
**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 **March 31, 2012**

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)

22-3509099

(I.R.S. Employer
Identification Number)

**7195 Oakport Street
Oakland, California**

(Address of principal executive offices)

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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company)

Smaller reporting company

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 May 1, 2012, there were approximately 30,918,344 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 par value)

	<u>March 31,</u> <u>2012</u>	<u>December 31,</u> <u>2011</u>
Assets		
Current assets:		
Cash and cash equivalents	\$ 15,031	\$ 18,190
Accounts receivable, net of allowances for sales returns and doubtful accounts of \$2,077 as of March 31, 2012 and \$2,024 as of December 31, 2011	23,695	31,598
Inventories	26,519	27,393
Prepaid expenses and other current assets	2,823	2,672
Total current assets	<u>68,068</u>	<u>79,853</u>
Property and equipment, net	624	608
Restricted cash	58	58
Other assets	213	213
Total assets	<u>\$ 68,963</u>	<u>\$ 80,732</u>
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	\$ 9,284	\$ 11,797
Line of credit	10,000	15,000
Accrued and other liabilities	9,051	10,029
Total current liabilities	<u>28,335</u>	<u>36,826</u>
Other long-term liabilities	4,282	4,379
Total liabilities	<u>32,617</u>	<u>41,205</u>
Stockholders' equity:		
Common stock, \$0.001 par value. Authorized 180,000 shares; issued and outstanding 30,909 and 30,820 shares as of March 31, 2012 and December 31, 2011, respectively	31	31
Additional paid-in capital	1,071,619	1,071,390
Other comprehensive income	241	237
Accumulated deficit	<u>(1,035,545)</u>	<u>(1,032,131)</u>
Total stockholders' equity	<u>36,346</u>	<u>39,527</u>
Total liabilities and stockholders' equity	<u>\$ 68,963</u>	<u>\$ 80,732</u>

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three Months Ended	
	March 31,	
	2012	2011
Net revenue	\$27,062	\$29,572
Cost of revenue	18,682	18,993
Gross profit	<u>8,380</u>	<u>10,579</u>
Operating expenses:		
Research and product development	4,925	5,516
Sales and marketing	4,715	5,494
General and administrative	2,094	2,071
Total operating expenses	<u>11,734</u>	<u>13,081</u>
Operating loss	(3,354)	(2,502)
Interest expense	(18)	(49)
Interest income	—	2
Other (loss) income, net	(9)	56
Loss before income taxes	(3,381)	(2,493)
Income tax provision (benefit)	33	(53)
Net loss	<u>(3,414)</u>	<u>(2,440)</u>
Other comprehensive income (loss) – foreign currency translation adjustments	4	(10)
Comprehensive loss	<u>\$ (3,410)</u>	<u>\$ (2,450)</u>
Basic and diluted net loss per share	\$ (0.11)	\$ (0.08)
Weighted average shares outstanding used to compute basic and diluted net loss per share	30,857	30,591

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three Months Ended	
	March 31,	
	2012	2011
Cash flows from operating activities:		
Net loss	\$ (3,414)	\$ (2,440)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	77	453
Stock-based compensation	169	231
Provision for sales returns and doubtful accounts	404	487
Changes in operating assets and liabilities:		
Accounts receivable	7,499	(158)
Inventories	874	2,143
Prepaid expenses and other current assets	(151)	(1)
Other assets	—	68
Accounts payable	(2,513)	(1,081)
Accrued and other liabilities	(1,075)	(1,482)
Net cash provided by (used in) operating activities	1,870	(1,780)
Cash flows from investing activities:		
Purchases of property and equipment	(93)	(253)
Net cash used in investing activities	(93)	(253)
Cash flows from financing activities:		
Proceeds from exercise of stock options and purchases under the ESPP plan	60	48
Repayment of debt	(5,000)	—
Net cash (used in) provided by financing activities	(4,940)	48
Effect of exchange rate changes on cash	4	(10)
Net decrease in cash and cash equivalents	(3,159)	(1,995)
Cash and cash equivalents at beginning of period	18,190	21,174
Cash and cash equivalents at end of period	\$15,031	\$19,179

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, as “Zhone” or the “Company”) designs, develops and manufactures communications network equipment for telecommunications, wireless 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, except as noted below) that, in the opinion of management, are necessary for a fair presentation of the results for the interim periods presented in accordance with accounting principles generally accepted in the United States of America (“GAAP”). All significant inter-company transactions and balances have been eliminated in consolidation. In the quarter ended March 31, 2012, the Company recorded a \$0.3 million credit to the income statement as a result of vendor liabilities identified on the condensed consolidated balance sheet where the applicable statute of limitations had expired in prior fiscal years and thus the Company was no longer legally liable for these amounts. 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, 2011.

(c) Risks and Uncertainties

The accompanying condensed consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company’s continued losses reduced cash and cash equivalents in 2011 and the three months ended March 31, 2012. As of March 31, 2012, the Company had approximately \$15.0 million in cash and cash equivalents and \$10.0 million in current debt outstanding under its revolving line of credit and letter of credit facility (the “WFB Facility”). The Company entered into the new WFB Facility on March 13, 2012 to replace its former revolving line of credit and letter of credit facility and provide liquidity and working capital through March 12, 2014, as discussed in Note 8.

The global unfavorable economic and market conditions could impact the Company’s business in a number of ways, including:

- Potential deferment of purchases and orders by customers;
- Customers’ inability to obtain financing to make purchases from the Company and/or maintain their business;
- Negative impact from increased financial pressures on third-party dealers, distributors and retailers; and
- Negative impact from increased financial pressures on key suppliers.

