
UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2007

OR

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

For the transition period from _____ to _____

000-32743

(Commission File Number)

ZHONE TECHNOLOGIES, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

7001 Oakport Street
Oakland, California
(Address of principal executive offices)

22-3509099
(I.R.S. Employer
Identification Number)

94621
(Zip code)

(510) 777-7000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of October 31, 2007, there were approximately 149,850,775 shares of the registrant's common stock outstanding.

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PART I. FINANCIAL INFORMATION**Item 1. Financial Statements****ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES**
Unaudited Condensed Consolidated Balance Sheets
(In thousands, except per share data)

| | <u>September 30,</u> <u>2007</u> | <u>December 31,</u> <u>2006</u> |
|--|-------------------------------------|------------------------------------|
| Assets | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 37,412 | \$ 46,973 |
| Short-term investments | 12,980 | 17,337 |
| Accounts receivable, net of allowances for sales returns and doubtful accounts of \$6,522 in 2007 and \$6,939 in 2006 | 35,642 | 31,828 |
| Inventories | 42,739 | 45,036 |
| Prepaid expenses and other current assets | 3,853 | 3,852 |
| Total current assets | 132,626 | 145,026 |
| Property and equipment, net | 21,220 | 23,704 |
| Goodwill | 70,401 | 70,737 |
| Restricted cash | 183 | 636 |
| Other assets | 85 | 79 |
| Total assets | <u>\$ 224,515</u> | <u>\$ 240,182</u> |
| Liabilities and Stockholders' Equity | | |
| Current liabilities: | | |
| Accounts payable | \$ 20,281 | \$ 18,893 |
| Line of credit | 15,000 | 14,500 |
| Current portion of long-term debt | 279 | 7,673 |
| Accrued and other liabilities | 19,342 | 20,088 |
| Total current liabilities | 54,902 | 61,154 |
| Long-term debt, less current portion | 19,192 | 19,376 |
| Other long-term liabilities | 255 | 2,048 |
| Total liabilities | <u>74,349</u> | <u>82,578</u> |
| Stockholders' equity: | | |
| Common stock, \$0.001 par value. Authorized 900,000 shares; issued and outstanding 149,834 and 149,277 shares as of September 30, 2007 and December 31, 2006, respectively | 150 | 149 |
| Additional paid-in capital | 1,061,284 | 1,058,317 |
| Other comprehensive income | 562 | 98 |
| Accumulated deficit | (911,830) | (900,960) |
| Total stockholders' equity | <u>150,166</u> | <u>157,604</u> |
| Total liabilities and stockholders' equity | <u>\$ 224,515</u> | <u>\$ 240,182</u> |

See accompanying notes to unaudited condensed consolidated financial statements.

ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES
Unaudited Condensed Consolidated Statements of Operations
(In thousands, except per share data)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|--------------|------------------------------------|--------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net revenue | \$ 41,604 | \$ 43,138 | \$ 128,835 | \$ 150,038 |
| Cost of revenue | 29,133 | 28,029 | 85,849 | 103,380 |
| Gross profit | 12,471 | 15,109 | 42,986 | 46,658 |
| Operating expenses: | | | | |
| Research and product development | 8,154 | 9,042 | 25,338 | 27,471 |
| Sales and marketing | 8,446 | 9,308 | 25,141 | 29,582 |
| General and administrative | 2,260 | 3,930 | 7,868 | 11,068 |
| Amortization of intangible assets | — | 307 | — | 2,764 |
| Gain on sale of patents | (5,000) | — | (5,000) | — |
| Impairment of intangible assets and goodwill | — | 113,666 | — | 113,666 |
| Total operating expenses | 13,860 | 136,253 | 53,347 | 184,551 |
| Operating loss | (1,389) | (121,144) | (10,361) | (137,893) |
| Interest expense | (508) | (648) | (1,768) | (1,946) |
| Interest income | 470 | 735 | 1,486 | 1,799 |
| Other income, net | 22 | 47 | 61 | 188 |
| Loss before income taxes | (1,405) | (121,010) | (10,582) | (137,852) |
| Income tax provision | 125 | 22 | 288 | 184 |
| Net loss | \$ (1,530) | \$ (121,032) | \$ (10,870) | \$ (138,036) |
| Basic and diluted net loss per share | (\$ 0.01) | (\$ 0.81) | (\$ 0.07) | (\$ 0.93) |
| Weighted average shares outstanding used to compute basic and diluted net loss per share | 149,715 | 148,905 | 149,512 | 148,589 |

See accompanying notes to unaudited condensed consolidated financial statements.

ZHONE TECHNOLOGIES, INC. AND SUBSIDIARIES
Unaudited Condensed Consolidated Statements of Cash Flows
(In thousands)

| | Nine Months Ended September 30, | |
|---|------------------------------------|------------------|
| | 2007 | 2006 |
| Cash flows from operating activities: | | |
| Net loss | \$(10,870) | \$(138,036) |
| Adjustments to reconcile net loss to net cash used in operating activities: | | |
| Depreciation and amortization | 2,044 | 4,721 |
| Impairment of goodwill and intangible assets | — | 113,666 |
| Stock-based compensation | 2,462 | 4,225 |
| Accretion of investments | (341) | — |
| Gain on sale of patents | (5,000) | — |
| Provision for sales returns and doubtful accounts | 2,311 | 5,402 |
| (Gain)/loss on sale of assets | 75 | (289) |
| Changes in operating assets and liabilities, net of effect of acquisitions: | | |
| Accounts receivable | (6,125) | (5,507) |
| Inventories | 2,297 | (38) |
| Prepaid expenses and other current assets | (1) | 627 |
| Restricted cash and other assets | 447 | 30 |
| Accounts payable | 1,388 | 3,136 |
| Accrued and other liabilities | (2,539) | (2,282) |
| Net cash used in operating activities | <u>(13,852)</u> | <u>(14,345)</u> |
| Cash flows from investing activities: | | |
| Purchases of property and equipment | (1,135) | (1,987) |
| Proceeds from sale of assets | 1,500 | 1,661 |
| Proceeds from sale of patents | 5,000 | 9,055 |
| Purchases of short-term investments | (23,432) | (30,790) |
| Proceeds from sale of short-term investments | 28,130 | 35,287 |
| Tax adjustment related to acquisition of Sorrento | 336 | — |
| Net cash provided by investing activities | <u>10,399</u> | <u>13,226</u> |
| Cash flows from financing activities: | | |
| Proceeds from issuance of common stock | 506 | 2,104 |
| Proceeds from repayment of officer loans | — | 550 |
| Borrowings under credit facilities | 500 | — |
| Repayment of debt, net | (7,578) | (2,655) |
| Net cash used in financing activities | <u>(6,572)</u> | <u>(1)</u> |
| Effect of exchange rate changes on cash | 464 | 268 |
| Net decrease in cash and cash equivalents | <u>(9,561)</u> | <u>(852)</u> |
| Cash and cash equivalents at beginning of period | 46,973 | 52,166 |
| Cash and cash equivalents at end of period | <u>\$ 37,412</u> | <u>\$ 51,314</u> |

See accompanying notes to unaudited condensed consolidated financial statements.

Notes to Unaudited Condensed Consolidated Financial Statements

(1) Organization and Summary of Significant Accounting Policies

(a) Description of Business

Zhone Technologies, Inc. (sometimes referred to, collectively with its subsidiaries, “Zhone” or the “Company”) designs, develops and markets communications network equipment for telephone companies and cable operators worldwide. The Company’s products allow network service providers to deliver video and interactive entertainment services in addition to their existing voice and data service offerings. The Company was incorporated under the laws of the state of Delaware in June 1999. The Company began operations in September 1999 and is headquartered in Oakland, California.

(b) Basis of Presentation

The condensed consolidated financial statements are unaudited and reflect all adjustments (consisting only of normal recurring adjustments) that, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented. The results of operations for the current interim period are not necessarily indicative of results to be expected for the current year or any other period. These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Company’s Form 10-K for the year ended December 31, 2006.

(c) Use of Estimates

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

(d) Concentration of Risk

The Company’s customers include competitive and incumbent local exchange carriers, competitive access providers, Internet service providers, wireless carriers, and resellers serving these markets. The Company performs ongoing credit evaluations of its customers and generally does not require collateral. Allowances are maintained for potential doubtful accounts. For the three months ended September 30, 2007, no customer represented 10% or more of net revenue. For the three months ended September 30, 2006, sales to one customer represented 12% of net revenue. For the nine months ended September 30, 2007 and 2006, no customer represented 10% or more of net revenue. As of September 30, 2007, two customers accounted for 16% and 14% of accounts receivable, respectively, and as of December 31, 2006, no customer represented 10% or more of accounts receivable. As of September 30, 2007 and December 31, 2006, receivables from customers in territories outside of the United States of America represented 65% and 48%, respectively, of accounts receivable.

(e) Presentation of Transactional-based Taxes

In accordance with the provisions of Emerging Issues Task Force Issue No. 06-3 (EITF 06-3), *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation)*, the Company nets sales taxes against revenue.

(f) Recent Accounting Pronouncements

SFAS 157 – Fair Value Measurements

In September 2006, the Financial Accounting Standards Board (“FASB”) issued Statement of Financial Accounting Standards No. 157 (SFAS 157), *Fair Value Measurements*, which defines fair value, establishes guidelines for measuring fair value and expands disclosures regarding fair value measurements. SFAS 157 does not require any new fair value measurements but rather eliminates inconsistencies in guidance found in various prior accounting pronouncements. SFAS 157 is effective for fiscal years beginning after November 15, 2007. Earlier adoption is permitted, provided the company has not yet issued financial statements, including for interim periods, for that fiscal year. The Company is currently evaluating the impact, if any, that the adoption of SFAS 157 will have on the consolidated financial statements.

