquired the video networking software business of Entone Technologies, Inc. and, on July 31, 2007, we completed the acquisition of Rhozet Corporation, and we expect to make additional acquisitions in the future.

We may face challenges as a result of these activities, because acquisitions entail numerous risks, including:

- difficulties in the assimilation of acquired operations, technologies and/or products;
- unanticipated costs associated with the acquisition transaction;
- the diversion of management s attention from other business;
- difficulties in integrating acquired companies systems controls, policies and procedures to comply with the internal control over financial reporting requirements of the Sarbanes-Oxley Act of 2002;
- adverse effects on existing business relationships with suppliers and customers;
- risks associated with entering markets in which we have no or limited prior experience;
- the potential loss of key employees of acquired businesses;
- difficulties in the assimilation of different corporate cultures and practices;

substantial charges for the amortization of certain purchased intangible assets, deferred stock compensation or similar items;

Table of Contents

substantial impairments to goodwill or intangible assets in the event that an acquisition proves to be less valuable than the price we paid for it; and

delays in realizing or failure to realize the benefits of an acquisition.

For example, we closed all operations and product lines related to Broadcast Technology Limited, which we acquired in 2005 and we have recorded charges associated with that closure.

Competition within our industry for acquisitions of businesses, technologies, assets and product lines has been, and may in the future continue to be, intense. As such, even if we are able to identify an acquisition that we would like to consummate, we may not be able to complete the acquisition on commercially reasonable terms or because the target is acquired by another company. Furthermore, in the event that we are able to identify and consummate any future acquisitions, we could:

issue equity securities which would dilute current stockholders percentage ownership;

incur substantial debt;

assume contingent liabilities; or

expend significant cash.

These financing activities or expenditures could harm our business, operating results and financial condition or the price of our common stock. Alternatively, due to difficulties in the capital and credit markets, we may be unable to secure capital on acceptable terms, or all, to complete acquisitions.

Moreover, even if we do obtain benefits from acquisitions in the form of increased sales and earnings, there may be a delay between the time when the expenses associated with an acquisition are incurred and the time when we recognize such benefits.

If we are unable to successfully address any of these risks, our business, financial condition or operating results could be harmed.

We depend on our international sales and are subject to the risks associated with international operations, which may negatively affect our operating results.

Sales to customers outside of the U.S. in the first nine months of 2008 and the fiscal years 2007 and 2006 represented 43%, 44% and 49% of net sales, respectively, and we expect that international sales will continue to represent a meaningful portion of our net sales for the foreseeable future. Furthermore, a substantial portion of our contract manufacturing occurs overseas. Our international operations, the international operations of our contract manufacturers and our efforts to increase sales in international markets are subject to a number of risks, including:

changes in foreign government regulations and telecommunications standards;

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

fluctuations in currency exchange rates;

difficulty in collecting accounts receivable;

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

difficulty in staffing and managing foreign operations;

political and economic instability, including risks related to terrorist activity; and

changes in economic policies by foreign governments.

In the past, certain of our international customers accumulated significant levels of debt and have undertaken reorganizations and financial restructurings, including bankruptcy proceedings. Even where these restructurings

Table of Contents

have been completed, in some cases these customers have not been in a position to purchase new equipment at levels we have seen in the past.

While our international sales and operating expenses have typically been denominated in U.S. dollars, fluctuations in currency exchange rates could cause our products to become relatively more expensive to customers in a particular country, leading to a reduction in sales or profitability in that country. A significant portion of our European business is denominated in Euros, which may subject us to increased foreign currency risk. Gains and losses on the conversion to U.S. dollars of accounts receivable, accounts payable and other monetary assets and liabilities arising from international operations may contribute to fluctuations in operating results.

Furthermore, payment cycles for international customers are typically longer than those for customers in the U.S. Unpredictable sales cycles could cause us to fail to meet or exceed the expectations of security analysts and investors for any given period. In addition, foreign markets may not further develop in the future.

Another significant legal risk resulting from our international operations is compliance with the U.S. Foreign Corrupt Practices Act, or FCPA. In many foreign countries, particularly in those with developing economies, it may be a local custom that businesses operating in such countries engage in business practices that are prohibited by the FCPA or other U.S. laws and regulations. Although we have implemented policies and procedures designed to ensure compliance with the FCPA and similar laws, there can be no assurance that all of our employees, and agents, as well as those companies to which we outsource certain of our business operations, will not take actions in violation of our policies. Any such violation, even if prohibited by our policies, could have a material adverse effect on our business.

Any or all of these factors could adversely impact our business and results of operations.

Fluctuations in our future effective tax rates could affect our future operating results, financial condition and cash flows.

