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TERAFORCE TECHNOLOGY CORP  
Form 10-K  
April 15, 2003

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549

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FORM 10 - K

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

FOR THE YEAR ENDED DECEMBER 31, 2002

Commission File Number 0-11630  
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TERAFORCE TECHNOLOGY CORPORATION  
(Exact Name of Registrant as Specified in Its Charter)

DELAWARE (State or Other Jurisdiction of Incorporation or Organization)	76-0471342 (I.R.S. Employer Identification No.)
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1240 E. CAMPBELL, RICHARDSON, TEXAS  
75081  
(Address of Principal Executive Offices and Zip Code)

469-330-4960  
(Registrant's Telephone Number, Including Area Code)  
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Securities Registered Pursuant to Section 12 (b) of the Act  
NONE

Securities Registered Pursuant to Section 12 (g) of the Act  
COMMON STOCK PAR VALUE \$0.01 PER SHARE  
(Title of Class)

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No  
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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K [ ]

Indicate by check mark whether the Registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities and Exchange Act of 1934). Yes No X  
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The aggregate market value of voting stock held by non-affiliates of the Registrant was approximately \$19,872,133 as of June 28, 2002 (based upon the average of the highest bid and lowest asked prices on such date as reported on the OTC Bulletin Board). All directors, officers and 5% or greater shareholders are presumed to be affiliates for purposes of this calculation.

There were 118,422,183 shares of Common Stock outstanding as of March 31, 2003.

### DOCUMENTS INCORPORATED BY REFERENCE

None

### TABLE OF CONTENTS

	Section -----	Page Number -----
ITEM 1 -	Business	3
ITEM 2 -	Properties	16
ITEM 3 -	Legal Proceedings	16
ITEM 4 -	Submission of Matters to a Vote of Security Holders	17
ITEM 5 -	Markets for Registrant's Common Equity and Related Stockholder Matters	18
ITEM 6 -	Selected Financial Data	19
ITEM 7 -	Management's Discussion and Analysis of Financial Condition and Results of Operations	20
ITEM 7A -	Quantitative and Qualitative Disclosures About Market Risk	29
ITEM 8 -	Financial Statements and Supplementary Data	30
ITEM 9 -	Changes in and Disagreements With Accountants on Accounting and Financial Disclosure	56
ITEM 10 -	Directors and Executive Management of the Registrant	56
ITEM 11 -	Executive Compensation	57
ITEM 12 -	Security Ownership of Certain Beneficial Owners and Management	62
ITEM 13 -	Certain Relationships and Related Transactions	64
ITEM 14 -	Controls and Procedures	65
ITEM 15 -	Exhibits, Financial Statement Schedules and Reports on Form 8-K	65

PART I

ITEM 1 - BUSINESS

FORWARD-LOOKING STATEMENT

The statements in this Annual Report on Form 10K of TeraForce Technology Corporation (the "Company") regarding future financial and operating performance and results, and other statements that are not historical facts, are forward-looking statements, as defined in Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. We use the words "may," "expect," "anticipate," "believe," "continue," "estimate," "project," "intend," "designed" or other similar expressions to identify forward-looking statements. You should read statements that contain such words carefully because they discuss future expectations, contain projections of results of operations or of our financial condition, and/or state other "forward-looking" information. These statements also involve risks and uncertainties, including, but not limited to:

- o events, conditions and financial trends that may affect the Company's future plans and business strategy,
- o results of expectations and estimates as to prospective events, and
- o circumstances about which the Company can give no firm assurance.

Examples of types of forward-looking statements include statements on future levels of net revenue and cash flow, new product development, strategic plans and financing. These forward-looking statements involve risks and uncertainties that could cause actual results to differ materially from those projected or anticipated. Factors that might cause a difference include, but are not limited to:

- o general economic conditions in the markets the Company operates in;
- o success in the development and market acceptance of new and existing products;
- o dependence on suppliers, third party manufacturers and channels of distribution;
- o customer and product concentration;
- o fluctuations in customer demand;
- o the ability to obtain and maintain access to external sources of capital;
- o the ability to control costs;
- o overall management of the Company's expansion; and
- o other risk factors detailed from time to time in the Company's filings with the Securities and Exchange Commission.

We believe it is important to communicate our expectations of future performance to our investors. However, events may occur in the future that we

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are unable to accurately predict, or that we cannot control. Any forward-looking statement speaks only as of the date the statement was made, and the Company undertakes no obligation to update any forward-looking statement to reflect events or circumstances after the date the statement was made. Because it is not possible to predict every new factor that may emerge, forward-looking statements should not be relied upon as a prediction of actual future financial condition or results. When considering our forward-looking statements, keep in mind the risk factors and other cautionary statements in this Annual Report on Form 10-K. The risk factors noted in this section and other factors noted throughout this prospectus provide examples of risks, uncertainties and events that may cause our actual results to differ materially from those contained in any forward-looking statement. If one or more of these risks or uncertainties materialize, or if underlying assumptions prove incorrect, actual outcomes may vary materially from those forward-looking statements included in this Annual Report on Form 10-K. The terms "we," "our" and "us" and similar terms refer to the Company and its consolidated subsidiaries, not to any individual or group of individuals.

3

### OVERVIEW

TeraForce Technology Corporation, through its wholly-owned subsidiary, DNA Computing Solutions, Inc. ("DNA-CS"), designs, develops, produces and sells high-density, high-capacity embedded computing platforms and systems. Embedded computing generally refers to the physical integration of computing nodes (microprocessor and memory) into a host system or application. These nodes are often deployed in arrays. Embedded computing platforms and systems are widely applied in a number of industries including communications, medical imaging, seismic processing, industrial control and defense electronics. Although we have sold these products into a number of these industries, our primary focus is in defense electronics; therefore, we refer to this as our Defense Electronics Business. Prior to 2001 this business was referred to as the digital signal processor ("DSP") business. In 2002, all of our net revenues related to the defense electronics business.

Prior to 2002, we were also involved in providing design engineering services through a wholly-owned subsidiary, DNA Enterprises, Inc. ("DNA"), and in designing and producing telecommunications equipment through other wholly-owned subsidiaries. (See Item 1- Business- Prior Operations.)

### PRODUCTS

Embedded computing products, such as ours, are used for applications in which there is a need for high-density and high-capacity computing, especially in environments where limiting space, weight and power consumption are important considerations. Examples of defense and intelligence gathering applications that utilize embedded computing products include the following:

- o Airborne radar
- o Signal intelligence
- o Unmanned aerial vehicles (UAV's)
- o Automated fire control
- o Ground based radar
- o Image processing
- o Smart munitions
- o Battlefield control

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- o Airborne surveillance
- o Electronic countermeasures
- o Ship based radar
- o Submarine based sonar
- o Satellite communications
- o Infrared search and tracking
- o Ship based sonar
- o Missile interception

Our products are organized in the following broad categories:

DSP Products - DSP products consist of single-board computers utilizing digital signal processors produced by Texas Instruments Inc. These products are produced in versions with one, two or four digital signal processors per board. The boards include both VME and PCI versions, which are industry standard terms and describe the manner in which electronic systems interconnect.

PowerPC Single Board Computers - PowerPC Single Board Computers products are VME single board computers with one, two or four processors per board. The microprocessors used in these products are the Motorola PowerPC(C) line of reduced instruction set or "RISC" processors. We also sell "ruggedized" versions of these products. "Ruggedized" products have been mechanically modified to withstand harsh operating environments such as temperature, shock and vibration.

Embedded Sub-Systems - Embedded Sub-Systems are products that comprise an entire element of a larger system. These elements may include a number of single board computers, deployed in arrays, as well as other system components and enclosures. We have developed a new product that we call Eagle to be used as an element in embedded sub-systems. Eagle is based on the Company's Matched Heterogeneous Array Topology ("MHAT") technology. We anticipate that the Eagle product will be available to customers in 2003.

WingSpan(TM) Software Suite - WingSpan is "middleware" that we provide with our products in order to enhance functionality and to facilitate the customer's development process. WingSpan is a suite of software that includes (a) a board support package to facilitate testing and integration into the operating system, (b) a

4

library of commonly used algorithms that have been optimized for our products and (c) tools to facilitate the development of application software or the porting of existing software to our products. We do not sell WingSpan separately from our hardware products. We do not supply the application software to be utilized on our products. The application software is generally designed to operate under certain commercially available operating systems, most often VX Works or Linux. Our products are generally offered in versions that will support either of these two operating systems, as well as certain others.

As of March 31, 2003, our backlog of orders for defense electronic products amounted to approximately \$3,200,000, as compared to approximately \$500,000 at March 31, 2002. Included in backlog are orders for products for which we have received a purchase order or similar commitment from the customer. Generally, purchase orders are received for products that are to ship within a relatively short period of time, usually 60 days or less. Of the backlog at March 31, 2003, approximately \$1,000,000 is not expected to ship during 2003 due to the customer's required delivery schedule. We consider the backlog to be an

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indicator, but not the sole predictor, of future revenue. A variety of conditions, both specific to the individual customer and generally affecting the customer's industry, may cause our customers to cancel, reduce or delay orders that were previously made or anticipated. We cannot assure the timely replacement of canceled, delayed or reduced orders. Significant or numerous cancellations, reductions or delays in orders by a customer or group of customers could materially adversely affect our business, financial condition and results of operations. Our backlog alone should not be relied upon as indicative of our revenues for any future period.

### MARKETS AND CUSTOMERS

Our customers are generally large prime defense contractors and subcontractors to the prime defense contractors. We also sell directly to governmental agencies and to value added resellers who combine our products with other system components for re-sale to the prime or subcontractors. Certain of our DSP products are sold through an OEM arrangement with a reseller. Sales to this reseller amounted to approximately 37% of consolidated net revenues for the year ended December 31, 2002.

Our sales and marketing activities are directed by in-house sales managers and we utilize a network of manufacturer's representatives in the United States. Most international sales prospects are handled through a U.K. based value added reseller. International sales have not been material to date.