SFAS 159 – Fair Value Option for Financial Assets and Financial Liabilities

In February 2007, the FASB issued Statement of Financial Accounting Standards No. 159, “The Fair Value Option for Financial Assets and Financial Liabilities” (“SFAS 159”). SFAS 159 permits companies to choose to measure certain financial instruments and certain other items at fair value. The standard requires that unrealized gains and losses on items for which the fair value option has been elected be reported in earnings. SFAS 159 is effective for the Company beginning in the first quarter of fiscal year 2008, although earlier adoption is permitted. The Company is currently evaluating the impact, if any, that the adoption of SFAS 159 will have on the consolidated financial statements.

(g) Reclassifications

Certain reclassifications have been made to prior period balances in order to conform to the current period’s presentation. Commencing with the first quarter of 2007, the Company is reporting the historical optical transport business with the legacy, services and other product category.

(2) Acquisitions

Paradyne Networks, Inc.

In September 2005, the Company completed the acquisition of Paradyne Networks, Inc. in exchange for total consideration of \$184.5 million, consisting of common stock valued at \$164.1 million, options and warrants to purchase common stock valued at \$19.4 million, and acquisition costs of \$1.0 million. Common stock and options were valued using an average closing price as reported by Nasdaq for the two days immediately preceding and following the date of the announcement. The Company acquired Paradyne to strengthen its position as a leading provider of next-generation local access network solutions as well as increase its customer base. Paradyne had an existing contract with the Company to resell certain of the Company’s products.

In September 2006, the purchase allocation was adjusted to reflect the Company’s revised plan with respect to acquired excess facilities. The final purchase consideration was allocated as follows: net tangible assets - \$48.6 million, amortizable intangible assets - \$54.8 million, purchased in-process research and development - \$1.2 million, goodwill - \$79.0 million, and deferred compensation - \$0.9 million. The amount allocated to purchased in-process research and development was charged to expense during the third quarter of 2005, because technological feasibility had not been established and no future alternative uses for the technology existed. The estimated fair value of the purchased in-process research and development was determined using a discounted cash flow model, based on a discount rate which took into consideration the stage of completion and risks associated with developing the technology. Of the amount allocated to amortizable intangible assets, \$12.3 million was allocated to core technology and \$10.1 million was allocated to patents, both of which were assigned an estimated useful life of five years. Of the remaining \$32.4 million, \$3.3 million was allocated to backlog and \$29.1 million was allocated to customer relationships, which were assigned estimated useful lives of six months and seven years, respectively.

Net tangible assets acquired consisted of total assets of \$71.4 million, of which \$70.4 million were current, offset by adjusted assumed liabilities of \$22.8 million. Assumed liabilities included employee severance and estimated exit costs which were recorded based on Emerging Issues Task Force Issue No. 95-3, *Recognition of Liabilities in Connection with a Purchase Business Combination* (EITF 95-3). As a result of the Paradyne acquisition, the Company assumed a lease commitment for facilities in Largo, Florida. The term of the lease expires in June 2012 and had an estimated remaining obligation of approximately \$22.8 million as of September 30, 2007, of which \$4.0 million was accrued for excess facilities, which is net of estimated sublease income. In September 2006, the Company updated its plan to exit the excess portion of these facilities and recorded an adjustment to the purchase price allocation of \$1.0 million to increase the assumed liabilities relating to this lease, which is net of estimated sublease income. In September 2007, the Company updated its estimated sublease assumptions and recorded an adjustment of \$0.5 million to increase the assumed liabilities relating to this lease. A summary of current period activity related costs accrued in accordance with EITF 95-3 is as follows (in thousands):

| | <u>Exit Costs</u> |
|-------------------------------|-------------------|
| Balance at December 31, 2006 | \$ 4,531 |
| Cash payments | (995) |
| Lease Adjustment | 477 |
| Balance at September 30, 2007 | <u>\$ 4,013</u> |

A summary of the assumed lease liabilities at their net present value is as follows (in thousands):

| | |
|-----------------------------------|-------------------|
| | <u>Exit Costs</u> |
| Future lease payments | \$ 8,279 |
| Less: contractual sublease income | (2,555) |
| Less: estimated sublease income | (1,891) |
| Other sublease expenses | 180 |
| Balance at September 30, 2007 | <u>\$ 4,013</u> |

(3) Long-Lived Assets, Goodwill and Other Acquisition-Related Intangible Assets

The Company tests goodwill for impairment using a two step approach during the month of November on an annual basis, or when certain indicators of impairment exist in accordance with Statement of Financial Accounting Standards No. 142 (SFAS 142), *Goodwill and Other Intangible Assets*. Impairment of goodwill is tested at the reporting unit level by comparing the reporting unit's carrying amount, including goodwill, to the fair value of the reporting unit using the market approach. The Company has determined that it operates in a single segment with one operating unit. If the carrying amount of the reporting unit exceeds its fair value, a second step is performed to measure the amount of impairment loss, if any. In 2006 and 2005, the Company determined that such indicators of impairment existed and the second step was performed, resulting in a goodwill impairment loss of \$110.5 million and \$55.2 million, respectively. At September 30, 2007 and December 31, 2006, the Company had goodwill with a carrying value of \$70.4 million and \$70.7 million, respectively.

In accordance with Statement of Financial Accounting Standards No. 144 (SFAS 144), *Accounting for the Impairment or Disposal of Long-Lived Assets*, the Company reviews long-lived assets, including intangible assets other than goodwill, for impairment whenever events or changes in circumstances indicate that the carrying value of an asset may not be recoverable based on expected undiscounted cash flows attributable to that asset. The amount of any impairment is measured as the difference between the carrying value and the fair value of the impaired asset. The Company estimates the fair value of its long-lived assets based on a combination of the market, income and replacement cost approaches. In the application of the impairment testing, the Company is required to make estimates of future operating trends and resulting cash flows and judgments on discount rates and other variables. Actual future results and other assumed variables could differ from these estimates.

During the third quarter of 2006, the Company determined that indicators of impairment existed and an impairment analysis was performed, resulting in an impairment loss to amortizable intangibles of \$3.2 million. During the fourth quarter of 2005, the Company recorded a non-cash impairment charge of \$46.9 million related to acquired intangibles consisting of customer lists and developed technology. The primary circumstance leading to the impairment of these intangibles was a decline in the Company's projected future cash flows associated with customers and technology attributable to the Company's prior acquisitions. As a result of the impairment charges, the Company's amortizable intangibles at September 30, 2007 and December 31, 2006 were zero.

Sale of Land

During the second quarter of 2007, the Company completed the sale of approximately 3.625 acres of undeveloped land at a price of \$1.5 million to the Redevelopment Agency of the City of Oakland pursuant to a repurchase option exercised by it. No gain or loss was recorded on the sale.

Sale of Patents

In July 2007, the Company sold some of its previously impaired non-strategic patents for \$5.0 million, which was recorded within operating income.

(4) Inventories

Inventories as of September 30, 2007 and December 31, 2006 were as follows (in thousands):

| | <u>September 30,</u> <u>2007</u> | <u>December 31,</u> <u>2006</u> |
|-----------------|-------------------------------------|------------------------------------|
| Inventories: | | |
| Raw materials | \$ 31,043 | \$ 30,452 |
| Work in process | 6,980 | 10,392 |
| Finished goods | 4,716 | 4,192 |
| | <u>\$ 42,739</u> | <u>\$ 45,036</u> |

Sale of Legacy Inventory and Other Assets

During 2006, the Company entered into an agreement to sell inventory and certain assets related to its iMarc legacy product line to a third party. The sale of the iMarc product line was not treated as a discontinued operation since it did not represent a component of the Company that had operations and cash flows that were clearly distinguishable, operationally and for financial reporting purposes, from the rest of the entity. Upon the performance of certain obligations and delivery of the assets in the first quarter of 2007, the Company recognized a gain of \$1.8 million that was recorded in cost of revenue. Upon sale of the remaining iMarc inventory during the second quarter of 2007, the Company recognized an additional gain to cost of revenue of \$1.1 million related to the sale of the legacy iMarc product line.

(5) Stock-Based Compensation

The Company accounts for stock based compensation expense in accordance with the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R). The Company has estimated the fair value of stock-based payment awards on the date of grant using the Black Scholes pricing model, which is affected by the Company's stock price as well as assumptions regarding a number of complex and subjective variables. These variables include the Company's expected stock price volatility over the term of the awards, actual and projected employee option exercise behaviors, risk free interest rate and expected dividends. The estimated expected term of options granted was determined based on historical option exercise trends. Estimated volatility was based on historical volatility as well as peer group data and the risk free interest rate was based on U.S. Treasury yield in effect at the time of grant for the expected life of the options.

In conjunction with the provisions of SFAS 123R, the Company changed its method of attributing the value of stock-based compensation expense from the accelerated multiple option approach to the straight line single option method in the first quarter of 2006. Compensation expense for all employee share-based payment awards granted on or prior to December 31, 2005 continues to be recognized using the accelerated multiple option approach while compensation expense for all share-based payment awards granted subsequent to December 31, 2005 is recognized using the straight line single option method.

The Company has two types of share-based compensation plans, a stock option plan and an employee stock purchase plan. The compensation cost that has been charged against income for those plans was \$0.7 million and \$1.3 million for the three months ended September 30, 2007 and 2006, respectively, and \$2.5 million and \$4.2 million for the nine months ended September 30, 2007 and 2006, respectively.

