UTSTARCOM INC
Form 10-Q
June 22, 2006

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2006

OR

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

For the transition period from to
COMMISSION FILE NUMBER 000-29661

UTSTARCOM, INC.

(Exact name of registrant as specified in its charter)

DELAWARE (State of Incorporation)	**52-1782500** (I.R.S. Employer Identification No.)
1275 HARBOR BAY PARKWAY **ALAMEDA, CALIFORNIA** (Address of principal executive offices)	**94502** (zip code)

Registrant's telephone number, including area code: **(510) 864-8800**

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 ý No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).
Large Accelerated Filer ý Accelerated Filer o Non-Accelerated Filer o

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

As of May 23, 2006 there were 121,089,996 shares of the registrant's common stock outstanding, par value $0.00125.

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PART I FINANCIAL INFORMATION

ITEM 1 CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

UTSTARCOM, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS (UNAUDITED)

(In thousands, except share and per share data)

	March 31, 2006	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 673,625	$ 645,571
Short-term investments	10,852	13,266
Accounts receivable, net of allowances for doubtful accounts of $68,837 and $67,789 at March 31, 2006 and December 31, 2005, respectively	405,938	453,671
Accounts receivable, related parties, net of allowances for doubtful accounts of $28 and $5 at March 31, 2006 and December 31, 2005, respectively	89,050	69,293
Notes receivable	7,659	2,065
Inventories	424,028	425,955
Deferred costs/Inventories at customer sites under contracts	246,678	239,876
Prepaids	66,598	61,795
Short-term restricted cash and investments	69,078	53,680
Other current assets	36,677	37,267
Total current assets	2,030,183	2,002,439
Property, plant and equipment, net	221,003	233,403
Long-term investments	25,643	26,023
Goodwill	3,063	3,063
Intangible assets, net	70,389	75,313
Other long-term assets	25,235	25,811
Total assets	$ 2,375,516	$ 2,366,052
LIABILITIES, MINORITY INTEREST AND STOCKHOLDERS' EQUITY		
Current liabilities:		
Accounts payable	$ 339,865	$ 320,677
Short-term debt	172,141	198,826
Income taxes payable	31,708	33,608
Customer advances	265,359	221,301
Deferred revenue	86,681	69,030
Other current liabilities	243,888	289,867
Total current liabilities	1,139,642	1,133,309
Long-term debt	274,900	274,900
Other long-term liabilities	30,943	20,958
Total liabilities	1,445,485	1,429,167
Commitments and contingencies (Note 16)		
Minority interest in consolidated subsidiaries	7,852	8,338

	March 31, 2006	December 31, 2005
Stockholders' equity:		
Common stock: $0.00125 par value; authorized: 750,000,000 shares; issued and outstanding: 120,607,118 and 120,585,158 at March 31, 2006 and December 31, 2005, respectively	152	152
Additional paid-in capital	1,166,519	1,168,166
Deferred stock compensation		(3,493)
Accumulated deficit	(263,809)	(253,174)
Accumulated other comprehensive income	19,317	16,896
Total stockholders' equity	922,179	928,547
Total liabilities, minority interest and stockholders' equity	$ 2,375,516	$ 2,366,052

See accompanying notes to the condensed consolidated financial statements.

UTSTARCOM, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)

(In thousands, except per share data)

	Three months ended March 31, 2006	Three months ended March 31, 2005 as restated
Net sales		
Unrelated party	$ 560,361	$ 603,931
Related party	36,210	297,953
	596,571	901,884
Cost of net sales		
Unrelated party	459,381	536,952
Related party	14,736	127,508
Gross profit	122,454	237,424
Operating expenses:		
Selling, general and administrative	83,172	109,011
Research and development	46,309	66,260
Amortization of intangible assets	4,925	6,972
Total operating expenses	134,406	182,243
Operating (loss) income	(11,952)	55,181
Interest income	3,532	1,349
Interest expense	(3,500)	(4,278)
Other income (expense), net	3,568	(6,847)
(Loss) income before income taxes, minority interest and equity in loss of affiliated companies	(8,352)	45,405
Income tax expense	2,839	7,680
Minority interest in consolidated subsidiaries	556	(222)
Equity in loss of affiliated companies		(459)
Net (loss) income	$ (10,635)	$ 37,044
(Loss) earnings per share Basic	$ (0.09)	$ 0.32
(Loss) earnings per share Diluted	$ (0.09)	$ 0.29
Weighted average shares used in per-share calculation:		
Basic	120,600	114,523
Diluted	120,600	132,949

See accompanying notes to the condensed consolidated financial statements.

UTSTARCOM, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

(In thousands)

	Three months ended March 31,	
	2006	**2005**
		as restated
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net (loss) income	$ (10,635)	$ 37,044
Adjustments to reconcile net (loss) income to net cash provided by (used in) operating activities:		
Depreciation and amortization	17,476	25,897
Loss on sale and disposal of assets	4,708	1,278
Stock compensation expense	4,159	575
Reversal of stock compensation due to terminations	(2,390)	
Provision for doubtful accounts	892	17,548
Provision for inventory reserve	795	15,160
Other	(578)	1,769
Changes in operating assets and liabilities, net of of acquisitions:		
Accounts receivable	28,787	(120,621)
Inventories	(4,337)	(15,724)
Deferred costs/Inventories at customer sites under contracts	(810)	3,533
Other current and non-current assets	(6,771)	49,621
Accounts payable	18,077	33,429
Income taxes payable	(2,020)	(32,015)
Customer advances	43,097	(223,720)
Deferred revenue	14,207	28,016
Other current liabilities	(50,985)	(4,667)
Net cash provided by (used in) operating activities	53,672	(182,877)
CASH FLOWS FROM INVESTING ACTIVITIES:		
Additions to property, plant and equipment	(3,162)	(28,313)
Purchase of business, net of cash acquired		(18,449)
Sale of business	19,965	
Change in restricted cash and investments	(17,037)	5,796
Purchase of short-term investments	(10,819)	(101,194)
Proceeds from sale of short-term investments	13,309	221,253
Other	499	(18)
Net cash provided by investing activities	2,755	79,075
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from borrowings	62,370	146,000
Payments on borrowings	(89,948)	(230,000)
Other	(3,184)	667
Net cash used in financing activities	(30,762)	(83,333)
Effect of exchange rate changes on cash and cash equivalents	2,389	(2,683)
Net increase (decrease) in cash and cash equivalents	28,054	(189,818)
Cash and cash equivalents at beginning of period	645,571	562,532

	Three months ended March 31,	
Cash and cash equivalents at end of period	$ 673,625	$ 372,714
Supplemental disclosure of cash flow information:		
Cash paid:		
Interest	$ 2,511	$ 5,104
Income taxes	$ 3,801	$ 1,489
Non-cash operating activity		
Accounts receivable transferred to notes receivable	$ 8,977	$ 9,394

See accompanying notes to the condensed consolidated financial statements.

UTSTARCOM, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

1. BASIS OF PRESENTATION:

The accompanying unaudited condensed consolidated financial statements include the accounts of UTStarcom, Inc. (the "Company") and its wholly and majority owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in the preparation of the condensed consolidated financial statements. The minority interests in consolidated subsidiaries and equity in affiliated companies are shown separately in the condensed consolidated financial statements.

The accompanying financial statements as of March 31, 2006 and for the three months ended March 31, 2006 and 2005 have been prepared by the Company pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC"). Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. The December 31, 2005 balance sheet was derived from audited financial statements, but does not include all disclosures required by generally accepted accounting principles. These condensed consolidated financial statements should be read in conjunction with the Company's audited December 31, 2005 financial statements, including the notes thereto, and the other information set forth in the Company's Annual Report on Form 10-K for the year ended December 31, 2005.

In the opinion of management, the accompanying unaudited condensed consolidated financial statements reflect all adjustments (consisting of only normal recurring adjustments) considered necessary for a fair statement of the Company's financial condition, the results of its operations and its cash flows for the periods indicated. The results of operations for the three months ended March 31, 2006 are not necessarily indicative of the operating results for the full year.

2. RESTATEMENT OF FINANCIAL STATEMENTS

The Company has restated its previously issued consolidated financial statements for the years ended December 31, 2004 and 2003. Accordingly, the consolidated balance sheets at December 31, 2004 and 2003, and consolidated statements of operations, stockholders' equity and cash flows for the years then ended were restated from amounts previously reported, and are included in the Form 10-K for the year ended December 31, 2005. In addition, the unaudited quarterly condensed consolidated financial statements for the interim reporting periods during the years ended December 31, 2005, 2004 and 2003 are also restated and, are included in the "Quarterly Financial Data (unaudited)" in the Form 10-K for the year ended December 31, 2005, following the Notes to the Consolidated Financial Statements therein.

The restatement follows completion of an investigation by independent legal counsel with the assistance of forensic accountants that was ordered by and under the direction of the Audit Committee of the Company's Board of Directors. The genesis for this independent investigation was the discovery, in December 2005, of two previously unknown side letter agreements provided to a customer in India in 2004 and 2005. The side letter agreements obligated the Company to deliver a variety of software bug fixes, features, updates and upgrades for no additional consideration, and, contrary to Company policy, these side letter agreements were withheld from the Company's financial management and the Company's independent registered public accounting firm. Therefore, neither management nor the Company's independent registered public accounting firm was able to properly evaluate their effect on the recognition of revenue under contracts with this customer.

The independent investigation's initial focus was on the potential existence of other unknown side letter agreements with customers, but the investigation was broadened to encompass other areas involving revenue recognition and some non-revenue related areas to ensure completeness of the investigation. The Audit Committee did not restrict the scope of the independent investigation.

Upon completion of the independent investigation, the investigation team shared its final findings with the Audit Committee and with the Company's independent registered public accounting firm. Financial management conducted follow-up procedures to ensure the information provided by the investigation team was complete, attempted to locate any additional relevant information, and then evaluated the initial accounting for these transactions given the newly available additional information to determine whether the initial accounting was appropriate. Based on the evaluation of available information, management concluded that the original amount of the revenue recognized under contracts with certain customers and other matters discovered as part of the investigation constituted accounting errors. In making a decision regarding whether a restatement of the previously issued financial statements was required, consideration was given to the individual and aggregate effect of all potential restatement adjustments as well as qualitative issues that enter into materiality decisions.

The restatement consists primarily of adjustments for errors in the timing of when revenues, cost and expenses should have been recognized in accordance with generally accepted accounting principles. It resulted in no change to the reported cash balances at the end of the restatement period or as of December 31, 2005. Revenues, contract costs and profits deferred at the end of the restatement period will be recognized in the Company's consolidated statements of operations of future periods when conditions that permit revenue recognition in accordance with generally accepted accounting principles are met.

The following table summarizes the impact of the restatement adjustments on the consolidated statement of operations for the three months ended March 31, 2005:

	Three months ended March 31, 2005		
	As previously reported	Total adjustments	As restated
	(in thousands, except per share amounts)		
Net sales			
Unrelated party	$ 606,160	$ (2,229)	$ 603,931
Related party	295,635	2,318	297,953
	901,795	89	901,884
Cost of net sales			
Unrelated party	537,638	(686)	536,952
Related party	125,968	1,540	127,508
Gross profit	238,189	(765)	237,424
Operating expenses:			
Selling, general and administrative	108,210	801	109,011
Research and development	66,660	(400)	66,260
Amortization of intangible assets	6,972		6,972
Total operating expenses	181,842	401	182,243
Operating income	56,347	(1,166)	55,181
Interest income	1,349		1,349
Interest expense	(4,278)		(4,278)
Other expense, net	(6,847)		(6,847)
Income before income taxes, minority interest and equity in loss of affiliated companies	46,571	(1,166)	45,405
Income tax expense	7,884	(204)	7,680

	Three months ended March 31, 2005		
Minority interest in earnings of consolidated subsidiaries	(222)		(222)
Equity in loss of affiliated companies	(459)		(459)
Net income	$ 38,006	$ (962)	$ 37,044
Earnings per share Basic	$ 0.33	$ (0.01)	$ 0.32
Earnings per share Diluted	$ 0.29		$ 0.29

3. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Use of Estimates:

The preparation of consolidated financial statements in conformity with generally accepted accounting principles in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are used for revenue recognition, allowance for doubtful accounts and sales returns, reserves for inventory, deferred costs and accrued product warranty costs, tax valuation allowances, goodwill impairments and loss contingencies, among others. Actual results could differ from those estimates.

Revenue Recognition:

Revenues from sales of telecommunications equipment and handsets are recognized when persuasive evidence of an arrangement exists, delivery of the product has occurred, customer acceptance has been obtained, the fee is fixed or determinable and collectibility is reasonably assured. If the payment due from the customer is not fixed or determinable due to extended payment terms, revenue is recognized as payments become due from the customer, assuming all other criteria for revenue recognition are met. Any payments received prior to revenue recognition are recorded as customer advances. Normal payment terms differ for various reasons amongst different customer regions, depending upon common business practices for customers within a region. Shipping and handling costs are recorded as revenues and costs of revenues. Any expected losses on contracts are recognized when identified.

Sales may be generated from complex contractual arrangements that require significant revenue recognition judgments, particularly in the area of contracts with multiple deliverable elements (multiple element arrangements). Where multiple elements exist in an arrangement, contract revenue is allocated to the different elements based upon and in proportion to verifiable objective evidence of the fair value of the various elements, as governed under Emerging Issues Task Force Issue ("EITF") No. 00-21, ("Accounting for Revenue Arrangements with Multiple Deliverables) and SEC Staff Accounting Bulletin No. 104 ("Revenue Recognition"). Multiple element arrangements primarily involve the sale of equipment, installation, training and the provision of such equipment to different locations for the same customer. Revenue is recognized as each element is earned, namely upon installation and acceptance of equipment or delivery of handsets, provided that the fair value of the undelivered element(s) has been determined, the delivered element(s) has stand-alone value, there is no right of return on delivered element(s), and the Company is in control of the undelivered element(s). For arrangements that include service elements, including promotional support and installation, for which verifiable objective evidence of fair value does not exist, revenue is deferred until such services are deemed complete, or until the time the Company can establish verifiable objective evidence.

Final acceptance is required for revenue recognition when installation services are not considered perfunctory. Final acceptance indicates that the customer has fully accepted delivery of equipment and the Company is entitled to the full payment. The Company will not recognize revenue before final acceptance is granted by the customer if acceptance is considered substantive to the transaction. Additionally, the Company does not recognize revenue when cash payments are received from customers for transactions that do not have the customer's final acceptance. The Company records these cash receipts as customer advances, and defers revenue recognition until final acceptance is received.

Where multiple elements exist in an arrangement that includes software, and the software is considered more than incidental to the equipment or services in the arrangement, software and software related elements are recognized under the provisions of Statement of Position 97-2 ("Software

Revenue Recognition,") as amended, and EITF No. 03-05 ("Applicability of SOP 97-2 to non-software deliverables containing more than incidental software.") The Company allocates revenues to each element of software arrangements based on vendor specific objective evidence ("VSOE"). VSOE of each element is based on the price charged when the same element is sold separately. The Company uses the residual method to recognize revenue when an arrangement includes one or more elements to be delivered at a future date and VSOE of the fair value of all the undelivered elements exists. Under the residual method, the fair value of the undelivered elements is deferred and the remaining portion of the contract revenue is recognized as revenue. If evidence of fair value of one or more undelivered elements does not exist, all revenue for delivered and undelivered elements is deferred and recognized when delivery of all elements occurs or when VSOE can be established.

The Company recognizes revenue for system integration, installation and training upon completion of performance and if all other revenue recognition criteria are met. Other service revenue, principally related to maintenance and support contracts, is recognized ratably over the contract term. Revenues from services were less than 10% of revenues for all periods present.

The Company also sells products through resellers. Revenue is generally recognized when the standard price protection period, which ranges from 30 to 90 days, has lapsed. If collectibility cannot be reasonably assured in a reseller arrangement, revenue is recognized upon sell-through to the end customer and receipt of cash. There may be additional obligations in reseller arrangements such as inventory rotation, or stock exchange rights on the product. As such, revenue is recognized in accordance with Statement of Financial Accounting Standards ("SFAS") No. 48, "Revenue Recognition When Right of Return Exists." In most cases, the Company has developed reasonable estimates for stock exchanges based on historical experience with similar types of sales of similar products.

The Company has sales agreements with certain wireless customers that provide for a rebate of the selling price to such customers if the particular product is subsequently sold at a lower price to such customers or to a different customer. The rebate period extends for a relatively short period of time. Historically, the amounts of such rebates paid to customers have not been material. The Company estimates the amount of the rebate based upon the terms of each individual arrangement, historical experience and future expectations of price reductions and the records its estimate of the rebate amount at the time of the sale. The Company also enters into sales incentive programs, such as co-marketing arrangements, with certain wireless and handset customers. The Company records the incurred incentive as a reduction of revenue when the sales revenue is recognized.

The assessment of collectibility is also a factor in determining whether revenue should be recognized. The Company assesses collectibility based on a number of factors, including payment history and the credit-worthiness of the customer. The Company does not request collateral from its customers. In international sales, the Company often requires letters of credit from its customers that can be drawn on demand if the customer defaults on its payment. If the Company determines that collection of a payment is not reasonably assured, the Company defers revenue recognition until collection becomes reasonably assured, which is generally upon receipt of cash.

Occasionally, the Company enters into revenue sharing arrangements. Under these arrangements, the Company collects revenues only after its customer, the telecommunications service provider, collects service revenues. When the Company enters a revenue sharing arrangement, the Company does not recognize revenue until collection is reasonably assured.

Because of the nature of doing business in China and other emerging markets, the Company's billings and/or customer payments may not correlate with the contractual payment terms and the Company generally does not enforce contractual payment terms prior to final acceptance. Accordingly, accounts receivable are not booked until the Company recognizes the related customer revenue. Advances from customers are recognized when the Company has collected cash from the customer, prior to recognizing revenue. Deferred revenue is recorded if there are undelivered elements after final acceptance has been obtained.

4. STOCK-BASED COMPENSATION:

Stock Option Plans

The 1997 Stock Plan:

On January 31, 1997, the Board of Directors adopted, and the Company's stockholders approved, the Company's 1997 Stock Plan. Under the 1997 plan, officers, employees and consultants are eligible to receive options to purchase shares of common stock and stock purchase rights. In December 1999, the Board of Directors amended the 1997 plan, which the Company's stockholders approved in February 2000. As of March 31, 2006, the Company was authorized to issue up to 34,636,391 shares subject to options under the plan. During the term of the 1997 plan, the number of shares issuable under the plan will be increased annually on the first day of each fiscal year beginning in 2001 by an amount equal to 6,000,000 shares, or 4% of the outstanding shares of common stock on that date, or a lesser amount determined by the Board. The plan terminates in January 2007, but may be terminated earlier by the Board of Directors. As of March 31, 2006, there were options to purchase 21,500,115 shares of common stock outstanding under the 1997 plan. The Compensation Committee administers the 1997 plan.

Options granted under the 1997 plan may be incentive stock options ("ISOs") which are intended to qualify for favorable federal income tax treatment under the provisions of Section 422 of the Internal Revenue Code of 1986, as amended, or non-qualified stock options ("NSOs"), which do not so qualify. The Compensation Committee selects the eligible persons to whom options will be granted and determines the grant date, amounts, exercise prices, vesting periods and other relevant terms of the options, including whether the options will be ISOs or NSOs. The exercise price of ISOs granted under the 1997 plan may not be less than 100% of the fair market value of common stock on the grant date, while the exercise price of NSOs can be determined by the Compensation Committee in its discretion. Options are generally not transferable during the life of the optionee.

Options vest and become exercisable as determined by the Compensation Committee, generally over four years. Options may generally be exercised at any time after they vest and before their expiration date as determined by the Compensation Committee. However, no option may be exercised more than ten years after the grant date. Options will generally terminate (i) 12 months after the death or permanent disability of an optionee and (ii) 90 days after termination of employment for any other reason. The aggregate fair market value of the shares of common stock represented by ISOs that become exercisable in any calendar year by any one option holder may not exceed $100,000. Options in excess of this limit are treated as NSOs.

In the event the Company is merged with or into another corporation, or all or substantially all of the Company's assets are sold, each outstanding option will be assumed or an equivalent option or right will be substituted by the successor corporation or its parent or subsidiary. If the successor corporation refuses to assume or substitute for the option or right, the option or right will automatically vest and become exercisable in full for a period of at least fifteen days, after which time the option or right will terminate.

Under the 1997 plan, the Company may grant stock purchase rights to eligible participants. Any shares purchased pursuant to stock purchase rights will be subject to a restricted stock purchase agreement. Unless the Compensation Committee determines otherwise, this agreement will grant the Company a right to repurchase the stock upon the voluntary or involuntary termination of the employee for any reason, including death or disability. The purchase price for repurchased shares will be the original price paid and may be paid by cancellation of any indebtedness owed to the Company.

The shares of stock subject to the right of repurchase lapse over time. There were 50,000 stock purchase rights granted during the three months ended March 31, 2006 with a fair value of $0.4 million and a four year vesting term to employees.

2001 Director Option Plan:

On March 2, 2001, the Board of Directors adopted, and in May 2001, the Company's stockholders approved, the Company's 2001 Director Option Plan. Under the 2001 Director Option Plan, those directors who are not employees of the Company ("Outside Directors") are eligible to receive options to purchase shares of common stock. As of March 31, 2006, Directors Horner, Lenzmeier, Clarke and Toy were Outside Directors. All grants of options to Outside Directors are automatic and nondiscretionary. In July 2001, the Board of Directors amended the 2001 Director Option Plan. As of March 31, 2006, the Company was authorized to issue up to 1,200,000 shares pursuant to options under the 2001 Director Option Plan. The plan terminates in May 2011, but may be terminated earlier by the Board of Directors. As of March 31, 2006, there were options to purchase 360,000 shares of common stock outstanding under the 2001 Director Option Plan. The Compensation Committee administers the 2001 Director Plan. On April 27, 2006, the Board of Directors suspended until further action all future grants of stock options to our Outside Directors under the 2001 Director Option Plan.

Pursuant to the terms of the 2001 Director Option Plan, each Outside Director is automatically granted an option to purchase eighty thousand shares of common stock (the "First Option") on the date on which such person first becomes an Outside Director (the "Anniversary Date"). A director who is an employee of the Company and ceases employment with the Company to become an Outside Director receives an option to purchase twenty thousand shares of common stock (a "Subsequent Option") at the Company's first annual meeting of stockholders following such conversion to an Outside Director and at each subsequent annual stockholder meeting thereafter, provided he or she is serving as an Outside Director on each such date. As such time as each Outside Director's First Option is fully vested, each Outside Director is automatically granted a Subsequent Option on the Anniversary Date of each year provided he or she is then an Outside Director.

Under the terms of the 2001 Director Option Plan, the exercise price of each option granted is equal to the market value of the common stock on the date of grant. Such options have terms of ten years, but terminate earlier if the individual ceases to serve as a director. The First Option grants vest as to 25% of shares subject to the First Option on each of the first four anniversaries of its date of grant. The Subsequent Option grants vest as to 100% of the shares subject to the Subsequent Option on the first anniversary of its date of grant.

Issanni Communications, Inc. Incentive Program:

The Issanni plan was established for the issuance of up to a total of 39,876 shares of UTStarcom's common stock to specified former employees of Issanni Communications, Inc. ("Issanni") who became UTStarcom's employees in connection with UTStarcom's acquisition of Issanni. The Issanni plan is administered by the Board of Directors or a committee appointed by the Board. A participant in the Issanni plan is eligible to earn and vest in a designated number of shares that are subject to the award of shares made to a participant under the plan, based upon the attainment of one of six milestones related to the amount of revenue generated from Issanni products in 2002 and 2003 and subject to the participant's continued employment with Issanni, the Company or one of their subsidiaries through the day of the determination that the applicable milestone has been satisfied. In addition, each participant is entitled to receive the unearned shares, if any, on the fifth anniversary of the acquisition of Issanni if the employee continues to be employed with Issanni, the Company or any of their subsidiaries on such date regardless of whether any milestone is attained. The shares subject to an award will in any event become issuable, whether or not the milestones were achieved and whether or not the five-year vesting schedule has elapsed, upon (i) the sale or the discontinuation of the Company or UTStarcom

International Products Inc., (ii) the sale of substantially all or any of the technology acquired by UTStarcom International Products Inc. in connection with the acquisition of Issanni, or (iii) the employment termination of certain Issanni principals.

If, prior to the date on which all of a participant's shares are earned, the participant's service with Issanni, the Company or one of their subsidiaries is terminated (i) voluntarily or for cause, the Company may exercise its repurchase option with respect to any of the participant's unearned shares, (ii) other than voluntarily or for cause, death or disability, the participant will be entitled to receive the shares that the participant would have otherwise earned with respect to milestones achieved within 24 months of the participant's termination, or (iii) as a result of death or disability, the participant (or his estate) will be entitled to receive the unearned portion of his shares with respect to all milestones.

The 2003 Non-Statutory Stock Option Plan:

On April 15, 2003, the Board of Directors adopted the Company's 2003 Non-Statutory Stock Option Plan. Under the 2003 plan, directors, officers, employees and consultants of the Company are eligible to be granted options to purchase shares of the Company's common stock. Only non-statutory stock options, which do not qualify for favorable federal income tax treatment under the provisions of Section 422 of the Internal Revenue Code of 1986, as amended, may be granted under the 2003 plan. As of March 31, 2006, the Company was authorized to issue up to 1,500,000 shares pursuant to options granted under the 2003 plan, subject to adjustment in certain instances (including stock splits, stock dividends, business combinations or other changes in capitalization). As of March 31, 2006, options to purchase 970,535 shares of common stock were outstanding under the 2003 plan.

The 2003 plan is administered by the Compensation Committee of the Board of Directors. The Compensation Committee is charged with selecting the eligible persons to whom options will be granted and determines the number of shares subject to the option, exercise prices, vesting periods and other terms applicable to each option.

Options granted under the 2003 plan generally vest and become exercisable over four years, and may be exercised at any time after they vest but before their expiration date. Options will generally terminate (i) 12 months after the death or employment termination due to disability of an option holder and (ii) 90 days after termination of an option holder's service for any other reason other than for disability or due to the option holder's death. However, no option may be exercised more than ten years after the grant date.

In the event the Company is merged with or into another corporation, or all or substantially all of the Company's assets are sold, the 2003 plan provides for each outstanding option to be assumed or an equivalent option or right to be substituted by the successor corporation or its parent or subsidiary. If the successor corporation refuses to assume or substitute for the option, the option will automatically vest and become exercisable in full for a period determined by the compensation committee, after which time the option will terminate.

A summary of activity under the Plans follows:

	Number of options	Weighted average exercise price	Shares available for grant
Options outstanding, December 31, 2005	19,908,010	$ 18.34	6,495,767
Options authorized in 2006			400,000
Options granted	4,689,373	6.27	(4,689,373)
Options exercised	(21,960)	3.66	
Options forfeited or expired	(1,726,939)	20.55	1,726,939
Options outstanding, March 31, 2006	22,848,484	$ 15.71	3,933,333

Stock Award Activity

During the three months ended March 31, 2006, the Company granted restricted stock awards to its employees under the 1997 Stock Option Plan. Such awards generally vest over a period of four years from the date of grant. The restricted stock awards have the voting rights of common stock and the shares underlying the restricted are considered issued and outstanding. The Company expenses the cost of the restricted stock awards, which is determined to be the fair market value of the shares at the date of grant, ratably over the period during which the restrictions lapse. The grant of restricted stock awards is deducted from the shares available for grant under the Company's stock option plan. Restricted stock activity under the Company's stock option plans for the three months ended March 31, 2006 is summarized below (in thousands, except per share amounts):

	Resticted stock outstanding	Weighted average grant date fair value
	(in thousands)	
Balance at December 31, 2005	137,709	$ 8.12
Restricted stock granted	50,000	8.33
Restricted stock forfeited		
Restricted stock vested	(11,980)	8.19
Balance at March 31, 2006	175,729	$ 8.17

Information regarding the stock options outstanding at March 31, 2006 is summarized below:

	Options Outstanding				Options Exercisable		
Range of exercise price	Outstanding at March 31, 2006	Weighted average exercise price	Intrinsic value	Weighted average remaining contractual life	Exercisable at March 31, 2006	Weighted average exercise price	Intrinsic value
			(in thousands)	(in years)			(in thousands)
$ 0.06 - $ 0.07	28,321	$ 0.06	$ 176	2.7	28,321	$ 0.06	$ 176
0.25 - 0.25	16,781	0.25	$ 101	2.5	16,781	0.25	$ 101
1.57 - 2.28	169,474	2.23	$ 688	1.8	169,474	2.23	$ 688
2.50 - 3.65	121,585	3.47	$ 343	3.0	121,585	3.47	$ 343
4.00 - 5.99	651,574	4.66	$ 1,062	4.0	575,774	4.49	$ 1,036
6.06 - 8.87	7,451,945	6.63		9.8	58,332	7.98	
9.38 - 13.61	2,923,326	11.45		7.0	1,199,988	11.86	
14.23 - 21.32	5,609,059	18.17		6.0	4,720,409	18.26	
21.53 - 32.05	4,617,869	26.58		6.9	4,557,385	26.64	
32.65 - 45.21	1,258,550	37.72		6.9	1,258,550	37.72	
$ 0.06 - $45.21	22,848,484	$ 15.71	$ 2,371	7.5	12,706,599	$ 21.50	$ 2,345
Options exercisable and expected to vest March 31, 2006	20,700,727	$ 15.71	$ 2,148				

The intrinsic value is calculated as the difference between the market value as reported by NASDAQ on March 31, 2006 and the exercise price of the in-the-money shares. The total intrinsic value of options exercised during the three months ended March 31, 2006 was $0.1 million and the amount of cash received for the exercise of options was $0.1 million.

2000 Employee Stock Purchase Plan:

In February 2000, the Company's stockholders approved the 2000 Employee Stock Purchase Plan. The purchase plan is intended to qualify as an "employee stock purchase plan" under Section 423 of the Internal Revenue Code.

The Company has reserved 1,914,934 shares of common stock for sale under the stock purchase plan at March 31, 2006. The number of shares reserved for sale under the plan will be increased annually on the first day of each fiscal year beginning in 2001 by an amount equal to 2.0 million shares, or 2% of the outstanding shares of the Company's common stock on that date, or a lesser amount determined by the Board of Directors. The stock purchase plan will be administered by the Board or a committee appointed by the Board.

The stock purchase plan is implemented by offering periods, the duration of which may not exceed 24 months. Offering periods may contain interim purchase periods. Shares purchased under the stock purchase plan will be held in separate accounts for each participant. The first offering period began in March 2000 and ended on the last trading day before April 30, 2002. Subsequent consecutive overlapping offering periods begin on May 1 and November 1 annually. These offering periods end twenty-four months thereafter.

Employees will be eligible to participate in the stock purchase plan if they are employed by the Company for more than 20 hours per week and more than five months in a calendar year. The stock purchase plan permits eligible employees to purchase the Company's common stock through payroll deductions, which may not exceed 15% of the employee's total compensation. Stock may be purchased under the plan at a price equal to 85% of the fair market value of the Company's stock on either the date of purchase or the first day of the offering period, whichever is lower. However, the Board of Directors may in its discretion provide that the price at which shares of common stock are purchased under the plan shall be 85% of the fair market value of the Company's shares on the date of purchase. Participants may not purchase shares of common stock having a value greater than $25,000 during any calendar year.