If the economic, market and geopolitical conditions in the United States and the rest of the world do not continue to improve or if they deteriorate, the Company may experience material adverse impacts on its business, operating results and financial condition.

The Company expects that operating losses and negative cash flows from operations may continue. In order to meet the Company’s liquidity needs and finance its capital expenditures and working capital needs for the business, the Company may be required to sell assets, issue debt or equity securities or borrow on unfavorable terms. Continued uncertainty in credit markets may negatively impact the Company’s ability to access debt financing or to refinance existing indebtedness in the future on favorable terms, or at all. The Company may be unable to sell assets, issue securities or access additional indebtedness to meet these needs on favorable terms, or at all. As a result, the Company may become unable to pay its ordinary expenses, including its debt service, on a timely basis. The Company’s current lack of liquidity could harm it by:

- increasing its vulnerability to adverse economic conditions in its industry or the economy in general;
- requiring substantial amounts of cash to be used for debt servicing, rather than other purposes, including operations;
- limiting its ability to plan for, or react to, changes in its business and industry; and

- influencing investor and customer perceptions about its financial stability and limiting its ability to obtain financing or acquire customers.

If additional capital is raised through the issuance of debt securities or other debt financing, the terms of such debt may include covenants, restrictions and financial ratios that may restrict the Company's ability to operate its business. Likewise, any equity financing could result in additional dilution of the Company's stockholders. If the Company is unable to obtain additional capital or is required to obtain additional capital on terms that are not favorable, it may be required to reduce the scope of its planned product development and sales and marketing efforts beyond the reductions it has previously taken. Based on the Company's current plans and business conditions, it believes that its existing cash, cash equivalents and available credit facilities will be sufficient to satisfy its anticipated cash requirements for the foreseeable future.

(d) 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 at the date of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ materially from those estimates.

(e) Revenue Recognition

The Company recognizes revenue when the earnings process is complete. The Company recognizes product revenue upon shipment of product under contractual terms which transfer title to customers upon shipment, under normal credit terms, net of estimated sales returns and allowances at the time of shipment. The Company's arrangements generally do not have any significant post-delivery obligations. If the Company's arrangements include customer acceptance provisions, revenue is recognized upon obtaining the signed acceptance certificate from the customer, unless the Company can objectively demonstrate that the delivered products or services meet all the acceptance criteria specified in the arrangement prior to obtaining the signed acceptance. In those instances where revenue is recognized prior to obtaining the signed acceptance certificate, the Company uses successful completion of customer testing as the basis to objectively demonstrate that the delivered products or services meet all the acceptance criteria specified in the arrangement. The Company also considers historical acceptance experience with the customer, as well as the payment terms specified in the arrangement, when revenue is recognized prior to obtaining the signed acceptance certificate. When collectability is not reasonably assured, revenue is recognized when cash is collected.

The Company makes 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. The Company recognizes 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 revenue is recognized upon shipment to distributors, the Company uses historical rates of return from the distributors to provide for estimated product returns. The Company accrues for warranty costs, sales returns and other allowances at the time of shipment based on historical experience and expected future costs.

The Company's products and services qualify as separate units of accounting and are deemed to be non-contingent deliverables as the Company's arrangements typically do not have any significant performance, cancellation, termination and refund type provisions. Products are typically considered delivered upon shipment. Revenue from services is recognized ratably over the period during which the services are to be performed.

The Company derives revenue primarily from stand-alone sales of its products. In certain cases, the Company's products are sold along with services, which include education, training, installation, and/or extended warranty services. The Company has established third-party evidence of selling price ("TPE") for its training, education and installation services. TPE is determined based on competitor prices for similar deliverables when sold separately. These service arrangements are typically short term in nature and are largely completed shortly after delivery of the product. Training and education services are based on a daily rate per person and vary according to the type of class offered. Installation services are based on daily rate per person and vary according to the complexity of the products being installed.

Extended warranty services are priced based on the type of product and are sold in one to five year durations. Extended warranty services include the right to warranty coverage beyond the standard warranty period. In substantially all of the arrangements with multiple deliverables pertaining to arrangements with these services, the Company has used and intends to continue using vendor-specific objective evidence of selling price ("VSOE") to determine the selling price for the services. Consistent with its methodology under previous accounting guidance, the Company determines VSOE based on its normal pricing practices for these specific services when sold separately.

In most instances, particularly as it relates to products, the Company is not able to establish VSOE for all deliverables in an arrangement with multiple elements. This may be due to infrequently selling each element separately, not pricing products within a narrow range, or only having a limited sales history. When VSOE cannot be established, the Company attempts to establish the selling price of each element based on TPE. Generally, the Company's marketing strategy differs from that of the Company's peers and the Company's offerings contain a significant level of customization and differentiation such that the comparable pricing of products with similar functionality cannot be obtained. Furthermore, the Company is unable to reliably determine what similar competitor products' selling prices are on a stand-alone basis. Therefore, the Company is typically not able to determine TPE for the Company's products.

When the Company is unable to establish selling price using VSOE or TPE, the Company uses best estimate of selling price ("BSP"). The objective of BSP is to determine the price at which the Company would transact a sale if the product or service were sold on a stand-alone basis. The BSP of each deliverable is determined using average discounts from list price from historical sales transactions or cost plus margin approaches based on the factors, including but not limited to, the Company's gross margin objectives and pricing practices plus customer and market specific considerations.

