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, 2013
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	**22-3509099**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
7195 Oakport Street **Oakland, California**	**94621**
(Address of principal executive offices)	**(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 November 1, 2013, there were approximately 31,671,986 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)

	September 30, 2013	December 31, 2012
Assets		
Current assets:		
Cash and cash equivalents	$ 14,301	$ 11,119
Accounts receivable, net of allowances for sales returns and doubtful accounts of $1,675 as of September 30, 2013 and $2,878 as of December 31, 2012	29,356	25,820
Inventories	21,179	21,404
Prepaid expenses and other current assets	2,411	2,590
Total current assets	67,247	60,933
Property and equipment, net	642	583
Other assets	251	208
Total assets	$ 68,140	$ 61,724
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 11,545	$ 7,229
Line of credit	10,000	10,000
Accrued and other liabilities	8,650	8,836
Total current liabilities	30,195	26,065
Other long-term liabilities	2,688	3,719
Total liabilities	32,883	29,784
Stockholders' equity:		
Common stock, $0.001 par value. Authorized 180,000 shares; issued and outstanding 31,553 and 31,116 shares as of September 30, 2013 and December 31, 2012, respectively	31	31
Additional paid-in capital	1,073,387	1,072,839
Other comprehensive income	103	216
Accumulated deficit	(1,038,264)	(1,041,146)
Total stockholders' equity	35,257	31,940
Total liabilities and stockholders' equity	$ 68,140	$ 61,724

See accompanying notes to unaudited condensed consolidated financial statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net revenue	$ 31,515	$ 29,198	$ 89,942	$ 87,095
Cost of revenue	19,608	20,966	55,919	61,211
Gross profit	11,907	8,232	34,023	25,884
Operating expenses:				
Research and product development	3,934	5,090	11,514	14,835
Sales and marketing	4,644	4,976	14,539	14,516
General and administrative	1,702	2,305	4,916	6,118
Total operating expenses	10,280	12,371	30,969	35,469
Operating income (loss)	1,627	(4,139)	3,054	(9,585)
Interest expense	(25)	(26)	(74)	(53)
Other income (loss), net	—	(19)	(20)	(13)
Income (loss) before income taxes	1,602	(4,184)	2,960	(9,651)
Income tax provision	6	14	78	63
Net income (loss)	1,596	(4,198)	2,882	(9,714)
Other comprehensive loss – foreign currency translation adjustments	(30)	(8)	(113)	(24)
Comprehensive income (loss)	$ 1,566	$ (4,206)	$ 2,769	$ (9,738)
Basic and diluted net income (loss) per share	$ 0.05	$ (0.14)	$ 0.09	$ (0.31)
Weighted average shares outstanding used to compute basic net income (loss) per share	31,480	31,086	31,273	30,927
Weighted average shares outstanding used to compute diluted net income (loss) per share	33,344	31,086	32,599	30,927

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,	
	2013	**2012**
Cash flows from operating activities:		
Net income (loss)	$ 2,882	$ (9,714)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	266	234
Stock-based compensation	367	1,266
Provision for sales returns and doubtful accounts	1,203	1,651
Impairment of fixed assets	—	61
Loss on disposal of fixed assets	—	5
Changes in operating assets and liabilities:		
Accounts receivable	(4,739)	3,841
Inventories	225	2,014
Prepaid expenses and other current assets	179	53
Other assets	(43)	(1)
Accounts payable	4,316	(134)
Accrued and other liabilities	(1,217)	(2,027)
Net cash provided by (used in) operating activities	3,439	(2,751)
Cash flows from investing activities:		
Purchases of property and equipment	(325)	(329)
Restricted cash	—	58
Net cash used in investing activities	(325)	(271)
Cash flows from financing activities:		
Proceeds from exercise of stock options and purchases	181	130
Repayment of debt	—	(5,000)
Net cash provided by (used in) financing activities	181	(4,870)
Effect of exchange rate changes on cash	(113)	(24)
Net increase (decrease) in cash and cash equivalents	3,182	(7,916)
Cash and cash equivalents at beginning of period	11,119	18,190
Cash and cash equivalents at end of period	$ 14,301	$ 10,274

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, 2013, the Company recorded a $0.6 million credit to the statement of comprehensive income as a result of a vendor refund received in 2013 which related to overpayments made in 2012. 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, 2012.