Participants may increase or decrease their payroll deductions at any time during an offering period, subject to limits imposed by the Board of Directors. If a participant withdraws from the stock purchase plan, any contributions that have not been used to purchase shares shall be refunded. A participant who has withdrawn may not participate in the stock purchase plan again until the next offering period. In the event of retirement or cessation of employment for any reason, any contributions that have not yet been used to purchase shares will be refunded to the participant, or to the participant's designated beneficiary in the case of death, and a certificate will be issued for the full shares in the participant's account.

The Board of Directors may terminate or amend the stock purchase plan, subject to stockholder approval in some circumstances. Unless terminated earlier by the Board, the stock purchase plan will have a term of ten years.

Stock-Based Compensation

On January 1, 2006, the Company adopted Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment," ("SFAS 123(R)") which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors including employee stock options and employee stock purchases related to the Employee Stock Purchase Plan ("employee stock purchases") based on estimated fair values. SFAS 123(R) supersedes the Company's previous accounting under Accounting Principles Board Opinion No. 25, "Accounting for Stock Issued to Employees" ("APB 25") for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 107 ("SAB 107") relating to SFAS 123(R). The Company has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

Stock-based compensation expense recognized during the period is based on the value of the portion of share-based payment awards that is ultimately expected to vest during the period. Stock-based compensation expense recognized in the Company's Consolidated Statement of Operations for the three months ended March 31, 2006 included compensation expense for share-based payment awards granted prior to, but not yet vested as of December 31, 2005 based on the grant date fair value estimated in accordance with the pro forma provisions of SFAS 123 and compensation expense for the share-based payment awards granted subsequent to December 31, 2005 based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R). Compensation expense for all share-based payment awards granted on or prior to December 31, 2005 was recognized using the straight-line single-option method, and the Company will continue to use the straight-line single-option method for all share-based payment awards granted subsequent to December 31, 2005. The stock-based compensation expense recognized in the Consolidated Statement of Operations for the first quarter of fiscal 2006 is based on awards ultimately expected to vest and has been reduced for estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. In the Company's pro forma information required under SFAS 123 for the periods prior to fiscal 2006, the Company accounted for forfeitures as they occurred.

The Company has used the Black-Scholes option-pricing model ("Black-Scholes model") method of valuation for share-based awards granted on or prior to December 31, 2005, and has continued to use the Black-Scholes model for subsequent share-based payment awards. The Company's determination of fair value of share-based payment awards on the date of grant using the Black-Scholes model is affected by the Company's stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include our expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends. The Company uses historical volatility as management believes it is more representative of future stock price trends than implied volatility due to the relatively small number of actively traded options on our common stock available to determine implied volatility. The Company estimates an expected term of options granted based upon the Company's historical exercise and cancellation data for vested options. In addition, separate groups of employees that have similar exercise behavior are considered separately. The expected term of employee stock purchase plan shares is the average of the remaining purchase periods under each offering period. The Company bases the risk-free interest rate used in the option valuation model on U.S. Treasury zero-coupon issues with remaining terms similar to the expected term on the options. The Company does not anticipate paying any cash dividends in the foreseeable future and therefore uses an expected dividend yield of zero in the option valuation model. The Company is required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from those estimates. The Company uses historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All stock-based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods.

Because the Company's employee stock options have certain characteristics that are significantly different from traded options, and because changes in the subjective assumptions can materially affect the estimated value, in management's opinion, the existing valuation models may not provide an accurate measure of the fair value of the Company's employee stock options. Although the fair value of employee stock options is determined in accordance with SFAS 123(R) and SAB 107 using an option-pricing model, that value may not be indicative of the fair value observed in a willing buyer/willing seller market transaction.

On November 10, 2005, the Financial Accounting Standards Board ("FASB") issued FASB Staff Position No. FAS 123(R)-3 "Transition Election Related to Accounting for Tax Effects of Share-Based Payment Awards." The Company has not yet chosen a transition method to establish the beginning balance of the additional paid-in capital pool ("APIC pool") related to the tax effects of employee stock-based compensation, and to determine the subsequent impact on the APIC pool and

Consolidated Statements of Cash Flows of the tax effects of employee stock-based compensation awards that are outstanding upon adoption of SFAS 123(R).

The assumptions used to value option grants for the quarters ended March 31, 2006 and 2005 are as follows:

	Three months ended March 31,	
	2006	2005
		as restated
Expected remaining term in years	4.00	4.00
Weighted average risk-free interest rate	4.64%	3.52%
Volatility	56.98%	55.90%

The assumptions used to value employee stock purchase plan shares for the quarters ended March 31, 2006 and 2005 are as follows:

	Three months ended March 31,	
	2006	2005
		as restated
Expected remaining term in years	1.50	3.00
Weighted average risk-free interest rate	4.64%	3.52%
Volatility	61.00%	55.90%

At March 31, 2006, there was $27.7 million of total unrecognized compensation cost related to non-vested stock options, which is expected to be recognized over a weighted-average period of 3.0 years. The weighted average fair value (computed using the Black-Scholes option pricing model) of options granted under the stock option plans during the 3 months ended March 31, 2006 was $3.04 per share.

The Company adopted SFAS 123(R) using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of the Company's fiscal year 2006. The Company's Consolidated Financial Statements as of and for the three months ended March 31, 2006 reflect the impact of SFAS 123(R). In accordance with the modified prospective transition method, the Company's Consolidated Financial Statements for prior periods have not been restated to reflect, and do not include, the impact of SFAS 123(R). The total stock-based compensation cost recognized in income for the three month period ended March 31, 2006 was as follows:

		Three months ended March 31, 2006
		(in thousands, except per share data)
Stock-based compensation expense by type of award:		
Employee stock options	$	3,175
Employee stock purchase plan		367
Restricted stock		617
Tax effect		
Total	$	4,159
EPS effect:		
Basic	$	0.03

	Three months ended March 31, 2006
Diluted	$ 0.03

Adopting SFAS 123(R) increased pre-tax loss by $3.5 million.

Prior to the adoption of SFAS 123(R)

Prior to the adoption of SFAS 123(R), the Company applied APB 25 and related interpretations to account for employee stock-based compensation. As such, compensation expense was recorded only if on the date of the grant, the current fair value of the underlying stock exceeded the exercise price of the stock option. The Company recorded deferred compensation in connection with stock options granted, as well as stock options issued in acquisitions, with exercise prices less than the fair market value of common stock on the date of the grant. The amount of such deferred compensation per share was equal to the excess of the fair market value over the exercise price on the grant date. The Company also recorded deferred compensation in connection with the restricted stock units granted, the amount of which equaled the fair market value of common stock on the date of the grant. Recorded deferred compensation was recognized as stock-based compensation expense ratably over the vesting periods. In accordance with SFAS 123(R), all deferred compensation, totaling $3.5 million that had previously been recorded, has been eliminated with a corresponding reduction in additional paid-in capital. In accordance with SFAS 123, Company provided pro forma information to illustrate the effect on net income and earnings per share if the Company had applied the fair value recognition provision of SFAS 123 to stock-based employee compensation.

The pro forma information required under SFAS 123 for the three months ended March 31, 2005 was as follows:

		Three months ended March 31, 2005
		as restated (in thousands, except per share data)
Basic		
Net income (loss):		
As reported	$	37,044
Add: Stock-based employee compensation expense included in reported net income (loss), net of related tax effects		409
Deduct: Total compensation expense determined under fair value based method for all awards, net of related tax effects		(6,278)
Pro forma net income (loss)	$	31,175
Basic income (loss) per share:		
As reported		0.32
Pro forma		0.28
Diluted		
Net income (loss):		
As reported	$	37,044
Effect of dilutive securities 7/8% Convertible subordinated notes		951
Add: Stock-based employee compensation expense included in reported net income (loss), net of related tax effects		409
Deduct: Total compensation expense determined under fair value method for all awards, net of related tax effects		(6,278)
Pro forma net income (loss)	$	32,126
Diluted income (loss) per share:		
As reported	$	0.29
Pro forma	$	0.25

5. (LOSS) EARNINGS PER SHARE:

Basic (loss) earnings per share is computed by dividing net income available to holders of common stock by the weighted average number of shares of the Company's common stock outstanding during the period. Diluted (loss) earnings per share is determined by adjusting net (loss) income as reported by the effect of dilutive securities and increasing the number of shares by potentially dilutive shares of common stock outstanding during the period. Potentially dilutive shares of common stock consist of employee stock options, a written call option, warrants, convertible subordinated notes and unvested acquisition-related stock options.

The following is a summary of the calculation of basic and diluted (loss) earnings per share:

	Three months ended March 31,	
	2006	2005
		as restated
	(in thousands except per share data)	
Numerator:		
Net (loss) income for basic EPS computation	$ (10,635)	$ 37,044
Effect of dilutive securities 7/8% convertible subordinated notes		951
Net (loss) income adjusted for dilutive securities	$ (10,635)	$ 37,995
Denominator:		
Shares used to compute basic EPS	120,600	114,523
Dilutive common stock equivalent shares:		
Stock options		1,157
Written call option		
Conversion of convertible subordinated notes		16,919
Warrants		
Unvested acquisition-related stock		350
Shares used to compute diluted EPS	120,600	132,949
(Loss) Earnings per share basic	$ (0.09)	$ 0.32
(Loss) Earnings per share diluted	$ (0.09)	$ 0.29

Potentially dilutive shares are excluded from the computations of diluted net loss per share for the three months ended March 31, 2006 as the effect would be anti-dilutive. These shares totaled 22.8 million with a weighted average exercise price of $15.71 per share. Certain potential shares related to employee stock options outstanding during the three months ended March 31, 2005 were excluded in the diluted per share computations, since their exercise prices were greater than the average market price of the Company's common stock during the period and, accordingly, their effect is anti-dilutive under the treasury stock method. For the three months ended March 31, 2005, these shares totaled 15.4 million shares with a weighted average exercise price of $24.09 per share.

At March 31, 2006, the Company's 7/8% convertible subordinated notes outstanding were ineligible for conversion into shares of common stock. For each $1,000 of aggregate principal amount of notes converted, the Company will deliver 42.0345 shares of common stock, if the Company's closing stock price exceeds $26.17 as of the last trading day of the immediately preceding fiscal quarter. At December 31, 2005, the closing price of the Company's common stock was below $26.17. In September 2004, the EITF reached a consensus related to EITF No. 04-8 "The Effect of Contingently

Convertible Debt on Diluted Earnings per Share." The consensus requires contingently convertible debt instruments with a market price trigger to be treated the same as traditional convertible debt instruments for purposes of computed earnings per share using the "if converted" method for all periods presented for which the effect would be anti-dilutive. The EITF pronouncement is effective and conversion is assumed in this diluted EPS computation.

The Company entered into convertible bond hedge and call option transactions to reduce the potential dilution from conversion of the notes. Both the bond hedge and call option transactions may be settled at the Company's option either in cash or net shares and expire on March 1, 2008. Using the treasury stock method, under Statement of Financial Accounting Standards No. 128, "Earnings Per Share" ("SFAS 128"), during periods when the average price of the Company's stock is above the specified strike prices of the bond hedge and call option transactions, the effect to the diluted earnings per share calculation would be a decrease to the denominator for the bond hedge transaction, and an increase to the denominator for the call option transaction. However, only the potential dilutive effect with respect to the call option transaction is included in the Company's diluted earnings per share calculations. The convertible bond hedge, under SFAS 128, is always anti-dilutive.

During the three months ended March 31, 2006 and March 31, 2005, the average price of the Company's stock was below the specified strike prices of both the convertible bond hedge and call option transactions and, therefore, there was no dilutive effect.

6. COMPREHENSIVE (LOSS) INCOME:

The reconciliation of net (loss) income to comprehensive (loss) income for the three months ended March 31, 2006 and 2005 is as follows:

	Three months ended March 31,	
	2006	2005
		as restated
	(in thousands)	
Net (loss)income	$ (10,635)	$ 37,044
Unrealized gain on investments	521	
Foreign currency translation	1,900	(475)
Total comprehensive (loss) income	$ (8,214)	$ 36,569

7. CASH, CASH EQUIVALENTS AND SHORT-TERM INVESTMENTS:

Cash and cash equivalents consist of instruments with maturities of three months or less at the date of purchase. There were no available-for-sale securities included in cash and cash equivalents at March 31, 2006 or December 31, 2005. Short-term investments, consisting entirely of available-for-sale securities, were $10.9 million and $13.3 million at March 31, 2006 and December 31, 2005, respectively. These available-for-sale securities consist of government-backed notes, commercial paper, floating rate corporate bonds and fixed income corporate bonds. These investments are recorded at fair value. Any unrealized holding gains or losses are reported as a component of comprehensive other income. Realized gains and losses are reported in earnings.

The Company accepts bank notes receivable with maturity dates of between three and six months from its customers in China in the normal course of business. The Company may discount these notes with banking institutions in China. A sale of these notes is reflected as a reduction of cash and cash equivalents or short-term investments and the proceeds of the settlement of these notes are included in cash flows from operating activities in the consolidated statement of cash flows. There were no bank notes sold during the three months ended March 31, 2006. Bank notes totaling $56.9 million were sold during the three months ended March 31, 2005. The cost of settling these notes receivable was $0.5 million for the three months ended March 31, 2005.

Any notes that have been sold are not included in the Company's consolidated balance sheets as the criteria for sale treatment established by Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities" ("SFAS 140"), have been met. Under SFAS 140, upon a transfer, the transferor or entity must derecognize financial assets when control has been surrendered and the transferee obtains control over the assets. In addition, the transferred assets have been isolated from the transferor, beyond the reach of its creditors, and the transferee has the right, without conditions or constraints, to pledge or exchange the assets it has received.

8. RESTRICTED CASH AND INVESTMENTS:

At March 31, 2006 the Company had short-term restricted cash and investments of $69.1 million and long-term restricted cash of $2.0 million. At December 31, 2005 the Company had short-term restricted cash and investments of $53.7 million, and long-term restricted cash of $0.3 million. These amounts are primarily comprised of restricted cash held to collateralize commercial and standby letters of credit.

The Company issues standby letters of credit primarily to support international sales activities outside of China. When the Company submits a bid for a sale, often the potential customer will require that the Company issue a bid bond or a standby letter of credit to demonstrate its commitment through the bid process. In addition, the Company may be required to issue standby letters of credit as guarantees for advance customer payments upon contract signing or performance guarantees. The standby letters of credit usually expire six to nine months from date of issuance without being drawn by the beneficiary thereof. Finally, the Company may issue commercial letters of credit in support of purchase commitments.

9. ACCOUNTS AND NOTES RECEIVABLE:

The Company accepts bank notes and commercial notes receivable from its customers in China in the normal course of business. The notes are typically non-interest bearing, with maturity dates between three and six months. Bank notes are included in short-term investments. Commercial notes receivable available for sale were $7.7 million and $2.1 million at March 31, 2006 and December 31, 2005, respectively. The Company may discount these notes with banking institutions in China. A sale of these notes is reflected as a reduction of notes receivable and the proceeds of the settlement of these notes are included in cash flows from operating activities in the consolidated statement of cash flows. Any notes that have been sold are not included in the Company's consolidated balance sheets as the criteria for sale treatment established by SFAS No. 140, "Accounting for Transfers and Services of Financial Assets and Extinguishment of Liabilities," has been met. There were no notes receivable sold during the three months ended March 31, 2006 and 2005.

In August 2005, the Company entered into a Committed Receivables Purchase Agreement ("Agreement") with a commercial bank, whereby the Company may sell up to $100.0 million of its eligible accounts receivable, as defined in the Agreement. The Agreement contains provisions customary in transactions of this nature including certain commitment fees. During the three months ended March 31, 2006, no receivables had been sold pursuant to provisions of the Agreement, and the Company recorded commitment fees of $0.1 million.

10. INVENTORIES

As of March 31, 2006 and December 31, 2005, total inventories consisted of the following:

	March 31, 2006	December 31, 2005
	(in thousands)	
Inventories:		
Raw materials	$ 69,828	$ 70,608
Work-in-process	45,471	27,582
Finished goods	252,287	270,374
Inventories at customer sites without contracts	56,442	57,391
Total Inventories	$ 424,028	$ 425,955

11. SALE OF BUSINESS

Marvell Technology Group Ltd.

In February 2006, the Company sold substantially all of the assets and selected liabilities of its semiconductor design business division to Marvell Technology Group Ltd. ("Marvell"). The Company received $20.0 million in cash and an additional $4.0 million in cash was paid by Marvell to an escrow account and will be received by the Company in August 2007 in the absence of a material breach of the original contractual terms. The Company may also receive an additional $16.0 million from Marvell if certain defined milestones are achieved before September 30, 2006.

The assets sold include the assets related to the prior acquisition of Advanced Communications Devices Corporation in 2001, and other system-on-chip semiconductors. The net book value of assets sold was $2.9 million, and the Company incurred transaction costs of approximately $0.6 million.

In connection with the sale of assets, the Company has entered into a supply agreement with Marvell. Pursuant to the supply agreement, the Company has agreed to purchase chipsets supplied by Marvell for a period of five years. These chipsets will be included in certain handset products designed and manufactured by the Company. The purchase quantities will be proportionate to the total number of handsets produced by the company.

As of March 31, 2006, the $4.0 million in cash held in escrow has been recorded in other assets. The net proceeds received of $23.4 million was allocated between the assets sold and the supply agreement, in the amounts of $2.9 million and $20.5 million, respectively. The value allocated to the supply agreement is included in other current and long-term liabilities, and will be amortized in proportion to the quantities of chipsets purchased under the supply agreement over the next five years. As of March 31, 2006, approximately $0.3 million has been amortized against Cost of Sales.

The Company considered whether or not the sale of the semiconductor design business constituted a discontinued operation, as defined by Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"). Due to the Company's continuing involvement with the disposed business, as it has committed to purchase product from Marvell and assist in the development of future products, the requirements for presentation as a discontinued operation have not been met.

12. GOODWILL AND INTANGIBLE ASSETS:

As of March 31, 2006 and December 31, 2005, goodwill was $3.1 million, of which the entire amount was allocated to the service operating segment. As of March 31, 2006 and December 31, 2005, intangible assets consisted of the following:

	March 31, 2006	December 31, 2005
	(in thousands)	
Intangible assets:		
Existing technology	$ 39,530	$ 39,530
Less accumulated amortization	(23,311)	(21,702)
	$ 16,219	$ 17,828
Customer relationships	$ 57,220	$ 57,220
Less accumulated amortization	(13,682)	(12,037)
	$ 43,538	$ 45,183
Supplier relationships	$ 5,300	$ 5,300
Less accumulated amortization	(3,754)	(3,092)
	$ 1,546	$ 2,208
Trade names	$ 4,940	$ 4,940
Less accumulated amortization	(2,829)	(2,496)
	$ 2,111	$ 2,444
Non-compete agreement	$ 10,800	$ 10,800
Less accumulated amortization	(3,825)	(3,150)
	$ 6,975	$ 7,650
Total intangible assets	$ 70,389	$ 75,313

Amortization expense was $4.9 million and $7.0 million for the three months ended March 31, 2006 and 2005, respectively. The estimated aggregate amortization expense for intangibles for each of the five years from the year ended December 31, 2007 through the year ended December 31, 2011 is $16.0 million, $12.7 million, $6.9 million, $5.1 million, $5.1 million and $10.6 million thereafter.

The weighted average amortization period for each class of unamortized identifiable intangible assets include the following:

	Weighted average life
	(in years)
Technology	3.0
Customer relationships	6.1
Supplier relationships	0.8
Trade names	1.8
Non-compete	2.8

	Weighted average life
Total	3.6

13. LONG-TERM INVESTMENT:

	March 31, 2006	December 31, 2005
	(in thousands)	
Cellon International	$ 8,000	$ 8,000
Restructuring Fund No. 1	829	1,538
Global Asia Partners L.P.	1,700	1,700
Fiberxon Inc.	3,000	3,000
Immenstar	2,000	2,000
Matsushita Joint Venture	468	465
GCT SemiConductor	3,000	3,000
Xalted Networks	3,302	3,000
Infinera	1,902	1,902
Others	1,442	1,418
Total	$ 25,643	$ 26,023

Cellon International

In September 2001, the Company invested $2.0 million in Cellon International Holdings Corporation ("Cellon"). Cellon designs wireless terminals and related technology for handset manufacturers and private distributors. The Company invested an additional $3.0 million each in April and December 2002. In November 2005 the Company and Cellon entered into an agreement whereby the Company will receive additional shares of Cellon preferred stock in exchange for a contribution of fixed assets and the transfer of a workforce in place from the Company to Cellon. As of March 31, 2006, the Company had a 6.5% ownership interest in Cellon and upon completion of the transaction, assuming the conversion of all outstanding preferred stock into common, the percentage of the Company's ownership is approximately 11%. This investment is accounted for under the cost method, and its carrying value has been evaluated for possible impairment based on the achievement of business objectives and milestones, the financial condition and prospects of the company and other relevant factors. On May 31, 2006, the Company completed this transaction with Cellon.

Restructuring Fund No. 1

During the first quarter of fiscal 2002, the Company invested $2.0 million in Restructuring Fund No. 1, a venture capital investment limited partnership established by SOFTBANK INVESTMENT CORP., an affiliate of SOFTBANK CORP. SOFTBANK America Inc., an entity affiliated with SOFTBANK CORP., is a significant stockholder of the Company. The fund focuses on leveraged buyout investments in companies in Asia undergoing restructuring or bankruptcy procedures. The total fund offering is expected to be between approximately $150 million and $225 million, with each investor contributing a minimum of $0.8 million. The fund has a separate management team, and none of the Company's employees are employed by the fund. The Company accounts for this investment under the equity method of accounting. The Company received a cash distribution of approximately $0.7 million during the three months ended March 31, 2006, and reduced the carrying value of the investment accordingly.

Xalted Networks

In May 2005 and August 2005, the Company invested $2.0 million and $1.0 million, respectively, in Xalted Networks ("Xalted"). In March 2006 the Company invested an additional $0.3 million in Xalted. Xalted is a development stage company providing telecommunication operator customers with a comprehensive set of network systems, software solutions and service offerings. The Company has a 9%

ownership interest in Xalted and accounts for the investment under the cost method. As of March 31, 2006, the Company has not recorded any impairment of this investment.

14. DEBT:

The following represents the outstanding borrowings at March 31, 2006 and December 31, 2005:

	March 31, 2006	December 31, 2005
	(in thousands)	
Bank loans	$ 172,141	$ 198,826
Other	300	300
Convertible subordinated notes	274,600	274,600
Total debt	$ 447,041	$ 473,726
Long-term debt	$ 274,900	$ 274,900
Short-term debt	$ 172,141	$ 198,826

Occasionally, the Company issues short-term notes, payable to its vendors, in lieu of trade accounts payable. The payment terms are normally three to nine months and are typically non-interest bearing. At March 31, 2006, the Company had loans with various banks totaling $172.1 million with interest rates ranging from 4.70% to 5.22% per annum. These bank loans mature during 2006 and 2007, and are included in short-term debt. There are no significant covenants associated with these loans.

On March 12, 2003, the Company completed an offering of convertible subordinated notes due March 1, 2008 to qualified buyers pursuant to Rule 144A under the Securities Act of 1933. During 2005, a portion of the notes was extinguished. As of March 31, 2006 and December 31, 2005, $274.6 million of these notes were outstanding. The notes bear interest at a rate of $^7/_8$% per annum and are convertible into the Company's common stock at a conversion price of $23.79 per share and are subordinated to all present and future senior debt of the Company. Holders of the notes may convert their notes only if: (i) the price of the Company's common stock issuable upon conversion of a note reaches a specified threshold, (ii) specified corporate transactions occur, or (iii) the trading price for the notes falls below certain thresholds. At the initial conversion price, each $1,000 principal amount of notes will be convertible into 42.0345 shares of common stock. Expenses associated with the convertible subordinated notes issuance have been recorded in other long-term assets and are being amortized over the life of the notes.

The Company has entered into a convertible bond hedge and call option transaction. The convertible bond hedge allows the Company to purchase 11.5 million shares of its common stock at $23.79 per share from the other party to the agreement. The written call option allows the holder to purchase 11.5 million shares of the Company's common stock from the Company at $32.025 per share. Both the bond hedge and call option transactions may be settled at the Company's option either in cash or net shares and expire on March 1, 2008.

The Company recorded these instruments at cost, and their carrying value at March 31, 2006 equaled their original cost as adjusted for amendments related to the early extinguishment of debt. The convertible bond hedge and call option transactions are expected to reduce the potential dilution from conversion of the notes. The options have been included in stockholders' equity in accordance with the guidance in EITF No. 00-19, "Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock."

From March 15, 2006 until June 1, 2006, the Company was in technical non-compliance with loan covenants of the convertible subordinated notes due to the non-filing of the annual report on

Form 10-K for the year ended December 31, 2005. The Company is currently in compliance with all covenants.

15. WARRANTY OBLIGATIONS AND OTHER GUARANTEES:

The Company provides a warranty on its equipment and handset sales for a period generally ranging from one to three years from the time of final acceptance. Very rarely, the Company has entered into arrangements to provide limited warranty services for periods longer than three years. The longest of such warranty periods is ten years. The Company provides for the expected cost of product warranties at the time that revenue is recognized based on an assessment of past warranty experience.

Warranty obligations are as follows:

	Three months ended March 31,	
	2006	**2005**
		as restated
	(in thousands)	
Beginning of period	$ 76,719	$ 46,596
Accruals for warranties issued during the period	8,949	23,089
Settlements made during the period	(16,966)	(11,823)
Balance at end of period	$ 68,702	$ 57,862

During the three months ended March 31, 2005, the Company incurred special warranty coverage for certain asynchronous digital subscriber line ("ADSL") equipment sold to Softbank during 2003 and 2004. Since the agreement to repair these parts exceed the Company's normal warranty terms, the Company has recorded an additional special warranty charge in the first quarter of 2005 of $9.5 million.

Certain of the Company's sales contracts include provisions under which customers would be indemnified by the Company in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to the Company's products. There are no limitations on the maximum potential future payments under these guarantees. The Company has not accrued any amount in relation to these provisions as no such claims have been made and the Company believes it has valid, enforceable rights to the intellectual property embedded in its products.

The Company issues standby letters of credit primarily to support international sales activities outside of China. When the Company submits a bid for a sale, often the potential customer will require that the Company issue a bid bond or a standby letter of credit to demonstrate its commitment through the bid process. In addition, the Company may be required to issue standby letters of credit as guarantees for advance customer payments upon contract signing or performance guarantees. The standby letters of credit usually expire six to twelve months from the date of issuance without being drawn by the beneficiary thereof. The Company may issue commercial letters of credit in support of purchase commitments.

16. COMMITMENTS AND CONTINGENCIES:

Leases:

The Company leases certain facilities under non-cancelable operating leases that expire at various dates through 2011. The minimum future lease payments under the leases at March 31, 2006 were as follows:

	(in thousands)
1 year	$ 15,527
2 year	10,865
3 year	7,177
4 year	5,303
5 year and after	1,448
Total minimum lease payments	$ 40,320

Rent expense for the quarters ending March 31, 2006 and 2005 was $5.6 million and $5.6 million, respectively.

In connection with the sale of assets to Marvell, the Company has entered into a supply agreement with Marvell. Pursuant to the supply agreement, the Company has agreed to purchase chipsets supplied by Marvell for a period of five years. These chipsets will be included in certain handset products designed and manufactured by the Company. The purchase quantities will be proportionate to the total number of handsets produced by the company.

Investment commitments:

As of March 31, 2006, the Company had invested a total of $2.6 million in Global Asia Partners L.P.; a fund anticipated to grow to $10 million. The fund was formed to make private equity investments in private or pre-IPO technology and telecommunications companies in Asia. The Company has a commitment to invest up to a maximum of $5.0 million. The remaining amount is due at such times and in such amounts as shall be specified in one or more future capital calls to be issued by the general partner.

The Company has also entered into various earnout agreements related to certain acquisitions, which are subject to the completion of performance milestones.

Contractual obligations and commercial commitments:

As of March 31, 2006 the Company's obligations under contractual obligations and commercial commitments are as follows:

	March 31, 2006 Payments due by period			
	Total	Less than 1 year	1-3 years	3-5 years
	(in thousands)			
Bank loans	$ 172,441	$ 172,141	$ 300	$
Convertible subordinated notes	$ 274,600	$	$ 274,600	$
Interest payable on subordinated notes	$ 4,806	$ 2,403	$ 2,403	$
Standby letters of credit	$ 98,287	$ 96,316	$ 1,971	$
Purchase commitments	$ 676,083	$ 667,253	$ 8,830	$

Bank loans

At March 31, 2006, the Company had loans with various banks totaling $172.1 million with interest rates ranging from 4.70% to 5.22% per annum. These bank loans mature during 2006 and first quarter of 2007 and are included in short-term debt.

Convertible subordinated notes

The Company's convertible subordinated notes, due March 1, 2008, bear interest at a rate of $^7/_8$% per annum, payable semiannually on May 1 and September 1, are convertible into the Company's common stock at a conversion price of $23.79 per share and are subordinated to all the Company's present and future senior debt. The principal is due only at maturity of the notes.

Standby letters of credit:

The Company issues standby letters of credit primarily to support international sales activities outside of China. When the Company submits a bid for a sale, often the potential customer will require that the Company issue a bid bond or a standby letter of credit to demonstrate its commitment through the bid process. In addition, the Company may be required to issue standby letters of credit as guarantees for advance customer payments upon contract signing or performance guarantees. The standby letters of credit usually expire six to twelve months from the date of issuance without being drawn by the beneficiary thereof. The Company may issue commercial letters of credit in support of purchase commitments.

Purchase commitments

The Company is obligated to purchase raw materials and work-in-process inventory under various orders from various suppliers, all of which should be fulfilled without adverse consequences material to its operations or financial condition. As of March 31, 2006 total open commitments under these purchase orders extending beyond one year were approximately $8.8 million. Additionally, the Company has agreed to purchase from Marvell certain chip-sets that will be included in the Company's PAS handsets, through 2011.

Intellectual property:

Certain sales contracts include provisions under which customers would be indemnified by us in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to our products. There are no limitations on the maximum potential future payments under these guarantees. The Company has not accrued any amounts in relation to these provisions as no such claims have been made and the Company believes it has valid enforceable rights to the intellectual property embedded in its products.

Litigation:

Securities Class Action Litigation

Beginning in October 2004, several shareholder class actions alleging federal securities violations were filed against the Company and various officers and directors. The actions have been consolidated in United States District Court for the Northern District of California. The lead plaintiffs in the case filed a First Amended Consolidated Complaint on July 26, 2005. The First Amended Complaint alleged violations of the Securities Exchange Act of 1934, and was brought on behalf of a putative class of shareholders who purchased the Company's stock after April 16, 2003 and before September 20, 2004. On April 13, 2006, the lead plaintiffs filed a Second Amended Complaint adding new allegations and extending the end of the class period to October 6, 2005. In addition to the Company defendants, the plaintiffs are also suing Banc of America Securities LLC and Softbank. Plaintiffs' complaint seeks recovery of damages in an unspecified amount.

This litigation is in its preliminary stage, and its outcome cannot be predicted. Management of the Company believes that the claims are not meritorious. Nevertheless, an adverse outcome in the litigation, if it occurred, could have a material adverse effect on the Company's results of operations, financial position and cash flows.