In the second quarter of 2008, we released $18.0 million of the valuation allowance as an offset against certain of our U.S. and foreign net deferred tax assets, of which $15.1 million was taken as a discrete item and $2.9 million was accounted for as a reduction to goodwill or other non-current intangible assets related to the Entone and Rhozet acquisitions. In accordance with SFAS 109, we have evaluated the need for a valuation allowance based on historical evidence, trends in profitability, expectations of future taxable income and implemented tax planning strategies. As such, during the second quarter of 2008, we determined that a valuation allowance was no longer necessary for our U.S. deferred tax assets because, based on the available evidence, we concluded that a realization of these net deferred tax assets was more likely than not. However, pursuant to SFAS 109, we are required to periodically review our deferred tax assets and determine whether, based on available evidence, a valuation allowance is necessary. In the event that, in the future, we determine that a valuation allowance is necessary with respect to our deferred tax assets, we would incur a charge equal to the amount of the valuation allowance in the period in which we made such determination, and this could have a material and adverse impact on our results of operations for such period.

The calculation of tax liabilities involves dealing with uncertainties in the application of complex global tax regulations. We recognize potential liabilities for anticipated tax audit issues in the U.S. and other tax jurisdictions based on our estimate of whether, and the extent to which, additional taxes will be due. If payment of these amounts ultimately proves to be unnecessary, the reversal of the liabilities would result in tax benefits being recognized in the period when we determine the liabilities are no longer necessary. If the estimate of tax liabilities proves to be less than the ultimate tax assessment, a further charge to expense would result. The Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes (FIN 48) on January 1, 2007, the first day of fiscal 2007. FIN 48 prescribes a comprehensive model for recognizing, measuring, presenting and disclosing in the consolidated financial statements tax positions taken or expected to be taken on a tax return, including a decision whether to file or not to file in a particular jurisdiction.

We are in the process of expanding our international operations and staff to better support our expansion into international markets. This expansion includes the implementation of an international structure that includes, among

Table of Contents

other things, a research and development cost-sharing arrangement, certain licenses and other contractual arrangements between us and our wholly-owned domestic and foreign subsidiaries. As a result of these changes, we anticipate that our consolidated pre-tax income will be subject to foreign tax at relatively lower tax rates when compared to the United States federal statutory tax rate and, as a consequence, our effective income tax rate is expected to be lower than the United States federal statutory rate. Our future effective income tax rates could be adversely affected if tax authorities challenge our international tax structure or if the relative mix of United States and international income changes for any reason. Accordingly, there can be no assurance that our income tax rate will be less than the United States federal statutory rate.

We face risks associated with having important facilities and resources located in Israel.

We maintain a facility in Caesarea in the State of Israel with a total of 81 employees as of September 26, 2008, or approximately 12% of our workforce. The employees at this facility consist principally of research and development personnel. In addition, we have pilot production capabilities at this facility consisting of procurement of subassemblies and modules from Israeli subcontractors and final assembly and test operations. Accordingly, we are directly influenced by the political, economic and military conditions affecting Israel. Any significant conflict involving Israel could have a direct effect on our business or that of our Israeli subcontractors, in the form of physical damage or injury, reluctance to travel within or to Israel by our Israeli and foreign employees or those of our subcontractors, or the loss of employees to active military duty. Most of our employees in Israel are currently obligated to perform annual reserve duty in the Israel Defense Forces and several have been called for active military duty recently. In the event that more employees are called to active duty, certain of our research and development activities may be adversely affected and significantly delayed. In addition, the interruption or curtailment of trade between Israel and its trading partners could significantly harm our business. Terrorist attacks and hostilities within Israel, the hostilities between Israel and Hezbollah, and the conflict between Hamas and Fatah have also heightened these risks. Current or future tensions in the Middle East may adversely affect our business and results of operations.

Changes in telecommunications legislation and regulations could harm our prospects and future sales.

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

Negative conditions in the global credit markets may impair the liquidity of a portion of our investment portfolio.

As of September 26, 2008, we held approximately $14.4 million of auction rate securities, or ARSs, which were invested in preferred securities in closed-end mutual funds. The recent negative conditions in the credit markets have restricted our ability from liquidating holdings of ARSs because the amount of securities submitted for sale has exceeded the amount of purchase orders for such securities. During the first nine months of 2008, we were able to sell $20.4 million of ARSs through successful auctions and redemptions. The remaining balance of $14.4 million in ARSs as of September 26, 2008 all had failed auctions in the first nine months of 2008. Based on current market conditions, we believe that it is likely that future auctions related to these securities will be unsuccessful in the near term, which will result in our continuing to hold these securities beyond their next scheduled auction reset dates and limiting the short-term liquidity of these investments. During August 2008, we received notification from our investment manager who holds the ARSs that it had reached a settlement with certain regulatory authorities, pursuant to which the Company would be able to sell its outstanding ARSs to the investment manager at par, plus accrued interest and dividends at any time during the period from January 2, 2009 through January 15, 2010. In the event we need or desire to access these funds, we may not be able to do so until a future auction on these investments is successful, the issuer redeems the security, or a buyer is found outside the auction process. If a buyer is found but is unwilling to purchase the investments at par, we may incur a loss. Further, rating downgrades of the security issuer or the third parties insuring such investments may require us to adjust the carrying value of these investments through an impairment charge. Our inability to sell ARSs at par, or rating downgrades of issuers of these securities, could adversely affect our results of operations or financial condition.

