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**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

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**FORM 10-Q**

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

**For the quarterly period ended March 31, 2005  
Commission File Number 000-30229**

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**SONUS NETWORKS, INC.**

(Exact name of Registrant as specified in its charter)

**DELAWARE**

(State or other jurisdiction of  
incorporation or organization)

**04-3387074**

(I.R.S. employer identification no.)

**250 Apollo Drive, Chelmsford, Massachusetts 01824**

(Address of principal executive offices, including zip code)

**(978) 614-8100**

(Registrant's telephone number, including area code)

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  No

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes  No

As of April 30, 2005, there were 248,181,487 shares of \$0.001 par value per share, common stock outstanding.

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FORM 10-Q  
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## Item 1: Financial Statements

## SONUS NETWORKS, INC.

## Condensed Consolidated Balance Sheets

(In thousands, except share data)

	March 31, 2005	December 31, 2004
	(unaudited)	
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 123,115	\$ 121,931
Marketable securities	180,709	170,145
Accounts receivable, net	27,631	32,486
Inventory, net	31,256	28,346
Other current assets	11,653	10,891
	<u>374,364</u>	<u>363,799</u>
Total current assets	374,364	363,799
Property and equipment, net	11,145	8,217
Long-term investments	7,488	21,029
Other assets	864	783
	<u>\$ 393,861</u>	<u>\$ 393,828</u>
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 9,988	\$ 8,654
Accrued expenses	16,954	18,240
Accrued restructuring expenses	189	186
Current portion of deferred revenue	69,267	65,105
Current portion of long-term liabilities	25	30
	<u>96,423</u>	<u>92,215</u>
Total current liabilities	96,423	92,215
Long-term deferred revenue, net of current portion	22,746	25,960
Long-term liabilities, net of current portion	614	613
Convertible subordinated note	10,000	10,000
Commitments and contingencies (Note 5)		
<b>Stockholders' equity:</b>		
Preferred stock, \$0.01 par value; 5,000,000 shares authorized, none issued and outstanding	—	—
Common stock, \$0.001 par value; 600,000,000 shares authorized, 250,473,969 and 249,755,118 shares issued and 248,177,059 and 247,458,208 shares outstanding at March 31, 2005 and December 31, 2004	250	250
Capital in excess of par value	1,051,875	1,049,142
Accumulated deficit	(787,780)	(784,085)
Treasury stock, at cost; 2,296,910 common shares at March 31, 2005 and December 31, 2004	(267)	(267)
	<u>264,078</u>	<u>265,040</u>
Total stockholders' equity	264,078	265,040
	<u>\$ 393,861</u>	<u>\$ 393,828</u>

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

**SONUS NETWORKS, INC.**  
**Condensed Consolidated Statements of Operations**  
(In thousands, except per share data)  
(unaudited)

	Three months ended March 31,	
	2005	2004
<b>Revenues:</b>		
Product	\$ 22,458	\$ 26,245
Service	11,152	10,287
Total revenues	33,610	36,532
<b>Cost of revenues (1):</b>		
Product	6,843	8,141
Service	5,269	4,259
Total cost of revenues	12,112	12,400
<b>Gross profit</b>	<b>21,498</b>	<b>24,132</b>
<b>Operating expenses:</b>		
Research and development (1)	11,017	8,928
Sales and marketing (1)	9,027	6,860
General and administrative (1)	6,800	4,827
Stock-based compensation	—	379
Amortization of purchased intangible assets	—	600
Total operating expenses	26,844	21,594
<b>Income (loss) from operations</b>	<b>(5,346)</b>	<b>2,538</b>
Interest expense	(128)	(122)
Interest income	1,875	765
<b>Income (loss) before income taxes</b>	<b>(3,599)</b>	<b>3,181</b>
Provision for income taxes	96	167
<b>Net income (loss)</b>	<b>\$ (3,695)</b>	<b>\$ 3,014</b>
<b>Net income (loss) per share:</b>		
Basic	\$ (0.01)	\$ 0.01
Diluted	\$ (0.01)	\$ 0.01
<b>Shares used in computing net income (loss) per share:</b>		
Basic	247,877	244,607
Diluted	247,877	255,592

(1) Excludes non-cash, stock-based compensation expense as follows:

Cost of revenues	\$ —	\$ 4
Research and development	—	110
Sales and marketing	—	211
General and administrative	—	54
	\$ —	\$ 379

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

**SONUS NETWORKS, INC.**  
**Condensed Consolidated Statements of Cash Flows**  
(In thousands)  
(unaudited)

	Three months ended March 31,	
	2005	2004
<b>Cash flows from operating activities:</b>		
Net income (loss)	\$ (3,695)	\$ 3,014
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation	1,476	1,632
Stock-based compensation	—	379
Amortization of purchased intangible assets	—	600
Changes in current assets and liabilities:		
Accounts receivable	4,855	(8,308)
Inventory	(2,910)	(1,553)
Other current assets	(762)	(1,455)
Accounts payable	1,334	2,403
Accrued expenses	(1,330)	(1,169)
Deferred revenue	948	7,760
	(84)	3,303
Net cash provided by (used in) operating activities	(84)	3,303
<b>Cash flows from investing activities:</b>		
Purchases of property and equipment	(4,303)	(2,230)
Maturities of marketable securities	35,621	29,187
Purchases of marketable securities	(32,644)	(13,277)
Other assets	(81)	136
	(1,407)	13,816
Net cash provided by (used in) investing activities	(1,407)	13,816
<b>Cash flows from financing activities:</b>		
Sale of common stock in connection with employee stock purchase plan	2,313	796
Proceeds from exercise of stock options	420	400
Payments of long-term liabilities	(58)	(59)
	2,675	1,137
Net cash provided by financing activities	2,675	1,137
<b>Net increase in cash and cash equivalents</b>	1,184	18,256
<b>Cash and cash equivalents, beginning of period</b>	121,931	133,715
<b>Cash and cash equivalents, end of period</b>	\$ 123,115	\$ 151,971
<b>Supplemental disclosure of cash flow information:</b>		
Cash paid for interest expense	\$ 2	\$ 3
Cash paid for taxes	\$ 551	\$ 147

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

Notes to Condensed Consolidated Financial Statements

(unaudited)

**(1) Description of Business**

Sonus Networks, Inc. (Sonus) was incorporated on August 7, 1997 and is a leading provider of packet voice infrastructure solutions for wireline and wireless service providers. Sonus offers a new generation of carrier-class switching equipment and software that enable telecommunications service providers to deliver voice services over packet-based networks.

**(2) Summary of Significant Accounting Policies**

The accompanying consolidated financial statements reflect the application of certain significant accounting policies as described in this note and elsewhere in the accompanying consolidated financial statements and notes.

***(a) Basis of Presentation and Principles of Consolidation***

The accompanying unaudited consolidated financial statements have been prepared by Sonus and reflect all adjustments, consisting only of normal recurring adjustments that in the opinion of management are necessary for a fair presentation of the results and financial position for the interim periods. The unaudited consolidated financial statements have been prepared in accordance with the regulations of the Securities and Exchange Commission (SEC), and omit or condense certain information and footnote disclosures pursuant to existing SEC rules and regulations. Results for the interim periods are not necessarily indicative of results to be expected for any other interim period or for the entire fiscal year. These statements should be read in conjunction with the consolidated financial statements and related notes included in Sonus' Annual Report on Form 10-K for the year ended December 31, 2004.

The accompanying consolidated financial statements include the accounts of Sonus and its wholly owned subsidiaries. All material intercompany transactions and balances have been eliminated.

Certain reclassifications have been made to the consolidated financial statements for the year ended December 31, 2004 in order to conform to the March 31, 2005 presentation.

***(b) Use of Estimates and Judgments***

The preparation of financial statements in conformity with generally accepted accounting principles 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 revenues and expenses during the reporting periods. Significant estimates and judgments relied upon in preparing these financial statements include revenue recognition for multiple element arrangements, allowances for doubtful accounts, estimated fair value of investments, inventory reserves, expected future cash flows used to evaluate the recoverability of long-lived assets, restructuring and other related charges, contingencies associated with revenue contracts, contingent liabilities, and recoverability of Sonus' net deferred tax assets and related valuation allowance. Although Sonus regularly assesses these estimates, actual results could differ materially from these estimates. Changes in estimates are recorded in the period in which they become known. Sonus bases its estimates on historical experience and various other assumptions that it believes to be reasonable under the circumstances. Actual results may differ from Sonus' estimates if past experience or other assumptions do not turn out to be substantially accurate.

**(c) Cash Equivalents, Marketable Securities and Long-Term Investments**

Cash equivalents are stated at cost plus accrued interest, which approximates market value, and have remaining maturities of three months or less at the date of purchase.

Marketable securities are classified as held-to-maturity, as Sonus has the intent and ability to hold to maturity. Marketable securities are reported at amortized cost. Cash equivalents and marketable securities are invested in high quality credit instruments, primarily U.S. Government, municipal and corporate obligations. Current marketable securities have remaining contractual maturities of less than one year as of the balance sheet date. There have been no material gains or losses to date.

Long-term investments consist of high-quality credit instruments, primarily U.S. Government and corporate obligations with remaining maturities of greater than one year as of the balance sheet date.

**(d) Concentrations of Credit and Off-Balance Sheet Risk, Significant Customers and Limited Suppliers**

The financial instruments that potentially subject Sonus to concentrations of credit risk are cash, cash equivalents, marketable securities, accounts receivable and long-term investments. Sonus has no off-balance sheet arrangements such as foreign exchange contracts, options contracts or other foreign hedging arrangements. Sonus' cash, cash equivalent and investment portfolio holdings are diversified among four financial institutions.

For the three months ended March 31, 2005 and 2004, two and three customers each contributed 10% or more of Sonus' revenues, representing an aggregate of 40% and 67% of total revenues, respectively. The following customers contributed 10% or more of Sonus' revenues for the three months ended March 31, 2005 and 2004:

	Three months ended March 31,	
	2005	2004
<b>Customer:</b>		
Global Crossing	25%	*%
Level 3 Communications	15	*
Verizon Global Networks	*	30
Softbank Broadband Corporation	*	26
Qwest Communications	*	11

\* Less than 10%.

As of March 31, 2005 and December 31, 2004, one and two customers each accounted for more than 10% of Sonus' accounts receivable balance, representing an aggregate of 14% and 53% of total accounts receivable as of these dates. Sonus performs ongoing credit evaluations of its customers and generally does not require collateral on accounts receivable. Sonus maintains an allowance for doubtful accounts and credit losses have been within management's expectations.

International revenues, primarily from Asia and Europe, were 12% and 29% of revenues for the quarters ended March 31, 2005 and 2004.

Certain components and software licenses from third parties used in Sonus' products are procured from a single source. The failure of a supplier, including a subcontractor, to deliver on schedule could

delay or interrupt Sonus' delivery of products and thereby materially adversely affect Sonus' revenues and operating results.

**(e) Accounts Receivable**

Accounts receivable consist of the following, in thousands:

	<b>March 31, 2005</b>	<b>December 31, 2004</b>
Earned accounts receivable	\$ 8,175	\$ 9,088
Unearned accounts receivable	19,939	23,807
Accounts receivable, gross	28,114	32,895
Allowance for doubtful accounts	(483)	(409)
Accounts receivable, net	\$ 27,631	\$ 32,486

Unearned accounts receivable represent products shipped to customers where Sonus has a contractual right to bill the customer and collectibility is probable under ordinary collection terms prior to satisfying Sonus' revenue recognition criteria. The allowance for doubtful accounts is based on Sonus' detailed assessment of the collectibility of specific customer accounts.

**(f) Inventory**

Inventory consists of the following, in thousands:

	<b>March 31, 2005</b>	<b>December 31, 2004</b>
On-hand final assemblies and finished goods inventory	\$ 15,639	\$ 18,725
Unearned inventory	19,292	14,054
Evaluation inventory	4,922	6,107
Inventory, gross	39,853	38,886
Excess, obsolete and evaluation reserve	(8,597)	(10,540)
Inventory, net	\$ 31,256	\$ 28,346

Unearned inventory represents deferred cost of revenues for product shipments prior to satisfaction of Sonus' revenue recognition criteria.

Sonus values inventory at the lower of cost or net realizable value and provides inventory reserves based on excess and obsolete inventory determined primarily by future demand forecasts and records adjustments to such reserves through charges to cost of revenues. Sonus also records a full inventory reserve for evaluation equipment at the time of shipment to its customers as a charge to sales and marketing expense as Sonus' experience with this type of inventory indicates it is probable that the inventory will not be realizable. If these evaluation shipments should convert to revenue, Sonus records a benefit to sales and marketing expense and records the full cost of revenues in the period of revenue recognition.



**(g) Property and Equipment**

Property and equipment are stated at cost, net of accumulated depreciation. Expenditures for maintenance and repairs are charged to expense as incurred. Depreciation is computed using the straight-line method over the estimated useful life of the related assets, which range from two to five years. Leasehold improvements are amortized over the lesser of the life of the lease or five years. When an item is sold or retired, the cost and related accumulated depreciation is relieved, and the resulting gain or loss, if any, is recognized in the statement of operations.

**(h) Deferred Revenue**

Deferred revenue consists of the following, in thousands:

	<u>March 31, 2005</u>	<u>December 31, 2004</u>
Maintenance and support contracts	\$ 49,270	\$ 44,859
Customer deposits	22,804	22,399
Unearned revenue	19,939	23,807
	<u>92,013</u>	<u>91,065</u>
Total deferred revenue	92,013	91,065
Less current portion	(69,267)	(65,105)
	<u>22,746</u>	<u>25,960</u>
Long-term deferred revenue	\$ 22,746	\$ 25,960

Maintenance and support contracts are recognized ratably over the life of the service contract. Customer deposits represent payments received in advance of revenue recognition. Unearned revenue represents billings for which payment has not been received and revenue recognition criteria have not been met. As of March 31, 2005 and December 31, 2004, deferred revenue and accounts receivable excluded \$16.8 million and \$6.5 million related to products shipped and billed to customers which are collectible under extended payment terms or for which revenue is recognized as cash is collected. Such amounts will be recorded pursuant to Sonus' revenue recognition policy.