(c) Risks and Uncertainties

The accompanying condensed consolidated financial statements have been prepared assuming that the Company will continue as a going concern. Although the Company generated net income in the four most recent quarters, the Company incurred a net loss for the year ended December 31, 2012 and there can be no assurance that the Company will continue to generate net income in the future. As of September 30, 2013, the Company had approximately $14.3 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") with Wells Fargo Bank ("WFB"). The Company currently expects to repay the WFB Facility within the next twelve months. The Company entered into its WFB Facility to provide liquidity and working capital through March 31, 2016, as discussed in Note 5.

Global 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;
- Intense competition in the communication equipment market;
- Commercial acceptance of the Company's Single Line Multi-Service ("SLMS") products; 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.

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. In addition, the Company may be required to reduce its operations in low margin regions, including reductions in headcount. 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 at least the next twelve months.

(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. Revenue is deferred if there are significant post-delivery obligations or if the fees are not fixed or determinable. When significant post-delivery obligations exist, revenue is deferred until such obligations are fulfilled. 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 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. As such, some of the Company's sales have multiple deliverables. 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.

For multiple deliverable revenue arrangements, the Company allocates revenue to products and services using the relative selling price method to recognize revenue when the revenue recognition criteria for each deliverable are met. The selling price of a deliverable is based on a hierarchy and if the Company is unable to establish vendor-specific objective evidence of selling price (“VSOE”) it uses third-party evidence of selling price (“TPE”), and if no such data is available, it uses a best estimated selling price (“BSP”). 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 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.

The Company has established 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 VSOE to determine the selling price for the services. The Company determines VSOE based on its normal pricing practices for these specific services when sold separately.

(f) Fair Value of Financial Instruments

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 Company does not have any financial assets or liabilities measured at fair value on a recurring basis. The following financial instruments are not measured at fair value on the Company’s condensed consolidated balance sheet as of September 30, 2013 and December 31, 2012, but require disclosure of their fair values: cash and cash equivalents, accounts receivable, accounts payable, accrued liabilities, and debt. The estimated fair value of such instruments at September 30, 2013 approximated their carrying value as reported on the condensed consolidated balance sheet due to their short maturity. The fair value of such financial instruments is determined using the income approach based on the present value of estimated future cash flows. The fair value of these instruments would be categorized as Level 2 in the fair value hierarchy, with the exception of cash and cash equivalents, which would be categorized as Level 1.

(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 September 30, 2013 and 2012, two customers represented 23% and 25% of net revenue, respectively. For the nine months ended September 30, 2013 and 2012, three customers represented 33% and 27% of net revenue, respectively.

As of September 30, 2013 and December 31, 2012, three customers accounted for 53% and 52% of net accounts receivable, respectively.

As of September 30, 2013 and December 31, 2012, receivables from customers in countries other than the United States represented 79% and 70%, respectively, of net accounts receivable.

(h) ***Comprehensive Income***

There have been no items reclassified out of accumulated other comprehensive income and into net income. The Company's other comprehensive loss for the three and nine months ended September 30, 2013 is comprised of only foreign exchange translations.

(2) Inventories

Inventories as of September 30, 2013 and December 31, 2012 were as follows (in thousands):

	September 30, 2013	December 31, 2012
Raw materials	$ 12,693	$ 13,226
Work in process	2,026	2,051
Finished goods	6,460	6,127
	$ 21,179	$ 21,404

(3) Property and Equipment, net

Property and equipment, net, as of September 30, 2013 and December 31, 2012 were as follows (in thousands):

	September 30, 2013	December 31, 2012
Machinery and equipment	$ 9,485	$ 9,178
Computers and acquired software	3,777	3,758
Furniture and fixtures	248	248
Leasehold improvements	2,067	2,067
	15,577	15,251
Less accumulated depreciation and amortization	(14,935)	(14,668)
	$ 642	$ 583

Depreciation and amortization expense associated with property and equipment amounted to $0.3 million and $0.2 million for the nine months ended September 30, 2013 and 2012, respectively.

(4) Net Income (Loss) Per Share

Basic net income (loss) per share is computed by dividing the net income (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 income (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 incremental shares of common equivalent shares issuable upon the exercise of stock options and warrants.

