NEXT LEVEL COMMUNICATIONS INC
Form 10-Q/A
February 07, 2003

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A

(Mark One)

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

For the quarterly period ended September 30, 2002

OR

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

Commission file number: 0-27877

NEXT LEVEL COMMUNICATIONS, INC.

(Exact Name of Registrant as Specified in Its Charter)

DELAWARE (State or Other Jurisdiction of Incorporation or Organization)	94-3342408 (I.R.S. Employer Identification No.)

6085 State Farm Drive
Rohnert Park, California 94928
(Address of Principal Executive Offices, Including Zip Code)

Registrant s Telephone Number, Including Area Code: **(707) 584-6820**

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. [X] Yes [ ] No

The number of shares of our common stock, par value $0.01 per share, outstanding as of October 31, 2002 was 86,692,161.

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Explanatory Note

This Amendment No. 1 to Form 10-Q/A amends Items 2 and 4 of Part I of our Quarterly Report on Form 10-Q for the quarter ended September 30, 2002, which was originally filed on November 14, 2002. This amendment is being filed in response to the Staff s letter dated January 24, 2003 which encouraged the company to revise disclosure related to Critical Accounting Policies and Estimates (Item 2) and Controls and Procedures (Item 4).

Except for the aforementioned revised disclosures, all information contained in this report is stated as of November 14, 2002. This amendment does not otherwise update the information in the originally filed Form 10-Q to reflect events occurring after November 14, 2002.

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PART I. FINANCIAL INFORMATION

Item 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Next Level Communications, Inc.
Condensed Consolidated Statements of Operations
Three months and nine months ended September 30, 2002 and 2001
(In Thousands, except per share data) (Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2002	2001	2002	2001
Revenues	$ 12,344	$ 20,198	$ 43,200	$ 80,840
Cost of revenues	11,357	17,569	37,714	66,135
Inventory charges				72,016
Gross profit (loss)	987	2,629	5,486	(57,311)
Operating expenses				
Research & development	5,545	11,788	19,075	38,742
Selling, general and administrative	7,693	12,932	25,611	42,280
Asset impairments and disposals, net	1,934		1,934	796
Total operating expenses	15,172	24,720	46,620	81,818
Operating loss	(14,185)	(22,091)	(41,134)	(139,129)
Interest expense, net	(6,218)	(5,441)	(21,066)	(8,525)
Investment impairments and other expense, net	(53)	(236)	(891)	(4,648)
Net loss	$ (20,456)	$ (27,768)	$ (63,091)	$ (152,302)
Accretion and dividends payable on preferred stock	(2,218)		(3,841)	
Net loss available to common shareholders	$ (22,674)	$ (27,768)	$ (66,932)	$ (152,302)
Basic and diluted net loss per common share	$ (0.26)	$ (0.32)	$ (0.78)	$ (1.79)
Shares used to compute basic and diluted net loss per common share	86,436	85,473	86,210	85,115

See notes to condensed consolidated financial statements.

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Next Level Communications, Inc.
Condensed Consolidated Balance Sheets
September 30, 2002 and December 31, 2001
(In Thousands, except share data) (Unaudited)

	September 30, 2002	December 31, 2001
Assets		
Current assets		
Cash and cash equivalents	$ 27,895	$ 20,580
Trade receivables, net	10,586	15,989
Other receivables	6,007	3,373
Inventories	45,961	62,645
Prepaid expenses and other current assets	1,542	3,104
Total current assets	91,991	105,691
Property and equipment, net	40,460	46,740
Long-term investments and other assets	1,604	1,604
Total assets	$ 134,055	$ 154,035
Liabilities and stockholders deficit		
Current liabilities		
Accounts payable	$ 6,701	$ 13,938
Accrued liabilities	14,615	19,213
Notes and loans payable	9,788	24,340
Notes and loans payable due to Motorola, net of discount	43,874	
Deferred revenue	649	415
Total current liabilities	75,627	57,906
Long-term liabilities		
Due to Motorola		
Note payable, net of discount		55,984
Tax sharing agreement liability	29,346	29,346
Mortgage Note, net of discount	18,336	19,098
Total long term liabilities	47,682	104,428
Redeemable convertible preferred stock	68,772	
Stockholders deficit		
Common stock $.01 par value, 400,000,000 shares authorized, 86,601,027 and 85,869,316 shares issued and outstanding	798	791
Additional paid-in-capital	492,784	479,426
Accumulated deficit	(551,608)	(488,516)
Total stockholders deficit	(58,026)	(8,299)
Total liabilities and stockholders deficit	$ 134,055	$ 154,035

See notes to condensed consolidated financial statements.