45

Table of Contents

In addition, we invest our cash, cash equivalents and short-term investments in a variety of investment vehicles in a number of countries with and in the custody of financial institutions with high credit ratings. While our investment policy and strategy attempt to manage interest rate risk, limit credit risk, and only invest in what we view as very high-quality securities, the outlook for our investment holdings is dependent on general economic conditions, interest rate trends and volatility in the financial marketplace, which can all affect the income that we receive, the value of our investments, and our ability to sell them.

During the three months ended September 26, 2008, we recorded an impairment charge of $0.8 million on an investment in the unsecured debt of Lehman Brothers Holdings, Inc. We believe that our investment securities are carried at fair value. However, over time the economic and market environment may provide additional insight regarding the fair value of certain securities which could change our judgment regarding impairment. This could result in realized losses relating to other than temporary declines being charged against future income. Given the current market conditions involved, there is continuing risk that further declines in fair value may occur and additional impairments may be charged to income in future periods, resulting in realized losses

In order to manage our growth, we must be successful in addressing management succession issues and attracting and retaining qualified personnel.

Our future success will depend, to a significant extent, on the ability of our management to operate effectively, both individually and as a group. We must successfully manage transition and replacement issues that may result from the departure or retirement of members of our senior management. We cannot assure you that changes of management personnel would not cause disruption to our operations or customer relationships, or a decline in our financial results. In addition, we are dependent on our ability to retain and motivate high caliber personnel, in addition to attracting new personnel. Competition for qualified management, technical and other personnel can be intense and we may not be successful in attracting and retaining such personnel. Competitors and others have in the past and may in the future attempt to recruit our employees. While our employees are required to sign standard agreements concerning confidentiality and ownership of inventions, we generally do not have employment contracts or non-competition agreements with any of our personnel. The loss of the services of any of our key personnel, the inability to attract or retain qualified personnel in the future or delays in hiring required personnel, particularly senior management and engineers and other technical personnel, could negatively affect our business.

Accounting standards and stock exchange regulations related to equity compensation could adversely affect our earnings, our ability to raise capital and our ability to attract and retain key personnel.

Since our inception, we have used stock options as a fundamental component of our employee compensation packages. We believe that our stock option plans are an essential tool to link the long-term interests of stockholders and employees, especially executive management, and serve to motivate management to make decisions that will, in the long run, give the best returns to stockholders. The Financial Accounting Standards Board (FASB) issued SFAS 123(R) that requires us to record a charge to earnings for employee stock option grants and employee stock purchase plan rights for all periods from January 1, 2006. This standard has negatively impacted and will continue to negatively impact our earnings and may affect our ability to raise capital on acceptable terms. For the nine months ended September 26, 2008, stock-based compensation expense recognized under SFAS 123(R) was $5.5 million, which consisted of stock-based compensation expense related to board of directors restricted stock units, employee equity awards and employee stock purchases.

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

Table of Contents

We are exposed to additional costs and risks associated with complying with increasing regulation of corporate governance and disclosure standards.

We are spending an increased amount of management time and external resources to comply with changing laws, regulations and standards relating to corporate governance and public disclosure, including the Sarbanes-Oxley Act of 2002, SEC regulations and the Nasdaq Stock Market rules. In particular, Section 404 of the Sarbanes-Oxley Act requires management s annual review and evaluation of our internal control over financial reporting and attestation of the effectiveness of our internal control over financial reporting by the Company s independent registered public accounting firm in connection with the filing of the annual report on Form 10-K for each fiscal year. We have documented and tested our internal control systems and procedures and have made improvements in order for us to comply with the requirements of Section 404. This process required us to hire additional personnel and outside advisory services and has resulted in significant additional expenses. While our management s assessment of our internal control over financial reporting resulted in our conclusion that as of December 31, 2007, our internal control over financial reporting was effective, we cannot predict the outcome of our testing in future periods. If we conclude in future periods that our internal control over financial reporting is not effective or if our independent registered public accounting firm is unable to provide an unqualified opinion as of future year-ends, investors may lose confidence in our financial statements, and the price of our stock may suffer.