The following table is a reconciliation of the numerator and denominator in the basic and diluted net income (loss) per share calculation (in thousands, except per share data):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income (loss):	$ 1,596	$ (4,198)	$ 2,882	$ (9,714)
Weighted average number of shares outstanding:				
Basic	31,480	31,086	31,273	30,927
Effect of dilutive securities:				
Stock options and share awards	1,864	—	1,326	—
Diluted	33,344	31,086	32,599	30,927
Net income (loss) per share:				
Basic	$ 0.05	$ (0.14)	$ 0.09	$ (0.31)
Diluted	$ 0.05	$ (0.14)	$ 0.09	$ (0.31)

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

	Three Months Ended September 30, 2013	Weighted Average Exercise Price	Nine Months Ended September 30, 2013	Weighted Average Exercise Price
Warrants	7	$ 116.54	7	$ 116.54
Outstanding stock options and unvested restricted shares	541	$ 4.98	541	$ 4.98
	548		548	

	Three Months Ended September 30, 2012	Weighted Average Exercise Price	Nine Months Ended September 30, 2012	Weighted Average Exercise Price
Warrants	7	$ 116.54	7	$ 116.54
Outstanding stock options and unvested restricted shares	5,692	$ 2.01	5,692	$ 2.01
	5,699		5,699	

(5) Debt

Credit Facility

As of September 30, 2013, the Company had a $25.0 million revolving line of credit and letter of credit facility with WFB to provide liquidity and working capital through March 31, 2016.

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 and inventory, 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 letters of credit, which at September 30, 2013 was $10.2 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.

The Company had $10.0 million outstanding at September 30, 2013 under its WFB Facility. In addition, $10.2 million was committed as security for letters of credit. No additional amounts were available for borrowing under the WFB Facility as of September 30, 2013. 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 3.0%. The interest rate on the WFB Facility was 3.25% at September 30, 2013.

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 defaults under the WFB Facility due to a covenant breach or otherwise, WFB may be 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 September 30, 2013, the Company was in compliance with these covenants.

(6) 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:	
2013 (remainder of the year)	$ 432
2014	1,601
2015	1,273
2016	407
2017 and thereafter	39
Total minimum lease payments	$ 3,752

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, 2013 and 2012 (in thousands):

	Nine Months Ended September 30,	
	2013	2012
Beginning balance	$ 1,499	$ 1,546
Charged to cost of revenue	466	884
Claims and settlements	(719)	(857)
Ending balance	$ 1,246	$ 1,573

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 $4.3 million as of September 30, 2013.

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 $11.1 million as of September 30, 2013.

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.

(7) 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 September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenue by Geography:				
United States	$ 9,691	$ 11,534	$ 28,941	$ 34,016
Canada	881	676	2,691	3,151
Total North America	10,572	12,210	31,632	37,167
Latin America	8,317	7,500	20,610	23,149
Europe, Middle East, Africa	11,770	8,757	35,048	24,859
Asia Pacific	856	731	2,652	1,920
Total International	20,943	16,988	58,310	49,928
	$ 31,515	$ 29,198	$ 89,942	$ 87,095

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Revenue by Products and Services:				
Products	$ 29,653	$ 28,144	$ 83,699	$ 83,609
Services	1,862	1,054	6,243	3,486
Total	$ 31,515	$ 29,198	$ 89,942	$ 87,095

(8) Income Taxes

The total amount of unrecognized tax benefits, including interest and penalties, at September 30, 2013 was not material. The amount of tax benefits that would impact the effective income tax rate, if recognized, is not expected to be material. There were no significant changes to unrecognized tax benefits during the three and nine months ended September 30, 2013 and 2012. 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	2009 –2012
• California and Canada	2008 – 2012
• Brazil	2007 – 2012
• Germany	2009 – 2012
• United Kingdom	2008 – 2012

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 refinance or repay 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.

Although we generated net income in the four most recent quarters, we incurred a net loss for the year ended December 31, 2012 and have incurred significant operating losses in prior years. We had an accumulated deficit of $1,038.3 million as of September 30, 2013, and there can be no assurance that we will continue to generate net income in the future. 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 if they 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 cash equivalents.

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, 2012.

RESULTS OF OPERATIONS

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net revenue	100%	100 %	100%	100 %
Cost of revenue	62%	72 %	62%	70 %
Gross profit	38%	28 %	38%	30 %
Operating expenses:				
Research and product development	13%	17 %	13%	17 %
Sales and marketing	15%	17 %	16%	17 %
General and administrative	5%	8 %	6%	7 %
Total operating expenses	33%	42 %	35%	41 %
Operating income (loss)	5%	(14)%	3%	(11)%
Interest expense	0%	0 %	0%	0 %
Interest income	0%	0 %	0%	0 %
Other income (loss), net	0%	0 %	0%	0 %
Income (loss) before income taxes	5%	(14)%	3%	(11)%
Income tax provision	0%	0 %	0%	0 %
Net income (loss)	5%	(14)%	3%	(11)%
Other comprehensive loss	0%	0 %	0%	0 %
Comprehensive income (loss)	5%	(14)%	3%	(11)%