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Next Level Communications, Inc.
Condensed Consolidated Statements of Cash Flows
Nine Months Ended September 30, 2002 and 2001
(In Thousands) (Unaudited)

	September 30,	
	2002	2001
OPERATING ACTIVITIES		
Net loss	(63,091)	(152,302)
Adjustments to reconcile net loss to net cash used in operating activities:		
Inventory charge		72,016
Depreciation and amortization	7,227	12,451
Amortization of discount on note payable	15,949	6,433
Warrants issued for letter of certification	407	
Write-down of investments and property and equipment	1,278	6,586
Other		592
Equity in net loss of investee		536
Changes in assets and liabilities:		
Trade receivables	5,403	14,682
Inventories	16,684	(51,490)
Other assets	(1,071)	(3,139)
Accounts payable	(7,237)	(519)
Accrued liabilities and deferred revenue	(4,573)	(2,121)
Net cash used in operating activities	(29,024)	(96,275)
INVESTING ACTIVITIES		
Purchases of property and equipment	(732)	(4,059)
Long-term investments		(6,500)
Net cash used in investing activities	(732)	(10,559)
FINANCING ACTIVITIES		
Proceeds from issuance of convertible stock and warrants to Motorola	53,000	
Issuance of common stock	486	2,182
Proceeds from Tax Sharing Agreement		17,300
Proceeds from Motorola financing		64,000
Repayment of borrowings	(16,415)	
Repayment of capital lease obligations		(239)
Net cash provided by financing activities	37,071	83,243
Net Increase (Decrease) in Cash and Cash Equivalents	7,315	(23,591)
Cash and Cash Equivalents, Beginning of Period	20,580	35,863
Cash and Cash Equivalents, End of Period	$ 27,895	$ 12,272
NONCASH INVESTING AND FINANCING ACTIVITIES		
Conversion of Motorola note payable to convertible redeemable preferred stock	32,000	
Conversion of vendor payables and commitments into note payable		24,340
Building acquisition and related mortgage assumption	1,054	

See notes to condensed consolidated financial statements.

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NEXT LEVEL COMMUNICATIONS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (unaudited)

1. BASIS OF PRESENTATION

Next Level Communications, Inc. (the Company) is a leading provider of broadband communications systems that enable telephone companies and other emerging communications service providers to cost-effectively deliver voice, data and video services over the existing copper wire telephone infrastructure.

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information and pursuant to the rules and regulations of the Securities and Exchange Commission. While these financial statements reflect all adjustments which are, in the opinion of management, necessary to present fairly the results of the interim period, they do not include all information and footnotes required by generally accepted accounting principles for complete financial statements. These financial statements and notes should be read in conjunction with the financial statements and notes thereto, for the year ended December 31, 2001 contained in the Company s Annual Report on Form 10-K. Certain prior period amounts have been reclassified to conform to the current period presentation. The results of operations for the nine months ended September 30, 2002 are not necessarily indicative of the operating results for the full year.

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

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

2. REDEEMABLE CONVERTIBLE PREFERRED STOCK ISSUANCES TO MOTOROLA, INC.

On February 20, June 25 and September 26, 2002, the Company issued to Motorola, Inc. (Motorola) shares of redeemable, convertible preferred stock. Each share of Series A preferred (February issuance) is convertible into two shares of common stock; each share of Series A-1 preferred (June and September issuances) is convertible into 100 shares of common stock. Both Series A and Series A-1 preferred shares (Preferred) are entitled to cumulative dividends at an annual rate of 7.5% payable in cash or additional shares of Preferred. In the event of insolvency or dissolution of the Company, certain change in control, merger or consolidation events, or sales or

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transfers of a material portion of the Company s assets outside the ordinary course of business, each share of Preferred is entitled to a liquidation preference equal to 250% of the Preferred s initial purchase price. Motorola has waived its right to receive the liquidation preference in the event of a change of control or sale of a material portion of the Company s assets if such event occurs prior to April 1, 2003. Holders of a majority of the Preferred may require the Company to redeem the Preferred on or after the five year anniversary of issuance at a per share redemption price equal to 120% of the Preferred s initial purchase price. The Preferred shares were issued for cash and in connection with conversions of outstanding notes payable with Motorola. Upon the conversion of the note payable amounts into Preferred shares, the Company recorded additional interest expense for any remaining unamortized discount related to this portion of the note payable. In connection with the issuance of the Preferred, the Company granted Motorola warrants to purchase additional shares of the Company s common stock. The warrants issued in exchange for cash are exercisable immediately and expire five years from the date of issuance. Warrants issued for debt to equity conversions and redemption waivers become exercisable five years from the date of the preferred issuance and expire ten years from the date of the preferred issuance.

The following table details the significant components of the transactions.