Governmental Investigations

The Company has received notice of a formal inquiry by the staff of the Securities & Exchange Commission ("SEC") into certain aspects of the Company's financial disclosures during prior reporting periods and certain other issues. In addition, in December 2005 the U.S. Embassy in Mongolia informed the Company that it had forwarded to the Department of Justice ("DOJ") allegations that an agent of the Company's Mongolia joint venture had offered payments to a Mongolian government official in possible violation of the Foreign Corrupt Practices Act (the "FCPA"). In April 2006, the Company became aware that an agent of the Company may have made an offer to pay an Indian government official in possible violation of the FCPA. The Company, through its Audit Committee, authorized an independent investigation into these matters, and the Company has been in contact with the DOJ and SEC regarding the investigation. At this time, the Company cannot predict when any governmental inquiry will be completed or what the outcome of any governmental inquiry will be.

IPO Allocation

On October 31, 2001, a complaint was filed in United States District Court for the Southern District of New York against the Company, some of the Company's directors and officers and various underwriters for our initial public offering. Substantially similar actions were filed concerning the initial public offerings for more than 300 different issuers, and the cases were coordinated as *In re Initial Public Offering Securities Litigation*, 21 MC 92 for pretrial purposes. In April 2002, a consolidated amended complaint was filed in the matter against the Company, captioned *In re UTStarcom, Initial Public Offering Securities Litigation*, Civil Action No. 01-CV-9604. Plaintiffs allege violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 through undisclosed improper underwriting practices concerning the allocation of IPO shares in exchange for excessive brokerage commissions, agreements to purchase shares at higher prices in the aftermarket and misleading analyst reports. Plaintiffs seek unspecified damages on behalf of a purported class of purchasers of the Company's common stock between March 2, 2000 and December 6, 2000. The Company's directors and officers have been dismissed without prejudice pursuant to a stipulation. On February 19, 2003, the Court granted in part and denied in part a motion to dismiss brought by defendants including the Company. The order dismisses all claims against the Company except for a claim brought under Section 11 of the Securities Act of 1933, which alleges that the registration statement filed in accordance with the IPO was misleading. In June 2004, a stipulation of settlement and release of claims against the issuer defendants, including the Company, was submitted to the court for approval. The terms of the settlement, if approved, would dismiss and release all claims against the participating defendants (including the Company). In exchange for this dismissal, D&O insurance carriers would agree to guarantee a recovery by the plaintiffs from the underwriter defendants of at least $1 billion, and the issuer defendants would agree to an assignment or surrender to the plaintiffs of certain claims the issuer defendants may have against the underwriters. On February 15, 2005, the Court issued an order granting conditional preliminary approval of the settlement. On August 31, 2005, the Court entered an order confirming its preliminary approval of the settlement. The settlement remains subject to a number of conditions, including final court approval. The total amount of the loss associated with the above litigation is not determinable at this time. Therefore, the Company is unable to currently estimate the loss, if any, associated with the litigation.

Starent Patent Infringement Litigation

The Company has sued Starent Networks Corporation ("Starent") for patent infringement in the U.S. District Court for the Northern District of California. On March 22, 2004, the Company filed its Complaint. On June 3, 2004, the Company served its Complaint on Starent. On July 30, 2004, Starent filed and served its answer and counterclaims. On August 30, 2004, the Company served and filed its Amended Complaint. In the Company's Amended Complaint, the Company asserts that Starent infringes a UTStarcom patent through the manufacture, use, offer for sale, and sale of Starent's ST-16 Intelligent Mobile Gateway. We seek, inter alia, compensatory damages and injunctive relief. Starent filed its answer to the Amended Complaint and counterclaims on September 17, 2004. In its answer and counterclaims, Starent denies the Company's allegations and seeks a declaration that the patent-in-suit is not infringed, is invalid, and is unenforceable. The Court held an initial case management conference on November 2, 2004. On February 17, 2005, the Company filed a motion for a preliminary injunction against Starent's use, sale, and offer for sale of products having the infringing feature. The Court held a hearing on the Company's motion on May 11, 2005 and denied the Company's motion on June 17, 2005. On June 30, 2005, the Court held a hearing on the proper meaning or construction of the claims of the patent-in-suit and entered an order construing these claims on August 11, 2005. On September 20, 2005, Starent filed a motion for summary judgment of non-infringement and UTStarcom filed a motion for summary judgment that Starent is estopped from asserting invalidity and unenforceability. On October 4, 2005, Starent filed a motion to strike UTStarcom's final infringement contentions. On November 7, 2005, Starent's motion to strike was denied. Oral argument on UTStarcom's estoppel motion and Starent's non-infringement motion was held on November 8, 2005. On December 6, 2005, the Court granted Starent's motion for summary judgment of non-infringement. On December 12, 2005, the Court dismissed as moot Starent's counterclaims for declaratory relief based on invalidity or unenforceability of the asserted patent. On February 2, 2006, the Court entered judgment in favor of Starent. On March 2, 2006, UTStarcom filed a notice of appeal. The case is currently pending at the Federal Circuit. The parties have agreed to participate in the Feral Circuit's mediation program. Management believes that the mediation and/or the appeal will be successful. Nevertheless, the Company has indicated that it believes that an adverse judgment will not have a material adverse effect on the business, financial condition, or results of the Company's operations.

On February 16, 2005, the Company filed a second suit against Starent for patent infringement in the U.S. District Court for the Northern District of California. On May 6, 2005, the Company served the Complaint on Starent. In the Complaint, the Company asserts that Starent infringes a UTStarcom patent through Starent's development and testing of a software upgrade for its customer's installed ST-16 Intelligent Mobile Gateways. The Company seeks, inter alia, declaratory and injunctive relief.

Starent filed its answer and counterclaims on May 31, 2005, denying the Company's allegations and seeking a declaration that the patent-in-suit is not infringed, is invalid, and is unenforceable. On June 16, 2005, the Company filed a motion to strike Starent's affirmative defense and dismiss Starent's counterclaim alleging inequitable conduct. Pursuant to the parties' stipulation, the Company withdrew its motion to strike and, on July 27, 2005, Starent filed an amended answer and counterclaims, which pleaded its inequitable conduct allegations with more specificity. UTStarcom filed its answer to the amended counterclaims on August 10, 2005. The litigation is in the preliminary stage and its outcome cannot be predicted. However, management believes that its claims are meritorious. Nevertheless, the Company has indicated that it believes that any adverse judgment on Starent's counterclaims will not have a material adverse effect on the business, financial condition, or results of the Company's operations.

Fenner Investments Patent Infringement Litigation

On January 6, 2005, Fenner Investments, Ltd. ("Fenner") filed suit against the Company and co-defendants Juniper Networks, Inc., Nokia, Inc., Nortel Networks Corp., Lucent Technologies, Inc., and Cisco Systems, Inc. in the U.S. District Court for the Eastern District of Texas. On May 17, 2005, Fenner amended its complaint to add as defendants Ericsson Inc., Ericsson AB, Telefonaktiebolaget LM Ericsson, and Alcatel USA Inc. The suit alleged that certain products infringe two Fenner patents, U.S. Patent Nos. 5,561,706 and 6,819,670, for which Fenner sought compensatory and injunctive relief. On March 20, 2006, the Company agreed to settle Fenner's claims against it. As part of this settlement, Fenner agreed to dismiss with prejudice its claims against the Company. On April 27, 2006, the court ordered the dismissal with prejudice of Fenner's claims against the Company as a result of the settlement.

Telos Technology, Inc. Arbitration

On November 22, 2005, Telos Technology, Inc. ("Telos") filed a formal Demand for Arbitration against the Company with JAMS/Endispute in San Jose, California. The Demand for Arbitration seeks the release of $2.4 million from an escrow fund. Pursuant to the terms of an Asset Purchase Agreement dated April 21, 2004 and an Escrow Agreement dated May 19, 2004 between the parties, the escrow fund was created to indemnify the Company from certain losses associated with the Company's purchase of assets from Telos. Telos asserts that the Company's refusal to release the escrowed funds constitutes a breach of its contractual obligations under the agreements. Telos also seeks attorneys' fees, costs and prejudgment interest in the amount of $500,000. In its response to the Demand for Arbitration, the Company denied that it had breached its contractual obligations. In January 2006, Telos moved for summary judgment on its claim and the Company opposed the motion. On March 6, 2006, the Arbitrator issued a ruling denying Telos' motion. In light of the ruling on summary judgment, Telos dismissed its claim for arbitration without prejudice, subject to its contractual right to dispute any future disbursement from escrow.

Telos Technology, Inc. Litigation

On November 22, 2005, plaintiffs Telos Technology, Inc., Telos Technology (Canada), Inc., Telos Technology (Bermuda) Ltd., and Telos Engineering Limited (collectively, the "Telos Plaintiffs") filed a Complaint against the Company in the Superior Court of California, County of Santa Clara. The Complaint alleges five causes of action, including breach of contract, breach of the implied covenant of good faith and fair dealing, fraudulent inducement, intentional misrepresentation and negligent misrepresentation, all of which arise from the Asset Purchase Agreement between the parties dated April 21, 2004. The Telos Plaintiffs assert that the Company breached the express and implied terms of the Asset Purchase Agreement and made representations to the Telos Plaintiffs during negotiations that it never intended to fulfill. The Telos Plaintiffs seek at least $19 million in damages, unspecified punitive damages and attorneys' fees. On December 28, 2005, the Telos Plaintiffs filed a First Amended Complaint, alleging substantially the same facts and seeking the same relief. On January 26, 2006, the Company filed a demurrer with respect Telos' three tort causes of action. On March 23, 2006, the Court sustained the Company's demurrer to all three tort causes of action and allowed Telos thirty days to amend its complaint. On April 12, 2006, Telos filed a Second Amended Complaint, alleging substantially the same facts and seeking the same relief as in the First Amended Complaint. The Company has answered the Second Amended Complaint, denying all of the material allegations therein. Discovery is underway, and no trial date has been set.

Cell Communication Ltd. Arbitration

On October 27, 2005, the Company received notice of a demand for arbitration filed against it by Cell Communication Ltd. of Nigeria. The demand was filed in the London Court of International

Arbitration ("LCIA"). In its Amended Claim, Cell Communication claims 'general' damages of $26.6 million and 'special' damages of $15 million (alternatively $41 million general damages) in connection with alleged failures of products purchased from Telos Technology, whose assets have been acquired by the Company.

An arbitrator has been selected by the LCIA. The arbitrator has ordered the determination of certain preliminary issues as to whether the claims made by Cell Communication are irrecoverable as a matter of English law. There was a hearing on May 26, 2006 in respect of these preliminary issues. On June 13, 2006, the arbitrator issued a partial award in which he addressed several issues. Among them, the arbitrator adopted the Company's position that liability in this matter is limited to the amount of the purchase price paid by Cell Communications. No date for the substantive hearing has been scheduled. The Company intends to deny all liability, and believes it has meritorious defenses.

Other

The Company is a party to other litigation matters and claims that are normal in the course of operations, and while the results of such litigation matters and claims cannot be predicted with certainty, the Company believes that the final outcome of such matters will not have a material adverse impact on its financial position or results of operations.

17. SEGMENT REPORTING:

The Company has organized its business into five operating units, (i) Broadband Infrastructure, (ii) Wireless Infrastructure, (iii) Handsets, (iv) Personal Communications Division ("PCD"), and (v) Service. Each operating unit represents its own reporting segment and each operating unit is responsible for its own worldwide production and sales management.

Effective July 1, 2006, the Company intends to combine the Broadband Infrastructure and the Wireless Infrastructure segments into a newly created Network Solutions segment, as that is the basis on which management will manage the business.

The Company currently evaluates operating performance of and allocates resources to the reporting segments based on segment gross profit. Cost of sales and direct expenses in relation to productions are assigned to the reporting segments. Corporate headquarters expenses and non-operating items are not allocated to the segments. The accounting policies used in measuring segment assets and operating performance are the same as those used by corporate and are consistently applied across all segments.

Summarized below are the Company's segment sales revenue and gross profit for the three months ended March 31, 2006 and 2005, respectively.

	Three months ended March 31,			
	2006		2005 as restated	
	(in thousands)			
Sales by Segment				
Broadband Infrastructure	$ 57,156	10%	$ 326,307	36%
Wireless Infrastructure	100,433	17%	109,437	12%
PCD	322,995	55%	315,552	35%
Handsets	99,019	16%	128,083	14%
Service	16,968	2%	22,505	3%
	$ 596,571	100%	$ 901,884	100%

	Three months ended March 31,			
	2006	Gross Profit %	2005 as restated	Gross Profit %
	(in thousands)			
Gross profit by Segment				
Broadband Infrastructure	$ 22,957	40%	$ 164,057	50%
Wireless Infrastructure	49,517	49%	29,670	27%
PCD	14,434	4%	13,692	4%
Handsets	31,599	32%	14,539	11%
Service	3,947	23%	15,466	69%
	$ 122,454	21%	$ 237,424	26%

Assets by segment are as follows:

	March 31, 2006	December 31, 2005
	(in thousands)	
Long-lived assets		
Broadband Infrastructure	$ 44,967	$ 47,480
Wireless Infrastructure	83,032	87,673
PCD	1,387	1,512
Handsets	45,424	47,963
Service	46,193	48,775
	$ 221,003	$ 233,403

	March 31, 2006	December 31, 2005
	(in thousands)	
Total assets		
Broadband Infrastructure	$ 487,624	$ 471,783
Wireless Infrastructure	840,036	831,944
PCD	405,404	420,191
Handsets	552,097	546,788
Service	90,355	95,346
	$ 2,375,516	$ 2,366,052

Sales are attributed to a geographical area based upon the location of the customer. Sales data by geographical areas are as follows:

	Three months ended March 31,			
	2006	% of net sales	2005	% of net sales
			as restated	
	(in thousands)			
United States	$ 329,730	55%	$ 301,776	33%
China	194,434	33%	227,209	25%
Japan	47,660	8%	332,026	37%
Other	24,747	4%	40,873	5%
Total net sales	$ 596,571	100%	$ 901,884	100%

Long-lived assets, consisting of property, plant and equipment by geographical area are as follows:

	March 31, 2006	December 31, 2005
	(in thousands)	
U.S.	$ 13,527	$ 16,676
China	198,751	204,630
Other	8,725	12,097
Total long-lived assets	$ 221,003	$ 233,403

18. RELATED PARTY TRANSACTIONS:

Softbank

The Company recognized revenue of $36.1 million and $26.0 million during the quarters ended March 31, 2006 and 2005, respectively, with respect to sales of telecommunications equipment to affiliates of SOFTBANK CORP. ("Softbank"), a significant stockholder of the Company. Softbank offers asynchronous digital subscriber line ("ADSL") coverage throughout Japan, which is marketed under the name "YAHOO! BB." The Company supports Softbank's fiber-to-the-home service through sales of its carrier class Gigabit Ethernet Passive Optical Network ("GEPON") product as well as its multi-service optical transport product ("NetRing "). In addition, the Company supports Softbank's new internet protocol television ("IPTV"), through sales of its RollingStream product. Included in revenue for the three months ended March 31, 2006 is a fee of $17.0 million charged for the cancellation of orders for broadband products.

Included in accounts receivable at March 31, 2006 and December 31, 2005 were $86.8 million and $69.3 million, respectively, related to these agreements. Sales to Softbank include a three year service period and a penalty clause if product failure rates exceed a certain level over a seven year period. There were $13.1 million and $16.3 million included in long term deferred revenue with respect to these agreements at March 31, 2006 and December 31, 2005, respectively. Additionally, there were $8.7 million and $6.3 million included in current deferred revenue at March 31, 2006 and December 31, 2005, respectively. As of March 31, 2006 and December 31, 2005, there were $5.4 million and $5.4 million, respectively, included in customer advance related to Softbank agreements.

During August 2004, the Company entered into several agreements with Japan Telecom Co., Ltd ("JT"), a wholly owned subsidiary of Softbank. These agreements relate to the sale of *i*AN-8000 equipment with specified value and delivery dates, as well as an oral agreement which subsequently converted into specific service contracts to manage a sales promotional program for JT. The Company has determined that the service activities revenue should be recorded net of expected promotional spending.

Because the Company had not provided these activities in the past and could not estimate the fair value of these services, the Company determined under the guidance of SAB 104 that all revenue related to these agreements could not be recognized until all goods and services were delivered. The Company had delivered and received final acceptance for all equipment contemplated under these agreements in the quarter ended March 31, 2005.

The promotional services discussed above involved contracting with third party promotional vendors, who in turn, facilitated the marketing and subscriber recruitment for the JT fiber-to-the-home program. During the fourth quarter of 2004, the Company determined that it would end its involvement with the JT promotional program after completion of the contract discussed above. Accordingly, late in the fourth quarter of 2004 and during the first quarter of 2005, the Company either cancelled or assigned to another party all third party contracts with promotional vendors related to the JT contract. Such termination or assignment of all third party promotional agreements, as well as effective satisfaction of the Company's obligations with JT under such agreements, satisfied the revenue recognition criteria for these agreements and as such, the net value of the promotional services and the value of equipment delivered, which totaled $205.4 million, was reported in the quarter ended March 31, 2005.

The Company also entered into an agreement with JT during the third quarter of 2004 to supply chassis equipment. The equipment shipped under this agreement is considered linked to the *i*AN-8000 sale noted above and as such, was also deferred until the completion of the above-mentioned promotional activities. The revenue recognition criteria related to the sale of the *i*AN-8000 equipment was satisfied in the first quarter of 2005 and as such, the revenue related to the chassis sale of $66.5 million was reported in the quarter ended March 31, 2005. During the three months ended March 31, 2006 and 2005, sales to Softbank included $0.5 and $271.9 million, respectively, with regards to telecommunications equipment and services sold to JT.

On July 17, 2003, the Company entered into a Mezzanine Loan Agreement with BB Modem Rental PLC ("BB Modem"), an affiliate of SOFTBANK CORP. Under the terms of the agreement, the Company loaned BB Modem $10.1 million at an effective interest rate of 12.01% per annum, for the purpose of investing in a portfolio of ADSL modems and associated modem rental agreements, from Softbank. Softbank will continue to service such modems and modem rental agreements. The Company's loan is subordinated to certain senior lenders of BB Modem, and repayments are payable to the Company over a 42-month period through January 31, 2007, with a substantial portion of the principal amount of the loan schedule to be repaid during the last 16 months of this period. The Company's recourse for nonpayment of the loan is limited to the assets of BB Modem, the account into which subscriber payments are made and its rights under the securitization transaction documents. The value of BB Modem's modems that serve as collateral for the loan may decrease over time and may not be sufficient upon sale to pay the outstanding amounts on the loans. The Company assesses the loan for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. The Company periodically reviews the underlying quality of the asset pool securing the loan to assess whether impairment has incurred and needs to be recorded. During the three months ended March 31, 2006 and 2005, the Company recorded $0.2 million and $0.3 million, respectively, in interest income in respect to this loan. The loan receivable at March 31, 2006 and December 31, 2005 was approximately $7.1 million and $9.0 million, respectively and is included in other current assets.

As of March 31, 2006, Softbank beneficially owned approximately 12.1% of the Company's outstanding stock.

Acoustek Int'l Corp.

The Company obtains consulting services from Acoustek Int'l Corp. ("Acoustek"), which employs an individual related to one of the Company's officers. The Company paid to Acoustek $0.1 million during each of the three months ended March 31, 2006 and 2005 for consulting services.

Cellon

In October 2002, the Company entered into a license and a royalty agreement with Cellon International Holding Corporation ("Cellon") in which the Company has an ownership interest. The Company paid $0.8 million to license certain technology for the development of certain handset products in China. Per the terms of the royalty agreement, the Company is required to pay Cellon $3 per unit shipped for a minimum of 0.1 million units. This agreement is not material to the overall financial results of Cellon. The Company has evaluated its relationship with Cellon under FIN 46, and determined that consolidation is not necessary.

In November 2005, the Company entered into an agreement with Cellon, which was completed on May 31, 2006. In exchange for preferred stock and warrants of Cellon, the Company transferred fixed assets with a net book value of $3.0 million, a lease and a workforce in place consisting of 156 engineers. Additionally, the Company prepaid $5.0 million in exchange for future product development. Cellon will pay the Company a royalty if certain technology shared by it to Cellon is used in products developed and sold through November 2007.

As of March 31, 2006 the Company had an accounts payable balance of $0.5 million.

Fiberxon

The Company has an outstanding purchase commitment with Fiberxon, in which the Company has a 7% ownership interest, to purchase component parts for optical networking products. Purchases from Fiberxon totaled $1.5 million and $5.0 million during the three months ended March 31, 2006 and 2005, respectively. The Company had $0.2 million and $0.3 million in accounts payable to Fiberxon at March 31, 2006 and December 31, 2005, respectively, along with payments for the period ended March 31, 2006 of $0.1 million.

Immenstar

The Company has an outstanding purchase commitment with Immenstar, in which the Company owns Series A preferred stock, to purchase component parts. Purchases from Immenstar totaled $2.0 million during the three months ended March 31, 2006, and payments to Immenstar totaled $0.9 during the three months ended March 31, 2006.

Matsushita Joint Venture

In July 2002, the Company entered into a joint venture agreement with Matsushita Communication Industrial Co., Ltd. to jointly design and develop, manufacture and sell telecommunication products. The Company has a 49% ownership interest in the joint venture company. As of March 31, 2006 and December 31, 2005, the Company had a receivable of $0.4 million and $0.1 million, respectively, and an account payable of $0.6 million at March 31, 2006. In December 2005, the partners agreed to dissolve the joint venture.

Global Asia Partners L.P.

Global Asia Partners L.P. is a venture capital fund formed to make private equity investments in private or pre-IPO technology and telecommunications companies in Asia. The general partner of this fund is also a sales agent of the Company. Between June 2002 and April 2005, the Company has invested a total of $2.6 million in the fund. As of March 31, 2006 and December 31, 2005, we have 49% of the outstanding partnership units.

Org, Inc.

The Company has a 49% ownership in Global Asia Partners L.P. which in turn is a significant shareholder in Org, Inc. During the three months ended March 31, 2006, the Company had sales of $0.1 million to Org, Inc. As of March 31, 2006 and December 31, 2005, the Company had a receivable of $0.1 million and $0.2 million, respectively and deferred revenue of $0.1 million as of December 31, 2005.

Spacetime

In January, 2005 the Company formed a joint venture with two other parties to provide mobile communication, broadband and IP related value added services in Mongolia. The operations of the joint venture are consolidated into the financial statements of the Company. In the first quarter of 2006, the Company decided to terminate the joint venture arrangement and wrote off the remaining net assets, of approximately $4.7 million. (See Note 24) As of March 31, 2006 and December 31, 2005, the Company has $0.3 million included in related party receivables and $0.3 million in long term debt related to one of the joint venture partners, Spacetime Golden Communication Technology USA, Inc.

Xalted Networks

The Company has received purchase orders from Xalted Networks totaling approximately $1.3 million in 2005 for telecommunications equipment that is for product not typically sold by the Company to other customers. The Company is charging a ten percent procurement fee to Xalted for obtaining and reselling these products. The equipment was delivered during 2005 but revenue has not been recognized as the revenue recognition process had not been completed. The equipment cost is included in inventory as of March 31, 2006 and December 31, 2005. In March 2006, the Company invested an additional $0.3 million in Xalted Networks.

19. RESTRUCTURING COSTS:

In 2005 the Company incurred $35.4 million in expenses in relation to the restructuring plan actions, primarily consisting of (i) $15.3 million related to severance payments (ii) $14.5 million in asset impairments primarily related to the write-off of equipment and licenses associated with discontinued products, which are included in operating expenses and (iii) $5.6 million in inventory write-down associated with discontinued products. Included in severance is a $1.8 million non-cash reversal of a housing allowance accrual in China. As of March 31, 2006, approximately 1,595 employees had been terminated or placed in the workforce reduction programs.

A summary of the restructuring accrual related to the 2005 charge during the three months ended March 31, 2006, is as follows:

	December 31, 2005 Balance	Cash payment	Non-cash settlement	March 31, 2006 Balance
	(in thousands)			
Broadband				
Severance payments	$ 50	$ (50)		
Handsets				
Severance payments	29	(29)		
Asset impairment/exit cost	350			350
Corporate				
Severance payments	207	(207)		
Asset impairment/exit cost	579		(92)	487
Summary Totals				
Severance payments	286	(286)		
Asset impairment/exit cost	929		(92)	837
Total	$ 1,215	$ (286)	$ (92)	$ 837

20. OTHER INCOME AND EXPENSES:

Net other income or expense was an income of $3.6 million and an expense of $6.8 million for the three months ended March 31, 2006 and 2005, respectively. The balances were comprised of the following:

	Three months ended March 31,	
	2006	2005
	(in millions)	
Foreign exchange gains (losses)	$ 2.8	$ (7.8)
Japan consumption tax refund		1.2
Chinese government financial subsidy	0.5	0.5
Other	0.3	(0.7)
Total	$ 3.6	$ (6.8)

21. CREDIT RISK AND CONCENTRATION

The table below outlines the Company's sales to, and the accounts receivable balances from its largest customers:

	For the three months ended March 31,	
	% of Net sales	% of Accounts receivable
2006		
Customer A	16%	1%
Customer B	13%	7%
2005		
Customer C	33%	18%

Approximately 33% and 25% of the Company's net sales during the three months ended March 31, 2006 and 2005, respectively, were to entities affiliated with the government of China. Accounts receivable balances from these China government affiliated entities or state owned enterprises were $252.1 million and $268.8 million, respectively, as of March 31, 2006 and December 31, 2005. The Company extends credit to its customers in China generally without requiring collateral. In global sales outside of China, the Company often requires letters of credit from its customers. The Company monitors its exposure for credit losses and maintains allowances for doubtful accounts.

Approximately 33% and 25% of the Company's sales for the three months ended March 31, 2006 and 2005, respectively, were made in China. Accordingly, the political, economic and legal environment, as well as the general state of China's economy may influence the Company's business, financial condition and results of operations. The Company's operations in China are subject to special considerations and significant risks not typically associated with companies in the United States. These include risks associated with, among others, the political, economic and legal environments and foreign currency exchange. The Company's results may be adversely affected by, among other things, changes in the political, economic and social conditions in China, and by changes in governmental policies with respect to laws and regulations, changes in China's telecommunications industry and regulatory rules and policies, anti-inflationary measures, currency conversion and remittance abroad, and rates and methods of taxation.

Approximately 8% and 37% of the Company's sales for the three months ended March 31, 2006 and 2005, respectively, were made in Japan. Accordingly, the political, economic and legal environment and the general state of Japan's economy may influence the Company's business, financial condition and results of operations.

22. INCOME TAX ASSETS AND LIABILITIES:

In establishing its deferred income tax assets and liabilities, the Company makes judgments and interpretations based on the enacted tax laws and published tax guidance applicable to its operations as well as the amount and jurisdiction of future taxable income. The Company records deferred tax assets and liabilities and evaluates the need for valuation allowances to reduce the deferred tax assets to realizable amounts. We expect to maintain a full valuation allowance on our net deferred tax assets in China, the United States, and other countries until an appropriate level of profitability that generates taxable income is sustained or until we are able to develop tax strategies that would enable us to conclude that it is more likely than not that a portion of our deferred tax assets will be realizable. Any reversal of valuation allowances will favorably impact our results of operations in the period of the reversal.

Income tax expense for the three months ended March 31, 2006 was $2.8 million and $7.7 million for the three months ended March 31, 2005. The Company's 2006 annual effective tax rate is estimated to be negative 14%. There are two primary reasons for the negative 14% effective tax rate. First, the Company has not provided any tax benefit on the forecasted current year losses incurred and tax credits generated in the United States and other countries, because management believes that it is more likely than not that the tax benefit associated with these losses will not be realized. Also, the Company continues to accrue tax expense in jurisdictions where the Company has been historically profitable. Estimates of the annual effective tax rate at the end of the interim periods are based on evaluations of possible future events and transactions and may be subject to subsequent refinement or revision.

23. RECENT ACCOUNTING PRONOUNCEMENTS:

In June 2005, the FASB issued FASB Statement No. 154, "Accounting Changes & Error Corrections," ("SFAS 154"). The statement applies to all voluntary changes in accounting principle and changes the requirements for the accounting for and reporting of, a change in accounting principle. SFAS 154 requires retrospective application to prior period's financial statements unless this would impracticable. Also, if an entity changes it method of depreciation, amortization, or depletion for long-lived, non-financial assets, the change must be accounted for as a change in accounting estimate.

The Company adopted this standard in the quarter ended March 31, 2006. The adoption will only impact the financial statements in periods in which a change in accounting principle is made.

24. VARIABLE INTEREST ENTITY:

The Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46, ("FIN 46"). FIN 46 requires that if an entity is the primary beneficiary of a variable interest entity, ("VIE"), the assets, liabilities, and results of operations of the VIE should be included in the consolidated financial statements of the entity.

During the fourth quarter of 2005, the Company provided an interest free, $12.4 million loan to a party in China as seed capital for a venture organized to participate in providing technical service, networking technology, and equipment to the emerging market for IPTV products in China. The loan is partially secured by an indirect ownership interest in the venture, is payable in 10 years and may be called early without penalty. As a result of the foregoing, and the fact that the venture's continuing viability is heavily dependent on the further provision of network and terminal equipment by the Company, the Company has determined that the venture is a VIE and that the Company is the primary beneficiary of the venture. Therefore, this venture is consolidated into the Company's results as of March 31, 2006. This VIE had no revenue during the three months ended March 31, 2006, and had net losses of $0.7 million during the three months ended March 31, 2006. The consolidation of this VIE represented $18.3 million and $18.9 million of the total assets of the Company as of March 31, 2006 and December 31, 2005. The creditors of this VIE have no recourse to the Company.

In the first quarter of 2005, the Company invested in an additional entity, which is considered a VIE where the Company is the primary beneficiary and does not hold a majority voting interest. The company was established to install, develop and operate a PAS network in Mongolia. The creditors of this VIE have no recourse to the Company. In December 2005, the U.S. Embassy in Mongolia informed the Company that it had forwarded to the Department of Justice allegations that an agent of the joint venture had offered payments to a Mongolian government official, in possible violation of the Foreign Corrupt Practices Act. The Audit Committee authorized an independent investigation into the matter. As a result of the investigation, the Company wrote off $1.2 million of intangibles and established a $2.6 million VAT liability at December 31, 2005. The investigation is still ongoing. The consolidation of this entity resulted in a $6.0 million increase in both total assets and total liabilities and equity as of December 31, 2005. In the first quarter of 2006, the Company decided to terminate the joint venture arrangement and wrote off the remaining net assets, of approximately $4.7 million.

25. SUBSEQUENT EVENTS:

On March 16, 2006, the Company filed a current report on Form 8-K with the Securities and Exchange Commission disclosing that the Company would delay the filing of its Annual Report on Form 10-K for the year ended December 31, 2005(the "2005 Form 10-K"). The delay resulted in a technical default of the Company's 7 / 8% Convertible Subordinated Notes due 2008 (the "Notes"). The Company received notice from the trustee for the Notes asserting that if the Company failed to file the 2005 Form 10-K on or before June 2, 2006, such failure would constitute an event of default pursuant to the indenture for the Notes. If an event of default were to occur and be continuing, the trustee or the holders of at least 25% in aggregate principal amount of the notes then outstanding could declare all unpaid principal and accrued interest on the Notes then outstanding to be immediately due and payable. This technical default was cured prior to June 2, 2006 upon filing of the 2005 Form 10-K.