Net Revenue

Information about our net revenue for products and services for the three and nine months ended September 30, 2013 and 2012 is summarized below (in millions):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2013	2012	Increase	% change	2013	2012	Increase	% change
Products	$ 29.7	$ 28.1	$ 1.6	5.7%	$ 83.7	$ 83.6	$ 0.1	0.1%
Services	1.8	1.1	0.7	63.6%	6.2	3.5	2.7	77.1%
Total	$ 31.5	$ 29.2	$ 2.3	7.9%	$ 89.9	$ 87.1	$ 2.8	3.2%

Information about our net revenue for North America and international markets for the three and nine months ended September 30, 2013 and 2012 is summarized below (in millions):

	Three Months Ended September 30,				Nine Months Ended September 30,			
	2013	2012	Increase (Decrease)	% change	2013	2012	Increase (Decrease)	% change
Revenue by geography:								
United States	$ 9.7	$ 11.5	$ (1.8)	(15.7)%	$ 28.9	$ 34.0	$ (5.1)	(15.0)%
Canada	0.9	0.7	0.2	28.6 %	2.7	3.2	(0.5)	(15.6)%
Total North America	10.6	12.2	(1.6)	(13.1)%	31.6	37.2	(5.6)	(15.1)%
Latin America	8.3	7.5	0.8	10.7 %	20.6	23.1	(2.5)	(10.8)%
Europe, Middle East, Africa	11.8	8.8	3.0	34.1 %	35.0	24.9	10.1	40.6 %
Asia Pacific	0.8	0.7	0.1	14.3 %	2.7	1.9	0.8	42.1 %
Total International	20.9	17.0	3.9	22.9 %	58.3	49.9	8.4	16.8 %
Total	$ 31.5	$ 29.2	$ 2.3	7.9 %	$ 89.9	$ 87.1	$ 2.8	3.2 %

For the three months ended September 30, 2013, net revenue increased 8% or $2.3 million to $31.5 million from $29.2 million for the same period last year. The increase in net revenue was due to increases in both product and service revenue.

For the nine months ended September 30, 2013, net revenue increased 3% or $2.8 million to $89.9 million from $87.1 million for the same period last year. The increase in net revenue for the nine months ended September 30, 2013 was primarily due to increased service revenue.

For the three months ended September 30, 2013, product revenue increased 6% or $1.6 million to $29.7 million, compared to $28.1 million for the same period last year. The increase in product revenue was primarily due to increased sales of our ONT products.

For the nine months ended September 30, 2013, product revenue remained relatively flat at $83.7 million compared to the same period last year.

Service revenue represents revenue from maintenance and other services associated with product shipments. The increase in service revenue for the three and nine months ended September 30, 2013 of $0.7 million and $2.7 million, respectively, was primarily due to new service contracts, increased sales of installation services, and recognition of previously deferred revenue associated with extended warranties.

International net revenue increased 23% or $3.9 million to $20.9 million for the three months ended September 30, 2013 from $17.0 million for the same period last year, and represented 66% of total net revenue compared with 58% during the same period of 2012. International net revenue increased 17% or $8.4 million to $58.3 million for the nine months ended September 30, 2013 from $49.9 million for the same period last year. The increases in international net revenue were primarily due to increased sales of our products in the Middle East compared to the prior year, which were partially offset by decreases in sales of our products to customers in the United States.

For the three months ended September 30, 2013 and 2012, two customers represented 23% and 25% of net revenue, respectively. For the nine months ended September 30, 2013 and 2012, three customers represented 33% and 27% of net revenue, respectively. 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 7% or $1.4 million to $19.6 million for the three months ended September 30, 2013, compared to $21.0 million for the three months ended September 30, 2012. Cost of revenue decreased $5.3 million or 9% to $55.9 million for the nine months ended September 30, 2013 compared to $61.2 million for the same period last year. The decrease in cost of revenue for the three and nine months ended September 30, 2013 was primarily due to changes in product mix and an improved pricing environment. Gross margin increased due primarily to greater sales of products with higher gross margin, such as MxK products.