The selection by a customer of our products for use in a particular system or program is referred to as a "design win." The sales cycle leading to a design win will often take a long time. We will usually provide a customer with a demonstration unit that they may evaluate and test. After the evaluation period ends, the customer will either return the unit or purchase it. If the potential customer determines that the initial evaluation is satisfactory, the customer will often purchase a limited number of units to use in the design, development and testing of the customer's larger system.

Even after a customer has elected to purchase our product, the customer will not usually purchase a significant number of units immediately. Although the production phase of a particular program may last several years and ultimately involve a significant number of units, the customer will usually only purchase the units it will need for a short period of time. At this stage, there are still a number of factors that will determine whether the customer purchases a significant number of products, and when these products are purchased. These factors include:

- o the suitability of our products for a particular application, including performance and cost issues;
- o the technical performance of the final system;
- o the customer's ability to fund the final system;
- o the performance of the customer's other suppliers for the final system; and
- o the overall development and integration of the system by the customer.

Sales are typically not made under long-term contracts, but instead are made under purchase orders.

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Historically, products similar to ours were often developed internally by the large defense contractors. However, beginning about eight years ago the Department of Defense implemented a program to force the contractors to utilize commercial off the shelf ("COTS") components wherever possible. This has fueled the growth in the Company's markets, and we anticipate that the growth will continue. We expect the growth in the COTS market to continue as legacy systems that were developed years ago are upgraded or replaced with systems with significant COTS content.

### COMPETITION

The market for our products is highly competitive and is characterized by rapidly changing technology and frequent product performance improvements. The market for our products in the defense electronics market is characterized by a number of competitors. These include Mercury Computer Systems, Inc., Radstone Technology, PLC, CSPI Multi Computer Division of CSP Inc., and DY4 Systems, a Force Computer business unit. Our competitors also include in-house design teams of large defense contractors. However, competition from in-house design teams has diminished in recent years because of the increased use of COTS products and the trend toward greater use of outsourcing. Despite this recent change, there can be no assurance that in house developments will not return as a major competitive force in the future. Increased use of in-house design teams by defense contractors may have a material adverse effect on our business, financial condition and results of operations.

All of the large defense contractors and majority of our other competitors, have substantially greater research and development resources, guaranteed long term supply capacity, marketing and financial resources, manufacturing capability and customer support organizations than we have. We believe our future ability to compete effectively will partially depend upon our ability to continue to improve product and process technologies, to develop new technologies that demonstrate performance advantages over our competitors, to adapt products and processes to changes in technology, to identify and adopt emerging industry standards and to adapt to our customer needs.

Most of our competitors have greater financial and other resources than we have. We may be operating at a cost disadvantage compared to those manufacturers who have greater direct buying power from component suppliers or who have lower cost structures. There can be no assurance that we will be able to compete successfully in the future with any of these competitors. In addition, there can be no assurance that competitive pressures will not result in price erosion, reduced margins, loss of market share or other factors that could have a material adverse effect on our business, financial condition and results of operations.

### MANUFACTURING

We use third party electronic manufacturing service ("EMS") providers to manufacture our products. Generally, we will acquire the components necessary for the manufacture of the product and provide the components to the EMS provider for assembly and initial testing. Completed units are normally then delivered to our facility in Richardson, Texas for final testing and shipment. Recently, we have shifted more of the product testing to the EMS providers. We expect to rely more on the EMS provider for product testing. We expect that moving the initial product testing to the EMS provider will allow us to use our existing operations infrastructure to produce higher sales volumes. We also expect that as production volumes increase and can be more accurately predicted, the EMS providers will also buy many of the components required for our products, which will allow us to use our resources in other ways.

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We usually use a particular EMS provider for a specific product family. A number of EMS providers are capable of producing our products; however, switching from one provider to another involves significant costs and risks related to product quality and timing.

Components are usually available from multiple sources. However, items such as processors and memory chips may be available from limited or sole sources. Historically, we have had to order some components a significant time in advance of the date we plan to use the components. Sometimes components may be discontinued by the manufacturer, requiring us to acquire a substantial supply or to alter our product design. These design changes can result in the obsolescence of other components in our inventory.

6

### INTELLECTUAL PROPERTY AND OTHER PROPRIETARY RIGHTS

We believe we have a substantial base of intellectual property, including software and hardware. We believe that factors such as technological and creative skills of our personnel, new product developments, frequent product enhancements, name recognition, and reliable product manufacturing are essential to establishing and maintaining a technology leadership position.

We rely on a combination of patent, copyright, trademark and trade secret laws to establish and protect our products' proprietary rights. In addition, we currently require our employees and consultants to enter into nondisclosure and assignment of invention agreements to limit the use of, access to and distribution of, proprietary information. There can be no assurance that our means of protecting our proprietary rights in the U.S. or abroad will be adequate. The laws of some foreign countries may not protect our proprietary rights as fully or in the same manner as do the laws of the U.S. Also, despite the steps we take to protect our proprietary rights, it may be possible for unauthorized third parties to copy or reverse engineer aspects of our products, develop similar technology independently or otherwise obtain and use information that we regard as proprietary. There can be no assurance that others will not develop technologies similar or superior to our technology or design around the proprietary rights we own.

Although we are not aware that our products infringe on the proprietary rights of third parties, there can be no assurance that others will not assert claims of infringement in the future or that, if made, such claims will not be successful. We may seek to obtain a license under a third party's intellectual property rights. There can be no assurance that a license will be available under reasonable terms or that a license will be available at all.

Litigation to determine the validity of any claims against the Company, whether or not such litigation is determined in favor of the Company, could result in significant expense to us and divert the efforts of our technical and management personnel from daily operations. In the event of any adverse ruling in any litigation regarding intellectual property, we may be required to pay substantial damages, discontinue the sale of infringing products, expend significant resources to develop non-infringing technology or obtain licenses to use infringing or substituted technology. The failure to develop, or license on acceptable terms, a substitute technology could have a material adverse effect on our business, financial condition and results of operations.

Litigation may also be necessary to enforce our patents and other intellectual property rights, to protect our trade secrets, and to determine the validity of and scope of the proprietary rights of others. Such litigation could



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result in substantial costs and diversion of resources and could have a material adverse effect on our business, financial condition or results of operations.

We currently hold 11 United States patents relating to telecommunications and computing technology and have 18 currently pending patents relating to telecommunications and computing technology. We seek to protect our software, documentation and other written materials under trade secret and copyright laws, which afford only limited protection. Patent positions frequently are uncertain and involve complex and evolving legal and factual questions. The coverage sought in a patent application may be denied or significantly reduced before or after the patent is issued. There can be no assurance that:

- o any patents from pending patent applications or from any future patent application will be issued,
- o the scope of any patent protection will exclude competitors or provide competitive advantages to us,
- o any of our patents will be held valid if subsequently challenged, or
- o others will not claim rights in or ownership of the patents and other proprietary rights held by us.

7

Because patent applications are confidential until patents are issued in the United States or corresponding applications are published in other countries, and because publication of discoveries in the scientific or patent literature often lags behind actual discoveries, we cannot be certain that we were the first to make the inventions covered by each of our pending patent applications or that we were the first to file patent applications for such inventions. In addition, there can be no assurance that competitors, many of which have substantial resources and have made substantial investments in competing technologies, will not seek to apply for and obtain patents that will prevent, limit or interfere with our ability to make, use or sell our products either in the United States or in international markets.

### EMPLOYEES

As of March 31, 2003 we had 48 full-time employees, of which fifteen were engaged in engineering and development, 11 were engaged in sales, marketing, and customer support, 11 were engaged in manufacturing operations, and 11 were engaged in administration and finance. None of our employees are represented by a labor organization. We have experienced no material work stoppages and believe we have a good relationship with our employees.

### PRIOR OPERATIONS

Our name was changed to TeraForce Technology Corporation on January 30, 2001, upon approval by its stockholders, from Intellect Communications, Inc. The Company was incorporated in Delaware on May 23, 1995. Its predecessor, Intellect Communications Systems Limited ("Intellect (Bermuda)") was incorporated under the laws of Bermuda in April 1980 and operated under the name Coastal International, Ltd. until September 1985 and as Challenger International Ltd. until December 1995. On December 4, 1997, the shareholders of Intellect (Bermuda) approved a merger proposal that reincorporated Intellect (Bermuda) to Delaware and resulted in Intellect (Bermuda) becoming a publicly traded corporation. The merger was

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effected on December 4, 1997.

### Engineering Design Services

Our engineering design services business was conducted through DNA, a 20-year old engineering design services organization located in Richardson, Texas that we acquired in 1996. Over its history DNA provided high-end engineering design services to both established companies and start-up organizations, primarily related to the telecommunications industry. During the course of 2001, DNA experienced a significant decline in the demand for its services. This was caused by the continued down-turn and uncertainty in the telecommunications business and the financing difficulties experienced by many start-up organizations. We determined that there was no longer adequate justification to continue to fund the costs associated with maintaining the DNA organization in light of the uncertainty in future demand for its services. Therefore, as of December 31, 2001 we commenced a plan to dispose of this business and on January 11, 2002 sold substantially all of the assets related to the design services business to Flextronics International, Ltd. ("Flextronics"). The operations related to the engineering design services business are treated as discontinued operations in the accompanying consolidated financial statements. (See Note 4 of the Notes to Consolidated Financial Statements - included in Item 8 - "Financial Statements and Supplementary Data.")

Effective with the sale of substantially all the assets of DNA to Flextronics we no longer provide contract engineering design services. These services had been provided on a time and material basis and the customer retained all rights to the developed intellectual property.

A variety of clients utilized our engineering design services, ranging from start-up ventures seeking to launch new products to large multi-national corporations looking to access key know-how for extending current product lines or introducing new products and services. The products we developed for these clients

8

ranged from compact circuit boards to multi-board systems. We marketed our services directly to prospects worldwide. Principal customers for our services included board manufacturers, telecommunications equipment vendors, semiconductor suppliers, and communications service providers. During 2001, three customers accounted for 65% of net revenue from engineering design services.