On May 5, 2006, Hong Liang Lu notified the Company of his resignation as the Company's President, Chief Executive Officer and Chairman of the Board, effective December 31, 2006. Ying Wu, Chief Executive Officer of the Company's China operations and Vice Chairman of the Board, will assume the position of Chief Executive Officer effective January 1, 2007. Thomas Toy, currently an independent director of the Company, will assume the position of Chairman of the Board effective January 1, 2007.

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

FORWARD-LOOKING STATEMENTS

This Report on Form 10-Q contains forward-looking statements within the meaning of the federal securities laws. These statements are based on information that is currently available to management. We intend such forward-looking statements to be covered by the safe harbor provisions of the Private Securities Litigation Reform Act of 1995, and we are including this statement for purposes of complying with those provisions. The forward-looking statements include, without limitation, those concerning the following: our expectations as to the nature of possible trends; our expectations regarding continued growth in our business and operations; our expectations regarding fluctuations in our overall sales, gross profit, product mix, quarterly and annual operating results, customer base and selling prices; our plans regarding payment of cash dividends; our expectations regarding recognition of certain compensation costs; our expectations regarding receipt of funds associated with the Marvell transaction; our plans regarding legal proceedings; our expectations regarding the effect of legal proceedings; our plans regarding the combination of the Broadband Infrastructure and Wireless Infrastructure segments; our expectations regarding the functionality, performance and features of our products; our expectation regarding Softbank's continued service of certain modems and modem rental agreements; our expectations regarding the vacancy of the offices of Chief Executive Officer and Chairman of the Board and planned replacements thereto; our expectations regarding the importance of investment in research and development; our expectation regarding our ability to maintain a full valuation allowance of our net deferred tax assets; our plans and expectations regarding relationships with vendors and suppliers, including Marvell and Cellon; our expectations regarding the future source and costs of integrated circuits; our plans regarding the use of financial instruments to hedge against certain foreign currency exchange rate risks; our plans regarding the use of derivative financial instruments for speculative trading purposes; our plans regarding the discounting of certain bank notes and commercial notes; our expectations regarding our ability to raise funds; our plan regarding the sale of accounts receivable to Citibank, N.A.; our expectations regarding our right to intellectual property embedded in our products; our expectations regarding the effect of market risks on our operating results; our plans to implement measures to remediate material weaknesses; our expectations regarding the effectiveness of remediation measures; our plans to continue to review internal controls; our expectations regarding competition and the competitive advantages of our competitors; our expectations regarding consolidation of the telecommunications industry; our expectations regarding the development and introduction of new products; our plans and expectations regarding growth management; our plans to reinvest cost savings derived from employee terminations; our expectations regarding the importance of hiring and retaining of key personnel and qualified employees; our expectation regarding the adoption of environmental, health and safety laws by countries world-wide; our expectations regarding the effect of the Sarbanes-Oxley Act on our corporate governance and disclosure practices; our expectation regarding the expenses associated with compliance with the Sarbanes-Oxley Act; our expectations regarding the maturation of the PAS market and corresponding decrease in PAS subscriber growth; our expectations regarding our annual effective tax rate; our expectations regarding the sufficiency of credit facilities, short-term investments, lines of credit, cash and cash equivalents to meet our operating needs for the foreseeable future; our expectations regarding our ability to receive licenses for our products; our expectation that our business, financial condition and results of operations will continue to be significantly influenced by the political, economic, legal and social environment in China and other international markets, including Japan; our expectations regarding the nature of political, economic and legal reform in China; our expectations regarding the continued importance of the Chinese market for our technologies and development; our expectations regarding subscriber growth; our expectations regarding global expansion of sales outside of China; our plans regarding improvement of our internal supply chain and inventory management processes; our expectations regarding the reliability of stock-based compensation valuation models; our expectations regarding the importance of sales in China to our operating results; and our expectations regarding our ability to implement and enhance our administrative infrastructure. Additional forward-looking statements may be identified by the words "anticipate," "expect," "believe," "intend," "will," and similar expressions, as they relate to us or our management, or by the words "designed," "intended" and similar expressions, as they relate to our products and services. Investors are cautioned that these forward-looking statements are inherently uncertain. These statements are subject to risks and uncertainties that may cause actual results and events to differ materially. For a detailed discussion of these risks and uncertainties, see the "Factors Affecting Future Operating Results" section of this Form 10-Q. We do not guarantee future results and undertake no obligation to update the forward-looking statements to reflect events or circumstances occurring after the date of this Form 10-Q.

RESTATEMENT OF CONSOLIDATED FINANCIAL STATEMENTS

In December 2005, we discovered two previously unknown side letter agreements that were provided to a customer in India. The side letter agreements obligated us to deliver a variety of software bug fixes, features, updates and upgrades for no additional consideration, and, contrary to our policy, these side letter agreements were withheld from our financial management and the Company's independent registered public accounting firm. As a result, neither management nor our independent registered public accounting firm were able to properly evaluate their effect on the recognition of revenue under contracts with this customer. The discovery of these side letter agreements prompted an investigation by independent legal counsel that was ordered by and under the direction of the Audit Committee of the Company's Board of Directors.

As a result of the independent review conducted for the Audit Committee of the Board of Directors, we identified accounting errors that impacted certain of our previously issued financial statements. We have determined that our previously issued financial statements and related financial information for the years ended December 31, 2004 and 2003, the corresponding quarterly periods therein, and the first three quarterly periods of 2005 should be restated to correct accounting errors identified in those periods. The restated financial statements include a number of restatement adjustments, relating to errors in the accounting for revenue, rebate accrual, inventory reserves, and other miscellaneous items. The financial statements for each restated period has been presented in the 2005 Form 10-K. For additional information regarding the restatement adjustments for the three months ended March 31, 2005, see Note 2, "Restatement of Financial Statements," of the Notes to the Condensed Consolidated Financial Statements.

EXECUTIVE SUMMARY

Effective July 1, 2006 the Company intends to combine the Broadband Infrastructure and the Wireless Infrastructure segments into a newly created Network Solutions segment.

We design, manufacture and sell telecommunications infrastructure, handsets and customer premise equipment and provide services associated with their installation, operation, and maintenance. Our products are sold primarily to telecommunications service providers or operators. We sell an extensive range of products that are designed to enable voice, data and video services for our operator customers and consumers around the world. While historically the vast majority of our sales have been to service providers in China, we have expanded our focus to build a global presence and currently sell our products in several other established and emerging growth markets, which include North America, Japan, India, Central and Latin America, Europe, the Middle East, Africa and Southeast and North Asia.

We differentiate ourselves with products designed to reduce network complexity, integrate high performance capabilities and allow a simple transition to next generation networks. We design our products to facilitate cost-effective and efficient deployment, maintenance and upgrades.

We have structured the Company across five key business segments:

Wireless Infrastructure: Our Wireless Infrastructure segment designs, builds and sells software and hardware products that enable end users, or subscribers, to send and receive voice and data communication in either a fixed or mobile environment by using wireless devices;

Broadband Infrastructure: Our Broadband Infrastructure segment designs, builds and sells software and hardware products that enable end users to access high-speed, cost effective fixed data, voice and media communication;

Personal Communications Division: Our Personal Communications Division ("PCD") markets, sells and supports handsets other than PAS handsets for markets other than China. Most of our handset sales in 2005 and 2004 were designed and built by other manufacturers, but we anticipate that during 2006 and beyond future sales will include more products built by our Handsets segment;

Handsets: Our Handsets segment designs, builds and sells consumer devices that allow customers to access wireless services. Revenues from worldwide PAS handsets and all handset revenues within China are included in this segment; and

Services: Our Services segment provides service and support for Wireless Infrastructure and Broadband Infrastructure customers in the areas of planning, deployment, operations and ongoing maintenance.

Our products within each of these categories, excluding services, include multiple hardware and software subsystems that can be offered in various combinations to suit individual carrier needs. Our system products are based on widely adopted global communications standards and are designed to allow service providers to quickly and cost-efficiently integrate our systems into their existing networks and deploy our systems in new broadband, IP and wireless network rollouts. Our products are also designed for quick and cost-effective transition to future network technologies, enabling our customers to make the best use of their existing infrastructure.

Our largest market for the three months ended March 31, 2006 and the year ended December 31, 2005 was the United States of America representing 55% and 46% of sales, respectively, for the periods. Prior to 2005, the majority of our sales were to service providers in China. This shift in market concentration and revenue is due to the combination of China's continued slow-down in its economy since the fourth quarter of 2004 and our ability to capture growth opportunities internationally as well as the incremental sales contributed by PCD subsequent to its acquisition in November 2004. During the three months ended March 31, 2005, we posted strong sales revenue in Japan principally resulting from the recognition of revenue previously deferred in relation to certain agreements with Japan Telecom. As a result, for the three months ended March 31, 2005 sales to Japan Telecom were 37% of total sales, the largest concentration for the period.

China has been one of our largest markets and we believe that it will continue to be an important market for our current and future technologies and development for the foreseeable future. However, we have also experienced a maturation of our PAS market in China resulting in our need to have a more diversified product and customer base. We also believe sales generated from China, as a percentage of total sales, may continue to decline as we continue to grow internationally.

We use subscriber growth statistics to gauge future inventory purchasing requirements as well as to forecast our anticipated revenue growth. We expect this subscriber growth to continue throughout 2005 since China's teledensity rates, or the number of telephones per person in a region, remain low in comparison to that of developed countries.

The number of competitors for communications access and switching systems and handsets in China has grown in line with China's telecommunications market expansion. This growth has led to competitive pricing pressure, causing average selling prices to decrease during the three months ended March 31, 2006 relative to those in the comparative period in 2005. Our gross profit as a percentage of sales in both our wireless infrastructure and handset product lines have improved despite the decline in sales prices as a result of improved product cost management. We expect gross profit as a percentage of sales to decline during the remainder of the year as cost reduction measures will not keep pace with price reductions.

We strive to develop products with more advanced features and to enhance the features of our existing products, which we believe will enable us to offer our customers more advanced products at higher average selling prices than otherwise would be possible in the future.

Over the past few years, we have undertaken a significant globalization program and we intend to continue to expand our global sales outside of China in the current year. As we expand, we will continue to improve our internal supply chain and inventory management processes to ensure timely deliveries. We will also continue to implement and enhance our administrative infrastructure to assist with our growth and globalization transformation.

KEY TRANSACTIONS

Marvell Technology Group Ltd.

In February 2006, we sold substantially all of the assets and selected liabilities of our semiconductor design business division, including the assets related to the prior acquisition of Advanced Communications Devices Corporation ("ACD"), to Marvell Technology Group Ltd. ("Marvell"). We received $20.0 million in cash in February 2006 and will receive an additional $4.0 million in cash in August 2007 currently held in an escrow account in the absence of a material breach of the original contractual terms. We may also receive up to an additional $16.0 million from Marvell if certain defined milestones are achieved before September 30, 2006.

In connection with the sale of assets, we have entered into a supply agreement with Marvell to purchase chipsets for our handset products over the next five years. The total consideration received of $24.0 million was allocated between the assets sold and the supply agreement, in the amounts of $3 and $21 million, respectively. The value allocated to the supply agreement is included in other current and long-term liabilities, and will be amortized in proportion to the quantities of chipsets purchased under the supply agreement over the next five years. As of March 31, 2006, approximately $0.3 million of gain had been recognized.

We considered whether or not the sale of the semiconductor design business constituted a discontinued operation, as defined by Statement of Financial Accounting Standard No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" ("SFAS 144"). Due to our continuing involvement with the disposed business, as we have committed to purchase product from Marvell and assist in the development of future products, the requirements for presentation as a discontinued operation have not been met.

Stock-based Compensation

During the first quarter of 2006, we adopted the provisions of, and account for stock-based compensation in accordance with, Financial Accounting Standards Board ("FASB") Statement of Financial Accounting Standards No. 123 revised 2004 ("SFAS 123R"), "Share-Based Payment." We elected the modified-prospective method, under which prior periods are not revised for comparative purposes. Under the fair value recognition provisions of this statement, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense on a straight-line basis over the requisite service period, which is the vesting period.

We currently use the Black-Scholes option pricing model to determine the fair value of stock options and employee stock purchase plan shares. The determination of the fair value of stock-based payment awards on the date of grant using an option-pricing model is affected by our stock price as well as assumptions regarding a number of complex and subjective variables. These variables include our expected stock price volatility over the term of the awards, actual and projected employee stock option exercise behaviors, risk-free interest rate and expected dividends.

We estimate the expected term of options granted by taking the average of the vesting term and the contractual term of the option. We estimate the volatility of our common stock by using implied volatility in market traded options in accordance with SAB 107. We base the risk-free interest rate that we use in the option pricing model on U.S. Treasury zero-coupon issues with remaining terms similar to the expected term on the options. We do not anticipate paying any cash dividends in the foreseeable future and therefore use an expected dividend yield of zero in the option pricing model. We are required to estimate forfeitures at the time of grant and revise those estimates in subsequent periods if actual forfeitures differ from these estimates. We use historical data to estimate pre-vesting option forfeitures and record stock-based compensation expense only for those awards that are expected to vest. All share based payment awards are amortized on a straight-line basis over the requisite service periods of the awards, which are generally the vesting periods.

If factors change and we employ different assumptions for estimating stock-based compensation expense in future periods or if we decide to use a different valuation model, the future periods may differ significantly from what we have recorded in the current period and could materially affect our operating income, net income and net income per share.

The Black-Scholes option-pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable, characteristics not present in our option grants and employee stock purchase plan shares. Existing valuation models, including the Black-Scholes and lattice binomial models, may not provide reliable measures of the fair values of our stock-based compensation. Consequently, there is a risk that our estimates of the fair values of our stock-based compensation awards on the grant dates may bear little resemblance to the actual values realized upon the exercise, expiration, early termination or forfeiture of those stock-based payments in the future. Certain stock-based payments, such as employee stock options, may expire worthless or otherwise result in zero intrinsic value as compared to the fair values originally estimated on the grant date and reported in our financial statements. Alternatively, value may be realized from these instruments that are significantly higher than the fair values originally estimated on the grant date and reported in our financial statements. There is currently no market-based mechanism or other practical application to verify the reliability and accuracy of the estimates stemming from these valuation models, nor is there a means to compare and adjust the estimates to actual values.

The guidance in SFAS 123R is relatively new. The application of these principles may be subject to further interpretation and refinement over time. There are significant differences among valuation models, and there is a possibility that we will adopt different valuation models in the future. This may result in a lack of consistency in future periods and materially affect the fair value estimate of stock-based payments. It may also result in a lack of comparability with other companies that use different models, methods and assumptions.

Subsequent events:

Change in Management

On May 5, 2006, Hong Liang Lu notified us of his resignation as our President, Chief Executive Officer and Chairman of the Board, effective December 31, 2006. Ying Wu, Chief Executive Officer of our China operations and Vice Chairman of the Board, will assume the position of Chief Executive

Officer effective January 1, 2007. Thomas Toy, currently an independent director of the Company, will assume the position of Chairman of the Board effective January 1, 2007.

RELATED PARTY TRANSACTIONS:

Softbank

We recognized revenue of $36.1 million and $26.0 million during the quarters ended March 31, 2006 and 2005, respectively, with respect to sales of telecommunications equipment to affiliates of SOFTBANK CORP. ("Softbank"), a significant stockholder of the Company. Softbank offers asynchronous digital subscriber line ("ADSL") coverage throughout Japan, which is marketed under the name "YAHOO! BB." We support Softbank's fiber-to-the-home service through sales of our carrier class Gigabit Ethernet Passive Optical Network ("GEPON") product as well as our multi-service optical transport product ("NetRing "). In addition, we support Softbank's new internet protocol television ("IPTV"), through sales of our RollingStream product. Included in revenue for the three months ended March 31, 2006 is a fee of $17.0 million charged for the cancellation of orders for broadband products.

Included in accounts receivable at March 31, 2006 and December 31, 2005 were $86.8 million and $69.3 million, respectively, related to these agreements. Sales to Softbank include a three year service period and a penalty clause if product failure rates exceed a certain level over a seven year period. There were $13.1 million revenue included and $16.3 million included in long term deferred revenue with respect to these agreements at March 31, 2006 and December 31, 2005, respectively. Additionally, there were $8.7 million and $6.3 million included in current deferred revenue at March 31, 2006 and December 31, 2005, respectively. As of March 31, 2006 and December 31, 2005, there were $5.4 million and $5.4 million, respectively, included in customer advance related to Softbank agreements.

During August 2004, we entered into several agreements with Japan Telecom Co., Ltd ("JT"), a wholly owned subsidiary of Softbank. These agreements relate to the sale of *i*AN-8000 equipment with specified value and delivery dates, as well as an oral agreement which subsequently converted into specific service contracts to manage a sales promotional program for JT. We have determined that the service activities revenue should be recorded net of expected promotional spending.

Because we had not provided these activities in the past and could not estimate the fair value of these services, we determined under the guidance of SAB 104 that all revenue related to these agreements could not be recognized until all goods and services were delivered. We had delivered and received final acceptance for all equipment contemplated under these agreements in the quarter ended March 31, 2005.

The promotional services discussed above involved contracting with third party promotional vendors, who in turn, facilitated the marketing and subscriber recruitment for the JT fiber-to-the-home program. During the fourth quarter of 2004, we determined that we would end our involvement with the JT promotional program after completion of the contract discussed above. Accordingly, late in the fourth quarter of 2004 and during the first quarter of 2005, we either cancelled or assigned to another party all third party contracts with promotional vendors related to the JT contract. Such termination or assignment of all third party promotional agreements, as well as effective satisfaction of our obligations with JT under such agreements, satisfied the revenue recognition criteria for these agreements and as such, the net value of the promotional services and the value of equipment delivered, which totaled $205.4 million, was reported in the quarter ended March 31, 2005.

We also entered into an agreement with JT during the third quarter of 2004 to supply chassis equipment. The equipment shipped under this agreement is considered linked to the *i*AN-8000 sale noted above and as such, was also deferred until the completion of the above-mentioned promotional activities. The revenue recognition criteria related to the sale of the *i*AN-8000 equipment was satisfied in the first quarter of 2005 and as such, the revenue related to the chassis sale of $66.5 million was reported in the quarter ended March 31, 2005. During the three months ended March 31, 2006 and 2005, sales to Softbank included $0.5 and $271.9 million, respectively, with regards to telecommunications equipment and services sold to JT.

On July 17, 2003, we entered into a Mezzanine Loan Agreement with BB Modem Rental PLC ("BB Modem"), an affiliate of SOFTBANK CORP. Under the terms of the agreement, we loaned BB Modem $10.1 million at an effective interest rate of 12.01% per annum, for the purpose of investing in a portfolio of ADSL modems and associated modem rental agreements, from Softbank. Softbank will continue to service such modems and modem rental agreements. Our loan is subordinated to certain senior lenders of BB Modem, and repayments are payable to us over a 42-month period through January 31, 2007, with a substantial portion of the principal amount of the loan schedule to be repaid during the last 16 months of this period. Our recourse for nonpayment of the loan is limited to the assets of BB Modem, the account into which subscriber payments are made and its rights under the securitization transaction documents. The value of BB Modem's modems that serve as collateral for the loan may decrease over time and may not be sufficient upon sale to pay the outstanding amounts on the loans. We assess the loan for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. We periodically review the underlying quality of the asset pool securing the loan to assess whether impairment has incurred and needs to be recorded. During the three months ended March 31, 2006 and 2005, we recorded $0.2 million and $0.3 million, respectively, in interest income in respect to this loan. The loan receivable at March 31, 2006 and December 31, 2005 was approximately $7.1 million and $9.0 million, respectively and is included in other long-term assets.

As of March 31, 2006, Softbank beneficially owned approximately 12.1% of our outstanding stock.

Acoustek Int'l Corp.

We obtain consulting services from Acoustek Int'l Corp. ("Acoustek"), which employs an individual related to one of our officers. We paid to Acoustek $0.1 million during each of the three months ended March 31, 2006 and 2005 for consulting services.

Cellon

In October 2002, we entered into a license and a royalty agreement with Cellon International Holding Corporation ("Cellon") in which we have an ownership interest. We paid $0.8 million to license certain technology for the development of certain handset products in China. Per the terms of the royalty agreement, we are required to pay Cellon $3 per unit shipped for a minimum of 0.1 million units. This agreement is not material to the overall financial results of Cellon. We have evaluated our relationship with Cellon under FIN 46, and determined that consolidation is not necessary.

In November 2005, we entered into an agreement with Cellon, which was completed on May 31, 2006. In exchange for preferred stock and warrants of Cellon, we transferred fixed assets with a net book value of $3.0 million, a lease and a workforce in place consisting of 156 engineers. Additionally, we prepaid $5.0 million in exchange for future product development. Cellon will pay us a royalty if certain technology shared by us to Cellon is used in products developed and sold through November 2007.

As of March 31, 2006 we had an accounts payable balance of $0.5 million.

Fiberxon

We have an outstanding purchase commitment with Fiberxon, in which we have a 7% ownership interest, to purchase component parts for optical networking products. Purchases from Fiberxon totaled

$1.5 million and $5.0 million during the three months ended March 31, 2006 and 2005, respectively and we had $0.2 million and $0.3 million in accounts payable to Fiberxon at March 31, 2006 and December 31, 2005, respectively.

Global Asia Partners L.P.

Global Asia Partners L.P. is a venture capital fund formed to make private equity investments in private or pre-IPO technology and telecommunications companies in Asia. The general partner of this fund is also one of our sales agents. Between June 2002 and April 2005, we have invested a total of $2.6 million in the fund. As of March 31, 2006 and December 31, 2005, we have 49% of the outstanding partnership units.

Immenstar

We have an outstanding purchase commitment with Immenstar, in which we own Series A preferred stock, to purchase component parts. Purchases from Immenstar totaled $2.0 million during the three months ended March 31, 2006, and payments to Immenstar totaled $0.9 during the three months ended March 31, 2006.

Matsushita Joint Venture

In July 2002, we entered into a joint venture agreement with Matsushita Communication Industrial Co., Ltd. to jointly design and develop, manufacture and sell telecommunication products. We have a 49% ownership interest in the joint venture company. As of March 31, 2005 and December 31, 2005, we had a receivable of $0.4 million and $0.1 million, respectively. In December 2005, the partners agreed to dissolve the joint venture.

Org, Inc.

We have a 49% ownership in Global Asia Partners L.P. which in turn is a significant shareholder in Org, Inc. During the three months ended March 31, 2006, we had sales of $0.1 million to Org, Inc. As of March 31, 2006 and December 31, 2005, we had a receivable of $0.1 million and $0.2 million, respectively, and deferred revenue of $0.1 million as of December 31, 2005.

Spacetime

In January 2005, we formed a joint venture with two other parties to provide mobile communication, broadband and IP related value added services in Mongolia. The operations of the joint venture are consolidated into our financial statements. In the first quarter of 2006, we decided to terminate the joint venture arrangement and wrote off the remaining net assets, of approximately $4.7 million. (See Note 24 to the Condensed Consolidated Financial Statements) As of March 31, 2006 and December 31, 2005, we had $0.3 million included in related party receivables, and $0.3 million in long term debt related to one of the joint venture partners, Spacetime Golden Communication Technology USA, Inc.

Xalted Networks

We received purchase orders from Xalted Networks totaling approximately $1.3 million in 2005 for telecommunications equipment that is for product not typically sold by us to other customers. We are charging a 10% procurement fee to Xalted for obtaining and reselling these products. The equipment was delivered during 2005 but revenue has not been recognized as the revenue recognition process had not been completed. The equipment cost is included in inventory as of March 31, 2006 and December 31, 2005. In March 2006 the Company invested an additional $0.3 million in Xalted Networks.

RESULTS OF OPERATIONS

We manage our business based principally upon product families of five operating segments, (i) Broadband Infrastructure, (ii) Wireless Infrastructure, (iii) PCD, (iv) Handsets, and (v) Service. Broadband infrastructure is primarily comprised of digital subscriber line products, multi-service access node products, fiber optics products and IP-based television. Wireless infrastructure is primarily comprised of the PAS family of core infrastructure equipment and Code Division Multiple Access ("CDMA") family of infrastructure equipment. Our PCD segment markets wireless handsets through international wireless carriers and their agents. The Handsets segment includes global PAS handset sales and sales of CDMA, Wireless Fidelity ("WiFi") and CDMA handset sales in China. We also provide installation and certain maintenance services. For each of the periods presented, total services sales accounted for less than 10% of net sales.

Effective July 1, 2006 the Company intends to combine the Broadband Infrastructure and the Wireless Infrastructure segments into a newly created Network Solutions segment. We are currently evaluating the reporting effect of this change.

THREE MONTHS ENDED MARCH 31, 2006 AND 2005

NET SALES

	Three months ended March 31,			
	2006	% of net sales	2005	% of net sales
			as restated	
	(in thousands)			
Broadband	$ 57,156	10%	$ 326,307	36%
Wireless	100,433	17%	109,437	12%
PCD	322,995	55%	315,552	35%
Handsets	99,019	16%	128,083	14%
Service	16,968	2%	22,505	3%
Net sales	$ 596,571	100%	$ 901,884	100%

Three months ended March 31, 2006 and 2005

Net sales decreased by 34% to $596.6 million during the quarter ended March 31, 2006 compared to the same period in 2005. The decrease is primarily due to a decrease in sales in the Broadband segment by 83% from March 31, 2005 to March 31, 2006. The greater Broadband segment sales during the three months ended March 31, 2005 included sales of $271.9 million to Japan Telecom, an affiliate of Softbank, primarily for the iAN8000 product. Due to the customer concentration in the Broadband segment, revenues fluctuate based upon the magnitude and timing of revenue recognition on certain contracts. Additionally, Handset sales declined by $29.1 million, or 23%. As we have been experiencing in the recent quarters, the demand of our PAS/iPAS products including PAS/iPAS system based handsets in the China market continued to mature which resulted in lower demand and average selling price.

Net sales increased in our PCD segment and declined in the other four segments in the three months ended March 31, 2006, compared to the corresponding quarter in fiscal 2005. For additional discussion see Segment Reporting.

GROSS PROFIT

	Three months ended March 31,			
	2006	Gross profit %	2005	Gross profit %
			as restated	
	(in thousands)			
Broadband	$ 22,957	40%	$ 164,057	50%
Wireless	49,517	49%	29,670	27%
PCD	14,434	4%	13,692	4%
Handsets	31,599	32%	14,539	11%
Service	3,947	23%	15,466	69%
Gross Profit	$ 122,454	21%	$ 237,424	26%

Cost of sales consists primarily of material and labor costs associated with manufacturing, assembly and testing of products, costs associated with installation and customer training, warranty costs, fees to agents, inventory provision and overhead. Cost of sales also includes import taxes and tariffs on components and assemblies. Some components and materials used in our products are purchased from a single supplier or a limited group of suppliers and, in some cases, are subject to our obtaining Chinese import permits and approvals. We also rely on third party manufacturers to manufacture and assemble most of our CDMA handsets.

Our gross profit has been affected by average selling prices, material costs, product mix and the impact of warranty charges as well as inventory reserves. Our gross profit, as a percentage of net sales, varies among our product families. We expect that our overall gross profit, as a percentage of net sales, will fluctuate from period to period as a result of shifts in product mix, stage of product life cycle, anticipated decreases in average selling prices and our ability to reduce cost of sales.

Three months ended March 31, 2006 and 2005

Gross profit was $122.5 million, or 21% of net sales, in the three months ended March 31, 2006, compared to $237.4 million, or 26% of net sales, in the corresponding quarter of 2005. The overall gross profit decrease is due to a decline in sales and lower gross profit percentages in the Broadband segment. Gross profit percentages improved in the Wireless and Handset segments, declined in the Broadband and Service segments, and remained the same in PCD. For additional discussion see "Segment Reporting."

OPERATING EXPENSES

The following table summarizes our operating expenses:

	Three months ended March 31,			
	2006	% of net sales	2005	% of net sales
			as restated	
	(in thousands)			
Selling, general and administrative	$ 83,172	14%	$ 109,011	12%
Research and development	46,309	8%	66,260	7%
Amortization of intangible assets	4,925	1%	6,972	1%

	Three months ended March 31,					
Total operating expenses	$	134,406	23%	$	182,243	20%

Selling, general and administrative expenses ("SG&A") include compensation and benefits, professional fees, sales commissions, provision for doubtful accounts receivable and travel and entertainment costs. Research and development expenses consist primarily of compensation and benefits of employees engaged in research, design and development activities, costs of parts for prototypes, equipment depreciation and third party development expenses. A portion of our costs are fixed and are difficult to quickly reduce in periods of lower sales. However, during the second quarter of 2005, we announced and initiated a restructuring plan which resulted in the reduction of certain SG&A and research and development costs. We believe that continued investment in research and development is critical to our long-term success.

SELLING, GENERAL AND ADMINISTRATIVE

Selling, general and administrative expenses decreased $25.8 million but increased by 2% as a percentage of net sales during the three months ended March 31, 2006 compared to the same period in 2005. The decrease in SG&A expenses was primarily due to a $16.7 million decrease in our provision for doubtful accounts compared to the same period in 2005. Approximately $4.5 million in reduction was due to lower travel and entertainment costs, particularly in the China operations. In addition, there were reductions in expenses across all entities due to expense controls. Days sales outstanding was 74 days at March 31, 2006 as compared to 90 days at March 31, 2005. The shorter days sales outstanding and resultant decrease in provision for doubtful accounts is the result of improved cash collections in the first quarter of 2006 relative to the comparable period in 2005.

In the first quarter of 2006, the Company decided to terminate the Mongolian joint venture arrangement and wrote off the remaining net assets, of approximately $4.7 million.

RESEARCH AND DEVELOPMENT

Research and development ("R&D") expenses decreased by $19.9 million but increased by 1% as a percentage of net sales during the three months ended March 31, 2006 compared to the same period in 2005. The absolute decrease in R&D expenses can be attributed to a decrease in headcount of approximately 778 employees resulting from restructuring activities and the transfer of engineers as part of the sale of ACD. Personnel related expenses decreased by $4.7 million and facility and depreciation costs decreased by $5.6 million as a result of restructuring and write down of R&D equipment. Additionally, professional services decreased by $3.6 million due to a decreased use of consultants.

AMORTIZATION OF INTANGIBLE ASSETS

Amortization of intangible assets decreased by $2.0 million in the three months ended March 31, 2006 compared to the same quarter last year. Amortization of intangible assets declined as several intangible assets became fully amortized during the preceding twelve months.

INTEREST INCOME

Interest income was $3.5 million and $1.3 million for the three months ended March 31, 2006 and 2005, respectively. Interest income was generated from cash and short-term investment balances which remained consistent in the three months ended March 31, 2006 and the corresponding quarter of 2005. The effective interest rate doubled between the two periods.

INTEREST EXPENSE

Interest expense was $3.5 million and $4.3 million for the three months ended March 31, 2006 and 2005, respectively. The decrease in interest expense for the three months ended March 31, 2006 was attributable to the decrease in borrowings.