(f) Fair Value of Financial Instruments

The Company utilizes the market approach to measure fair value of its financial assets and liabilities. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets or liabilities.

The Company utilizes a fair value hierarchy that is intended to increase consistency and comparability in fair value measurements and related disclosures. The fair value hierarchy is based on inputs to valuation techniques that are used to measure fair value that are either observable or unobservable. Observable inputs reflect assumptions market participants would use in pricing an asset or liability based on market data obtained from independent sources while unobservable inputs reflect a reporting entity's pricing based upon their own market assumptions. The fair value hierarchy consists of the following three levels:

- Level 1 - Inputs are quoted prices in active markets for identical assets or liabilities.
- Level 2 - Inputs are quoted prices for similar assets or liabilities in an active market, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable and market-corroborated inputs which are derived principally from or corroborated by observable market data.
- Level 3 - Inputs are derived from valuation techniques in which one or more significant inputs or value drivers are unobservable.

The following financial instruments are not measured at fair value on the Company's condensed consolidated balance sheet as of March 31, 2012, but require disclosure of their fair values: cash and cash equivalents. The estimated fair value of such instruments at March 31, 2012 approximated their carrying value as reported on the condensed consolidated balance sheet. The fair values of such financial instruments are determined using the income approach based on the present value of the estimated future cash flows. There have been no changes in the Company's valuation technique during the first quarter of fiscal 2012. The fair value of these instruments would be categorized as Level 1 at March 31, 2012 and December 31, 2012. The fair value of the Company's debt obligations approximates fair value based on Level 2 inputs at March 31, 2012 and December 31, 2011.

(g) 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 March 31, 2012, Global Village Telecom ("GVT") and Emirates Telecommunications Corporation ("Etisalat") accounted for 13% and 8% of net revenue, respectively. For the three months ended March 31, 2011, GVT and Etisalat accounted for 7% and 22% of net revenue, respectively.

As of March 31, 2012, GVT and Etisalat accounted for 14% and 10% of net accounts receivable, respectively. As of December 31, 2011, the same customers accounted for 2% and 29% of net accounts receivable, respectively. Etisalat receivables are denominated in United Arab Emirates Dirhams, a currency that tracks to the U.S. dollar.

As of March 31, 2012 and December 31, 2011, receivables from customers in countries other than the United States represented 67% and 71%, respectively, of net accounts receivable.

(h) Property and Equipment

Property and equipment are stated at cost and depreciated using the straight-line method over their estimated useful lives. Useful lives of all property and equipment range from 3 to 5 years. Leasehold improvements are generally amortized over the shorter of their useful lives or the remaining lease term.

(i) Inventories

Inventories are stated at the lower of cost or market, with cost being determined using the first-in, first-out (FIFO) method. In assessing the net realizable value of inventories, the Company is required to make judgments as to future demand requirements and compare these with the current or committed inventory levels. Once inventory has been written down to its estimated net realizable value, its carrying value cannot be increased due to subsequent changes in demand forecasts. To the extent that a severe decline in forecasted demand occurs, or the Company experiences a higher incidence of inventory obsolescence due to rapidly changing technology and customer requirements, the Company may incur significant charges for excess inventory.

(2) Cash and Cash Equivalents

Cash and cash equivalents as of March 31, 2012 and December 31, 2011 consisted of the following (in thousands):

	<u>March 31, 2012</u>	<u>December 31, 2011</u>
Cash and Cash Equivalents:		
Cash	\$15,031	\$ 18,124
Money Market Funds	—	66
	<u>\$15,031</u>	<u>\$ 18,190</u>

As of March 31, 2012 and December 31, 2011, the fair value equaled cost of the cash and cash equivalents.

(3) Fair Value Measurement

The Company had no financial assets and liabilities as of March 31, 2012 recorded at fair value. The following table represents the Company's financial assets and liabilities measured at fair value on a recurring basis as of December 31, 2011 and the basis for that measurement:

	<u>Fair Value Measurements as of December 31, 2011 (In Thousands)</u>			
	<u>Total</u>	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Money market funds (1)	\$ 66	\$ 66	\$ —	\$ —
Total	<u>\$ 66</u>	<u>\$ 66</u>	<u>\$ —</u>	<u>\$ —</u>

(1) Included in cash and cash equivalents on the Company's condensed consolidated balance sheet.

(4) Operating Lease Liabilities

As a result of the acquisition of Paradyne Networks, Inc. ("Paradyne") in September 2005, the Company assumed certain lease liabilities for facilities in Largo, Florida. The Company has accrued a liability for the excess portion of these facilities. The term of the lease expires in June 2012 and had an estimated remaining obligation of approximately \$1.8 million as of March 31, 2012, of which \$0.4 million was accrued for excess facilities, net of contractual and estimated sublease income.

A summary of current period activity related to excess lease liabilities accrued is as follows (in thousands):

	<u>Exit Costs</u>
Balance at December 31, 2011	\$ 835
Cash payments, net	(430)
Balance at March 31, 2012	<u>\$ 405</u>

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

	<u>Exit Costs</u>
Future lease payments for excess space	\$ 536
Less: contractual and estimated sublease income	(131)
Balance at March 31, 2012	<u>\$ 405</u>

The total excess lease liability of \$0.4 million is classified as current as of March 31, 2012 in “Accrued and other liabilities” in the accompanying condensed consolidated balance sheet.