### Telecommunications Equipment

Prior to 2001, a major focus of our business was the development, design, production and sale of optical networking equipment for application in telecommunication networks. We had specifically focused on our OmniLynx product line. The business related to OmniLynx, and predecessor products SonetLynx(C) and FibreTrax(C), was conducted through a wholly-owned subsidiary, Intellect Network Technologies Company ("INT"). During 2000, opportunities in the telecommunications market began to decline dramatically. As a result of this, we determined that the long-term strategic value of the OmniLynx product line was not as promising as the Company's other businesses and implemented a plan to materially curtail the operations of INT and to sell INT or substantially all of the assets related to the OmniLynx product line. In February 2001, a potential sale of the OmniLynx business to a company in the United Kingdom did not materialize, and we terminated the majority of the employees of INT. In August 2001, we completed a sale of the OmniLynx product line and substantially all of

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the related assets to a newly formed entity, Intellect Technologies, Inc. ("ITI"). ITI is a corporation initially owned 67% by Singapore Technology Electronics, Ltd. ("STE") and 33% by the Company. In February, 2003 STE made an additional investment in ITI increasing its ownership to approximately 78% and decreasing our ownership to approximately 22%. ITI is continuing with the active production and sale of the OmniLynx product line, primarily for use in purpose-built network applications such as highway systems, rail systems, airport communication systems and pipeline networks. We have minority board of director representation in ITI and have no involvement in day-to-day operations. We account for its investment in ITI using the equity method of accounting. (See Note 5 of the Notes to Consolidated Financial Statements - included in Item 8 - "Financial Statements and Supplementary Data.")

During 2001, we continued development activities on a new generation of optical networking equipment through another wholly-owned subsidiary, Aegean Networks, Incorporated ("Aegean"). We funded all development activities, but had sought strategic investors to provide funding in order to allow full-scale development. We had received indications of interest from a number of potential strategic investors, but the uncertainties surrounding the recovery of markets for telecommunications equipment and other economic factors resulted in no firm commitments to provide funding for Aegean. In the fourth quarter 2001 we curtailed development activities related to Aegean and in the second quarter of 2002 ceased all development activity related to Aegean.

During 2001, we launched development activities related to a line of products to provide high-density, telecommunications-grade solutions to the Internet server and storage markets. These activities were conducted through a wholly-owned subsidiary, Centauri NetSystems Corporation ("Centauri"). Economic and industry conditions made obtaining third party financing for this project difficult and in March, 2002 we suspended all development activity related to the Centauri project.

See Item 7 - "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a discussion of research and development expenditures over the past three years. See Note 16 of the Notes to Consolidated Financial Statements - included in Item 8 - "Financial Statements and Supplementary Data."- for information regarding revenue and profits by segment and geographic region.

### RISK FACTORS

In addition to the other information in this Annual Report on Form 10-K, the following are risk factors that should be considered in evaluating the Company and an investment in our common stock. The trading price of the common stock could decline due to any of these risks, and investors in our common stock could lose all or part of their investment.

9

#### RISK FACTORS RELATED TO OUR BUSINESS

A Number of Factors Could Cause Operating Results to Fluctuate Significantly.

Our revenues and operating results in any reporting period may fluctuate significantly due to a variety of factors, including:

- o changes in the price or availability of components for our products;

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- o the mix of products sold to the defense electronics markets and other markets;
- o our ability to introduce new technologies and features ahead of competitors;
- o the timing and size of orders we receive from customers;
- o fluctuations in demand for our products;
- o delays in testing by customers;
- o production delays due to quality problems with outsourced components;
- o changes in our pricing policies or the pricing policies of our competitors;
- o changes in customers' requirements, including changes or cancellations of orders from customers;
- o manufacturing and shipment delays and deferrals;
- o our ability to efficiently produce and ship orders promptly on a price-competitive basis;
- o announcements or introductions of new products by our competitors;
- o changes in general economic conditions as well as those specific to the defense electronics industry.

Current economic conditions have made it more difficult to make reliable estimates of future revenues. Fluctuations in our revenue can lead to greater fluctuations in our operating profits. In addition, we expect to incur significant research and development expenses as we develop products to serve our markets, all of which are subject to rapidly changing technology, frequent product performance improvements and evolving industry standards. The ability to deliver superior technological performance on a timely and cost effective basis is a critical factor in securing design wins for future generations of defense electronics systems. Significant research and development spending by the Company does not ensure that our products will be designed into a customer's system. Because future production orders are usually contingent upon securing a design win, our operating results may fluctuate due to either obtaining or failing to obtain design wins for significant customer systems.

We Have Incurred Significant Losses in the Past and Are Not Currently Profitable.

We are not currently profitable. In 2002, 2001 and 2000 we have incurred net losses of \$4,350,000, \$21,549,00 and, \$29,572,000, respectively. These losses have been funded from borrowings under credit facilities and sales of common stock. It is not certain when we will become profitable. The ability to become profitable will depend, in part, on our ability to increase net revenue from sales of defense electronics products. Because of this we have experienced a lack of liquidity from time to time, and therefore have not paid our obligations in a timely manner in some cases. This in turn has impacted our ability to operate our business. If our need for capital exceeds available resources, there can be no assurance that additional capital will be available through public or private equity or debt financing.

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Debt Service Obligations May Adversely Affect Our Cash Flow and We May Be Unable to Repay the Debt On Time.

We have approximately \$4,900,000 of debt outstanding. Of this amount, approximately \$4,000,000 is due by December 31, 2003. It is unlikely that we will be able to generate sufficient cash flow from operations to repay all of this debt when it comes due. While we intend to restructure or refinance this debt, there is no assurance that we will be able to do so in a timely manner. Even if we are able to refinance or restructure this debt, we may still be subject to substantial interest and principal repayment obligations.

10

Our Auditors Have Expressed Doubt as to Our Ability to Continue as a Going Concern.

Our independent certified public accountants have added an explanatory paragraph to their audit opinion issued in connection with our consolidated financial statements. The opinion states that our ability to continue as a going concern is uncertain due to the amount of debt that is due in 2003, the uncertainty of refinancing or restructuring the debt and our history of operating losses. Our consolidated financial statements do not include any adjustments that might result from the outcome of this uncertainty. These adjustments might include changes in the possible future recoverability and classification of assets or the amounts and classification of liabilities that might result from the outcome of this uncertainty.

We May Not Be Able to Successfully Complete Development and Achieve Customer Acceptance of New Defense Electronics Products.

We must continually enhance our products. Certain enhancements to our products are in the development phase and are not yet ready for commercial manufacturing or deployment. The successful development and deployment of these products is subject to substantial risk. The development of these products, from laboratory prototype to customer trial, and subsequently to general availability, involves a number of steps including the following:

- o completion of product development;
- o the qualification and multiple sourcing of critical components;
- o validation of manufacturing methods and processes;
- o extensive quality assurance and reliability testing, and staffing of testing infrastructure;
- o validation of embedded software; and
- o establishment of systems integration and systems test validation requirements.

Each of these steps in turn presents serious risks of failure, rework or delay. Any one of these setbacks could decrease the speed and scope of product introduction and marketplace acceptance of the product. In addition, unexpected intellectual property disputes, failure of critical design elements, and other setbacks may delay or even prevent the introduction of these products. A lack of working capital may also negatively impact our ability to enhance our products in a timely manner.

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Additionally, the markets for our new products may be undeveloped. The commercial acceptance of these types of products is uncertain. We cannot assure you that our sales and marketing efforts for these products will be successful.

We are a Party to Lawsuits and May Be Subject to Other Contingent Liabilities.

We are a named party in a lawsuit and may be subject to significant other contingent liabilities. Defending these matters may require a substantial amount of our resources, and any judgments may materially affect our financial condition and results of operations. For more information see" Item 3 - Legal Proceedings."

Our Failure to Quickly Adopt to Rapidly Changing Competitive and Economic Conditions Could Have a Material Adverse Effect on Our Business and Results of Operations.

We operate in a rapidly changing and competitive and economic environment. Our future success will depend, in part, on our ability to enhance our current products and to develop new products on a timely and cost-effective basis that respond to technological developments and changing customer needs. The markets for sophisticated technology are constantly undergoing rapid competitive and economic changes. The full scope and nature of these changes are difficult to predict. The defense electronics market, in particular, demands constant technological improvements as a means of gaining military advantage. We believe that technological change will continue to attract new entrants to our market. Industry consolidation among competitors may increase their financial resources, which may allow our competitors to reduce their prices. This would require us to reduce the prices of our products or risk losing market share.

11

We Have a Limited Customer Base.

We are dependent on a small number of customers for a large portion of our revenues. In fiscal 2002, three customers accounted for 65% of our revenues. Customers in the defense electronics market purchase our products in connection with government programs that may have limited duration, leading to fluctuating sales to any particular customer in the defense electronics market from year to year. A significant decrease in our sales to any of our major customers, or the loss of any of our major customers, would have a material adverse effect on our business, financial condition and results of operations. In addition, our revenues are largely dependent upon the ability of our customers to develop and sell products and systems that incorporate our products. There is no assurance that our customers will not experience financial or other difficulties that could adversely affect our operations and, in turn, our results of operations.

We May Not Be Successful if We Do Not Attract New Customers.

Our future success will depend on our attracting additional customers. The growth of our customer base could be adversely affected by:

- o customer unwillingness to implement our defense electronics technology;
- o any delays or difficulties that we may incur in completing the development, introduction and production manufacturing of our planned products or product enhancements;

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- o new product introductions by our competitors;
- o any failure of our products to perform as expected;
- o any difficulty we may incur in meeting customers' delivery, installation or performance requirements; or
- o customer concerns over our financial condition.

We Must Attract, Retain and Motivate Key Technical and Management Personnel in a Competitive Market in Order to Sustain and Grow Our Business.

Our success depends to a significant extent upon key technical and management employees. Competition for highly qualified employees can be intense and the process of locating key technical and management personnel with the required combination of skills and attributes can be lengthy and expensive. There can be no assurance that we will be successful in retaining our existing key personnel or in attracting and retaining the additional employees we may require. We must continue to recruit, train, assimilate, motivate, and retain qualified managers and employees to manage our operations effectively. If we do not successfully recruit, hire and retain key employees, we may be unable to execute our business plan effectively and our results of operations could be significantly adversely affected.