OTHER INCOME (EXPENSES)

Net other income or expense was an income of $3.6 million and an expense of $6.8 million for the three months ended March 31, 2006 and 2005, respectively. Net other income for the three months ended March 31, 2006 was primarily due to a $2.8 million gain on foreign currency revaluation and a $0.5 million financial subsidy from the local Chinese government. Net other expense for the three months ended March 31, 2005 was primarily due to a $7.8 million loss on foreign currency revaluation and offset by consumption tax refunds in Japan of $1.2 million, and a $0.5 million financial subsidy from the local Chinese government.

INCOME TAX EXPENSE

Income tax expense is based upon a blended effective tax rate based upon our expectation of the amount of income to be earned in each tax jurisdiction and is accounted under the liability method. Deferred income taxes are recognized for the differences between the tax bases of assets and liabilities and their financial statement amounts based on enacted tax rates. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized. We expect to maintain a full valuation allowance on our remaining net deferred tax assets until an appropriate level of profitability that generates taxable income is sustained or until we are able to develop tax strategies that would enable us to conclude that it is more likely than not that a portion of our deferred tax assets will be realizable. Any reversal of valuation allowances will favorably impact our results of operations in the period of the reversal.

Income tax expense was $2.8 million and $7.7 million for the three months ended March 31, 2006 and 2005, respectively. The Company's 2006 annual effective tax rate is estimated to be negative 14%. There are two primary reasons for the negative 14% effective tax rate. First, we have not provided any tax benefit on the forecasted current year losses incurred and tax credits generated in the United States and other countries, because management believes that it is more likely than not that the tax benefit associated with these losses will not be realized. Also, we continue to accrue tax expense in jurisdictions where we have been historically profitable. Estimates of the annual effective tax rate at the end of the interim periods are based on evaluations of possible future events and transactions and may be subject to subsequent refinement or revision.

EQUITY IN NET LOSS OF AFFILIATED COMPANIES

Equity in net gain or loss of affiliated companies was zero for the three months ended March 31, 2006 and a loss of $0.5 million for the three months ended March 31, 2005. The loss in 2005 primarily resulted from losses incurred by our joint venture with Matsushita Communication Industrial Co., Ltd., and was partially offset by the gain recognized on our investment in Restructuring Fund.

SEGMENT REPORTING

We manage our business on the basis of our five operating segments, namely Broadband Infrastructure, Wireless Infrastructure, Handsets, PCD, and Service. Each operating segment represents its own reporting segment and each operating segment is responsible for its own production and sales management.

We currently evaluate operating performance of and allocate resources to the reporting segments based on segment gross profit. Cost of sales and direct expenses in relation to production are assigned to the reporting segments. Corporate headquarters expenses and non-operating items are not allocated to the segments. The accounting policies used in measuring segment assets and operating performance are the same as those used by corporate and are consistently applied across all segments.

Effective July 1, 2006 the Company intends to combine the Broadband Infrastructure and the Wireless Infrastructure segments into a newly created Network Solutions segment. We are currently evaluating the reporting effect of this change.

Summarized below are our segment sales revenue and gross profit for the three months ended March 31, 2006 and 2005, respectively.

Broadband Infrastructure

	Three months ended March 31,	
	2006	2005
		as restated
	(in thousands)	
Sales	$ 57,156	$ 326,307
Gross profit	$ 22,957	$ 164,057
Gross profit as a percentage of sales	40%	50%

Our largest Broadband Infrastructure customer is Softbank in Japan, representing approximately 60% and 87% of total broadband sales during the three months ended March 31, 2006 and 2005. Due to the customer concentration in this segment, revenues fluctuate based upon the magnitude and timing of revenue recognition on certain contracts. Broadband Infrastructure net sales during the three months ended March 31, 2005 included one large transaction with Softbank totaling $271.9 million of revenue on certain agreements entered into with Japan Telecom primarily for the iAN8000 product in 2005.

Included in Broadband Infrastructure sales for the three months ended March 31, 2006 are order cancellation fees of $22.6 million and included in cost of sales is a $3.1 million inventory write-down. During the three months ended March 31, 2006 we incurred a negative gross profit in China of $2.1 million, primarily as a result of a reduction in the realizable value of inventory at customer sites without contracts for products in the IPTV, GEPON and IPDSLAM product lines.

Wireless Infrastructure

	Three months ended March 31,	
	2006	2005
		as restated
	(in thousands)	
Sales	$ 100,433	$ 109,437
Gross profit	$ 49,517	$ 29,670
Gross profit as a percentage of sales	49%	27%

During the three months ended March 31, 2006, PAS systems sales declined 18% and now comprise approximately 85% of our Wireless Infrastructure sales compared to 95% during the same period in 2005. Wireless sales declined in China by 9%, and were offset by marginal increases in other regions. The decrease in PAS systems sales is primarily a result of our customers in China transitioning from new system installations to system expansions as PAS/iPAS systems reach product maturity.

Gross profit increased by 22 percentage points in the three months ended March 31, 2006, as compared to the corresponding quarter in 2005 due to a number of factors, including: (i) The margins on PAS infrastructure improved due to a shift in product mix towards higher margin cell sites as well as a reduction in product discounts given; (ii) an improvement in inventory management resulting in a decrease in excess inventory write-downs; and (iii) sales of voice and data networks software totaling $8.6 million which has nearly 100% gross margins.

PCD

	Three months ended March 31, 2006	2005 as restated
	(in thousands)	
Sales	$ 322,995	$ 315,552
Gross profit	$ 14,434	$ 13,692
Gross profit as a percentage of sales	4%	4%

Revenue from external customers in the three months ended March 31, 2006 was consistent with the corresponding quarter of 2005, increasing $7.4 million or 2%. The number of units sold during the three months ended March 31, 2006 increased to 1.65 units from 1.55 units in the comparable period in the prior year. The average sales price per unit declined by approximately 4%. During the three months ended March 31, 2006, the sales activities of the PCD division were expanded to include sales of handsets other than PAS in countries other than China that were previously included in the Handset division. This resulted in additional sales of $3.1 million for the segment. Although gross profit as a percentage of sales was greater for these sales, there was no significant effect on the overall segment gross profit.

Historically, PCD has relied upon a limited number of manufacturers to supply its handset products. During the three months ended March 31, 2006, one vendor accounted for approximately 45% of PCD purchases. This vendor will continue to supply PCD existing handset models but plans to sell new models directly to some of our customers. We plan to replace this supplier by introducing more models of our own design and expanding our relationships with other manufacturers, but we still expect to see flat or declining sales during the first half of 2006 while we make this transition. The percentage of product sourced from this vendor has already declined from 67% of PCD purchases during the three months ended March 31, 2005 and 63% of PCD purchases during all of 2005. During the three months ended March 31, 2006, sales of UTStarcom branded devices increased to approximately seven percent from zero in the same period last year

Gross profit as a percentage of sales remained the same for the periods ending March 31, 2006 and 2005.

Handsets

	Three months ended March 31, 2006	2005 as restated
	(in thousands)	
Sales	$ 99,019	$ 128,083
Gross profit	$ 31,599	$ 14,539
Gross profit as a percentage of sales	32%	11%

Net sales declined 23% primarily due to decreases in both volume and price for our PAS handsets in China as the units sold declined to 2.0 million compared to 2.5 million in the comparable period last year. We believe that the 20% volume decline was primarily attributed to lower demand for our PAS handsets resulting from slower subscriber growth. During the three months ended March 31, 2006, the PAS net subscriber growth slowed to 4.0 million from 5.5 million during the comparable period in the prior year as service providers reduced marketing efforts for PAS handsets in anticipation of next generation technology networks.

We believe the average selling price per unit declined 14% due to a combination of competitive pricing pressures, and a shift in product mix to sales of lower-end models. We have also experienced continuing pricing pressure in the China telecommunications market since the latter part 2003, which has driven average unit selling prices lower. We expect to see cumulative PAS subscriber growth at lower rates in future periods.

Gross profit as a percentage of sales for our handsets segment increased by 21% in the three months ended March 31, 2006, as compared to the corresponding quarter in 2005. A portion of the improvement in the gross profit percentage relates to increased use of chip-sets with greater functionality in PAS handsets that reduce the overall component costs of each unit. Additional factors leading to the improvement in gross profit is a reduction in scrap, variances and warranty costs.

In future periods, the chip-sets will be supplied by Marvell as a result of the sale of the semiconductor design division. (See Note 11) We anticipate that the costs of chip-sets supplied by Marvell will continue to decline due to improved purchasing efficiencies experienced by Marvell. However, we do not expect gross profit as a percentage of sales to continue at this level over the remainder of the year as the decline of the price per unit will likely exceed our ability to continue to reduce per-unit costs.

Service

	Three months ended March 31,	
	2006	**2005**
		as restated
	(in thousands)	
Sales	$ 16,968	$ 22,505
Gross profit	$ 3,947	$ 15,466
Gross profit as a percentage of sales	23%	69%

Our Service segment's revenue from external customers decreased by $5.5 million, or 25%, in the three months ended March 31, 2006 as compared to the corresponding quarter last year. The Service segment's revenue for the quarter ended March 31, 2005 includes $12.6 million of revenue and gross profit associated with promotional services for Softbank and affiliates. There was no comparable revenue during the same period in 2006.

During the first quarter of 2006, we focused on the revenue opportunities with respect to support in China. Approximately 477 employees previously providing sales and support services were shifted towards generating revenue from support arrangements, resulting in additional cost of goods sold of $3.4 million and a corresponding decrease to operating expenses. Additionally, revenues of $2.6 million from Wireless Infrastructure and $0.2 million from Broadband segment sales in China were allocated to the Service segment during the three months ended March 31, 2006. The allocation was made on certain completed contracts for which the service element was not separately priced.

LIQUIDITY AND CAPITAL RESOURCES

Operating Activities

2006

Net cash provided by operating activities for the three months ended March 31, 2006 was $53.7 million. Operating cash was affected by changes in deferred costs/inventories at customer sites under contract, customer advances, accounts receivable, and accounts payable and offset by the net loss as well as changes in other current liabilities and inventory.

Customer advances increased by $43.1 million for the three months ended March 31, 2006. Customer advances represent cash deposits we have received from our customers for orders that have not yet received final acceptance. Upon subsequent receipt of final acceptances and revenue recognition, customer advances are reduced and revenue and cost of sales is recorded. Deferred costs/inventories at customer sites under contracts decreased by $0.8 million from December 31, 2005 to March 31, 2006. The decrease in deferred costs results from a greater number of customer acceptances.

The $28.8 million decrease in accounts receivable was attributable to a decline in sales preceding the end of the March 31, 2006 quarter as compared to sales in the preceding quarter. Partially offsetting this is a lengthening of days sales outstanding to 74 days at March 31, 2006 as compared to 65 days at December 31, 2005.

Accounts payable increased by $18.1 million, inventory decreased by $4.3 million, and other current liabilities decreased by $51.0 million. The decrease in other current liabilities is primarily the result of a decrease in taxes payable of approximately $14.2 million, a decrease in compensation related costs of approximately $8.8 million, a decrease in accrued expenses, such as warranty, royalty and legal, of approximately $13.9 million, and a decrease of approximately $14.1 million in other liabilities.

2005

Net cash used in operating activities for the three months ended March 31, 2005 was $182.9 million. Operating cash was affected by changes in accounts receivable, inventory and customer advances offset by changes in accounts payable and deferred revenue.

The $120.6 million increase in accounts receivable was attributable to incremental sales derived from PCD sales and longer China collection cycles experienced during the three months ended March 31, 2005 as compared to the same quarter in the prior year. Days sales outstanding was 119 days excluding PCD, or 90 days including PCD, at March 31, 2005 as compared to 63 days at March 31, 2004. Also contributing to the increase was a larger volume of sales, from $901.9 million for the three months ended March 31, 2005 compared to $617.6 million for the same quarter in 2004. The longer days sales outstanding is a direct result of slower collection cycles in China due to the recent slow-down in the economy.

Inventory increased by $15.7 million, due to the increase in sales volume noted above. Also contributing to the increase was a larger volume of sales, from $901.9 million for the three months ended March 31, 2005. Customer advances decreased by $223.7 million for the three months ended March 31, 2005. Customer advances represent cash deposits we have received from our customers for orders that have not yet received final acceptance. Upon subsequent receipt of final acceptances and revenue recognition, customer advances are reduced and revenue and cost of sales is recorded. The reduction of customer advances in the three months ended March 31, 2005 was primarily due to the completion of the revenue earning process for most of the agreements with Japan Telecom, Inc. ("JT"), an affiliate of Softbank Corp. All cash received from JT in advance of revenue recognition and in advance of spending for promotional activities was reflected as a customer advance in prior periods. Revenue for certain of these agreements has been recognized in the three months ended March 31, 2005. For additional information, refer to Note 18, "Related Party Transactions," to our condensed consolidated financial statements.

Offsetting the activity that decreased operating cash for the period were net income and non-cash charges, including $25.9 million of depreciation and amortization, $17.5 million of provision for doubtful accounts and $15.2 million of inventory provision. Accounts payable increased by $33.4 million, deferred revenue increased by $28.0 million and other current and non-current assets decreased by $49.6 million, all of which contributed to the increase in operating cash.

Investing Activities

2006

Net cash provided by investing activities for the three months ended March 31, 2006 totaled $2.8 million. Cash of $20.0 million was received from the sale of assets of the semiconductor design business division to Marvell Technology Group, Ltd., and $13.3 million was received from the net sale of short-term investments. Cash outflows from investing activities included an increase in restricted cash of $17.0 million as well as $10.8 million used to purchase short-term investments.

2005

Net cash provided by investing activities for the three months ended March 31, 2005 totaling $79.1 million was primarily due to $120.1 million of proceeds from the net sale of short-term investments which was used to pay down our borrowings. Cash outflows from investing activities included our purchase of the selected assets of Giga, which resulted in a cash outflow of $18.5 million as well as $28.3 million invested in property, plant and equipment.

Financing Activities

2006

Net cash used in financing activities was $30.8 million, primarily consisting of a net repayment of short-term borrowings in excess of new borrowing of $27.6 for the three months ended March 31, 2006.

2005

Net cash used in financing activities was $83.3 million for the repayment of short-term borrowings in excess of new borrowing for the three months ended March 31, 2005.

Liquidity

Our working capital was $0.9 billion and $1.1 billion at March 31, 2006, and 2005, respectively. This decrease in working capital was primarily due to decrease in accounts receivable, and increases in customer advances and deferred revenue. These are partially offset by smaller accounts payable and short-term debt. Cash and cash equivalents increased to $673.6 million at March 31, 2006 from $372.7 million at March 31, 2005 while short-term investments decreased to $10.9 million at March 31, 2006 from $16.2 million at March 31, 2005.

Our China sales are generally denominated in local currency. Due to the limitations on converting Renminbi, we are limited in our ability to engage in foreign currency hedging activities in China. We cannot guarantee that fluctuations in foreign currency exchange rates in the future will not have a material adverse effect on revenues from international sales and, correspondingly, on our business, financial condition and results of operations. We have contracts negotiated in Japanese Yen and we maintain a bank account in Japanese Yen for purchasing portions of our inventories and supplies. The balance of this Japanese Yen account at March 31, 2006 was approximately $4.1 million. We may hedge certain Japanese Yen-denominated balance sheet exposures against future movements in foreign currency exchange rates by using foreign currency forward contracts. Gains and losses on these fair value hedges are intended to offset gains and losses from the revaluation of our Japanese Yen-denominated recognized assets and liabilities. In accordance with Statement of Financial Accounting Standards No. 133 ("SFAS 133"), "Accounting for Derivative Instruments and Hedging Activities," we recognize derivative instruments and hedging activities as either assets or liabilities on the balance sheet and measure them at fair value. We do not intend to utilize derivative financial instruments for speculative trading purposes.

We accept bank notes receivable and commercial notes receivable with maturity dates of between three and six months from our customers in China in the normal course of business. Notes receivable available for sale was $7.7 million and $2.1 million at March 31, 2006 and December 31, 2005, respectively. We may discount these notes with banking institutions in China. Any notes that have been sold are not included in our consolidated balance sheets as the criteria for sale treatment established by Statement of Financial Accounting Standards No. 140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishment of Liabilities" ("SFAS 140"), have been met.

In March 2003, we completed an offering of $402.5 million of convertible subordinated notes due March 1, 2008 to qualified institutional buyers pursuant to Rule 144A under the Securities Act of 1933, as amended. The notes bear interest at a rate of 7/8% per annum and are convertible into our common stock at a conversion price of $23.79 per share and are subordinated to all of our present and future senior debt. Concurrent with the issuance of the convertible notes, we entered into a convertible bond hedge and a call option transaction with respect to our common stock. Both the bond hedge and call option transactions may be settled at our option either in cash or net shares and expire on March 1, 2008.

During 2005, we completed exchanges of approximately 5.0 million shares of our common stock and approximately $57.1 million in cash for $127.9 million aggregate principal amount of outstanding notes. As a result of the early extinguishment, we also amended the above convertible bond hedge and call option transactions to reflect the change in principal amount of the underlying notes.

On August 1, 2005, we entered into a 364-day $100.0 million committed receivables purchase facility with a financial institution. The initial term of the Agreement will expire one year from execution but shall be extended automatically. Pursuant to the terms of the receivable purchase facility, we may sell certain receivables arising from the sale of telecommunications equipment to this financial institution. No receivables had been sold, pursuant to this arrangement.

We believe that our existing credit facilities and cash and cash equivalents, short-term investments and cash from operations will be sufficient to finance our operations through at least the next 12 months. As of March 31, 2006, we had cash, short-term restricted cash, and investments of $753.6 million. We also had credit facilities totaling $703.5 million of which $504.2 remained available for future borrowings. $642.4 million of these credit facilities expire in 2006 and $61.1 million of these facilities expire in 2007. We are proceeding with the extension or renewal of these credit facilities, however, such renewal is not certain. Interest rates for borrowings under these credit facilities range from approximately 4.7% to 5.22%. We have not guaranteed any debt that is not included in the consolidated balance sheet.

Of our total cash and short-term investment balance, as of March 31, 2006 $499.8 million was held in China, where currency exchange controls exist. As a result, our ability to make payments in other jurisdictions could be limited by our ability to move money from China to other jurisdictions.

In the event that our current cash balances, future cash flows from operations and current credit facilities are not sufficient to meet our obligations or strategic needs or in the event that market conditions are favorable, we would consider raising additional funds in the capital or equity markets. Due to the delinquent filing of our Annual Report on Form 10-K for the year ended December 31, 2005, we are not eligible to register equity securities using Form S-3, which could have an impact on our ability to raise additional funds. If additional financing is needed, there can be no assurance that such financing will be available to us on commercially reasonable terms, or at all. In addition, the delayed filing has resulted in a technical default of the Company's 7/8% Convertible Subordinated Notes due in 2008. The technical default was cured upon the recent filing of the 2005 Form 10-K.

Income taxes

Certain subsidiaries and joint ventures located in China enjoy tax benefits in China which are generally available to foreign investment enterprises, including full exemption from national enterprise income tax for two years starting from the first profit-making year and/or a 50% reduction in national income tax rate for the following three years. In addition, local enterprise income tax is often waived or reduced during this tax holiday/incentive period. Under current regulations in China, foreign investment enterprises that have been accredited as technologically advanced enterprises are entitled to additional tax incentives. These tax incentives vary in different locales and could include preferential national enterprise income tax treatment at 50% of the usual rates for different periods of time. The tax holidays discussed above are applicable or potentially applicable to CUTS, HUTS, Hangzhou UTStarcom Telecom Co., Ltd. ("HSTC") and UTStarcom China Co., Ltd. ("UTSC"), our active subsidiaries in China, as those entities may qualify as accredited technologically advanced enterprises.

Off balance sheet arrangements

On August 1, 2005, we entered into a 364-day committed receivables purchase facility with Citibank, N.A., which provides for the sale of up to $100.0 million of trade accounts receivable of our PCD segment. Sales of the accounts receivables to Citibank, N.A. under this program will result in a reduction of total accounts receivable in our consolidated balance sheet. The remaining accounts receivables not sold to Citibank, N.A. will be carried at their net realizable value, including an allowance for doubtful accounts. We have not sold any receivables pursuant to this facility during 2005 or the first three months of 2006. We believe that available funding under our accounts receivable financing program provides us increased flexibility to manage working capital requirements, and that there are sufficient trade accounts receivable to support the U.S. financing programs. Under the program, we will continue to service the accounts receivable.

Contractual obligations and other commitments

Our obligations under contractual obligations and commercial commitments at March 31, 2006 were as follows:

	March 31, 2006 Payments due by period			
	Total	Less than 1 year	1-3 years	3-5 years
	(in thousands)			
Contractual Obligations				
Bank loans	$ 172,441	$ 172,141	$ 300	
Convertible subordinated notes	$ 274,600		$ 274,600	
Interest payable on subordinated notes	$ 4,806	$ 2,403	$ 2,403	
Lease obligations	$ 40,320	$ 15,527	$ 18,042	$ 6,751
Other Commercial Commitments				
Standby letters of credit	$ 98,287	$ 96,316	$ 1,971	
Purchase commitments	$ 676,083	$ 667,253	$ 8,830	

Notes payable

Occasionally, we issue short-term notes payable to our vendors in lieu of trade accounts payable. The payment terms are normally three to nine months and are typically non-interest bearing.

Bank loans

At March 31, 2006, we had loans with various banks totaling $172.1 million with interest rates ranging from 4.70% to 5.22% per annum. These bank loans mature during 2006 and first quarter of 2007 and are included in short-term debt.

Convertible subordinated notes

Our convertible subordinated notes, due March 1, 2008, bear interest at a rate of 7/8% per annum, payable semiannually on May 1 and September 1, are convertible into our common stock at a conversion price of $23.79 per share and are subordinated to all our present and future senior debt. The principal is due only at maturity of the notes.

Operating leases

We lease certain facilities under non-cancelable operating leases that expire at various dates through 2011.

Standby letters of credit

We issue standby letters of credit primarily to support international sales activities outside of China. When we submit a bid for a sale, often the potential customer will require that we issue a bid bond or a standby letter of credit to demonstrate our commitment through the bid process. In addition, we may be required to issue standby letters of credit as guarantees for advance customer payments upon contract signing or performance guarantees. The standby letters of credit usually expire six to twelve months from date of issuance without being drawn by the beneficiary thereof.

Purchase commitments

We are obligated to purchase raw materials and work-in-process inventory under various orders from various suppliers, all of which should be fulfilled without adverse consequences material to our operations or financial condition. As of March 31, 2006 total open commitments under these purchase orders extending beyond one year were approximately $8.8 million. Additionally, we have agreed to purchase from Marvell certain chip-sets that will be included in 50% to 100% of our PAS handsets, through 2011.

Investment commitments

As of March 31, 2006, we had invested a total of $2.6 million in Global Asia Partners L.P. that is recorded as a long-term investment. The fund size is anticipated to be $10 million, and was formed to make private equity investments in private or pre-IPO technology and telecommunications companies in Asia. We have a commitment to invest up to a maximum of $5.0 million. The remaining amount is due at such times and in such amounts as shall be specified in one or more future capital calls to be issued by the general partner.

Intellectual property

Certain sales contracts include provisions under which customers would be indemnified by us in the event of, among other things, a third-party claim against the customer for intellectual property rights infringement related to our products. There are no limitations on the maximum potential future payments under these guarantees. We have not accrued any amounts in relation to these provisions as no such claims have been made and we believe we have valid enforceable rights to the intellectual property embedded in our products.

RECENT ACCOUNTING PRONOUNCEMENTS

In June 2005, the FASB issued FASB Statement No. 154, "Accounting Changes & Error Corrections," ("SFAS 154"). The statement applies to all voluntary changes in accounting principle and changes the requirements for the accounting for and reporting of, a change in accounting principle. SFAS 154 requires retrospective application to prior period's financial statements unless this would impracticable. Also, if an entity changes it method of depreciation, amortization, or depletion for long-lived, non-financial assets, the change must be accounted for as a change in accounting estimate.

We adopted this standard in the quarter ended March 31, 2006. The adoption will only impact the financial statements in periods in which a change in accounting principle is made.

ITEM 3 QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

We are exposed to the impact of interest rate changes, changes in foreign currency exchange rates and changes in the stock market.

Interest Rate Risk

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio. The fair value of our investment portfolio would not be significantly affected by either a 10% increase or decrease in interest rates due mainly to the short-term nature of most of our investment portfolio. However, our interest income can be sensitive to changes in the general level of U.S. interest rates since the majority of our funds are invested in instruments with maturities less than one year. Our policy is to ensure the safety of invested funds by generally attempting to limit market risk. Funds in excess of current operating requirements are mostly invested in government-backed notes, commercial paper, floating rate corporate bonds, fixed income corporate bonds and tax-exempt instruments. In accordance with our investment policy, all short-term investments are invested in "investment grade" rated securities with minimum A or better ratings. Currently, most of our short-term investments have AA or better ratings.

The table below represents carrying amounts and related weighted-average interest rates of our investment portfolio at March 31, 2006:

	(in thousands, except interest rates)	
Cash and cash equivalents	$	673,625
Average interest rate		2.09%
Restricted cash	$	69,078
Average interest rate		4.22%
Short-term investments	$	10,852
Average interest rate		1.44%
Total cash, cash equivalents and investment securities	$	753,555
Average interest rate		2.28%

Equity Investment Risk

Our investment portfolio includes equity investments in publicly traded companies, the values of which are subject to market price volatility. Economic events could adversely affect the public equities market and general economic conditions may continue to worsen. Should the fair value of our publicly traded equity investments decline below their cost basis in a manner deemed to be other-than-temporary, our earnings may be adversely affected. We have also invested in several privately held companies as well as investment funds which invest primarily in privately held companies, many of which can still be considered in the start-up or development stages. These investments are inherently risky, as the market for the technologies or products they have under development are typically in the early stages and may never materialize.

Debt Investment Risk:

Our debt investment portfolio consists of a $7.1 million note receivable from BB Modem, an affiliate of SOFTBANK CORP., pursuant to a Mezzanine Loan Agreement we entered into with BB Modem on July 17, 2003. Our loan is subordinated to certain senior lenders of BB Modem, and repayments are payable to us over a 42-month period, with a substantial portion of the principal amount of the loan schedule to be repaid during the last 16 months of this period. Our recourse for nonpayment of the loan is limited to the assets of BB Modem, the account into which subscriber payments are made and its rights under the securitization transaction documents. The value of BB Modem's modems that serve as collateral for the loan may decrease over time and may not be sufficient upon sale to pay the outstanding amounts on the loan.

Foreign Exchange Rate Risk:

We are exposed to foreign currency exchange rate risk because most of our sales in China are denominated in Renminbi and portions of our accounts receivable and payable are denominated in Japanese Yen. Due to the limitations on converting Renminbi, we are limited in our ability to engage in foreign currency hedging activities in China. Although the impact of currency fluctuations of Renminbi to date has been slight, fluctuations in currency exchange rates in the future may have a material adverse effect on our results of operations. The balance of cash and short-term investment balance held in China was $499.8 million at March 31, 2006. In July 2005, China uncoupled the Renminbi from the U.S. dollar and let it float in a narrow band against a basket of foreign currencies. The move revalued the Renminbi by 2.1% against the U.S. dollar. Additionally, during 2005 and the first three months of 2006 we made significant sales in both Japanese Yen and in Euros. We maintain Japanese yen bank accounts for purchasing portions of our inventories and supplies.

Our revenues, earnings and cash flows are subject to fluctuations due to changes in foreign currency exchange rates. We may hedge currency exposures associated with certain assets and liabilities denominated in nonfunctional currencies and certain anticipated nonfunctional currency transactions using forward foreign currency exchange rate contracts. We have not hedged any such transactions, and due to the limitations on converting Renminbi, we are limited in our ability to engage in currency hedging activities in China. As a global concern, we face exposure to adverse movements in foreign currency exchange rates.

We have performed a sensitivity analysis as of March 31, 2006, using a modeling technique that measures the change in the fair values arising from a hypothetical 10% positive or adverse movement in the levels of foreign currency exchange rates relative to the U.S. Dollar, with all other variables held constant. The analysis covers all of our foreign currency contracts offset by the underlying exposures. The foreign currency exchange rates used were based on market rates in effect at March 31, 2006. The sensitivity analysis indicated that a hypothetical 10% movement in foreign currency exchange rates would result in a gain or loss in the fair values of our foreign exchange financial instruments of $9.7 million at March 31, 2006.

ITEM 4 CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

UTStarcom, Inc. (the "Company") maintains disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports the Company files or submits under the Securities Exchange Act of 1934, as amended (the "Exchange Act"), is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and that such information is accumulated and communicated to the Company's management, including its Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO"), as appropriate, to allow timely decisions regarding required financial disclosure.

In connection with the preparation of this Quarterly Report on Form 10-Q, the Company carried out an evaluation under the supervision and with the participation of the Company's management, including the CEO and CFO, as of March 31, 2006 of the effectiveness of the design and operation of the Company's disclosure controls and procedures, as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act. Based upon this evaluation, the CEO and CFO concluded that as of March 31, 2006 the Company's disclosure controls and procedures were not effective because of the material weaknesses described in Item 9A of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005 (the "2005 Form 10-K"), which we are still the in the process of remediating. Investors are directed to Item 9A of the 2005 Form 10-K for the description of these weaknesses.

To address the material weaknesses described in "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K, the Company performed additional analyses and other procedures (as further described below under the subheading "Interim Measures" under "Management's Further Remediation Initiatives and Interim Measures") to ensure that the Company's consolidated financial statements were prepared in accordance with generally accepted accounting principles in the United States. Accordingly, the Company's management believes that the consolidated financial statements included in this Quarterly Report on Form 10-Q fairly present in all material respects the Company's financial condition, results of operations and cash flows for the periods presented and that this Quarterly Report on Form 10-Q 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 periods covered by this report.

Management's Remediation Initiatives and Interim Measures

In response to the matter discussed in "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K, the Company plans to continue to review and make necessary changes to the overall design of its control environment, including the roles and responsibilities of each functional group within the organization and reporting structure, as well as policies and procedures to improve the overall internal control over financial reporting. In particular, the Company has implemented and/or plans to implement during 2006 the specific measures described below to remediate the material weaknesses described above in "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K. In addition, in the absence of full implementation of these remediation measures as of March 31, 2006, during the first quarter of 2006 or subsequent to March 31, 2006 and in connection with the March 31, 2006 quarter-end reporting process, the Company has undertaken the additional measures described under the subheadings " Interim Measures" below to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's consolidated financial statements included in this Quarterly Report on Form 10-Q and to ensure that material information relating to the Company and its consolidated subsidiaries was made known to management in connection with the preparation of this Quarterly Report on Form 10-Q.

Material weaknesses described in item 1 of "Management's Report on Internal Control Over Financial Reporting"

Remediation Initiatives. The Company's failure to have a sufficient complement of personnel with a level of accounting knowledge, experience and training in the application of generally accepted accounting principles commensurate with the Company's financial reporting requirements contributed to the Company's failure to maintain effective controls over the financial reporting process. To remediate the material weaknesses described in item 1 of "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K, the Company has implemented or plans to implement the measures described below, and will continue to evaluate and may in the future implement additional measures.