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 23% or \$1.2 million to \$3.9 million for the three months ended September 30, 2013 compared to \$5.1 million for the three months ended September 30, 2012, and decreased 22% or \$3.3 million to \$11.5 million for the nine months ended September 30, 2013 compared to \$14.8 million for the nine months ended September 30, 2012. The decrease in the three and nine months ended September 30, 2013 was primarily due to lower personnel-related expenses resulting from a lower headcount in 2013 as compared with 2012 as well as decreased stock-based compensation expense and lower software maintenance expenses. 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 7% or \$0.4 million to \$4.6 million for the three months ended September 30, 2013 compared to \$5.0 million for the three months ended September 30, 2012, and remained flat at \$14.5 million for the nine months ended September 30, 2013 compared to the nine months ended September 30, 2012. The decrease in the three months ended September 30, 2013 was primarily due to decreases in personnel-related expenses.

General and Administrative Expenses

General and administrative expenses decreased 26% or \$0.6 million to \$1.7 million for the three months ended September 30, 2013 compared to \$2.3 million for the three months ended September 30, 2012, and decreased 20% or \$1.2 million to \$4.9 million for the nine months ended September 30, 2013 compared to \$6.1 million for the nine months ended September 30, 2012. The decrease in the three months ended September 30, 2013 was primarily due to lower stock-based compensation expense and decreased transportation costs. The decrease in the nine months ended September 30, 2013 was primarily due to lower personnel-related expenses, decreased transportation costs, and decreased bad debt expense, partially offset by a \$0.5 million gain recorded in the quarter ended June 30, 2012 as a result of patent sales. There was no similar gain in the current year period.

Income Tax Provision

During the three and nine months ended September 30, 2013 and 2012, no material provision or benefit for income taxes was recorded, due to our previous 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, such as gain (loss) on sale of assets or impairment of fixed assets. 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; 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 net income (loss) to Adjusted EBITDA, which we consider to be the most directly comparable GAAP financial measure to Adjusted EBITDA (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2013	2012	2013	2012
Net income (loss)	$ 1,596	$ (4,198)	$ 2,882	$ (9,714)
Add:				
Interest expense	25	26	74	53
Provision for taxes	6	14	78	63
Depreciation and amortization	92	77	266	234
Non-cash equity-based compensation expense	55	834	367	1,266
Adjusted EBITDA	$ 1,774	$ (3,247)	$ 3,667	$ (8,098)

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 September 30, 2013, cash and cash equivalents were $14.3 million compared to $11.1 million at December 31, 2012. The $3.2 million increase in cash and cash equivalents was attributable to net cash provided by operating and financing activities of $3.4 million and $0.2 million, respectively, partially offset by net cash used in investing activities of $0.3 million.

Operating Activities

Net cash provided by operating activities for the nine months ended September 30, 2013 consisted of net income of $2.9 million, adjusted for non-cash charges totaling $1.8 million and offset by an increase in net operating assets totaling $1.3 million. The most significant components of the changes in net operating assets were an increase of $4.7 million in accounts receivable offset by an increase of $4.3 million in accounts payable. The increase in accounts receivable was primarily the result of increased sales to several large customers in the current year period. The increase in accounts payable was primarily due to the timing of payments to vendors.

Net cash used in operating activities for the nine months ended September 30, 2012 was $2.8 million and consisted of a net loss of $9.7 million, adjusted for non-cash charges totaling $3.2 million and a decrease in net operating assets totaling $3.7 million. The most significant components of the changes in net operating assets were a decrease of $3.8 million in accounts receivable and a decrease of $2.0 million in inventories, offset by a decrease of $2.0 million in accrued and other liabilities. The decrease in accounts receivable was primarily the result of significant cash collections from several large customers. The decrease in inventories was primarily due to better utilization of inventory. The decrease in accrued and other liabilities was comprised of the decrease in the operating lease liability related to our Largo facility of $0.8 million, non-cash decreases in the deferred gain and leasehold improvement allowance of $0.6 million, and reduced personnel accruals of $0.2 million.

Investing Activities

Net cash used in investing activities for the nine months ended September 30, 2013 consisted of purchases of property and equipment of $0.3 million. Net cash used in investing activities for the nine months ended September 30, 2012 consisted of purchases of property and equipment of $0.3 million, partially offset by restricted cash of $0.1 million.

Financing Activities

Net cash provided by financing activities for the nine months ended September 30, 2013 was $0.2 million, which consisted of proceeds related to exercises of stock options and purchases under our Employee Stock Purchase Plan (ESPP). Net cash used in financing activities for the nine months ended September 30, 2012 was $4.9 million and consisted of repayments of debt of $5.0 million, partially offset by proceeds related to exercises of stock options and purchases under our ESPP of $0.1 million.

Cash Management

Our primary source of liquidity comes from our cash and cash equivalents which totaled $14.3 million at September 30, 2013, and our $25.0 million revolving line of credit and letter of credit facility with WFB. At current revenue levels, we anticipate that some portion of our existing cash and cash equivalents may be consumed by operations.