We May Be Unable to Secure Necessary Components and Support Because We Depend Upon a Limited Number of Third-Party Manufacturers and Support Organizations.

We depend on a limited number of suppliers for components of our products, as well as for equipment used to design and test our products. Certain components used in our products are only available from a single source or limited number of vendors. Some of the sole source and limited source vendors are companies who, from time to time, allocate parts to equipment manufacturers due to market demand for components and equipment. Many of our competitors are much larger and may be able to obtain priority allocations from these shared vendors, thereby limiting or making our sources of supply unreliable for these components. Any delay in component availability for any of our products could result in delays in deployment of these products and in our ability to recognize revenues. Suppliers may be concerned regarding our financial condition and therefore may be unwilling to sell components to us, or to grant trade credit to us.

12

If we are unable to obtain a sufficient supply of components from alternative sources, reduced supplies and higher prices of components will significantly limit our ability to meet scheduled product deliveries to customers. A delay in receiving certain components or the inability to receive certain components could harm our customer relationships and our results of operations.

Failures of components affect the reliability and performance of our products, can reduce customer confidence in our products, and may adversely affect our financial performance. From time to time, we have experienced delays in receipt of components and have received components that do not perform according to their specifications. Any future difficulty in obtaining sufficient and timely delivery of components could result in delays or reductions in product shipments that could harm our business. In addition, a consolidation

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among suppliers of these components or adverse developments in their businesses that affect their ability to meet our supply demands could adversely impact the availability of components that we depend on. Delayed deliveries from these sources could adversely affect our business.

Our defense electronics products are manufactured by a limited number of third-party manufacturers. If we were required to find alternative third-party manufacturers, we may be forced to incur significant costs and risks. There is no assurance that the alternative manufacturers could produce our products with quality or costs comparable to the existing manufacturers. In addition, the transfer of the manufacturing process to an alternative provider could result in significant delays that could cause us to miss deadlines imposed by our customers.

### Defense Electronics Products Business Is Subject to Special Risks.

We expect that the majority of our net revenues in the future will come from the sale of our defense electronics products. We supply products to sub-contractors and prime contractors whose ultimate customer is often an agency of the United States government. Reductions in government spending on programs that incorporate our products could have a material adverse effect on our business, financial condition and results of operations. The contracts with the United States government are subject to special risks including the following: delays or cancellations of funding for programs; ability of the government to unilaterally cancel the contract; reduction or modification as a result of budgetary restraints or political changes; and other factors not under the control of us or the prime contractor.

The Failure to Develop and Introduce New Products That Meet Changing Customer Requirements and Address Technological Advances Would Limit Our Ability to Sell Our Products and Services.

New product development often requires long-term forecasting of market trends, and development and implementation of new technologies. If we fail or are late to respond to new technological developments, market acceptance of our products may be significantly reduced or delayed. The markets we participate in are characterized by rapidly changing technology, evolving industry standards, changes in end user requirements, and frequent new product introductions and enhancements. The introduction of products embodying new technologies or the emergence of new industry standards can render our existing products obsolete or unmarketable. There can be no assurance that we will be able to develop and introduce new products ahead of our competitors, or that our products will not be rendered obsolete.

### We May Not Be Able to Secure an Adequate Number of Design Wins.

Before buying our products, a customer will evaluate our products, and those of our competitors, as a part of designing a larger system. When a product is selected by a customer to be utilized in its system we refer to it as a "design win." The design-win process is typically lengthy and expensive, and there can be no assurance that we will be able to continue to meet the product specifications of our customers in a timely and adequate manner. In the defense electronics market, military planners have historically funded significantly more design projects than actual deployments of new equipment. There can be no assurance that we will secure an adequate number of design wins. Failure to secure future design wins could have a material adverse effect on our business, financial condition and results of operations.



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### Product Performance Problems Could Limit Sales Prospects.

The production of new products with high technology content involves occasional problems as the technology and manufacturing methods mature. If significant reliability, quality or network monitoring problems develop, including those due to faulty components, a number of negative effects on our business could result, including:

- o costs associated with reworking the manufacturing processes;
- o high service and warranty expenses;
- o high inventory obsolescence expense;
- o high levels of product returns;
- o delays in collecting accounts receivable;
- o reduced orders from existing customers; and
- o declining interest from potential customers.

Although we maintain accruals for product warranties, actual costs could exceed these amounts. From time to time, there will be interruptions or delays in the activation of products at a customer's site. These interruptions or delays may result from product performance problems or from aspects of the installation and activation activities, some of which are outside our control. If we experience significant interruptions or delays that cannot be promptly resolved, confidence in our products could be undermined, which could have a material adverse effect on operations.

### Failure to Protect Our Intellectual Property Will Adversely Affect Our Ability to Compete in the Industry and Our Profitability.

We rely on a combination of patents, copyright, trademark and trade secret laws, and restrictions on disclosure to protect our intellectual property. We also enter into confidentiality or license agreements with our employees, consultants and corporate partners and control access to and distribution of our software, documentation and other proprietary information. These intellectual property protection measures may not be sufficient to prevent wrongful misappropriation of our technology. In addition, these measures will not prevent competitors from independently developing technologies that are substantially equivalent or superior to our technology. The laws of many foreign countries do not protect intellectual property rights to the same extent as the laws of the United States. Failure to protect proprietary information could result in, among other things, loss of competitive advantage, loss of customer orders and decreased revenues. Monitoring the unauthorized use of our products is difficult and we cannot be certain that the steps we have taken will prevent unauthorized use of our technology, particularly in foreign countries where the laws may not protect our proprietary rights as fully as in the United States. If competitors are able to use our technology, our ability to compete effectively could be impaired. This litigation could result in substantial costs and diversion of resources and may not ultimately be successful.

### We May Be Subject to Intellectual Property Infringement Claims That Are Costly to Defend and Could Limit Our Ability to Use Some Technologies in the Future.

Like other participants in our industry, we expect that we will continue to be subject to infringement claims and other intellectual property disputes as competition in the marketplace continues to intensify. In the

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future, we may be subject to litigation and may be required to defend against claimed infringements of the rights of others or to determine the scope and validity of the proprietary rights of others. Any such litigation could be costly and divert management's attention from operations. In addition, adverse determinations in such litigation could:

- o result in the loss of our proprietary rights to use the technology;
- o subject us to significant liabilities;
- o require us to seek licenses from third parties;
- o require us to redesign the products that use the technology;  
or
- o prevent manufacturing or sale of our products that employ the technology.

14

If we are forced to take any of the foregoing actions, our business may be seriously harmed.

**We May Be Unable to License Third-Party Technology at a Reasonable Cost.**

From time to time we may be required to license technology from third parties to develop new products or product enhancements. We cannot ensure that third-party licenses will be available to us on commercially reasonable terms. The inability to obtain any third-party license required to develop new products and product enhancements could require us to obtain substitute technology of lower quality or performance standards, or to license such technology at a greater cost. Both licensing inferior technology at a reasonable cost and licensing necessary technology at a higher cost could seriously harm the competitiveness of our products.

**Our Products Are Subject to Government Regulation.**

The export of our products and related technology may be subject at times to regulation and restriction by the Department of Commerce. Because our products are utilized in defense and intelligence gathering related applications, in some cases the export of our products and related technology may be subject to further regulation and restriction by the Department of State. Sales to foreign countries have not been material to date, but the export controls could limit our ability to sell our products outside the United States or could delay such sales in the future. We also may be required to spend substantial time and resources in order to comply with the regulations and restrictions. We could be subject to fines if we fail to properly comply with these regulations.

In addition, our business and operating results may also be adversely affected by the imposition of certain tariffs, duties and other import restrictions on components that we obtain from non-domestic suppliers or by the imposition of export restrictions on products that we sell internationally. We do not believe we have material exposure to environmental laws. Changes in current or future laws or regulations, in the United States or elsewhere, could materially and adversely affect our business and results of operations.

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### RISK FACTORS RELATED TO THE SECURITIES MARKET

#### Our Common Stock Is Subject to Price Volatility.

The price of our common stock is volatile. Fluctuations in operating results, such as revenues or operating results being below the expectations of public market analysts and investors, may cause additional volatility in the price of the common stock. In such event, the market price of our common stock could decline significantly. A significant decline in the market price of the common stock could result in litigation that could also result in increased costs and a diversion of management's attention and resources from operations.

#### There May Not Be a Liquid Market for our Common Stock.

Our common stock currently is traded on the OTC Bulletin Board operated by Nasdaq. This market generally has less liquidity than the Nasdaq SmallCap Market and certain institutional investors are precluded from buying stock in this market. There can be no assurance that our investors will be able to sell the Common Stock at prices and times that are desirable.

#### Additional Capital May Dilute Current Stockholders.

In order to provide capital for the operation of our business we may enter into additional financing arrangements. These arrangements may involve the issuance of new common stock, preferred stock that is convertible into common stock, debt securities that are convertible into common stock or warrants for the purchase of common stock. Any of these items could result in a material increase in the number of shares of

15

common stock outstanding which would in turn result in a dilution of the ownership interest of existing common shareholders. In addition these new securities could contain provisions, such as priorities on distributions and voting rights, which could affect the value of our existing common stock.

#### We May Propose a Reverse-Split of Our Common Stock.

In order to reduce the number of shares outstanding, increase the trading price of our common stock and possibly attract additional groups of investors we may at some time in the future propose a reverse-split of our common stock. Such a proposal would require the approval of the majority of the outstanding shares of voting stock to be implemented. There can be no assurance that a reverse split would have the intended effect and therefore it could dilute the value of our common stock.

### ITEM 2 - PROPERTIES

All of our facilities are leased and are located in Richardson, Texas. We lease approximately 50,000 square feet, and we currently utilize approximately 25,000 feet. These facilities include production, engineering, sales, marketing and administrative offices and we believe it to be suitable for our current operations.