1. General plan for hiring and training of personnel The Company's planned remediation measures are intended to generally address this material weakness by ensuring that the Company will have sufficient personnel with knowledge, experience and training in the application of generally accepted accounting principles commensurate with the Company's financial reporting requirements. These measures include the following:

   (a) The Company hired an executive vice president and chief financial officer with relevant accounting experience, skills and knowledge in August 2005;

   (b) The chief financial officer, with assistance from senior financial staff and outside consultants, other than the Company's independent registered public accounting firm, has reviewed and will continue to review and adapt the overall design of the Company's financial reporting structure, including the roles and responsibilities of each functional group within the Company;

   (c) The Company hired a corporate controller and vice president of finance with relevant accounting experience, skills and knowledge in November 2005;

   (d) The Company hired a vice president of finance for the Company's China operations with relevant accounting experience, skills and knowledge in April 2006;

   (e) The Company hired a vice president of compliance with relevant accounting, audit and compliance experience, skills and knowledge in May 2006;

   (f) The Company hired a director of cost accounting with relevant accounting experience, skills and knowledge in March 2006;

   (g) The Company retained and intends to continue to retain the services of outside consultants, other than the Company's independent registered public accounting firm, with relevant accounting experience, skills and knowledge, working under the supervision and direction of the Company's management, to supplement the Company's existing accounting personnel; and

   (h) The Company plans to continue to hire, and has allocated resources to hire, additional accounting and internal audit personnel in the U.S., China and Japan, in the areas of tax, external financial reporting, revenue recognition and corporate accounting with relevant accounting experience, skills and knowledge.

2. Revenue Recognition The Company's planned remediation measures are intended to address material weaknesses related to revenue and deferred revenue accounts and associated cost of sales that have the potential of misstating revenue, deferred revenue and associated cost of sales in future financial periods. The Company's planned remediation measures include the following:

   (a) In the fourth quarter of 2005, the Company further expanded the number of personnel required to certify to senior management with respect to identification and communication of contract amendments, side agreements or other matters which could have a bearing on revenue recognition. The Company also plans to implement additional steps to ensure appropriate members of management have reviewed and confirmed critical information necessary to assess the proper revenue recognition accounting;

(b)

During 2006, the Company plans to evaluate and enhance its contract review process including requiring sales, operations, finance and legal staff to provide input during the contract negotiation process to ensure timely identification and accurate accounting treatment of non-standard contracts;

(c)

The Company plans to evaluate and enhance its process during 2006 related to various specific activities associated with revenue recognition including the evaluation and review of handset rebates, invoice processing and the assessment of customer credit;

(d)

During the second quarter of 2006, the Company implemented enhancements to its Oracle system which will improve its controls related to the proper release of costs associated with revenue; and

(e)

The Company has and will continue its focus on training related to revenue recognition including the impact of amendments and side agreements. In June 2005, the Company conducted a training seminar regarding revenue recognition for the European sales group. In July 2005, a similar seminar was held in China. In October 2005, the Company's key management participated in a seminar on the critical factors associated with revenue recognition. During the first quarter of 2006, several additional seminars were conducted for various sales teams in North and South America and China. The Company plans to conduct additional training seminars in various international locations regarding revenue recognition throughout 2006.

3.

Inventory Management The Company's planned remediation measures are intended to address material weaknesses related to inventory, deferred costs, inventory reserve accounts and cost of sales that have the potential of misstating inventory and deferred costs and expected recoverability of inventory in future financial periods. The Company's planned remediation measures include the following:

(a)

During the second quarter of 2006, the Company implemented enhancements to its Oracle system which will improve its ability to more effectively track inventory and evaluate deferred costs;

(b)

The Company hired a director of cost accounting with relevant accounting experience, skills and knowledge in March 2006; and

(c)

The Company plans in 2006 to enhance its processes and procedures related to the evaluation and impact of obsolete inventory including the development of detailed inventory reports and additional review by management.

4.

Recording of Accrued Expenses The Company's planned remediation measures are intended to address a material weakness related to the Company's recording of accrued expenses that has the potential of misstating accrued expenses and related income statement accounts in future financial periods. The Company's planned remediation measures include the implementation in 2006 of a process of enhanced review of open purchase orders and review of invoices and disbursements after the end of each quarter to ensure proper recording of accrued expenses and open purchase order commitments.

5.

Accurate Preparation and Review of Financial Statements and Segment Reporting The Company's planned remediation measures are intended to address material weaknesses related to the financial close and reporting process that have the potential of preventing the accurate preparation and review of the Company's consolidated financial statements in future financial periods. The Company's planned remediation measures include the following:

(a)

During 2005, the Company implemented and in 2006 plans to continue to enhance its month and quarter-end closing procedures to standardize its processes for financial review to ensure that U.S. reviewers monitor financial information from decentralized locations in a consistent manner.

(b) In 2006, The Company's corporate finance department plans to expand and improve the required reporting package from various business units and subsidiaries in order to ensure it has accumulated the necessary accounting, finance and operational information to effectively analyze information required for financial statement preparation and footnote disclosures;

(c) The Company's external reporting department plans in 2006 to expand and improve the documentation and review of required information associated with the preparation of its quarterly and annual filings under the Exchange Act; and

(d) During 2005, the Company implemented, and plans to continue to improve new and enhanced procedures to ensure that non-routine transactions are identified and escalated to senior financial management during the close process to help ensure proper accounting treatment.

6. Income Tax Analysis The Company's planned remediation measures are intended to address material weaknesses related to the calculation of its provision for income taxes that have the potential of misstating the provision for income taxes and related balance sheet accounts in future financial periods. The Company's planned remediation measures include the following:

(a) The Company plans to hire and train additional experienced tax managers and supporting staff in 2006 to support the preparation of the Company's income tax provision and to assist in managing audits and to monitor tax compliance in China and other foreign locations;

(b) During 2005 and the first quarter of 2006, the Company utilized outside consultants, other than the Company's independent registered public accounting firm, to assist the Company's management, working under its supervision and direction, in its analysis and calculation of its income tax provision, and the Company plans to continue to utilize outside consultants, other than the Company's independent registered public accounting firm, to assist the Company's management, working under its supervision and direction, in its analysis of such matters in future periods; and

(c) The Company plans to develop a more formalized and comprehensive process to accumulate and organize financial and tax data used in connection with income tax calculation and reporting.

7. Utilization of Automated Controls The Company's planned remediation measures are intended to address a material weakness related to the segregation of duties and user access to certain J. D. Edwards business process applications associated with the Company's Personal Communications Division that have the potential of misstating various accounts in future financial periods. The Company's planned remediation measures include the following:

(a) During the first quarter of 2006, the Company removed access rights from certain employees associated with inappropriate segregation of duties; and

(b) The Company has expanded its level of management oversight related to areas associated with segregation of duties issues including changes to the general ledger master file, invoice terms and inventory.

Interim Measures. Management has not yet implemented all of the measures described in items 1 through 7 above and/or tested them. Nevertheless, management believes those measures identified above as having been implemented, together with the other measures undertaken by the Company described below, all of which were undertaken during the first quarter of 2006 or subsequent to March 31, 2006 in connection with the March 31, 2006 quarter-end reporting process, address the

material weaknesses described in item 1 of "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K. These other measures include the following:

The March 31, 2006 quarter-end reporting process was extended, allowing the Company to conduct additional analysis and make additional adjustments as necessary to ensure the accuracy of financial reporting.

The Company retained on an interim basis outside consultants, other than the Company's independent registered public accounting firm, with relevant accounting experience, skills and knowledge, working under the supervision and direction of the Company's management, to assist with the March 31, 2006 quarter-end reporting process.

The Company conducted an additional review of a substantial majority of its revenue-generating contracts for compliance with revenue recognition criteria. As part of this review, the Company gathered and analyzed evidence of delivery and final acceptance.

The Company performed the following reviews of inventory-related matters: it reviewed consolidated revenue schedules from the first quarter of 2006 to determine the proper recording of cost of goods sold; it conducted a reconciliation of inventories at customer sites to outstanding contracts as of the quarter-end and analyzed inventory for recovery and potential impairment; and it conducted an analysis of inventory relating to purchase orders to identify under-recorded inventory.

The Company conducted a review of the processes to record inventory reserves and a review of the manual procedures by which the Company tracks the cost of its products.

The Company conducted a variety of manual review procedures, such as an extensive review of journal entry postings into the Oracle system and an extensive review of account reconciliations.

The Company conducted a detailed and extensive review of the following matters: all non-routine transactions and internal representations; financial statements, as well as certifications from decentralized locations, for accuracy; spreadsheets; and journal entries.

The Company reviewed its reserves and related schedules and reported its findings to the Audit Committee.

Material weakness described in item 2 of "Management's Report on Internal Control Over Financial Reporting"

Remediation Initiatives. The Company's failure to ensure that key management fully understood the nature and potential significance of related parties and to ensure that a robust process for the identification of related party transactions contributed to the Company's failure to maintain effective controls over the identification of and accounting for related party relationships and related party transactions with the Company. To remediate the material weakness described in item 2 of "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K, the Company has implemented or plans to implement the measures described below, and will continue to evaluate and may in the future implement additional measures.

1. The Company conducted an educational seminar with the Company's key management in March 2005 in which the Company's internal and outside legal counsel and members of the Audit Committee reviewed certain key objectives of the Company's Code of Conduct, including the identification, recognition and disclosure of related party transactions.

2. In the fourth quarter of 2005, the Company further expanded the number of Company personnel required to certify to senior management with respect to identification, recognition and disclosure of related party transactions for SEC reporting purposes, and revised the Company's internal

certification process concerning identification, recognition and disclosure of related party transactions.

3. The Company plans to continue to evaluate the Company's procedures to ensure the identification, recognition and disclosure of related party transactions.

4. The Company plans to conduct periodic training sessions with key managers and senior executives regarding the Code of Conduct, including the identification, recognition and disclosure of related party transactions.

5. The Company plans to provide key managers and senior executives with access to legal and accounting personnel to enable such managers and executives to more accurately and comprehensively comply with the Company's internal certification process for SEC reporting purposes.

Interim Measures. Management has not yet implemented all of the measures described above and/or tested them. Nevertheless, management believes those measures identified above as having been implemented, together with the other measures undertaken by the Company described below, all of which were undertaken during the first quarter of 2006 or subsequent to March 31, 2006 in connection with the March 31, 2006 quarter-end reporting process are sufficient to address the material weakness described in item 2 of "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K. These other measures include the following:

- Senior executives provided new certifications regarding related party transactions.

Material weakness described in item 3 of "Management's Report on Internal Control Over Financial Reporting"

Remediation Initiatives. Lack of clarity in roles and responsibilities in certain areas affecting the Company's financial reporting structure contributed to a material weakness relating to the monitoring of its business unit accounting functions. To remediate this material weakness, described in item 3 of "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K, the Company has implemented or plans to implement the measures described under " Material weaknesses described in item 1 of 'Management's Report on Internal Control Over Financial Reporting' Remediation Initiatives 1. General plan for hiring and training of personnel" in Item 9A of the 2005 Form 10-K., as well as those described below. The Company will continue to evaluate and may in the future implement additional measures.

1. During 2005, the Company implemented and in 2006 plans to continue to enhance its month and quarter-end closing procedures to standardize its processes for financial review to ensure that U.S. reviewers monitor financial information from decentralized locations in a consistent manner.

2. In 2006, the Company's corporate finance department plans to expand and improve the required reporting package from various business units and subsidiaries in order to ensure it has accumulated the necessary accounting, finance and operational information to effectively analyze information required for financial statement preparation and footnote disclosures.

3. In 2006, the Company's external reporting department plans to expand and improve the documentation and review of required information associated with the preparation of its quarterly and annual filings under the Exchange Act.

4. The Company plans to expand the size of the internal audit group and the scope of the internal audit group's responsibilities to monitor decentralized operations through reviews and audits of such business units, subsidiaries and locations.

5. The Company's chief financial officer, with assistance from senior financial staff and outside consultants, other than the Company's independent registered public accounting firm, has reviewed and will continue to review and adapt the overall design of the Company's financial reporting structure, including the roles and responsibilities of each functional group within the Company.

Interim Measures. Management has not yet implemented all of the measures described above and/or tested them. Nevertheless, management believes those measures identified above as having been implemented, together with the other measures undertaken by the Company described below, all of which were undertaken during the first quarter of 2006 or subsequent to March 31, 2006 in connection with the March 31, 2006 quarter-end reporting process, address the material weakness described in item 3 of "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K. These other measures include the following:

- Senior financial staff in the Company's U.S. headquarters did a thorough review of trial balances issued from decentralized locations.

- The Company utilized outside consultants, other than the Company's independent registered public accounting firm, to assist the Company's management, working under its supervision and direction, with the March 31, 2006 quarter-end review of decentralized operations.

- All non-routine material transactions for decentralized locations were documented by staff in such decentralized locations and reviewed by senior financial staff in the Company's U.S. headquarters.

Material weakness described in item 4 of "Management's Report on Internal Control Over Financial Reporting"

Remediation Initiatives. The Company's failure to have sufficient personnel with knowledge, experience and training in the application of generally accepted accounting principles commensurate with the Company's financial reporting requirements as well as failure to prevent or detect instances of non-compliance with established policies and procedures or instances of non-compliance with laws and regulations contributed to a material weakness relating to the Company's control environment. To remediate this material weakness, described in item 4 of "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K, the Company has implemented or plans to implement the measures described under " Material weaknesses described in item 1 of 'Management's Report on Internal Control Over Financial Reporting' Remediation Initiatives 1. General plan for hiring and training of personnel" in Item 9A of the 2005 Form 10-K, as well as those described below. The Company will continue to evaluate and may in the future implement additional measures.

1. During the second quarter of 2006, the Company launched a formal investigation at the direction of the Audit Committee, to review alleged violations of the Foreign Corrupt Practices Act. Upon the conclusion of this investigation, the Company will take any appropriate actions including possible changes to its processes and procedures related to the due diligence evaluation of business partnerships.

2. During 2005, the Company implemented and in 2006 plans to continue to enhance its month-end and quarter-end closing procedures to standardize its processes for financial review to ensure that U.S. reviewers monitor financial information from decentralized locations in a consistent manner.

3. In 2006, the Company's corporate finance department plans to expand and improve the required reporting package from various business units and subsidiaries in order ensure it has accumulated the necessary accounting, finance and operational information to effectively analyze information required for financial statement preparation and footnote disclosures.

4. In 2006, the Company's external reporting department plans to expand and improve the documentation and review of required information associated with the preparation of its quarterly and annual filings under the Exchange Act.

5. The Company plans to expand the size of the internal audit group and the scope of the internal audit group's responsibilities to monitor decentralized operations through reviews and audits of such business units, subsidiaries and locations.

6. The Company's chief financial officer, with assistance from senior financial staff and outside consultants, other than the Company's independent registered public accounting firm, has reviewed and will continue to review and adapt the overall design of the Company's financial reporting structure, including the roles and responsibilities of each functional group within the Company.

Interim Measures. Management has not yet implemented all of the measures described above and/or tested them. Nevertheless, management believes those measures identified above as having been implemented, together with the other measures undertaken by the Company described below, all of which were undertaken during the first quarter of 2006 or subsequent to March 31, 2006 in connection with the March 31, 2006 quarter-end reporting process, address the material weaknesses described in item 4 of "Management's Report on Internal Control Over Financial Reporting." These other measures include the following:

- Senior financial staff in the Company's U.S. headquarters did a thorough review of trial balances issued from decentralized locations.

- The Company utilized outside consultants, other than the Company's independent registered public accounting firm, to assist the Company's management, working under its supervision and direction, with the March 31, 2006 quarter-end review of decentralized operations.

- Non-routine material transactions for decentralized locations were documented by staff in such decentralized locations and reviewed by senior financial staff in the Company's U.S. headquarters.

Control deficiencies not constituting material weaknesses

In addition to the material weaknesses described in "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K, management has identified other deficiencies in internal control over financial reporting that did not constitute material weaknesses as of December 31, 2005. The Company has implemented and/or plans to implement during 2006 various measures to remediate these control deficiencies and has undertaken other interim measures to address these control deficiencies.

Management's Conclusions

Management believes the remediation measures described under "Management's Remediation Initiatives and Interim Measures" above will strengthen the Company's internal control over financial reporting and remediate the material weaknesses identified in "Management's Report on Internal Control Over Financial Reporting" in Item 9A of the 2005 Form 10-K. However, management has not yet implemented all of these measures and/or tested them. Management has concluded that the interim measures described under "Management's Further Remediation Initiatives and Interim Measures" above provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements included in this Quarterly Report on Form 10-Q and has discussed its conclusions with the Company's Audit Committee.

The Company is committed to continuing to improve its internal control processes and will continue to diligently and vigorously review its disclosure controls and procedures and its internal control over financial reporting in order to ensure compliance with the requirements of Section 404 of the Sarbanes-Oxley Act. However, any control system, regardless of how well designed, operated and evaluated, can provide only reasonable, not absolute, assurance that its objectives will be met. As management continues to evaluate and work to improve the Company's internal control over financial reporting, it may determine to take additional measures to address control deficiencies, and it may determine not to complete certain of the measures described under "Management's Further Remediation Initiatives and Interim Measures" above.

Changes in Internal Control over Financial Reporting

The discussion above under "Management's Remediation Initiatives and Interim Measures" describes the material planned and actual changes to the Company's internal control over financial reporting during the first quarter of 2006 and subsequent to March 31, 2006 that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART II OTHER INFORMATION

ITEM 1 LEGAL PROCEEDINGS

Securities Class Action Litigation

Beginning in October 2004, several shareholder class actions alleging federal securities violations were filed against us and various officers and directors. The actions have been consolidated in United States District Court for the Northern District of California. The lead plaintiffs in the case filed a First Amended Consolidated Complaint on July 26, 2005. The First Amended Complaint alleged violations of the Securities Exchange Act of 1934, and was brought on behalf of a putative class of shareholders who purchased our stock after April 16, 2003 and before September 20, 2004. On April 13, 2006, the lead plaintiffs filed a Second Amended Complaint adding new allegations and extending the end of the class period to October 6, 2005. In addition to the Company defendants, the plaintiffs are also suing Banc of America Securities LLC and Softbank. Plaintiffs' complaint seeks recovery of damages in an unspecified amount.

This litigation is in its preliminary stage, and we cannot predict its outcome. Our management believes that the claims are not meritorious. Nevertheless, an adverse outcome in the litigation, if it occurred, could have a material adverse effect on our results of operations, financial position and cash flows.

Governmental Investigations

We have received notice of a formal inquiry by the staff of the Securities & Exchange Commission ("SEC") into certain aspects of our financial disclosures during prior reporting periods and certain other issues. In addition, in December 2005 the U.S. Embassy in Mongolia informed us that it had forwarded to the Department of Justice ("DOJ") allegations that an agent of our Mongolia joint venture had offered payments to a Mongolian government official in possible violation of the Foreign Corrupt Practices Act (the "FCPA"). In April 2006, we became aware that an agent of the Company may have made an offer to pay an Indian government official in possible violation of the FCPA. We, through our Audit Committee, authorized an independent investigation into these matters, and we have been in contact with the DOJ and SEC regarding the investigation. At this time, we cannot predict when any governmental inquiry will be completed or what the outcome of any governmental inquiry will be.

IPO Allocation

On October 31, 2001, a complaint was filed in United States District Court for the Southern District of New York against us, some of our directors and officers and various underwriters for our initial public offering. Substantially similar actions were filed concerning the initial public offerings for more than 300 different issuers, and the cases were coordinated as *In re Initial Public Offering Securities Litigation*, 21 MC 92 for pretrial purposes. In April 2002, a consolidated amended complaint was filed in the matter against the Company, captioned *In re UTStarcom, Initial Public Offering Securities Litigation*, Civil Action No. 01-CV-9604. Plaintiffs allege violations of the Securities Act of 1933 and the Securities Exchange Act of 1934 through undisclosed improper underwriting practices concerning the allocation of IPO shares in exchange for excessive brokerage commissions, agreements to purchase shares at higher prices in the aftermarket and misleading analyst reports. Plaintiffs seek unspecified damages on behalf of a purported class of purchasers of our common stock between March 2, 2000 and December 6, 2000. Our directors and officers have been dismissed without prejudice pursuant to a stipulation. On February 19, 2003, the Court granted in part and denied in part a motion to dismiss brought by defendants including us. The order dismisses all claims against us except for a claim brought under Section 11 of the Securities Act of 1933, which alleges that the registration statement filed in accordance with the IPO was misleading. In June 2004, a stipulation of settlement and release of claims against the issuer defendants, including us, was submitted to the court for approval. The terms of the settlement, if approved, would dismiss and release all claims against the participating defendants (including us). In exchange for this dismissal, D&O insurance carriers would agree to guarantee a recovery by the plaintiffs from the underwriter defendants of at least $1 billion, and the issuer defendants would agree to an assignment or surrender to the plaintiffs of certain claims the issuer defendants may have against the underwriters. On February 15, 2005, the Court issued an order granting conditional preliminary approval of the settlement. On August 31, 2005, the Court entered an order confirming its preliminary approval of the settlement. The settlement remains subject to a number of conditions, including final court approval. The total amount of the loss associated with the above litigation is not determinable at this time. Therefore, we are unable to currently estimate the loss, if any, associated with the litigation.

Starent Patent Infringement Litigation

We have sued Starent Networks Corporation ("Starent") for patent infringement in the U.S. District Court for the Northern District of California. On March 22, 2004, we filed our Complaint. On June 3, 2004, we served our Complaint on Starent. On July 30, 2004, Starent filed and served its answer and counterclaims. On August 30, 2004, we served and filed our Amended Complaint. In our Amended Complaint, we assert that Starent infringes a UTStarcom patent through the manufacture, use, offer for sale, and sale of Starent's ST-16 Intelligent Mobile Gateway. We seek, inter alia, compensatory damages and injunctive relief. Starent filed its answer to the Amended Complaint and counterclaims on September 17, 2004. In its answer and counterclaims, Starent denies our allegations and seeks a declaration that the patent-in-suit is not infringed, is invalid, and is unenforceable. The Court held an initial case management conference on November 2, 2004. On February 17, 2005, we filed a motion for a preliminary injunction against Starent's use, sale, and offer for sale of products having the infringing feature. The Court held a hearing on our motion on May 11, 2005 and denied our motion on June 17, 2005. On June 30, 2005, the Court held a hearing on the proper meaning or construction of the claims of the patent-in-suit and entered an order construing these claims on August 11, 2005. On September 20, 2005, Starent filed a motion for summary judgment of non-infringement and UTStarcom filed a motion for summary judgment that Starent is estopped from asserting invalidity and unenforceability. On October 4, 2005, Starent filed a motion to strike UTStarcom's final infringement contentions. On November 7, 2005, Starent's motion to strike was denied. Oral argument on UTStarcom's estoppel motion and Starent's non-infringement motion was held on November 8, 2005. On December 6, 2005, the Court granted Starent's motion for summary judgment of non-infringement. On December 12, 2005, the Court dismissed as moot Starent's counterclaims for declaratory relief based on invalidity or unenforceability of the asserted patent. On February 2, 2006, the Court entered judgment in favor of Starent. On March 2, 2006, UTStarcom filed a notice of appeal. We have indicated that we believe that this adverse judgment will not have a material adverse effect on the business, financial condition, or results of our operations.

On February 16, 2005, we filed a second suit against Starent for patent infringement in the U.S. District Court for the Northern District of California. On May 6, 2005, we served the Complaint on Starent. In the Complaint, we assert that Starent infringes a UTStarcom patent through Starent's development and testing of a software upgrade for its customer's installed ST-16 Intelligent Mobile Gateways. We seek, inter alia, declaratory and injunctive relief. Starent filed its answer and counterclaims on May 31, 2005, denying our allegations and seeking a declaration that the patent-in-suit is not infringed, is invalid, and is unenforceable. On June 16, 2005, we filed a motion to strike Starent's affirmative defense and dismiss Starent's counterclaim alleging inequitable conduct. Pursuant to the parties' stipulation, we withdrew our motion to strike and, on July 27, 2005, Starent filed an amended answer and counterclaims, which pleaded its inequitable conduct allegations with more specificity. UTStarcom filed its answer to the amended counterclaims on August 10, 2005. We have indicated that we believe that any adverse judgment on Starent's counterclaims will not have a material adverse effect on the business, financial condition, or results of our operations. However, we have not made an evaluation of the possibility of a favorable or unfavorable outcome.

Fenner Investments Patent Infringement Litigation

On January 6, 2005, Fenner Investments, Ltd. ("Fenner") filed suit against us and co-defendants Juniper Networks, Inc., Nokia, Inc., Nortel Networks Corp., Lucent Technologies, Inc., and Cisco Systems, Inc. in the U.S. District Court for the Eastern District of Texas. On May 17, 2005, Fenner amended its complaint to add as defendants Ericsson Inc., Ericsson AB, Telefonaktiebolaget LM Ericsson, and Alcatel USA Inc. The suit alleged that certain products infringe two Fenner patents, U.S. Patent Nos. 5,561,706 and 6,819,670, for which Fenner sought compensatory and injunctive relief. On March 20, 2006, we agreed to settle Fenner's claims against us. As part of this settlement, Fenner agreed to dismiss with prejudice its claims against us. On April 27, 2006, the court ordered the dismissal with prejudice of Fenner's claims against us as a result of the settlement. The settlement did not have a significant financial impact on operations.

Telos Technology, Inc. Arbitration

On November 22, 2005, Telos Technology, Inc. ("Telos") filed a formal Demand for Arbitration against us with JAMS/Endispute in San Jose, California. The Demand for Arbitration seeks the release of $2.4 million from an escrow fund. Pursuant to the terms of an Asset Purchase Agreement dated April 21, 2004 and an Escrow Agreement dated May 19, 2004 between the parties, the escrow fund was created to indemnify us from certain losses associated with our purchase of assets from Telos. Telos asserts that our refusal to release the escrowed funds constitutes a breach of our contractual obligations under the agreements. Telos also seeks attorneys' fees, costs and prejudgment interest in the amount of $500,000. In our response to the Demand for Arbitration, we denied that we had breached our contractual obligations. In January 2006, Telos moved for summary judgment on its claim and we opposed the motion. On March 6, 2006, the Arbitrator issued a ruling denying Telos' motion. In light of the ruling on summary judgment, Telos dismissed its claim for arbitration without prejudice, subject to its contractual right to dispute any future disbursement from escrow.

Telos Technology, Inc. Litigation

On November 22, 2005, plaintiffs Telos Technology, Inc., Telos Technology (Canada), Inc., Telos Technology (Bermuda) Ltd., and Telos Engineering Limited (collectively, the "Telos Plaintiffs") filed a Complaint against us in the Superior Court of California, County of Santa Clara. The Complaint alleges five causes of action, including breach of contract, breach of the implied covenant of good faith and fair dealing, fraudulent inducement, intentional misrepresentation and negligent misrepresentation, all of which arise from the Asset Purchase Agreement between the parties dated April 21, 2004. The Telos Plaintiffs assert that we breached the express and implied terms of the Asset Purchase Agreement and made representations to the Telos Plaintiffs during negotiations that we never intended to fulfill. The Telos Plaintiffs seek at least $19 million in damages, unspecified punitive damages and attorneys' fees. On December 28, 2005, the Telos Plaintiffs filed a First Amended Complaint, alleging substantially the same facts and seeking the same relief. On January 26, 2006, we filed a demurrer with respect Telos' three tort causes of action. On March 23, 2006, the Court sustained our demurrer to all three tort causes of action and allowed Telos thirty days to amend its complaint. On April 12, 2006, Telos filed a Second Amended Complaint, alleging substantially the same facts and seeking the same relief as in the First Amended Complaint. We have not yet answered Telos' allegations in the Second Amended Complaint and intend to file another demurrer to the tort causes of action, denying all of the material allegations therein. Discovery is underway, and no trial date has been set.

Passave, Inc. Litigation

In November 2005, we filed suit against Passave, Inc. ("Passave") for breaches of contract and warranties in connection with a semiconductor device sold by Passave, Ltd. (Passave's wholly-owned subsidiary) to us. The case is currently pending in the Superior Court of California, County of Santa Clara. Our Complaint alleges that the Passave device, known as the PAS5001M3 chip, has exhibited certain operational malfunctions within some of our Fiber-to-the-Home product line, and has thereby caused damage to us. On or about January 20, 2006, Passave filed its answer, affirmative defenses and demurrer to the Complaint. The Court sustained Passave's demurrer after the hearing on March 28, 2006. On May 9, 2006, we filed our Amended Complaint naming both Passave, Inc. and its Israeli subsidiary, Passave, Ltd., as defendants. The Amended Complaint states causes of action for breach of contract, breaches of warranty, indemnification, unfair competition and negligent misrepresentation, and seeks compensatory damages and other relief. Discovery is ongoing. On June 7, 2006, Passave, Ltd. filed a notice of removal in the Northern District of California. Passave, Inc. filed a motion to dismiss the Amended Complaint in the Northern District Court on June 14, 2006, and noticed the hearing for August 18, 2006. On June 19, 2006, we filed a motion for remand to return the action to the Santa Clara County Superior Court, and noticed the hearing for August 4, 2006. We intend to pursue our rights and remedies against Passave, Inc. and Passave, Ltd. vigorously.

Cell Communication Ltd. Arbitration

On October 27, 2005, we received notice of a demand for arbitration filed against us by Cell Communication Ltd. of Nigeria. The demand was filed in the London Court of International Arbitration ("LCIA"). In its Amended Claim, Cell Communication claims 'general' damages of $26.6 million and "special' damages of $15 million (alternatively $41 million general damages) in connection with alleged failures of products purchased from Telos Technology, whose assets have been acquired by us.

An arbitrator has been selected by the LCIA. The arbitrator has ordered the determination of certain preliminary issues as to whether the claims made by Cell Communication are irrecoverable as a matter of English law. There was a hearing on May 26, 2006 in respect of these preliminary issues. On June 13, 2006, the arbitrator issued a partial award in which he addressed several issues. Among them, the arbitrator adopted our position that liability in this matter is limited to the amount of the purchase price paid by Cell Communications. No date for the substantive hearing has been scheduled. We intend to deny all liability, and believe we have meritorious defenses.

Other

We are a party to other litigation matters and claims that are normal in the course of operations, and while the results of such litigation matters and claims cannot be predicted with certainty, we believe that the final outcome of such matters will not have a material adverse impact on our financial position or results of operations.

In the future we may subject to other lawsuits. Any litigation, even if not successful against us, could result in substantial costs and divert management's attention and other resources away from our business operations.

ITEM 1A RISK FACTORS

FACTORS AFFECTING FUTURE OPERATING RESULTS
RISKS RELATED TO OUR COMPANY

Our future product sales are unpredictable and, as a result, our operating results are likely to fluctuate from quarter to quarter.

Our quarterly and annual operating results have fluctuated in the past and are likely to fluctuate in the future due to a variety of factors, some of which are outside of our control. Factors that may affect our future operating results include:

- the timing and size of the orders for our products;
- consumer acceptance of new products we may introduce to market;
- changes in the growth rate of customer purchases of communications services;
- the lengthy and unpredictable sales cycles associated with sales of our products;
- revenue recognition, which is based primarily on customer acceptance of delivered products, is unpredictable;
- cancellation, deferment or delay in implementation of large contracts;
- quality issues resulting from the design or manufacture of the products, or from the software used in the product;
- cash collection cycles in China and other emerging markets;
- the decline in business activity we typically experience during the Chinese Lunar New Year, which leads to decreased sales and collections during our first fiscal quarter;
- issues that might arise from the integration of acquired entities or the inability to achieve expected results from such acquisitions; and
- shifts in our product mix or market focus.