As of September 30, 2013, we had a $25.0 million revolving line of credit and letter of credit facility with WFB to provide liquidity and working capital through March 31, 2016. In addition, $10.2 million was committed as security for letters of credit. No additional amounts were available for borrowing under the WFB Facility as of September 30, 2013. Amounts borrowed under the WFB Facility bear interest, payable monthly, at a floating rate equal to the three-month LIBOR plus a margin of 3.0%. The interest rate on the WFB Facility was 3.25% at September 30, 2013. The amount that we are able to borrow under the WFB Facility varies based on eligible accounts receivable and inventory, 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 letters of credit. In addition, under the WFB Facility, we are able to utilize the facility as security for letters of credit. To maintain availability of funds under the WFB Facility, we pay a commitment fee on the unused portion. The commitment fee is 0.25% and is recorded as interest expense.

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 default under the WFB Facility due to a covenant breach or otherwise, WFB may be 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 September 30, 2013, 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. Our operating lease commitments also include $1.3 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.

From time to time, we may provide or commit to extend credit or credit support to our customers. This financing may include extending the terms for product payments to customers. Any extension of financing to our customers will limit the capital that we have available for other uses.

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 September 30, 2013, three customers accounted for 53% of net accounts receivable and receivables from customers in countries other than the United States of America represented 79% 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. In addition, we may be required to reduce our operations in low margin regions, including reductions in headcount.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 at least the next twelve months.

Contractual Commitments and Off-Balance Sheet Arrangements

At September 30, 2013, our future contractual commitments by fiscal year were as follows (in thousands):

		Payments due by period				
	Total	2013	2014	2015	2016	2017 and thereafter
Operating leases	$ 3,752	$ 432	$ 1,601	$ 1,273	$ 407	$ 39
Purchase commitments	11,076	11,076	—	—	—	—
Line of credit (1)	10,000	10,000	—	—	—	—
Total future contractual commitments	$ 24,828	$ 21,508	$ 1,601	$ 1,273	$ 407	$ 39

(1) The specified payment period reflects our current intent to repay all outstanding borrowings within the current year. The maturity date under the WFB Facility is March 31, 2016.

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.

Purchase Commitments

The purchase commitments shown above represent non-cancellable inventory purchase commitments as of September 30, 2013. 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 September 30, 2013, the interest rate under the WFB Facility was 3.25%.

As of September 30, 2013, we had $10.0 million outstanding under our line of credit under the WFB Facility and an additional $10.2 million committed as security for letters of credit. See above under “Cash Management” for further information about the WFB Facility.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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 September 30, 2013 and 2012, two customers represented 23% and 25% of net revenue, respectively. For the nine months ended September 30, 2013 and 2012, three customers represented 33% and 27% of net revenue, respectively.

As of September 30, 2013 and December 31, 2012, three customers accounted for 53% and 52% of net accounts receivable, respectively.

As of September 30, 2013, and December 31, 2012, receivables from customers in countries other than the United States represented 79% and 70%, 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 September 30, 2013, our outstanding debt balance under our WFB Facility was $10.0 million. Amounts borrowed under the WFB Facility bear interest, payable monthly, at a floating rate equal to the three-month LIBOR plus a margin of 3.0%. The interest rate on our WFB Facility was 3.25% as of September 30, 2013. 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 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 2013 and 2012, we did not hedge any of our foreign currency exposure.

We have performed sensitivity analyses as of September 30, 2013 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 $0.4 million at September 30, 2013. 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, 2012, as updated by our Quarterly Report on Form 10-Q for the quarter ended June 30, 2013, 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, 2012, as so updated. The risks described in our Annual Report on Form 10-K and Quarterly Reports on Form 10-Q 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 5. Other Information

New Incentive Bonus Plan

On November 8, 2013, the Compensation Committee of the Board of Directors of Zhone Technologies, Inc. established a new incentive bonus plan for Morteza Ejabat, our Chairman of the Board and Chief Executive Officer, as well as other key employees designated from time to time by the Compensation Committee.

Under the initial bonus program instituted by the Compensation Committee under the plan, Mr. Ejabat will be eligible to receive quarterly bonuses based on corporate performance objectives to be determined by the Compensation Committee on a quarterly basis. The corporate performance objectives will relate to the company's performance relative to one or more of the following criteria: operating income, gross or net profit or operating margin, and/or earnings per share. Mr. Ejabat's quarterly bonuses will be determined in the sole discretion of the Compensation Committee based on its consideration of the company's performance relative to the corporate performance objectives established by the Compensation Committee for such quarter and such other factors as the Compensation Committee determines to be appropriate. Mr. Ejabat's maximum quarterly bonus will be $206,250, for a maximum aggregate bonus under the plan of $825,000 per year.

