

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

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

For the quarterly period ended June 30, 2007

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

Commission File Number 000-30229

**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.)

**7 Technology Park Drive, Westford, Massachusetts 01886**  
(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 a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

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

As of August 7, 2007, there were 259,995,241 shares of the registrant's common stock, \$0.001 par value, outstanding.

**SONUS NETWORKS, INC.  
FORM 10-Q  
QUARTER ENDED JUNE 30, 2007  
TABLE OF CONTENTS**

	<u>Page</u>
<b><u>PART I FINANCIAL INFORMATION</u></b>	
<b><u>Item 1.</u></b> <u>Financial Statements</u>	
<u>Condensed Consolidated Balance Sheets as of June 30, 2007 and December 31, 2006 (unaudited)</u>	3
<u>Condensed Consolidated Statements of Operations for the Three and Six Months Ended June 30, 2007 and 2006 (unaudited)</u>	4
<u>Condensed Consolidated Statements of Cash Flows for the Six Months Ended June 30, 2007 and 2006 (unaudited)</u>	5
<u>Notes to Condensed Consolidated Financial Statements (unaudited)</u>	6
<b><u>Item 2.</u></b> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	26
<b><u>Item 3.</u></b> <u>Quantitative and Qualitative Disclosures About Market Risk</u>	37
<b><u>Item 4.</u></b> <u>Controls and Procedures</u>	37
<b><u>PART II OTHER INFORMATION</u></b>	
<b><u>Item 1.</u></b> <u>Legal Proceedings</u>	40
<b><u>Item 1A.</u></b> <u>Risk Factors</u>	43
<b><u>Item 2.</u></b> <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	57
<b><u>Item 6.</u></b> <u>Exhibits</u>	58
<u>Signatures</u>	59
<u>Exhibit Index</u>	60

**PART I - FINANCIAL INFORMATION**  
**Item 1. Financial Statements**

**SONUS NETWORKS, INC.**  
**Condensed Consolidated Balance Sheets**  
(in thousands, except share data)  
(unaudited)

	June 30, 2007	December 31, 2006
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 61,617	\$ 44,206
Marketable debt securities	243,605	256,485
Accounts receivable, net	72,438	70,726
Inventory, net	33,177	22,266
Deferred income taxes	21,833	21,808
Other current assets	27,178	18,523
Total current assets	<u>459,848</u>	<u>434,014</u>
Property and equipment, net	20,174	19,051
Purchased intangible assets, net	2,900	—
Goodwill	7,841	—
Long-term investments	39,470	60,189
Deferred income taxes	46,968	52,613
Other assets	20,744	23,737
	<u>\$ 597,945</u>	<u>\$ 589,604</u>
<b>Liabilities and stockholders' equity</b>		
Current liabilities:		
Accounts payable	\$ 24,989	\$ 17,219
Accrued expenses	36,950	43,653
Accrued restructuring expenses	—	61
Current portion of deferred revenue	55,270	60,383
Current portion of long-term liabilities	1,630	501
Total current liabilities	<u>118,839</u>	<u>121,817</u>
Long-term deferred revenue	31,319	33,787
Deferred income taxes	912	—
Long-term liabilities, net of current portion	2,748	1,467
Total liabilities	<u>153,818</u>	<u>157,071</u>
Commitments and contingencies (Note 5)		
Stockholders equity:		
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; 262,091,030 and 262,065,332 shares issued; 259,794,120 and 259,768,422 shares outstanding at June 30, 2007 and December 31, 2006, respectively	262	262
Additional paid-in capital	1,183,548	1,160,853
Accumulated deficit	(739,237)	(728,233)
Accumulated other comprehensive loss	(179)	(82)
Treasury stock, at cost; 2,296,910 common shares at June 30, 2007 and December 31, 2006	(267)	(267)
Total stockholders' equity	<u>444,127</u>	<u>432,533</u>
	<u>\$ 597,945</u>	<u>\$ 589,604</u>

See notes to the condensed consolidated financial statements.

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

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Revenue:				
Product	\$ 52,171	\$ 48,853	\$ 103,798	\$ 93,395
Service	23,322	15,627	42,841	31,080
Total revenue	<u>75,493</u>	<u>64,480</u>	<u>146,639</u>	<u>124,475</u>
Cost of revenue:				
Product	23,561	16,199	40,643	32,082
Service	9,563	6,987	18,142	13,716
Total cost of revenue	<u>33,124</u>	<u>23,186</u>	<u>58,785</u>	<u>45,798</u>

Gross profit	42,369	41,294	87,854	78,677
Operating expenses:				
Research and development	22,350	12,900	41,048	25,976
Sales and marketing	21,219	15,646	44,269	29,671
General and administrative	14,202	7,248	28,264	14,228
Total operating expenses	57,771	35,794	113,581	69,875
Income (loss) from operations	(15,402)	5,500	(25,727)	8,802
Interest expense	(79)	(81)	(83)	(218)
Interest income	4,522	3,899	9,146	7,341
Other income (expense), net	(256)	—	(936)	—
Income (loss) before income taxes	(11,215)	9,318	(17,600)	15,925
Income tax benefit (provision)	4,239	(404)	6,646	(1,195)
Net income (loss)	<u>\$ (6,976)</u>	<u>\$ 8,914</u>	<u>\$ (10,954)</u>	<u>\$ 14,730</u>
Net income (loss) per share:				
Basic	\$ (0.03)	\$ 0.04	\$ (0.04)	\$ 0.06
Diluted	\$ (0.03)	\$ 0.03	\$ (0.04)	\$ 0.06
Shares used in computing net income (loss) per share:				
Basic	259,786	252,664	259,777	251,371
Diluted	259,786	256,326	259,777	255,454

See notes to the condensed consolidated financial statements.

4

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

	Six months ended June 30,	
	2007	2006
Cash flows from operating activities:		
Net income (loss)	\$ (10,954)	\$ 14,730
Adjustments to reconcile net income (loss) to cash flows provided by operating activities:		
Depreciation and amortization of property and equipment	6,351	4,732
Amortization of purchased intangible assets	141	—
Stock-based compensation	23,486	5,042
Loss on disposal of property and equipment	—	6
Increase in fair value of modified stock options held by former employees	936	—
Deferred income taxes	5,645	—
Changes in operating assets and liabilities:		
Accounts receivable	(1,261)	(5,162)
Inventory	(10,579)	4,170
Other operating assets	(5,693)	(7,812)
Accounts payable	6,541	(3,712)
Accrued expenses, deferred rent and accrued restructuring expenses	(6,901)	52
Deferred revenue	(7,377)	(6,661)
Net cash provided by operating activities	<u>335</u>	<u>5,385</u>
Cash flows from investing activities:		
Purchases of property and equipment	(7,138)	(5,163)
Acquisition of Zynetix Limited	(8,825)	—
Maturities of available-for-sale marketable debt securities	38,158	68,775
Purchases of available-for-sale marketable debt securities	(36,008)	(31,175)
Maturities of held-to-maturity marketable debt securities and long-term investments	170,000	58,006
Purchases of held-to-maturity marketable debt securities and long-term investments	(138,551)	(225,007)
Decrease in restricted cash	261	250
Net cash provided by (used in) investing activities	<u>17,897</u>	<u>(134,314)</u>
Cash flows from financing activities:		
Sale of common stock in connection with employee stock purchase plan	—	2,310
Proceeds from exercise of stock options	—	11,386
Repayment of convertible subordinated note	—	(10,000)
Repayment of notes payable to Zynetix Limited shareholders	(335)	—
Payment of tax withholding obligations related to net share settlement of restricted stock award	(300)	—
Principal payments of capital lease obligations	(73)	(23)
Net cash provided by (used in) financing activities	<u>(708)</u>	<u>3,673</u>
Effect of exchange rate changes on cash and cash equivalents	<u>(113)</u>	<u>(40)</u>
Net increase (decrease) in cash and cash equivalents	17,411	(125,296)
Cash and cash equivalents, beginning of period	44,206	155,679
Cash and cash equivalents, end of period	<u>\$ 61,617</u>	<u>\$ 30,383</u>
Supplemental disclosure of cash flow information:		
Interest paid	\$ 23	\$ 211
Income taxes paid	\$ 1,886	\$ 1,649
Supplemental disclosure of non-cash investing activities:		
Non-cash purchases of property and equipment	\$ 267	\$ 872
Property and equipment acquired as part of a facility lease	\$ —	\$ 50
Supplemental disclosure of non-cash financing activities:		
Issuance of restricted stock	\$ 193	\$ —
Modifications of stock options—reclassification from equity to liability award	\$ 849	\$ —

**SONUS NETWORKS, INC.**  
**Notes to Condensed Consolidated Financial Statements**  
**(Unaudited)**

**(1) Description of Business**

Sonus Networks, Inc. ("Sonus" or the "Company") was incorporated in 1997 and is a leading provider of voice infrastructure solutions for wireline and wireless service providers. Sonus offers a new generation of carrier-class infrastructure equipment and software that enables voice services to be delivered over packet-based networks.

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

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

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

The accompanying unaudited condensed consolidated financial statements have been prepared by Sonus pursuant to the rules and regulations of the United States Securities and Exchange Commission ("SEC") regarding interim financial reporting. Accordingly, they do not include all of the information and notes required by accounting principles generally accepted in the United States of America ("U.S. GAAP") for complete financial statements and should be read in conjunction with the audited financial statements included in Sonus' Annual Report on Form 10-K for the year ended December 31, 2006.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements have been prepared on the same basis as the audited financial statements, and include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results of the interim periods presented. The operating results for the interim periods presented are not necessarily indicative of the results expected for the full fiscal year.

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

On April 13, 2007, the Company completed the acquisition of Zynetix Limited ("Zynetix") (see Note 3). The operating results of Zynetix have been included in the Company's condensed consolidated financial statements for the period subsequent to its acquisition.

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

The preparation of financial statements in conformity with U.S. GAAP 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, assumptions used to determine the fair value of stock-based compensation, assumptions used to determine the fair value of purchased intangible assets, contingent liabilities and recoverability of Sonus' net deferred tax assets and related valuation allowance. Sonus regularly assesses these estimates and records changes in estimates 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 could differ from those estimates.

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

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

Cash equivalents and marketable debt securities are invested in high-quality debt instruments, primarily U.S. Government, municipal and corporate obligations. Investments in U.S. Government and corporate obligations are classified as held-to-maturity, as Sonus has the intent and ability to hold them to maturity. Held-to-maturity marketable debt securities are reported at amortized cost. Investments in municipal obligations are classified as available-for-sale and are reported at fair value. Unrealized gains and losses from available-for-sale marketable debt securities were not material for the periods presented. The unrealized losses related to these securities at June 30, 2007 are not considered to be a permanent decline in the fair value of such securities. There have been no material realized gains or losses to date. Current marketable debt securities include held-to-maturity investments with remaining maturities of less than one year as of the balance sheet date and available-for-sale investments that are expected to be sold in the current period or to be used in current operations. Long-term investments include held-to-maturity investments with remaining maturities of one to five years as of the balance sheet date.

At June 30, 2007 and December 31, 2006, marketable debt securities and long-term investments consisted of the following (in thousands):

	June 30, 2007			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
<i>Marketable debt securities</i>				
Available-for-sale:				
State and municipal obligations	\$ 26,000	\$ —	\$ —	\$ 26,000
Held-to-maturity:				
U.S. government agency notes	101,568	1	(111)	101,458

Corporate debt securities	38,168	2	(50)	38,120
Commercial paper	77,869	1	(216)	77,654
	<u>\$ 243,605</u>	<u>\$ 4</u>	<u>\$ (377)</u>	<u>\$ 243,232</u>
<i>Long-term investments</i>				
Held-to-maturity:				
U.S. government agency notes	\$ 27,965	\$—	\$ (67)	\$ 27,898
Corporate debt securities	11,505	—	(43)	11,462
	<u>\$ 39,470</u>	<u>\$—</u>	<u>\$ (110)</u>	<u>\$ 39,360</u>

7

	December 31, 2006			Fair Value
	Amortized Cost	Unrealized Gains	Unrealized Losses	
<i>Marketable debt securities</i>				
Available-for-sale:				
State and municipal obligations	\$ 28,150	\$—	\$ —	\$ 28,150
Held-to-maturity:				
U.S. government agency notes	97,698	9	(110)	97,597
Corporate debt securities	32,878	6	(43)	32,841
Commercial paper	97,759	7	(358)	97,408
	<u>\$ 256,485</u>	<u>\$ 22</u>	<u>\$ (511)</u>	<u>\$ 255,996</u>
<i>Long-term investments</i>				
Held-to-maturity:				
U.S. government agency notes	\$ 44,835	\$ 11	\$ (39)	\$ 44,807
Corporate debt securities	15,354	5	(25)	15,334
	<u>\$ 60,189</u>	<u>\$ 16</u>	<u>\$ (64)</u>	<u>\$ 60,141</u>

At June 30, 2007 and December 31, 2006, Sonus had \$80,000 and \$341,000, respectively, of restricted cash, which is used to collateralize standby letters of credit. Restricted cash is included in Other current assets in the Condensed Consolidated Balance Sheets.