The following table summarizes stock-based compensation expense for the three and nine months ended September 30, 2007 and 2006 (in thousands):

| | <u>Three Months Ended</u> <u>September 30,</u> | | <u>Nine Months Ended</u> <u>September 30,</u> | |
|---|---|-----------------|--|-----------------|
| | <u>2007</u> | <u>2006</u> | <u>2007</u> | <u>2006</u> |
| Stock-based compensation | \$ 649 | \$ 1,217 | \$ 2,289 | \$ 3,979 |
| Compensation expense relating to non-employees | | 1 | 1 | 10 |
| Compensation expense relating to Employee Stock Purchase Plan | 59 | 100 | 172 | 236 |
| Stock-based compensation expense | <u>\$ 708</u> | <u>\$ 1,318</u> | <u>\$ 2,462</u> | <u>\$ 4,225</u> |

Stock Options

The share-based compensation plans are designed to attract, motivate, retain and reward talented employees, directors and consultants and align stockholder and employee interests. The Company has two active stock option plans, the Amended and Restated Special 2001 Stock Incentive Plan and the Amended and Restated 2001 Stock Incentive Plan. Stock options are primarily issued from the Amended and Restated 2001 Stock Incentive Plan. This plan provides for the grant of incentive stock options, non-statutory stock options, restricted stock awards and other stock-based awards to officers, employees, directors and consultants of the Company. As of September 30, 2007, 3.7 million shares were available for grant under these plans.

The assumptions used to value option grants for the three and nine months ended September 30, 2007 and 2006 are as follows:

| | Three Months Ended September 30, 2007 | Three Months Ended September 30, 2006 | Nine Months Ended September 30, 2007 | Nine Months Ended September 30, 2006 |
|-------------------------|---|---|--|--|
| Expected term | 4.7 years | 4.1 years | 4.7 years | 4.5 years |
| Volatility | 60% | 71% | 60% | 74% |
| Risk free interest rate | 4.07% | 4.5% | 4.16% | 4.65% |

The following table sets forth the summary of option activity under the stock option program for the nine months ended September 30, 2007 (in thousands, except per share data):

| | Options Outstanding | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|------------------------|--|---|---------------------------------|
| Outstanding as of December 31, 2006 | 25,141 | \$ 4.56 | 5.76 | \$ 553 |
| Granted | 154 | \$ 1.23 | | |
| Canceled/Forfeited | (776) | \$ 3.30 | | |
| Exercised | (2) | \$ 0.21 | | |
| Outstanding as of March 31, 2007 | 24,517 | \$ 4.58 | 5.50 | \$ 516 |
| Granted | 273 | \$ 1.31 | | |
| Canceled/Forfeited | (835) | \$ 5.35 | | |
| Exercised | (5) | \$ 0.21 | | |
| Outstanding as of June 30, 2007 | 23,950 | \$ 4.51 | 5.32 | \$ 687 |
| Granted | 3,196 | \$ 1.26 | | |
| Canceled/Forfeited | (960) | \$ 2.98 | | |
| Exercised | (20) | \$ 0.21 | | |
| Outstanding as of September 30, 2007 | 26,166 | \$ 4.17 | 5.04 | \$ 460 |
| Vested and expected to vest at September 30, 2007 | 25,006 | \$ 4.25 | 4.97 | \$ 460 |
| Exercisable at September 30, 2007 | 17,978 | \$ 5.27 | 4.17 | \$ 457 |

The aggregate intrinsic value represents the total pretax intrinsic value, based on the Company's closing stock price of \$1.19 as of September 28, 2007, which would have been received by the option holders had all option holders exercised their options as of that date.

The weighted average grant date fair value of options granted during the three and nine months ended September 30, 2007 was \$0.67 per share and \$0.67 per share, respectively. The weighted average grant date fair value of options granted during the three and nine months ended September 30, 2006 was \$0.90 per share and \$1.16 per share, respectively. The intrinsic value of options exercised during the three and nine months ended September 30, 2007 were insignificant. The intrinsic value of options exercised during the three and nine months ended September 30, 2006 were \$20,000 and \$688,000, respectively. The proceeds received were insignificant for the three and nine months ended September 30, 2007. For the three and nine months ended September 30, 2006, the Company received \$43,000 and \$1.4 million, respectively, in proceeds from stock option exercises.

As of September 30, 2007, there was \$5.5 million of unrecognized compensation costs, adjusted for estimated forfeitures related to unvested stock-based payments granted which are expected to be recognized over a weighted average period of 2.0 years.

Employee Stock Purchase Plan

The Company's 2002 Employee Stock Purchase Plan ("ESPP") allows eligible employee participants to purchase shares of the Company's common stock at a price equal to 85% of the lower of the fair market value of the common stock at the beginning or the end of each three month offering period. Participation is limited to 10% of an employee's eligible compensation, not to exceed amounts allowed by the Internal Revenue Code.

The following table summarizes shares purchased, weighted average purchase price, cash received and the aggregate intrinsic value for ESPP purchases during the three and nine months ended September 30, 2007 and 2006, respectively:

| | Three Months Ended September 30, (in thousands, except per share data) | | Nine Months Ended September 30, (in thousands, except per share data) | |
|---------------------------------|--|---------|---|---------|
| | 2007 | 2006 | 2007 | 2006 |
| Shares purchased | 153 | 173 | 496 | 412 |
| Weighted average purchase price | \$ 1.05 | \$ 1.38 | \$ 1.01 | \$ 1.64 |
| Cash received | \$ 160 | \$ 238 | \$ 500 | \$ 678 |
| Aggregate intrinsic value | \$ 65 | \$ 137 | \$ 154 | \$ 277 |

The assumptions used to value stock purchases under the Company's ESPP for the three and nine months ended September 30, 2007 are as follows:

| | Three Months Ended September 30, 2007 | Nine Months Ended September 30, 2007 |
|---------------------------------------|---|--|
| Expected term | 3 months | 3 months |
| Volatility | 57% | 63% |
| Risk free interest rate | 4.8% | 5.0% |
| Weighted average fair value per share | \$ 0.38 | \$ 0.36 |

(6) Net Loss Per Share

The following table sets forth unweighted potentially dilutive securities that have been excluded from the diluted net loss per share calculation because their effect would be antidilutive for the periods indicated (in thousands, except per share data):

| | Three Months Ended September 30, 2007 | Weighted Average Exercise Price | Nine Months Ended September 30, 2007 | Weighted Average Exercise Price |
|---------------------------|---|--|---|--|
| Warrants | 2,185 | \$ 4.20 | 2,185 | \$ 4.20 |
| Outstanding stock options | 26,166 | \$ 4.17 | 26,166 | \$ 4.41 |
| | <u>28,351</u> | | <u>28,351</u> | |

| | Three Months Ended September 30, 2006 | Weighted Average Exercise Price | Nine Months Ended September 30, 2006 | Weighted Average Exercise Price |
|---------------------------|---|--|---|--|
| Convertible debentures | 1,231 | \$ 6.02 | 1,231 | \$ 6.02 |
| Warrants | 2,716 | \$ 4.68 | 2,716 | \$ 4.68 |
| Outstanding stock options | 25,783 | \$ 4.55 | 25,783 | \$ 4.55 |
| | <u>29,730</u> | | <u>29,730</u> | |

(7) Comprehensive Loss

The components of comprehensive loss, net of tax, for the three and nine months ended September 30, 2007 and 2006 are as follows (in thousands):

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|-------------------------------------|--------------------|------------------------------------|--------------------|
| | 2007 | 2006 | 2007 | 2006 |
| Net loss | \$(1,530) | \$(121,032) | \$(10,870) | \$(138,036) |
| Other comprehensive loss: | | | | |
| Change in unrealized gain/loss on investments | 6 | 6 | — | 12 |
| Foreign currency translation adjustments | 275 | 123 | 464 | 268 |
| Total comprehensive loss | <u>\$(1,249)</u> | <u>\$(120,903)</u> | <u>\$(10,406)</u> | <u>\$(137,756)</u> |

(8) Commitments and Contingencies

Long-Term Debt

Long-term debt consisted of the following as of September 30, 2007 and December 31, 2006 (in thousands):

| | September 30, 2007 | December 31, 2006 |
|--|-----------------------|----------------------|
| Secured real estate loan due April 2011 | \$ 19,471 | \$ 19,639 |
| Convertible debentures assumed in Sorrento acquisition due August 2007 | — | 7,410 |
| | <u>\$ 19,471</u> | <u>27,049</u> |
| Less current portion of long-term debt | 279 | 7,673 |
| | <u>\$ 19,192</u> | <u>\$ 19,376</u> |

Aggregate debt maturities as of September 30, 2007 were \$0.1 million for the remainder of 2007, \$0.3 million in 2008, \$0.3 million in 2009, \$0.3 million in 2010 and \$18.5 million in 2011.

Secured Real Estate Loan

In December 2005, the Company entered into an amendment to an existing loan with a financial institution relating to the financing of its Oakland, California campus (the "Amended Loan"). As of September 30, 2007, the Company had \$19.5 million of debt outstanding under this secured real estate loan which matures in April 2011. The interest rate on this debt was 8.3% as of September 30, 2007. The Company's obligations under the Amended Loan remain secured by a security interest in the Company's campus. As of September 30, 2007 and December 31, 2006, the debt was collateralized by land and buildings with a net book value of \$16.6 million and \$18.5 million, respectively.

Convertible Debentures

In July 2004, the Company assumed convertible debentures of \$11.7 million in connection with the acquisition of Sorrento Networks Corporation, with an interest rate of 7.5%. During 2006, the Company made a voluntary repayment of \$1.5 million relating to the convertible debenture debt. On August 2, 2007, the convertible debentures matured and the Company repaid the outstanding principal amount of \$7.4 million plus accrued interest. The debentures were convertible into common stock at the option of the holder at a conversion price of \$6.02 per share. No holders elected to convert their debentures into common stock. The outstanding principal amount of the convertible debentures was zero as of September 30, 2007 and \$7.4 million as of December 31, 2006.