(5) Inventories

Inventories as of March 31, 2012 and December 31, 2011 were as follows (in thousands):

	<u>March 31, 2012</u>	<u>December 31, 2011</u>
Inventories:		
Raw materials	\$16,916	\$ 16,770
Work in process	2,287	2,985
Finished goods	7,316	7,638
	<u>\$26,519</u>	<u>\$ 27,393</u>

(6) Property and Equipment, net

Property and equipment, net, as of March 31, 2012 and December 31, 2011 were as follows (in thousands):

	<u>March 31, 2012</u>	<u>December 31, 2011</u>
Property and equipment:		
Machinery and equipment	\$ 9,107	\$ 9,043
Computers and acquired software	4,105	4,076
Furniture and fixtures	310	310
Leasehold improvements	2,067	2,067
	15,589	15,496
Less accumulated depreciation and amortization	<u>(14,965)</u>	<u>(14,888)</u>
	<u>\$ 624</u>	<u>\$ 608</u>

Depreciation and amortization expense associated with property and equipment amounted to \$0.1 million and \$0.5 million for the three months ended March 31, 2012 and 2011, respectively.

(7) Net Loss Per Share

Basic net loss per share is computed by dividing the net loss applicable to holders of common stock for the period by the weighted average number of shares of common stock outstanding during the period. The calculation of diluted net loss per share gives effect to common stock equivalents; however, potential common equivalent shares are excluded if their effect is antidilutive. Potential common equivalent shares are composed of common stock subject to repurchase rights and incremental shares of common equivalent shares issuable upon the exercise of stock options and warrants, and the conversion of convertible debt.

The following tables set forth potential common stock that is not included in the diluted net loss per share calculation because their effect would be anti-dilutive for the periods indicated (in thousands, except exercise price per share data):

	Three Months Ended March 31, 2012	Weighted Average Exercise Price
Warrants	7	\$116.54
Outstanding stock options and unvested restricted shares	5,629	\$ 2.16
	<u>5,636</u>	

	Three Months Ended March 31, 2011	Weighted Average Exercise Price
Warrants	7	\$116.54
Outstanding stock options and unvested restricted shares	5,037	\$ 3.03
	<u>5,044</u>	

(8) Debt

Credit Facility

In March 2012, the Company's former revolving credit and letter of credit facility with Silicon Valley Bank expired, and the Company entered into its new \$25.0 million WFB Facility with WFB to provide liquidity and working capital through March 12, 2014.

Under the WFB Facility, the Company has the option of borrowing funds at agreed upon interest rates. The amount that the Company is able to borrow under the WFB Facility varies based on eligible accounts receivable, as defined in the agreement, as long as the aggregate amount outstanding does not exceed \$25.0 million less the amount committed as security for various letters of credit, which at March 31, 2012 was \$8.5 million. To maintain availability of funds under the WFB Facility, the Company pays a commitment fee on the unused portion. The commitment fee is 0.25% per annum and is recorded as interest expense.

Under the WFB Facility, \$10.0 million was outstanding at March 31, 2012. In addition, \$8.5 million was committed as security for various letters of credit and the Company had no unused availability under the WFB Facility as of March 31, 2012. The amounts borrowed under the WFB Facility bear interest, payable monthly, at a floating rate equal to the three-month LIBOR plus a margin of 3.5%. The interest rate on the WFB Facility was 3.97% at March 31, 2012.

The Company's obligations under the WFB Facility are secured by substantially all of its personal property assets and those of its subsidiaries that guarantee the WFB Facility, including their intellectual property. The WFB Facility contains certain financial covenants, and customary affirmative covenants and negative covenants. If the Company does not comply with the various covenants and other requirements under the WFB Facility, WFB is entitled to, among other things, require the immediate repayment of all outstanding amounts and sell the Company's assets to satisfy the obligations under the WFB Facility. As of March 31, 2012, the Company was in compliance with these covenants.

(9) Commitments and Contingencies

Operating 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 as follows (in thousands):

	Operating Leases
Year ending December 31:	
2012 (remainder of the year)	\$ 2,232
2013	1,187
2014	736
2015	486
2016 and thereafter	—
Total minimum lease payments	<u>\$ 4,641</u>

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 three months ended March 31, 2012 and 2011 (in thousands):

	Three months Ended	
	March 31,	
	2012	2011
Beginning balance	\$ 1,546	\$ 1,683
Charged to cost of revenue	256	205
Claims and settlements	(231)	(283)
Ending balance	<u>\$ 1,571</u>	<u>\$ 1,605</u>

Other Commitments

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 potential claims.

Performance Bonds

In the normal course of operations, the Company arranges for the issuance of various types of surety bonds, such as bid and performance bonds, which are agreements under which the surety company guarantees that the Company will perform in accordance with contractual or legal obligations. If the Company fails to perform under its obligations, the maximum potential payment under these surety bonds would have been \$2.3 million as of March 31, 2012.

Purchase Commitments

The Company has agreements with various contract manufacturers which include non-cancellable inventory purchase commitments. The Company's inventory purchase commitments typically allow for cancellation of orders 30 days in advance of the required inventory availability date as set by the Company at time of order. The amount of non-cancellable purchase commitments outstanding was \$4.6 million as of March 31, 2012.

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 and is recorded in cost of revenue.

Legal Proceedings

The Company is subject to various 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 its 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.