In connection with the relocation of its headquarters to Westford, Massachusetts in January 2007, the Company issued a \$500,000 standby letter of credit. The standby letter of credit may be drawn upon in the event of the Company's noncompliance with the terms and conditions of the sublease for the Westford headquarters facility.

**(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 debt securities, accounts receivable and long-term investments. Sonus' cash, cash equivalents and investment portfolio holdings were diversified among four financial institutions at June 30, 2007.

One customer contributed at least 10% of Sonus' revenue for the three and six months ended June 30, 2007 and 2006:

Customer	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
A	36%	61%	40%	36%

At June 30, 2007 and December 31, 2006, two customers and three customers, respectively, each accounted for at least 10% of Sonus' accounts receivable balance, representing a total of approximately 55% and 45% of the Company's total accounts receivable balances. 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 such losses have been within management's expectations.

8

The following table shows the percentage of revenue by geographic region for the three and six months ended June 30, 2007 and 2006:

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
United States	75%	95%	79%	86%
Japan	13	2	10	6
Other Asia Pacific	*	*	*	5
Europe, Middle East and Africa	11	3	9	3
Other	1	*	2	*
	<u>100%</u>	<u>100%</u>	<u>100%</u>	<u>100%</u>

\* Represents less than 1% of revenue.

Certain components and software licenses from third parties used in Sonus' products are procured from single sources of supply. 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'

revenue and operating results.

In 2006, Sonus consolidated its manufacturing to a single manufacturer. Failure to manage these consolidation activities could result in a disruption in the supply of its products and in delays in the fulfillment of the Company's customer orders.

**(e) Accounts Receivable**

Accounts receivable consist of the following (in thousands):

	<u>June 30, 2007</u>	<u>December 31, 2006</u>
Earned accounts receivable	\$ 55,936	\$ 42,086
Unearned accounts receivable	16,855	29,232
Accounts receivable, gross	72,791	71,318
Allowance for doubtful accounts	(353)	(592)
Accounts receivable, net	<u>\$ 72,438</u>	<u>\$ 70,726</u>

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):

	<u>June 30, 2007</u>	<u>December 31, 2006</u>
On-hand final assemblies and finished goods inventory	\$ 15,538	\$ 15,738
Unearned inventory	35,330	27,166
Evaluation inventory	4,535	4,380
Inventory, gross	55,403	47,284
Excess, obsolete and evaluation reserve	(5,721)	(5,969)
Inventory, net	49,682	41,315
Less current portion	(33,177)	(22,266)
Long-term portion (included in Other assets)	<u>\$ 16,505</u>	<u>\$ 19,049</u>

Inventory is stated at the lower of cost (first-in, first-out basis) or market and consists of final assembly materials and finished goods.

Unearned inventory represents deferred cost of revenue for product shipments to customers prior to satisfaction of Sonus' revenue recognition criteria. Unearned inventory amounts related to revenue which the Company does not expect to recognize within one year of the balance sheet date are recorded as long-term assets and included as a component of Other assets in the Condensed Consolidated Balance Sheets.

Sonus provides inventory reserves based on excess and obsolete inventory determined primarily by future demand forecasts, recording any adjustments to such reserves through charges to cost of revenue. 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 it is probable that the inventory will not be realizable. If these evaluation shipments are later purchased by Sonus' customers, Sonus reclassifies amounts previously charged to sales and marketing expense to cost of revenue in the period when all revenue recognition criteria are met.

**(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 lives of the related assets, which range from two to five years. Leasehold improvements are amortized over the lesser of the lease term or five years. When an item is sold or retired, the cost and related accumulated depreciation or amortization is removed, and the resulting gain or loss, if any, is recognized in income (loss) from operations in the Condensed Consolidated Statements of Operations.

**(h) Acquisitions**

In accordance with the purchase method of accounting and Statement of Financial Accounting Standards ("SFAS") No. 141, *Business Combinations* ("SFAS 141"), the fair values of tangible and identifiable intangible assets acquired and liabilities assumed are determined and recorded as of the date of the acquisition. Costs to acquire the business, including transaction costs, are allocated to the fair value of net assets acquired. Any excess of the purchase price over the estimated fair value of the net assets acquired is recorded as goodwill. The Company typically employs valuation consultants to assist in the determination of fair values of tangible and identifiable intangible assets acquired.

**(i) Purchased Intangible Assets and Goodwill**

Purchased intangible assets consist of certain identifiable intangible assets resulting from the April 13, 2007 acquisition of Zynetix. The components of the Company's purchased intangible assets at June 30, 2007 consist of the following (in thousands):

<u>Useful life</u>	<u>Cost</u>	<u>Accumulated amortization</u>	<u>Net carrying value</u>
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Customer relationships	7 years	\$ 1,419	\$ (50)	\$ 1,369
Intellectual property	5 years	1,318	(66)	1,252
Trade name	3 years	304	(25)	279
		<u>\$ 3,041</u>	<u>\$ (141)</u>	<u>\$ 2,900</u>

The Company amortizes its purchased intangible assets over the estimated useful lives of the respective assets, which have a weighted average useful life of 5.7 years. Amortization expense related to purchased intangible assets was \$141,000 in both the three and six months ended June 30, 2007. Estimated future amortization expense for purchased intangible assets recorded by the Company at June 30, 2007 is as follows (in thousands):

Remainder of 2007	\$ 284
2008	568
2009	568
2010	492
2011	466
Thereafter	522
	<u>\$2,900</u>

Goodwill is recorded when the consideration for an acquisition exceeds the fair value of net tangible and identifiable intangible assets acquired. In accordance with SFAS No. 142, *Goodwill and Other Intangible Assets* ("SFAS 142"), goodwill is not amortized, but rather, is tested at least annually for impairment at the reporting unit level. The Company has recorded goodwill aggregating \$7.8 million at June 30, 2007, related to the acquisition of Zynetix. The changes in the carrying amounts of goodwill in the six months ended June 30, 2007 are as follows (in thousands):

Balance at January 1, 2007	\$ —
Acquisition of Zynetix Limited	7,734
Foreign currency translation adjustment	107
Balance at June 30, 2007	<u>\$7,841</u>

#### (j) Impairment of Goodwill and Long-Lived Assets

In accordance with SFAS 142, goodwill and intangible assets with indefinite lives are tested for impairment on an annual basis and between annual tests if indicators of potential impairment exist. Intangible assets with estimated lives and other long-lived assets are reviewed for impairment when events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* ("SFAS 144"). Recoverability of intangible assets with estimated lives and other long-lived assets is measured by a comparison of the carrying amount of an asset or asset group to future net undiscounted pretax cash flows expected to be generated by the asset or asset group. If these comparisons indicate that an asset is not recoverable, the Company will recognize an impairment loss for the amount by which the carrying value of the asset or asset group exceeds the related estimated fair value. Estimated fair value is based on either discounted future pretax operating cash flows or appraised values, depending on the nature of the asset.

Factors that could indicate that an impairment may exist include significant underperformance relative to plan or long-term projections, strategic changes in business strategy, significant negative industry or economic trends, a significant change in circumstances relative to a large customer, a significant decline in the Company's stock price for a sustained period, and a decline in the Company's market capitalization to below net book value.

#### (k) Other Assets

Other assets consist of the following (in thousands):

	June 30, 2007	December 31, 2006
Prepaid commissions	\$ 1,984	\$ 3,103
Prepaid royalties	1,382	336
Deposits	873	1,249
Unearned inventory	16,505	19,049
	<u>\$20,744</u>	<u>\$ 23,737</u>

#### (l) Accrued Expenses

Accrued expenses consist of the following (in thousands):

	June 30, 2007	December 31, 2006
Employee compensation and related costs	\$ 19,071	\$ 21,715
Employee stock purchase plan	4,550	1,966
Professional fees	4,241	4,223
Royalties	1,372	2,640
Income taxes payable	28	7,239
Sales taxes payable	1,114	761
Other taxes	4,181	3,486
Other	2,393	1,623
	<u>\$ 36,950</u>	<u>\$ 43,653</u>

#### (m) Revenue Recognition



Sonus' products are primarily marketed based on the software elements contained therein. In addition, hardware sold generally can not be used apart from the software. Therefore, Sonus considers its principal products to be software-related. Sonus recognizes revenue from product sales when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or 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 involve complex contractual, multiple element arrangements. When a sale includes multiple elements, such as products, maintenance and/or professional services, Sonus recognizes revenue using the residual method. Revenue associated with undelivered elements that are considered not essential to the functionality of the product and for which VSOE has been established, is deferred based on the VSOE value and any remaining arrangement fee is then allocated to, and recognized as, product revenue. VSOE is determined based upon the price charged when the same element is sold separately or

established by the relevant pricing authority. If Sonus cannot establish VSOE for each undelivered element, including specified upgrades, it defers revenue on the entire arrangement until VSOE for all undelivered elements is known or all elements are delivered and all other revenue recognition criteria are met.

Revenue from maintenance and support services is recognized ratably over the life of the service period, ranging from one to five years. Earned maintenance revenue is typically deferred until the associated product is accepted by the customer and all other revenue recognition criteria are met. Maintenance and support services include telephone support, return and repair support and unspecified rights to product upgrades and enhancements.

Revenue from installation services is generally recognized when the service is complete. Revenue from other professional services for which VSOE has been established is typically recognized based on the proportional performance method as the services are delivered.

Revenue from consulting, custom development and other professional service-only engagements is recognized as services are rendered.

Sonus records deferred revenue for product delivered or services performed for which collection of the amount billed is either probable or has been collected but other revenue recognition criteria have not been satisfied. Deferred revenue includes customer deposits and amounts associated with maintenance contracts. Deferred revenue expected to be recognized as revenue more than one year subsequent to the balance sheet date is classified as long-term deferred revenue.

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.

**(n) Deferred Revenue**

Deferred revenue consists of the following (in thousands):

	<u>June 30, 2007</u>	<u>December 31, 2006</u>
Maintenance and support contracts	\$ 45,047	\$ 41,077
Customer deposits	24,686	23,861
Unearned revenue	16,855	29,232
Total deferred revenue	86,588	94,170
Less current portion	(55,269)	(60,383)
Long-term portion	<u>\$ 31,319</u>	<u>\$ 33,787</u>

Revenue from maintenance and support contracts is recognized ratably over the life of the maintenance and support period. 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. At June 30, 2007 and December 31, 2006, both deferred revenue and accounts receivable excluded \$21.7 million and \$12.4 million, respectively, related to products shipped and billed to customers for which revenue is recognized as cash is collected, or for which title had not passed to the customer as of the period end date.

**(o) Stock-based Compensation**

Sonus issues stock options and restricted stock pursuant to the 1997 Stock Incentive Plan ("Stock Plan") and provides employees the right to purchase stock pursuant to the 2000 Employee Stock Purchase Plan ("ESPP"). The Stock Plan provides for the award of stock options and restricted stock to employees,

officers, directors (including those directors who are not employees or officers of the Company), consultants and advisors of the Company and its subsidiaries.

The ESPP is designed to provide eligible employees of the Company and its participating subsidiaries an opportunity to purchase common stock of the Company through accumulated payroll deductions. The ESPP has a two year offering period comprised of four six month purchase periods (subject to extension). The purchase price of the stock is equal to 85% of the lower of the market price on the first day of the two year offering period or the market price on the last day of any of the four purchase periods. If the market price at any of the four purchase periods is less than the market price on the first date of the two year offering period, subsequent to the purchase, the offering period is cancelled and the employee is entered into a new two year offering period with the then current market price as the new base price. Sonus recognizes compensation expense associated with the ESPP in accordance with the provisions of SFAS No. 123(R), *Share-based Payment* ("SFAS 123R"), and Financial Accounting Standards Board ("FASB") Technical Bulletin 97-1, *Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*.



Stock options are generally issued with an exercise price equal to the current market price on the date of grant with a four-year vesting period and contractual term of ten years. Restricted stock is generally issued with no purchase price, with fair value based on the market price on the date of grant. Sonus includes as part of its inventory a portion of the fair value of stock compensation, which is expensed as inventory is relieved, generally over six months. All of Sonus' stock-based compensation is accounted for as an equity instrument and there have been no liability awards granted; however, modifications to stock awards for certain former employees have been recorded as liabilities in accordance with EITF 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock* ("EITF 00-19"). These liability awards are accounted for as derivative financial instruments, and accordingly, are marked to market at each interim reporting date and the changes in fair value are recorded as Other income or expense. Sonus recorded \$0.2 million and \$0.9 million to Other expense for the three and six months ended June 30, 2007, respectively, as a result of changes in the fair value of the liability awards.

Effective January 1, 2006, Sonus adopted the fair value recognition provisions of SFAS 123R, using the modified prospective transition application method, which requires measurement of compensation cost at fair value on the date of grant and recognition of compensation expense over the service period for awards expected to vest. As a result, Sonus recorded \$14.6 million and \$2.7 million of stock-based compensation for the three months ended June 30, 2007 and 2006, respectively, and \$23.5 million and \$5.0 million, respectively, for the six months then ended. These amounts are included as components of the following expense categories in the Condensed Consolidated Statements of Operations (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Product cost of revenue	\$ 188	\$ 10	\$ 278	\$ 25
Service cost of revenue	1,023	199	1,605	483
Research and development	6,482	633	9,691	1,420
Sales and marketing	5,699	1,166	9,221	1,676
General and administrative	1,225	735	2,691	1,438
	<u>\$ 14,617</u>	<u>\$ 2,743</u>	<u>\$ 23,486</u>	<u>\$ 5,042</u>

In addition, Sonus included in inventory approximately \$405,000 and \$32,000 of stock-based compensation at June 30, 2007 and December 31, 2006, respectively.