### ITEM 3 - LEGAL PROCEEDINGS

We are involved in various legal proceedings and claims arising in the ordinary course of business.

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Shareholder Action. A shareholder class action lawsuit was filed in the U. S. District Court for the Northern District of Texas in November 1999 on behalf of all persons and entities who purchased the Company's common stock during the period between February 24, 1998 and November 17, 1998. The named defendants include the Company and certain former and present officers and directors of the Company. The complaint alleges that the defendants violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder by making false and misleading statements concerning the Company's reported financial results during the period, primarily relating to revenue recognition, asset impairment and capitalization issues. The plaintiffs seek monetary damages, interest, costs and expenses. In March 2001, our motion to dismiss the case was denied. In December 2002, the Court denied the plaintiffs' motion for class certification. The plaintiffs appealed this ruling to the 5th Circuit Court of Appeals and in March 2003 the appellate court refused to hear the appeal. Certain motions are now pending before the U. S. District Court to determine the extent of individual plaintiffs' claims in this matter.

United Pacific Insurance Company, an affiliate of Reliance Insurance Company, the insurance carrier that provides the primary \$2 million of insurance coverage for this matter, has been ordered liquidated by the insurance commissioner of the State of Pennsylvania. At this time we are unable to determine what amounts, if any, may be available under this insurance coverage and it could be some period of time before we can determine this. We received \$300,000 related to this claim from guarantee funds maintained by the insurance commissioner of the State of Texas. If we don't receive the full benefit of this coverage, there could be a material adverse impact on the Company.

Savage Matters. We are contingently liable for certain potential claims that arise out of Savage Arms, Inc., a manufacturer of sporting bolt action rifles ("Savage Arms"). We sold Savage Arms to the Savage Sports Corporation ("Savage Sports"), and pursuant to the Stock Purchase Agreement we executed on October 3, 1995, we agreed to indemnify Savage Sports for certain product liability claims, environmental clean-up costs and other contractual liabilities, including certain asserted successor liability claims, that Savage Sports incurred because of Savage Arms.

A firearms product liability lawsuit was filed in Alaska Superior Court ("the Taylor litigation"). Western Auto Supply Co. is a defendant in the Taylor litigation, and has settled the claim for \$5 million. Western Auto Supply Co. asserted a third-party claim against Savage Sports seeking indemnification in the amount of the settlement, plus attorneys' fees and related costs. During 2002 Savage reached a settlement on this matter pursuant to which it agreed to pay a total of \$1,000,000 over a period of four years. Savage then sought indemnification from the Company for these amounts.

In October, 2002 we reached an agreement in principle with Savage regarding this and indemnification matters, including the balance of amounts due Savage pursuant to a settlement agreement reached in January, 2001. Under this agreement we have agreed to pay Savage a total of \$1,575,000, which includes the remaining balance of the prior settlement, over a four year period. Savage has agreed to fund the cost of insurance programs that are expected to respond to any other such claim that may arise in the future. We are aware of no such claims and Savage has advised us that they are not aware of any additional claims. We recorded a charge of \$1,520,000 related to this matter in the third quarter of 2002.

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SCI Action. In July 2002, the Company's wholly-owned subsidiary, DNA Enterprises, Inc. ("DNA") filed suit against SCI Technology, Inc. and SCI Systems, Inc. (collectively "SCI") for breach of contract and fraudulent inducement. The suit alleges that SCI has failed to pay DNA royalties related to a Licensing Agreement involving the joint development of certain circuit card assembly ("CCA") boards. The suit is currently pending in United States District Court for the Northern District of Texas. In August 2002, SCI filed a counter claim against DNA alleging breach of contract, fraudulent inducement and negligent misrepresentation. In April 2003, the Company and SCI reached a settlement of these matters whereby all claims will be dismissed and SCI will pay the Company an undisclosed amount. This settlement will not have a material effect on the Company's financial condition or results of operations.

### ITEM 4 - SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

During the quarter ended December 31, 2002, no matters were submitted to a vote of our stockholders.

17

## PART II

### ITEM 5 - MARKETS FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Our common stock is traded on the OTC Bulletin Board operated by Nasdaq under the symbol "TERA." Prior to June 19, 2001, our common stock was traded on the Nasdaq SmallCap Market. Our common stock was de-listed from the Nasdaq SmallCap Market on June 19, 2001 for failure to maintain a minimum bid price of \$1.00. On January 30, 2001, we changed our trading symbol to "TERA" from "ICOM" to reflect our name change to TeraForce Technology Corporation from Intellect Communications, Inc.

The high and low bid prices for our common stock for each full quarter of the last two fiscal years, as reported on the OTC Bulletin Board and Nasdaq, are as follows (these prices are inter-dealer prices, without mark-up, mark-down or commission included and may not necessarily represent actual transactions):

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Quarter period ended -----	High -----	Low -----
2002		
March 31	0.240	0.080
June 30	0.360	0.090
September 30	0.240	0.100
December 31	0.260	0.100
2001		
March 31	1.438	0.344
June 30	0.960	0.330
September 30	0.420	0.150
December 31	0.200	0.080

As of March 31, 2003, there were approximately 45,000 owners of record of our common stock, including nominee holders such as banks and brokerage firms who hold shares for the benefit of beneficial owners of our common stock.

The closing bid price of our common stock on the OTC Bulletin Board on March 31, 2003 was \$0.195.

### DIVIDEND POLICY

No dividends were paid on any class of equity in 2002 or 2001. We do not currently plan to pay any dividends on our common stock. Delaware law would restrict our ability to pay any dividends on our common stock.

### SECURITIES SOLD

From October, 2002 through March, 2003 we issued a total of 29,333,333 of our common stock in a series of private placements. We received proceeds totaling \$3,520,000 from these sales. We used \$2,000,000 of this amount to repay debt outstanding under a bank credit facility and the balance for working capital.

These sales of common stock were exempt from registration pursuant to Section 4(2) of the Securities Act of 1933 (the Securities Act), as amended, and pursuant to Rule 506 of Regulation D of the Securities Act. A Rule 506 exemption was available for these sales because the Company sold only to accredited investors; the Company did not solicit or advertise the sales; a registered restrictive legend was placed on each certificate issued describing the restrictions against resale; and a Form D was filed with the Securities and Exchange Commission and in each state where the individual investors reside.

### ITEM 6 - SELECTED FINANCIAL DATA

The following tables set forth certain historical consolidated financial data for the Company.

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	Years ended December 31,			
	2002	2001*	2000*	
	(\$ in thousands, except per share)			
<b>STATEMENT OF OPERATIONS:</b>				
Net revenues	\$ 5,036	\$ 6,822	\$ 11,748	\$
Operating loss	\$ (7,235)	\$ (16,724)	\$ (29,062)	\$
Loss from continuing operations	\$ (2,830)	\$ (17,181)	\$ (28,790)	\$
Loss from discontinued operations	(1,520)	(3,412)	(782)	
Loss on disposal of discontinued operations	--	(956)	--	
Extraordinary item - loss	--	--	--	
Net loss	\$ (4,350)	\$ (21,549)	\$ (29,572)	\$
Loss allocable to common stockholders	\$ (4,350)	\$ (21,549)	\$ (30,538)	\$
Basic and diluted loss per share:				
Continuing operations	\$ (0.03)	\$ (0.20)	\$ (0.36)	\$
Extraordinary item	--	--	--	
Discontinued operations	(0.02)	(0.05)	(0.01)	
Net loss	\$ (0.05)	\$ (0.25)	\$ (0.37)	\$
Weighted average shares (thousands)	93,581	86,354	83,229	
<b>BALANCE SHEET:</b>				
<b>ASSETS:</b>				
Current assets	\$ 4,918	\$ 8,105	\$ 18,805	\$
Excess of cost over assets of companies acquired	--	--	3,354	
Other long-term assets	1,806	2,091	1,845	
Total assets	\$ 6,724	\$ 10,196	\$ 24,004	\$
<b>LIABILITIES &amp; STOCKHOLDERS' EQUITY:</b>				
Current liabilities including current maturities of long-term debt	\$ 7,358	\$ 11,807	\$ 4,593	\$
Long-term liabilities	2,000	--	--	
Stockholders' equity (deficit)	(2,634)	(1,611)	19,411	
	\$ 6,724	\$ 10,196	\$ 24,004	\$

\*Certain amounts have been reclassified to conform to current classifications.

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### ITEM 7 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion should be read in conjunction with the Consolidated Financial Statements and their related notes found on pages 33 through 55 of this Form 10-K. Except for historical facts, all statements included in the following discussion about our financial position, business strategy, and plans of management for future operations are forward looking statements. Forward-looking statements involve risks and uncertainties and actual results could materially differ from those expressed in or implied by the forward-looking statements.

#### RESULTS OF OPERATIONS

The following discussions of revenues, gross profit (loss), engineering and development expenses, and selling and administrative expenses do not include amounts related to our engineering design services business for any period presented.

The following table shows the revenue and gross profit (loss) for our products:

	Years Ended December 31,		
	2002	2001	2000
	(\$ in Thousands)		
<b>NET REVENUE:</b>			
Defense electronic products	\$ 5,036	\$ 4,195	\$ 3,599
Optical networking equipment	--	2,368	6,994
Other	--	259	1,155
	\$ 5,036	\$ 6,822	\$ 11,748
<b>GROSS PROFIT (LOSS):</b>			
Defense electronic products	\$ 1,702	\$ (424)	\$ 375
Optical networking equipment	--	--	(1,813)
Other	--	(715)	(67)
	\$ 1,702	\$ (1,139)	\$ (1,505)

#### Net revenues

Net revenue from the sale of defense electronics products increased 20% between 2001 and 2002 and 17% between 2000 and 2001. The increased product sales reflect our continued penetration of the market for these products and customer acceptance of our products. The majority of the increase in net revenues results from sales of our PowerPC-based product line. We have sold these products into an increasing number of programs; however, these programs have not yet reached their full production phase. In the full production phase, orders tend to be larger and more predictable. In the first quarter of 2003 we have received new orders, or "bookings," for our products amounting to approximately \$4,000,000. We believe this is an indication of continuing increased demand for these products.