**(k) Revenue Recognition**

Sonus recognizes revenue from product sales when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed and determinable, and collectibility of the related receivable is probable under ordinary payment terms. When Sonus has future obligations, including a requirement to deliver additional elements which are essential to the functionality of the delivered elements or for which vendor specific objective evidence of fair value (VSOE) does not exist or customer acceptance is required, Sonus defers revenue recognition and related costs until those obligations are satisfied. The ordering patterns and sales lead times associated with customer orders may vary significantly from period to period.

Many of Sonus' sales are generated from complex contractual arrangements which require significant revenue recognition judgments, particularly in the case of multiple element arrangements. When a sale involves multiple elements, such as products, maintenance or professional services, Sonus allocates the entire sales price to each respective element based on VSOE or using the residual method when VSOE cannot be established for a single delivered element in the arrangement. Sonus then recognizes revenue on each element in accordance with its policies for revenue recognition related to each element. Sonus determines VSOE based upon the price charged when the same element is sold

separately. If Sonus cannot establish VSOE for each undelivered element, it defers revenue recognition on the entire arrangement until the earlier of the establishment of VSOE or delivery of the undelivered element.

In addition, if an arrangement with a customer includes a specified upgrade right for which VSOE cannot be established, Sonus defers all revenue related to the arrangement until the earlier of the delivery of the specified upgrade or the establishment of VSOE for the specified upgrade. Sonus has concluded that a specified upgrade exists if it is included in the customer contract or otherwise becomes part of the arrangement with the customer. Sonus has concluded that communications with customers in the normal course of business regarding customer feature requests and Sonus' product plans do not create specified upgrade rights.

Maintenance and support services are recognized ratably over the life of the maintenance and support service period, which typically is one year when the services are sold separately and up to five years when the fees for the services are bundled with the product fees as part of a multiple element arrangement, following recognition of the related product revenue. Maintenance and support services include telephone support and unspecified rights to product upgrades and enhancements. Maintenance and support VSOE represents a consistent percentage of the sales prices charged to customers, and is dependent upon the size of the installed base of Sonus product at the customer. The application of judgment could affect the continued determination of maintenance and support VSOE and Sonus' ability to recognize revenue using the residual method.

Installation service revenues are generally recognized at the time of the related product revenue recognition as installation is typically complete by such time. Professional services are typically recognized as the services are performed.

Sonus sells the majority of its products directly to end-users. For products sold through resellers and distributors, Sonus recognizes revenue on a sell-through method utilizing information provided to Sonus from its resellers and distributors.

Sonus records deferred revenue for product shipped to customers and related services where amounts are billed pursuant to a contractual right and collection is probable, or collected, in the ordinary course of business if the revenue recognition criteria have not been satisfied. Deferred revenues include customer deposits and amounts associated with maintenance contracts. Deferred revenues expected to be recognized as revenue more than one year of the balance sheet date are classified as long-term deferred revenues.

Sonus defers recognition of incremental direct costs, such as cost of goods, royalties, commissions and third-party installation costs, until satisfaction of the criteria for recognition of the related revenue.

#### ***(1) Software Development Costs***

Sonus accounts for its software development costs in accordance with Statement of Financial Accounting Standards (SFAS) No. 86, *Accounting for the Costs of Computer Software to Be Sold, Leased or Otherwise Marketed*. Accordingly, the costs for the development of new software and substantial enhancements to existing software are expensed as incurred until technological feasibility has been established, at which time any additional costs would be capitalized. Sonus has determined that technological feasibility is established at the time a working model of the software is completed.

Because Sonus believes its current process for developing software is essentially completed concurrently with the establishment of technological feasibility, no costs have been capitalized to date.

**(m) Stock-based Compensation**

SFAS No. 123, *Accounting for Stock-Based Compensation*, provides that companies may account for stock-based compensation under either the fair value-based method of accounting under SFAS No. 123 or the intrinsic value-based method provided by Accounting Principles Board (APB) No. 25, *Accounting for Stock Issued to Employees*. Sonus uses the intrinsic value-based method of APB No. 25 to account for all of its employee stock-based compensation plans and uses the fair value method of SFAS No. 123 to account for all non-employee stock-based compensation. Sonus follows Financial Interpretation No. (FIN) 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans* and amortizes the intrinsic value for all awards as measured under APB No. 25 on an accelerated basis. SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123*, requires companies following APB No. 25 to make pro forma disclosure in the notes to the consolidated financial statements using the measurement provisions of SFAS No. 123.

Sonus has computed the pro forma disclosures required under SFAS No. 123 for stock options granted to employees and shares purchased under the 2000 Employee Stock Purchase Plan (ESPP) using the Black Scholes option-pricing model. In valuing the stock options granted, Sonus used an assumed risk-free interest rate of 3.89% and 3% for the three months ended March 31, 2005 and 2004; volatility of 122% and 128% for the three months ended March 31, 2005 and 2004; and an expected life of four and five years for the three months ended March 31, 2005 and 2004, with the assumption that dividends will not be paid. In valuing the ESPP, Sonus used an assumed risk-free interest rate of 1.3-2.1% for the three months ended March 31, 2005, and 1%-3% for the three months ended March 31, 2004; volatility of 72-154% for the three months ended March 31, 2005 and 26%-150% for the three months ended March 31, 2004; and an expected life ranging from six months to two years, with the assumption that dividends will not be paid. The pro forma information is as follows, in thousands except per share data:

	Three months ended March 31,	
	2005	2004
<b>Net income (loss)</b>		
As reported	\$ (3,695)	\$ 3,014
Plus: Employee stock-based compensation expense included in net income (loss) under intrinsic value method related to options	—	342
Less: Employee stock-based compensation under fair value method	(10,391)	(11,670)
<b>Pro forma</b>	<b>\$ (14,086)</b>	<b>\$ (8,314)</b>
<b>Basic and diluted net income (loss) per share—</b>		
As reported	\$ (0.01)	\$ 0.01
Pro forma	\$ (0.06)	\$ (0.03)

**(n) Comprehensive Net Income (Loss)**

Sonus applies SFAS No. 130, *Reporting Comprehensive Income*. The comprehensive net income (loss) for the three months ended March 31, 2005 and 2004 does not differ from the reported net income (loss).

**(o) Fair Value of Financial Instruments**

The carrying amounts of Sonus' financial instruments, which include cash equivalents, marketable securities, long-term investments, accounts payable, long-term liabilities and the convertible subordinated note, approximate their fair value.

**(p) Disclosures about Segments of an Enterprise**

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information*, established standards for reporting information regarding operating segments and established standards for related disclosures about products and services and geographic areas. Operating segments are identified as components of an enterprise about which separate discrete financial information is available for evaluation by the chief operating decision maker in making decisions regarding resource allocation and assessing performance. To date, the chief operating decision maker has made such decisions and assessed performance at the company level.

**(q) Net Income (Loss) Per Share**

Basic net income (loss) per share is computed by dividing the net income (loss) for the period by the weighted average number of shares of unrestricted common stock outstanding during the period. Diluted net income (loss) per share is computed by dividing the net income (loss) for the period by the weighted average number of shares of unrestricted common stock and dilutive potential common shares outstanding based on the average market price of Sonus' common stock (under the treasury stock method). Dilutive potential common shares consist of restricted common stock and common stock issuable upon the exercise of stock options and conversion of a convertible subordinated note.

The following table sets forth the computation of shares used in calculating the net income (loss) per share, in thousands:

	Three months ended March 31,	
	2005	2004
Weighted average common shares outstanding	247,877	245,465
Less weighted average restricted common shares outstanding	—	(858)
Shares used in basic per share calculation	247,877	244,607
Add effect of dilutive potential common shares	—	10,985
Shares used in dilutive per share calculation	247,877	255,592

Excluded from the shares used in the calculations above are options to purchase shares of common stock and shares of common stock issuable upon conversion of a convertible subordinated note representing an aggregate of 2,709,290 shares as of March 31, 2004 as their effect would have been anti-dilutive.

***(r) Warranty Reserve***

Sonus' products are covered by a standard warranty of 90 days for software and one year for hardware. In addition, certain customer contracts include warranty-type provisions for epidemic or similar product failures, generally for the contractual period or the life of the product in accordance with published telecommunications standards. Sonus accrues for warranty obligations when the occurrence of such obligation is probable and the amount of such obligation is reasonably estimable. Sonus has not incurred significant costs related to such obligations. Sonus' customers typically purchase maintenance and support contracts, which encompass its warranty obligations. Sonus' estimates of anticipated rates of warranty claims and costs are primarily based on historical information and future forecasts.

In addition, certain of Sonus' customer contracts include provisions under which Sonus may be obligated to pay penalties generally for the contractual period or for the life of the product if Sonus' products fail or do not perform in accordance with specifications. Sonus accrues for such contingent obligations when the occurrence of such obligation is probable and the amount of such obligation is reasonably estimable. Sonus has not incurred significant costs related to such provisions. Sonus periodically assesses the adequacy of its recorded warranty liabilities and adjust the amounts as necessary. Increases in product failure rates, material usage or service delivery costs may result in increases to Sonus' warranty reserve and its gross profit could be adversely affected. As of March 31, 2005 and December 31, 2004 Sonus had no warranty reserve recorded.

***(s) Recent Accounting Pronouncements***

In October 2004, the American Jobs Creation Act of 2004 (the "AJCA") was passed. The AJCA provides a deduction for income from qualified domestic production activities, which will be phased in from 2005 through 2010. The AJCA also provides for a two-year phase-out of the existing extra-territorial income exclusion for foreign sales that was viewed to be inconsistent with international trade protocols by the European Union. In December 2004, the FASB issued FASB Staff Position ("FSP") No. 109-1, "*Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004.*" FSP 109-1 treats the deduction as a "special deduction" as described in SFAS No. 109. This special deduction has no effect on deferred tax assets and liabilities existing at the enactment date and the effect of this deduction will be reported in the same period in which the deduction is claimed by Sonus in its tax return. The AJCA also creates a temporary incentive for U.S. corporations to repatriate accumulated income earned abroad by providing an 85% dividends received deduction for certain dividends from controlled foreign corporations. This deduction is subject to a number of limitations. Sonus is currently evaluating the effects that the AJCA might have on its results of operations and financial position, and, or to what extent, Sonus might repatriate foreign earnings that have not yet been remitted to the U.S.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs, an amendment of Accounting Research Bulletin (ARB) No. 43, Chapter 4*. SFAS 151 amends the guidance in ARB No 43, Chapter 4, "Inventory Pricing" to clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. The provisions of SFAS 151 are effective for fiscal years beginning

after June 15, 2005. Sonus is evaluating the provisions of SFAS 151 and presently do not believe that its adoption will have a material impact on its financial condition, results of operations or cash flows.

In December 2004, the FASB issued SFAS 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values at the date of grant. Pro forma disclosure is no longer an alternative. SFAS 123(R) was due to be adopted in fiscal periods beginning after June 15, 2005. In April 2005, the SEC delayed the adoption of SFAS 123(R) to fiscal years beginning after June 15, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. Sonus is required to adopt SFAS 123(R) on January 1, 2006, the commencement of its first quarter of fiscal year 2006. SFAS 123(R) permits public companies to adopt its requirements using one of two methods: a "modified prospective" method, in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date, and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested on the effective date; or a "modified retrospective" method, which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption. Sonus has not yet determined which method to use in adopting SFAS 123(R). As permitted by SFAS 123, Sonus currently accounts for share-based payments to employees using APB Opinion No. 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Sonus is evaluating SFAS 123(R) and has not yet determined the amount of stock option expense that will be incurred in future periods as a result of the adoption of SFAS 123(R). The adoption of SFAS 123(R) will have no impact on Sonus' net cash flows or overall financial condition.

### **(3) Accrued Restructuring Expenses**

Commencing in the third quarter of fiscal 2001 and extending through fiscal 2002, in response to unfavorable business conditions primarily caused by significant declines in capital spending by telecommunications service providers, Sonus implemented restructuring plans designed to reduce expenses and align its cost structure with its revised business outlook. The restructuring plans included worldwide workforce reductions, consolidation of excess facilities and the write-off of excess inventory and purchase commitments.

## 2002 Restructuring Accrual

The following table summarizes the activity during the three months ended March 31, 2005 relating to Sonus' accrual for fiscal 2002 restructuring actions, in thousands:

	December 31, 2004 Accrual Balance	Cash Payments	March 31, 2005 Accrual Balance	Current Portion	Long-term Portion
Consolidation of facilities	\$ 799	\$ (45)	\$ 754	\$ 189	\$ 565

The remaining cash expenditures relating to the consolidation of excess facilities are expected to be paid through 2008.

### (4) Convertible Subordinated Note

In May 2001, Sonus completed a private placement of an aggregate principal amount of \$10,000,000 of a 4.75% convertible subordinated note, due May 1, 2006, with a customer. Interest payments are due semi-annually on May 1 and November 1 of each year through May 2006. The note may be converted by the holder into shares of Sonus' common stock at any time before its maturity or prior to its redemption or repurchase by Sonus. The conversion rate is 33.314 shares per each \$1,000 principal amount of the note, subject to adjustment in certain circumstances. After May 1, 2004, Sonus has the option to redeem all or a portion of the note at 100% of the principal amount. Also, at any time if the market price of Sonus' common stock exceeds \$60.04 per share for twenty trading days in any thirty trading-day period, Sonus may redeem this note through the issuance of shares of common stock or for cash. In the event of a change of control in Sonus, the holder at its option may require Sonus to redeem the note through the issuance of common stock or cash. Interest expense related to Sonus' convertible subordinated note was \$119,000 for both the three months ended March 31, 2005 and 2004.