We may need additional capital in the future and may not be able to secure adequate funds on terms acceptable to us.

We have generated substantial operating losses since we began operations in June 1988. We have been engaged in the design, manufacture and sale of a variety of video products and system solutions since inception, which has required, and will continue to require, significant research and development expenditures. As of September 26, 2008 we had an accumulated deficit of $1.9 billion. These losses, among other things, have had and may have an adverse effect on our stockholders equity and working capital.

We believe that our existing liquidity sources, including the net proceeds of our recent public offering of common stock, will satisfy our cash requirements for at least the next twelve months. However, we may need to raise additional funds if our expectations are incorrect, to take advantage of unanticipated strategic opportunities, to satisfy our other liabilities, or to strengthen our financial position. Our ability to raise funds may be adversely affected by a number of factors relating to Harmonic, as well as factors beyond our control, including weakness in the economic conditions in markets in which we operating and into which we sell our products, increased uncertainty in the financial, capital and credit markets, as well as conditions in the cable and satellite industries. In particular, companies are experiencing difficulty raising capital from issuances of debt or equity securities in the current capital market environment, and may also have difficulty securing credit financing. There can be no assurance that such financing will be available on terms acceptable to us, if at all.

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

We may raise additional financing through public or private equity offerings, debt financings or additional corporate collaboration and licensing arrangements. To the extent we raise additional capital by issuing equity securities, our stockholders may experience dilution. To the extent that we raise additional funds through collaboration and licensing arrangements, it may be necessary to relinquish some rights to our technologies or products, or grant licenses on terms that are not favorable to us. For example, debt financing arrangements may require us to pledge assets or enter into covenants that could restrict our operations or our ability to incur further indebtedness. If adequate funds are not available, we will not be able to continue developing our products.

Table of Contents

If demand for our products increases more quickly than we expect, we may be unable to meet our customers requirements.

If demand for our products increases, the difficulty of accurately forecasting our customers requirements and meeting these requirements will increase. For example, we had insufficient quantities of certain products to meet customer demand late in the second quarter of 2006 and, as a result, our revenues were lower than internal and external expectations. Forecasting to meet customers needs and effectively managing our supply chain is particularly difficult in connection with newer products. Our ability to meet customer demand depends significantly on the availability of components and other materials as well as the ability of our contract manufacturers to scale their production. Furthermore, we purchase several key components, subassemblies and modules used in the manufacture or integration of our products from sole or limited sources. Our ability to meet customer requirements depends in part on our ability to obtain sufficient volumes of these materials in a timely fashion. Also, in previous years, in response to lower sales and the prolonged economic recession, we significantly reduced our headcount and other expenses. As a result, we may be unable to respond to customer demand that increases more quickly than we expect. If we fail to meet customers supply expectations, our net sales would be adversely affected and we may lose business.

We purchase several key components, subassemblies and modules used in the manufacture or integration of our products from sole or limited sources, and we are increasingly dependent on contract manufacturers.

Many components, subassemblies and modules necessary for the manufacture or integration of our products are obtained from a sole supplier or a limited group of suppliers. For example, we depend on a small private company for certain video encoding chips which are incorporated into several new products. Our reliance on sole or limited suppliers, particularly foreign suppliers, and our increased reliance on subcontractors involves several risks, including a potential inability to obtain an adequate supply of required components, subassemblies or modules and reduced control over pricing, quality and timely delivery of components, subassemblies or modules. In particular, certain optical components have in the past been in short supply and are available only from a small number of suppliers, including sole source suppliers. While we expend resources to qualify additional component sources, consolidation of suppliers in the industry and the small number of viable alternatives have limited the results of these efforts. We do not generally maintain long-term agreements with any of our suppliers. Managing our supplier and contractor relationships is particularly difficult during time periods in which we introduce new products and during time periods in which demand for our products is increasing, especially if demand increases more quickly than we expect. Furthermore, from time to time we assess our relationship with our contract manufacturers. In 2003, we entered into a three-year agreement with Plexus Services Corp. as our primary contract manufacturer, and Plexus currently provides us with a majority of the products that we purchase from our contract manufacturers. This agreement has automatic annual renewals unless prior notice is given and has been renewed until October 2009.

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

Cessation of the development and production of video encoding chips by C-Cube s spun-off semiconductor business may adversely impact us.