14

At June 30, 2007, there was \$23.1 million of unrecognized compensation cost related to share-based awards, which is expected to be recognized over a weighted average period of approximately three years. At June 30, 2007, there was \$1.2 million of additional stock-based compensation expense to be recorded over the remaining ESPP period.

#### Valuation Assumptions

The grant-date fair value of options to purchase common stock granted in the three and six months ended June 30, 2007 and 2006 was estimated using the Black-Scholes valuation model with the following assumptions:

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Risk-free interest rate	4.8%	5.0%	4.7%	4.7%
Expected dividend yield	—	—	—	—
Expected volatility	62.4%	70%	57.5%–62.4%	70%–78%
Weighted average volatility	62.4%	70%	60.1%	78%
Expected life (years)	4.5	4.5	4.5	4.5

Based on the above assumptions, the weighted average fair value of stock options granted during the three and six months ended June 30, 2007 was \$4.46 and \$4.16, respectively, and \$2.90 and \$3.13 for the three and six months ended June 30, 2006, respectively.

The fair value of the rights to purchase shares of common stock under the ESPP was estimated on the commencement date of the offering period using the Black-Scholes valuation model with the following assumptions:

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Risk-free interest rate	3.6%–5.1%	2.7%–4.8%	3.6%–5.1%	1.8%–4.8%
Expected dividend yield	—	—	—	—
Weighted average volatility	46%–79%	55%–117%	46%–79%	55%–126%
Expected life (years)	0.33–2.0 years	0.5–2.0 years	0.33–2.0 years	0.5–2.0 years

The risk-free interest rate is the average U.S. Treasury Constant Maturities Rate for the expected term. The expected dividend yield of zero is based on the fact that Sonus has never paid dividends and has no present intention to pay cash dividends. Expected volatility is based on a combination of historical and implied volatility; the Company believes that such a combination provides a more accurate estimate of the grant-date fair value because it is a more accurate indicator of the market's expectations regarding future volatility. The expected life for stock options is based on a combination of the Company's historical option patterns and exercise patterns within similar industries. The expected life for stock purchase rights under the ESPP is based on the purchase periods defined within the ESPP. The Company estimates its forfeiture rate at 5% per year.

15

### Stock Option and Restricted Stock Grant Activity

The following table summarizes information relating to Stock Plan activity during the six months ended June 30, 2007:

Stock Options	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (Years)	Aggregate Intrinsic Value (in thousands)
Outstanding at January 1, 2007	39,200,777	\$ 4.78		
Granted	2,949,495	\$ 7.85		
Exercised	—	\$ —		
Canceled	(419,453)	\$ 5.65		
Outstanding at June 30, 2007	41,730,819	\$ 4.99	6.00	\$ 153,570
Vested or expected to vest at June 30, 2007	41,066,330	\$ 4.97	5.95	\$ 151,974
Exercisable at June 30, 2007	34,386,417	\$ 4.78	5.35	\$ 134,518

The total intrinsic value of options exercised during the three and six months ended June 30, 2006 was \$2.4 million and \$4.5 million, respectively. There were no options exercised during the three or six months ended June 30, 2007. The total fair value of options vested during the three and six months ended June 30, 2007 was \$6.7 million and \$13.1 million, respectively, and \$1.6 million and \$3.2 million during the three and six months ended June 30, 2006.

During December 2006, in order to remedy the unfavorable personal tax consequences for those who have not exercised stock options after December 31, 2005 subject to Section 409A of the Internal Revenue Code, the Company entered into agreements with its directors and executive officers who are subject to the disclosure requirements of Section 16 of the Securities Exchange Act of 1934. The Company's agreement with its directors and executive officers originally had a vesting requirement, but was amended in the first quarter of 2007 to eliminate such vesting requirement. This resulted in additional stock-based compensation expense of approximately \$1.2 million in the Company's consolidated financial statements in the first quarter of 2007.

The Company could not issue any securities under its registration statements on Form S-8 until it became current in its SEC reporting obligations for filing its periodic reports under the Securities Exchange Act of 1934 (the "Exchange Act"). Consequently, during the first and second quarters of 2007, the Company extended the contractual terms of approximately 833,000 and 1.7 million vested stock options, respectively, held by former executives and other former employees. The Company accounted for the modifications to extend the contractual term of the awards for former executives and other former employees in accordance with SFAS 123R. Based on the guidance in SFAS 123R and related FASB Staff Positions, after the modification those stock options held by former executives and other former employees became subject to the provisions of EITF 00-19. As a result, certain of those stock option awards were reclassified as liability awards within current liabilities. Therefore, at the end of each reporting period, the Company determines the fair value of those awards utilizing the Black-Scholes valuation model and recognizes any change in fair value in the Company's Condensed Consolidated Statement of Operations in the period of change until the awards are exercised, expire, or are otherwise settled. As a result of the modifications, the Company recorded additional stock-based compensation of \$7.2 million and \$10.8 million in the three and six months ended June 30, 2007, respectively. The aggregate fair value of these liability awards included in current liabilities was \$4.5 million and \$1.1 million at June 30, 2007 and December 31, 2006, respectively. The Company recorded Other expense of \$0.2 million and \$0.9 million in the three and six months ended June 30, 2007 as a result of changes in the fair value of the liability awards.

During the first quarter of 2007, as a result of the Company's inability to issue any securities under its registration statement on Form S-8, the Company extended the contractual terms of approximately 185,000 vested stock options held by current employees which were due to expire. The Company accounted for the modifications to extend the contractual term of the awards for current employees in accordance with SFAS 123R, and recorded expense of \$0.8 million at the time of the extension.

The Company was not able to issue shares under the ESPP as scheduled on February 28, 2007. As a result, the Company made multiple modifications to the ESPP in order to delay the issuance of shares until after it became current in its SEC reporting obligations. The Company also delayed the commencement of the next scheduled ESPP purchase period from March 1, 2007 to April 1, 2007. These modifications to the ESPP resulted in additional stock-based compensation expense of \$2.8 million and \$5.6 million in the three and six months ended June 30, 2007, respectively, and will result in an additional \$3.3 million during the three months ending September 30, 2007.

The activity related to the Company's outstanding restricted stock awards for the six months ended June 30, 2007 is as follows:

	Shares	Weighted Average Grant-date Fair Value
Nonvested balance at December 31, 2006	330,000	\$ 4.60
Granted	15,000	\$ 7.62
Vested	(40,000)	\$ 4.82
Nonvested balance at June 30, 2007	305,000	\$ 4.72

### (p) Comprehensive Income (Loss)

Sonus' comprehensive income (loss) for the three and six months ended June 30, 2007 and 2006 is as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Net income (loss)	\$ (6,976)	\$ 8,914	\$ (10,954)	\$ 14,730
Foreign currency translation adjustments	(158)	(27)	(97)	(21)
Comprehensive income (loss)	\$ (7,134)	\$ 8,887	\$ (11,051)	\$ 14,709

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

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, as one segment. The Company's chief operating decision maker is its Chief Executive Officer.

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

Net income (loss) per share is computed in accordance with SFAS No. 128, Earnings per Share. Basic net income (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding during the period. For periods in which the Company reports net income, diluted net income per share is determined by using the weighted average number of common and dilutive common equivalent shares outstanding during the period unless the effect is antidilutive. Potential dilutive common shares consist of common stock issuable upon the exercise of stock options and purchases of common shares under the Company's ESPP using the treasury stock method.

17

The calculation of shares used to compute basic and diluted net income per share is as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Weighted average shares outstanding—basic	259,786	252,664	259,777	251,371
Potential dilutive common shares	—	3,662	—	4,083
Weighted average shares outstanding—diluted	<u>259,786</u>	<u>256,326</u>	<u>259,777</u>	<u>255,454</u>

The calculation above for the three and six months June 30, 2006 excludes options to purchase shares of common stock and shares of common stock issuable upon conversion of a convertible subordinated note aggregating approximately 21.4 million shares and 20.7 million shares, respectively, as their effect would be antidilutive.

**(s) Warranty Reserve**

Sonus' products are covered by a standard warranty of 90 days for software and one year for hardware or a warranty of longer periods under certain customer contracts. 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 adjusts the amounts as necessary. At June 30, 2007 and December 31, 2006, Sonus had \$80,000 and \$45,000, respectively, of warranty reserves recorded.

**(t) Income Taxes**

Sonus provides income taxes during interim periods based on the estimated effective tax rate for the full fiscal year. Sonus records cumulative adjustments to the tax provision in an interim period in which a change in the estimated annual effective rate is determined.

In June 2006, the FASB issued FIN 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* ("FIN 48"), which clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 describes a two-step process to determine the amount of tax benefit to be recognized. First, the tax position must be evaluated to determine the likelihood that it will be sustained upon external examination. If the tax position is deemed more-likely-than-not to be sustained, the tax position is then assessed to determine the amount of benefit to recognize in the financial statements. The amount of the benefit that may be recognized is the largest amount that has a greater than 50% likelihood of being realized upon ultimate settlement.

Sonus adopted the provisions of FIN 48 on January 1, 2007. As a result of the implementation of FIN 48, the Company recognized an increase of approximately \$0.1 million in the liability for unrecognized

18

tax benefits, which was accounted for as an increase to the accumulated deficit. In addition, the Company has \$7.1 million of federal and state unrecognized tax benefits consisting of \$5.6 million related to research and development credits previously fully reserved for probable tax exposure and \$1.5 million that reduced our state net operating loss carryforward which previously had a full valuation allowance. These amounts did not result in an adjustment to the accumulated deficit at January 1, 2007. To the extent these unrecognized tax benefits are ultimately recognized, they will impact the effective tax rate in a future period.

As of January 1, 2007, the Company had accrued \$31,000 of interest and penalties related to uncertain tax positions. As of June 30, 2007, the total amount of accrued interest and penalties was \$37,000. The Company accounts for interest and penalties related to uncertain tax positions as part of its provision for federal and state income taxes.

The Company and its subsidiaries file income tax returns in the U.S. federal jurisdiction, as well as various states and foreign jurisdictions. Generally, the tax years 2003 through 2006 remain open to examination by the major taxing jurisdictions to which we are subject. The Company's federal net operating

losses generated prior to 2003 could be adjusted on examination even though the year in which the loss was generated is otherwise closed by the statute of limitations. In 2006, the Massachusetts Department of Revenue (“Mass. DOR”) commenced an examination of the Company’s Massachusetts state income tax returns for 2002 and 2003. We extended the statute for the 2002 tax year to allow for additional time to complete this audit. As of June 30, 2007, the Mass. DOR had not proposed any significant adjustments to the Company’s tax positions.

**(u) Recent Accounting Pronouncements**

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* (“SFAS 159”). SFAS 159 permits an entity to measure certain financial assets and financial liabilities at fair value. Under SFAS 159, entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option may be elected on an instrument-by-instrument basis, with a few exceptions, as long as it is applied to the instrument in its entirety. SFAS 159 establishes presentation and disclosure requirements, but does not eliminate disclosure requirements of other accounting standards. Assets and liabilities that are measured at fair value must be displayed on the face of the balance sheet. SFAS 159 is effective in fiscal years beginning after November 15, 2007, although its provisions may be applied earlier if certain conditions are met. The Company is currently evaluating the impact of SFAS 159 on its consolidated results of operations and financial condition.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* (“SFAS 157”). SFAS 157 provides a single definition of fair value, along with a framework for measuring it, and requires additional disclosure about using fair value to measure assets and liabilities. SFAS 157 emphasizes that fair value measurement is market-based, not entity-specific, and establishes a fair value hierarchy in which the highest priority is quoted prices in active markets. Under SFAS 157, fair value measurements are disclosed according to their level within this hierarchy. While SFAS 157 does not add any new fair value measurements, it does change current practice in certain ways, including requiring entities to include their own credit standing when measuring their liabilities. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. The Company is currently evaluating the impact of SFAS 157 on its consolidated results of operations and financial condition.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* (“SAB 108”). SAB 108 provides specific guidance on disclosures for companies who elect not to restate prior periods for

misstatements and instead elect to record a cumulative-effect adjustment. Sonus applied the provisions of SAB 108 effective December 31, 2006. The application of SAB 108 had no impact on the Company’s consolidated results of operations or financial condition.