As a result of these and other factors, period-to-period comparisons of our operating results are not necessarily meaningful or indicative of future performance. In addition, the factors noted above may make it difficult for us to forecast and provide in a timely manner public guidance (including updates to prior guidance) related to our projected financial performance. Furthermore, it is possible that in some future quarters our operating results will fall below the expectations of securities analysts or investors. If this occurs, the trading price of our common stock could decline.

Competition in our markets may lead to reduced prices, revenues and market share.

We have experienced intense competition in the past years, and we believe that we will continue to face intense competition from both domestic and international companies in our target markets, many of which may operate under lower cost structures or may be given preferential treatment by applicable governmental regulators and policies and have much larger sales forces than we do. Additionally, other companies not presently offering competing products may also enter our target markets. Many of our competitors have significantly greater financial, technical, product development, sales, marketing and other resources than we do. As a result, our competitors may be able to respond more quickly to new or emerging technologies and changes in service provider requirements. Our competitors may also be able to devote greater resources than we can to the development, promotion and sale of new products. These competitors may be able to offer significant financing arrangements to service providers, which may give them a competitive advantage in selling systems to service providers with limited financial resources. In many of the developing markets in which we operate or intend to operate, relationships with local governmental telecommunications agencies are important to establish and maintain. In many such markets, our competitors may have or be able to establish better relationships with local governmental telecommunications agencies than we have, which could result in their ability to influence governmental policy formation and interpretation to their advantage. Additionally, our competitors might have better relationships with their third party suppliers and obtain component parts at a reduced rate, allowing them to offer their end products at reduced prices. Moreover, the telecommunications and data transmission industries have experienced significant consolidation, and we expect this trend to continue. If we have fewer significant customers, we may be more reliant on such large customers and our bargaining position and profit margins may suffer. Increased competition is likely to result in price reductions, reduced gross profit as a percentage of net sales and loss of market share, any one of which could materially harm our business, cash flows and financial condition, including potential impairment in value of our tangible and intangible assets and goodwill if extended losses were incurred.

If we seek to secure additional financing and are not able to do so, our ability to expand strategically may be limited. If we are able to secure additional financing, our stockholders may experience dilution of their ownership interest, or we may be subject to limitations on our operations and increased leverage.

We currently anticipate that our available cash resources, which include existing cash and cash equivalents, short-term investments, cash from operations and available credit lines will be sufficient to meet our anticipated needs for working capital and capital expenditures for at least the next twelve months. If we are unable to generate sufficient cash flows from operations, we may need to raise additional funds to develop new or enhanced products, respond to competitive pressures, take advantage of acquisition opportunities or raise capital for strategic purposes. If we raise additional funds through the issuance of equity securities, our stockholders will experience dilution of their ownership interest, and the newly issued securities may have rights superior to those of common stock. If we raise additional funds by issuing debt, we may be subject to limitations on our operations and our leverage may increase. For example, in connection with the sale of convertible debt securities in March 2003, we incurred $402.5 million of indebtedness. As a result of this indebtedness, our principal and interest payment obligations have increased substantially. In fiscal year 2005, approximately $127.9 million of this indebtedness was exchanged with the holders for $57.1 million in cash and 4,988,100 shares of our common stock. The degree to which we are leveraged could materially and adversely affect our ability to obtain financing for working capital, acquisitions or other purposes and could make us more vulnerable to industry downturns and competitive pressures. Our ability to meet our debt service obligations will be dependent upon our future performance, which will be subject to financial, business and other factors affecting our operations, many of which are beyond our control. Finally, we are not certain that we can maintain our existing unsecured credit lines available to our China operations or additional sources of financing may not be available on reasonable terms or at all if and when we require it, either of which could harm our business.

The average selling prices of our products may decrease, which may reduce our revenues and our gross profit. As a result, we must introduce new products and reduce our costs in order to maintain profitability.

The average selling prices for communications access and switching systems and handsets have historically declined as a result of a number of factors, including:

- increased competition;
- aggressive price reductions by competitors;
- rapid technological change; and
- constant change in customer buying behavior and market trends.

The average selling prices of our products may continue to decrease in the future in response to product introductions by us or our competitors or other factors, including price pressures from customers. Certain of our products, including wireless handsets, have historically had low gross profit margins, and any further deterioration of our profit margins on such products could result in losses with respect to such products. Therefore, we must continue to develop and introduce new products and enhancements to existing products that incorporate features that can be sold at higher average selling prices. Failure to do so, or the failure of consumers or our direct customers to accept such new products could cause our revenues and gross profit to decline.

Our cost reduction efforts may not allow us to keep pace with competitive pricing pressures or lead to improved gross profit, as a percentage of net sales. In order to be competitive, we must continually reduce the cost of manufacturing our products through design and engineering changes. We may not be successful in these efforts or in delivering our products to market in a timely manner. In addition, any redesign may not result in sufficient cost reductions to allow us to reduce the prices of our products to remain competitive or to improve or maintain our gross profit, as a percentage of net sales, which would cause our financial results to suffer.

Sales in China have historically accounted for a material portion of our total sales, and our business, financial condition and results of operations are to a significant degree subject to economic, political and social events in China.

Approximately $929.0 million, or 32%, and $2,133.3 million, or 79%, of our net sales in the fiscal years ended 2005 and 2004, respectively, occurred in China. While we have expanded into other markets, a significant portion of our net sales will be derived from China for the foreseeable future. In addition, we have made substantial investments in China and, therefore, our business, financial condition and results of operations are to a significant degree subject to economic, political, legal and social developments and other events in China. Please read the risks detailed below under the heading "Risks Related to Conducting Business in China" for additional information about the risks we face in connection with our China operations.

Our market is subject to rapid technological change, and to compete effectively, we must continually introduce new products and product enhancements that achieve market acceptance.

The market for communications equipment is characterized by rapid technological developments, frequent new product introductions, changes in consumer preferences and evolving industry and regulatory standards. Our success will depend in large part on our ability to enhance our technologies and develop and introduce new products and product enhancements that anticipate changing service provider requirements, technological developments and evolving consumer preferences. We may need to make substantial capital expenditures and incur significant research and development costs to develop and introduce new products and enhancements. If we fail to develop and introduce new products or enhancements to existing products that effectively respond to technological change on a timely basis, our business, financial condition and results of operations could be materially adversely affected. Certain of our products, including wireless handsets, have a short product life. Moreover, from time to time, our competitors or we may announce new products or product enhancements, technologies or services that have the potential to replace or shorten the life cycles of our products and that may cause customers to defer purchasing our existing products, resulting in charges for inventory obsolescence reserves. Future technological advances in the communications industry may diminish or inhibit market acceptance of our existing or future products or render our products obsolete.

Even if we are able to develop and introduce new products, they may not gain market acceptance. Market acceptance of our products will depend on various factors, including:

- our ability to obtain necessary approvals from regulatory organizations within the countries in which we operate and for any new technologies that we introduce;
- the length of time it takes service providers to evaluate our products, causing the timing of purchases to be unpredictable;
- the compatibility of our products with legacy technologies and standards existing in previously deployed network equipment;
- our ability to attract customers who may have preexisting relationships with our competitors;
- product pricing relative to performance;
- the level of customer service available to support new products; and
- the timing of new product introductions meeting demand patterns.

If our products fail to obtain market acceptance in a timely manner, our business and results of operations could suffer.

We depend on some sole source and key suppliers, as well as international sources, for handsets, base stations, components and materials used in our products. If we cannot secure adequate supplies of high quality products at competitive prices or in a timely manner from these suppliers or sources, or if the suppliers successfully market their products directly to our customers, our competitive position, reputation and business could be harmed.

We have contracts with a limited group of suppliers to purchase some components and materials used in our products. If any supplier is unwilling or unable to provide us with high-quality components and materials in the quantities required and at the costs specified by us, we may not be able to find alternative sources on favorable terms, in a timely manner, or at all. Further, a supplier could market its products directly to our customers. The possibility of a supplier marketing its own products would create direct competition and may affect our ability to obtain adequate supplies. Our inability to obtain or to develop alternative sources if and as required could result in delays or reductions in manufacturing or product shipments. From time to time, there could be shortages of certain products or components. Moreover, our suppliers may supply us with inferior quality products. If an inferior product supplied by a third party is embedded in our end product and causes a problem, it might be difficult to identify the source of the problem as being due to the component parts. If any of these events occur, our competitive position, reputation and business could suffer.

Our ability to source a sufficient quantity of high-quality, cost-effective components used in our products may also be limited by import restrictions and duties in the foreign countries in which we manufacture our products. We require a significant number of imported components to manufacture our products, and imported electronic components and other imported goods used in the operation of our business may be limited by a variety of permit requirements, approval procedures, import duties and licensing requirements. Moreover, import duties on such components increase the cost of our products and may make them less competitive.

Product defects or performance quality issues could cause us to lose customers and revenue or to incur unexpected expenses.

Many of our products are highly complex and may have quality deficiencies resulting from the design or manufacture of such product, or from the software or components used in the product. For example, during 2005 we recorded warranty charges of $70.6 million, including special warranty charges of $11.7 million for certain asynchronous digital subscriber line ("ADSL") products, $4.0 million for NetRing equipment and $14.9 million for GEPON equipment sold to SBBC, an affiliate of SOFTBANK CORP and SOFTBANK America Inc., during 2003 and 2004. Often these issues are identified prior to the shipment of the products and may cause delays in market acceptance of our products, delays in shipping products to customers, or the cancellation of orders. In other cases, we may identify the quality issues after the shipment of products. In such cases, we may incur unexpected expenses and diversion of resources to replace defective products or correct problems. Such pre-shipment and post-shipment quality issues could result in delays in the recognition of revenue, loss of revenue or future orders, and damage to our reputation and customer relationships. In addition, we may be required to pay damages for failed performance under certain customer contracts.

Our global diversification strategy and growth has strained our resources, and if we are unable to manage this growth, our operating results will be negatively affected.

We have recently experienced a period of rapid growth and anticipate that we must continue to transform our operations to address market demands and potential market opportunities globally. This transformation will place a significant strain on our management, operational, financial and other resources. To manage this transformation effectively, we will need to take various actions, including:

- enhancing management information systems, including forecasting procedures;
- further developing our operating, administrative, financial and accounting systems and controls;
- managing our working capital and sources of financing;
- maintaining close coordination among our engineering, accounting, finance, marketing, sales and operations organizations;
- retaining, training and managing our employee base;
- enhancing human resource operations and improving employee hiring and training programs;
- reorganizing our business structure to more effectively allocate and utilize our internal resources;
- improving and sustaining our supply chain capability; and
- managing both our direct and indirect sales channels in a cost-efficient and competitive manner.

If we fail to implement or improve systems or controls or to manage any future growth and transformation effectively, our business could suffer.

Any failure by us to execute planned cost reductions successfully could result in total costs and expenses that are greater than expected.

We have undertaken restructuring plans to bring operational expenses to appropriate levels for each of our businesses, while simultaneously implementing extensive new company-wide expense-control programs. In 2005, we announced workforce restructurings. These programs involved the termination of approximately 1,595 employees worldwide through December 31, 2005. We expect the cost savings to be used to offset market forces or to be reinvested in our businesses to strengthen our competitiveness. We may have further workforce reductions or rebalancing actions in the future. Significant risks associated with these actions and other workforce management issues that may impair our ability to achieve anticipated cost reductions or may otherwise harm our business include delays in implementation of anticipated workforce reductions in highly regulated locations outside of the United States, particularly in Europe and Asia, redundancies among restructuring programs, decreases in employee morale and the failure to meet operational targets due to the loss of employees, particularly sales employees.

Our success is dependent on continuing to hire and retain qualified personnel, and if we are not successful in attracting and retaining these personnel and in managing key employee turnover, our business will suffer.

The success of our business depends in significant part upon the continued contributions of key technical and senior management personnel, many of whom would be difficult to replace. In particular, our success depends in large part on the knowledge, expertise and services of Hong Liang Lu, our Chairman of the Board, President and Chief Executive Officer, Ying Wu, our Chairman and Chief Executive Officer of China Operations, and Philip Christopher, President and Chief Executive Officer of our Personal Communications Division. The loss of any key employee, the failure of any key employee to perform satisfactorily in his or her current position or our failure to attract and retain other key technical and senior management employees could have a significant negative impact on our operations. For example, Mr. Lu has announced that he will resign as our Chairman of the Board, President and Chief Executive Officer, effective as of December 31, 2006, and we are searching for a Chief Operating Officer. Mr. Wu will assume the CEO position as of January 1, 2007. Moreover, we have experienced turnover in key employee positions within our financial management team each of our current chief financial officer and controller joined the Company in the latter half of 2005. If we cannot adequately transition management of our Company after Mr. Lu's resignation or if we cannot recruit a suitable Chief Operating Officer, or if we cannot successfully manage employee turnover in other key positions, our business may suffer.

Notwithstanding our workforce restructurings, to effectively manage our operations, we will need to recruit, train, assimilate, motivate and retain qualified employees both locally and internationally. Competition for qualified employees is intense, and the process of recruiting personnel in all fields, including technology, research and development, sales and marketing, administration and management with the combination of skills and attributes required to execute our business strategy can be difficult, time-consuming and expensive. As we grow globally, we must implement hiring and training processes that are capable of quickly deploying qualified local residents to knowledgeably support our products and services. Alternatively, if there is an insufficient number of qualified local residents available, we might incur substantial costs importing expatriates to service new global markets. For example, we have historically experienced difficulty finding qualified accounting personnel knowledgeable in both U.S. and Chinese accounting standards who are Chinese residents. If we fail to attract, hire, assimilate or retain qualified personnel, our business would be harmed.

Competitors and others have in the past, and may in the future, attempt to recruit our employees. In addition, companies in the telecommunications industry whose employees accept positions with competitors frequently claim that the competitors have engaged in unfair hiring practices. We may be the subject of these types of claims in the future as we seek to hire qualified personnel. Some of these claims may result in material litigation and disruption to our operations. We could incur substantial costs in defending ourselves against these claims, regardless of their merit.

Any acquisitions and divestitures that we undertake could be difficult to integrate, disrupt our business, dilute our stockholders and harm our operating results.

We have acquired and divested certain businesses, products and technologies. Anticipated benefits of these acquisitions and divestitures may not be realized. We have in the past and will continue to evaluate acquisition prospects that would complement our existing product offerings, augment our market coverage, enhance our technological capabilities, or that may otherwise offer growth opportunities. Acquisitions may result in dilutive issuances of equity securities, use of our cash resources, the incurrence of debt and the amortization of expenses related to intangible assets. In addition, acquisitions involve numerous risks, including difficulties in the assimilation of operations, technologies, products and personnel of the acquired company, diversion of management's attention from other business concerns, risks of entering markets in which we have no direct or limited prior experience, the potential loss of key employees of the acquired company, unanticipated costs and, in the case of the acquisition of financially troubled businesses, challenges as to the validity of such acquisitions from third party creditors of such businesses. For example, in the fourth quarter 2004, we encountered difficulties in integrating Hyundai Syscomm, Inc. ("HSI") legacy operations into our operations and determined to abandon a substantial amount of HSI's legacy operations. As a result, in the fourth quarter 2004, we wrote off the entire goodwill and intangibles associated with HSI.

We may be unable to adequately protect the loss or misappropriation of our intellectual property, which could substantially harm our business.

We rely on a combination of patents, copyrights, trademarks, trade secret laws and contractual obligations to protect our technology. We have applied for patents in the United States and internationally. Additional patents may not be issued from our pending patent applications, and our issued patents may not be upheld. In addition, we have, from time to time, chosen to abandon previously filed patent and trademark applications. Moreover, we may face difficulties in registering our existing trademarks in new jurisdictions in which we operate, and we may be forced to abandon or change product or service trademarks because of the unavailability of our existing trademarks. We cannot guarantee that the intellectual property protection measures that we have taken will be sufficient to prevent misappropriation of our technology or trademarks or that our competitors will not independently develop technologies that are substantially equivalent or superior to ours. In addition, the legal systems of many foreign countries do not protect or honor intellectual property rights to the same extent as the legal system of the United States. For example, in China, the legal system in general, and the intellectual property regime in particular, are still in the development stage. It may be very difficult, time-consuming and costly for us to attempt to enforce our intellectual property rights in these jurisdictions.

We may be subject to claims that we infringe the intellectual property rights of others, which could substantially harm our business.

The industry in which we compete is moving towards aggressive assertion, licensing, and litigation of patents and other intellectual property rights. From time to time, we have become aware of the possibility or have been notified that we may be infringing certain patents or other intellectual property rights of others. Regardless of their merit, responding to such claims could be time consuming, divert management's attention and resources and cause us to incur significant expenses. In addition, although some of our supplier contracts provide for indemnification from the supplier with respect to losses or expenses incurred in connection with any infringement claim, certain contracts with our key suppliers do not provide for such protection. Moreover, certain of our sales contracts provide that we must indemnify our customers against claims by third parties for intellectual property rights infringement related to our products. There are no limitations on the maximum potential future payments under these guarantees. Therefore, we may incur substantial costs related to any infringement claim, which may substantially harm our results of operations and financial condition.

We have been and may in the future become subject to litigation to defend against claimed infringements of the rights of others or to determine the scope and validity of the proprietary rights of others. Future litigation may also be necessary to enforce and protect our patents, trade secrets and other intellectual property rights. Any intellectual property litigation or threatened intellectual property litigation could be costly, and adverse determinations or settlements could result in the loss of our proprietary rights, subject us to significant liabilities, require us to seek licenses from or pay royalties to third parties which may not be available on commercially reasonable terms, if at all, and/or prevent us from manufacturing or selling our products, which could cause disruptions to our operations.

In the event that there is a successful claim of infringement against us and we fail to develop non-infringing technology or license the propriety rights on commercially reasonable terms and conditions, our business, results of operations and financial condition could be materially and adversely impacted.

Our multinational operations subject us to various economic, political, regulatory and legal risks.

We market and sell our products globally, with a significant portion of our sales made in China. The expansion of our existing multinational operations and entry into new markets will require significant management attention and financial resources. Multinational operations are subject to a variety of risks, such as:

- the burden of complying with a variety of foreign laws and regulations;
- the burden of complying with United States laws and regulations for foreign operations, including the Foreign Corrupt Practices Act;
- difficulty complying with continually evolving and changing global product and communications standards and regulations for both our end products and their component technology;
- market acceptance of our new products, including longer product acceptance periods in new markets into which we enter;
- reliance on local original equipment manufacturers ("OEMs"), third party distributors and agents to effectively market and sell our products;
- unusual contract terms required by customers in developing markets;
- changes in local governmental control or influence over our customers;
- changes to import and export regulations, including quotas, tariffs, licensing restrictions and other trade barriers;
- evolving and unpredictable nature of the economic, regulatory, competitive and political environments;
- reduced protection for intellectual property rights in some countries;
- unproven business operation models developed or operated in specific countries or regions;
- longer accounts receivable collection periods; and
- difficulties and costs of staffing, monitoring and managing multinational operations, including but not limited to internal controls and compliance.

We do business in markets that are not fully developed, which subjects us to various economic, political, regulatory and legal risks unique to developing economies.

Less developed markets present additional risks, such as the following:

- customers that may be unable to pay for our products in a timely manner or at all;

new and unproven markets for our products and the telecommunications services that our products enable;

lack of a large, highly trained workforce;

difficulty in controlling local operations from our headquarters;

variable ethical standards and an increased potential for fraud;

unstable political and economic environments; and

lack of a secure environment for our personnel, facilities and equipment.

In particular, these factors create the potential for physical loss of inventory and misappropriation of operating assets. We have in the past experienced cases of vandalism and armed theft of our equipment that had been or was being installed in the field. If disruptions for any of these reasons become too severe in any particular market, it may become necessary for us to terminate contracts and withdraw from that market and suffer the associated costs and lost revenue.

Our wireless handset products are subject to a wide range of environmental, health and safety laws, and may expose us to potential health and environmental liability claims.

Our handset products are subject to a wide range of environmental, health and safety laws, including laws relating to the use, disposal and clean up of, and human exposure to hazardous substances. In the United States, these laws often require parties to fund remedial action regardless of fault. Factors such as the discovery of additional contaminants, the extent of remediation and compliance expenses, and the imposition of additional clean up obligations could cause us to incur substantial costs relating to remediation activities. Compliance with existing or future environmental, health and safety laws could also cause us to incur substantial costs relating to such compliance, including the expense of modifying product designs and manufacturing processes. In addition, restrictions on the use of certain materials in our facilities or products in the future could have a negative impact on our operations.

Additionally, there have been claims made alleging a link between the use of wireless handsets and the development or aggravation of certain cancers, including brain cancer. The scientific community is divided on whether there is a risk from wireless handset use, and if so, the magnitude of the risk. Even if there is no link established between wireless handset use and cancer, the negative publicity and possible litigation could have a material adverse effect on our business. In the past, several plaintiffs' groups have brought class actions against wireless handset manufacturers and distributors, alleging that wireless handsets have caused cancer. To date, we have not been named in any of these actions and none of these actions has been successful. In the future we could incur substantial costs in defending ourselves against similar claims, regardless of their merit. Also, claims may be successful in the future and may have a material adverse effect on our business.

We are subject to a wide range of environmental, health and safety laws and efforts to comply with such laws may be costly and may adversely impact our financial performance.

Our operations and the products we manufacture and/or sell are subject to a wide range of global environmental, health and safety laws. Compliance with existing or future environmental, health and safety laws could subject us to future costs, liabilities, impact our production capabilities, constrict our ability to sell, expand or acquire facilities and generally impact our financial performance. Some of these laws relate to the use, disposal, clean up of, and exposure to hazardous substances. In the United States, laws often require parties to fund remedial studies or action regardless of fault. Over the last several years, the European Union (the "EU") countries have enacted environmental laws regulating electronic products. Our products are impacted by laws that mandate the recycling of waste in electronic products sold in the EU and that will limit or prohibit the use of certain substances in electronic products beginning July 1, 2006. Other countries outside of Europe are expected to adopt similar laws. We may incur additional expenses to comply with these laws.

Currency rate fluctuations and exchange controls may adversely affect our cash flow and operating results.

Because a significant percentage of our sales are made in foreign countries and denominated in local currency, we are exposed to market risk for changes in foreign exchange rates on our foreign currency denominated accounts and notes receivable balances. Historically, the majority of our sales have been made in China and denominated in Renminbi. Prior to July 2005, the impact of currency fluctuations of Renminbi were insignificant as it was fixed to the U.S. dollar. However, in July 2005, China uncoupled the Renminbi from the U.S. dollar and let it float in a narrow band against a basket of foreign currencies. The move revalued the Renminbi by 2.1% against the U.S. dollar; however, it is uncertain what further adjustments may be made in the future. The Renminbi-U.S. dollar exchange rate could float, and the Renminbi could appreciate relative to the U.S. dollar. For example, the Renminbi-U.S. dollar exchange rate was 8.28 to the U.S. dollar prior to the float of the Renminbi in July 2005 and 8.07 Renminbi to the U.S. dollar at the end of 2005. Any significant revaluation of the Renminbi may materially and adversely affect our cash flows, revenues, operating results and financial position.

Outside of China, our primary foreign currency exposures have related to non-dollar denominated sales and purchases in Japan, Europe and Canada. Additionally, we have exposures to emerging market currencies, which can have extreme currency volatility. We have experienced material adverse impacts on our results of operations from fluctuations in currency exchange rates and may continue to do so in the future.

We may, from time to time, enter into foreign exchange forward contracts to minimize the short-term impact of foreign currency fluctuations on certain foreign currency receivables and payables. Our attempts to hedge against these risks may not be successful, resulting in an adverse impact on our results of operations.

Moreover, some of the foreign countries in which we do business might impose currency restrictions that may limit the ability of our subsidiaries and joint ventures in such countries to obtain and remit foreign currency necessary for the purchase of imported components and may limit our ability to obtain and remit foreign currency in exchange for foreign earnings. For example, China employs currency controls restricting Renminbi conversion, limiting our ability to engage in currency hedging activities in China. Various foreign exchange controls may also make it difficult for us to repatriate earnings, which could have a material adverse effect on our ability to conduct business globally.

Business interruptions could adversely affect our business.

Our operations are vulnerable to interruption by fire, earthquake, power loss, telecommunications failure, external interference with our information technology systems, incidents of terrorism and other events beyond our control. For example, our Hangzhou manufacturing facility's ability to produce sufficient products is dependent upon a continuous power supply. However, the Hangzhou facility has in the past been subject to power shortages, which has affected our ability to produce and ship sufficient products. We do not have a detailed disaster recovery plan, and the occurrence of any events like these that disrupt our business could harm our business and operating results.

We may suffer losses with respect to equipment held at customer sites, which could harm our business.

We face the risk of loss relating to our equipment held at customer sites. In some cases, our equipment held at customer sites is under contract, pending final acceptance by the customer. We generally do not hold title or risk of loss on such equipment, as title and risk of loss are typically transferred to the customer upon delivery of our equipment. However, we do not recognize revenue and accounts receivable with respect to the sale of such equipment until we obtain acceptance from the customer. If we do not obtain final acceptance, we may not be able to collect the contract price and recover this equipment or its associated costs. In other cases, particularly in China, where governmental approval is required to finalize certain contracts, inventory not under contract may be held at customer sites. We hold title and risk of loss on this inventory until the contracts are finalized and, as such, are subject to any losses incurred resulting from any damage to or loss of this inventory. If our contract negotiations fail or if the government of China otherwise delays approving contracts, we may not recover or receive payment for this inventory. Moreover, our insurance may not cover all losses incurred if our inventory at customer sites not under contract is damaged prior to contract finalization. If we incur a loss relating to inventory for any of the above reasons, our financial condition, cash flows, and operating results could be harmed.

Restrictions on the use of handsets while driving could affect our future growth.

Several foreign governments and U.S. state and local governments have adopted or are considering adopting legislation that would restrict or prohibit the use of wireless handsets while driving. Widespread legislation that restricts or prohibits the use of wireless handsets while driving could negatively affect our future growth.

We have been named as a defendant in securities litigation and other lawsuits, as well as lawsuits in the ordinary course of business.

We are currently a defendant in several securities litigation class actions and other lawsuits, as well as lawsuits in the ordinary course of our business. In the future, we may be subject to similar litigation. The defense of these lawsuits may divert our management's attention, and we may incur significant expenses in defending these lawsuits (including substantial fees of lawyers and other professional advisors and potential obligations to indemnify officers and directors who may be parties to such actions). In addition, we may be required to pay judgments or settlements that could have a material adverse effect on our results of operations, financial condition and liquidity.

We face risks related to pending governmental inquiries.

We have received notice of a formal inquiry by the staff of the Securities & Exchange Commission ("SEC") into certain aspects of our financial disclosures during prior reporting periods and certain other issues. In addition, in December 2005 the U.S. Embassy in Mongolia informed us that it had forwarded to the Department of Justice ("DOJ") allegations that an agent of our Mongolia joint venture had offered payments to a Mongolian government official in possible violation of the Foreign Corrupt Practices Act (the "FCPA"). In April 2006, we became aware that an agent of the Company may have made an offer to pay an Indian government official in possible violation of the FCPA. We, through our Audit Committee, authorized an independent investigation into these matters, and we have been in contact with the DOJ and SEC regarding the investigation. At this time, we cannot predict when any governmental inquiry will be completed or what the outcome of any governmental inquiry will be. These inquiries could harm relationships with existing customers and our ability to obtain new customers and partners. If the SEC or the DOJ makes a determination that we have violated federal laws, we may face sanctions including, but not limited to, fines, disgorgement and an injunction. Additionally, such a determination by the SEC or the DOJ could adversely affect our stock price. It is also possible that the findings and outcome of these inquiries may affect other lawsuits that are pending. Finally, the inquiries could divert management attention and resources, which could harm our business.

Failure to achieve and maintain effective internal controls in accordance with Section 404 of the Sarbanes-Oxley Act of 2002 could have a material adverse effect on our business and stock price.

Section 404 of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") requires that we establish and maintain an adequate internal control structure and procedures for financial reporting and include a report of management on our internal control over financial reporting. Our annual report on Form 10-K must contain an assessment by management of the effectiveness of our internal control over financial reporting and must include disclosure of any material weaknesses in internal control over financial reporting that we have identified. In addition, our independent registered public accounting firm must attest to and report on management's assessment of the effectiveness of our internal control over financial reporting.

We have identified material weaknesses in our internal control over financial reporting. See "Item 9A Controls and Procedures Management's Report on Internal Control Over Financial Reporting." As of the date of this annual report on Form 10-K, we are still in the process of implementing remedial measures related to the material weaknesses identified both in 2004 and 2005. If our efforts to remediate the weaknesses we identified are not successful, our business and operating results could be harmed and the reliability of our financial statements could be impaired, which could adversely affect our stock price. The requirements of Section 404 of the Sarbanes-Oxley Act are ongoing and also apply to future years. We expect that our internal control over financial reporting will continue to evolve as we continue in our efforts to transform our business. Although we are committed to continue to improve our internal control processes and we will continue to diligently and vigorously review our internal control over financial reporting in order to ensure compliance with the Section 404 requirements, any control system, regardless of how well designed, operated and evaluated, can provide only reasonable, not absolute, assurance that its objectives will be met. In addition, successful remediation of the noted control deficiencies is dependent on the Company's ability to hire and retain qualified personnel. Therefore, we cannot be certain that in the future additional material weaknesses or significant deficiencies will not exist or otherwise be discovered.

Recently enacted changes in securities laws and regulations may result in additional expenses.

The Sarbanes-Oxley Act has required and will continue to require changes in some of our corporate governance and securities disclosure or compliance practices. The Sarbanes-Oxley Act also requires the SEC to promulgate new rules on a variety of subjects, in addition to rule proposals already made, and NASDAQ has revised its requirements for companies that are quoted on it. These developments (i) have required and may continue to require us to devote additional resources to our operational, financial and management information systems procedures and controls to ensure our continued compliance with current and future laws and regulations, (ii) will make it more difficult and more expensive for us to obtain director and officer liability insurance, and may require us to accept reduced coverage, increase our level of self-insurance, or incur substantially higher costs to obtain coverage, and (iii) could make it more difficult for us to attract and retain qualified members on our board of directors, or qualified executive officers. To implement plans and measures to comply with Section 404 of the Sarbanes-Oxley Act and other related rules, we expect to expend significant resources and incur additional expenses. We continue to evaluate and monitor regulatory developments and cannot estimate the timing or magnitude of additional costs that we may incur as a result of such developments.

Changes in accounting rules will increase our compensation expense and may adversely affect our net income.

We prepare our financial statements in conformity with accounting principles generally accepted in the United States of America. These principles are subject to interpretation by the SEC and various bodies formed to interpret and create appropriate accounting policies. A change in these policies can have a significant effect on our reported results and may even retroactively affect previously reported transactions. For example, there have been changes to FASB guidelines relating to accounting for stock-based compensation that will increase our compensation expense, could make our net income less predictable in any given reporting period and could change the way we compensate our employees or cause other changes in the way we conduct our business.

Our ability to complete our planned restructuring and cost-reduction actions and the impact of such actions on our business may be affected by a variety of factors. These actions may, in turn, expose us to additional operation risks and have an adverse effect on our sales and profitability.