Credit Facility

During the first quarter of 2007, the Company entered into an amendment to its existing \$25 million revolving credit facility and accounts receivable purchase facility with Silicon Valley Bank (the "SVB Facilities") providing for a one year extension of the term of the SVB Facilities. Under the SVB Facilities, as amended, the Company has the option of either borrowing funds at agreed upon rates of interest or selling specific accounts receivable to Silicon Valley Bank, on a limited recourse basis, at agreed upon discounts to the face amount of those accounts receivable, so long as the aggregate amount of outstanding borrowings and the aggregate amount of the Company's repurchase obligations with respect to purchased accounts receivable do not exceed \$25 million. The amounts borrowed under the revolving credit facility will bear interest, payable monthly, at a floating rate that, at the Company's option, is either (1) Silicon Valley Bank's prime rate, or (2) the sum of the LIBOR rate plus 2.9%; provided that in either case, the minimum interest rate is 4.0%. The Company's obligations under the SVB Facilities remain secured by substantially all of the Company's assets and those of its subsidiaries, including its intellectual property. The SVB Facilities contain certain financial covenants, and customary affirmative covenants and negative covenants. As of September 30, 2007, the Company was in compliance with these covenants. The interest rate was 7.75% at September 30, 2007. Under the SVB Facilities, \$15.0 million was outstanding at September 30, 2007 and \$14.5 million was outstanding at December 31, 2006, and an additional \$5.7 million and \$10.2 million were committed as security for various letters of credit, respectively.

Leases

The Company has entered into operating leases for certain office space and equipment, some of which contain renewal options. Estimated future lease payments under all non-cancelable operating leases with terms in excess of one year, including taxes and service fees, are \$24.1 million.

The total minimum lease payments include projected payments and obligations for leases that the Company is no longer utilizing, some of which relate to excess facilities obtained through acquisitions. At September 30, 2007, the Company had estimated commitments of \$22.8 million related to facilities assumed as a result of the Paradyne acquisition, of which \$4.0 million was accrued for excess facilities, which is net of estimated sublease income. For operating leases that include contractual commitments for operating expenses and maintenance, estimates of such amounts are included based on current rates.

Warranties

The Company accrues for warranty costs based on historical trends for the expected material and labor costs to provide warranty services. Warranty periods are generally one year from the date of shipment. The following table reconciles changes in the Company's accrued warranties and related costs for the nine months ended September 30, 2007 and 2006 (in thousands):

| | Nine Months Ended | |
|----------------------------|-------------------|-----------------|
| | September 30, | |
| | 2007 | 2006 |
| Beginning balance | \$ 3,128 | \$ 5,247 |
| Charged to cost of revenue | 2,046 | 2,252 |
| Claims and settlements | (2,215) | (3,583) |
| Ending balance | <u>\$ 2,959</u> | <u>\$ 3,916</u> |

Other Commitments

The Company depends on sole source and limited source suppliers for several key components and on contract manufacturers to manufacture certain product lines. If the Company was unable to obtain these components on a timely basis, or if its contract manufacturers were unable to meet the Company's delivery requirements, the Company's operating results could be materially adversely affected. The Company has agreements with various contract manufacturers which include inventory repurchase commitments for excess material based on the Company's sales forecasts.

Certain Tellium pre-acquisition contingencies continue to exist for which the Company has reserved an estimated amount which the Company believes is sufficient to cover probable claims.

The Company is currently under audit examination by several state taxing authorities for non-income based taxes. The Company has reserved an estimated amount which the Company believes is sufficient to cover probable claims.

In connection with the acquisition of Sorrento in July 2004, the Company recorded assumed liabilities for possible contingencies related to the resolution of an employee defined benefit plan dispute. A final determination was issued and accordingly, as of September 30, 2007, the Company has reversed substantially all of the assumed liabilities related to this matter.

Royalties

The Company has certain royalty commitments associated with the shipment and licensing of certain products. Royalty expense is generally based on a dollar amount per unit shipped or a percentage of the underlying revenue.

Legal Proceedings

Paradyne Matters

As a result of the acquisition of Paradyne Networks, Inc., the Company became involved in various legal proceedings, claims and litigation, including those identified below, relating to the operations of Paradyne prior to the acquisition of Paradyne.

A purported stockholder class action complaint was filed in December 2001 in the United States District Court in the Southern District of New York (the "District Court") against Paradyne, Paradyne's then-current directors and executive officers, and each of the underwriters (the "Underwriter Defendants") who participated in Paradyne's initial public offering and follow-on offering (collectively, the "Paradyne Offerings"). The complaint alleges that, in connection with the Paradyne Offerings, the Underwriter Defendants charged excessive commissions, inflated transaction fees not disclosed in the applicable registration statements and allocated shares of the Paradyne Offerings to favored customers in exchange for purported promises by such customers to purchase additional shares in the aftermarket, thereby allegedly inflating the market price for the Paradyne Offerings. The complaint seeks damages in an unspecified amount for the purported class for the losses suffered during the class period. This action has been consolidated with hundreds of other securities class actions commenced against more than 300 companies (collectively, the "Issuer Defendants") and approximately 40 investment banks in which the plaintiffs make substantially similar allegations as those made against Paradyne with respect to the initial public offerings and/or follow-on offerings at issue in those other cases. All of these actions have been consolidated in the District Court before Judge Shira Scheindlin under the caption In re: Initial Public Offering Securities Litigation (the "IPO Actions").

In 2003, the Issuer Defendants participated in a global settlement among the plaintiffs and the insurance companies that provided directors' and officers' insurance coverage to the Issuer Defendants (the "Issuer Settlement"). The Issuer Settlement agreements provided for the Issuer Defendants (including Paradyne) to be fully released and dismissed from the IPO Actions. Under the terms of the Issuer Settlement agreements, Paradyne would not have been required to make any cash payment to the plaintiffs. Although the District Court preliminarily approved the Issuer Settlement, the preliminary approval remained subject to a future final settlement order, after notice of settlement had been provided to class members and they had been afforded the opportunity to oppose or opt out of the settlement. However, before the District Court could conduct its final settlement hearing, on December 5, 2006, the United States Court of Appeals for the Second Circuit (the "Second Circuit") reversed an October 13, 2004 order of the District Court in which Judge Scheindlin had granted class certification for six "test cases" in the IPO Actions. On April 4, 2007, the Second Circuit denied the plaintiffs' petition for rehearing of the December 5, 2006 ruling. The District Court has since made clear that the Issuer Settlement cannot be approved — in its current form — as a class action settlement in light of the Second Circuit's December 5, 2006 ruling and has declined to schedule a final approval hearing with respect to the Issuer Settlement for that reason. Counsel for the plaintiffs, for the Issuer Defendants and for the insurance companies that provided directors' and officers' insurance to the Issuer Defendants are currently engaged in discussions to restructure and salvage the Issuer Settlement. There can be no assurance that a restructured Issuer Settlement will be reached by the parties or that any such future settlement will meet the conditions for final approval by the District Court.

Other Matters

The Company is subject to other legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, the Company does not expect that the ultimate costs to resolve these matters will have a material adverse effect on the Company's consolidated financial position or results of operations. However, litigation is subject to inherent uncertainties, and unfavorable rulings could occur. If an unfavorable ruling were to occur, there exists the possibility of a material adverse impact on the results of operations of the period in which the ruling occurs, or future periods.

(9) Segment Information

The Company designs, develops and markets communications products for network service providers. The Company derives substantially all of its revenues from the sales of the Zhone product family. The Company's chief operating decision maker is the Company's Chief Executive Officer. The Chief Executive Officer reviews financial information presented on a consolidated basis accompanied by disaggregated information about revenues by geographic region for purposes of making operating decisions and assessing financial performance. The Company has determined that it has operated within one discrete reportable business segment since inception. The following summarizes required disclosures about geographic concentrations and revenue by product family.

| | Three Months Ended | | Nine Months Ended | |
|------------------------------|---------------------------|------------------------|--------------------------|-------------------------|
| | September 30, | | September 30, | |
| | 2007 | 2006 | 2007 | 2006 |
| | (in thousands) | | (in thousands) | |
| Revenue by Geography: | | | | |
| United States | \$20,937 | \$25,327 | \$ 60,636 | \$ 80,400 |
| Canada | 2,497 | 1,857 | 7,925 | 7,514 |
| Total North America | <u>\$23,434</u> | <u>\$27,184</u> | <u>68,561</u> | <u>\$ 87,914</u> |
| Latin America | 8,646 | 6,660 | 25,110 | 19,940 |
| Europe, Middle East, Africa | 7,918 | 7,460 | 31,015 | 35,718 |
| Asia Pacific | 1,606 | 1,834 | 4,149 | 6,466 |
| Total International | <u>18,170</u> | <u>15,954</u> | <u>60,274</u> | <u>62,124</u> |
| | <u><u>\$41,604</u></u> | <u><u>\$43,138</u></u> | <u><u>\$128,835</u></u> | <u><u>\$150,038</u></u> |

| | <u>Three Months Ended</u> | | <u>Nine Months Ended</u> | |
|-----------------------------------|---------------------------|-----------------|--------------------------|------------------|
| | <u>September 30,</u> | | <u>September 30,</u> | |
| | <u>2007</u> | <u>2006</u> | <u>2007</u> | <u>2006</u> |
| | (in thousands) | | (in thousands) | |
| Revenue by Product Family: | | | | |
| SLMS | \$29,227 | \$23,608 | \$ 91,105 | \$ 92,035 |
| Legacy, service, and other | <u>12,377</u> | <u>19,530</u> | <u>37,730</u> | <u>58,003</u> |
| Total revenue | <u>\$41,604</u> | <u>\$43,138</u> | <u>\$128,835</u> | <u>\$150,038</u> |

(10) Accounting for Uncertainty in Income Taxes

In accordance with the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), the total amount of unrecognized tax benefits, including interest and penalties, at September 30, 2007 is not material. The amount of tax benefits that would impact the effective rate, if recognized, is not expected to be material. There were no significant changes to unrecognized tax benefits at the date of adoption or at the quarter ended September 30, 2007. The Company does not anticipate any significant changes with respect to unrecognized tax benefits within the next 12 months.