### (5) Contingencies

In November 2001, a purchaser of Sonus' common stock filed a complaint in the federal district court for the Southern District of New York against Sonus, two of its officers and the lead underwriters alleging violations of the federal securities laws in connection with Sonus' initial public offering (IPO) and seeking unspecified monetary damages. The purchaser seeks to represent a class of persons who purchased Sonus' common stock between the IPO on May 24, 2000 and December 6, 2000. An amended complaint was filed in April 2002. The amended complaint alleges that Sonus' registration statement contained false or misleading information or omitted to state material facts concerning the alleged receipt of undisclosed compensation by the underwriters and the existence of undisclosed arrangements between underwriters and certain purchasers to make additional purchases in the after market. The claims against Sonus are asserted under Section 10(b) of the Securities Exchange Act of 1934 and Section 11 of the Securities Act of 1933 and against the individual defendants under Sections 11 and 15 of the Securities Act and Sections 10(b) and 20(a) of the Exchange Act. Other plaintiffs have filed substantially similar class action cases against approximately 300 other publicly traded companies and their IPO underwriters which, along with the actions against Sonus, have been transferred to a single federal judge for purposes of coordinated case management. On July 15, 2002, Sonus, together with the other issuers named as defendants in these coordinated proceedings, filed a collective motion

to dismiss the consolidated amended complaints on various legal grounds common to all or most of the issuer defendants. The plaintiffs voluntarily dismissed the claims against many of the individual defendants, including those Sonus officers named in the complaint. On February 19, 2003, the court granted a portion of the motion to dismiss by dismissing the Section 10(b) claims against certain defendants including Sonus, but denied the remainder of the motion as to the defendants. In June 2003, a special committee of Sonus' Board of Directors authorized Sonus to enter into a proposed settlement with the plaintiffs on terms substantially consistent with the terms of a Memorandum of Understanding negotiated among representatives of the plaintiffs, the issuer defendants and the insurers for the issuer defendants. On February 15, 2005, the court preliminarily approved the terms of the proposed settlement contingent on modifications to the proposed settlement. The settlement is subject to final approval by the court. No hearing date has been scheduled for final approval. It remains uncertain when the settlement will become final. Sonus does not expect that the settlement would have a material impact on its business or financial results.

Beginning in July 2002, several purchasers of Sonus' common stock filed complaints in federal district court for the District of Massachusetts against Sonus, certain officers and directors and a former officer under Sections 10(b) and 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934 (Class Action Complaints). The purchasers seek to represent a class of persons who purchased Sonus' common stock between December 11, 2000 and January 16, 2002, and seek unspecified monetary damages. The Class Action Complaints were essentially identical and alleged that Sonus made false and misleading statements about its products and business. On March 3, 2003, the plaintiffs filed a Consolidated Amended Complaint. On April 22, 2003, Sonus filed a motion to dismiss the Consolidated Amended Complaint on various grounds. On May 11, 2004, the court held oral argument on the motion, at the conclusion of which the court denied Sonus' motion to dismiss. The plaintiffs filed a motion for class certification on July 30, 2004, and Sonus filed its opposition on September 10, 2004, to which the plaintiffs replied on September 30, 2004. On February 16, 2005, the court certified the class and appointed a class representative. On March 9, 2005, the court appointed the law firm of Moulton & Gans as lead counsel. The court has requested additional briefing on the adequacy of the class representative, but has not yet held a hearing or issued a decision on the matter. Sonus believes the claims in the Consolidated Amended Complaint are without merit and that it has substantial legal and factual defenses, which it intends to pursue vigorously. There is no assurance Sonus will prevail in defending these actions.

Beginning in February 2004, a number of purported shareholder class action complaints were filed in the United States District Court for the District of Massachusetts against Sonus and certain of its current officers and directors. On June 28, 2004, the court consolidated the claims. On December 1, 2004, the lead plaintiff filed a consolidated amended complaint. The complaint asserts claims under the federal securities laws, specifically Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Sections 11, 12(a), and 15 of the Securities Act of 1933, relating to Sonus' restatement of its financial results for 2001, 2002, and the first three quarters of 2003. Specifically, the complaint alleges that Sonus issued a series of false or misleading statements to the market concerning Sonus' revenues, earnings and financial condition. Plaintiffs contend that such statements caused Sonus' stock price to be artificially inflated. The complaint seeks unspecified damages on behalf of a purported class of purchasers of Sonus' common stock during the period from March 28, 2002, through March 26, 2004. On January 28, 2005, Sonus filed a motion to dismiss the Section 10(b) and 12(a) claims and joined the



motion to dismiss the Section 11 claim filed by the individual defendants. On March 22, 2005, the plaintiff filed its opposition to the motion. A hearing on the motion in federal court has been scheduled for June 1, 2005. Sonus believes that it has substantial legal and factual defenses to the claims, which it intends to pursue vigorously. There is no assurance Sonus will prevail in defending these actions.

In February 2004, three purported shareholder derivative lawsuits were filed in the United States District Court for the District of Massachusetts against Sonus and certain of its officers and directors, naming Sonus as a nominal defendant. Also in February 2004, two-purported shareholder derivative lawsuits were filed in the business litigation session of the superior court of Suffolk County of Massachusetts against Sonus and certain of its directors and officers, also naming Sonus as a nominal defendant. The suits claim that certain of Sonus' officers and directors breached their fiduciary duties to Sonus' stockholders and to the company. The complaints are derivative in nature and do not seek relief from Sonus. However, Sonus has entered into indemnification agreements in the ordinary course of business with certain of the defendant officers and directors and may be obligated throughout the pendency of these actions to advance payment of legal fees and costs incurred by the defendants pursuant to Sonus' obligations under the indemnification agreements or applicable Delaware law. On September 27, 2004, the state court granted Sonus' motion to dismiss. On October 26, 2004, the plaintiffs filed a notice appealing the state court's dismissal of the actions. In the federal actions, on June 28, 2004, the court consolidated and stayed the three actions. On October 12, 2004, the lead plaintiff filed a consolidated amended complaint. Sonus believes that it has substantial legal and factual defenses to the federal claims and has filed a motion to dismiss based on the decision by the state court. A hearing on the motion in federal court has been scheduled for June 1, 2005. There is no assurance Sonus will prevail in defending these actions.

In December 2004, a purchaser of Sonus' common stock filed a complaint in the circuit court in Will County, Illinois, against the Company, one of its officers, and a former officer alleging misrepresentation and fraud in connection with the plaintiff's purchase of Sonus stock. The Complaint seeks unspecified damages. Sonus filed a motion to dismiss the complaint. The court ordered the plaintiff to file an amended complaint on or before May 5, 2005. Sonus believes that it has substantial legal and factual defenses to these claims, which it intends to pursue vigorously. There is no assurance Sonus will prevail in defending this action.

In June 2004, Sonus received a formal order of private investigation from the SEC. Sonus is cooperating with the investigation. There can be no assurance as to the outcome of the SEC investigation. Sonus may incur substantial costs in connection with the investigation including fines and significant legal expenses.

Sonus has been contacted by third parties, who claim that Sonus' products infringe on certain intellectual property of the third party. Sonus evaluates these claims and accrues for royalties when the amounts are probable and reasonably estimable. While Sonus believes that the amounts accrued for estimated royalties are adequate, any subsequent change in Sonus' estimates will be recorded at such time the change is probable and estimable.

## **(6) Stockholders' Equity**

### ***(a) 1997 Stock Incentive Plan***

On January 1 of each year, the aggregate number of shares of common stock available for issuance under the 1997 Stock Incentive Plan (Plan) shall increase by the lesser of (i) 5% of the outstanding shares on December 31 of the preceding year or (ii) an amount determined by the Board of Directors. As of March 31, 2005, 135,227,031 shares were authorized and 47,829,844 shares were available under the Plan for future issuance.

### ***(b) 2000 Employee Stock Purchase Plan***

On January 1 of each year, the aggregate number of shares of common stock available for purchase under the ESPP shall increase by the lesser of (i) 2% of the outstanding shares on December 31 of the preceding year or (ii) an amount determined by the Board of Directors. As of March 31, 2005, 25,290,812 shares were authorized and 20,011,984 shares were available under the ESPP for future issuance.

### ***(c) Stock-based Compensation***

Stock-based compensation expenses include the amortization of deferred employee compensation and other equity related expenses for non-employees. Sonus has valued the stock options and the issuances of restricted common stock to non-employees based upon the fair market value of the services rendered where Sonus believes the value of these services is more readily determinable than the value of the options or restricted stock.

Sonus did not record any stock-based compensation for the three months ended March 31, 2005 as all amounts had been fully amortized as of December 31, 2004. For the three months ended March 31, 2004, \$379,000 was recorded.

## Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

*This Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements, which are subject to a number of risks and uncertainties. These forward-looking statements are based on our current expectations, assumptions, estimates and projections about our industry and ourselves, and we do not undertake an obligation to update our forward-looking statements to reflect future events or circumstances. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of various factors, including the factors set forth in "Cautionary Statements" in this Quarterly Report on Form 10-Q. This discussion should be read in conjunction with the unaudited consolidated financial statements and related notes for the periods specified. Further reference should be made to our Annual Report on Form 10-K for the year ended December 31, 2004, on file with the SEC.*

### Overview

We are a leading supplier of packet voice infrastructure solutions for wireline and wireless service providers. Our products are a new generation of carrier-class switching equipment and software that enable voice services to be delivered over packet-based networks.

In 2004 and continuing into 2005, there was increased interest and activity in the market for packet-based voice infrastructure products. While it remains uncertain as to the speed and extent of the adoption of carrier packet voice infrastructure products by large carriers, we believe that over time the market opportunity for packet voice solutions is substantial. This has shown in our order activity as in the fourth quarter of fiscal 2004 we achieved record orders and in the first quarter of fiscal 2005 orders continued strong at a ratio of modestly below two times revenue. For the three months ended March 31, 2005, revenues were \$33.6 million compared to \$36.5 million in the same period in the prior year and total deferred revenue increased to \$92.0 million as of March 31, 2005 from \$91.1 million as of December 31, 2004. This variability in our quarterly revenue and operating results was caused primarily by the timing of revenue recognition and the late renewal of several annual maintenance contracts.

We sell our products primarily through a direct sales force and, in some markets, through or with the assistance of resellers and distributors. Customers' decisions to purchase our products to deploy in commercial networks involve a significant commitment of resources and a lengthy evaluation, testing and product qualification process. We believe our revenues and results of operations may vary significantly and unexpectedly from quarter to quarter as a result of long sales cycles, our expectation that customers will tend to sporadically place large orders with short lead times and the application of complex revenue recognition rules to certain transactions, which may result in customer shipments and orders from multiple quarters being recognized as revenue in one quarter. We expect to recognize revenues from a limited number of customers for the foreseeable future.

Since our inception through December 31, 2003, we incurred significant losses. As of March 31, 2005, we had an accumulated deficit of \$787.8 million. Although we achieved profitability in each quarter and on an annual basis in fiscal year 2004, we incurred a net loss for the quarter ended March 31, 2005 and may incur additional losses in future quarters and years. We have a lengthy sales cycle for our products and, accordingly, we expect to incur sales and other expenses before we realize the related revenues. We expect to continue to incur significant sales and marketing, research and development and general and administrative expenses, many of which are fixed prior to the beginning of any particular fiscal period and, as a result, we will need to generate significant revenues to maintain profitability.

## Critical Accounting Policies and Estimates

**Revenue Recognition.** We recognize revenue from product sales when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed and determinable, and collectibility of the related receivable is probable under ordinary payment terms. When we have future obligations, including a requirement to deliver additional elements which are essential to the functionality of the delivered elements or for which vendor specific objective evidence of fair value (VSOE) does not exist or customer acceptance is required, we defer revenue recognition and related costs until those obligations are satisfied. The ordering patterns and sales lead times associated with customer orders may vary significantly from period to period.

Many of our sales are generated from complex contractual arrangements which require significant revenue recognition judgments, particularly in the case of multiple element arrangements. When a sale involves multiple elements, such as products, maintenance or professional services, we allocate the entire sales price to each respective element based on VSOE or using the residual method when VSOE cannot be established for a single delivered element in the arrangement. We then recognize revenues on each element in accordance with our policies for revenue recognition related to each element. We determine VSOE based upon the price charged when the same element is sold separately. If we cannot establish VSOE for each undelivered element, we defer revenue recognition on the entire arrangement until the earlier of the establishment of VSOE or delivery of the undelivered element.

In addition, if an arrangement with a customer includes a specified upgrade right for which VSOE cannot be established, we defer all revenue related to the arrangement until the earlier of the delivery of the specified upgrade or the establishment of VSOE for the specified upgrade. We have concluded that a specified upgrade exists if it is included in the customer contract or otherwise becomes part of the arrangement with the customer. We have concluded that communications with customers in the normal course of business regarding customer feature requests and our product plans do not create specified upgrade rights.

Maintenance and support services are recognized ratably over the life of the maintenance and support service period, which typically is one year when the services are sold separately and up to five years when the fees for the services are bundled with the product fees as part of a multiple element arrangement, following recognition of the related product revenue. Maintenance and support services include telephone support and unspecified rights to product upgrades and enhancements. Maintenance and support VSOE represents a consistent percentage of the sales prices charged to customers, and is dependent upon the size of the installed base of Sonus product at the customer. The application of judgment could affect the continued determination of maintenance and support VSOE and our ability to recognize revenue using the residual method.