**(3) Acquisition of Zynetix Limited**

On April 13, 2007, Sonus completed the acquisition of Zynetix, a privately-held designer of innovative Global System for Mobile Communications (“GSM”) infrastructure solutions located in the United Kingdom. The Company believes that integrating Zynetix technology with Sonus’ IMS portfolio is a critical step in the development of Sonus’ wireless portfolio of 3G and GSM next generation solutions that address the demand for carrier-class, end-to-end IP-based networks. In consideration, Sonus paid the selling shareholders £3,000,000 on the acquisition date (U.S. \$5.9 million as of the acquisition date) and £1,330,583 on June 11, 2007 (U.S. \$2.6 million as of June 11, 2007). The Share Purchase Agreement also includes two additional potential payments (the “earnouts”) to the selling shareholders: (1) £1,500,000 (U.S. \$3.0 million as of the acquisition date) payable on May 1, 2008; and (2) 175,000 shares of Sonus common stock deliverable on April 30, 2009, contingent upon the business achieving certain predetermined financial and business metrics. Each earnout will be recorded as an addition to the purchase price at the time the contingency is resolved and consideration is distributable. In addition, the Company paid \$265,000 in transaction costs related to the acquisition. A summary of the transaction is as follows (in thousands):

<b>Consideration:</b>	
Cash paid	\$ 8,560
Transaction costs	265
Total consideration	<u>\$ 8,825</u>
<b>Preliminary allocation of the purchase consideration:</b>	
Current assets	\$ 1,015
Other assets	25
Identifiable intangible assets:	
Customer relationships	1,400
Intellectual property	1,300
Trade name	300
Goodwill	7,734
Current liabilities	(1,714)
Deferred income taxes	(900)
Notes payable to shareholders	(335)
	<u>\$ 8,825</u>

Current assets acquired primarily relate to accounts receivable and inventory. Current liabilities assumed primarily relate to accounts payable, accrued royalties and accrued payroll taxes.

The preliminary amounts assigned to identifiable intangible assets acquired were based on their respective fair values determined as of the acquisition date. The Company is amortizing these identifiable intangible assets using the straight line method over their respective useful lives, which range from three to seven years. The excess of the purchase price over net assets acquired was recorded as goodwill. In accordance with SFAS 142, the goodwill will not be amortized, but will instead test for impairment at least annually. The goodwill is not deductible for income tax purposes. Pro forma results of operations are not presented as the amounts are not material to the Company’s historical results.

#### (4) Accrued Restructuring Expenses

In the fourth quarter of fiscal 2006, Sonus recorded \$61,000 of restructuring charges related to the closing of an office in India. These charges include severance and fringe benefit costs for two eliminated positions and lease and facility-related obligations. This initiative was completed in the first quarter of fiscal 2007.

The following table summarizes the activity related to this initiative during the six months ended June 30, 2007 (in thousands):

	Balance December 31, 2006	Cash payments	Balance June 30, 2007
Severance and fringe benefits	\$ 54	\$ (54)	\$ —
Facility and related costs	7	(7)	—
	<u>\$ 61</u>	<u>\$ (61)</u>	<u>\$ —</u>

#### (5) Contingencies

In November 2001, a purchaser of the Company's common stock filed a complaint in the United States 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 the Company's 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 the underwriters and certain purchasers to make additional purchases in the after market. The claims against Sonus are asserted under Section 10(b) of the Exchange Act 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 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 our 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. In October 2004, the court certified the class in a case against certain defendants. On February 15, 2005, the court preliminarily approved the terms of the proposed settlement contingent on modifications to the proposed settlement. On August 31, 2005, the court approved the terms of the proposed settlement, as modified. On April 24, 2006, the court held a hearing on a motion to approve the final settlement and took the matter under advisement. On December 5, 2006, the Court of Appeals for the Second Circuit reversed the court's October 2004 order certifying a class. On June 25, 2007, the Court entered an order terminating the settlement. Accordingly, the Company is unable to determine the ultimate outcome or potential range of loss, if any.

Beginning in July 2002, several purchasers of the Company's common stock filed complaints in the United States 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 Exchange Act (the "Class Action Complaints"). The purchasers seek to represent a class of persons who purchased the Company's 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, 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 Sonus' motion to dismiss. The plaintiffs filed a motion for class certification on July 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. After the court requested additional briefing on the adequacy of the class representative, the class representative withdrew. Lead counsel then filed a motion to substitute a new plaintiff as the class representative. On May 19, 2005, the court held a hearing on the motion and took the matter under advisement. On August 15, 2005, the court issued an order decertifying the class and requiring the parties to submit a joint report informing the court whether the cases have been settled and whether defendants would be seeking to recover attorney's fees from the plaintiffs. On September 30, 2005, the plaintiffs filed motions to voluntarily dismiss their complaints with prejudice. On October 5, 2005, the court entered an order dismissing the cases. On June 26, 2006, the court issued an order denying Sonus' motion for recovery of attorneys' fees.

On January 6, 2006, a purchaser of the Company's common stock filed a complaint in the United States District Court for the District of Massachusetts that is essentially identical to the Consolidated Amended Complaint previously filed against the defendants. The Court has appointed the Public Employees' Retirement System of Mississippi as lead plaintiff. The lead plaintiff has filed an Amended Consolidated Complaint. The defendants filed on April 19, 2007 a motion to dismiss the Amended Consolidated Complaint. There is no assurance Sonus will prevail in such a motion or defending this action. A judgment or a settlement of the claims against the defendants could have a material impact on the Company's financial results. It is too early to determine the ultimate outcome or potential range of loss, if any.

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 Exchange Act and Sections 11, 12(a), and 15 of the Securities Act, relating to the restatement of Sonus' 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 its revenues, earnings and financial condition. Plaintiffs contend that such statements caused the Company's stock price to be artificially inflated. The complaint seeks unspecified damages on behalf of a purported class of purchasers of the Company's 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 June 1, 2005, the court held a hearing on the motion and allowed the plaintiff to file an amended complaint. The plaintiff filed an amended complaint that included the same claims and substantially similar allegations as set forth in the initial complaint. On September 12, 2005, the defendants filed motions to dismiss this amended complaint. On December 10, 2005, the court held a hearing on the motions and took the matter under



advisement. On May 10, 2006, the court issued an order granting the defendants' motions in part and denying the motions in part. The court dismissed the Section 12(a)(2) claims against all the defendants and the Section 10(b) and Section 11 claims against the

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individual defendants. The court denied the motions as to the Section 10(b) and Section 11 claims against Sonus and Section 15 claims against the individual defendants. The plaintiff has filed a motion for class certification, which the defendants have opposed. The court held a hearing on February 28, 2007 on plaintiff's motion for class certification and took the matter under advisement. The Company believes that it has substantial legal and factual defenses to the claims, which it intends to pursue vigorously. Sonus expects to incur significant legal fees in defending this action. At this time, Sonus is unable to determine the ultimate outcome or potential range of loss, if any.

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 the Company's 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 the Company's 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. On June 24, 2005, the plaintiffs withdrew the appeal and dismissed the case with prejudice. 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. On June 1, 2005, the court held a hearing on the motion and allowed the plaintiff to file an amended complaint. On July 1, 2005, the plaintiff filed an amended complaint. The defendants renewed their motions to dismiss. On December 10, 2005, the court held a hearing on the motions and took the matter under advisement. On March 31, 2006, the court entered an order granting the defendants' motions to dismiss the amended complaint. On April 26, 2006, the plaintiffs filed a notice of appeal of the dismissal order. On February 6, 2007, the First Circuit Court of Appeals held a hearing on the appeal. Sonus does not expect that this claim will have a material impact on its financial statements.

On June 14, 2006, C2 Communications sued AT&T, Inc., Verizon Communications, Inc., Qwest, Bellsouth Corporation, Sprint Nextel Corporation, Global Crossing and Level 3 in the Eastern District of Texas, Marshall Division. C2 Communications has alleged that each of the defendants infringe U.S. Patent No. 6,243,373 entitled "Method and Apparatus for Implementing a Computer Network Internet Telephone System." Sonus has agreed, subject to certain conditions, to assume the defense of Qwest, Global Crossing and Level 3 in this litigation to the extent the claim results from their use of products purchased from Sonus. There can be no assurance that other defendants who have purchased Sonus products will not seek indemnification from Sonus. The court issued a scheduling order with a trial date of August 4, 2008. Sonus believes that the defendants have substantial legal and factual defenses to the infringement claim, which the Company intends to pursue vigorously on behalf of the defendants for whom Sonus agrees or is required to assume defense of the litigation. However, there is no assurance any of the defendants will prevail in defending this action. There also can be no assurance that Sonus will not be required to indemnify any of the defendants from any judgment of infringement rendered against them. Sonus may be required to devote significant time and resources in connection with assuming the defense of the claim of infringement on behalf of the defendants for whom Sonus has agreed to assume defense of the litigation. An adverse outcome with respect to the claim and Sonus' indemnification could have a material adverse impact on Sonus' business, operating results and financial condition. Sonus cannot predict the ultimate outcome of this litigation or any potential impact on the Company's operating results or financial position.

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On November 14, 2006, a purported shareholder derivative lawsuit was filed in the United District Court for the District of Massachusetts against Sonus and certain of its officers and directors, naming Sonus as a nominal defendant. Other purported shareholders filed virtually identical complaints. The suits claim that certain of Sonus' officers and directors breached their fiduciary duties to its stockholders and to Sonus in connection with its announced stock option review. 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 the Company's obligations under the indemnification agreements or applicable Delaware law. By order dated December 18, 2006, the Court consolidated the actions. The plaintiffs have filed a consolidated complaint. The defendants filed on March 19, 2007 a motion to dismiss the consolidated complaint. The Court held a hearing on July 11, 2007, and took the motion under advisement. Sonus believes that it has substantial legal and factual defenses to the derivative claims, which it intends to pursue vigorously. There is no assurance Sonus will prevail in defending these actions. Sonus cannot predict the ultimate outcome of this litigation or any potential impact on the Company's operating results or financial position.

On January 19, 2007, a purported shareholder derivative lawsuit was filed in the Superior Court Department of Middlesex County of Massachusetts against certain of the Sonus' directors and officers, also naming Sonus as a nominal defendant. Another purported shareholder filed a virtually identical complaint. The suits assert similar claims and seek relief similar to the derivative suits filed in federal court. On May 7, 2007, the plaintiffs filed a consolidated complaint. On June 6, 2007, the defendants moved to dismiss the consolidated complaint. The Court has scheduled a hearing on the motion for August 14, 2007. Sonus believes that it has substantial legal and factual defenses to the derivative claims, which it intends to pursue vigorously. There is no assurance Sonus will prevail in defending these actions. Sonus cannot predict the ultimate outcome of this litigation or any potential impact on the Company's operating results or financial position.

As announced on March 19, 2007, the SEC is conducting a formal private investigation into Sonus' historical stock option granting practices. If the Company is subject to adverse findings, it could be required to pay damages or penalties or have other remedies imposed, including criminal penalties, which could adversely impact Sonus' business, financial position or results of operations.

Sonus includes standard intellectual property indemnification provisions in its product agreements in the ordinary course of business. Pursuant to its product agreements, Sonus will indemnify, hold harmless, and reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally business partners or customers, in connection with certain patent, copyright or other intellectual property infringement claims by third parties with respect to Sonus products. Other agreements with Sonus' customers provide indemnification for claims relating to property damage or personal injury

resulting from the performance of services by Sonus or its subcontractors. Historically, Sonus' costs to defend lawsuits or settle claims relating to such indemnity agreements have been insignificant. Accordingly, the estimated fair value of these indemnification provisions is immaterial.

The Internal Revenue Service has notified the Company that its payroll tax returns for the years ended December 31, 2004, 2005 and 2006 have been selected for audit in connection with its stock option review. In connection with the restatement of its financial statements, Sonus has recorded approximately \$1.6 million of accrued liabilities for additional tax, penalties and interest related to adjustments resulting from errors in stock option accounting. Sonus could be required to pay additional tax, penalties or interest, or have other remedies imposed, which could adversely impact its business, financial position or results of operations.

24

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## (6) Subsequent Event

On August 7, 2007, Sonus announced that its President and Chief Operating Officer, who is also a member of the Board of Directors, would be leaving the Company effective August 10, 2007. The separation arrangement requires Sonus to make a lump sum payment to this officer of approximately \$902,000 six months from the date of separation and continue to pay health care benefits for 18 months from the date of separation. The stock options held by this officer will continue to vest during the 18 months from the date of separation and are exercisable for up to 24 months from the date of separation. In the third quarter of 2007, Sonus expects to record a charge totaling approximately \$2.4 million associated with the required separation payments, other benefits and unamortized stock-based compensation associated with the unvested stock options held by this officer as of the date of separation.

25

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## 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 Item 1A. "Risk Factors" in this Quarterly Report on Form 10-Q. This discussion should be read in conjunction with the unaudited condensed 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, 2006.*

### Overview

We are a leading provider of voice infrastructure solutions for wireline and wireless service providers. Our products are a new generation of carrier-class infrastructure equipment and software that enables voice services to be delivered over Internet Protocol ("IP") packet-based networks. Our target customers include both traditional and emerging communications service providers, including long distance carriers, local exchange carriers, Internet service providers, wireless operators, cable operators, international telephone companies and carriers that provide services to other carriers. IP packet-based networks, which transport traffic in small bundles, or "packets," offer a significantly more flexible, cost-effective and efficient means for providing communications services than existing circuit-based networks, designed years ago to primarily deliver telephone calls.

Our suite of voice infrastructure solutions allows wireline and wireless operators to build converged voice over IP ("VoIP") networks. Our products are built on the same distributed, IP-based principles embraced by the IP Multimedia Subsystem ("IMS") architecture, as defined by the Third Generation Partnership ("3GPP") program. This IMS architecture is being accepted by network operators globally as the common approach for building converged voice, data, wireline and wireless networks. The IMS architecture is based primarily on IP packets and the SIP protocol, which has been the foundation of our products since our formation.