Our DiviCom business, which we acquired in 2000, and the C-Cube semiconductor business (acquired by LSI Logic in June 2001) collaborated on the production and development of two video encoding microelectronic chips prior to our acquisition of the DiviCom business. In connection with the acquisition, we have entered into a contractual relationship with the spun-off semiconductor business of C-Cube, under which we have access to certain of the spun-off semiconductor business technologies and products on which the DiviCom business depends for certain

Table of Contents

product and service offerings. The current term of this agreement is through October 2009, with automatic annual renewals unless terminated by either party in accordance with the agreement provisions. On July 27, 2007, LSI announced that it had completed the sale of its consumer products business (which includes the design and manufacture of encoding chips) to Magnum Semiconductor, and the agreement providing us with access to certain of the spun-off semiconductor business technologies and products was assigned to Magnum Semiconductor. If the spun-off semiconductor business is not able to or does not sustain its development and production efforts in this area, our business, financial condition, results of operations and cash flow could be harmed.

We need to effectively manage our operations and the cyclical nature of our business.

The cyclical nature of our business has placed, and is expected to continue to place, a significant strain on our personnel, management and other resources. We reduced our work force by approximately 44% between December 31, 2000 and December 31, 2003 due to reduced industry spending and demand for our products. If demand for products increases significantly, we may need to increase our headcount, as we did during 2004, adding 33 employees. In the first quarter of 2005, we added 42 employees in connection with our acquisition of BTL, and in connection with the consolidation of our two operating divisions in December 2005, we reduced our workforce by approximately 40 employees. Following the closure of our BTL operations in the first quarter of 2007, we reduced our headcount by 29 employees in the UK. Our purchase of the video networking software business of Entone in December 2006 resulted in the addition of 43 employees, most of whom are based in Hong Kong, and we added approximately 18 employees on July 31, 2007, in connection with the completion of our acquisition of Rhozet. Our ability to manage our business effectively in the future, including any future growth, will require us to train, motivate and manage our employees successfully, to attract and integrate new employees into our overall operations, to retain key employees and to continue to improve our operational, financial and management systems.

We are subject to various environmental laws and regulations that could impose substantial costs upon us and may adversely affect our business, operating results and financial condition.

Some of our operations use substances regulated under various federal, state, local and international laws governing the environment, including those governing the management, disposal and labeling of hazardous substances and wastes and the cleanup of contaminated sites. We could incur costs and fines, third-party property damage or personal injury claims, or could be required to incur substantial investigation or remediation costs, if we were to violate or become liable under environmental laws. The ultimate costs under environmental laws and the timing of these costs are difficult to predict.

We also face increasing complexity in our product design as we adjust to new and future requirements relating to the presence of certain substances in electronic products and making producers of those products financially responsible for the collection, treatment, recycling, and disposal of certain products. For example, the European Parliament and the Council of the European Union have enacted the Waste Electrical and Electronic Equipment (WEEE) directive, which regulates the collection, recovery, and recycling of waste from electrical and electronic products, and the Restriction on the Use of Certain Hazardous Substances in Electrical and Electronic Equipment (RoHS) directive, which bans the use of certain hazardous materials including lead, mercury, cadmium, hexavalent chromium, and polybrominated biphenyls (PBBs), and polybrominated diphenyl ethers (PBDEs) that exceed certain specified levels. Legislation similar to RoHS and WEEE has been or may be enacted in other jurisdictions, including in the United States, Japan, and China. Our failure to comply with these laws could result in our being directly or indirectly liable for costs, fines or penalties and third-party claims, and could jeopardize our ability to conduct business in such countries. We also expect that our operations will be affected by other new environmental laws and regulations on an ongoing basis. Although we cannot predict the ultimate impact of any such new laws and regulations, they will likely result in additional costs or decreased revenue, and could require that we redesign or change how we manufacture our products, any of which could have a material adverse effect on our business.

We are liable for C-Cube s pre-merger liabilities, including liabilities resulting from the spin-off of its semiconductor business.

Under the terms of the merger agreement with C-Cube, we are generally liable for C-Cube s pre-merger liabilities. As of September 26, 2008, approximately $1.8 million of pre-merger liabilities remained outstanding and are included in accrued liabilities. We are working with LSI Logic, which acquired C-Cube s spun-off semiconductor

49

Table of Contents

business in June 2001 and assumed its obligations, to develop an approach to settle these obligations, a process which has been underway since the merger in 2000. These liabilities represent estimates of C-Cube s pre-merger obligations to various authorities in six countries. We paid $4.8 million to satisfy a portion of this liability in the first quarter of 2008, but are unable to predict when the remaining obligations will be paid. The full amount of the estimated obligations has been classified as a current liability. To the extent that these obligations are finally settled for less than the amounts provided, we are required, under the terms of the merger agreement, to refund the difference to LSI Logic. Conversely, if the settlements are more than the remaining $1.8 million pre-merger liability, LSI Logic is obligated to reimburse us.

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

We rely on value-added resellers and systems integrators for a substantial portion of our sales, and disruptions to, or our failure to develop and manage our relationships with these customers and the processes and procedures that support them could adversely affect our business.