(10) Enterprise-Wide Information

The Company designs, develops and manufactures 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 tables summarize required disclosures about geographic concentrations and revenue by products and services (in thousands):

	Three Months Ended March 31,	
	2012	2011
Revenue by Geography:		
United States	\$10,279	\$12,697
Canada	1,403	732
Total North America	11,682	13,429
Latin America	7,205	5,795
Europe, Middle East, Africa	7,609	10,187
Asia Pacific	566	161
Total International	15,380	16,143
	<u>\$27,062</u>	<u>\$29,572</u>
	Three Months Ended March 31,	
	2012	2011
Revenue by Products and Services:		
Products	\$26,006	\$28,511
Services	1,056	1,061
Total	<u>\$27,062</u>	<u>\$29,572</u>

(11) Income Taxes

The total amount of unrecognized tax benefits, including interest and penalties, at March 31, 2012 was 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 during the quarters ended March 31, 2012 and 2011. The Company does not anticipate any significant changes with respect to unrecognized tax benefits within the next 12 months.

The Company and its subsidiaries file 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 2008 – 2011
- California and Canada 2007 – 2011
- Brazil 2006 – 2011
- Germany 2005 – 2011
- United Kingdom 2007 – 2011

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 Single Line Multi-Service, or SLMS, products; our ability to refinance or repay our existing indebtedness prior to the applicable maturity date; future economic conditions and performance; 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, including those identified under the heading "Risk Factors" in Part II, Item 1A elsewhere in this report and our other filings with the Securities and Exchange Commission (the SEC). 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 or to repay or refinance our existing indebtedness, 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 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 global customer base includes regional, national and international telecommunications carriers. To date, our products are deployed by over 750 network service providers on six continents worldwide. 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 \$1,035.5 million as of March 31, 2012, and we expect that our operating losses and negative cash flows from operations may continue. If we are unable to access or raise the capital needed to meet liquidity needs and finance capital expenditures and working capital, or if the economic, market and geopolitical conditions in the United States and the rest of the world do not continue to improve or deteriorate, we may experience material adverse impacts on our business, operating results and financial condition.

Going forward, our key financial objectives include the following:

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

CRITICAL ACCOUNTING POLICIES AND ESTIMATES

There have been no material changes to our critical accounting policies and estimates from the information provided in Part II, “Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations – Critical Accounting Policies and Estimates” included in our Annual Report on Form 10-K for the year ended December 31, 2011

RESULTS OF OPERATIONS

We list in the table below the historical condensed consolidated statement of comprehensive loss data as a percentage of net revenue for the periods indicated.

	Three Months Ended March 31,	
	2012	2011
Net revenue	100%	100%
Cost of revenue	69%	64%
Gross profit	31%	36%
Operating expenses:		
Research and product development	18%	19%
Sales and marketing	18%	18%
General and administrative	8%	7%
Total operating expenses	44%	44%
Operating loss	(13)%	(8)%
Interest expense	0%	0%
Interest income	0%	0%
Other (loss) income, net	0%	0%
Loss before income taxes	(13)%	(8)%
Income tax provision (benefit)	0%	0%
Net loss	(13)%	(8)%
Other comprehensive income (loss)	0%	0%
Comprehensive loss	(13)%	(8)%

Net Revenue

Information about our net revenue for products and services for the three months ended March 31, 2012 and 2011 is summarized below (in millions):

	Three Months Ended March 31,			
	2012	2011	Increase (Decrease)	% change
Products	\$26.0	\$28.5	\$ (2.5)	(8)%
Services	1.1	1.1	—	— %
Total	\$27.1	\$29.6	\$ (2.5)	(8)%

Information about our net revenue for North America and international markets for the three months ended March 31, 2012 and 2011 is summarized below (in millions):

	Three Months Ended March 31,			
	2012	2011	Increase (Decrease)	% change
Revenue by geography:				
United States	\$10.3	\$12.7	\$ (2.4)	(19)%
Canada	1.4	0.7	0.7	100%
Total North America	11.7	13.4	(1.7)	(13)%
Latin America	7.2	5.8	1.4	24%
Europe, Middle East, Africa	7.6	10.2	(2.6)	(25)%
Asia Pacific	0.6	0.2	0.4	200%
Total International	15.4	16.2	(0.8)	(5)%
Total	\$27.1	\$29.6	\$ (2.5)	(8)%

For the three months ended March 31, 2012, net revenue decreased 8% or \$2.5 million to \$27.1 million from \$29.6 million for the same period last year. For the three months ended March 31, 2012, product revenue decreased 8% or \$2.5 million to \$26.0 million, compared to \$28.5 million for the same period last year. The decreases in net revenue and product revenue for the three months ended March 31, 2012 were primarily due to fewer sales of our new products in the Middle East and the United States (including a reduction in sales to Emirates Telecommunications Corporation (Etisalat)) compared to the prior year, which were partially offset by increases in sales of our new products to customers in Latin America. For the three months ended March 31, 2012, service revenue remained unchanged at \$1.1 million.

International net revenue decreased 5% or \$0.8 million to \$15.4 million for the three months ended March 31, 2012 from \$16.2 million for the same period last year, and represented 57% of total net revenue compared with 55% during the same period of 2011. The decrease in international net revenue during the three months ended March 31, 2012 was primarily due to a decrease in sales as compared with the same period last year in the Middle East, which was only partially offset by a 24% increase in sales to customers in Latin America.