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. 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. At June 30, 2007, we had an accumulated deficit of \$739.2 million. Although we achieved profitability on an annual basis in fiscal years 2006 and 2005, we incurred net losses in the first and second quarters of 2007 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.

26

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## Acquisition of Zynetix Limited

On April 13, 2007, we completed the acquisition of Zynetix Limited ("Zynetix"), a privately-held designer of innovative Global System for Mobile Communications ("GSM") infrastructure solutions located in the United Kingdom. In consideration, we paid the selling shareholders £3,000,000 on the acquisition date (U.S. \$5.9 million as of the acquisition date), and £1,330,583 on June 11, 2007 (U.S. \$2.6 million as June 11, 2007). We also paid \$0.3 million of transaction costs related to this acquisition. The Share Purchase Agreement also includes two additional potential payments to the selling shareholders: (1) £1,500,000 (U.S. \$3.0 million as of the acquisition date) payable on May 1, 2008; and (2) 175,000 shares of our common stock deliverable



on April 30, 2009, contingent upon the business achieving certain predetermined financial and business metrics. The operating results of Zynetix have been included in our condensed consolidated financial statements for the period subsequent to its acquisition.

### Stock-Based Compensation

On January 1, 2006, we adopted Statement of Financial Accounting Standards (“SFAS”) No. 123(R), *Share-Based Payment* (“SFAS 123R”). SFAS 123R supersedes APB Opinion 25 (“APB 25”), *Accounting for Stock Issued to Employees*, and provided the required disclosures in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation* (“SFAS 123”). In transitioning to SFAS 123R, we used the proscribed modified prospective transition method. Under the modified prospective transition method, the unrecognized expense of awards not yet vested at the date of adoption will be recognized in net income in the periods after the date of adoption using the same valuation method, Black-Scholes, and assumptions determined under the original provisions of SFAS 123. We recorded \$14.6 million and \$2.7 million of stock-based compensation in the Condensed Consolidated Statements of Operations for the three months ended June 30, 2007 and 2006, respectively, and \$23.5 million and \$5.0 million for the six months ended June 30, 2007 and 2006, respectively. These amounts are included in the following expense categories (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Product cost of revenue	\$ 188	\$ 10	\$ 278	\$ 25
Service cost of revenue	1,023	199	1,605	483
Research and development	6,482	633	9,691	1,420
Sales and marketing	5,699	1,166	9,221	1,676
General and administrative	1,225	735	2,691	1,438
	<u>\$ 14,617</u>	<u>\$ 2,743</u>	<u>\$ 23,486</u>	<u>\$ 5,042</u>

In addition, we included in inventory approximately \$405,000 and \$32,000 of stock-based compensation at June 30, 2007 and December 31, 2006.

At June 30, 2007, there was \$23.1 million of unrecognized compensation cost related to share-based awards, which is expected to be recognized over a weighted average period of approximately three years. At June 30, 2007, we had \$1.2 million of additional stock-based compensation expense to be recorded over the remaining ESPP purchase period.

During December 2006, in order to remedy the unfavorable personal tax consequences for those who have not exercised stock options after December 31, 2005 subject to Section 409A, we entered into agreements with our directors and executives who are designated as Section 16 filers with the Securities and Exchange Commission. Our agreement with our directors and executives originally had a vesting requirement, but was amended in the first quarter of 2007 to eliminate such vesting requirement. This resulted in additional stock-based compensation expense of \$1.2 million in the first quarter of 2007.

Our registration statements on Form S-8 were unavailable for use during a portion of fiscal 2006 and 2007. As a result, we extended the contractual terms of vested stock options held by former executives and other former employees aggregating approximately 833,000 and 1.7 million during the three and six months ended June 30, 2007, respectively. During the fourth quarter of 2006, we extended the contractual terms of approximately 756,000 vested stock options held by former executives and other former employees. Modifications of stock options subsequent to the departure of former employees were initially recorded as stock-based compensation expense in accordance with FAS 123R. Subsequently, the options were reclassified to current liabilities under the provisions of Emerging Issues Task Force (“EITF”) Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company’s Own Stock* (“EITF 00-19”). Under EITF 00-19, changes in fair value calculated at the end of each reporting period until final settlement using the Black-Scholes valuation model are expensed in our consolidated statement of operations in the period of change. We recorded additional stock-based compensation of \$7.2 million and \$10.8 million in the three and six months ended June 30, 2007, respectively, associated with modifications of stock options. We also recorded \$0.2 million and \$0.9 million in the three and six months ended June 30, 2007, respectively, of Other expense as a result of changes in the fair value of the liability awards. We are accounting for these liability awards as derivative financial instruments, and accordingly, changes in fair value are reported as Other expense. Any changes to the fair values of these options in future periods until settlement will be expensed in our consolidated statement of operations in the period of change.

During the first quarter of 2007, as a result of our inability to issue any securities under our registration statement on Form S-8, we extended the contractual terms of approximately 185,000 vested stock options held by current employees which were due to expire. We accounted for the modifications to extend the contractual term of the awards for current employees in accordance with SFAS 123R, and recorded expense of \$0.8 million in the six months ended June 30, 2007.

In addition we were unable to issue shares under our ESPP as scheduled on February 28, 2007. As a result, the Company made multiple modifications to the ESPP in order to delay the issuance of shares until after we became current in our SEC reporting obligations. In addition, we delayed the commencement of the next scheduled ESPP period from March 1, 2007 to April 1, 2007. The modifications to the ESPP resulted in additional stock-based compensation expense of \$2.8 million and \$5.6 million in the three and six months ended June 30, 2007, respectively, and will result in an additional \$3.3 million during the three months ending September 30, 2007.

### Critical Accounting Policies and Estimates

Management’s discussion and analysis of financial condition and results of operations is based upon our condensed consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. We base our estimates and judgments on historical experience, knowledge of current conditions and beliefs of what could occur in the future given available information. We consider the following accounting policies to be both those most important to the portrayal of our financial condition and those that require the most subjective judgment. If actual results differ significantly from management’s estimates and projections, there could be a material effect on our financial statements. The significant accounting policies that we believe are the most critical include the following:

- Revenue recognition;
- Deferred revenue;
- Allowance for doubtful accounts;

- Inventory reserves;
- Warranty, royalty, litigation and other loss contingency reserves;
- Stock-based compensation;
- Acquisitions;
- Goodwill and identifiable intangible assets; and
- Accounting for income taxes.

**Revenue Recognition.** We recognize revenue from product sales when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or 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 involve complex contractual, multiple-element arrangements. When a sale includes multiple elements, such as products, maintenance and/or professional services, we recognize revenue using the residual method as we have not established VSOE of fair value for our products or specified features/upgrades. Revenue associated with undelivered elements that are not considered essential to the functionality of the product and for which VSOE of fair value has been established, is deferred based on the VSOE of fair value and any remaining arrangement fee is then allocated to, and recognized as, product revenue. We have established VSOE of fair value for maintenance arrangements (post-contract support) and some professional services. VSOE of fair value for maintenance and professional services is determined by either the price charged when the same element is sold separately or established by management having the relevant pricing authority. Our Pricing Committee has the relevant authority for establishing pricing for products and services. If we cannot establish VSOE of fair value for any undelivered element, including specified features and upgrades, we defer revenue on the entire arrangement until VSOE of fair value for all undelivered elements is known or all elements are delivered and all other revenue recognition criteria are met.

Revenue from maintenance and support services is recognized ratably over the service period, ranging from one to five years. Earned maintenance revenue is typically deferred until the associated product is accepted by the customer and all other revenue recognition criteria are met. Maintenance and support services include telephone support, return and repair support and unspecified rights to product upgrades and enhancements.

Revenue from installation services is generally recognized when the service is complete. Revenue from other professional services for which VSOE has been established is typically recognized based on proportional performance as the services are delivered.

Revenue from consulting, custom development and other professional services-only engagements are recognized as services are completed.

**Deferred Revenue.** We record deferred revenue for product delivered or services performed for which collection of the amount billed is either probable or has been collected but other revenue recognition criteria have not been satisfied. Deferred revenue includes customer deposits and amounts associated with maintenance contracts. Deferred revenue expected to be recognized as revenue more than one year subsequent to the balance sheet date is classified as long-term deferred revenue.

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.

**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 estimated based on our detailed assessment of the collectibility of specific customer accounts.

**Inventory Reserves.** Inventory purchases and commitments are based upon estimated future demand for our products. We value inventory at the lower of cost on a first-in, first-out basis or net realizable value. We provide inventory reserves based on excess and obsolete inventory determined primarily by future demand forecasts and estimated returns of defective product, and record charges to cost of revenue. 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 record a full inventory reserve for evaluation equipment at the time of shipment to our customers as a charge to sales and marketing expenses, as it is not probable that the inventory value will be realizable. If these evaluation shipments are later purchased by our customers, we reclassify amounts previously charged to sales and marketing expense to cost of revenue in the period that all revenue recognition criteria are met.

**Warranty Reserve.** Our products are covered by a standard warranty of 90 days for software and one year for hardware or a warranty for longer periods under certain customer contracts. 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 warranty obligations 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.

**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.

**Reserve for Litigation and Legal Fees.** We are subject to various legal claims, including securities litigation. 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.

**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

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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.

**Stock-based Compensation.** On January 1, 2006, we adopted SFAS 123R, using the modified prospective transition method. We account for all stock-based compensation awards to consultants and other non-employees in accordance with the Financial Accounting Standards Board (“FASB”) Emerging Issues Task Force Issue No. 96-18, *Accounting for Equity Instruments that are Issued to Other than Employees for Acquiring or in Conjunction with Selling Goods or Services*, and SFAS 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation—Transition and Disclosure* (prior to January 1, 2006), or in accordance with SFAS 123R (subsequent to January 1, 2006). We followed FASB Interpretation No. 28, *Accounting for Stock Appreciation Rights and Other Variable Stock Option or Award Plans—an Interpretation of APB Opinions No. 15 and 25*, in the recognition of stock-based compensation expense measured under APB 25 (prior to January 1, 2006) and the straight-line method in the recognition of stock-based compensation expense under SFAS 123 (prior to January 1, 2006) and SFAS 123R (subsequent to December 31, 2005). Under both APB 25 and SFAS 123R, the requisite service period over which stock-based compensation is expensed generally equals the vesting periods of the awards.

**Acquisitions.** In accordance with the purchase method of accounting, the fair values of assets acquired and liabilities assumed are determined and recorded as of the date of the acquisition. We utilize independent valuation specialists to assist us in determining the fair values of identifiable intangible assets acquired in order to determine the portion of the purchase price allocable to these assets. Costs to acquire the business, including transaction costs, are allocated to the fair value of net assets acquired. Any excess of the purchase price over the estimated fair value of the net assets acquired is recorded as goodwill.

**Goodwill and Purchased Intangible Assets.** At June 30, 2007, we had goodwill and net purchased intangible assets of \$7.8 million and \$2.9 million, respectively. Goodwill and intangible assets with indefinite lives are tested annually for impairment in accordance with the goodwill provisions of SFAS No. 142, *Goodwill and Other Intangible Assets* (“SFAS 142”). Intangible assets with estimated lives and other long-lived assets are reviewed for impairment when events or changes in circumstances indicate that the carrying amount of an asset or asset group may not be recoverable in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (“SFAS 144”). Recoverability of intangible assets with estimated lives and other long-lived assets is measured by comparing the carrying amount of the asset or asset group to future net undiscounted pretax cash flows expected to be generated by the asset or asset group. If these comparisons indicate that an asset is not recoverable, we will recognize an impairment loss for the amount by which the carrying value of the asset or asset group exceeds the related estimated fair value. Estimated fair value is based on either discounted future pretax operating cash flows or appraised values, depending on the nature of the asset. Considerable judgment is required to estimate discounted future operating cash flows. Judgment is also required in determining whether an event has occurred that may impair the value of goodwill or identifiable intangible or other long-lived assets. Factors that could indicate that an impairment may exist include significant underperformance relative to plan or long-term projections, strategic changes in business strategy, significant negative industry or economic trends, a significant change in circumstances relative to a large customer, a significant decline in our stock price for a sustained period and a decline in our market capitalization to below net book value. We must make assumptions about future cash flows, future operating plans, discount rates and other factors in the models and valuation reports. To the extent these future projections and estimates change, the estimated amounts of impairment could differ from current estimates.

**Accounting for Income Taxes.** Our provision for income taxes is comprised of a current and a deferred portion. The current income tax provision is calculated as the estimated taxes payable or refundable on tax

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returns for the current year. We provide for deferred income taxes resulting from temporary differences between financial and taxable income. Such differences arise primarily from tax net operating loss and credit carryforwards, depreciation, deferred revenue, stock-based compensation expense, accruals and reserves. We assess the recoverability of any tax assets recorded on the balance sheet and provide any necessary valuation allowances as required. If we were to determine that it was more likely than not that we would be unable to realize all or part of our net deferred tax asset in the future, an adjustment to the deferred tax asset would be charged to operations in the period that such determination was made. In evaluating our ability to recover our deferred tax assets, we consider all available positive and negative evidence including our past operating results, the existence of cumulative income in the most recent fiscal years, changes in the business in which we operate and our forecast of future taxable income. In determining future taxable income, we are responsible for assumptions utilized including the amount of state, federal and international pre-tax operating income, the reversal of temporary differences and the implementation of feasible and prudent tax planning strategies. These assumptions require significant judgment about the forecasts of future taxable income and are consistent with the plans and estimates we are using to manage the underlying businesses. Such assessment is completed on a jurisdiction by jurisdiction basis.