Interest and penalties, to the extent accrued on unrecognized tax benefits in the future, will be included in tax expense.

The Company or one of its subsidiaries files income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. The open tax years for the major jurisdictions are as follows:

- Federal, Illinois, North Carolina and Virginia 2003 –2006
- California, New Jersey, Texas and Canada 2002 –2006
- Brazil 2001 –2006
- Germany and United Kingdom 2005 –2006

However, due to the fact the Company had net operating losses and credits carried forward in most jurisdictions, certain items attributable to technically closed years are still subject to adjustment by the relevant taxing authority through an adjustment to tax attributes carried forward to open years.

In addition, to the extent the Company is deemed to have a sufficient connection to a particular taxing jurisdiction to enable that jurisdiction to tax the Company but the Company has not filed an income tax return in that jurisdiction for the year(s) at issue, the jurisdiction would typically be able to assert a tax liability for such years without limitation on the number of years it may examine.

The Company is not currently under examination for income taxes in any material jurisdiction.

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

This report, including “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” contains forward-looking statements regarding future events and our future results that are subject to the safe harbors created under the Securities Act of 1933 and the Securities Exchange Act of 1934. These statements are based on current expectations, estimates, forecasts, and projections about the industries in which we operate and the beliefs and assumptions of our management. We use words such as “anticipate,” “believe,” “continue,” “could,” “estimate,” “expect,” “goal,” “intend,” “may,” “plan,” “project,” “seek,” “should,” “target,” “will,” “would,” variations of such words, and similar expressions to identify forward-looking statements. In addition, statements that refer to projections of earnings, revenue, costs or other financial items; anticipated growth and trends in our business or key markets; future growth and revenues from our SLMS products; improvements in the capital spending environment; anticipated performance of products or services; plans, objectives and strategies for future operations; and other characterizations of future events or circumstances, are forward-looking statements. Readers are cautioned that these forward-looking statements are only predictions and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, actual results may differ materially and adversely from those expressed in any forward-looking statements. Factors that might cause such a difference include, but are not limited to, the ability to generate sufficient revenue to achieve or sustain profitability, the ability to raise additional capital to fund existing and future operations, defects or other performance problems in our products, the economic slowdown in the telecommunications industry that has restricted the ability of our customers to purchase our products, commercial acceptance of our SLMS products, intense competition in the communications equipment market from large equipment companies as well as private companies

with products that address the same networks needs as our products, higher than anticipated expenses that we may incur, and other factors identified elsewhere in this report and in our most recent reports on Forms 10-K, 10-Q and 8-K. We undertake no obligation to revise or update any forward-looking statements for any reason.

OVERVIEW

We believe that we are the first company dedicated solely to developing the full spectrum of next-generation access network solutions to cost-effectively deliver high bandwidth services while simultaneously preserving the investment in today's networks. Our next-generation solutions are based upon our Single Line Multi Service, or SLMS, architecture. From its inception, this SLMS architecture was specifically designed for the delivery of multiple classes of subscriber services (such as voice, data and video distribution), rather than being based on a particular protocol or media. In other words, our SLMS products are built to support the migration from legacy circuit to packet technologies and from copper to fiber technologies. This flexibility and versatility allows our products to adapt to future technologies while allowing service providers to focus on the delivery of additional high bandwidth services. Because this SLMS architecture is designed to interoperate with existing legacy equipment, service providers can leverage their existing networks to deliver a combination of voice, data and video services today, while they migrate, either simultaneously or at a future date, from legacy equipment to next-generation equipment with minimal interruption. We believe that our SLMS solution provides an evolutionary path for service providers from their existing infrastructures, as well as gives newer service providers the capability to deploy cost-effective, multi-service networks that can support voice, data and video.

Our product offerings fall within two categories: (1) the SLMS product family and (2) legacy, services and other. Commencing with the first quarter of 2007, we have reported our optical transport business with our legacy, services and other product category. We have reclassified prior period balances in order to conform to the current period's presentation.

Our global customer base includes regional, national and international telecommunications carriers, as well as cable service providers. We believe that we have assembled the employee base, technological breadth and market presence to provide a simple yet comprehensive set of next-generation solutions to the bandwidth bottleneck in the access network and the other problems encountered by network service providers when delivering communications services to subscribers.

Since inception, we have incurred significant operating losses and had an accumulated deficit of \$911.8 million at September 30, 2007.

Going forward, our key financial objectives include the following:

- Increase revenue while continuing to carefully control costs;
- Continue investments in strategic research and product development activities that will provide the maximum potential return on investment; and
- Minimize consumption of our cash and short-term investments.

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

Management's discussion and analysis of financial condition and results of operations is based upon our consolidated financial statements, which have been prepared in accordance with generally accepted accounting principles in the United States of America. The preparation of these financial statements requires management to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. The policies discussed below are considered by management to be critical because changes in such estimates can materially affect the amount of our reported net income or loss. For all of these policies, management cautions that actual results may differ materially from these estimates under different assumptions or conditions.

Revenue Recognition

We recognize revenue when the earnings process is complete. We recognize product revenue upon shipment of product under contractual terms which transfer title to customers upon shipment, under normal credit terms, or under sales-type leases, net of estimated sales returns and allowances at the time of shipment. Revenue is deferred if there are significant post-delivery obligations, if collection is not considered reasonably assured at the time of sale, or if the fees are not fixed or determinable. When significant post-delivery obligations exist, revenue is deferred until such obligations are fulfilled. Our arrangements generally do not have any significant post-delivery obligations. We offer products and services such as support, education and training, hardware upgrades and post-warranty support. For multiple element revenue arrangements, we establish the fair value of these products and services based primarily on sales prices when

the products and services are sold separately. If fair value cannot be established for undelivered elements, all of the revenue under the arrangement is deferred until those elements have been delivered. When collectibility is not reasonably assured, revenue is recognized when cash is collected. Revenue from education services and support services is recognized over the contract term or as the service is performed. We make certain sales to product distributors. These customers are given certain privileges to return a portion of inventory. Return privileges generally allow distributors to return inventory based on a percent of purchases made within a specific period of time. We recognize revenue on sales to distributors that have contractual return rights when the products have been sold by the distributors, unless there is sufficient customer specific sales and sales returns history to support revenue recognition upon shipment. In those instances when shipments made to distributors are recognized upon shipment of the products from the factory, we use historical rates of return from the distributors to provide for estimated product returns in accordance with SFAS 48, *Revenue Recognition When Right of Return Exists*. Revenue from sales of software products is recognized provided that a purchase order has been received, the software has been shipped, collection of the resulting receivable is probable, and the amount of the related fees is fixed or determinable. To date, revenue from software transactions and sales-type leases has not been significant. We accrue for warranty costs, sales returns and other allowances at the time of shipment based on historical experience and expected future costs.

Allowances for Sales Returns and Doubtful Accounts

We record an allowance for sales returns for estimated future product returns related to current period product revenue. The allowance for sales returns is recorded as a reduction of revenue and an allowance against our accounts receivable. We base our allowance for sales returns on periodic assessments of historical trends in product return rates and current approved returned products. If the actual future returns were to deviate from the historical data on which the reserve had been established, our future revenue could be adversely affected. We record an allowance for doubtful accounts for estimated losses resulting from the inability of customers to make payments for amounts owed to us. The allowance for doubtful accounts is recorded as a charge to general and administrative expenses. We base our allowance on periodic assessments of our customers' liquidity and financial condition through analysis of information obtained from credit rating agencies, financial statement reviews, and historical collection trends. Additional allowances may be required in the future if the liquidity or financial condition of our customers deteriorates, resulting in impairment in their ability to make payments.

Stock-Based Compensation

We account for stock based compensation expense in accordance with the provisions of Statement of Financial Accounting Standards No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R). We have estimated the fair value of stock-based payment awards on the date of grant using the Black Scholes pricing model, which is affected by our stock price as well as assumptions regarding a number of complex and subjective variables. These variables include our expected stock price volatility over the term of the awards, actual and projected employee option exercise behaviors, risk free interest rate and expected dividends. The estimated expected term of options granted was determined based on historical option exercise trends. Estimated volatility was based on historical volatility as well as peer group data and the risk free interest rate was based on U.S. Treasury yield in effect at the time of grant for the expected life of the options.

Valuation of Long-Lived Assets, Including Goodwill and Other Intangible Assets

Our long-lived assets consist primarily of goodwill, other intangible assets and property and equipment. We review long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of such assets may not be recoverable. Such events or circumstances include, but are not limited to, a significant decrease in the benefits realized from the acquired business, difficulty and delays in integrating the business, or a significant change in the operations of the acquired business or use of an asset. Goodwill and other intangible assets not subject to amortization are tested annually during the month of November for impairment using a two-step approach, and are tested for impairment more frequently if events and circumstances indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. We estimate the fair value of our long-lived assets based on a combination of the market, income and replacement cost approaches. In the application of the impairment testing, we are required to make estimates of future operating trends and resulting cash flows, and judgments on discount rates and other variables. Actual future results and other assumed variables could differ from these estimates.