Installation service revenues are generally recognized at the time of the related product revenue recognition as installation is typically complete by such time. Professional services are typically recognized as the services are performed.

We sell the majority of our products directly to end-users. For products sold through resellers and distributors, we recognize revenue on a sell-through method utilizing information provided to us from our resellers and distributors.

We record deferred revenue for product shipped to customers and related services where amounts are billed pursuant to a contractual right and collection is probable, or collected, in the ordinary course of business if the revenue recognition criteria have not been satisfied. Deferred revenues include customer deposits and amounts associated with maintenance contracts. Deferred revenues expected to be recognized as revenue more than one year of the balance sheet date are classified as long-term deferred revenues.

We defer recognition of incremental direct costs, such as cost of goods, royalties, commissions and third-party installation costs, until satisfaction of the criteria for recognition of the related revenue.

**Loss Contingencies and Reserves.** We are subject to ongoing business risks arising in the ordinary course of business that affect the estimation process of the carrying value of assets, the recording of liabilities and the possibility of various loss contingencies. Under SFAS No. 5, *Accounting for Contingencies*, an estimated loss contingency is accrued when it is probable that a liability has been incurred or an asset has been impaired and the amount of loss can be reasonably estimated. We regularly evaluate current information available to determine whether such amounts should be adjusted and record changes in estimates in the period they become known.

**Allowance for Doubtful Accounts.** We establish billing terms at the time we negotiate purchase agreements with our customers. We continually monitor for timely payments and potential collection issues. The allowance for doubtful accounts is based on our detailed assessment of the collectibility of specific customer accounts. While we believe that our allowance for doubtful accounts is adequate and that the judgment applied is appropriate, if there is a deterioration of a customer's creditworthiness or actual defaults are higher than our historical experience, the actual results could differ from these estimates. While such credit losses have historically been within our expectations and the allowances we established, we can provide no assurance that we will continue to experience the same credit loss rates that we have in the past. If the financial condition of our customers were to deteriorate, resulting in an impairment of their ability to make payment, additional allowances may be required. We defer revenue recognition for customers for which we believe collection is less than probable. Our failure to accurately estimate the losses for doubtful accounts or receive payments on a timely basis could have a material adverse effect on our business, financial condition and results of operations.

**Inventory Reserves.** Inventory purchases and commitments are based upon estimated future demand for our products. We value inventory at the lower of cost or net realizable value. We provide inventory reserves based on excess and obsolete inventory determined primarily by future demand forecasts and returns of defective product, and record charges to cost of revenues. We assess such demand forecasts and return history on at least a quarterly basis. If we record a charge to reduce inventory to its estimated net realizable value, we do not increase its carrying value due to subsequent changes in demand forecasts or product repairs. Accordingly, if inventory previously reserved for is subsequently sold, we may realize improved gross profit margins on those transactions in the period the related revenue is recognized.

We also record a full inventory reserve for evaluation equipment at the time of shipment to our customers as a charge to sales and marketing expense as our experience with this type of inventory indicates it is probable that the inventory value will not be realizable. If these evaluation shipments should convert to revenue, we record a benefit to sales and marketing expenses and record the full cost of revenues in the period of revenue recognition.

We have experienced significant changes in our product demand and, as a result, our required inventory reserves have fluctuated in recent periods. It is possible that significant changes in required inventory reserves may continue to occur in the future if there is a sudden and significant change in the demand for our products, changes in the amount of customer evaluation inventory or higher risks of inventory obsolescence because of rapidly changing technology.

**Warranty Reserve.** Our products are covered by a standard warranty of 90 days for software and one year for hardware. In addition, certain customer contracts include warranty-type provisions for epidemic or similar product failures, generally for the contractual period or the life of the product in accordance with published telecommunications standards. We accrue for warranty obligations when the occurrence of such obligation is probable and the amount of such obligation is reasonably estimable. We have not incurred significant costs related to such obligations. Our customers typically purchase

maintenance and support contracts, which encompass our warranty obligations. Our estimates of anticipated rates of warranty claims and costs are primarily based on historical information and future forecasts.

In addition, certain of our customer contracts include provisions under which we may be obligated to pay penalties generally for the contractual period or for the life of the product if our products fail or do not perform in accordance with specifications. We accrue for such contingent obligations when the occurrence of such obligation is probable and the amount of such obligation is reasonably estimable. We have not incurred significant costs related to such provisions. We periodically assess the adequacy of our recorded warranty liabilities and adjust the amounts as necessary. Increases in product failure rates, material usage or service delivery costs may result in increases to our warranty reserve and our gross profit could be adversely affected. As of March 31, 2005 and December 31, 2004 we had no warranty reserve recorded.

**Royalty Accrual.** We accrue for royalties for technology we license from vendors based on established royalty rates and usage. In certain cases, we have been contacted by third parties who claim that our products infringe on certain intellectual property of the third party. We evaluate these claims and accrue for royalties when the amounts are probable and reasonably estimable. While we believe that the amounts accrued for estimated royalties are adequate, the amounts required to ultimately settle royalty obligations may be different.

**Reserve for Litigation and Legal Fees.** We are subject to various legal claims, including securities litigation and intellectual property claims. We reserve for legal contingencies and legal fees when the amounts are probable and reasonably estimable. Our director and officer liability insurance policies provide only limited liability protection relating to the securities class action and derivative lawsuits against us and certain of our officers and directors. In addition, our insurance does not cover fines that may be imposed by the SEC. We intend to defend these matters vigorously, although the ultimate outcome of these items is uncertain and the potential loss, if any, may be significantly different than the amounts we have previously accrued.

**Accounting for Income Taxes.** SFAS No. 109, *Accounting for Income Taxes*, requires the establishment of a valuation allowance to reflect the likelihood of realization of deferred tax assets. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. We evaluate all available evidence, such as recent and expected future operating results by tax jurisdiction, and current and enacted tax legislation and other temporary differences between book and tax accounting, to determine whether it is more likely than not that some portion or all of the deferred income tax assets will not be realized.

As a result of net operating losses incurred in prior years in most jurisdictions in which we operate, a net operating loss in the first fiscal quarter of 2005, and uncertainty as to the extent, jurisdiction and timing of profitability in future periods, we have continued to record a full valuation allowance against deferred tax assets, which was approximately \$95 million as of March 31, 2005. The establishment and amount of the valuation allowance requires significant estimates and judgment and can materially affect our results of operations. If the realization of deferred tax assets in the future is considered more likely than not, an adjustment to the valuation reserve for the deferred tax asset would be made. A portion of the release of the valuation allowance will increase net income in the period such determination was made. In addition, approximately \$26 million of the valuation allowance relates to tax benefits from stock option compensation. A substantial portion of the tax benefit of that item, when realized, will result in an increase in capital in excess of par value. Our effective tax rate may vary from period to period based on changes in estimated taxable income or loss in each jurisdiction, changes to the valuation allowance, statutory minimum tax rates or changes to federal, state or foreign tax laws, future expansion into areas with varying country, state, and local income tax

rates including statutory minimum tax rates, deductibility of certain costs and expenses by jurisdiction and as a result of acquisitions.

**Stock-based Compensation.** In October 1995, the FASB issued SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS No. 123 provides that companies may account for stock-based compensation under either the fair value-based method of accounting under SFAS No. 123 or the intrinsic value-based method provided by APB No. 25, *Accounting for Stock Issued to Employees*. We use the intrinsic value based method of APB No. 25 to account for all of our employee stock-based compensation plans and use the fair value method of SFAS No. 123 to account for all non-employee stock-based compensation. We follow FIN 28, and amortize the intrinsic value as measured under APB No. 25 on an accelerated basis. SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure—an amendment of FASB Statement No. 123*, requires companies following APB No. 25 to make pro forma disclosure in the notes to the consolidated financial statements using the measurement provisions of SFAS No. 123.

Beginning on January 1, 2006, we will adopt SFAS 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123 and supersedes APB Opinion No. 25. SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values at the date of grant in fiscal years beginning after June 15, 2005, and eliminates pro forma disclosure in the notes to the financial statements.

**Restructuring and Other Related Charges.** We established exit plans for each of the restructuring activities which took place in 2001 and 2002 and accounted for these plans in accordance with Emerging Issues Task Force (EITF) Issue No. 94-3, *Liability Recognition for Certain Employee Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)*. These exit plans required that we make estimates as to the nature, timing and amount of the exit costs that we specifically identified. The consolidation of facilities required us to make estimates, which included contractual rental commitments or lease buy-outs for office space being vacated and related costs and leasehold improvement write-downs, offset by estimated sub-lease income. We have remaining accrued exit costs of \$754,000 as of March 31, 2005, which relate to remaining lease payments. SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, was effective for exit or disposal activities that are initiated after December 31, 2002. SFAS No. 146 requires that a liability for a cost that is associated with an exit or disposal activity be recognized when the liability is incurred. A liability is recognized when the severance amounts relate to prior services rendered, the payment of the amount is probable and the amount can be reasonably estimated.

### Three Months Ended March 31, 2005 and 2004

**Revenues.** Revenues for the three months ended March 31, 2005 and 2004 were as follows, in thousands:

	Three months ended March 31,	
	2005	2004
<b>Revenues:</b>		
Product	\$ 22,458	\$ 26,245
Service	11,152	10,287
Total revenues	\$ 33,610	\$ 36,532

Product revenues comprise sales of our voice infrastructure products, including our GSX9000™ Open Services Switch, the Insignus™ Softswitch, the Sonus Insight™ Management System and related product offerings. Product revenues for the three months ended March 31, 2005 decreased 14% from

the comparable period in fiscal 2004. The decrease in product revenues was the result of the timing of revenue recognition, which in part is dependent upon completion of certain customer deployments as of the end of a fiscal quarter.

Service revenues primarily comprise hardware and software maintenance and support, network design, installation and other professional services. Service revenues for the three months ended March 31, 2005 increased 8% from the comparable period in fiscal 2004. The increase in service revenues was primarily a result of increases in maintenance revenues due to our growing installed customer base, partially offset by late renewals of several annual maintenance contracts and lower installation and resident engineer revenues.

For the three months ended March 31, 2005 and 2004, two and three customers each contributed 10% or more of our revenues, representing an aggregate of 40% and 67% of total revenues. The following customers contributed 10% or more of our revenues in the three months ended March 31, 2005 and 2004:

	Three months ended March 31,	
	2005	2004
<b>Customer:</b>		
Global Crossing	25%	*%
Level 3 Communications	15	*
Verizon Global Networks	*	30
Softbank Broadband Corporation	*	26
Qwest Communications	*	11

\* Less than 10%.

International revenues, primarily from Asia and Europe, were 12% and 29% of revenues for the three months ended March 31, 2005 and 2004. International revenues decreased due to uneven ordering patterns of our international customers and the achievement of revenue recognition criteria associated with each customer's arrangement. We expect that international revenues will remain uneven as a percentage of revenue from quarter to quarter.

Our deferred product revenue was \$42.7 million and \$47.6 million as of March 31, 2005 and 2004. Our deferred service revenue was \$49.3 million and \$47.1 million as of March 31, 2005 and 2004. Our deferred revenue balance may fluctuate as a result of the timing of revenue recognition, customer payments, maintenance contract renewals, contractual billing rights, customer creditworthiness and maintenance revenue deferrals included in multiple element arrangements. As of March 31, 2005 and December 31, 2004, deferred revenue and accounts receivable excluded \$16.8 million and \$6.5 million related to products shipped and billed to customers which are collectible under extended payment terms or for which revenue is recognized as cash is collected. Such amounts will be recorded pursuant to our revenue recognition policy.



**Cost of Revenues/Gross Profit.** Our cost of revenues consists primarily of amounts paid to third-party manufacturers for purchased materials and services, royalties, manufacturing and professional services personnel and related costs and inventory obsolescence. Cost of revenues and gross profit as a percentage of revenues for the three months ended March 31, 2005 and 2004 were as follows (in thousands, except percentages):

	Three months ended March 31,	
	2005	2004
<b>Cost of revenues:</b>		
Product	\$ 6,843	\$ 8,141
Service	5,269	4,259
Total cost of revenues	\$ 12,112	\$ 12,400
<b>Gross profit (% of respective revenues):</b>		
Product	70%	69%
Service	53	59
Total gross profit	64%	66%

The increase in product gross profit as a percentage of revenues was primarily due to customer and product mix. Our product gross profit remained higher than our long-term financial model of 58-62%. We can provide no assurance that this favorable customer and product mix will continue and we expect that over time our gross margins will return to levels consistent with our long-term financial model. The decrease in service gross profit as a percentage of service revenues was primarily due to increased investment in our service organization to support the expansion of our installed base, partially offset by an increase in service revenues. Our service cost of revenues is relatively fixed in advance of any particular quarter and, therefore, changes in service revenue will have a significant impact on service gross profit percentage.

**Research and Development Expenses.** Research and development expenses consist primarily of salaries and related personnel expenses and prototype costs related to the design, development, testing and enhancement of our products. Research and development expenses were \$11.0 million for the three months ended March 31, 2005, an increase of \$2.1 million or 23%, from \$8.9 million for the same period in fiscal 2004. This increase primarily reflects an increase in salary and related expenses associated with increased headcount. Some aspects of our research and development efforts require significant short-term expenditures, the timing of which can cause significant variability in our expenses. We believe that rapid technological innovation is critical to our long-term success and we intend to continue to make substantial investments to enhance our products and technologies to meet the requirements of our customers and market. We believe that our research and development expenses for the second quarter of fiscal 2005 will increase from the first quarter of fiscal 2005 primarily as a result of increases in salary and related expenses associated with increased headcount, and depreciation expenses associated with new capital expenditures. The additional investments are directed primarily toward the growth of our access, wireless and international businesses as well as the start up and expansion of our research and development operations in India.