While the majority of our defense electronics products are utilized in



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defense and intelligence related applications, they have also been utilized in commercial telecommunications applications. The severe downturn in the telecommunications industry resulted in a sharp decline in demand for our products in these applications. Therefore, revenues in 2001 from sales to the telecommunications market were less than we had anticipated. Revenue from sales of products for defense and intelligence related applications in 2001 was also less than we had expected. Prior to September 11, 2001, funding for various defense and intelligence related programs had been delayed pending the Bush administration's assessment of the military and its priorities. This resulted in delays in new orders throughout the industry. The events of September 11, 2001 compounded these delays.

20

Net revenue from optical networking equipment relates almost exclusively to the OmniLynx product line. In August 2001, we sold essentially all of the assets related to the OmniLynx product line to ITI, of which we continue to own a portion. Prior to the completion of this transaction we had significantly curtailed the OmniLynx operations. Accordingly, revenues from optical networking equipment declined significantly in 2001. Subsequent to August 2001, we had no revenues from optical networking equipment. The decision to dispose of the OmniLynx related assets and operations was made in reaction to rapidly changing market conditions that resulted in very significant declines in the actual and expected demand for the OmniLynx product line. A significant factor in our decision to curtail the OmniLynx operations was the decline in demand from small to medium sized competitive local exchange carriers, which had been one of our target markets.

Other revenues consist primarily of the voice and data switching products used in air traffic control applications and video network products, which we no longer sell.

Gross profit (loss)

Our gross profit from sales of defense electronics products increased because of higher sales levels and certain fixed production costs. Furthermore, this increase reflects higher sales of our PowerPC-based products that tend to produce higher gross margins than our other products. In the fourth quarter of 2002 we recorded a charge of approximately \$270,000 to adjust the carrying value of component and finished goods inventories. This adjustment resulted primarily from our on-going analysis of component obsolescence.

The gross loss related to defense electronics products for 2001 includes approximately \$750,000 of charges related to the adjustment of the carrying value of component and finished goods inventories. These charges resulted from an evaluation of current component costs and the adjustment of certain finished goods to net realizable value. Without the effect of these charges, the gross profit related to defense electronic products in 2001 amounted to approximately \$326,000, as compared to \$375,000 in 2000. The decline in gross profit, despite the increase in related net revenue between the periods, reflects the costs of certain fixed infrastructure established to handle higher production levels expected in the future, higher testing and re-work costs in the early phases of PowerPC-based product production and higher unit costs related to relatively low volume production runs during this early phase.

As of December 31, 2000, our assets related to the OmniLynx product line, including inventories, were reduced to estimated net realizable value. Therefore, revenue from the sales of such OmniLynx products in 2001 produced no

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gross profit or loss. The gross loss in 2001 represents manufacturing and production overhead costs incurred in 2001. During 2000, gross loss from optical networking equipment reflects the effect of relatively low production levels for our manufacturing operations. The lower production levels resulted in unabsorbed overhead of approximately \$1,400,000 in 2000. The amortization of technology costs and capitalized software development costs of approximately \$1,300,000 in 2000 also affected the gross loss.

### Engineering and development expenses

Engineering and development ("E&D") expense decreased to \$3,065,000 in 2002 from \$5,096,000 in 2001 and \$5,258,000 in 2000. In 2000, certain amounts of software development costs were capitalized. Including those capitalized amounts, the total E&D expenditures were \$6,153,000 in 2000. Total E&D expense by product line were distributed as follows:

	Years ended December 31,		
	2002	2001	2000
	(\$ in Thousands)		
Defense electronic products	\$ 2,803	\$ 2,286	\$ 1,722
Optical networking products	84	1,336	3,504
Other	178	1,474	32
	-----	-----	-----
	\$ 3,065	\$ 5,096	\$ 5,258
	-----	-----	-----

21

E&D costs related to our defense electronics products have increased in each of the past three years. This increase reflects our on-going product development efforts. Activities in 2000 and 2001 primarily involved our PowerPC products that were first introduced in late 2000. Activities in 2002 included enhancements of these products, including the development of a "ruggedized" version of these products. In addition, during 2001 and 2002 we expended considerable effort in the development of our Eagle product line. Included in E&D expenses for 2002 is approximately \$800,000 related to engineering design services provided by Flextronics pursuant to the arrangement entered into with Flextronics concurrent with the sale of our engineering design services business.

In 2000, we incurred E&D costs relating to optical networking equipment primarily from enhancements and extensions of the OmniLynx product line. The E&D costs in 2001 relate to the Aegean product line that we began developing in 2000. In the fourth quarter of 2001, we curtailed activity related to the Aegean product line because we were unable to arrange outside funding for these activities. We ceased all activities related to Aegean in the second quarter of 2002.

Other E&D costs in 2001 included approximately \$670,000 related to the engineering organization involved with the OmniLynx product line, which was eliminated during 2001. The balance of other E&D costs in 2001 arose from development activities on the Centauri product line. In the first quarter of

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2002, we suspended all development activities related to the Centauri project.

### Selling and administrative expenses

Selling and administrative expenses decreased \$2,516,000, or 30%, between 2001 and 2002 and decreased \$4,660,000, or 36%, between 2000 and 2001. These expenses decreased because of the curtailment and sale of the operations related to the OmniLynx product line. The decrease was offset by increased general and administrative expenses related to our defense electronics business. We have reduced other selling and administrative costs, including headcount, in response to the elimination of various business operations.

### Asset write downs and costs related to sale of assets

In the fourth quarter of 2000, we determined that, due to changes in certain target customer markets in telecommunications, our OmniLynx line of optical networking products no longer fit within our long-term objectives and began plans to sell the product line and related operations. A transaction for the sale of the OmniLynx business failed in the first quarter of 2001 due to business difficulties experienced by the potential purchaser. At that time, we significantly curtailed the ongoing operations of the OmniLynx business and began to pursue other methods of disposing of the business, including liquidating the assets. As of December 31, 2000, the carrying values of the assets related to the OmniLynx product line were adjusted to the lower of cost and estimated net realizable value. A charge to operations was recorded as of December 31, 2000 as follows:

	(\$ in Thousands)
Reduction of inventory to net realizable value	\$ 5,642
Reduction of property and equipment to net realizable value	2,199
Write-off of capitalized software development costs and purchased intangibles	1,383
Other	27
	-----
Asset writedown	\$ 9,251
	=====

In August 2001 we sold substantially all of the OmniLynx assets to ITI. We received a cash payment of \$1,000,000 and are entitled to receive additional amounts from ITI based upon the utilization of inventory acquired from us and based on the financial position of ITI at specific points in time. The total additional amount to be received cannot be determined at this time. The amounts due from ITI have been recorded at the carrying value of the assets disposed of, less amounts received from ITI. Accordingly, no gain or loss has been recorded as a result of this transaction.

In 2001, we recognized non-recurring costs in connection with the sale of the OmniLynx assets that amounted to \$2,101,000. These costs related to

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maintaining the assets until the sale and the settlement of certain contractual obligations related to those assets such as warranty obligations, employee retention agreements and lease obligations.

### Litigation settlement

In April 2002, we settled litigation that we had brought against Cadence. See "Item 3 - Legal Proceedings." Pursuant to this settlement we received \$6,300,000, net of fees paid to our attorneys related to this matter.

### Litigation costs

Litigation costs represent legal fees and expenses related to a shareholder suit. See "Item 3 - Legal Proceedings." The allegations in the suit relate to operations that have been sold or otherwise discontinued; therefore, these costs are reflected as non-operating expenses. Amounts incurred by the Company in excess of \$200,000 are reimbursable under an insurance policy. However, the insurance carrier that provides the first \$2,000,000 of such coverage is in receivership and has not paid any amounts to us. We have received \$300,000 from a guarantee fund maintained by the State of Texas. The costs for 2002 have been reduced by \$300,000. We may be able to recover some amounts from the estate of our insurance carrier, but the amount and timing of such recovery is uncertain. Therefore, no estimate of any such recovery has been recorded.

### Earnings (loss) of unconsolidated affiliate

Subsequent to the sale to ITI of substantially all of the assets related to the OmniLynx product line, ITI has conducted all operations related to the OmniLynx product. We have a 33% equity interest in ITI, which decreased to 22% in February 2003, minority board of director representation, no funding obligations and no involvement in day-to-day operations. We account for our investment in ITI using the equity method of accounting. Earnings (loss) of unconsolidated affiliate for the years ended December 31, 2002 and 2001 represent our proportionate share of the net earnings or loss of ITI for each period.

### Interest expense

Interest expense, including non-cash financing charges, consists of the following:

	Years ended December 31,		
	2002	2001	2000
	-----	-----	-----
	(in Thousands)		
Interest on debt instruments	\$ 291	\$ 151	\$ 348
Non-cash financing costs	125	82	426
Other interest	92	29	24
	-----	-----	-----
	\$ 508	\$ 262	\$ 798
	-----	-----	-----

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Interest on debt instruments in 2002 and 2001 relates to amounts borrowed under bank credit agreements and short-term notes. In 2000, these amounts were primarily attributable to amounts borrowed from St. James Capital Corp., SJMB, L.P., and the Coastal Corporation Second Pension Trust.

Non-cash financing costs in 2002, 2001 and 2000 were the result of warrants to purchase common stock issued in connection with various financings. The reported expense amount is amortization of the value of the warrants determined by using the Black-Scholes pricing model.

### Interest income and other

Interest income and other includes interest on the temporary investment of cash balances of approximately \$47,000 in 2001 and \$1,028,000 in 2000. The year 2000 also includes approximately \$1,070,000 from the settlement of a dispute with a professional service provider offset by a charge of approximately \$875,000 related to the settlement of certain litigation.

### Discontinued operations

The loss from discontinued operations of \$1,520,000 in 2002 results from a charge recorded in the third quarter of 2002 relating to the settlement of certain indemnification obligations. These obligations arose from the sale of certain operations to Savage Sports. See "Item 3 - Legal Proceedings."