We provide for income taxes during interim periods based on the estimated effective tax rate for the full fiscal year. We record a cumulative adjustment to the tax provision in an interim period in which a change in the estimated annual effective tax rate is determined.

We have not provided for U.S. income taxes on the undistributed earnings of non-U.S. subsidiaries, as we plan to permanently reinvest these amounts.

Effective January 1, 2007, we adopted FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109* (“FIN 48”). The Interpretation prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of tax positions taken or expected to be taken in a tax return. For those benefits to be recognized, a tax position must be more likely than not to be sustained upon examination by taxing authorities.

We assessed all material positions taken in any income tax return, including all significant uncertain positions, in all tax years that are still subject to assessment or challenge by relevant taxing authorities. Assessing an uncertain tax position begins with the initial determination of the position’s sustainability

and is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. As of each balance sheet date, unresolved uncertain tax positions must be reassessed, and we will determine whether (i) the factors underlying the sustainability assertion have changed and (ii) the amount of recognized tax benefit is still appropriate. The recognition and measurement of tax benefits requires significant judgment. Judgments concerning the recognition and measurement of a tax benefit might change as new information becomes available.

### Three and Six Months Ended June 30, 2007 and 2006

**Revenue.** Revenue for the three and six months ended June 30, 2007 and 2006 was as follows (in thousands):

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Product	\$52,171	\$48,853	\$103,798	\$93,395
Service	23,322	15,627	42,841	31,080
Total revenue	<u>\$75,493</u>	<u>\$64,480</u>	<u>\$146,639</u>	<u>\$124,475</u>

32

Product revenue is comprised of sales of our voice infrastructure products, including our GSX9000<sup>®</sup> and GSX4000<sup>®</sup> Open Services Switches, PSX Call Routing Server, SGX Signaling Gateway, ASX Feature Server, the Sonus Insight<sup>®</sup> Management System and related product offerings. Product revenue for the three and six months ended June 30, 2007 increased 6.8% and 11.1%, respectively, from the comparable prior year periods. The increase in product revenue in both current year periods was primarily the result of increased product sales and shipments, including the successful completion of the deployment of our products into new and expanded customer networks.

Service revenue is primarily comprised of hardware and software maintenance and support, network design, installation and other professional services. Service revenue increased 49.2% in the three months ended June 30, 2007 and 37.8% in the six months ended June 30, 2007, compared to the same prior year periods. The increase in the three months ended June 30, 2007 was primarily the result of higher maintenance and installation revenue; the increase in the six months ended June 30, 2007 was primarily attributable to higher maintenance, installation and resident engineering revenue.

AT&T contributed more than 10% of our revenue in both the three and six months ended June 30, 2007. Cingular Wireless (part of AT&T as of January 1, 2007) contributed more than 10% of our revenue in both the three and six months ended June 30, 2006. For presentation purposes, AT&T (in fiscal 2007) and Cingular Wireless (in fiscal 2006) are reported as the same customer in year to year comparisons.

International revenue was approximately 25% and 5% of revenue for the three months ended June 30, 2007 and 2006, respectively, and 21% and 14% of revenue for the six months ended June 30, 2007 and 2006, respectively. We expect that international revenue will remain uneven as a percentage of revenue from quarter to quarter.

Our deferred product revenue was \$34.6 million and \$32.7 million at June 30, 2007 and December 31, 2006, respectively. Our deferred service revenue was \$52.0 million and \$61.5 million at June 30, 2007 and December 31, 2006, respectively. 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. At June 30, 2007 and December 31, 2006, deferred revenue and accounts receivable excluded \$21.7 million and \$12.4 million, respectively, related to products shipped and billed to customers for which revenue is recognized as cash is collected, or for which title had not passed to the customer as of the period end date.

**Cost of Revenue/Gross Profit.** Our cost of revenue 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 revenue and gross profit as a percentage of revenue for the three and six months ended June 30, 2007 and 2006 were as follows (in thousands, except percentages):

	Three months ended June 30,		Six months ended June 30,	
	2007	2006	2007	2006
Cost of product	\$23,561	\$16,199	\$40,643	\$32,082
Cost of service	9,563	6,987	18,142	13,716
Total cost of revenue	<u>\$33,124</u>	<u>\$23,186</u>	<u>\$58,785</u>	<u>\$45,798</u>
Gross profit margin (% of respective revenue)				
Product	54.8%	66.8%	60.8%	65.6%
Service	59.0%	55.3%	57.7%	55.9%
Total gross profit margin	56.1%	64.0%	59.9%	63.2%

33

The decrease in product gross profit as a percentage of revenue was primarily due to product mix. We believe that our product gross profit over time will remain in our long-term financial model of 58% to 62%. The increase in service gross profit as a percentage of service revenue was primarily due to higher service revenue relative to our fixed service costs. Our service cost of revenue 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 \$22.4 million for the three months ended June 30, 2007, an increase of \$9.5 million, or 73.3%, from \$12.9 million in the same period of fiscal 2006. Research and development expenses were \$41.0 million for the six months ended June 30, 2007, an increase of \$15.0 million, or 58.0%, from \$26.0 million in the six months ended June 30, 2006. The current year increases primarily reflect an increase in salary and related expenses associated with increased headcount and stock-based compensation. Stock-based compensation costs accounted for \$5.8 million and \$8.3 million of increased research and development expenses in the three and six months ended June 30, 2007, compared to the same prior year periods. 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 are tailoring our investments to meet the requirements of our customers and market.

**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 \$21.2 million for the three months ended June 30, 2007, an increase of \$5.6 million, or 35.6%, compared to \$15.6 million in the same prior year period. Sales and marketing expenses were \$44.3 million for the six months ended June 30, 2007, an increase of \$14.6 million, or 49.2%, from \$29.7 million in the comparable prior year period. The current year increases primarily reflect an increase in salaries, commissions and travel expenses associated with increased headcount related to the expansion of our worldwide sales and support coverage and higher sales levels, stock-based compensation expense and evaluation equipment expenses. Stock-based compensation costs accounted for \$4.5 million and \$7.5 million of increased sales and marketing expenses in the three and six months ended June 30, 2007, compared to the same prior year periods.

**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 \$14.2 million for the three months ended June 30, 2007, an increase of \$7.0 million, or 95.9%, compared to \$7.2 million in the same prior year period. General and administrative expenses for the six months ended June 30, 2007 were \$28.3 million, an increase of \$14.1 million, or 98.7%, compared to \$14.2 million in the six months ended June 30, 2006. The increase in both the three and six month current year periods primarily reflects higher professional fees, including \$9.9 million and \$14.1 million, respectively, of professional fees and other costs associated with our stock option review and resulting restatement, stock compensation expense and salary and related expenses associated with increased headcount, partially offset by a decrease in directors and officers insurance premiums. Stock-based compensation expense accounted for \$0.5 million and \$1.3 million of increased general and administrative expenses in the three and six months ended June 30, 2007, compared to the same prior year periods.

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**Interest Income, net.** Interest income consists of interest earned on our cash equivalents, marketable debt securities and long-term investments. Interest expense in the current year periods primarily relates to interest on capital lease obligations. Interest expense in the prior year periods includes interest incurred on a convertible subordinated note and capital lease obligations. Interest income, net of interest expense, was \$4.4 million and \$9.1 million, respectively, for the three and six months ended June 30, 2007, and \$3.8 million and \$7.1 million, respectively, for the three and six months ended June 30, 2006. This increase is primarily attributable to higher balances available for investment and higher interest rates on our invested funds.

**Other Expense.** We recorded \$0.2 million and \$0.9 million of expense in the three and six months ended June 30, 2007, to reflect the change in fair value of stock options modified to extend their expiration dates subsequent to the departure of the former employees who are the optionees affected.

**Income Taxes.** We provide for income taxes during interim periods based on the estimated effective tax rate for the full fiscal year, and record a cumulative adjustment to the tax provision in an interim period in which a change in the estimated annual effective tax rate is determined. Our effective tax rate, including discrete items, was 37.8% for both the three and six months ended June 30, 2007, compared to 4.3% and 7.5%, respectively, for the three and six months ended June 30, 2006. The income tax benefit of \$4.2 and \$6.6 million in the three and six months ended June 30, 2007, respectively, primarily reflects a current benefit for federal, state and foreign taxes. The income tax benefit for the six months ended June 30, 2007 also includes a discrete expense of \$52,000 which consists of \$46,000 related to the tax effect of certain stock option activity as required by SFAS 123R and \$6,000 related to interest accrued on uncertain tax positions. The income tax provision of \$0.4 million and \$1.2 million for the three and six months ended June 30, 2006, respectively, reflects a current provision for federal, state and foreign taxes. In addition, we maintained a full valuation allowance against our domestic deferred tax assets for these periods. At December 31, 2006, the Company released the majority of its deferred tax asset valuation allowance. The effective tax rate, including discrete items, could be volatile depending on the nature and timing of the dispositions of incentive stock options, the exercise of nonqualified stock options and the resolution of uncertain tax positions.

#### **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 June 30, 2007, our principal sources of liquidity were our cash, cash equivalents, marketable debt securities and long-term investments that totaled \$344.7 million.

Our operating activities provided \$0.3 million of cash in the six months ended June 30, 2007, compared to \$5.4 million in the same prior year period. Non-cash adjustments to our net loss primarily related to stock-based compensation, deferred income taxes, depreciation and amortization of property and equipment, the increase in fair value of modified stock options held by former employees and amortization of purchased intangible assets. These amounts were offset by increases of \$10.6 million, \$5.7 million and \$1.3 million in inventory, other operating assets and accounts receivable, respectively. The increase in inventory levels is primarily due to a buildup of stock in anticipation of increased sales demand in the second half of the fiscal year. Decreases in deferred revenue and accrued expenses, deferred rent and accrued restructuring expenses used \$7.4 million and \$6.9 million of cash, respectively. The decrease in deferred revenue is primarily attributable to lower levels of deferred service revenue compared to December 31, 2006. The decrease in accrued expenses, deferred rent and accrued restructuring expenses is primarily attributable to lower income taxes payable, employee compensation and related costs, and

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accrued royalties, partially offset by the accumulation of employee stock purchase plan contributions resulting from our inability to issue shares of our common stock through the Employee Stock Purchase Plan ("ESPP") and increased sales and other taxes payable. Higher accounts payable levels provided \$6.5 million of cash. Cash provided by operating activities in the six months ended June 30, 2006 came from net income, after adjustments for non-cash items including stock-based compensation and depreciation and amortization of property and equipment, coupled with \$4.2 million of lower inventory levels. These amounts were partially offset by decreases of \$6.7 million and \$3.7 million in deferred revenue and accounts payable, respectively, and higher levels of accounts receivable and other operating assets aggregating \$13.0 million.

Our investing activities provided \$17.9 million of cash in the six months ended June 30, 2007, primarily comprised of \$33.6 million of net maturities of marketable debt securities and long-term investments, partially offset by \$8.8 million spent to acquire Zynetix Limited and \$7.1 million of investments in property and equipment. In the six months ended June 30, 2006, our net investment in marketable debt securities and long-term investments was \$129.4 million, and we used \$5.2 million of cash to purchase property and equipment.

Our financing activities used \$0.7 of cash in the six months ended 30, 2007, of which \$0.3 million was used to pay notes payable to the shareholders of Zynetix, a liability we assumed in connection with our acquisition of Zynetix, \$0.3 million was used to pay tax withholding obligations related to the net share settlement in December 31, 2006 of a restricted stock award and \$0.1 million was used for payments on our capital leases for office equipment. Due to the stock option review and related restatement, which we recently completed, we had been unable to issue shares of our common stock through either the ESPP or to allow any exercises of outstanding options to purchase our common stock during the six months ended June 30, 2007. Our financing activities provided \$3.7 million of cash in the six months ended June 30, 2006, the result of \$13.7 million of proceeds from the sale of common stock in connection with our ESPP and the exercise of stock options, partially offset by the repayment of our \$10.0 million convertible subordinated note.

Based on our current expectations, we believe our current cash, cash equivalents, marketable debt 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. We anticipate devoting substantial capital resources to continue our research and development efforts, to maintain our sales, support and marketing, to improve our internal control environment and for other general corporate activities, as well as to vigorously defend against existing and potential litigation relating to the restatement of our consolidated financial statements. See Note 5 to our Condensed Consolidated Financial Statements.