**Sales and Marketing Expenses.** Sales and marketing expenses consist primarily of salaries and related personnel costs, commissions, travel and entertainment expenses, promotions, customer evaluations inventory and other marketing and sales support expenses. Sales and marketing expenses were \$9.0 million for the three months ended March 31, 2005, an increase of \$2.2 million, or 32%, from \$6.9 million for the same period in fiscal 2004. This increase primarily reflects an increase in salaries associated with increased headcount related to the expansion of our access, wireless and international sales opportunities, offset by a decrease in commission expense resulting from lower

revenues. We believe that our sales and marketing expenses for the second quarter of fiscal 2005 will increase from the first quarter of fiscal 2005 related to personnel costs and trade show expenses. The magnitude of the increase will be dependent upon our level of revenues in the second quarter as commission expenses fluctuate primarily based on revenue levels.

**General and Administrative Expenses.** General and administrative expenses consist primarily of salaries and related personnel costs for executive and administrative personnel, recruiting expenses, allowance for doubtful accounts and professional fees. General and administrative expenses were \$6.8 million for the three months ended March 31, 2005, an increase of \$2.0 million, or 41%, from \$4.8 million for the same period in fiscal 2004. This increase primarily reflects an increase in professional fees in the first quarter of fiscal 2005 compared to the first quarter of fiscal 2004 incurred to perform the assessment and audit of our internal control over financial reporting required under Section 404 of the Sarbanes-Oxley Act of 2002 and to begin remedying identified material weaknesses in our internal control environment, an increase in audit related expense, as well as an increase in directors and officers insurance costs. We believe that our general and administrative expenses for the second quarter of fiscal 2005 will remain generally consistent with the first quarter of fiscal 2005 due to continued costs associated with improvements we are making in our internal control environment to address material weaknesses.

**Stock-based Compensation Expenses.** Stock-based compensation expenses include the amortization of stock compensation charges resulting from the granting of stock options, including those telecom technologies, inc. (TTI) stock options assumed by us, stock awards to TTI employees under the 2000 Retention Plan and the sales of restricted common stock. As of December 31, 2004 deferred stock-based compensation was fully amortized. Stock-based compensation expenses for the three months ended March 31, 2004 were \$379,000.

**Amortization of Purchased Intangible Assets.** In fiscal 2001, we acquired certain intellectual property, in-process research and development and intangible assets in connection with our acquisitions of TTI and Linguatq, Inc. As of December 31, 2004 the purchased intangible assets were fully amortized, therefore there was no amortization expense for the three months ended March 31, 2005. Amortization expense for purchased intangible assets was approximately \$600,000 for the three months ended March 31, 2004.

**Interest Income, net.** Interest income consists of interest earned on our cash equivalent balances, marketable securities and long-term investments. Interest expense consists of interest incurred on a convertible subordinated note and capital lease arrangements. Interest income, net of interest expense, was \$1.7 million for the three months ended March 31, 2005, as compared to \$643,000 for the same period in fiscal 2004. This increase primarily reflects the benefit of an increase in the yield on our portfolio due to an increasing interest rate environment.

**Income Taxes.** Provisions for income taxes in the amounts of \$96,000 and \$167,000 have been recorded for the three months ended March 31, 2005 and 2004, which are primarily attributable to foreign income taxes and state minimum income taxes in the U.S.

#### **Off-balance Sheet Arrangements**

We have no off-balance sheet arrangements that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

#### **Liquidity and Capital Resources**

At March 31, 2005, our principal sources of liquidity were our cash, cash equivalents, marketable securities and long-term investments that totaled \$311.3 million.

Our cash used in operating activities was \$84,000 for the three months ended March 31, 2005, as compared to cash generated from operating activities of \$3.3 million for the same period in fiscal 2004. This decrease was primarily due to our net loss for the three months ended March 31, 2005, an increase in inventory and a decrease in accrued expenses, offset by a decrease in accounts receivable and increases in accounts payable and deferred revenue.

Net cash used in investing activities was \$1.4 million for the three months ended March 31, 2005, as compared to net cash provided by investing activities of \$13.8 million for the same period in fiscal 2004. Net cash used in investing activities for the three months ended March 31, 2005 primarily reflects capital expenditures of \$4.3 million, partially offset by net maturities of marketable securities and long-term investments of \$3.0 million. Net cash provided by investing activities for the three months ended March 31, 2004 primarily reflects net maturities of marketable securities and long-term investments of \$15.9 million, partially offset by capital expenditures of \$2.2 million. We expect to incur approximately \$10-13 million in additional capital expenditures in the remaining three fiscal quarters of 2005.

Net cash provided by financing activities was \$2.7 million for the three months ended March 31, 2005, as compared to \$1.1 million for the same period in fiscal 2004. The net cash provided by financing activities for the three months ended March 31, 2005 and 2004 primarily resulted from the sale of common stock in connection with our employee stock purchase plan and proceeds from the exercise of stock options, partially offset by payments on our long-term liabilities.

Based on our current expectations, we believe our current cash, cash equivalents, marketable securities and long-term investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least 12 months. Although it is difficult to predict future liquidity requirements with certainty, the rate at which we will consume cash will be dependent on the cash needs of future operations, including changes in working capital, which will, in turn, be directly affected by the levels of demand for our products, the timing and rate of expansion of our business, the resources we devote to developing our products and any litigation settlements or SEC fines. We anticipate devoting substantial capital resources to continue our research and development efforts, to maintain our sales, support and marketing, to improve our controls environment and for other general corporate activities, as well as to vigorously defend against existing and potential litigation and resolve pending or potential investigations relating to the restatement of our consolidated financial statements.

### ***Recent Accounting Pronouncements***

In October 2004, the American Jobs Creation Act of 2004 (the "AJCA") was passed. The AJCA provides a deduction for income from qualified domestic production activities, which will be phased in from 2005 through 2010. The AJCA also provides for a two-year phase-out of the existing extra-territorial income exclusion for foreign sales that was viewed to be inconsistent with international trade protocols by the European Union. In December 2004, the FASB issued FASB Staff Position ("FSP") No. 109-1, "*Application of FASB Statement No. 109, Accounting for Income Taxes, to the Tax Deduction on Qualified Production Activities Provided by the American Jobs Creation Act of 2004.*" FSP 109-1 treats the deduction as a "special deduction" as described in SFAS No. 109. This special deduction has no effect on deferred tax assets and liabilities existing at the enactment date and the effect of this deduction will be reported in the same period in which the deduction is claimed in our tax return. The AJCA also creates a temporary incentive for U.S. corporations to repatriate accumulated income earned abroad by providing an 85% dividends received deduction for certain dividends from controlled foreign corporations. This deduction is subject to a number of limitations. We are currently evaluating the effects that the AJCA might have on our results of operations and financial position, and, or to what extent, we might repatriate foreign earnings that have not yet been remitted to the U.S.

In November 2004, the FASB issued SFAS No. 151, *Inventory Costs, an Amendment of Accounting Research Bulletin (ARB) No. 43, Chapter 4*. SFAS 151 amends the guidance in ARB No 43, Chapter 4, "Inventory Pricing" to clarify that abnormal amounts of idle facility expense, freight, handling costs, and wasted material (spoilage) should be recognized as current-period charges. In addition, SFAS 151 requires that allocation of fixed production overhead to the costs of conversion be based on the normal capacity of the production facilities. The provisions of SFAS 151 are effective for fiscal years beginning after June 15, 2005. We are evaluating the provisions of SFAS 151 and presently do not believe that its adoption will have a material impact on our financial condition, results of operations or cash flows.

In December 2004, the FASB issued SFAS 123(R), *Share-Based Payment*, which is a revision of SFAS No. 123, *Accounting for Stock-Based Compensation*. SFAS 123(R) supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and amends SFAS No. 95, *Statement of Cash Flows*. Generally, the approach in SFAS 123(R) is similar to the approach described in SFAS 123. However, SFAS 123(R) requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their fair values at the date of grant. Pro forma disclosure is no longer an alternative. SFAS 123(R) was due to be adopted in fiscal periods beginning after June 15, 2005. In April 2005, the SEC delayed the adoption of SFAS 123(R) to fiscal years beginning after June 15, 2005. Early adoption will be permitted in periods in which financial statements have not yet been issued. Sonus is required to adopt SFAS 123(R) on January 1, 2006, the commencement of its first quarter of fiscal year 2006. SFAS 123(R) permits public companies to adopt its requirements using one of two methods: a "modified prospective" method, in which compensation cost is recognized beginning with the effective date (a) based on the requirements of SFAS 123(R) for all share-based payments granted after the effective date, and (b) based on the requirements of SFAS 123 for all awards granted to employees prior to the effective date of SFAS 123(R) that remain unvested on the effective date; or a "modified retrospective" method, which includes the requirements of the modified prospective method described above, but also permits entities to restate based on the amounts previously recognized under SFAS 123 for purposes of pro forma disclosures either (a) all prior periods presented or (b) prior interim periods of the year of adoption. Sonus has not yet determined which method to use in adopting SFAS 123(R). As permitted by SFAS 123, Sonus currently accounts for share-based payments to employees using APB Opinion No. 25's intrinsic value method and, as such, generally recognizes no compensation cost for employee stock options. Sonus is evaluating SFAS 123(R) and has not yet determined the amount of stock option expense that will be incurred in future periods as a result of the adoption of SFAS 123(R). The adoption of SFAS 123(R) will have no impact on Sonus' net cash flows or overall financial condition.

## Cautionary Statements

*This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Securities Litigation Reform Act of 1995 that involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements as a result of a number of factors, including those set forth in the following cautionary statements and elsewhere in this Quarterly Report on Form 10-Q. If any of the following risks were to occur, our business, financial condition or results of operations would likely suffer and the trading price of our common stock would likely decline. Investing in our common stock involves a high degree of risk. You should carefully consider the risks described below before buying our common stock.*

***We have identified material weaknesses in our disclosure controls and procedures and our internal control over financial reporting, which, if not remedied effectively, could have an adverse effect on the trading price of our common stock and otherwise seriously harm our business.***

Management has concluded that our disclosure controls and procedures and our internal control over financial reporting had material weaknesses as of March 31, 2005. We have taken certain actions to begin to address those material weaknesses. Our inability to remedy such material weaknesses promptly and effectively could have a material adverse effect on our business, results of operations and financial condition, as well as impair our ability to meet our quarterly and annual reporting requirements in a timely manner. These effects could in turn adversely affect the trading price of our common stock. Prior to the remediation of these material weaknesses, there remains risk that the transitional controls on which we currently rely will fail to be sufficiently effective, which could result in a material misstatement of our financial position or results of operations and require a restatement. In addition, even if we are successful in strengthening our controls and procedures, such controls and procedures may not be adequate to prevent or identify irregularities or facilitate the fair presentation of our financial statements or SEC reporting.

***Failure or circumvention of our controls and procedures could seriously harm our business.***

We are making significant changes in our internal control over financial reporting and our disclosure controls and procedures. Any system of controls, however well designed and operated, is based in part on certain assumptions and can provide only reasonable, and not absolute, assurances that the objectives of the system are met. The failure or circumvention of our controls, policies and procedures could have a material adverse effect on our business, results of operations and financial condition.

***We face risks related to securities litigation and investigations that could have a material adverse effect on our business, financial condition and results of operations.***

We have been named as a defendant in a number of securities class action and derivative lawsuits and are the subject of a formal investigation initiated by the SEC. We are generally obliged, to the extent permitted by law, to indemnify our current and former directors and officers who are named as defendants in some of these lawsuits. Defending against existing and potential litigation relating to the restatement of our consolidated financial statements will likely require significant attention and resources of management. Regardless of the outcome, such litigation and investigation will result in significant legal expenses and may also negatively affect our relationships with our customers and our employees. If our defenses are ultimately unsuccessful, or if we are unable to achieve a favorable settlement, we could be liable for large damage awards that could have a material adverse effect on our business, results of operations and financial condition.

***The limitations of our director and officer liability insurance may materially harm our business and financial condition.***

Our director and officer liability insurance policies provide only limited liability protection relating to the securities class action and derivative lawsuits against us and certain of our officers and directors. In addition, our insurance does not cover fines that may be imposed by the SEC. If these policies do not adequately cover expenses and certain liabilities relating to these lawsuits, our results of operations and our financial condition could be materially harmed. The facts underlying the lawsuits and SEC investigation have made director and officer liability insurance extremely expensive for us, and may make this insurance coverage unavailable for us in the future. Increased premiums could materially harm our financial results in future periods. The inability to obtain this coverage due to its unavailability or prohibitively expensive premiums would make it more difficult to retain and attract officers and directors and expose us to potentially self-funding any potential future liabilities ordinarily mitigated by director and officer liability insurance.

***Management's time and effort expected to be spent to respond to the SEC investigation may adversely affect our business and our results of operations.***

We have received a formal order of private investigation from the SEC. Our management will spend considerable time and effort cooperating with the SEC in its investigation. The significant time and effort expected to be spent on this SEC investigation may adversely affect our business, results of operations and financial condition. We may incur substantial costs in connection with the investigation including fines and significant legal expenses.

***If we are not current in our SEC filings, we will face several adverse consequences.***

If we are unable to remain current in our SEC filings, we will not be able to have a registration statement under the Securities Act of 1933, covering a public offering of securities, declared effective by the SEC, and we will not be able to make offerings pursuant to existing registration statements (including registration statements on Form S-8 covering employee stock plans), or pursuant to certain "private placement" rules of the SEC under Regulation D to any purchasers not qualifying as "accredited investors." In addition, our affiliates will not be able to sell our securities pursuant to Rule 144 under the Securities Act. Finally, we will not be eligible to use a "short form" registration statement on Form S-3 for a period of 12 months after the time we become current in our filings. These restrictions may impair our ability to raise funds in the public markets should we desire to do so, and to attract and retain key employees.