(in millions, except price per share data)	Feb. 20, 2002	June 25, 2002	Sept. 26, 2002
Preferred Stock Issued Shares	6.9	0.3	0.2
Preferred Stock Issued Price Per Share	$4.34	$119.00	$93.00
Common Stock Equivalent[1] Shares	13.8	27.7	23.7
Common Stock Equivalent Price Per Share	$2.17	$ 1.19	$ 0.93
Warrants Issued Shares	6.9	6.3	6.1
Warrant Average Exercise Price Per Share	$2.38	$ 1.23	$ 0.97
Cash Proceeds	$30.0	$ 13.0	$ 10.0
Debt Conversions	$	$ 20.0	$ 12.0
Total	$30.0	$ 33.0	$ 22.0
Amount allocated to warrants	6.5	3.9	3.2
Amount allocated to beneficial conversion feature		2.7	3.7
Net amount allocated to Preferred Stock	$23.5	$ 26.4	$ 15.1
Remaining unamortized discount charged to interest expense on conversion	$	$ 3.6	$ 1.7

The total amounts of these issuances were allocated between the preferred shares, warrants and any beneficial conversion feature on the preferred shares, as shown above. The fair values of the warrants were estimated using the Black-Scholes option pricing model with the following assumptions: no dividends; risk free interest rate in effect (4.6%) and volatility percent calculation (from 101% to 107%) at the time of issuance; and the contractual life of the warrants.

The Company is accreting the Preferred shares to their stated redemption price. The Company accreted $1.0 million on all outstanding Series A and A-1 Preferred in the current quarter, and $1.7 million in the nine-month period ended September 30, 2002, which has been reflected as an increase in the carrying value of the Preferred and a corresponding decrease to additional paid in capital. During the quarter ended September 30, 2002, the Company accrued $1.2 million for the payment of dividends. During the nine-month period ended September 30, 2002, the Company accrued $2.1 million for the payment of dividends.

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$35 Million Financing Commitment

At September 30, 2002, $12.0 million remains available under the March 29, 2002 $35.0 million financing commitment from Motorola.

Letter of Certification

On April 22, 2002, in connection with the Company maintaining compliance under the Nasdaq National Market listing requirements, Motorola provided to Nasdaq a Letter of Certification pursuant to which Motorola agreed (i) to waive, through November 1, 2002, Motorola s right of redemption under Section B(2) of the Certificate of Designation of the Series A Preferred in the event of a change of control or sale of a material portion of the Company s assets and (ii) not to transfer the Series A Preferred unless the transferee agrees in writing to be bound by the waiver. This waiver by Motorola allowed the Company to classify the preferred stock that had been issued to Motorola as equity for purposes of meeting the net tangible asset listing requirement which required the Company to maintain, at a minimum, a net tangible worth of $4.0 million. As consideration for the Letter of Certification, the Company issued to Motorola fully-vested and non-forfeitable warrants to purchase common stock, exercisable five years from the date of the letter, with an exercise price of $2.00 per share and expiring on April 22, 2012, as follows: (i) 100,000 warrants for the Letter of Certification and the overall contingent re-structuring; and (ii) 300,000 warrants for the waiver of the redemption in the event of a change of control relating to the $30.0 million Series A Preferred issued to Motorola in February 2002.

The fair value of the warrants ($0.4 million) was charged to other expense on the date of issuance. The fair value of the warrants was estimated using the Black-Scholes option pricing model with the following assumptions: no dividends; risk free interest rate of 4.6%; volatility 101%; and a contractual life of ten years.

3. NOTES PAYABLE

Vendor Note Payable

On May 18, 2002, a principal and interest payment of $13.0 million was made under the Company s vendor note payable. The remaining principal and interest payment of $9.5 million is due on March 31, 2003.

Note Payable to Motorola

On May 17, 2002, warrants to purchase 1,000,000 shares of common stock, issued in connection with the note payable to Motorola, became exercisable since full repayment under the note had not been made by that date. In addition, on May 30, 2002, the Company and Motorola amended the note to provide that the remaining warrants to purchase 2,000,000 shares of common stock became fully vested and exercisable. As a result, a measurement date was reached with respect to these warrants and their value was fixed.

On October 22, 2002, the Company and Motorola agreed to amend the note to extend the maturity date from May 16, 2003 to May 16, 2006. The extension was accounted for as an extinguishment of debt with a related party under EITF 96-19 and APB 26. Accordingly, the remaining unamortized warrant discount of $6.5 million on the $51.0 million outstanding under the note was accounted for as a dividend to a stockholder. As consideration for the extension, the Company granted to Motorola a warrant to purchase 3.0 million shares of common stock with an exercise price of $0.76, which represented the average closing price of the Company s stock over the five days prior to the agreement. The fair value of the warrants ($1.7 million) was treated as a

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cost associated with debt extinguishment, and as a result, was also accounted for as a dividend to a stockholder.

4. INVENTORIES

Inventories at September 30, 2002 and December 31, 2001 consisted of (in millions):

	September 30, 2002	December 31, 2001
Raw materials	$24.1	$26.2
Work-in-process	2.7	1.7
Finished goods	19.2	34.7
Total	$46.0	$62.6

5. LEGAL PROCEEDINGS

The Company is a party to various claims, litigation and other matters. Management believes that the ultimate resolution of these matters will not have a material adverse effect on the Company s condensed consolidated financial statements taken as a whole.

6. NET LOSS PER SHARE

Basic net loss per share excludes diluti