### Recent Accounting Pronouncements

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities* ("SFAS 159"). SFAS 159 permits an entity to measure certain financial assets and financial liabilities at fair value. Under SFAS 159, entities that elect the fair value option will report unrealized gains and losses in earnings at each subsequent reporting date. The fair value option may be elected on an instrument-by-instrument basis, with a few exceptions, as long as it is applied to the instrument in its entirety. SFAS 159 establishes presentation and disclosure requirements, but does not eliminate disclosure requirements of other accounting standards. Assets and liabilities that are measured at fair value must be displayed on the face of the balance sheet. SFAS 159 is effective in fiscal years beginning after November 15, 2007, although its provisions may be applied earlier if certain conditions are

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met. We are currently evaluating the impact of SFAS 159 on our consolidated results of operations and financial condition.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ("SFAS 157"). SFAS 157 provides a single definition of fair value, along with a framework for measuring it, and requires additional disclosure about using fair value to measure assets and liabilities. SFAS 157 emphasizes that fair value measurement is market-based, not entity-specific, and establishes a fair value hierarchy in which the highest priority is quoted prices in active markets. Under SFAS 157, fair value measurements are disclosed according to their level within this hierarchy. While SFAS 157 does not add any new fair value measurements, it does change current practice in certain ways, including requiring entities to include their own credit standing when measuring their liabilities. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. We are currently evaluating the impact of SFAS 157 on our consolidated results of operations and financial condition.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements* ("SAB 108"). SAB 108 provides specific guidance on disclosures for companies who elect not to restate prior periods for misstatements and instead elect to record a cumulative-effect adjustment. We applied the provisions of SAB 108 effective December 31, 2006. The application of SAB 108 had no impact on our consolidated results of operations or financial condition.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of FASB Statement No. 109 ("FIN 48"), which clarifies the accounting for uncertainty in income taxes recognized in a company's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. FIN 48 prescribes a two-step process to determine the amount of tax benefit to be recognized. First, the tax position must be evaluated to determine the likelihood that it will be sustained upon external examination. If the tax position is deemed more-likely-than-not to be sustained, the tax position is then assessed to determine the amount of benefit to recognize in the financial statements. The amount of the benefit that may be recognized is the largest amount that has a greater than 50% likelihood of being realized upon ultimate settlement. We recorded an increase to the accumulated deficit of \$0.1 million to reflect the cumulative effect of the adoption of FIN 48 on January 1, 2007.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

We are exposed to a variety of market risks, including changes in interest rates affecting the return on our investments and foreign currency fluctuations. We do not believe that a hypothetical 10% adverse movement in interest rates and foreign currency exchange rates would have a materially different impact than what was disclosed in our Annual Report on Form 10-K for the fiscal year ended December 31, 2006.

### Item 4. Controls and Procedures

#### Disclosure 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 and Exchange Act of 1934 (the Exchange Act)), as of June 30, 2007, which included an evaluation of disclosure controls and procedures applicable to the period covered by the filing of this periodic report. The term "disclosure controls and procedures," as defined in Rule 13a-15(e), means controls and other procedures of a company that are designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the SEC's rules and forms.

Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by a company in the reports that it files or submits under the Exchange Act is accumulated and communicated to the company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

In our *Management's Report on Internal Control over Financial Reporting* filed with our Annual Report on Form 10-K for the year ended December 31, 2006, we reported material weaknesses in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act). During the quarter ended June 30, 2007, we continued to design enhancements to our controls and implemented a limited number of changes to address the reported material weaknesses, as defined by the Public Company Accounting Oversight Board. As a result of these material weaknesses, which were not remediated as of June 30, 2007, we have concluded that our disclosure controls and procedures were not effective as of June 30, 2007.

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

During the fiscal quarter ended June 30, 2007, we made changes that have materially affected, or are reasonably likely to materially affect our internal control over financial reporting as follows:

#### ***Inadequate monitoring of foreign locations:***

- Designed a formal closing checklist and internal management representation letter to improve and standardize the financial closing and review process at foreign locations.

#### ***Inadequate revenue recognition procedures and controls:***

- Hired an additional Sales Controller; and
- Created and implemented a revenue closing checklist to ensure key contract terms for each customer are identified and reviewed on a timely basis;

#### ***Inadequate financial statement preparation and review procedures:***

- Hired a new Property and Equipment Accountant; and
- Improved segregation of duties control related to bank signatories.

In addition, we will continue to design and implement additional policies and procedures during the remediation of our reported material weaknesses.

#### ***Risks and Inherent Limitations***

Prior to the complete remediation of these material weaknesses, there remains risk that the processes and procedures 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. Moreover, because of the inherent limitations in all control systems, no evaluation of controls—even when we conclude the controls are operating effectively—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 a simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the 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 to our financial statements.

The certifications of our principal executive officer and principal financial officer required in accordance with Rule 13a-14(a) under the Exchange Act and 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.

## **PART II - OTHER INFORMATION**

### **Item 1. Legal Proceedings**

In November 2001, a purchaser of our common stock filed a complaint in the United States 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 the 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 (the "Exchange Act") 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. In October 2004, the court certified the class in a case against certain defendants. On February 15, 2005, the court preliminarily approved the terms of the proposed settlement contingent on modifications to the proposed settlement. On August 31, 2005, the court approved the terms of the proposed settlement, as modified. On April 24, 2006, the court held a hearing on a motion to approve the final settlement and took the matter under advisement. On December 5, 2006, the Court of Appeals for the Second Circuit reversed the court's October 2004 order certifying a class. On June 25, 2007, the Court entered an order terminating the settlement. Accordingly, we are unable to determine the ultimate outcome or potential range of loss, if any.

Beginning in July 2002, several purchasers of our common stock filed complaints in the United States 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 Exchange Act (the "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. 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. After the court requested additional briefing on the adequacy of the class representative, the class representative withdrew. Lead counsel then filed a motion to substitute a new plaintiff as the class representative. On May 19, 2005, the court held a hearing on the motion and took the matter under

40

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advisement. On August 15, 2005, the court issued an order decertifying the class and requiring the parties to submit a joint report informing the court whether the cases have been settled and whether defendants would be seeking to recover attorney's fees from the plaintiffs. On September 30, 2005, the plaintiffs filed motions to voluntarily dismiss their complaints with prejudice. On October 5, 2005, the court entered an order dismissing the cases. On June 26, 2006, the court issued an order denying our motion for recovery of attorneys' fees.

On January 6, 2006, a purchaser of our common stock filed a complaint in the United States District Court for the District of Massachusetts that is essentially identical to the Consolidated Amended Complaint previously filed against the defendants. The Court has appointed the Public Employees' Retirement System of Mississippi as lead plaintiff. The lead plaintiff has filed an Amended Consolidated Complaint. The defendants filed on April 19, 2007 a motion to dismiss the Amended Consolidated Complaint. There is no assurance we will prevail in such a motion or defending this action. A judgment or a settlement of the claims against the defendants could have a material impact on our financial results. It is too early to determine the ultimate outcome or potential range of loss, if any.

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 Exchange Act and Sections 11, 12(a), and 15 of the Securities Act, 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 June 1, 2005, the court held a hearing on the motion and allowed the plaintiff to file an amended complaint. The plaintiff filed an amended complaint that included the same claims and substantially similar allegations as set forth in the initial complaint. On September 12, 2005, the defendants filed motions to dismiss this amended complaint. On December 10, 2005, the court held a hearing on the motions and took the matter under advisement. On May 10, 2006, the court issued an order granting the defendants' motions in part and denying the motions in part. The court dismissed the Section 12(a)(2) claims against all the defendants and the Section 10(b) and Section 11 claims against the individual defendants. The court denied the motions as to the Section 10(b) and Section 11 claims against us and Section 15 claims against the individual defendants. The plaintiff has filed a motion for class certification, which the defendants have opposed. The court held a hearing on February 28, 2007 on plaintiff's motion for class certification and took the matter under advisement. We believe that we have substantial legal and factual defenses to the claims, which we intend to pursue vigorously. We expect to incur significant legal fees in defending this action. At this time, we are unable to determine the ultimate outcome or potential range of loss, if any.

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

41

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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. On June 24, 2005, the plaintiffs withdrew the appeal and dismissed the case with prejudice. 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. On June 1, 2005, the court held a hearing on the motion and allowed the plaintiff to file an amended complaint. On July 1, 2005, the plaintiff filed an amended complaint. The defendants renewed their motions to dismiss. On December 10, 2005, the court held a hearing on the motions and took the matter under advisement. On March 31, 2006, the court entered an order granting the defendants' motions to dismiss the amended

complaint. On April 26, 2006, the plaintiffs filed a notice of appeal of the dismissal order. On February 6, 2007, the First Circuit Court of Appeals held a hearing on the appeal. We do not expect that this claim will have a material impact on our financial statements.

On June 14, 2006, C2 Communications sued AT&T, Inc., Verizon Communications, Inc., Qwest, Bellsouth Corporation, Sprint Nextel Corporation, Global Crossing and Level 3 in the Eastern District of Texas, Marshall Division. C2 Communications has alleged that each of the defendants infringe U.S. Patent No. 6,243,373 entitled "Method and Apparatus for Implementing a Computer Network Internet Telephone System." We have agreed, subject to certain conditions, to assume the defense of Qwest, Global Crossing and Level 3 in this litigation to the extent the claim results from their use of products purchased from us. There can be no assurance that other defendants who have purchased our products will not seek indemnification from us. The court issued a scheduling order with a trial date of August 4, 2008. We believe that the defendants have substantial legal and factual defenses to the infringement claim, which we intend to pursue vigorously on behalf of the defendant for whom we agree or are required to assume defense of the litigation. However, there is no assurance any of the defendants will prevail in defending this action. There also can be no assurance that we will not be required to indemnify any of the defendants from any judgment of infringement rendered against them. We may be required to devote significant time and resources in connection with assuming the defense of the claim of infringement on behalf of the defendants for whom we have agreed to assume defense of the litigation. An adverse outcome with respect to the claim and our indemnification could have a material adverse impact on our business, operating results and financial condition. We cannot predict the ultimate outcome of this litigation or any potential impact on our results of operations or financial position.

On November 14, 2006, a purported shareholder derivative lawsuit was filed in the United District Court for the District of Massachusetts against us and certain of our officers and directors, naming us as a nominal defendant. Other purported shareholders filed virtually identical complaints. The suits claim that certain of our officers and directors breached their fiduciary duties to our stockholders and to us in connection with our announced stock option review. 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. By order dated December 18, 2006, the Court consolidated the actions. The plaintiffs have filed a consolidated complaint. The defendants filed on March 19, 2007 a motion to dismiss the consolidated complaint. The Court held a hearing on July 11, 2007, and took the motion under advisement. We believe that we have substantial legal and factual defenses to the derivative claims, which we intend to pursue vigorously. There is no assurance we will prevail in defending these actions. We cannot predict the ultimate outcome of this litigation or any potential impact on our results of operations or financial position.

On January 19, 2007, a purported shareholder derivative lawsuit was filed in the Superior Court Department of Middlesex County of Massachusetts against certain of our directors and officers, also

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naming us as a nominal defendant. Another purported shareholder filed a virtually identical complaint. The suits assert similar claims and seek relief similar to the derivative suits filed in federal court. On May 7, 2007, the plaintiffs filed a consolidated complaint. On June 6, 2007, the defendants moved to dismiss the consolidated complaint. The Court has scheduled a hearing on the motion for August 14, 2007. We believe that we have substantial legal and factual defenses to the derivative claims, which we intend to pursue vigorously. There is no assurance we will prevail in defending these actions. We cannot predict the ultimate outcome of this litigation or any potential impact on our results of operations or financial position.

As announced on March 19, 2007, the SEC is conducting a formal private investigation into our historical stock option granting practices. If we are subject to adverse findings, we could be required to pay damages or penalties or have other remedies imposed, including criminal penalties, which could adversely our business, financial position or results of operations.

We include standard intellectual property indemnification provisions in our product agreements in the ordinary course of business. Pursuant to our product agreements, we will indemnify, hold harmless, and reimburse the indemnified party for losses suffered or incurred by the indemnified party, generally business partners or customers, in connection with certain patent, copyright or other intellectual property infringement claims by third parties with respect to our products. Other agreements with our customers provide indemnification for claims relating to property damage or personal injury resulting from the performance of services by us or our subcontractors. Historically, our costs to defend lawsuits or settle claims relating to such indemnity agreements have been insignificant. Accordingly, the estimated fair value of these indemnification provisions is immaterial.

The Internal Revenue Service has notified us that our payroll tax returns for the years ended December 31, 2004, 2005 and 2006 have been selected for audit in connection with our stock option review. In connection with the restatement of our financial statements, we have recorded approximately \$1.6 million of accruals for additional tax, penalties and interest related to adjustments resulting from errors in stock option accounting. We could be required to pay additional tax, penalties or interest, or have other remedies imposed, which could adversely impact our business, financial position or results of operations.

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

*Investing in our common stock involves a high degree of risk. You should carefully consider the risks described below before buying our common stock. If any of the following risks actually occurs, the trading price of our common stock could decline and you may lose all or part of your investment.*

***The investigation of our historical stock option practices and the restatement of our prior financial statements required us to incur substantial expenses and diverted our management's attention from our business, which may impact our business, financial position and results of operations and the trading price of our common stock.***

Our internal review and our Audit Committee's investigation into our historical stock option practices and accounting have required us to incur substantial expenses for legal, accounting, tax and other professional services, have diverted management's attention from our business, and could in the future harm our business, financial condition and results of operations.

While we believe we have made appropriate judgments in determining the correct measurement dates for our stock option grants, the U.S. Securities and Exchange Commission ("SEC") may disagree with the manner in which we have accounted for and reported, or not reported, the financial impact. Accordingly, there is a risk we may have to further restate our historical financial statements, amend prior filings with the SEC, or take other actions not currently contemplated.