For the three months ended March 31, 2012, Global Village Telecom, (GVT), and Etisalat represented 13% and 8% of net revenue, respectively, whereas GVT and Etisalat represented 7% and 22% of net revenue, respectively, for the same period in 2011. 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, decreased 2% or \$0.3 million to \$18.7 million for the three months ended March 31, 2012, compared to \$19.0 million for the three months ended March 31, 2011. The decrease in cost of revenue for the three months ended March 31, 2012 was primarily due to the decrease in sales volume as well as a decrease recorded in the quarter ended March 31, 2012, of \$0.2 million due to vendor liabilities identified where the applicable statute of limitations had expired. There was also a decrease in gross margin to 31% as compared to 36% for the same prior year period due to change in product mix.

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, continued 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 11% or \$0.6 million to \$4.9 million for the three months ended March 31, 2012, compared to \$5.5 million for the three months ended March 31, 2011. The decrease in the three months ended March 31, 2012 was primarily due to decreased depreciation expense as a result of the fixed asset impairment and further decreases in the costs allocated to our facilities.

Sales and Marketing Expenses

Sales and marketing expenses decreased 14% or \$0.8 million to \$4.7 million for the three months ended March 31, 2012, compared to \$5.5 million for the three months ended March 31, 2011. The decrease for the three months ended March 31, 2012 was primarily due to a \$0.4 million decrease in sales expenses from continued cost reductions in travel and consulting expenses, and decreased commissions, as well as a decrease in marketing expenses due to a reduction in the number of trade shows compared to prior year period.

General and Administrative Expenses

General and administrative expenses remained consistent at \$2.1 million for the three months ended March 31, 2012 as compared to the three months ended March 31, 2011.

Income Tax Provision

During the three months ended March 31, 2012 and 2011, 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.

OTHER PERFORMANCE MEASURES

In managing our business and assessing our financial performance, we supplement the information provided by our GAAP results with adjusted earnings before stock-based compensation, interest, taxes, and depreciation, or Adjusted EBITDA, a non-GAAP financial measure. We define Adjusted EBITDA as net income (loss) plus (i) interest expense, (ii) provision (benefit) for taxes, (iii) depreciation and amortization, (iv) non-cash equity-based compensation expense, and (v) material non-recurring non-cash transactions. We believe that the presentation of Adjusted EBITDA enhances the usefulness of our financial information by presenting a measure that management uses internally to monitor and evaluate our operating performance and to evaluate the effectiveness of our business strategies. We believe Adjusted EBITDA also assists investors and analysts in comparing our performance across reporting periods on a consistent basis because it excludes the impact of items that we do not believe reflect our core operating performance.

Adjusted EBITDA has limitations as an analytical tool. Some of these limitations are:

- Adjusted EBITDA does not reflect our cash expenditures, or future requirements, for capital expenditures or contractual requirements;
- Adjusted EBITDA does not reflect changes in, or cash requirements for, our working capital needs;
- Adjusted EBITDA does not reflect the interest expense, or the cash requirements necessary to service interest or principal payments, on our debts;
- although depreciation and amortization are non-cash charges, the assets being depreciated and amortized will often have to be replaced in the future, and Adjusted EBITDA does not reflect any cash requirements for such replacements;
- non-cash compensation is and will remain a key element of our overall long-term incentive compensation package, although we exclude it as an expense when evaluating our ongoing operating performance for a particular period;
- Adjusted EBITDA does not reflect the impact of certain cash charges resulting from matters we consider not to be indicative of our ongoing operations; and
- other companies in our industry may calculate Adjusted EBITDA and similar measures differently than we do, limiting its usefulness as a comparative measure.

Because of these limitations, Adjusted EBITDA should not be considered in isolation or as a substitute for net income (loss) or any other performance measures calculated in accordance with GAAP or as a measure of liquidity. Management understands these limitations and compensates for these limitations by relying primarily on our GAAP results and using Adjusted EBITDA only supplementally.

Set forth below is a reconciliation of Adjusted EBITDA to net income (loss), which we consider to be the most directly comparable GAAP financial measure to Adjusted EBITDA:

	Three Months Ended March 31,	
	2012	2011
	(in thousands)	
Net loss	\$(3,414)	\$(2,440)
Add:		
Interest expense	18	49
Provision for taxes	33	(53)
Depreciation and amortization	77	453
Non-cash equity-based compensation expense	169	231
Adjusted EBITDA	<u>\$(3,117)</u>	<u>\$(1,760)</u>

LIQUIDITY AND CAPITAL RESOURCES

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

At March 31, 2012, cash and cash equivalents were \$15.0 million compared to \$18.2 million at December 31, 2011. The \$3.2 million decrease in cash and cash equivalents was attributable to net cash used in financing and investing activities of \$5.0 million and \$0.1 million, respectively, partially offset by net cash provided by operating activities of \$1.9 million.

Operating Activities

Net cash provided by operating activities for the three months ended March 31, 2012 consisted of a net loss of \$3.4 million, adjusted for non-cash charges totaling \$0.7 million and a decrease in net operating assets totaling \$4.6 million. The most significant components of the changes in net operating assets were a decrease of \$7.5 million in accounts receivable, offset by decreases of \$2.5 in accounts payable and \$1.1 million in accrued and other liabilities. The decrease in accounts receivable was primarily the result of significant cash collections from several large customers in the current year period which caused a corresponding decrease in accounts payable as more cash was available to apply to vendor invoices. The decrease in accrued and other liabilities was comprised of reduced personnel accruals of \$0.5 million, and the non-cash decreases in the deferred gain and leasehold improvement allowance of \$0.2 million and operating lease liability related to our Largo facility of \$0.4 million.

Investing Activities

Net cash used in investing activities for the three months ended March 31, 2012 consisted primarily of purchases of property and equipment of \$0.1 million.