We expect to adopt similar bonus programs under the incentive bonus plan for future years, which will reward achievement for corporate performance, as determined in the discretion of the Compensation Committee, and will contain maximum bonuses consistent with those disclosed above.

The foregoing description of the incentive bonus plan is qualified in its entirety by reference to the full text of the incentive bonus plan, which is filed as an exhibit to this report and incorporated herein by reference.

Item 6. Exhibits

The Exhibit Index on page 25 is incorporated herein by reference as the list of exhibits required as part of this report.

SIGNATURES

Pursuant to the retirements 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: November 8, 2013	By:	/s/ MORTEZA EJABAT
	Name:	**Morteza Ejabat**
	Title:	**Chief Executive Officer**
	By:	/s/ KIRK MISAKA
	Name:	**Kirk Misaka**
	Title:	**Chief Financial Officer**

EXHIBIT INDEX

Exhibit Number	Description
10.1#	Zhone Technologies, Inc. Incentive Bonus Plan
10.2	Second Amendment to Credit and Security Agreements, dated as of September 30, 2013, 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 10.1 of registrant's Current Report on Form 8-K dated September 30, 2013 filed on October 1, 2013)
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

\# Management contract or compensatory plan or arrangement in which one or more executive officers or directors participates.

Exhibit 10.1

ZHONE TECHNOLOGIES, INC.

INCENTIVE BONUS PLAN

This Incentive Bonus Plan (the "***Plan***") is intended to provide an additional incentive for key employees of Zhone Technologies, Inc., a Delaware corporation (the "***Company***"), to perform to the best of their abilities, to further the growth, development and financial success of the Company, and to enable the Company to attract and retain highly qualified employees.

The Compensation Committee (the "***Committee***") of the Board of Directors of the Company (the "***Board***") has adopted the Plan, effective November 8, 2013.

1. Participants. Participation in the Plan shall be limited to such employees of the Company and its subsidiaries and affiliates whom the Committee from time to time determines shall be eligible to receive a bonus hereunder (the "***Participants***").

2. Administration. The Plan shall be administered by the Committee. The Committee shall have the discretion and authority to administer and interpret the Plan, including the authority to establish bonus programs or guidelines under the Plan (the "***Plan Guidelines***") from time to time containing such terms and conditions as the Committee may determine or deem appropriate in its discretion, including, without limitation, the administration of the Plan and/or the determination and payment of bonuses hereunder. The Committee may modify, suspend, terminate or supersede the Plan Guidelines at any time in its sole discretion. Any and all Plan Guidelines adopted by the Committee shall be subject to the terms and conditions of the Plan.

3. Bonus Determinations.

(a) A Participant may receive a bonus payment under the Plan with respect to any period (s) of employment or performance established by the Committee and based upon such objective and/or subjective performance goals as the Committee may determine in its sole discretion (the "***Performance Goals***"), which may include, without limitation, performance goals based on one or more of the following corporate criteria and/or individual criteria: (i) net earnings (either before or after one or more of the following: (A) interest, (B) taxes, (C) depreciation and (D) amortization); (ii) gross or net sales or revenue; (iii) net income (either before or after taxes); (iv) adjusted net income; (v) operating income; (vi) cash flow (including, but not limited to, operating cash flow and free cash flow); (vii) return on assets; (viii) return on capital; (ix) stockholders' equity; (x) total stockholders' return; (xi) return on sales; (xii) gross or net profit or operating margin; (xiii) expenses; (xiv) working capital; (xv) earnings per share; (xvi) adjusted earnings per share; (xvii) price per share of the Company's common stock; (xviii) implementation or completion of critical projects; (xix) comparisons with various stock market indices; (xx) debt reduction; (xxi) operating efficiency; (xxii) financial ratios; and (xxiii) financing and other capital raising and strategic transactions.

(b) A Performance Goal may be a single goal or a range with a minimum goal up to a maximum goal. Unless otherwise determined by the Committee, the amount of each Participant's bonus shall be based upon a bonus formula determined by the Committee in its sole discretion that ties such bonus to the attainment of the applicable Performance Goals. The Committee may in its sole discretion modify or change the bonus formulas and/or Performance Goals at any time and from time to time during or upon completion of a performance period.