***Matters related to the investigation into our historical stock option granting practices and the restatement of our financial statements may result in additional litigation, regulatory proceedings and government enforcement actions for which we may be required to pay damages or penalties or have other remedies imposed.***

Our historical stock option granting practices and the restatement of our financial statements have exposed us to greater risks associated with litigation, regulatory proceedings and government enforcement action. For more information regarding our current litigation and related inquiries, please see Part II, Item 1 “Legal Proceedings” as well as the other risk factors related to litigation set forth in this section. We have provided the results of our internal review and independent investigation to the SEC, which has notified us of a formal order of private investigation. We have responded to requests for documents and additional information and we intend to continue to cooperate with the SEC. No assurance can be given regarding the outcomes from litigation, regulatory proceedings or government enforcement actions relating to our past stock option practices. The resolution of these matters will be time-consuming, expensive, and may distract management from the conduct of our business. Furthermore, if we are subject to adverse findings in litigation, regulatory proceedings or government enforcement actions, we could be required to pay damages or penalties or have other remedies imposed, which could harm our business, financial condition, results of operations and cash flows.

***We have identified material weaknesses in 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 impair our ability to timely file our SEC reports and otherwise seriously harm our business.***

Through, in part, the documentation, testing and assessment of our internal control over financial reporting pursuant to the rules promulgated by the SEC under Section 404 of the Sarbanes-Oxley Act of 2002 and Item 308 of Regulation S-K, management has concluded that our disclosure controls and procedures and our internal control over financial reporting had material weaknesses as of December 31, 2006. We have taken certain actions 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. Prior to the elimination 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 impair our ability to report accurate financial results and could seriously harm our business.***

As described in Item 4 of this Form 10-Q, we have made 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 impair our ability to report accurate financial results and could have a material adverse effect on our business, results of operations and financial position.

***We face risks related to securities litigation that could result in significant legal expenses and settlement or damage awards.***

We have been named as a defendant in a number of securities class action and derivative lawsuits. 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 these lawsuits. Defending against existing and potential litigation

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may require significant attention and resources of management. Regardless of the outcome, such litigation will result in significant legal expenses. 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 position.

Our historical stock option practices and the restatement of our prior financial statements have exposed us to greater risks associated with securities litigation. Several derivative actions were filed against certain current and former directors and officers based on allegations relating to our historical stock option practices. We may be subject to additional litigation arising in relation to our historical stock option practices and the restatement of our prior period financial statements.

***The limitations of our director and officer liability insurance may require us to pay significant legal expenses and settlement or damage awards.***

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. If these policies do not adequately cover expenses and certain liabilities relating to these lawsuits, our results of operations and our financial position could be materially harmed. The facts underlying the lawsuits have made director and officer liability insurance extremely expensive for us, and may make such 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 potentially expose us to self-funding any future liabilities ordinarily mitigated by director and officer liability insurance.

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

From August 9, 2006 through August 2, 2007, we were not current in our SEC filings. 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 until September 1, 2008 and we have lost our status as a “well known seasoned issuer,” including the registration advantages associated with such status. These restrictions may impair our ability to raise capital 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 Global Select 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.***

On August 2, 2007, we filed the Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 (the "Second Quarter Form 10-Q"), the Quarterly Report on Form 10-Q for the quarter ended September 30, 2006 (the "Third Quarter Form 10-Q"), the Annual Report on Form 10-K for the year ended December 31, 2006 (the "2006 Form 10-K") and the Quarterly Report on Form 10-Q for the quarter ended March 31, 2007 (the "First Quarter Form 10-Q") with the SEC. We consider that the filing of these reports has remedied our non-compliance with Marketplace Rule 4310(c)(14), subject to NASDAQ's affirmative completion of its compliance protocols and its notification to us accordingly. However, if NASDAQ disagrees with our position or if the SEC disagrees with the manner in which we have accounted for and reported, or not reported, the financial impact of past stock option grants, there

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could be further delays in filing subsequent SEC reports or other actions that might result in the delisting of our common stock from the NASDAQ Global Select Market.

In addition, if we fail to timely file all of our future periodic reports under the Exchange Act, our common stock may be delisted from the NASDAQ Global Select 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. Our delisting from the NASDAQ Global Select 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.

***Recent rulemaking by the Financial Accounting Standards Board requires us to expense equity compensation given to our employees 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 require companies to record a charge to earnings for employee stock option grants and other equity incentives effective January 1, 2006, which we have adopted. By causing us to incur significantly increased compensation costs, such accounting changes 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.

In addition, in order to eliminate the compensation expense associated with unvested employee stock options with an exercise price of \$4.00 or greater at that time, in December 2005, we accelerated the vesting on the majority of these options. The acceleration of these unvested options may affect our ability to retain key personnel.

***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. Three customers each contributed more than 10% of our revenues in fiscal 2006, or approximately 43% of our revenues in the aggregate. One customer contributed approximately 28% of our revenues in fiscal 2005. Two customers each contributed more than 10%, or approximately 29% in the aggregate, of our revenues in fiscal 2004. 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:

- acquisitions 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;

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- 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 and adversely affect our financial position 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 position could be materially and adversely affected.

***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, 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 of service providers. These conditions caused a substantial, unexpected reduction in demand for telecommunications equipment, including our products.

We expect some of 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 position.

***Consolidation in the 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.

***The market for voice infrastructure products for the 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 becoming 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.

47

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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 in 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 adversely affect our financial position in the applicable period affected.

***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 sales by 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 could 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 affected.

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

International revenues approximated \$78 million and \$48 million in fiscal 2006 and fiscal 2005, respectively, 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

48

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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 cycles;
- 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;

- 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.

***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 operating 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 length and variability of the sales cycle for our products;
- the timing of revenue recognition;
- new product introductions and enhancements by our competitors or by 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 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 have incurred significant losses since inception and, at June 30, 2007, had an accumulated deficit of \$739.2 million. Although we achieved profitability on an annual basis in fiscal 2006, fiscal 2005 and fiscal 2004, we have incurred a net loss in certain quarters and may incur additional losses in future quarters and years. Our revenues may not grow and we may never generate sufficient revenues to sustain profitability.

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 against incumbent telecommunications equipment companies, our ability to increase our revenues and sustain profitability will be impaired.***

Competition in the telecommunications market is intense. This market has historically been dominated by large incumbent telecommunications equipment companies, such as Alcatel-Lucent, NEC, Nortel Networks, Nokia Siemens and Ericsson, 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. Alcatel and Lucent recently completed their merger. Siemens has combined its networking business with Nokia's networking business. Other competitors may merge, intensifying competition. Additional competitors with significant financial resources also may enter our 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 and have the ability to offer lower prices to win business. 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;
- provide a cost-effective and space efficient solution for service providers; and
- meet price competition from low cost equipment 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

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- 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 which could affect our business and operations.***

We have made significant changes in our senior management team since January 1, 2006. Because of these significant changes, our management team may not be able to work together effectively to successfully develop and implement our business strategies. 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. We face increased risk associated with employee

retention due to restrictions imposed on our employees' ability to exercise stock options, delays in stock purchases under our Employee Stock Purchase Plan and the adverse tax impact of Section 409A on our employees' stock options—all of which resulted from our review of historical stock granting



practices and the restatement of our financial statements.

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 may 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 position and results of operations.

***We depend upon a single contract manufacturer and any disruption in this relationship may cause us to fail to meet the demands of our customers and damage our customer relationships.***

We rely on a contract manufacturer to manufacture our products according to our specifications and to fill orders on a timely basis. Our contract manufacturer provides comprehensive manufacturing services, including assembly and certain tests of our products and procurement of materials. Our contract manufacturer 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 a long-term supply contract with our manufacturer nor is our manufacturer 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. In 2006, we consolidated our manufacturing to a single contract manufacturer. We also intend to move our contract manufacturing to a lower cost, offshore facility. If we do not manage this consolidation effectively, these consolidation activities could result in the disruption in the supply of our products and in delays in our fulfillment of customer orders.

***We and our contract manufacturer 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 manufacturer 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.

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On June 14, 2006, C2 Communications Technologies, Inc. ("C2 Communications") sued AT&T, Inc., Verizon Communications, Inc., Qwest Communications International, Inc. ("Qwest"), Bellsouth Corporation ("Bellsouth"), Sprint Nextel Corporation, Global Crossing Limited ("Global Crossing") and Level 3 Communications, Inc. ("Level 3") in the Eastern District of Texas, Marshall Division. C2 Communications has alleged that each of the defendants infringe U.S. Patent No. 6,243,373 entitled "Method and Apparatus for Implementing a Computer Network Internet Telephone System." We have agreed, subject to certain conditions, to assume the defense of Qwest, Global Crossing and Level 3 in this litigation to the extent the claim results from their use of products purchased from us. There can be no assurance that other defendants who have purchased our products will not seek indemnification from us. We believe that the defendants have substantial legal and factual defenses to the infringement claim, which we intend to pursue vigorously on behalf of the defendant for whom we agree or are required to assume defense of the litigation. However, there is no assurance any of the defendants will prevail in defending this action. There also can be no assurance that we will not be required to indemnify any of the defendants from any judgment of infringement rendered against them. We will be required to devote significant time and resources in connection with assuming the defense of the claim of infringement on behalf of the defendants for whom we have agreed to assume defense of the litigation. An adverse outcome with respect to the claim and our indemnification could have a material adverse impact on our business, operating results and financial condition.

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

On April 13, 2007, we acquired Zynetix Limited, designers of innovative Global System for Mobile Communications infrastructure solutions. We intend to continue 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;
- reduce significantly our cash and investments;
- 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;
- potential loss of key employees, particularly those of the acquired organizations; and
- integration of internal controls and financial systems.

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.

***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 where we operate, including the United States. 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 position.

***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, respectively, 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.

***Changes in effective tax rates or adverse outcomes resulting from examination of our income or other tax returns could adversely affect our results.***

Our future effective tax rates could be adversely affected by earnings being lower than anticipated in countries where we have lower statutory rates and higher than anticipated earnings in countries where we have higher statutory rates, by changes in the valuation of our deferred tax assets and liabilities, or by changes in tax laws or interpretations thereof. The Internal Revenue Service has notified us that our payroll tax returns have been selected for audit in connection with our stock option review. In addition, we are subject to the potential for examination of our income tax returns by the Internal Revenue Service and other tax authorities. We regularly assess the likelihood of adverse outcomes resulting from these examinations to determine the adequacy of our provision for income taxes. There can be no assurance that the outcomes from these potential examinations will not have an adverse effect on our operating results and financial condition.

***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:

- the addition or loss of any major customer;

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- 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.

***Provisions of our charter documents and Delaware law 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 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

***Sales of Unregistered Securities***

None.

***Purchases of Equity Securities by the Issuer and Affiliated Purchasers***

We have not announced any currently effective authorization to repurchase shares of our common stock. However, upon vesting of restricted stock awards, employees are permitted to return to us a portion of the newly vested shares to satisfy the tax withholding obligations that arise in connection with such vesting. The following table summarizes repurchases of our common stock during the second quarter of fiscal 2007, which represent shares returned to satisfy tax withholding obligations:

<u>Period</u>	<u>Total Number of Shares Purchased</u>	<u>Average Price Paid per Share</u>	<u>Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs</u>	<u>Approximate Dollar Value of Shares that May Yet be Purchased Under the Plans or Programs</u>
April 1, 2007 to April 30, 2007	14,302	\$ 7.73	—	—
May 1, 2007 to May 31, 2007	—	—	—	—
June 1, 2007 to June 30, 2007	—	—	—	—
Total	<u>14,302</u>	<u>\$ 7.73</u>	—	—

57

## Item 6. Exhibits

<u>Exhibit Number</u>	<u>Description</u>
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

58

## SIGNATURES

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

Dated: August 9, 2007

SONUS NETWORKS, INC.

By: /s/ Ellen B. Richstone

Ellen B. Richstone

Chief Financial Officer (Principal Financial Officer)

By: /s/ Paul K. McDermott

Paul K. McDermott

Vice President of Finance, Corporate Controller and Principal Accounting Officer (Principal Accounting Officer)

59

## EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Description</u>
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**CERTIFICATION PURSUANT TO  
SECTION 302 OF THE SARBANES-OXLEY ACT OF 2002**

I, Hassan M. Ahmed, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Sonus Networks, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 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 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 report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent 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: August 9, 2007

/s/ Hassan M. Ahmed  
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Hassan M. Ahmed  
Chairman and Chief Executive Officer  
(Principal Executive Officer)

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

I, Ellen B. Richstone, certify that:

1. I have reviewed this Quarterly Report on Form 10-Q of Sonus Networks, Inc.;
2. Based on my knowledge, this 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 report;
3. Based on my knowledge, the financial statements, and other financial information included in this 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 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 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 report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - (d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent 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: August 9, 2007

/s/ Ellen B. Richstone  
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Ellen B. Richstone  
Chief Financial Officer  
(Principal Financial 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 June 30, 2007 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: August 9, 2007

/s/ Hassan M. Ahmed  
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Hassan M. Ahmed  
Chairman and Chief Executive Officer  
(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 June 30, 2007 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: August 9, 2007

/s/ Ellen B. Richstone  
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Ellen B. Richstone  
Chief Financial Officer  
(Principal Financial Officer)

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