We generate a substantial portion of our sales through net sales to value-added resellers, or VARs, and systems integrators. We expect that these sales will continue to generate a substantial percentage of our net sales in the future. Our future success is highly dependent upon establishing and maintaining successful relationships with a variety of VARs and systems integrators that specialize in video delivery solutions, products and services.

We have no long-term contracts or minimum purchase commitments with any of our VAR or system integrator customers, and our contracts with these parties do not prohibit them from purchasing or offering products or services that compete with ours. Our competitors may be effective in providing incentives to our VAR and systems integrator customers to favor their products or to prevent or reduce sales of our products. Our VAR or systems integrator customers may choose not to purchase or offer our products. Our failure to establish and maintain successful relationships with VAR and systems integrator customers would likely materially and adversely affect our business, operating results and financial condition.

Our failure to adequately protect our proprietary rights may adversely affect us.

We currently hold 40 issued U.S. patents and 18 issued foreign patents, and have a number of patent applications pending. Although we attempt to protect our intellectual property rights through patents, trademarks, copyrights, licensing arrangements, maintaining certain technology as trade secrets and other measures, we cannot assure you that any patent, trademark, copyright or other intellectual property rights owned by us will not be invalidated, circumvented or challenged, that such intellectual property rights will provide competitive advantages to us or that any of our pending or future patent applications will be issued with the scope of the claims sought by us, if at all. We cannot assure you that others will not develop technologies that are similar or superior to our technology, duplicate our technology or design around the patents that we own. In addition, effective patent, copyright and trade secret protection may be unavailable or limited in certain foreign countries in which we do business or may do business in the future.

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

50

Table of Contents

operating results, financial position or cash flows.

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

Our products include third-party technology and intellectual property, and our inability to use that technology in the future could harm our business.

We incorporate certain third-party technologies, including software programs, into our products, and intend to utilize additional third-party technologies in the future. Licenses to relevant third-party technologies or updates to those technologies may not continue to be available to us on commercially reasonable terms, or at all. In addition, the technologies that we license may not operate properly and we may not be able to secure alternatives in a timely manner, which could harm our business. We could face delays in product releases until alternative technology can be identified, licensed or developed, and integrated into our products, if we are able to do so at all. These delays, or a failure to secure or develop adequate technology, could materially and adversely affect our business.

We or our customers may face intellectual property infringement claims from third parties.

Our industry is characterized by the existence of a large number of patents and frequent claims and related litigation regarding patent and other intellectual property rights. In particular, leading companies in the telecommunications industry have extensive patent portfolios. From time to time, third parties have asserted and may assert patent, copyright, trademark and other intellectual property rights against us or our customers. Our suppliers and customers may have similar claims asserted against them. A number of third parties, including companies with greater financial and other resources than us, have asserted patent rights to technologies that are important to us. Any future litigation, regardless of its outcome, could result in substantial expense and significant diversion of the efforts of our management and technical personnel. An adverse determination in any such proceeding could subject us to significant liabilities, temporary or permanent injunctions or require us to seek licenses from third parties or pay royalties that may be substantial. Furthermore, necessary licenses may not be available on satisfactory terms, or at all.

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of our products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint sought injunctive relief, royalties and damages. On August 6, 2007, the District Court granted our motion to dismiss. The plaintiffs appealed this motion and on June 19, 2008 the U.S. Court of Appeals for the Federal Circuit issued a decision which vacated the District Court s decision and remanded for further proceedings. At a scheduling conference on October 6, 2008, 2008 the judge ordered the parties to mediation. A mediation session is scheduled for November 4, 2008. An unfavorable outcome on any of these litigation matters could require that Harmonic pay substantial damages, or, in connection with any intellectual property infringement claims, could require that we pay ongoing royalty payments or could prevent us from selling certain of our products. A settlement or an unfavorable outcome of this or any other litigation matter could have a material adverse effect on our business, operating results, financial position or cash flows.

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

We are the subject of litigation which, if adversely determined, could harm our business and operating results.

On July 3, 2003, Stanford University and Litton Systems filed a complaint in U.S. District Court for the Central District of California alleging that optical fiber amplifiers incorporated into certain of our products infringe U.S. Patent No. 4859016. This patent expired in September 2003. The complaint sought injunctive relief, royalties and

Table of Contents

damages. On August 6, 2007, the District Court granted our motion to dismiss. The plaintiffs appealed this motion and on June 19, 2008 the U.S. Court of Appeals for the Federal Circuit issued a decision which vacated the District Court s decision and remanded for further proceedings. At a scheduling conference on October 6, 2008, the judge ordered the parties to mediation. A mediation session is scheduled for November 4, 2008.