As of September 30, 2007, we had \$70.4 million of goodwill and \$21.2 million of net property and equipment. Our future operating performance will be impacted by potential charges related to purchased in-process research and development for future acquisitions, and potential impairment charges related to goodwill. Accordingly, the allocation of the purchase price of the acquired companies to goodwill has a significant impact on our future operating results.

The allocation process requires management to make significant estimates and assumptions, including estimates of future cash flows expected to be generated by the acquired assets and the appropriate discount rate for these cash flows. Should different conditions prevail, we would have to perform an impairment review that might result in impairment of the goodwill. Other factors we consider important which could trigger an impairment review, include, but are not limited to, significant changes in the manner of use of our acquired assets, significant changes in the strategy for our overall business or significant negative economic trends, such as stock price movements. For example, during 2006 and 2005, we determined that such indicators of impairment existed, resulting in an impairment charge to goodwill and amortizable intangibles of \$113.7 million and \$102.1 million, respectively. Due to uncertain market conditions and potential changes in our strategy and product portfolio, it is possible that forecasts used to support our goodwill may change in the future, which could result in additional non-cash impairment charges that would adversely affect our results of operations and financial condition.

During the second quarter of 2007, we completed the sale of approximately 3.625 acres of undeveloped land at a price of \$1.5 million to the Redevelopment Agency of the City of Oakland pursuant to a repurchase option exercised by it. No gain or loss was recorded on the sale.

RESULTS OF OPERATIONS

We list in the tables below the historical condensed consolidated statement of operations data as a percentage of revenue for the periods indicated.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|--|-------------------------------------|--------|------------------------------------|-------|
| | 2007 | 2006 | 2007 | 2006 |
| Net revenue | 100% | 100% | 100% | 100% |
| Cost of revenue | 70% | 65% | 67% | 69% |
| Gross profit | 30% | 35% | 33% | 31% |
| Operating expenses: | | | | |
| Research and product development | 20% | 21% | 19% | 18% |
| Sales and marketing | 20% | 22% | 20% | 20% |
| General and administrative | 5% | 9% | 6% | 7% |
| Amortization and impairment of intangible assets | 0% | 264% | 0% | 78% |
| Gain of sale of patents | (12)% | | (4)% | |
| Total operating expenses | 33% | 316% | 41% | 123% |
| Operating loss | (3)% | (281)% | (8)% | (92)% |
| Interest expense | (1)% | (2)% | (1)% | (1)% |
| Interest income | 1% | 2% | 1% | 1% |
| Other income (expense), net | 0% | 0% | 0% | 0% |
| Loss before income taxes | (3)% | (281)% | (8)% | (92)% |
| Income tax provision | 0% | 0% | 0% | 0% |
| Net loss | (3)% | (281)% | (8)% | (92)% |

Revenue

Information about our revenue for products and services for the three and nine months ended September 30, 2007 and 2006 is summarized below (in millions):

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|----------|-------------------------------------|--------|------------------------|----------|------------------------------------|---------|------------------------|----------|
| | 2007 | 2006 | Increase (Decrease) | % Change | 2007 | 2006 | Increase (Decrease) | % Change |
| Products | \$38.9 | \$39.9 | \$ (1.0) | (3)% | \$120.8 | \$140.8 | \$ (20.0) | (14)% |
| Services | 2.7 | 3.2 | (0.5) | (16)% | 8.0 | 9.2 | (1.2) | (13)% |
| Total | \$41.6 | \$43.1 | \$ (1.5) | (3)% | \$128.8 | \$150.0 | \$ (21.2) | (14)% |

Information about our revenue for North America and International markets for the three and nine months ended September 30, 2007 and 2006 is summarized below (in millions):

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|--------------------------------|-------------------------------------|--------|------------------------|----------|------------------------------------|---------|------------------------|----------|
| | 2007 | 2006 | Increase (Decrease) | % change | 2007 | 2006 | Increase (Decrease) | % change |
| Revenue by geography: | | | | | | | | |
| United States | \$20.9 | \$25.3 | \$ (4.4) | (17)% | \$ 60.7 | \$ 80.4 | \$ (19.7) | (25)% |
| Canada | 2.5 | 1.9 | 0.6 | 32% | 7.9 | 7.5 | 0.4 | 5% |
| Total North America | \$23.4 | \$27.2 | \$ (3.8) | (14)% | \$ 68.6 | \$ 87.9 | \$ (19.3) | (22)% |
| Latin America | 8.7 | 6.6 | 2.1 | 32% | 25.1 | 19.9 | 5.2 | 26% |
| Europe, Middle East, Africa | 7.9 | 7.5 | 0.4 | 5% | 31.0 | 35.8 | (4.8) | (13)% |
| Asia Pacific | 1.6 | 1.8 | (0.2) | (11)% | 4.1 | 6.4 | (2.3) | (36)% |
| Total International | \$18.2 | \$15.9 | \$ 2.3 | 14% | \$ 60.2 | \$ 62.1 | \$ (1.9) | (3)% |
| Total | \$41.6 | \$43.1 | \$ (1.5) | (3)% | \$128.8 | \$150.0 | \$ (21.2) | (14)% |

Information about our revenue by product line for the three and nine months ended September 30, 2007 and 2006 is summarized below (in millions):

| | Three Months Ended September 30, | | | | Nine Months Ended September 30, | | | |
|----------------------------|-------------------------------------|--------|------------------------|----------|------------------------------------|---------|------------------------|----------|
| | 2007 | 2006 | Increase (Decrease) | % change | 2007 | 2006 | Increase (Decrease) | % change |
| SLMS | \$29.2 | \$23.6 | \$ 5.6 | 24% | \$ 91.1 | \$ 92.0 | \$ (0.9) | (1)% |
| Legacy, service, and other | 12.4 | 19.5 | (7.1) | (36)% | 37.7 | 58.0 | (20.3) | (35)% |
| Total | \$41.6 | \$43.1 | \$ (1.5) | (3)% | \$128.8 | \$150.0 | \$ (21.2) | (14)% |

For the three months ended September 30, 2007, revenue decreased 3% or \$1.5 million to \$41.6 million from \$43.1 million for the same period last year. For the nine months ended September 30, 2007, revenue decreased 14% or \$21.2 million to \$128.8 million from \$150.0 million for the same period last year. The decrease in total revenue was primarily due to decreased demand for our legacy, service and other products compared to the prior year, particularly in the domestic region. Additionally, a reduction in customers' capital expenditure spending contributed to the overall decrease in revenue.

Product revenue accounted for the majority of the total decrease in revenue. For the three months ended September 30, 2007, product revenue decreased \$1.0 million or 3% to \$38.9 million from \$39.9 million, and \$20.0 million or 14% to \$120.8 million from \$140.8 million for the nine months ended September 30, 2007, compared to the same period last year. Service revenue decreased by \$0.5 million or 16% to \$2.7 million from \$3.2 million for the three months ended September 30, 2007 compared to 2006, and \$1.2 million or 13% to \$8.0 million from \$9.2 million for the nine months ended September 30, 2007 compared to the same period in 2006. Service revenue represents revenue from maintenance and other services associated with product shipments.

International revenue increased 14% or \$2.3 million to \$18.2 million for the three months ended September 30, 2007 from \$15.9 million for the same period last year, and represented 44% of total revenue compared with 37% during the same period of 2006. For the nine months ended September 30, 2007, international revenue decreased 3% or \$1.9 million to \$60.2 million from \$62.1 million for the same period last year, and represented 47% of total revenue compared with 41% during the same period of 2006. The significant increase in the concentration of international revenue represents the increasing opportunity for our next-generation products in both existing and new network deployments among emerging international carriers in the Middle East and Latin America.

By product family, revenue for our SLMS product family increased by \$5.6 million or 24% to \$29.2 million from \$23.6 million for the three months ended September 30, 2007 compared to the same period last year, and decreased \$0.9 million or 1% to \$91.1 million from \$92.0 million for the nine months ended September 30, 2007, as compared to the same period last year. Quarterly SLMS revenue growth was driven by the launch of our GPON solution. Year-to-date SLMS revenue decreased over the same period last year as customers deferred capital spending to evaluate technology direction and customer consolidation continued within the industry. Revenue for our legacy products and services decreased \$7.1 million or 36% to \$12.4 million from \$19.5 million for the three months ended September 30, 2007 as compared to the same period last year. For the nine months ended September 30, 2007, legacy products and services decreased by \$20.3 million or 35% to \$37.7 million from \$58.0 million in the same period last year. The decrease in legacy products and services was driven by the sale of the iMarc product line at the end of

2006 and expected migration of legacy products to next generation solutions. We anticipate that the product mix will continue to shift toward next generation products within the SLMS product family.

For the three months ended September 30, 2007, no customer represented 10% or more of net revenue. For the three months ended September 30, 2006, one customer represented 12% of net revenue. For the nine months ended September 30, 2007 and September 30, 2006, no customer represented 10% or more of net revenue. We anticipate that our results of operations in any given period may depend to a large extent on sales to a small number of large accounts. As a result, our revenue for any quarter may be subject to significant volatility based upon changes in orders from one or a small number of key customers.

Cost of Revenue and Gross Profit

Total cost of revenue, including stock-based compensation, increased \$1.1 million or 4% to \$29.1 million from \$28.0 million for the three months ended September 30, 2007, and decreased \$17.6 million or 17% to \$85.8 million from \$103.4 million for the nine months ended September 30, 2007 compared to the same periods in prior year. For the three months ended September 30, 2007, cost of revenue increased due to a greater mix of lower margin shipments. For the nine months ended September 30, 2007, cost of revenue decreased due to an overall decline in revenues as well as a significantly decreased obsolescence provision for legacy products as compared to prior periods. In addition, gains related to the sale of the iMarc product line during 2007 further reduced cost of revenue as compared to prior periods. Total cost of revenue was 70% and 65% of revenue for the three months ended September 30, 2007 and 2006, respectively, and 67% and 69% of revenue for the nine months ended September 30, 2007 and 2006, respectively.