Effective December 31, 2001 we commenced a plan to dispose of our engineering design services business and on January 11, 2002 sold substantially all of the assets related to this business for total consideration of \$2,800,000. Accordingly, this business segment has been accounted for as a discontinued operation.

24

The loss on disposal of discontinued operations in 2001 is computed based on the consideration received less the net book value of the assets disposed of, including goodwill, and the operating loss of the business from December 31, 2001 to the date of disposal, which amount includes severance costs related to certain employees, and an estimate of the costs related to a real estate lease utilized by the discontinued operation. The amount of the loss is as follows:

	(\$ in Thousands)
Proceeds	\$ 2,800
Net book value of assets sold	(517)
Goodwill	(2,682)
Operating loss through date of sale	(308)
Estimated cost of real estate lease	(249)
	-----
Loss on disposal of discontinued operation	\$ 956
	=====

The results of operations related to our engineering design services business are reflected as loss from discontinued operations in 2001 and 2000.

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Between 2000 and 2001, the loss related to the engineering design services operations increased to \$3,412,000 from \$782,000, primarily as a result of a decline in revenues from these operations to \$3,405,000 in 2001 as compared to \$7,002,000 in 2000. This decline resulted from the drastic downturn in the telecommunications industry over this same period of time. The majority of our engineering design services were provided to companies involved in the telecommunications industry. During the course of 2001, there was a significant decline in demand for our services as customers reduced or eliminated product development programs. This situation was also impacted by the inability of many start-up organizations that utilized our services to obtain additional funding.

### OUTLOOK FOR 2003 -

Net revenue from the sale of our defense electronic products has increased in each of the last three years and we expect it to further increase in 2003. Net revenue from these sales amounted to \$5,036,000 in 2002. In the first quarter of 2003 we received new orders for these products amounting to approximately \$4,000,000 and at March 31, 2003 our backlog of orders amounted to approximately \$3,200,000, as compared to approximately \$500,000 at this same time in 2002. Accordingly, we expect net revenues in 2003 to be significantly higher than in 2002. We had expected net revenues in 2002 to be higher than they were, primarily due to the anticipated commencement of full production in certain programs that our products had been selected for. Our customers, however, experienced delays in these programs and therefore delayed their orders to us. We believe that certain of these delays have now been overcome and these programs will contribute to our anticipated increase in net revenues in 2003. However, there can be no assurance that this increase will occur or that there will not be further delays in these and other programs.

Due to our increased working capital needs related to the increase in orders and unexpected delays in completing financing arrangements in the first quarter of 2003, we experienced delays in payments to some of our vendors. These delays in payment temporarily affected our ability to complete orders. As a result, revenues in the first quarter of 2003 are expected to be lower than we had originally anticipated. Management believes that the financing arrangements that have been concluded will alleviate the liquidity difficulties and that revenues in the second quarter 2003 will increase significantly as compared to the first quarter of 2003. However, if we are not successful in amending our outstanding debt obligations in an acceptable manner, or if working capital requirements increase further, the financing arranged to date may not be sufficient for our needs.

Our ability to generate a profit from operations and to generate positive cash flow from operations largely depends on the continued growth in revenue from sales of defense electronics products. Our ability to achieve higher levels of net revenue depends upon a number of factors, including customer acceptance of

our products, including new and enhanced products, our ability to meet customer demands as to product availability, price and performance, availability of funding for programs in which our products will be deployed, the performance of other companies who provide products or services to these programs and our access to adequate working capital, as well as other factors that may not be within our control (See Item 1 - Business - Risk Factors).

In order to execute our business plan we need access to capital. See Liquidity and Capital Resources - Financing activities for a discussion of these

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requirements and how we expect to meet them.

### LIQUIDITY AND CAPITAL RESOURCES

As of December 31, 2002, we had cash and temporary investments of \$512,000, negative working capital of \$2,440,000, funded debt of \$4,947,000 and other long-term liabilities of \$1,100,000. For the year ended December 31, 2002, cash flow used in operations amounted to \$730,000.

#### Operating activities

Net cash applied in operations primarily reflects the operating loss of \$7,235,000, a gain of \$6,300,000 from the settlement of litigation, net non-cash charges of \$2,785,000 and a decrease in working capital of \$603,000. Significant items contributing to these amounts are as follows:

- o Inventory decreased \$908,000.
- o Accounts receivable decreased \$415,000.
- o Accounts payable and accrued liabilities decreased by \$730,000
- o Non-cash charges include the following:
  - o Utilization of prepaid services of \$807,000
  - o Loss from unconsolidated affiliate of \$582,000
  - o Accrued settlement obligation of \$1,445,000

#### Investing activities

Cash flow from investing activities in 2002 includes \$6,300,000 from the settlement of the Cadence litigation and \$1,243,000 of proceeds from the sale of our engineering design services business.

#### Financing activities

During 2002 we raised \$3,020,000 from the sale of common stock in private placements. Of this amount, \$2,000,000 was used to repay notes payable. In addition, we reduced notes payable by an additional \$1,355,000 from the proceeds of the litigation settlement.

Subsequent to December 31, 2002, we have completed a series of financing transactions and are seeking to complete other transactions and to effect amendments to our credit agreements.

In January and March 2003, we completed private placement transactions in which we issued a total of 4,166,667 shares of common stock and warrants for the purchase of an additional 4,333,333 shares of common stock for aggregate proceeds of \$500,000. The warrants have an exercise price of \$0.15 per share and are exercisable at any time through March 31, 2007.

In March 2003, the Company and DNA-CS entered into a revolving line of credit with a bank in order to provide working capital to DNA-CS. Under the facility, DNA-CS may borrow up to \$1,000,000. Outstanding amounts are due March 26, 2004; however, DNA-CS may extend the maturity date six months, provided certain conditions are maintained. Interest is payable monthly at the greater of prime plus 1% and 5.25%. At March 31, 2003 \$600,000 was outstanding under this facility. This working capital facility is secured by the accounts receivable and inventory of DNA-CS, the guarantee of the Company and by limited guarantees provided by certain private investors. As consideration for providing the

guarantees that secure

26

the Note the Company has entered into a Reimbursement Agreement with the guarantors. The Reimbursement Agreement provides that the Company will reimburse the investors for any amounts that may be required to reimburse the bank pursuant to the guarantees. Pursuant to the Reimbursement Agreement and related agreements, the investors have the right to purchase up to 8,333,333 shares of the Company's common stock for \$1,000,000 in cash, and the proceeds will be used to repay amounts outstanding under the Note and provide for the release of the guarantees. In addition, the investors have received warrants to purchase an aggregate of 9,582,334 shares of the Company's common stock at a price of \$0.15 per share. The warrants may be exercised at any time through March 31, 2007.

We also have had a series of discussions with potential financial and strategic investors regarding additional financing activities. These activities might include the repayment of all or a portion of our currently outstanding debt, as well as providing us with additional working capital. These financing activities might include the issuance of convertible preferred stock or convertible debt securities. The discussions have not resulted in definitive agreements or arrangements to date and there is no assurance that any additional financing can be arranged on terms acceptable to all parties involved.

In connection with the financing activities described above, we have been negotiating amendments to our credit agreements with Bank One NA ("Bank One") and a private investor who has provided security to Bank One related to these agreements. Currently, the Company has \$1,500,000 outstanding under a Loan Agreement with Bank One that is secured by the guarantee of the private investor. These amounts were due January 31, 2003; however, Bank One has agreed to extend the maturity to June 30, 2003. In addition, the Company has outstanding \$2,700,000 under a Credit Agreement with Bank One that is secured by a letter of credit provided by this same private investor. Amounts outstanding under this facility are due March 31, 2004, with periodic reductions beginning April 30, 2003. The Company, Bank One and the private investor are currently engaged in discussion to amend these agreements in order to extend the maturities of these obligations. These discussions have not yet been concluded and there is no assurance that the Company will be able to reach agreements acceptable to all parties involved. If we are unable to reach agreements related to our debt obligations and if we are unable to obtain required additional working capital, it may have a material adverse effect on our operations.

Due to uncertainties regarding the restructuring or refinancing of our outstanding debt and our access to other sources of capital, our auditors have added an explanatory paragraph to their audit opinion that states there is substantial doubt concerning our ability to continue as a going concern. Our consolidated financial statements have been prepared on the basis that we are a going concern and do not include any adjustments that might be necessary if this were not the case. These adjustments include changes in the possible future recoverability and classification of assets or the amount and classification of liabilities.

27

As discussed above we are obligated under various contracts and



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commercial commitments. The following table summarizes these obligations:

Nature of Obligation	Period in which payments due (in thousands)			
	2003	2004	2005	2006
Notes payable	\$ 4,047	\$ 900	\$ --	\$ --
Operating leases	490	300	88	--
Non-cancelable purchase commitments	--	--	--	--
Settlement payments	549	500	600	--
<b>Total</b>	<b>\$ 5,086</b>	<b>\$ 1,700</b>	<b>\$ 688</b>	<b>\$ --</b>

Our estimate of capital needs is subject to a number of risks and uncertainties that could result in additional capital needs that have not been anticipated. An important aspect of our estimated capital requirements is our ability to begin to generate positive cash flow from operations. As discussed above, this in turn is dependent upon our ability to increase revenues from our defense electronics business, to generate adequate gross profit from those sales and to control other costs and expenses. Our capital needs could increase materially if any of our contingent liabilities are resolved adversely to the Company. In addition, we could require additional working capital if the defense electronics business increases more rapidly than we currently anticipate.

Potential sources of additional capital include the sale of additional debt or equity securities, other debt, such as bank debt, and the sale of assets. A sale of additional securities could result in dilution to existing common shareholders. There is no assurance that additional capital will be available under terms which are acceptable.

### Contingent liabilities

As discussed in Item 3 - "Legal Proceedings," we are exposed to certain contingent liabilities which, if resolved adversely to us, could adversely affect our liquidity, our results of operations, and/or our financial position.