During the second and third quarters of 2005, we announced our plans to undertake certain restructuring efforts to reduce costs and simplify our product portfolios in all of our business units. As a result, we consolidated certain operations in research and development and manufacturing and reduced our employee population. The impact of these actions on our sales and profitability may be influenced by a variety of factors, including but not limited to our ability to successfully execute our plans, our ability to achieve the anticipated level of cost savings, and our ability to retain key employees. We may reprioritize our new product development initiatives, which may delay new product introductions to the market and may harm our sales. We may face additional costs associated with future actions in streamlining our operations, including but not limited to, outsourcing of certain operations to other parties.

An important cost-reduction action has been to reduce the number of employees in our work force. While we have assessed the appropriateness of the size of our work force and made adjustments accordingly, the reduced work force could cause disruption to our operations. If this were to occur, we could have difficulties fulfilling our orders and our sales and profits could suffer. Another cost-reduction alternative we may consider is to develop outsourcing arrangements for operations such as supply-chain and information technology management. If we implement these measures, and the third parties we select to provide such services fail to deliver quality services on time and at reasonable costs, we could have difficulties operating efficiently and our operating results may be harmed.

RISKS RELATED TO CONDUCTING BUSINESS IN CHINA

China's governmental and regulatory reforms may impact our ability to do business in China.

Since 1978, the Chinese government has been in a state of evolution and reform. The reforms have resulted in and are expected to continue to result in significant economic and social development in China. Many of the reforms are unprecedented or experimental and may be subject to change or readjustment due to a variety of political, economic and social factors. Multiple government bodies are involved in regulating and administering affairs in the telecommunications and information technology industries, among which the Ministry of Information Industry ("MII"), the National Development and Reform Commission ("NDRC"), the State-owned Assets Supervision and Administration Commission ("SASAC") and the State Administration of Radio, Film and Television ("SARFT") play the leading roles. These government agencies have broad discretion and authority over all aspects of the telecommunications and information technology industry in China, including but not limited to, setting the telecommunications tariff structure, granting carrier licenses and frequencies, approving equipment and products, granting product licenses, approving of the form and content of transmitted data, specifying technological standards as well as appointing carrier executives, all of which may impact our ability to do business in China.

While we anticipate that the basic principles underlying the reforms will remain unchanged, any of the following changes in China's political and economic conditions and governmental policies could have a substantial impact on our business:

- the promulgation of new laws and regulations and the interpretation of those laws and regulations;
- inconsistent enforcement and application of the telecommunications industry's rules and regulations by the Chinese government between foreign and domestic companies;
- the restructuring of telecommunications carriers in China, including policy making governing 3G network infrastructure and licensing;

- restrictions on IPTV license grants, which could limit the potential market for our products;
- the introduction of measures to control inflation or stimulate growth;
- the introduction of new guidelines for tariffs and service rates, which affect our ability to competitively price our products and services;
- changes in the rate or method of taxation;
- the imposition of additional restrictions on currency conversion and remittances abroad; or
- any actions that limit our ability to develop, manufacture, import or sell our products in China, or to finance and operate our business in China.

In addition to modifying the existing telecommunications regulatory framework, the Chinese government is currently preparing a draft of a standard, national telecommunications law (the "Telecommunications Law") to provide a uniform regulatory framework for the telecommunications industry. Currently a draft of the law has been finished and delivered to the National People's Congress for discussion. We do not yet know the final nature or scope of the regulations that would be created if the Telecommunications Law is passed. Accordingly, we cannot predict whether it will have a positive or negative effect on us or on some or all aspects of our business.

Under China's current regulatory structure, the communications products that we offer in China must meet government and industry standards. In addition, a network access license for the equipment must be obtained. Without a license, telecommunications equipment is not allowed to be connected to public telecommunications networks or sold in China. Moreover, we must ensure that the quality of the telecommunications equipment for which we have obtained a network access license is stable and reliable, and will not negatively affect the quality or performance of other installed licensed products.

China's changing economic environment may impact our ability to do business in China.

Since 1978, the Chinese government has been reforming the economic system in China to increase the emphasis placed on decentralization and the utilization of market forces in the development of China's economy. These reforms have resulted in significant economic growth. However, any economic reform policies or measures in China may from time to time be modified or revised by the Chinese government. While we may be able to benefit from the effects of some of these policies, these policies and other measures taken by the Chinese government to regulate the economy could also have a significant negative impact on economic conditions in China, which would result in a negative impact on our business.

China's entry into the World Trade Organization and relaxation of trade restrictions have led to increased foreign investment in China's telecommunications industry and may lead to increased competition in our markets which may have an adverse impact on our business.

China's economic environment has been changing as a result of China's entry, in December of 2001, into the World Trade Organization (the "WTO"). As of 2005, China had fulfilled its WTO commitments in allowing up to 49% percent foreign investment in wireless service joint-ventures in major cities. Also, a regulation has been issued to allow 25% foreign investment in basic telecommunication service joint-ventures in Beijing, Shanghai and Guangzhou. Furthermore, China is gradually introducing a market oriented pricing mechanism for the telecommunication services. In August 2005, China MII and National Development and Reform Commission (NDRC) approved the launch of plan-based pricing for fixed-line telephone service by China's 2 fixed-line operators, China Telecom and China Netcom. In September, MII and NDRC endorsed a "Circular on the Changes in Administration of Telecom Service Pricing," further loosening the pricing administration on certain telecom services. Operators are allowed to freely set price for VOIP service. This is a further step for China toward a full market oriented pricing administration mechanism.

Fuelled by perceived market potential, already many overseas companies are carving out niches in China's telecommunications market, including Vodafone, AT&T, British Telecom, Japan Telecom and Hong Kong's PCCW and Hutchison Whampoa. France Telecom, for example, has set up a wholly-owned research and development (R&D) facility in China, as a step towards paving the way for future expansion in the world's biggest telecom market. As China gradually relaxes the foreign-invested enterprises, some international vendors may seize this opportunity to adjust their China strategy, increasing their investment in China and converting some of their joint-ventures into fully-owned enterprises.

As the existing international vendors increase their investment in China, and more vendors enter the China market, the competition in the telecommunication equipment market may increase, and as a result, our business may suffer. If China's entry into the WTO results in increased competition or has a negative impact on China's economy, our business could suffer. In addition, although China is increasingly according foreign companies and foreign investment enterprises established in China the same rights and privileges as Chinese domestic companies as a result of its admission into the WTO, special laws, administrative rules and regulations governing foreign companies and foreign investment enterprises in China may still place foreign companies at a disadvantage in relation to Chinese domestic companies and may adversely affect our competitive position.

Uncertainties with respect to the Chinese legal system may adversely affect us.

We conduct our business in China primarily through our wholly owned subsidiaries incorporated in China. Our subsidiaries are generally subject to laws and regulations applicable to foreign investment in China. Accordingly, our business might be affected by China's developing legal system. Since 1978, many new laws and regulations covering general economic matters have been promulgated in China, and government policies and internal rules promulgated by governmental agencies may not be published in time, or at all. As a result, we may operate our business in violation of new rules and policies without having any knowledge of their existence. In addition, there are uncertainties regarding the interpretation and enforcement of laws, rules and policies in China. The Chinese legal system is based on written statutes, and prior court decisions have limited precedential value. Because many laws and regulations are relatively new and the Chinese legal system is still evolving, the interpretations of many laws, regulations and rules are not always uniform. Moreover, the relative inexperience of China's judiciary in many cases creates additional uncertainty as to the outcome of any litigation, and the interpretation of statutes and regulations may be subject to government policies reflecting domestic political changes. Finally, enforcement of existing laws or contracts based on existing law may be uncertain and sporadic, and it may be difficult to obtain swift and equitable enforcement, or to obtain enforcement of a judgment by a court of another jurisdiction. Any litigation in China may be protracted and result in substantial costs and diversion of resources and management's attention.

If tax benefits available to our subsidiaries located in China are reduced or repealed, our business could suffer.

The Chinese government is considering the imposition of a "unified" corporate income tax that would phase out, over time, the preferential tax treatment to which foreign investment enterprises, such as ourselves and our joint ventures, are currently entitled. While it is not certain whether the government will implement such a unified tax structure or whether we will be grandfathered into any new tax structure, if a new tax structure is implemented, such new tax structure may adversely affect our financial condition. Moreover, certain of our subsidiaries and joint ventures located in China enjoy tax benefits in China that are generally available to foreign investment enterprises. If these tax benefits are reduced or repealed due to changes in tax laws, our business could suffer.

Our ability to continue successful deployment of PAS system and sales of PAS handsets are limited by certain factors, including the following:

Maturing PAS market and increased competition in handsets and tariffs.

The market for PAS exceeded 87 million users as of the end of fiscal year 2005 and is available in most of the provinces throughout China. We believe the PAS market has matured. For example, during fiscal year 2005, net sales of the PAS/IPAS system and the wireless infrastructure market declined significantly as compared to fiscal year 2004. In addition, the increase in handset competitors entering the market has resulted in decreased average selling prices and margins. If additional handset competitors enter the market or if competitors decide to further reduce pricing, our sales of PAS handsets may be adversely impacted.

Furthermore, competition from mobile operators, such as China Mobile and China Unicom, has increased in cities where PAS is deployed. Mobile operators offering special promotional pricing or incentives to customers, such as free incoming calls or free mobile-to-mobile calls, have harmed the ability of our customers, China Telecom and China Netcom, to compete effectively. The continued use of such incentive programs by mobile operators may adversely impact China Telecom and China Netcom's ability to increase PAS subscriptions. Due to our relationships with China Telecom and China Netcom, reduced subscription growth at these carriers may have a material adverse effect on our pricing and harm our business or results of operations.

Our PAS system and handsets sales may experience a sharp decline if China Telecom or China Netcom obtain licenses allowing them to deliver mobile services.

China's media sources have widely reported that the MII may grant 3G mobile licenses to China Telecom or China Netcom, or to both in 2006 or 2007. If China Telecom or China Netcom obtain 3G mobile licenses, they may re-allocate capital expenditures to construct 3G networks, and as a consequence, may significantly reduce capital expenditures relating to PAS networks that utilize our existing products. In addition, it is possible that current PAS frequency bands utilized by PAS networks may be reallocated for use by 3G networks, resulting in the restriction of or shutting down of PAS networks. If this were to occur, we could lose current and potential future customers of our products, and our financial condition and results of operations could be significantly harmed.

We only have trial licenses for the PAS system and handsets in China.

We only have trial licenses for our PAS systems and handsets. We have applied for, but have not yet received, a final official network access license for our PAS systems and handsets. Based upon communication with the MII, we understand that our PAS systems and handsets are considered to still be in the trial period and sales of our PAS systems and handsets may continue to be made by us during this trial period, but that licenses will ultimately be required. If we fail to obtain the required licenses, we could be prohibited from making further sales of the unlicensed products, including our PAS systems and handsets, in China, which would substantially harm our business, financial condition and results of operations. The regulations implementing these requirements are not very detailed, have not been applied by a court and may be interpreted and enforced by regulatory authorities in a number of different ways. Our legal counsel in China has advised us that China's governmental authorities may interpret or apply the regulations with respect to which licenses are required and the ability to sell a product while a product is in the trial period in a manner that is inconsistent with the information received by our legal counsel in China, and either of these conditions could have a material adverse effect on our business, financial condition and results of operations.

Increasing centralization of purchasing decision-making by carriers may lead to customer concentration and affect the results of our business.

Most Chinese carriers have three levels of operations: the central headquarters level, the provincial level and the local city/county level. Both central and provincial levels are independent legal persons and have their own corporate mandate. The purchasing decision-making process may take various forms for different projects and may also differ significantly from carrier to carrier.

In the case of PAS systems, we negotiate and enter into all China Netcom contracts with the provincial operators. However, the central headquarters of China Telecom has chosen to exert its influence in the purchasing decision-making process by negotiating contractual terms, such as purchase price, payment terms, and acceptance clauses at the central level. The provincial operator then further negotiates the contract based on the guidelines provided by the headquarters. We enter into final contracts with the provincial operator. However, if this trend of centralized decision-making expands to unified purchasing, resulting in the negotiation and execution of contracts at the central headquarter level, there may be a concentration of customers which could have a significant impact on our business.

If China Netcom follows China Telecom and exerts the headquarters' influence in price negotiation, it may give downward pressure to the margin of our PAS system products to China Netcom.

Television over the internet is a new business in China and laws regulating the business have not been fully-developed and are unpredictable. Unfavorable regulation of the industry may adversely affect our IPTV operations in China and negatively impact our business.

Broadcasting television over the internet has only recently begun in China. The State Administration of Radio, Film and Television (SARFT) issued a measure in July 2004 to regulate the broadcasting of audio-visual programs through the information network, which includes our Internet Protocol television (IPTV) business. SARFT categorized the information network into the mobile telecommunication network, fixed communications network, microwave communication network, cable television network, satellite or other metropolitan area network, wide area network, local area network and other information networks categories. The receiving terminal equipment includes computers, television sets, mobile phones and other electronic products. While regulating the IPTV business, SARFT is encouraging development in China of the digital television business, a business that may be competitive with IPTV in the target market. The digital television and IPTV target complementary markets and it is not clear the extent of support SARFT will provide for IPTV in setting regulations. For example the Quanzhou Administration of Radio, Film, and Television issued a notice to stop all IPTV business in Quanzhou on December 25, 2005. The Zhejiang Administration of Radio, Film, and Television issued a similar notice on January 10, 2006. In both instances, SARFT had not endorsed the launch of commercial IPTV services in those localities yet through its licensing regime. However, in some other cities, such as Shanghai and Harbin where IPTV licenses were specifically issued by SARFT, IPTV is progressing well. Because the IPTV industry relates to both television and Internet sectors, it may be subject to regulation by different governmental authorities, including the Ministry of Information Industry (MII), which may become involved as a proponent to the IPTV industry. As the growth rate for traditional telecom business slows down, China Telecom, China Netcom and other operators have made great efforts to develop IPTV. At the end of 2005, an official of MII declared that MII and SARFT would jointly administer the IPTV industry in the coming years. However, due to a lack of uniform regulation on the development of the IPTV industry, we cannot predict that our IPTV business will operate smoothly in China. Our business may suffer if the law or policy in China does not encourage the IPTV industry.

We currently do not have a license to engage in the IPTV operator service business in China and development of our IPTV business depends upon the cooperation of IPTV license holder(s) and network operators. If we are unable to work cooperatively with license holder(s) and network operators, our business may suffer.

Under the measures issued by SARFT in July 2004, entities intending to engage in the IPTV operator service business should obtain a license from SARFT and foreign investment enterprises are prohibited from engaging in the IPTV operator service business. In practice, SARFT only grants such licenses to state-owned companies. Since we are the technical service and equipment provider in this field, our business development will depend on the cooperation of license holders and network operators. Our business may suffer if we fail to cooperate with license holders or network operators, or if the license holder(s) we're cooperating with lose their licenses.

RISKS RELATED TO OUR STOCK PERFORMANCE AND CONVERTIBLE DEBT SECURITIES

Our stock price is highly volatile.

The trading price of our common stock has fluctuated significantly since our initial public offering in March of 2000. Our stock price could be subject to wide fluctuations in the future in response to many events or factors, including those discussed in the preceding risk factors relating to our operations, as well as:

- actual or anticipated fluctuations in operating results, actual or anticipated gross profit as a percentage of net sales, levels of inventory, our actual or anticipated rate of growth and our actual or anticipated earnings per share;
- changes in expectations as to future financial performance or changes in financial estimates or buy/sell recommendations of securities analysts;
- changes in governmental regulations or policies in China;
- our, or a competitor's, announcement of new products, services or technological innovations;
- the operating and stock price performance of other comparable companies; and
- news and commentary emanating from the media, securities analysts or government bodies in China relating to us and to the industry in general.

General market conditions and domestic or international macroeconomic factors unrelated to our performance may also affect our stock price. For these reasons, investors should not rely on recent trends to predict future stock prices or financial results. In addition, following periods of volatility in a company's securities, securities class action litigation against a company is sometimes instituted. We have experienced substantial costs and the diversion of management's time and resources on this type of litigation and may do so in the future.

In addition, public announcements by China Telecom, China Netcom, China Mobile, and China Unicom each of which exert significant influence over many of our major customers in China, may contribute to volatility in the price of our stock. The price of our stock may react to such announcements.

SOFTBANK CORP. with its related entities, including SOFTBANK America Inc., has significant influence over our management and affairs, which it could exercise against the best interests of our stockholders.

SOFTBANK CORP. and its related entities, including SOFTBANK America Inc. (collectively, "SOFTBANK"), beneficially owned approximately 12.1% of our outstanding stock as of March 31, 2006. As a result, SOFTBANK has the ability to influence all matters submitted to our stockholders for approval, as well as our management and affairs. Matters that could require stockholder approval include:

- election and removal of directors;
- our merger or consolidation with or into another entity; and
- sale of all or substantially all of our assets.

This concentration of ownership may delay or prevent a change of control or discourage a potential acquirer from making a tender offer or otherwise attempting to obtain control of us, which could decrease the market price of our common stock.

Delaware law and our charter documents contain provisions that could discourage or prevent a potential takeover, even if the transaction would benefit our stockholders.

Other companies may seek to acquire or merge with us. Our acquisition or merger could result in benefits to our stockholders, including an increase in the value of our common stock. Some provisions of our Certificate of Incorporation and Bylaws, as well as provisions of Delaware law, may discourage, delay or prevent a merger or acquisition that a stockholder may consider favorable. These provisions include:

- authorizing the board of directors to issue additional preferred stock;
- prohibiting cumulative voting in the election of directors;
- limiting the persons who may call special meetings of stockholders;
- prohibiting stockholder action by written consent;
- creating a classified board of directors pursuant to which our directors are elected for staggered three year terms; and
- establishing advance notice requirements for nominations for election to the board of directors and for proposing matters that can be acted on by stockholders at stockholder meetings.

Together with the holders of our convertible subordinated notes due in 2008, we face a variety of risks related to the notes.

Holders of our convertible subordinated notes due in 2008 (the "Notes") and we face a variety of risks with respect to the Notes, including the following:

- we may be limited in our ability to purchase the Notes in the event of a change in control, either for cash or stock, which could result in our defaulting on the Notes at the time of the change in control, and purchases for stock would be subject to market risk;
- an event of default under our senior debt, including one of our subsidiaries, could restrict our ability to purchase or pay any or all amounts due on Notes, and after paying our senior debt in full, we may not have sufficient assets remaining to pay any or all amounts due on the Notes;
- there is no listed trading market for the Notes, which could have a negative impact on the market price of the Notes;

we have significantly increased our leverage as a result of the sale of the Notes which could have an adverse impact on our ability to obtain additional financing for working capital;

hedging transactions related to the Notes and our common stock and other transactions, as well as changes in interest rates and our creditworthiness, may affect the value of the Notes and of our common stock; and the Notes are not rated, nor do we anticipate that they will be rated, ultimately having a negative effect on the price of the Notes and of our common stock.

In addition, we are subject to various covenants and obligations pursuant to the terms of the indenture governing the Notes (the "Indenture"). Should we default on certain of these obligations, then all unpaid principal and accrued interest on the Notes then outstanding could become immediately due and payable. For example, as of March 16, 2006 and continuing through June 1, 2006, we were in technical noncompliance under the Indenture due to the non-filing of our annual report on Form 10-K for the year ended December 31, 2005. The Company had received notice from the Trustee asserting that if the Company had failed to file the 2005 Form 10-K on or before June 2, 2006, such failure would constitute an event of default pursuant to the Indenture. If such an event were to occur, the trustee under the Indenture or the holders of at least 25% in aggregate principal amount of the Notes then outstanding would have the right to declare all unpaid principal and accrued interest on the Notes then outstanding to be immediately due and payable. If an event of default under the Indenture occurs and if payment of principal and accrued interest on the Notes is accelerated, our business could be seriously harmed.

Our failure to timely file periodic reports with the Securities and Exchange Commission could result in the delisting of our common stock from the NASDAQ National Market and cause us to default on covenants contained in contractual arrangements.

If we are unable to maintain compliance with the conditions for continued listing required by NASDAQ, then our shares of common stock may be subject to delisting from the NASDAQ National Market. For example, as a result of our failure to timely file our Annual Report on Form 10-K for the fiscal year ended December 31, 2005 and our Quarterly Report on Form 10-Q for the fiscal quarter ended March 31, 2006, we were not in full compliance with NASDAQ Marketplace Rule 4310(c)(14), which requires us to make, on a timely basis, all filings with the Securities and Exchange Commission required by the Securities Exchange Act of 1934. We are required to comply with NASDAQ Marketplace Rule 4310(c)(14) as a condition for our common stock to continue to be listed on the NASDAQ National Market. NASDAQ granted us an extension to file our Form 10-K for the fiscal year ended December 31, 2005 and Form 10-Q for the quarter ended March 31, 2006. With our filing of this Form 10-Q, we will have complied with NASDAQ's decision. If our shares of common stock are delisted from the NASDAQ National Market, they may not be eligible to trade on any national securities exchange or the over-the counter market. If our common stock is no longer traded through a market system, the liquidity of our common stock may be greatly reduced, which could negatively affect its price. In addition, we may be unable to obtain future equity financing, or use our common stock as consideration for mergers or other business combinations. A delisting from the NASDAQ National Market may also have 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.

ITEM 2 UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None

ITEM 3 DEFAULTS UPON SENIOR SECURITIES

The Company delayed the filing of the 2005 Form 10-K in order to (i) enable the Audit Committee of the Board to complete an investigation with regard to the circumstances surrounding the premature recognition of revenue on certain transactions, and (ii) management to complete the preparation of its 2005 consolidated financial statements and its assessment as of December 31, 2005 of the Company's internal control over financial reporting under Section 404 of the Sarbanes-Oxley Act of 2002.

Pursuant to the Indenture (the "Indenture") with respect to the Company's $^{7}/_{8}$% Convertible Subordinated Notes due 2008 (the "Notes"), the Company is required to file all reports and other information and documents which it is required to file with the Securities and Exchange Commission pursuant to Section 13 or 15(d) of the Exchange Act of 1934 and provide a copy of such filings to the trustee for the holders of the Notes (the "Trustee"). Pursuant to the Indenture, a default by the Company on this requirement becomes an event of default (as described in the Indenture) (i) if the Trustee notifies the Company of the default or (ii) the holders of at least 25% in aggregate principal amount of the Notes outstanding notify the Company and the Trustee of the default, and (iii) the Company does not cure the default within 60 days after receipt of such notice.

The Company received notice from the Trustee asserting that if the Company failed to file the 2005 Form 10-K on or before June 2, 2006, such failure would constitute an event of default pursuant to the Indenture. If such an event of default were to occur, the Trustee or the holders of at least 25% in aggregate principal amount of the Notes then outstanding would have had the right to declare all unpaid principal and accrued interest on the Notes then outstanding to be immediately due and payable. This technical default was cured prior to June 2, 2006 with the filing of the 2005 Form 10-K.

ITEM 4 SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None

ITEM 5 OTHER INFORMATION

Director Compensation

As previously announced in May 2006, Hong Liang Lu notified the Company of his resignation as the Company's President, Chief Executive Officer and Chairman of the Company's Board of Directors, effective December 31, 2006, and Thomas Toy, currently an independent director of the Company, will assume the position of Chairman of the Board, effective January 1, 2007. To promote and facilitate a smooth transition of the role of Chairman of the Board, Mr. Toy has assumed greater responsibility on the Board and has been assigned additional duties on the Board during the transition period.

On June 20, 2006, the Board approved a cash compensation award of $106,000 to Mr. Toy to compensate Mr. Toy for his additional services on the Board during the transition period. The compensation award will be payable in three equal payments of approximately $35,434 on each of June 30, 2006, September 30, 2006 and December 31, 2006. The compensation award is to be paid in addition to the regular annual cash retainer, fees and equity grants previously approved by the Board as compensation for Mr. Toy's services as a member of the Board and Board committees and as Lead Director of the Board.

Amendments to Employment Agreements with Section 16 Officers

On June 20, 2006, the Board approved amendments to the Change of Control and Severance Agreement dated January 31, 2003 between the Company and Ying Wu, Executive Vice President of the Company and Vice Chairman of the Board (the "**Wu Agreement**"), the Change of Control and Severance Agreement dated January 31, 2003 between the Company and William Huang, Senior Vice President and Chief Technology Officer of the Company (the "**Huang Agreement**"), and the Change of Control/Involuntary Termination Severance Agreement dated September 6, 2005 between the Company and Francis Barton, Executive Vice President and Chief Financial Officer of the Company (the "**Barton Agreement**" and collectively with the Wu Agreement and the Huang Agreement, the "**Employment Agreements**"), as described below.

Change of Control Amendments

Prior to the amendments, the Employment Agreements provided that if the employee's employment with the Company terminates as a result of an involuntary termination (as defined below) at any time within 12 months after a change of control (the "**Determination Period**"), (i) such employee will be entitled to 24 months of base salary as in effect as of the date of such termination payable in a lump sum within 30 days of termination and 100% of the bonus for the year in which termination occurs, (ii) the Company will continue to provide such employee the same level of health coverage as in effect on the day immediately preceding the termination date until the earlier of the date such employee is no longer eligible to receive continuation coverage pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended, or 12 months from the termination date, (iii) all stock options granted to such employee will become fully vested and exercisable as of the date of termination and the Company's right to repurchase any stock that was purchased by such employee prior to the change of control shall lapse, and (iv) with respect to the Barton Agreement, all share purchase rights granted to such employee will become fully vested and exercisable to the extent such share purchase rights are outstanding and unexercisable at the time of such termination.

The Employment Agreements have been amended to extend the Determination Period from 12 months to 18 months such that, if the applicable employee's employment with the Company terminates as a result of involuntary termination at any time within 18 months after a change of control, the employee will be entitled to the benefits provided in the respective Employment Agreement, as amended. Additionally, the Employment Agreements have been amended to provide that (i) all equity awards granted to the applicable employee, including without limitation option grants, restricted stock and stock purchase rights, will become fully vested and/or exercisable to the extent such equity awards are outstanding and/or unexercisable at the time of such termination, and (ii) such equity awards will remain exercisable for a period of 1 year following such termination.

Involuntary Termination Amendments

Prior to the amendments, the Wu Agreement and the Huang Agreement did not provide for severance benefits to be paid to the employee even if such employee's employment with the Company is terminated without cause (as defined below) except in the case of an involuntary termination following a change of control (as described below). Prior to the amendments, the Barton Employment Agreement provided that if such employee's employment with the Company is terminated without cause, even if such termination does not result from a change of control, the employee would be entitled to (i) 12 months of his base salary as in effect as of the date of such termination, less applicable withholding, payable in a lump sum within 30 days of such termination, (ii) 100% of his bonus for the year in which such termination occurs, and (iii) continued vesting in stock options and share purchase rights granted to such employee prior to the date of such termination, for a period of 12 months from the date of such termination, with the right to exercise said stock options and share purchase rights within 90 days from the end of said 12-month period; however, in the event of a termination for cause, the terminated employee shall not be entitled to any of the foregoing benefits.

The Employment Agreements have been amended to provide that if the applicable employee's employment with the Company terminates without cause, even if such termination does not result from a change of control, (i) such employee will be entitled to 12 months (24 months, in the case of the Barton Agreement) of such employee's base salary as in effect as of the date of such termination, less applicable withholding, payable in a lump sum within 30 days of such termination and 100% of such employee's bonus for the year in which such termination occurs, (ii) all equity awards, including without limitation option grants, restricted stock and stock purchase rights, granted to such employee will become fully vested and/or exercisable to the extent such equity awards are outstanding and/or unexercisable at the time of such termination, (iii) such equity awards will remain exercisable for a period of 1 year following such termination, and (iv) the Company will continue to provide such employee the same level of health coverage as in effect on the day immediately preceding the termination date until the earlier of the date such employee is no longer eligible to receive continuation coverage pursuant to the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended, or 12 months from the termination date. However, in the event of a termination for cause, the terminated employee shall not be entitled to any of the foregoing benefits.

Defined Terms

For the purpose of the Employment Agreements, "involuntary termination" includes (i) without the employee's express written consent, a significant reduction of the employee's duties, position or responsibilities relative to the employee's duties, position or responsibilities in effect immediately prior to such reduction, or the removal of the employee from such position, duties and responsibilities, unless the employee is provided with comparable duties, position and responsibilities, (ii) without the employee's express written consent, a substantial reduction, without good business reasons, of the facilities and perquisites (including office space and location) available to the employee immediately prior to such reduction, (iii) a reduction by the Company of the employee's base salary as in effect immediately prior to such reduction, (iv) a material reduction by the Company in the kind or level of employee benefits to which the employee is entitled immediately prior to such reduction with the result that the employee's overall benefits package is significantly reduced, (v) the relocation of the employee to a facility or a location more than 50 miles from his current location without the employee's express written consent, (vi) any purported termination of the employee by the Company which is not effected for cause or for which the grounds relied upon are not valid, or (vii) the Company's failure to obtain the assumption of the Employment Agreements by any successor to the Company.

For the purpose of the Employment Agreements, "change of control" is defined as (i) the approval by the Company's stockholders of a merger or consolidation with any other corporation, other than a merger or consolidation which would result in the Company's voting securities outstanding immediately prior thereto continuing to represent (either by remaining outstanding or by being converted into voting securities of the surviving entity) more than 50% of the total voting power represented by the Company's voting securities or such surviving entity outstanding immediately after such merger or consolidation, (ii) the approval by the Company's stockholders of a plan to complete liquidation or an agreement for the sale or disposition by the company of all or substantially all of the Company's assets, (iii) any "person" (as such term is used in Sections 13(d) and 14(d) of the Exchange Act) becoming the "beneficial owner" (as defined in Rule 13d-3 under said Exchange Act), directly or indirectly, of the Company's securities representing 50% or more of the total voting power represented by the Company's then outstanding voting securities, or (iv) a change in the composition of the Board, as a result of which fewer than a majority of the directors are incumbent directors.

For the purpose of the Employment Agreements, "cause" is defined as (i) any act of personal dishonesty taken by the employee in connection with his responsibilities as an employee which is intended to result in substantial personal enrichment of the employee, (ii) employee's conviction of a felony which the Board reasonably believes has had or will have a material detrimental effect on the Company's reputation or business, (iii) a willful act by the employee which constitutes misconduct and is injurious to the Company, and (iv) continued willful violations by the employee of the employee's obligations to the Company after a delivery of a written demand by the Company to the employee for performance which describes the basis of the Company's belief that the employee has not substantially performed his duties.

ITEM 6 EXHIBITS

Exhibit Number	EXHIBIT DESCRIPTION
31.1	Certification of the Chief Executive Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.
31.2	Certification of the Chief Financial Officer pursuant to Rule 13a-14(a) or Rule 15d-14(a) promulgated under the Securities Exchange Act of 1934, as amended.
32.1	Certifications of the Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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.

	UTSTARCOM, INC.	
Date: June 21, 2006	By:	/s/ HONG LIANG LU
		Hong Liang Lu *President, Chief Executive Officer and Director* *(Principal Executive Officer)*
Date: June 21, 2006	By:	/s/ FRANCIS P. BARTON
		Francis P. Barton *Executive Vice President of Finance and Chief Financial Officer* *(Principal Financial Officer)*

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