Financing Activities

Net cash used in financing activities for the three months ended March 31, 2012 consisted of repayments of debt of \$5.0 million, partially offset by proceeds related to exercises of stock options and purchases under our Employee Stock Purchase Plan of \$0.1 million.

Cash Management

Our primary source of liquidity comes from our cash and cash equivalents which totaled \$15.0 million at March 31, 2012, and our \$25.0 million revolving line of credit and letter of credit facility, or the WFB Facility, with Wells Fargo Bank, or WFB. Our cash and cash equivalents are held in accounts managed by third party financial institutions and consist of invested cash and cash in our operating accounts. At current revenue levels, we anticipate that some portion of our existing cash and cash equivalents will continue to be consumed by operations.

In March 2012, our former revolving line of credit and letter of credit facility with Silicon Valley Bank expired, and we entered into our new \$25.0 million WFB Facility to provide liquidity and working capital through March 12, 2014.

Under the WFB Facility, we have the option of borrowing funds at agreed upon interest rates. The amount that we are able to borrow under the WFB Facility varies based on eligible accounts receivable, as defined in the agreement, as long as the aggregate principal amount outstanding does not exceed \$25.0 million less the amount committed as security for various letters of credit, which at March 31, 2012 was \$8.5 million. To maintain availability of funds under the WFB Facility, we pay a commitment fee on the unused portion. The commitment fee is 0.25% per annum and is recorded as interest expense.

Under the WFB Facility, \$10.0 million was outstanding at March 31, 2012. In addition, \$8.5 million was committed as security under various letters of credit and we had no unused availability under the WFB Facility as of March 31, 2012. The amounts borrowed under the WFB Facility bear interest, payable monthly, at a floating rate equal to the three-month LIBOR plus a margin of 3.5%. The interest rate on our WFB Facility was 3.97% at March 31, 2012.

Our obligations under the WFB Facility are secured by substantially all of our personal property assets and those of our subsidiaries that guarantee the WFB Facility, including our intellectual property. The WFB Facility contains certain financial covenants, and customary affirmative covenants and negative covenants. If we do not comply with the various covenants and other requirements under the WFB Facility, WFB is entitled to, among other things, require the immediate repayment of all outstanding amounts and sell our assets to satisfy the obligations under the WFB Facility. As of March 31, 2012, we were in compliance with these covenants. We make no assurances that we will be in compliance with these covenants in the future.

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 acquisition of Paradyne Networks, Inc. in 2005, we 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 \$1.8 million as of March 31, 2012. We intend to continue to occupy only a portion of these facilities through the remainder of the lease. We have recorded a liability of \$0.4 million as of March 31, 2012, which we believe is adequate to cover costs incurred to exit the excess portion of these facilities, net of estimated sublease income. Our operating lease commitments also include \$2.2 million of future minimum lease payments spread over the five-year lease term under the lease agreement we entered into in September 2010 with respect to our Oakland, California campus following the sale of our campus in a sale-leaseback transaction.

Our accounts receivable, while not considered a primary source of liquidity, represent 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 March 31, 2012, GVT accounted for 14% of net accounts receivable, and receivables from customers in countries other than the United States of America represented 67% of net 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.

We expect that operating losses and negative cash flows from operations may continue. In order to meet our liquidity needs and finance our capital expenditures and working capital needs for our business, we may be required to sell assets, issue debt or equity securities or borrow on unfavorable terms. Continued uncertainty in credit markets may negatively impact our ability to access debt financing or to refinance existing indebtedness in the future on favorable terms, or at all. We may be unable to sell assets, issue securities or access additional indebtedness to meet these needs on favorable terms, or at all. If additional capital is raised through the issuance of debt securities or other debt financing, the terms of such debt may include covenants, restrictions and financial ratios that may restrict our ability to operate our business. Likewise, any equity financing could result in additional dilution of our stockholders. If we are unable to obtain additional capital or are required to obtain additional capital on terms that are not favorable to us, we may be required to reduce the scope of our planned product development and sales and marketing efforts beyond the reductions we have previously taken. Based on our current plans and business conditions, we believe that our existing cash, cash equivalents and available credit facilities will be sufficient to satisfy our anticipated cash requirements for the next twelve months.

Contractual Commitments and Off-Balance Sheet Arrangements

At March 31, 2012, our future contractual commitments by fiscal year were as follows (in thousands):

	Total	Payments due by period				
		2012	2013	2014	2015	2016 and Thereafter
Operating leases	\$ 4,641	\$ 2,232	\$ 1,187	\$ 736	\$ 486	\$ —
Purchase commitments	4,611	4,611	—	—	—	—
Line of credit (1)	10,000	10,000	—	—	—	—
Total future contractual commitments	<u>\$19,252</u>	<u>\$16,843</u>	<u>\$1,187</u>	<u>\$736</u>	<u>\$486</u>	<u>\$ —</u>

- (1) The specified payment period reflects our current intent to repay all outstanding borrowings within the current year. However, the maturity date under the WFB Facility is March 12, 2014.

Operating Leases

The operating lease amounts shown above represent primarily off-balance sheet arrangements. 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. For operating leases that include contractual commitments for operating expenses and maintenance, estimates of such amounts are included based on current rates. Payments made under operating leases will be treated as rent expense for the facilities currently being utilized. Of the total \$4.6 million operating lease amount, \$0.4 million has been recorded as an excess lease liability on our balance sheet as of March 31, 2012.