### CRITICAL ACCOUNTING POLICIES

We have identified the policies below as critical to our business operations and the understanding of our results operations. The impact and any associated risks related to these policies on our business operations is discussed below. For a more detailed discussion on the application of these and other accounting policies, see the Notes to the Consolidated Financial Statements included in this Annual Report on Form 10-K. The preparation of financial statements in accordance with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amount of assets, liabilities, revenue and expenses and the disclosure of contingent assets and liabilities. There can be no assurance that the actual results will not differ from those estimates.

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### Estimates

Management has made estimates regarding the following matter which could have a material effect on our consolidated financial statements:

- o The recoverability of amounts due from ITI and any potential impairment to our investment in ITI.

### Inventories

Our inventories consist primarily of electronic components that are subject to obsolescence and variations in market prices. We have adjusted the amount of excess and obsolete inventory based on current and expected sales trends, the number of parts on hand, the current market value for those parts and the viability and potential technical obsolescence of the components.

### Revenue recognition

We generally recognize revenue when our products are shipped to the customer. This is normally the point when all of the following factors have been achieved:

- o Persuasive evidence of a sales arrangement exists, such as a contract or binding purchase order,
- o The product has been delivered to the customer,
- o The price is fixed or determinable, and
- o Collection of the resulting receivable is reasonably assured.

In some cases the product is shipped to a customer for evaluation or testing. In such cases, revenue is not recognized until the customer has evidenced intent to purchase the product by issuing a non-cancelable purchase order to us for the product.

### ITEM 7A - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We have outstanding debt amounting to \$4,200,000 that bears interest at a variable interest rate. This interest rate is based on a widely used reference interest rate known as LIBOR. An increase of 50 basis points in LIBOR would result in an increase in our annual interest expense of \$21,000.

### ITEM 8 - FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

#### TERAFORCE TECHNOLOGY CORPORATION AND SUBSIDIARIES

#### INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Report of Independent Certified Public Accountants .....	31
Consolidated Balance Sheets .....	32

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Consolidated Statements of Operations .....	33
Consolidated Statements of Stockholders' Equity .....	34
Consolidated Statements of Cash Flows .....	35
Notes to Consolidated Financial Statements .....	36

### REPORT OF INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Board of Directors and Stockholders  
TeraForce Technology Corporation

We have audited the accompanying consolidated balance sheets of TeraForce Technology Corporation and subsidiaries as of December 31, 2002 and 2001, and the related consolidated statements of operations, stockholders' equity (deficit), and cash flows for each of the three years in the period ended December 31, 2002. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the consolidated financial position of TeraForce Technology Corporation and subsidiaries as of December 31, 2002 and 2001, and

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the consolidated results of their operations and their consolidated cash flows for each of the three years in the period ended December 31, 2002 in conformity with accounting principles generally accepted in the United States of America.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note 3 to the financial statements, the Company has incurred significant operating losses in 2002, 2001 and 2000. As of December 31, 2002, notes payable in the amount of \$4,047,000 are due within one year. The Company's continued existence is dependent on restructuring or refinancing these obligations and continued access to external sources of capital, none of which is assured. These matters raise substantial doubt about the Company's ability to continue as a going concern. Management's plans with respect to these matters are also discussed in Note 3. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

/s/ Grant Thornton LLP

Dallas, Texas  
March 25, 2003

31

TERAFORCE TECHNOLOGY CORPORATION AND SUBSIDIARIES  
Consolidated Balance Sheets  
December 31, 2002 and 2001  
(Thousands of dollars, except share data)

	2002	2001
	-----	-----
Assets		
Current assets:		
Cash and cash equivalents	\$ 55	\$ 1
Temporary cash investments	457	53
Accounts receivable, net of allowances of \$1,658 in 2001	573	869
Receivables from affiliate	699	816
Inventories	2,354	3,262
Net current assets of discontinued operations	--	2,880
Prepaid expenses and other current assets	780	224
	-----	-----
Total current assets	4,918	8,105
Property and equipment, net	573	638
Investment in affiliate	702	1,284
Other assets	531	169
	-----	-----
	\$ 6,724	\$ 10,196
	=====	=====
Liabilities and Stockholders' Deficit		
Current liabilities:		
Notes payable	\$ 4,047	\$ 7,554

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Accounts payable	1,919	1,864
Accrued liabilities	1,392	2,389
	-----	-----
Total current liabilities	7,358	11,807
Long-term notes payable	900	--
Other long-term liabilities	1,100	--
Commitments and contingencies (Notes 10 and 15)		
Stockholders' deficit:		
Common Stock, \$.01 par value. Authorized 200,000,000 shares, 114,255,518 and 87,088,850 shares issued in 2002 and 2001, respectively	1,143	871
Additional paid-in capital	184,953	181,898
Accumulated deficit	(187,143)	(182,793)
	-----	-----
	(1,047)	(24)
Less 400,474 shares of common stock in treasury -at cost	(1,587)	(1,587)
	-----	-----
Total stockholders' deficit	(2,634)	(1,611)
	-----	-----
	\$ 6,724	\$ 10,196
	=====	=====

See accompanying notes to consolidated financial statements.

32

TERAFORCE TECHNOLOGY CORPORATION AND SUBSIDIARIES  
Consolidated Statements of Operations  
(Thousands of dollars, except share data)

	Years ended December 31,		
	2002	2001	2000
	-----	-----	-----
Net revenue	\$ 5,036	\$ 6,822	\$ 11,748
Cost of revenue	3,334	7,961	13,253
	-----	-----	-----
Gross profit (loss)	1,702	(1,139)	(1,505)
	-----	-----	-----
Expenses:			
Engineering and development	3,065	5,096	5,258
Selling and administrative	5,872	8,388	13,048
Asset writedowns	--	--	9,251
Costs related to sale of assets	--	2,101	--
	-----	-----	-----
	8,937	15,585	27,557
	-----	-----	-----
Operating loss	(7,235)	(16,724)	(29,062)
	-----	-----	-----

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Other income (expense):			
Litigation settlement	6,300	--	--
Litigation costs	(872)	(282)	(218)
Share of income (loss) of unconsolidated affiliate	(582)	34	--
Interest expense	(508)	(262)	(798)
Interest income and other	67	53	1,288
	-----	-----	-----
	4,405	(457)	272
	-----	-----	-----
Loss from continuing operations	(2,830)	(17,181)	(28,790)
Loss from discontinued operations	(1,520)	(3,412)	(782)
Loss on disposal of discontinued operations	--	(956)	--
	-----	-----	-----
Net loss	(4,350)	(21,549)	(29,572)
Dividends on preferred stock	--	--	(966)
	-----	-----	-----
Loss allocable to common stockholders	\$ (4,350)	\$ (21,549)	\$ (30,538)
	=====	=====	=====
Basic and diluted loss per share:			
Continuing operations	\$ (0.03)	\$ (0.20)	\$ (0.36)
Discontinued operations	(0.02)	(0.05)	(0.01)
	-----	-----	-----
Net loss per share	\$ (0.05)	\$ (0.25)	\$ (0.37)
	=====	=====	=====
Weighted average number of common shares outstanding (thousands)	93,581	86,354	83,229
	=====	=====	=====

See accompanying notes to consolidated financial statements.

TERAFORCE TECHNOLOGY CORPORATION AND SUBSIDIARIES  
Consolidated Statements of Stockholders' Equity (Deficit)  
Years ended December 31, 2002, 2001 and 2000  
(Thousands of dollars, except share data)

	Preferred Stock		Common Stock	
	Shares	Par	Shares	Pa
	-----	-----	-----	-----
Balances at January 1, 2000	3,719,409	\$ 37	65,936,573	\$
Net loss	--	--	--	
Private placements of common stock	--	--	11,801,666	
Exercise of warrants	--	--	2,495,000	

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Exercise of employee stock options	--	--	418,795	
Conversion of notes payable	--	--	4,705,749	
Redemption of preferred stock	(3,719,409)	(37)	--	
Preferred dividends paid in cash	--	--	--	
Preferred dividends paid with stock	--	--	142,719	
Settlement of royalty agreement	--	--	350,000	
Directors' fees paid in stock	--	--	48,972	
Preferred dividends accrued	--	--	--	
Interest expense paid with stock	--	--	184,376	
Stock issued for services	--	--	15,000	
Stock received in legal settlement	--	--	--	
	-----	-----	-----	
Balances at December 31, 2000	--	--	86,098,850	\$
Net loss	--	--	--	
Stock issued in settlement of contractual obligations			990,000	
Warrants issued with notes			--	
	-----	-----	-----	
Balance at December 31, 2001	--	--	87,088,850	\$
Net loss			--	
Warrants issued with notes			--	
Stock issued in exchange of warrants			2,000,000	
Private placements of common stock			25,166,668	
	-----	-----	-----	
Balances at December 31, 2002	--	--	114,255,518	
	-----	-----	-----	

	Accumulated deficit	Treasury Stock	
	-----	-----	-----
	-----	-----	-----
Balances at January 1, 2000	\$ (130,706)	191,435	\$
Net loss	(29,572)	--	
Private placements of common stock	--	--	
Exercise of warrants	--	--	
Exercise of employee stock options	--	--	
Conversion of notes payable	--	--	
Redemption of preferred stock	--	--	
Preferred dividends paid in cash	(966)	--	
Preferred dividends paid with stock	--	--	
Settlement of royalty agreement	--	--	
Directors' fees paid in stock	--	--	
Preferred dividends accrued	--	--	
Interest expense paid with stock	--	--	
Stock issued for services	--	--	
Stock received in legal settlement	--	209,039	
	-----	-----	
Balances at December 31, 2000	\$ (161,244)	400,474	
Net loss	(21,549)	--	
Stock issued in settlement of contractual obligations	--	--	
Warrants issued with notes	--	--	
	-----	-----	
Balance at December 31, 2001	\$ (182,793)	400,474	
Net loss	(4,350)	--	
Warrants issued with notes	--	--	
Stock issued in exchange of warrants	--	--	
Private placements of common stock	--	--	