***Our common stock may be delisted from the NASDAQ National Market and transferred to the National Quotation Service Bureau ("Pink Sheets"), which may, among other things, reduce the price of our common stock and the levels of liquidity available to our stockholders.***

NASDAQ has notified us that we must timely file, without regard to any applicable 12b-25 extension period, all periodic reports with the SEC and NASDAQ for all reporting periods ending on or before September 30, 2005 due to our having been delisted in the third quarter of 2004. If we fail to keep current in our SEC filings, our common stock may be delisted from the NASDAQ National Market and subsequently would trade on the Pink Sheets. The trading of our common stock on the Pink Sheets may reduce the price of our common stock and the levels of liquidity available to our stockholders. In addition, the trading of our common stock on the Pink Sheets will materially adversely affect our access to the capital markets, and the limited liquidity and reduced price of our common stock could materially adversely affect our ability to raise capital through alternative financing sources on terms acceptable to us or at all. Stocks that trade on the Pink Sheets are no longer eligible for margin loans, and a company trading on the Pink Sheets cannot avail itself of federal preemption of state securities or "blue sky" laws, which adds substantial compliance costs to securities issuances.

including pursuant to employee option plans, stock purchase plans and private or public offerings of securities. Our delisting from the NASDAQ National Market and transfer to the Pink Sheets may also result in other negative implications, including the potential loss of confidence by suppliers, customers and employees, the loss of institutional investor interest and fewer business development opportunities.

***Our business has been adversely affected by developments in the telecommunications industry and these developments may continue to affect our revenues and operating results.***

From our inception through the year 2000, the telecommunications market experienced rapid growth spurred by a number of factors, including deregulation in the industry, entry of a large number of new emerging service providers, growth in data traffic and the availability of significant capital from the financial markets. Commencing in 2001 and continuing through 2004, the telecommunications industry experienced a reversal of some of these trends, marked by dramatic reductions in capital expenditures, financial difficulties, and, in some cases, bankruptcies experienced by service providers. These conditions caused a substantial, unexpected reduction in demand for telecommunications equipment, including our products.

We expect the developments described above to continue to affect our business in the following manner:

- our ability to accurately forecast revenue and plan our business is diminished;
- our revenues could be unexpectedly reduced; and
- we may incur losses because a high percentage of our operating expenses are expected to continue to be fixed in the short-term.

Any one or a combination of the above could materially and adversely affect our business, operating results and financial condition.

***Consolidation in telecommunications industry could harm our business.***

The industry has experienced consolidation and we expect this trend to continue. Consolidation among our customers may cause delays or reductions in capital expenditure plans and/or increased competitive pricing pressures as the number of available customers declines and their relative purchasing power increases in relation to suppliers. Any of these factors could adversely affect our business.

***We expect that a majority of our revenues will be generated from a limited number of customers and we will not be successful if we do not grow our customer base.***

To date, we have shipped our products to a limited number of customers. We expect that in the foreseeable future, the majority of our revenues will continue to depend on sales of our products to a limited number of customers. Two customers each contributed more than 10% of our revenues for the first three months of fiscal 2005, which represented an aggregate of 40% of total revenues. Two and four customers each contributed more than 10% of our revenues for fiscal 2004 and 2003, which represented an aggregate of 29% and 57% of total revenues. One customer contributed more than 10% of our revenues for fiscal 2002, which represented an aggregate of 42% of total revenues. Our future success will depend on our ability to attract additional customers beyond our current limited number. The growth of our customer base could be adversely affected by:

- acquisition of or by our customers;
- customer unwillingness to implement our new voice infrastructure products or renew contracts as they expire;

- potential customer concerns with selecting an emerging telecommunications equipment vendor;
- delays or difficulties that we may incur in completing the development and introduction of our planned products or product enhancements;
- further deterioration in the general financial condition of service providers, including additional bankruptcies, or inability to raise capital;
- new product introductions by our competitors;
- failure of our products to perform as expected; or
- difficulties we may incur in meeting customers' delivery requirements.

The loss of any of our significant customers or any substantial reduction in orders or contractual commitments from these customers could materially adversely affect our financial condition and results of operations. If we do not expand our customer base to include additional customers that deploy our products in operational commercial networks, our business, operating results and financial condition could be materially and adversely affected.

***The market for voice infrastructure products for the new public network is new and evolving and our business will suffer if it does not develop as we expect.***

The market for our products continues to evolve. In particular, wireless, cable and broadband access networks are emerging to become important markets for our products. Packet-based technology may not become widely accepted as a platform for voice and a viable market for our products may not be sustainable. If this market does not develop, or develops more slowly than we expect, we may not be able to sell our products in significant volume.

***If we do not anticipate and meet specific customer requirements or if our products do not interoperate with our customers' existing networks, we may not retain current customers or attract new customers.***

To achieve market acceptance for our products, we must effectively anticipate, and adapt in a timely manner to, customer requirements and offer products and services that meet changing customer demands. Prospective customers may require product features and capabilities that our current products do not have. The introduction of new or enhanced products also requires that we carefully manage the transition from older products in order to minimize disruption in customer ordering patterns and ensure that adequate supplies of new products can be delivered to meet anticipated customer demand. If we fail to develop products and offer services that satisfy customer requirements, or to effectively manage the transition from older products, our ability to create or increase demand for our products would be seriously harmed and we may lose current and prospective customers.

Many of our customers will require that our products be designed to interface with their existing networks, each of which may have different specifications. Issues caused by an unanticipated lack of interoperability may result in significant warranty, support and repair costs, divert the attention of our engineering personnel from our hardware and software development efforts and cause significant customer relations problems. If our products do not interoperate with those of our customers' networks, installations could be delayed or orders for our products could be cancelled, which would seriously harm our gross margins and result in loss of revenues or customers.

***Our large customers have substantial negotiating leverage, which may require that we agree to terms and conditions that may have an adverse effect on our business.***

Large telecommunications providers have substantial purchasing power and leverage negotiating contractual arrangements with us. These customers may require us to develop additional features and require penalties for failure to deliver such features. As we seek to sell more products to this class of



customer, we may be required to agree to such terms and conditions, which may affect the timing of revenue recognition and amount of deferred revenues and may have an adverse effect on our business and financial condition.

***We rely on distribution partners to sell our products in certain markets, and disruptions to or our failure to effectively develop and manage our distribution channel and the processes and procedures that support it could adversely affect our ability to generate revenues from the sale of our products in those markets.***

Our future success is highly dependent upon establishing and maintaining successful relationships with a variety of value-added reseller and distribution partners. A portion of our revenues is derived through distributors, many of which sell competitive products. Our revenues depend in part on the performance of these distributors. The loss of or reduction in sales by these distributors could materially reduce our revenues. If we fail to maintain relationships with these distribution partners, fail to develop new relationships with distributors in new markets, fail to manage, train, or provide incentives to, existing distributors effectively or if these partners are not successful in their sales efforts, sales of our products may decrease and our operating results would suffer.

In addition, we recognize a portion of our revenue based on a sell-through model using information provided by our distributors. If those distributors provide us with inaccurate or untimely information, the amount or timing of our revenues could be adversely impacted.

***We may face risks associated with our international expansion that could impair our ability to grow our revenues abroad.***

International revenues, primarily attributable to Asia and Europe, were approximately \$4.2 million for the first quarter of fiscal 2005, and \$28.8 million for fiscal 2004 and we intend to expand our sales in international markets. This expansion will require significant management attention and financial resources to successfully develop direct and indirect international sales and support channels. In addition, we may not be able to develop international market demand for our products, which could impair our ability to grow our revenues. We have limited experience marketing, distributing and supporting our products internationally and, to do so, we expect that we will need to develop versions of our products that comply with local standards. Furthermore, international operations are subject to other inherent risks, including:

- reliance on distributors and resellers;
- greater difficulty collecting accounts receivable and longer collection periods;
- difficulties and costs of staffing and managing international operations;
- the impact of differing technical standards outside the United States;
- the impact of recessions in economies outside the United States;
- unexpected changes in regulatory requirements and currency exchange rates;
- certification requirements;
- reduced protection for intellectual property rights in some countries;
- potentially adverse tax consequences; and
- political and economic instability.

***We may not return to or sustain profitability.***

We have incurred significant losses since inception and, as of March 31, 2005, had an accumulated deficit of \$787.8 million. Although we achieved profitability in each quarter and on an annual basis in

fiscal year 2004, we incurred a net loss for the quarter ended March 31, 2005 and may incur additional losses in future quarters and years. Our revenues may not grow and we may never generate sufficient revenues to return to or sustain profitability.

***The unpredictability of our quarterly results may adversely affect the trading price of our common stock.***

Our revenues and operating results may vary significantly from quarter to quarter due to a number of factors, many of which are outside of our control and any of which may cause our stock price to fluctuate. Generally, purchases by service providers of telecommunications equipment from manufacturers have been unpredictable and clustered, rather than steady, as the providers build out their networks. The primary factors that may affect our revenues and results include the following:

- fluctuation in demand for our voice infrastructure products and the timing and size of customer orders;
- the cancellation or deferral of existing customer orders or the renegotiation of existing contractual commitments;
- the failure of certain of our customers to successfully and timely reorganize their operations, including emerging from bankruptcy;
- the length and variability of the sales cycle for our products;
- the timing of revenue recognition and amount of deferred revenues;
- new product introductions and enhancements by our competitors and us;
- changes in our pricing policies, the pricing policies of our competitors and the prices of the components of our products;
- our ability to develop, introduce and ship new products and product enhancements that meet customer requirements in a timely manner;
- the mix of product configurations sold;
- our ability to obtain sufficient supplies of sole or limited source components;
- our ability to attain and maintain production volumes and quality levels for our products;
- costs related to acquisitions of complementary products, technologies or businesses;
- general economic conditions, as well as those specific to the telecommunications, networking and related industries;
- consolidation within the telecommunications industry, including acquisitions of or by our customers, and
- the application of complex revenue recognition accounting rules to our customer arrangements.

As with other telecommunications product suppliers, we may recognize a substantial portion of our revenue in a given quarter from sales booked and shipped in the last weeks of that quarter. As a result, delays in customer orders may result in delays in shipments and recognition of revenue beyond the end of a given quarter.

A significant portion of our operating expenses is fixed in the short-term. If revenues for a particular quarter are below expectations, we may not be able to reduce operating expenses proportionally for the quarter. Any such revenue shortfall would, therefore, have a significant effect on our operating results for the quarter.

We believe that quarter-to-quarter comparisons of our operating results are not a good indication of our future performance. It is likely that in some future quarters, our operating results may be below the expectations of public market analysts and investors, which may adversely affect our stock price.

***We are entirely dependent upon our voice infrastructure products and our future revenues depend upon their commercial success.***

Our future growth depends upon the commercial success of our voice infrastructure products. We intend to develop and introduce new products and enhancements to existing products in the future. We may not successfully complete the development or introduction of these products. If our target customers do not adopt, purchase and successfully deploy our current or planned products, our revenues will not grow.

***If we do not respond rapidly to technological changes or to changes in industry standards, our products could become obsolete.***

The market for packet voice infrastructure products is likely to be characterized by rapid technological change and frequent new product introductions. We may be unable to respond quickly or effectively to these developments. We may experience difficulties with software development, hardware design, manufacturing or marketing that could delay or prevent our development, introduction or marketing of new products and enhancements. The introduction of new products by our competitors, the market acceptance of products based on new or alternative technologies or the emergence of new industry standards could render our existing or future products obsolete. If the standards adopted are different from those that we have chosen to support, market acceptance of our products may be significantly reduced or delayed. If our products become technologically obsolete, we may be unable to sell our products in the marketplace and generate revenues.

***If we fail to compete successfully, our ability to increase our revenues or return to profitability will be impaired.***

Competition in the telecommunications market is intense. This market has historically been dominated by large companies, such as Lucent Technologies, NEC, Nortel Networks and Siemens, all of which are our direct competitors. We also face competition from other large telecommunications and networking companies, including Cisco Systems, some of which have entered our market by acquiring companies that design competing products. Because this market is rapidly evolving, additional competitors with significant financial resources may enter these markets and further intensify competition.

Many of our current and potential competitors have significantly greater selling and marketing, technical, manufacturing, financial and other resources. Further, some of our competitors sell significant amounts of other products to our current and prospective customers. Our competitors' broad product portfolios, coupled with already existing relationships, may cause our customers to buy our competitors' products or harm our ability to attract new customers.

To compete effectively, we must deliver innovative products that:

- provide extremely high reliability and voice quality;
- scale easily and efficiently;
- interoperate with existing network designs and other vendors' equipment;
- provide effective network management;
- are accompanied by comprehensive customer support and professional services; and

- provide a cost-effective and space efficient solution for service providers.

If we are unable to compete successfully against our current and future competitors, we could experience price reductions, order cancellations, loss of customers and revenues and reduced gross profit margins.

***Because our products are sophisticated and designed to be deployed in complex environments, they may have errors or defects that we find only after full deployment, which could seriously harm our business.***

Our products are sophisticated and are designed to be deployed in large and complex networks. Because of the nature of our products, they can only be fully tested when substantially deployed in very large networks with high volumes of traffic. Some of our customers have only recently begun to commercially deploy our products and they may discover errors or defects in the software or hardware, or the products may not operate as expected. As we continue to expand our distribution channel through distributors and resellers, we will need to rely on and support their service and support organizations. If we are unable to fix errors or other performance problems that may be identified after full deployment of our products, we could experience:

- loss of, or delay in, revenues;
- loss of customers and market share;
- a failure to attract new customers or achieve market acceptance for our products;
- increased service, support and warranty costs and a diversion of development resources; and
- costly and time-consuming legal actions by our customers.