Purchase Commitments

The purchase commitments shown above represent non-cancellable inventory purchase commitments as of March 31, 2012. The inventory purchase commitments typically allow for cancellation of orders 30 days in advance of the required inventory availability date as set by us at time of order.

Line of Credit

The line of credit obligation has been recorded as a liability on our balance sheet. The line of credit obligation amount shown above represents the scheduled principal repayment, but not the associated interest payments which may vary based on changes in market interest rates. At March 31, 2012, the interest rate under the WFB Facility was 3.97%.

As of March 31, 2012, we had \$10.0 million outstanding under our line of credit under the WFB Facility and an additional \$8.5 million committed as security for various letters of credit. See above under "Cash Management" for further information about the WFB Facility.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Cash and Cash Equivalents

Cash and cash equivalents consisted of the following as of March 31, 2012 and December 31, 2011 (in thousands):

	March 31, 2012	December 31, 2011
Cash	\$ 15,031	\$ 18,124
Money Market Funds	—	66
	<u>\$15,031</u>	<u>\$ 18,190</u>

Concentration of Credit Risk

Financial instruments which potentially subject us to concentrations of credit risk consist primarily of cash and cash equivalents, and accounts receivable. Cash and cash equivalents consist principally of demand deposit and money market accounts. Cash and cash equivalents are principally held with various domestic financial institutions with high credit standing. We perform ongoing credit evaluations of our customers and generally do not require collateral. Allowances are maintained for potential doubtful accounts. For the three months ended March 31, 2012, GVT and Etisalat accounted for 13% and 8% of net revenue, respectively. For the three months ended March 31, 2011, GVT and Etisalat accounted for 7% and 22% of net revenue, respectively.

As of March 31, 2012, GVT and Etisalat accounted for 14% and 10% of net accounts receivable, respectively. As of December 31, 2011, the same customers accounted for 2% and 29% of net accounts receivable, respectively. Etisalat receivables are denominated in United Arab Emirates Dirhams, a currency that tracks to the U.S. dollar.

As of March 31, 2012 and December 31, 2011, receivables from customers in countries other than the United States represented 67% and 71%, respectively, of net accounts receivable.

Interest Rate Risk

Our exposure to market risk for changes in interest rates relates primarily to our outstanding debt. As of March 31, 2012, our outstanding debt balance under our WFB Facility was \$10.0 million. Interest on the line of credit under our WFB Facility accrues at a floating rate equal to the three-month LIBOR plus a margin of 3.5%. The interest rate on our WFB Facility was 3.97% as of March 31, 2012. Assuming the outstanding balance on our variable rate debt remains constant over a year, a 2% increase in the interest rate would decrease pre-tax income and cash flow by approximately \$0.2 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 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 2012 and 2011, we did not hedge any of our foreign currency exposure.

We have performed sensitivity analyses as of March 31, 2012 using a modeling technique that measures the impact 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 \$0.3 million at March 31, 2012. 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 our 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 our 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

We are subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, we do 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, 2011, which could materially affect our business, financial condition or future results. There have been no material changes to the risk factors described in the “Risk Factors” section in our Annual Report on Form 10-K for the year ended December 31, 2011. 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 24 is incorporated herein by reference as the list of exhibits required as part of this report.

SIGNATURES

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

ZHONE TECHNOLOGIES, INC.

Date: May 10, 2012

By: _____ /s/ MORTEZA EJABAT
Name: Morteza Ejabat
Title: Chief Executive Officer

By: _____ /s/ KIRK MISAKA
Name: Kirk Misaka
Title: Chief Financial Officer

EXHIBIT INDEX

<u>Exhibit Number</u>	<u>Description</u>
10.1	Credit and Security Agreement, dated as of March 13, 2012, by and among Zhone Technologies, Inc., ZTI Merger Subsidiary III, Inc., Premisys Communications, Inc., Zhone Technologies International, Inc., Paradyne Networks, Inc., Paradyne Corporation and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.16 of registrant's Annual Report on Form 10-K for the year ended December 31, 2011 filed on March 15, 2012)
10.2	Credit and Security Agreement (Ex-Im Subfacility), dated as of March 13, 2012, by and among Zhone Technologies, Inc., ZTI Merger Subsidiary III, Inc., Premisys Communications, Inc., Zhone Technologies International, Inc., Paradyne Networks, Inc., Paradyne Corporation and Wells Fargo Bank, National Association (incorporated by reference to Exhibit 10.17 of registrant's Annual Report on Form 10-K for the year ended December 31, 2011 filed on March 15, 2012)
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
101.INS*	XBRL Instance Document
101.SCH*	XBRL Taxonomy Extension Schema
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase
101.DEF*	XBRL Taxonomy Extension Definition Linkbase
101.LAB*	XBRL Taxonomy Extension Labels Linkbase
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase

* Attached as Exhibit 101 to this report are documents formatted in XBRL (Extensible Business Reporting Language). Pursuant to applicable securities laws and regulations, we are deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and are not subject to liability under any anti-fraud provisions of the federal securities laws as long as we have made a good faith attempt to comply with the submission requirements and promptly amend the interactive data files after becoming aware that the interactive data files fail to comply with the submission requirements. Users of this data are advised that, pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, are deemed not filed or part of any registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, and are otherwise not subject to liability under these sections.

**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: May 10, 2012

/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: May 10, 2012

/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 March 31, 2012 (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: May 10, 2012

/s/ MORTEZA EJABAT

Morteza Ejabat

Chief Executive Officer

/s/ KIRK MISAKA

Kirk Misaka

Chief Financial Officer