4. Target and Maximum Bonuses. Each Participant will be assigned a target and/or maximum bonus for each period of employment or performance for which the Participant is eligible to receive a bonus award based on his or her job classification and responsibilities. A Participant's target and/or maximum bonus may, but need not, be expressed as a percentage of his or her base salary. Unless and until changed by the Committee, in its sole discretion, the maximum bonus for the Chief Executive Officer of the Company under the Plan shall be equal to $206,250 per quarter, for a maximum aggregate bonus under the Plan of $825,000 per year.

5. Payment of Bonuses.

(a) The payment of bonuses under the Plan shall be made on any date or dates determined by the Committee and shall be subject to such terms and conditions as may be determined by the Committee in its sole discretion. Unless otherwise determined by the Committee, a Participant must be an active employee of the Company or its subsidiaries or affiliates and in good standing as of the date on which the bonus is paid in order to be entitled to receive such bonus. If a Participant dies or a Participant's employment is terminated for any reason prior to the payment of his or her bonus, the payment of any bonus (and in the case of death, the person or persons to whom such payment shall be made) shall be determined at the sole discretion of the Committee.

(b) Any bonus that becomes payable under the Plan may be paid in the form of cash, shares of the Company's common stock or a combination of both, as determined by the Committee in its sole discretion. To the extent that the Committee determines to pay a bonus in the form of shares of the Company's common stock, such shares shall be awarded under the Company's then-effective equity plan, and shall be subject to the terms and conditions thereof.

6. Amendment, Suspension and Termination. The Committee may amend, suspend or terminate the Plan at any time in its sole discretion.

7. Miscellaneous.

(a) The Company shall deduct all federal, state and local taxes required by law or Company policy from any bonus paid hereunder.

(b) In no event shall the Company be obligated to pay to any Participant a bonus for any period by reason of the Company's payment of a bonus to such Participant in any other period, or by reason of the Company's payment of a bonus to any other Participant or Participants in such period or in any other period. Nothing contained in the Plan shall confer upon any person any claim or right to any payments hereunder. Such payments shall be made at the sole discretion of the Committee.

(c) Nothing contained in the Plan shall confer upon any Participant any right to continue in the employ of the Company, or shall interfere with or restrict in any way the right of the Company, which is hereby expressly reserved, to discharge any Participant at any time for any reason whatsoever, with or without cause.

(d) The Plan shall be unfunded. Amounts payable under the Plan are not and will not be transferred into a trust or otherwise set aside. The Company shall not be required to establish any special or separate fund or to make any other segregation of assets to assure the payment of any bonus under the Plan. Any accounts under the Plan are for bookkeeping purposes only and do not represent a claim against the specific assets of the Company.

(e) No award granted under the Plan may be sold, transferred, pledged, assigned or otherwise alienated or hypothecated. All rights with respect to an award granted to a Participant under the Plan shall be available during his or her lifetime only to the Participant.

(f) The Plan shall be construed, interpreted and the rights of the parties determined in accordance with the laws of the State of California.

(g) Bonus payments are not intended to constitute a deferral of compensation subject to Section 409A of the Internal Revenue Code of 1986, as amended (the "***Code***"), and are intended to satisfy the "short-term deferral" exemption under Section 409A of the Code and the Treasury Regulations issued thereunder. Accordingly, to the extent necessary to cause bonus payments hereunder to satisfy the "short-term deferral" exemption under Section 409A of the Code and the Treasury Regulations issued thereunder, a bonus payment shall be made not later than the later of (i) the fifteenth day of the third month following the Participant's first taxable year in which the bonus payment is no longer subject to a substantial risk of forfeiture, or (ii) the fifteenth day of the third month following the Company's first taxable year in which the bonus payment is no longer subject to a substantial risk of forfeiture; *provided*, *however*, that if due to administrative reasons bonuses are not paid within the foregoing time periods, then such bonuses will be paid as soon as administratively feasible but no later than the last day of the calendar year following the end of the calendar year to which such bonuses relate.

Exhibit 31.1

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 8, 2013

/s/ MORTEZA EJABAT

Morteza Ejabat
Chief Executive Officer

Exhibit 31.2

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 8, 2013

/s/ KIRK MISAKA

Kirk Misaka
Chief Financial Officer

Exhibit 32.1

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, 2013 (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 8, 2013

/s/ MORTEZA EJABAT	/s/ KIRK MISAKA
Morteza Ejabat	Kirk Misaka
Chief Executive Officer	Chief Financial Officer