In addition, we are involved in other litigation and may be subject to claims arising in the normal course of business. An unfavorable outcome of any of this or any other litigation matter could require that we pay substantial damages, or, in connection with any intellectual property infringement claims, could require that we pay ongoing royalty payments or could prevent us from selling certain of our products. In addition, we may decide to settle any litigation, which could cause us to incur significant costs. A settlement or an unfavorable outcome on this or any other litigation matter could have a material adverse effect on our business, operating results, financial position or cash flows.

We have reached a tentative agreement to settle certain outstanding securities class action claims which is subject to certain contingencies, including final execution of a definitive settlement agreement, funding by our insurers, and court approval.

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

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

Following a series of procedural actions at the District Court and at the United States Court of Appeals for the Ninth Circuit, a significant number of the claims alleged in the plaintiffs amended complaint were dismissed, including all claims against C-Cube and its officers and directors.

However, certain of the plaintiffs claims survived dismissal. In January 2007, the District Court set a trial date for August 2008, and also ordered the parties to participate in mediation. A derivative action purporting to be on our behalf was filed in the Superior Court for the County of Santa Clara against certain current and former officers and directors on May 15, 2003. It alleges facts similar to those alleged in the securities class action and names us as a nominal defendant. The action remains pending with no trial date set.

As a result of discussions and negotiations between plaintiffs counsel and Harmonic, and Harmonic and its insurance carriers, an agreement was reached in March 2008 to resolve the securities class action lawsuit. This agreement releases Harmonic, its officers, directors and insurance carriers from all claims brought in the lawsuit by the plaintiffs against Harmonic or its officers and directors, without any admission of fault on the part of Harmonic or its officers and directors. On October 29, 2008, the District Court issued a final order granting approval of the settlement agreement.

In the derivative action, recent discussions between the plaintiffs counsel and Harmonic have resulted in a tentative agreement which will require no payments by the Company or its officers and directors. If finalized, this tentative agreement will release Harmonic s officers and directors from all claims brought in the derivative lawsuit. This tentative agreement remains subject to certain contingencies, including negotiation and execution by the parties of a written settlement agreement and final approval by the District Court. A hearing to grant final approval is scheduled for December 19, 2008.

Table of Contents

Under the terms of the agreement to settle the securities class action lawsuit, Harmonic and its insurance carriers will pay $15.0 million in consideration to the plaintiffs in the securities class action. Of this amount, Harmonic will pay $5.0 million, and Harmonic s insurance carriers, in addition to having funded most litigation costs, will contribute the remaining $10.0 million on behalf of the individual defendants. The plaintiffs lawyers have applied for an award of fees and costs in an unspecified amount to be paid from the $15.0 million in consideration and subject to the approval of the District Court. In addition, Harmonic estimates that it has paid or will pay approximately $1.4 million in related legal fees and expenses in connection with proceedings in the securities class action and derivative lawsuits. Harmonic paid its share of the settlement consideration into escrow on August 5, 2008.

There can be no assurance that the settlements will be finalized and that definitive settlement agreements will be executed by the parties, either on the terms set forth above or at all. Further, even if we execute definitive settlement agreements, we cannot be certain that the courts will approve the settlements or that all conditions necessary to effectuate the settlements will occur. If definitive settlement agreements are not executed by the parties and approved by the courts, or if for any reason the settlement does not become final, Harmonic and its officers and directors will be required to continue to defend themselves in the securities class action litigation and/or the derivative litigation. An adverse verdict in a trial could require that we pay substantial damages. Any subsequent attempt to settle the litigation matters could be on terms less favorable to Harmonic than those set forth in the tentative agreements described above. A subsequent settlement of the securities class action or derivative action on terms that are different from those outlined above, or an unfavorable outcome of the securities class action or derivative litigation, could have a material adverse effect on our business, operating results, financial position or cash flows.

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

Our products are subject to U.S. export controls and may be exported outside the United States only with the required level of export license or through an export license exception, in most cases because we incorporate encryption technology into our products. In addition, various countries regulate the import of certain technology and have enacted laws that could limit our ability to distribute our products or could limit our customers ability to implement our products in those countries. Changes in our products or changes in export and import regulations may create delays in the introduction of our products in international markets, prevent our customers with international operations from deploying our products throughout their global systems or, in some cases, prevent the export or import of our products to certain countries altogether. Any change in export or import regulations or related legislation, shift in approach to the enforcement or scope of existing regulations, or change in the countries, persons or technologies targeted by such regulations, could result in decreased use of our products by, or in our decreased ability to export or sell our products to, existing or potential customers internationally.

In addition, we may be subject to customs duties and export quotas, which could have a significant impact on our revenue and profitability. While we have not encountered significant difficulties in connection with the sales of our products in international markets, the future imposition of significant increases in the level of customs duties or export quotas could have a material adverse effect on our business.