***Because our products are deployed in large, complex networks around the world, failure to establish a support infrastructure and maintain required support levels could seriously harm our business.***

Our products are deployed in large and complex networks around the world. Our customers expect us to establish a support infrastructure and maintain demanding support standards to ensure that their networks maintain high levels of availability and performance. To support the continued growth of our business, our support organization will need to provide service and support at a high level throughout the world. If we are unable to provide the expected level of support and service to our customers, we could experience:

- loss of customers and market share;
- a failure to attract new customers in new geographies;
- increased service, support and warranty costs and a diversion of development resources; and
- network performance penalties.

***We have experienced changes in our senior management recently, which could affect our business and operations.***

We have made significant changes in our senior management team recently including the hiring of a Vice President of Internal Operations in March 2005, and a new Chief Financial Officer in December 2004. Since April 2004, we have also hired a President and Chief Operating Officer, Chief Marketing Officer, a new Vice President of Finance, Corporate Controller and Chief Accounting Officer. Because of these recent changes, our management team may not be able to work together effectively to successfully develop and implement our business strategies and financial operations. In addition, management will need to devote significant attention and resources to preserve and strengthen relationships with employees, customers and the investor community. If our new

management team is unable to achieve these goals, our ability to grow our business and successfully meet operational challenges could be impaired.

***If we fail to hire and retain needed personnel, the implementation of our business plan could slow or our future growth could halt.***

Our business depends upon highly skilled engineering, sales, marketing and customer support personnel. Any failure to hire or retain needed qualified personnel could impair our growth. Our future success depends upon the continued services of our executive officers who have critical industry experience and relationships that we rely on to implement our business plan. None of our officers or key employees is bound by an employment agreement for any specific term. The loss of the services of any of our officers or key employees could delay the development and introduction of, and negatively impact our ability to sell, our products.

***If we are subject to employment claims, we could incur substantial costs in defending ourselves.***

We may become subject to employment claims in connection with employee terminations. In addition, companies in our industry whose employees accept positions with competitors frequently claim that their competitors have engaged in unfair hiring practices. These claims may result in material litigation. We could incur substantial costs defending ourselves or our employees against those claims, regardless of their merits. In addition, defending ourselves from those types of claims could divert our management's attention from our operations. If we are found liable in connection with any employment claim, we may incur significant costs that could adversely impact our financial condition and results of operations.

***We depend upon contract manufacturers and any disruption in these relationships may cause us to fail to meet the demands of our customers and damage our customer relationships.***

We rely on a small number of contract manufacturers to manufacture our products according to our specifications and to fill orders on a timely basis. Our contract manufacturers provide comprehensive manufacturing services, including assembly of our products and procurement of materials. Each of our contract manufacturers also builds products for other companies and may not always have sufficient quantities of inventory available to fill our orders or may not allocate their internal resources to fill these orders on a timely basis. We do not have long-term supply contracts with our manufacturers and they are not required to manufacture products for any specified period. We do not have internal manufacturing capabilities to meet our customers' demands. Qualifying a new contract manufacturer and commencing commercial scale production is expensive and time consuming and could result in a significant interruption in the supply of our products. If a change in contract manufacturers results in delays in our fulfillment of customer orders or if a contract manufacturer fails to make timely delivery of orders, we may lose revenues and suffer damage to our customer relationships.

***We and our contract manufacturers rely on single or limited sources for supply of some components of our products and if we fail to adequately predict our manufacturing requirements or if our supply of any of these components is disrupted, we will be unable to ship our products.***

We and our contract manufacturers currently purchase several key components of our products, including commercial digital signal processors, from single or limited sources. We purchase these components on a purchase order basis. If we overestimate our component requirements, we could have excess inventory, which would increase our costs. If we underestimate our requirements, we may not have an adequate supply, which could interrupt manufacturing of our products and result in delays in shipments and revenues.

We currently do not have long-term supply contracts with our component suppliers and they are not required to supply us with products for any specified periods, in any specified quantities or at any set price, except as may be specified in a particular purchase order. In the event of a disruption or delay in supply, or inability to obtain products, we may not be able to develop an alternate source in a timely manner or at favorable prices, or at all. A failure to find acceptable alternative sources could hurt our ability to deliver high-quality products to our customers and negatively affect our operating margins. In addition, reliance on our suppliers exposes us to potential supplier production difficulties or quality variations. Our customers rely upon our ability to meet committed delivery dates, and any disruption in the supply of key components would seriously adversely affect our ability to meet these dates and could result in legal action by our customers, loss of customers or harm our ability to attract new customers.

***If we are not able to obtain necessary licenses of third-party technology at acceptable prices, or at all, our products could become obsolete.***

We have incorporated third-party licensed technology into our current products. From time to time, we may be required to license additional technology from third parties to develop new products or product enhancements. Third-party licenses may not be available or continue to be available to us on commercially reasonable terms. The inability to maintain or re-license any third-party licenses required in our current products or to obtain any new third-party licenses to develop new products and product enhancements could require us to obtain substitute technology of lower quality or performance standards or at greater cost, and delay or prevent us from making these products or enhancements, any of which could seriously harm the competitiveness of our products.

***Failures by our strategic partners or by us in integrating products provided by our strategic partners could seriously harm our business.***

Our solutions include the integration of products supplied by strategic partners, who offer complementary products and services. We rely on these strategic partners in the timely and successful deployment of our solutions to our customers. If the products provided by these partners have defects or do not operate as expected or if we do not effectively integrate and support products supplied by these strategic partners, then we may have difficulty with the deployment of our solutions that may result in:

- loss of, or delay in, revenues;
- increased service, support and warranty costs and a diversion of development resources; and
- network performance penalties.

In addition to cooperating with our strategic partners on specific customer projects, we also may compete in some areas with these same partners. If these strategic partners fail to perform or choose not to cooperate with us on certain projects, in addition to the effects described above, we could experience:

- loss of customers and market share; and
- a failure to attract new customers or achieve market acceptance for our products.

***Our ability to compete and our business could be jeopardized if we are unable to protect our intellectual property or become subject to intellectual property rights claims, which could require us to incur significant costs.***

We rely on a combination of patent, copyright, trademark and trade secret laws and restrictions on disclosure to protect our intellectual property rights. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. Monitoring unauthorized use of our products is difficult and we cannot be certain that the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States. If competitors are able to use our technology, our ability to compete effectively could be harmed.

In addition, we have received inquiries from other patent holders and may become subject to claims that we infringe their intellectual property rights. Any parties asserting that our products infringe upon their proprietary rights could force us to license their patents for substantial royalty payments or to defend ourselves and possibly our customers or contract manufacturers in litigation. These claims and any resulting licensing arrangement or lawsuit, if successful, could subject us to significant royalty payments or liability for damages and invalidation of our proprietary rights. Any potential intellectual property litigation also could force us to do one or more of the following:

- stop selling, incorporating or using our products that use the challenged intellectual property;
- obtain from the owner of the infringed intellectual property right a license to sell or use the relevant technology, which license may not be available on reasonable terms, or at all; or
- redesign those products that use any allegedly infringing technology.

Any lawsuits regarding intellectual property rights, regardless of their success, would be time-consuming, expensive to resolve and would divert our management's time and attention.

***Any investments or acquisitions we make could disrupt our business and seriously harm our financial condition.***

We intend to consider investing in, or acquiring, complementary products, technologies or businesses. In the event of future investments or acquisitions, we could:

- issue stock that would dilute our current stockholders' percentage ownership;
- incur debt or assume liabilities;
- incur significant impairment charges related to the write-off of goodwill and purchased intangible assets;
- incur significant amortization expenses related to purchased intangible assets; or
- incur large and immediate write-offs for in-process research and development and stock based compensation.

Our integration of any acquired products, technologies or businesses will also involve numerous risks, including:

- problems and unanticipated costs associated with combining the purchased products, technologies or businesses;
- diversion of management's attention from our core business;
- adverse effects on existing business relationships with suppliers and customers;
- risks associated with entering markets in which we have limited or no prior experience; and
- potential loss of key employees, particularly those of the acquired organizations.

We may be unable to successfully integrate any products, technologies, businesses or personnel that we might acquire in the future without significant costs or disruption to our business.

***Recent rulemaking by the Financial Accounting Standards Board will require us to expense equity compensation given to our employees and may significantly harm our operating results and may reduce our ability to effectively utilize equity compensation to attract and retain employees.***

We historically have used stock options as a significant component of our employee compensation program in order to align employees' interests with the interests of our stockholders, encourage employee retention, and provide competitive compensation packages. The Financial Accounting Standards Board has adopted changes that will require companies to record a charge to earnings for employee stock option grants and other equity incentives beginning January 1, 2006. By causing us to incur significantly increased compensation costs, such accounting changes will reduce our reported earnings and may cause us to reduce the availability and amount of equity incentives provided to employees, which may make it more difficult for us to attract, retain and motivate key personnel. Each of these results could materially and adversely affect our business.

***Regulation of the telecommunications industry could harm our operating results and future prospects.***

The telecommunications industry is highly regulated and our business and financial condition could be adversely affected by the changes in the regulations relating to the telecommunications industry. Currently, there are few laws or regulations that apply directly to access to or delivery of voice services on IP networks. We could be adversely affected by regulation of IP networks and commerce in any country, including the United States, where we operate. Such regulations could include matters such as voice over the Internet or using Internet protocol, encryption technology, and access charges for service providers. The adoption of such regulations could decrease demand for our products, and at the same time increase the cost of selling our products, which could have a material adverse effect on our business, operating results and financial condition.

***We may seek to raise additional capital in the future, which may not be available to us, and if it is available, may dilute the ownership of our common stock.***

In April and September 2003, we completed public offerings of 20,000,000 and 17,000,000 shares of our common stock resulting in the dilution of our existing investors' percentage ownership of our common stock. In the future, we may seek to raise additional funds through public or private debt or equity financings in order to:

- fund ongoing operations and capital requirements;
- take advantage of opportunities, including more rapid expansion or acquisition of complementary products, technologies or businesses;
- develop new products; or
- respond to competitive pressures.

Any additional capital raised through the sale of convertible debt or equity may further dilute an investor's percentage ownership of our common stock. Furthermore, additional financings may not be available on terms favorable to us, or at all. A failure to obtain additional funding could prevent us from making expenditures that may be required to grow or maintain our operations.

***Our stock price has been and may continue to be volatile.***

The market for technology stocks has been and will likely continue to be extremely volatile. The following factors could cause the market price of our common stock to fluctuate significantly:

- changes in our listing status on the NASDAQ Stock Market;



- the addition or loss of any major customer;
- consolidation in the telecommunications industry;
- changes in the financial condition or anticipated capital expenditure purchases of any existing or potential major customer;
- quarterly variations in our operating results;
- changes in financial estimates by securities analysts;
- speculation in the press or investment community;
- announcements by us or our competitors of significant contracts, new products or acquisitions, distribution partnerships, joint ventures or capital commitments;
- sales of common stock or other securities by us or by our stockholders in the future;
- securities and other litigation;
- announcement of a stock split, reverse stock split, stock dividend or similar event;
- economic conditions for the telecommunications, networking and related industries; and
- worldwide economic instability.

***Sales of a substantial amount of our common stock in the future could cause our stock price to fall.***

Some stockholders who acquired shares prior to our IPO or in connection with our acquisition of TTI hold a substantial number of shares of our common stock that have not yet been sold in the public market. Further, additional shares may become available for sale upon the conversion or redemption of our convertible subordinated note. Sales of a substantial number of shares of our common stock within a short period of time in the future could impair our ability to raise capital through the sale of additional debt or stock and /or cause our stock price to fall.

***Provisions of our charter documents and Delaware law may have anti-takeover effects that could prevent a change of control.***

Provisions of our amended and restated certificate of incorporation, our amended and restated by-laws and Delaware law could make it more difficult for a third party to acquire us, even if doing so would be beneficial to our stockholders.

**Item 3: Quantitative and Qualitative Disclosures About Market Risk**

We do not currently use derivative financial instruments. We generally place our marketable security investments in high-quality credit instruments, primarily U.S. Government, state government obligations and corporate obligations with contractual maturities of less than one year. We do not expect any material loss from our marketable security investments and therefore believe that our potential interest rate exposure is not material. We have no current material exposure to foreign currency rate fluctuations, though we will continue to evaluate the impact of foreign currency exchange risk on our results of operations as we expand internationally.

**Item 4: Controls and Procedures**

Our management, with the participation of our principal executive officer and principal financial officer, has evaluated the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934 (the Exchange Act)) as of March 31, 2005, which included an evaluation of disclosure controls and procedures applicable to the period covered by the filing of this periodic report. We previously reported ten material weaknesses in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act), which were described

in Item 9A and Management's Report on Internal Control Over Financial Reporting in our Annual Report on Form 10-K for the year ended December 31, 2004. As a result of these material weaknesses in our internal control over financial reporting, which were not remediated as of March 31, 2005, we have concluded that our disclosure controls and procedures were not effective as of March 31, 2005 to ensure that the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the periods specified in the SEC's rules and forms.

During the fiscal quarter ended March 31, 2005, we made changes that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. These changes consist of the following:

- We have completed the design phase of our internal control over financial reporting remediation plan in which we identified the corrective actions to be taken to address the deficiencies underlying the material weaknesses described in our fiscal 2004 Annual Report.
- We created a new senior management position and hired a Vice President of Internal Business Operations to assist us with implementing the changes to our infrastructure and related processes to address the deficiencies underlying the material weaknesses described in our fiscal 2004 Annual Report.
- We require annual certifications of compliance with our code of conduct from our worldwide employee base.
- We implemented an annual ethics-training program for the worldwide employee base.
- We implemented new security measures to restrict access to our headquarters facility.
- Senior management held a company-wide meeting to discuss the material weaknesses described in our fiscal 2004 Annual Report and our remediation plan, and to reinforce the importance of internal controls.
- An information systems enhancement project is in process with a dedicated team designing and implementing the functionality required to address control deficiencies.
- We established cross-functional teams to design changes to our operating business processes.
- We began the design of a sales forecasting tool, which is intended to more accurately quantify potential bookings and related supporting material requirements purchases.
- We required all purchasing to be done through our automated procurement system.
- We established a process requiring our human resources department to review and approve all payroll changes.