In 2006, we entered into an agreement to sell inventory and certain assets related to our iMarc legacy product line to a third party. The sale of the iMarc product line was not treated as a discontinued operation since it did not represent a component of our company that had operations and cash flows that were clearly distinguishable, operationally and for financial reporting purposes, from the rest of the entity. Upon performance of certain obligations and delivery of the assets in the first quarter of 2007, we recognized a gain of \$1.8 million that was recorded in cost of revenue. Upon sale of the remaining iMarc inventory during the second quarter of 2007, we recognized an additional gain to cost of revenue of \$1.1 million related to the sale of the legacy iMarc product line.

We expect that in the future, our cost of revenue as a percentage of net revenue will vary depending on the mix and average selling prices of products sold. In addition, competitive and economic pressures could cause us to reduce our prices, adjust the carrying values of our inventory, or record inventory charges relating to discontinued products and excess or obsolete inventory.

Research and Product Development Expenses

Research and product development expenses decreased 9% or \$0.8 million to \$8.2 million from \$9.0 million for the three months ended September 30, 2007 compared to 2006 as a result of cost reduction efforts. Research and product development expenses decreased 8% or \$2.2 million to \$25.3 million from \$27.5 million for the nine months ended September 30, 2007 compared to 2006. This decrease was primarily attributable to non-recurring specific new product development efforts expended during the second quarter of 2006 for a potential major carrier customer. We intend to continue to invest in research and product development to attain our strategic product development objectives, while seeking to manage the associated costs through expense controls.

Sales and Marketing Expenses

Sales and marketing expenses decreased 10% or \$0.9 million to \$8.4 million from \$9.3 million for the three months ended September 30, 2007 compared to 2006, and 15% or \$4.5 million to \$25.1 million from \$29.6 million for the nine months ended September 30, 2007 compared to 2006. The decrease was primarily attributable to reduced commissions on lower sales volumes, a slightly lower headcount as we realigned our resources to focus on emerging markets, and reduced demonstration and trade show expenses.

General and Administrative Expenses

General and administrative expenses decreased 41% or \$1.6 million to \$2.3 million from \$3.9 million for the three months ended September 30, 2007 compared to 2006, and 29% or \$3.2 million to \$7.9 million from \$11.1 million for the nine months ended September 30, 2007 compared to 2006. The decrease was primarily due to reduced personnel costs, the reversal of certain contingent liabilities in the third quarter of 2007, reduced accounting and legal fees, the reversal of certain liabilities in the first quarter of 2007, and a favorable legal settlement in the second quarter of 2007.

Income Tax Provision

During the three and nine months ended September 30, 2007 and 2006, no material provision or benefit for income taxes was recorded, due to our recurring operating losses and the significant uncertainty regarding the realization of our net deferred tax assets, against which we have continued to record a full valuation allowance.

LIQUIDITY AND CAPITAL RESOURCES

Our operations are financed through a combination of our existing cash, cash equivalents and investments, available credit facilities, and sales of equity and debt instruments, based on our operating requirements and market conditions.

At September 30, 2007, cash equivalents and short-term investments, all of which are available to fund current operations, were \$50.4 million. This amount includes cash and cash equivalents of \$37.4 million, as compared with \$47.0 million at December 31, 2006. The decrease in cash and cash equivalents was attributable to net cash used in operating and financing activities of \$13.9 million and \$6.6 million, respectively, offset by net cash provided by investing activities of \$10.4 million.

Operating Activities

Net cash used in operating activities for the nine months ended September 30, 2007 consisted of net loss of \$10.9 million, adjusted for non-cash charges totaling \$6.5 million, and offset by gain on sale of patents of \$5.0 million and increases in operating assets net of liabilities totaling \$4.5 million. The most significant components of the changes in operating assets and liabilities were increases in accounts receivable of \$6.1 million and decreases in accrued and other liabilities of \$2.5 million offset by decreases in inventories of \$2.3 million.

Investing Activities

Net cash provided by investing activities consisted primarily of proceeds from the sale of short-term investments and sale of assets/patents of \$28.1 million and \$6.5 million, respectively, offset by purchases of short-term investments and property and equipment of \$23.4 million and \$1.1 million, respectively.

Financing Activities

Net cash used in financing activities consisted primarily of repayment of debt of \$7.6 million, partially offset by proceeds from the issuance of common stock of \$0.5 million and borrowings under credit facilities of \$0.5 million.

Cash Management

Our primary source of liquidity comes from our cash and cash equivalents and short-term investments, which totaled \$50.4 million at September 30, 2007, and our \$25.0 million line of credit, under which \$15.0 million was outstanding at September 30, 2007, and an additional \$5.7 million was committed as security for various letters of credit. Our short-term investments are classified as available-for-sale and consist of securities that are readily convertible to cash, including certificates of deposits, commercial paper and government securities, with original maturities at the date of acquisition ranging from 90 days to one year. At current revenue levels, we anticipate that some portion of our existing cash and cash equivalents and short-term investments will continue to be consumed by operations.

During the first quarter of 2007, we entered into an amendment to our existing \$25 million revolving credit facility and accounts receivable purchase facility with Silicon Valley Bank (the "SVB Facilities") providing for a one year extension of the term of the SVB Facilities. Under the SVB Facilities, as amended, we have the option of either borrowing funds at agreed upon rates of interest or selling specific accounts receivable to Silicon Valley Bank, on a limited recourse basis, at agreed upon discounts to the face amount of those accounts receivable, so long as the aggregate amount of outstanding borrowings and the aggregate amount of our repurchase obligations with respect to purchased accounts receivable do not exceed \$25 million.

Future Requirements and Funding Sources

Our fixed commitments for cash expenditures consist primarily of payments under operating leases, inventory purchase commitments, and payments of principal and interest for debt obligations. As a result of the Paradyne acquisition in September 2005, we assumed a lease commitment of facilities in Largo, Florida. The term of the lease expires in June 2012 and had an estimated remaining obligation of approximately \$22.8 million as of September 30, 2007. We intend to continue to occupy only a portion of these facilities and are evaluating our options to exit the excess portion of the lease. We have recorded an amount in accordance with Emerging Issues Task Force Issue No. 95-3 (EITF 95-3), which we believe is adequate to cover costs incurred to exit the excess portion of these facilities, net of estimated sublease income.

As a result of the financial demands of major network deployments and the difficulty in accessing capital markets, network service providers continue to request financing assistance from their suppliers. From time to time, we may provide or commit to extend credit or credit support to our customers. This financing may include extending credit to customers or guaranteeing the indebtedness of customers to third parties. Depending upon market conditions, we may seek to factor these arrangements to financial institutions, third parties and investors to free up our capital and reduce the amount of our financial commitments for such arrangements. For example, during the third quarter of 2007, we sold \$0.3 million of customer receivables to a financial institution on a non-recourse basis. Our ability to provide customer financing is limited and depends upon a number of factors, including our capital structure, the level of our available credit and our ability to factor commitments to third parties. Any extension of financing to our customers will limit the capital that we have available for other uses. Currently, we do not have any significant customer financing related commitments.

In March 2004, we filed a Form S-3 registration statement which allows us to sell, from time to time, up to \$100 million of our common stock or other securities. Although we may use this multi-purpose shelf registration to raise additional capital, there can be no certainty as to when or if we may offer any securities under the shelf registration or what the terms of any such offering would be.

Our accounts receivable, while not considered a primary source of liquidity, represents a concentration of credit risk because a significant portion of the accounts receivable balance at any point in time typically consists of a relatively small number of customer account balances. As of September 30, 2007, two customers accounted for 16% and 14% of accounts receivable, respectively, and receivables from customers in territories outside of the United States of America represented 65% of accounts receivable. We do not currently have any material commitments for capital expenditures, or any other material commitments aside from operating leases for our facilities, inventory purchase commitments and debt.

Based on our current plans and business conditions, we believe that our existing cash, cash equivalents and short-term investments and available credit facilities will be sufficient to satisfy our anticipated cash requirements for the foreseeable future.

Contractual Commitments and Off-Balance Sheet Arrangements

At September 30, 2007, our future contractual commitments by fiscal year are as follows (in thousands):

| | Payments due by period | | | | | | 2012 and beyond |
|---|------------------------|-----------------|----------------|----------------|----------------|-----------------|--------------------|
| | Total | 2007 | 2008 | 2009 | 2010 | 2011 | |
| Operating leases | \$24,148 | \$ 1,339 | \$4,803 | \$4,597 | \$4,478 | \$ 4,478 | \$ 4,453 |
| Line of credit | 15,000 | 15,000 | — | — | — | — | — |
| Debt | 19,471 | 69 | 285 | 315 | 342 | 18,460 | — |
| Inventory purchase commitments | 14 | 14 | — | — | — | — | — |
| Total future contractual commitments | \$58,633 | \$16,422 | \$5,088 | \$4,912 | \$4,820 | \$22,938 | \$ 4,453 |

The operating lease amounts shown above represent off-balance sheet arrangements to the extent that a liability is not already recorded on our balance sheet. For operating lease commitments, a liability is generally not recorded on our balance sheet unless the facility represents an excess facility for which an estimate of the facility exit costs has been recorded on our balance sheet, net of estimated sublease income. Payments made under operating leases will be treated as rent expense for the facilities currently being utilized. The debt and line of credit obligations have been recorded on our balance sheet. The debt obligation amounts shown above represent the scheduled principal repayments, but not the associated interest payments which may vary based on changes in market interest rates. For operating leases that include contractual commitments for operating expenses and maintenance, estimates of such amounts are included based on current rates. At September 30, 2007, the interest rate on our outstanding debt obligations ranged from 7.75% to 8.3%. Inventory purchase commitments represent the amount of excess inventory purchase commitments that have been recorded on our balance sheet at September 30, 2007. As of September 30, 2007 and December 31, 2006, we had \$5.7 million and \$10.2 million, respectively, committed as security under our line of credit.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Cash, Cash Equivalents and Short-Term Investments