The terrorist attacks of 2001 and the ongoing threat of terrorism have created great uncertainty and may continue to harm our business.

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

Table of Contents

We rely on a continuous power supply to conduct our operations, and any electrical and natural gas crisis could disrupt our operations and increase our expenses.

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

The markets in which we, our customers and our suppliers operate are subject to the risk of earthquakes and other natural disasters.

Our headquarters and the majority of our operations are located in California, which is prone to earthquakes, and some of the other locations in which we, our customers and suppliers conduct business are prone to natural disasters. In the event that any of our business centers are affected by any such disasters, we may sustain damage to our operations and properties and suffer significant financial losses. Furthermore, we rely on third-party manufacturers for the production of many of our products, and any disruption in the business or operations of such manufacturers could adversely impact our business. In addition, if there is a major earthquake or other natural disaster in any of the locations in which our significant customers are located, we face the risk that our customers may incur losses, or sustained business interruption and/or loss which may materially impair their ability to continue their purchase of products from us. A major earthquake or other natural disaster in the markets in which we, our customers or suppliers operate could have a material adverse effect on our business, financial condition, results of operations or cash flows.

Some anti-takeover provisions contained in our certificate of incorporation, bylaws and stockholder rights plan, as well as provisions of Delaware law, could impair a takeover attempt.

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

- authorizing blank check preferred stock, which could be issued with voting, liquidation, dividend and other rights superior to our common stock;
- limiting the liability of, and providing indemnification to, our directors and officers;
- limiting the ability of our stockholders to call and bring business before special meetings;
- requiring advance notice of stockholder proposals for business to be conducted at meetings of our stockholders and for nominations of candidates for election to our Board of Directors;
- controlling the procedures for conduct and scheduling of Board and stockholder meetings; and
- providing the Board of Directors with the express power to postpone previously scheduled annual meetings and to cancel previously scheduled special meetings.

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

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

Table of Contents

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

Any provision of our certificate of incorporation or bylaws, our stockholder rights plan or Delaware law that has the effect of delaying or deterring a change in control could limit the opportunity for our stockholders to receive a premium for their shares of our common stock, and could also affect the price that some investors are willing to pay for our common stock.

Our common stock price may be extremely volatile, and the value of your investment may decline.

Our common stock price has been highly volatile. We expect that this volatility will continue in the future due to factors such as:

- general market and economic conditions;
- actual or anticipated variations in operating results;
- announcements of technological innovations, new products or new services by us or by our competitors or customers;
- changes in financial estimates or recommendations by stock market analysts regarding us or our competitors;
- announcements by us or our competitors of significant acquisitions, strategic partnerships, joint ventures or capital commitments;
- announcements by our customers regarding end market conditions and the status of existing and future infrastructure network deployments;
- additions or departures of key personnel; and
- future equity or debt offerings or our announcements of these offerings.

In addition, in recent years, the stock market in general, and the NASDAQ Stock Market and the securities of technology companies in particular, have experienced extreme price and volume fluctuations. These fluctuations have often been unrelated or disproportionate to the operating performance of individual companies. These broad market fluctuations have in the past and may in the future materially and adversely affect our stock price, regardless of our operating results. Investors may be unable to sell their shares of our common stock at or above the purchase price.

Our stock price may decline if additional shares are sold in the market.

Future sales of substantial amounts of shares of our common stock by our existing stockholders in the public market, or the perception that these sales could occur, may cause the market price of our common stock to decline. In addition, we may be required to issue additional shares upon exercise of previously granted options that are currently outstanding. Increased sales of our common stock in the market after exercise of currently outstanding options could exert significant downward pressure on our stock price. These sales also might make it more difficult for us to sell equity or equity-related securities in the future at a time and price we deem appropriate.

If securities analysts do not continue to publish research or reports about our business, or if they downgrade our stock, the price of our stock could decline.

The trading market for our common stock relies in part on the availability of research and reports that third-party industry or financial analysts publish about us. Further, if one or more of the analysts who do cover us downgrade our stock, our stock price may decline. If one or more of these analysts cease coverage of us, we could lose visibility in the market, which in turn could cause the liquidity of our stock and our stock price to decline.

Table of Contents

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

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

None.

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

None

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

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

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15 (d) of the Securities Exchange Act of 1934, the Registrant, Harmonic Inc., a Delaware corporation, has duly caused this Quarterly Report on Form 10-Q to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Sunnyvale, State of California, on November 4, 2008.

HARMONIC INC.

By: /s/ Robin N. Dickson

Robin N. Dickson Chief Financial Officer
(Principal Financial and Accounting Officer)

Table of Contents

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