Subsequent to March 31, 2005 and through the filing date of this report, we continue to implement additional changes to our infrastructure and related processes that are also reasonably likely to materially affect our internal control over financial reporting, which include:

- We implemented processes to improve the quality of the close for the quarter ending March 31, 2005, including the issuance of policies and procedures covering account reconciliations, journal entries, supporting documentation and analysis for certain key accounts.
- We have designed a quote and proposal review and approval process intended to provide the appropriate level of management review for quotes and proposals before customer submission; capture the relevant data to identify all commitments made to customers; and define, automate and document the required approvals.
- We implemented controls intended to help provide assurance for the completeness of customer invoice recording in our financial accounting system.

- We implemented a networks password policy intended to provide assurance that access to our applications and financial systems is appropriately restricted.

We continue to plan and expect to implement additional changes to our infrastructure and related processes that we believe are also reasonably likely to strengthen and materially affect our internal control over financial reporting.

The remedial measures implemented by us to date will not in and of themselves remediate the material weaknesses, and certain of these remedial measures will require some time to be fully implemented or to take full effect. Prior to the remediation of these material weaknesses, there remains risk that the transitional controls, described below, on which we currently rely will fail to be sufficiently effective, which could result in material misstatement of our financial position or results of operations and require a restatement.

We are currently implementing an enhanced controls environment intended to address the material weaknesses in our internal control over financial reporting and to remedy the ineffectiveness of our disclosure controls and procedures. While this implementation phase is underway, we are relying on extensive manual procedures, including regular reviews and the significant utilization of outside accounting professionals, to assist us with meeting the objectives otherwise fulfilled by an effective controls environment. We expect to establish and implement a policy-based system of controls. While we are undertaking the implementation of this new controls environment, there remains risk that the transitional controls on which we are currently relying will fail to be sufficiently effective. We also note, however, that a control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must include an assessment of the costs and related risks associated with the control and the purpose for which it was intended. Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues including instances of fraud, if any, have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty, and breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Over time, our control systems, as we develop them, may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost-effective control system, misstatements due to error or fraud may occur and not be detected and could be material and require a restatement of our financial statements.

The certifications of our principal executive officer and principal financial officer required in accordance with Section 302 of the Sarbanes-Oxley Act of 2002 are attached as exhibits to this Quarterly Report on Form 10-Q. The disclosures set forth in this Item 4 contain information concerning the evaluation of our disclosure controls and procedures, and changes in internal control over financial reporting, referred to in paragraph 4 of the certifications. Those certifications should be read in conjunction with this Item 4 for a more complete understanding of the matters covered by the certifications.

**Item 1: Legal Proceedings**

In November 2001, a purchaser of our common stock filed a complaint in the federal district court for the Southern District of New York against us, two of our officers and the lead underwriters alleging violations of the federal securities laws in connection with our initial public offering (IPO) and seeking unspecified monetary damages. The purchaser seeks to represent a class of persons who purchased our common stock between the IPO on May 24, 2000 and December 6, 2000. An amended complaint was filed in April 2002. The amended complaint alleges that our registration statement contained false or misleading information or omitted to state material facts concerning the alleged receipt of undisclosed compensation by the underwriters and the existence of undisclosed arrangements between underwriters and certain purchasers to make additional purchases in the after market. The claims against us are asserted under Section 10(b) of the Securities Exchange Act of 1934 and Section 11 of the Securities Act of 1933 and against the individual defendants under Sections 11 and 15 of the Securities Act and Sections 10(b) and 20(a) of the Exchange Act. Other plaintiffs have filed substantially similar class action cases against approximately 300 other publicly traded companies and their IPO underwriters which, along with the actions against us, have been transferred to a single federal judge for purposes of coordinated case management. On July 15, 2002, we, together with the other issuers named as defendants in these coordinated proceedings, filed a collective motion to dismiss the consolidated amended complaints on various legal grounds common to all or most of the issuer defendants. The plaintiffs voluntarily dismissed the claims against many of the individual defendants, including our officers named in the complaint. On February 19, 2003, the court granted a portion of the motion to dismiss by dismissing the Section 10(b) claims against certain defendants including us, but denied the remainder of the motion as to the defendants. In June 2003, a special committee of our Board of Directors authorized us to enter into a proposed settlement with the plaintiffs on terms substantially consistent with the terms of a Memorandum of Understanding negotiated among representatives of the plaintiffs, the issuer defendants and the insurers for the issuer defendants. On February 15, 2005, the court preliminarily approved the terms of the proposed settlement contingent on modifications to the proposed settlement. The settlement is subject to final approval by the court. No hearing date has been scheduled for final approval. It remains uncertain when the settlement will become final. We do not expect that the settlement would have a material impact on our business or financial results.

Beginning in July 2002, several purchasers of our common stock filed complaints in federal district court for the District of Massachusetts against us, certain officers and directors and a former officer under Sections 10(b) and 20(a) and Rule 10b-5 of the Securities Exchange Act of 1934 (Class Action Complaints). The purchasers seek to represent a class of persons who purchased our common stock between December 11, 2000 and January 16, 2002, and seek unspecified monetary damages. The Class Action Complaints were essentially identical and alleged that we made false and misleading statements about our products and business. On March 3, 2003, the plaintiffs filed a Consolidated Amended Complaint. On April 22, 2003, we filed a motion to dismiss the Consolidated Amended Complaint on various grounds. On May 11, 2004, the court held oral argument on the motion, at the conclusion of which the court denied our motion to dismiss. The plaintiffs filed a motion for class certification on July 30, 2004, and we filed our opposition on September 10, 2004, to which the plaintiffs replied on September 30, 2004. On February 16, 2005, the court certified the class and appointed a class representative. On March 9, 2005, the court appointed the law firm of Moulton & Gans as lead counsel. The court has requested additional briefing on the adequacy of the class representative, but has not yet held a hearing or issued a decision on the matter. We believe the claims in the Consolidated Amended Complaint are without merit and that we have substantial legal and factual defenses, which we intend to pursue vigorously. There is no assurance we will prevail in defending these actions.

Beginning in February 2004, a number of purported shareholder class action complaints were filed in the United States District Court for the District of Massachusetts against us and certain of our current officers and directors. On June 28, 2004, the court consolidated the claims. On December 1, 2004, the lead plaintiff filed a consolidated amended complaint. The complaint asserts claims under the federal securities laws, specifically Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Sections 11, 12(a), and 15 of the Securities Act of 1933, relating to our restatement of our financial results for 2001, 2002, and the first three quarters of 2003. Specifically, the complaint alleges that we issued a series of false or misleading statements to the market concerning our revenues, earnings, and financial condition. Plaintiffs contend that such statements caused our stock price to be artificially inflated. The complaint seeks unspecified damages on behalf of a purported class of purchasers of our common stock during the period from March 28, 2002, through March 26, 2004. On January 28, 2005, we filed a motion to dismiss the Section 10(b) and 12(a) claims and joined the motion to dismiss the Section 11 claim filed by the individual defendants. On March 22, 2005, the plaintiff filed its opposition to the motion. A hearing on the motions has been scheduled for June 1, 2005. We believe that we have substantial legal and factual defenses to the claims, which we intend to pursue vigorously. There is no assurance we will prevail in defending these actions.

In February 2004, three purported shareholder derivative lawsuits were filed in the United States District Court for the District of Massachusetts against us and certain of our officers and directors, naming us as a nominal defendant. Also in February 2004, two-purported shareholder derivative lawsuits were filed in the business litigation session of the superior court of Suffolk County of Massachusetts against us and certain of our directors and officers, also naming us as a nominal defendant. The suits claim that certain of our officers and directors breached their fiduciary duties to our stockholders and to us. The complaints are derivative in nature and do not seek relief from us. However, we have entered into indemnification agreements in the ordinary course of business with certain of the defendant officers and directors and may be obligated throughout the pendency of these actions to advance payment of legal fees and costs incurred by the defendants pursuant to our obligations under the indemnification agreements or applicable Delaware law. On September 27, 2004, the state court granted our motion to dismiss. On October 26, 2004, the plaintiffs filed a notice appealing the state court's dismissal of the actions. In the federal actions, on June 28, 2004, the court consolidated and stayed the three actions. On October 12, 2004, the lead plaintiff filed a consolidated amended complaint. We believe that we have substantial legal and factual defenses to the federal claims and have filed a motion to dismiss based on the decision by the state court. A hearing on the motion in federal court has been scheduled for June 1, 2005. There is no assurance we will prevail in defending these actions.

In December 2004, a purchaser of our common stock filed a complaint in the circuit court in Will County, Illinois, against us, one of our officers, and a former officer alleging misrepresentation and fraud in connection with the plaintiff's purchase of our stock. The Complaint seeks unspecified damages. We filed a motion to dismiss the complaint. The court ordered the plaintiff to file an amended complaint on or before May 5, 2005. We believe that we have substantial legal and factual defenses to these claims, which we intend to pursue vigorously. There is no assurance we will prevail in defending this action.

In June 2004, we received a formal order of private investigation from the SEC. We are cooperating with the investigation. There can be no assurance as to the outcome of the SEC investigation. We may incur substantial costs in connection with the investigation including fines and significant legal expenses.

We have been contacted by third parties, who claim that our products infringe on certain intellectual property of the third party. We evaluate these claims and accrue for royalties when the amounts are probable and reasonably estimable. While we believe that the amounts accrued for

estimated royalties are adequate, any subsequent change in our estimates will be recorded at such time the change is probable and estimable.

**Item 6: Exhibits**

Exhibit Number	Description
31.1	Certification of Sonus Networks, Inc. Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
31.2	Certification of Sonus Networks, Inc. Chief Financial Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002.
32.1	Certification of Sonus Networks, Inc. Chief Executive Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002.
32.2	Certification of Sonus Networks, Inc. Chief Financial Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002.

**SIGNATURE**

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

Dated: May 9, 2005

SONUS NETWORKS, INC.

By: /s/ ELLEN B. RICHSTONE

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Ellen B. Richstone  
*Chief Financial Officer (Principal Financial Officer)*

By: /s/ BRADLEY T. MILLER

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Bradley T. Miller  
*Vice President of Finance, Corporate Controller and Chief Accounting Officer (Principal Accounting Officer)*

## EXHIBIT INDEX

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32.2	Certification of Sonus Networks, Inc. Chief Financial Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002.





**CERTIFICATION PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Hassan M. Ahmed, Chief Executive Officer and Chairman of the Board of Directors, of Sonus Networks, Inc., certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the period ended March 31, 2005 ("Quarterly Report") of Sonus Networks, Inc. (the "Registrant");
2. Based on my knowledge, this Quarterly Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Quarterly Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Quarterly Report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this Quarterly Report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Quarterly Report is being prepared;
  - (b) Designed such internal control over financial reporting or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this Quarterly Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Quarterly Report based on such evaluation; and
  - (d) Disclosed in this Quarterly Report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's first fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: May 9, 2005

/s/ HASSAN M. AHMED

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Hassan M. Ahmed  
*Chief Executive Officer and Chairman of the Board of Directors (Principal Executive Officer)*

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**EXHIBIT 31.2**

**CERTIFICATION PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Ellen B. Richstone, Chief Financial Officer, of Sonus Networks, Inc., certify that:

1. I have reviewed this Quarterly Report on Form 10-Q for the period ended March 31, 2005 ("Quarterly Report") of Sonus Networks, Inc. (the "Registrant");
2. Based on my knowledge, this Quarterly Report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this Quarterly Report;
3. Based on my knowledge, the financial statements, and other financial information included in this Quarterly Report, fairly present in all material respects the financial condition, results of operations and cash flows of the Registrant as of, and for, the periods presented in this Quarterly Report;
4. The Registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the Registrant and have:
  - (a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the Registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this Quarterly Report is being prepared;
  - (b) Designed such internal control over financial reporting or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - (c) Evaluated the effectiveness of the Registrant's disclosure controls and procedures and presented in this Quarterly Report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this Quarterly Report based on such evaluation; and
  - (d) Disclosed in this Quarterly Report any change in the Registrant's internal control over financial reporting that occurred during the Registrant's first fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Registrant's internal control over financial reporting; and
5. The Registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the Registrant's auditors and the audit committee of the Registrant's board of directors:
  - (a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the Registrant's ability to record, process, summarize and report financial information; and
  - (b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the Registrant's internal control over financial reporting.

Date: May 9, 2005

/s/ ELLEN B. RICHSTONE

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Ellen B. Richstone  
*Chief Financial Officer*  
*(Principal Financial Officer)*

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QuickLinks

[EXHIBIT 31.2](#)

[CERTIFICATION PURSUANT TO SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002](#)

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Sonus Networks, Inc. (the "Company") for the period ended March 31, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Hassan M. Ahmed, Chief Executive Officer and Chairman of the Board of Directors of the Company, hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: May 9, 2005

/s/ HASSAN M. AHMED

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Hassan M. Ahmed  
*Chief Executive Officer and Chairman of the Board of Directors (Principal Executive Officer)*

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**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

In connection with the Quarterly Report on Form 10-Q of Sonus Networks, Inc. (the "Company") for the period ended March 31, 2005 as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, Ellen B. Richstone, Chief Financial Officer of the Company, hereby certifies, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that:

- (1) the Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
- (2) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: May 9, 2005

/s/ ELLEN B. RICHSTONE

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Ellen B. Richstone  
*Chief Financial Officer*  
*(Principal Financial Officer)*

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