Cash, cash equivalents and short-term investments consisted of the following as of September 30, 2007 and December 31, 2006 (in thousands):

| | September 30, 2007 | December 31, 2006 |
|---------------------------|-----------------------|----------------------|
| Cash and cash equivalents | \$ 37,412 | \$ 46,973 |
| Short-term investments | 12,980 | 17,337 |
| | <u>\$ 50,392</u> | <u>\$ 64,310</u> |

Concentration of Credit Risk

Financial instruments which potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents, short-term investments and accounts receivable. Cash and cash equivalents consist principally of demand deposit and money market accounts, commercial paper, and debt securities of domestic municipalities with credit ratings of AA or better. Cash and cash equivalents and short-term investments are principally held with various domestic financial institutions with high-credit standing. As of September 30, 2007, two customers accounted for 16% and 14% of accounts receivable, respectively, and as of December 31, 2006, no customer represented 10% or more of accounts receivable. As of September 30, 2007 and December 31, 2006, receivables from customers in territories outside of the United States of America represented 65% and 48%, respectively, of accounts receivable.

Interest Rate Risk

Our exposure to market risk for changes in interest rates relates primarily to our investment portfolio and long-term debt. We do not use derivative financial instruments in our investment portfolio. We do not hold financial instruments for trading or speculative purposes. We manage our interest rate risk by maintaining an investment portfolio primarily consisting of debt instruments of high credit quality and relatively short average maturities. Under our investment policy, short-term investments have a maximum maturity of one year from the date of acquisition, and the average maturity of the portfolio cannot exceed six months. Due to the relatively short maturity of the portfolio, a 10% increase in market interest rates at September 30, 2007 would decrease the fair value of the portfolio by less than \$0.1 million.

Foreign Currency Exchange Risk

We transact business in various foreign countries. Substantially all of our assets are located in the United States. We have sales operations throughout Europe, Asia, the Middle East and Latin America. We are exposed to foreign currency exchange rate risk associated with foreign currency denominated assets and liabilities, primarily inter-company receivables and payables. Accordingly, our operating results are exposed to changes in exchange rates between the U.S. dollar and those currencies. During 2007 and 2006, we did not hedge any of our foreign currency exposure.

We have performed sensitivity analyses as of September 30, 2007 using a modeling technique that measures the change in the fair values arising from a hypothetical 10% adverse movement in the levels of foreign currency exchange rates relative to the U.S. dollar, with all other variables held constant. The sensitivity analyses indicated that a hypothetical 10% adverse movement in foreign currency exchange rates would result in a foreign exchange loss of \$1.3 million at September 30, 2007. This sensitivity analysis assumes a parallel adverse shift in foreign currency exchange rates, which do not always move in the same direction. Actual results may differ materially.

Item 4. Controls and Procedures

Disclosure Controls and Procedures

We conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. The controls evaluation was done under the supervision and with the participation of management, including our Chief Executive Officer and our Chief Financial Officer. Based upon this evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that, subject to the limitations noted in this Part I, Item 4, as of the end of the period covered by this report, our disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in our reports under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified by the SEC, and that material information relating to Zhone and its consolidated subsidiaries is made known to management, including the Chief Executive Officer and Chief Financial Officer, particularly during the period when our periodic reports are being prepared.

Changes in Internal Control Over Financial Reporting

There were no changes in our internal control over financial reporting that occurred during our last fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Inherent Limitations on Effectiveness of Controls

Our management, including the Chief Executive Officer and Chief Financial Officer, does not expect that our disclosure controls and procedures or our internal control over financial reporting will prevent or detect all error and all fraud. A control system, no matter how well designed and operated, can provide only reasonable, not absolute, assurance that the control system's objectives will be met. The design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs. Further, because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that misstatements due to error or fraud will not occur or that all control issues and instances of fraud, if any, within the company have been detected. These inherent limitations include the realities that judgments in decision-making can be faulty and that breakdowns can occur because of simple error or mistake. Controls can also be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the controls. The design of any system of controls is based in part on certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions. Projections of any evaluation of controls effectiveness to future periods are subject to risks. Over time, controls may become inadequate because of changes in conditions or deterioration in the degree of compliance with policies or procedures.

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

Paradyne Matters

As a result of our acquisition of Paradyne Networks, Inc., we became involved in various legal proceedings, claims and litigation, including those identified below, relating to the operations of Paradyne prior to our acquisition of Paradyne.

A purported stockholder class action complaint was filed in December 2001 in the United States District Court in the Southern District of New York (the "District Court") against Paradyne, Paradyne's then-current directors and executive officers, and each of the underwriters (the "Underwriter Defendants") who participated in Paradyne's initial public offering and follow-on offering (collectively, the "Paradyne Offerings"). The complaint alleges that, in connection with the Paradyne Offerings, the Underwriter Defendants charged excessive commissions, inflated transaction fees not disclosed in the applicable registration statements and allocated shares of the Paradyne Offerings to favored customers in exchange for purported promises by such customers to purchase additional shares in the aftermarket, thereby allegedly inflating the market price for the Paradyne Offerings. The complaint seeks damages in an unspecified amount for the purported class for the losses suffered during the class period. This action has been consolidated with hundreds of other securities class actions commenced against more than 300 companies (collectively, the "Issuer Defendants") and approximately 40 investment banks in which the plaintiffs make substantially similar allegations as those made against Paradyne with respect to the initial public offerings and/or follow-on offerings at issue in those other cases. All of these actions have been consolidated in the District Court before Judge Shira Scheindlin under the caption In re: Initial Public Offering Securities Litigation (the "IPO Actions").

In 2003, the Issuer Defendants participated in a global settlement among the plaintiffs and the insurance companies that provided directors' and officers' insurance coverage to the Issuer Defendants (the "Issuer Settlement"). The Issuer Settlement agreements provided for the Issuer Defendants (including Paradyne) to be fully released and dismissed from the IPO Actions. Under the terms of the Issuer Settlement agreements, Paradyne would not have been required to make any cash payment to the plaintiffs. Although the District Court preliminarily approved the Issuer Settlement, the preliminary approval remained subject to a future final settlement order, after notice of settlement had been provided to class members and they had been afforded the opportunity to oppose or opt out of the settlement. However, before the District Court could conduct its final settlement hearing, on December 5, 2006, the United States Court of Appeals for the Second Circuit (the "Second Circuit") reversed an October 13, 2004 order of the District Court in which Judge Scheindlin had granted class certification for six "test cases" in the IPO Actions. On April 4, 2007, the Second Circuit denied the plaintiffs' petition for rehearing of the December 5, 2006 ruling. The District Court has since made clear that the Issuer Settlement cannot be approved — in its current form — as a class action settlement in light of the Second Circuit's December 5, 2006 ruling and has declined to schedule a final approval hearing with respect to the

Issuer Settlement for that reason. Counsel for the plaintiffs, for the Issuer Defendants and for the insurance companies that provided directors' and officers' insurance to the Issuer Defendants are currently engaged in discussions to restructure and salvage the Issuer Settlement. There can be no assurance that a restructured Issuer Settlement will be reached by the parties or that any such future settlement will meet the conditions for final approval by the District Court.

Other Matters

We are subject to other legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, management does not expect that the ultimate costs to resolve these matters will have a material adverse effect on our consolidated financial position or results of operations. However, litigation is subject to inherent uncertainties, and unfavorable rulings could occur. If an unfavorable ruling were to occur, there exists the possibility of a material adverse impact on the results of operations of the period in which the ruling occurs, or future periods.

Item 1A. Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2006, which could materially affect our business, financial condition or future results. The risks described in our Annual Report on Form 10-K are not the only risks facing our company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

Item 6. Exhibits

The Exhibit Index on page 27 is incorporated herein by reference as the list of exhibits required as part of this report.

EXHIBIT INDEX

**Exhibit
Number**

Description

| | |
|------|---|
| 31.1 | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a)/15d-14(a) |
| 31.2 | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a)/15d-14(a) |
| 32.1 | Section 1350 Certification of Chief Executive Officer and Chief Financial Officer |

**CERTIFICATION OF CHIEF EXECUTIVE OFFICER
PURSUANT TO
RULE 13a-14(a)/15d-14(a)**

I, Morteza Ejabat, certify that:

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

Date: November 5, 2007

/s/ Morteza Ejabat

Morteza Ejabat

Chief Executive Officer

**CERTIFICATION OF CHIEF FINANCIAL OFFICER
PURSUANT TO
RULE 13a-14(a)/15d-14(a)**

I, Kirk Misaka, certify that:

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

Date: November 5, 2007

/s/ Kirk Misaka

Kirk Misaka

Chief Financial Officer

SECTION 1350 CERTIFICATION

Pursuant to 18 U.S.C. Section 1350, Morteza Ejabat, Chief Executive Officer of Zhone Technologies, Inc. (the "Company"), and Kirk Misaka, Chief Financial Officer of the Company, each hereby certify that, to their knowledge:

1. The Company's Quarterly Report on Form 10-Q for the quarter ended September 30, 2007 (the "Report") fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: November 5, 2007

/s/ Morteza Ejabat

Morteza Ejabat

Chief Executive Officer

/s/ Kirk Misaka

Kirk Misaka

Chief Financial Officer