

INFINERA CORP  
Form 10-Q  
August 03, 2010  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**Form 10-Q**

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the quarterly period ended June 26, 2010

OR

.. **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**  
For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number: 001-33486

**Infinera Corporation**

(Exact name of registrant as specified in its charter)

**Delaware**  
(State or other jurisdiction of  
incorporation or organization)

169 Java Drive

**77-0560433**  
(IRS Employer  
Identification No.)

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Sunnyvale, CA 94089

(Address of principal executive offices, including zip code)

(408) 572-5200

(Registrant's telephone number, including area code)

Indicate by checkmark 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 definition of accelerated filer, large accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a 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 July 30, 2010, 99,659,779 shares of the registrant's Common Stock, \$0.001 par value, were issued and outstanding.

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**INFINERA CORPORATION**  
**QUARTERLY REPORT ON FORM 10-Q**  
**FOR THE FISCAL QUARTER ENDED JUNE 26, 2010**

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**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements****INFINERA CORPORATION****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, except par value)****(Unaudited)**

	<b>June 26, 2010</b>	<b>December 26, 2009<sup>(1)</sup></b>
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 104,068	\$ 109,859
Short-term investments	163,876	143,350
Short-term restricted cash	1,690	1,533
Accounts receivable	55,619	70,410
Inventories, net	84,183	68,872
Deferred inventory costs	6,778	5,891
Prepaid expenses and other current assets	10,305	8,313
Total current assets	426,519	408,228
Property, plant and equipment, net	45,061	43,656
Deferred inventory costs, non-current	5,502	4,438
Cost-method investment	4,500	
Long-term investments	7,709	18,255
Long-term restricted cash	2,277	2,480
Deferred tax asset	9,249	12,449
Other non-current assets	2,454	2,439
Total assets	\$ 503,271	\$ 491,945
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Accounts payable	\$ 36,007	\$ 31,129
Accrued expenses	14,609	13,929
Accrued compensation and related benefits	20,077	19,248
Accrued warranty	6,071	6,091
Deferred revenue	23,314	18,295
Deferred tax liability	9,249	12,649
Total current liabilities	109,327	101,341
Accrued warranty, non-current	5,251	5,049
Deferred revenue, non-current	8,327	8,080
Other long-term liabilities	8,366	8,968
Commitments and contingencies		
Stockholders equity:		

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Preferred stock, \$0.001 par value		
Authorized shares 25,000 and no shares issued and outstanding		
Common stock, \$0.001 par value		
Authorized shares 500,000 as of June 26, 2010 and December 26, 2009		
Issued and outstanding shares	99	97
	99,234 as of June 26, 2010 and 96,874 as of December 26, 2009	
Additional paid-in capital	780,115	747,580
Accumulated other comprehensive loss	(1,302)	(1,810)
Accumulated deficit	(406,912)	(377,360)
Total stockholders' equity	372,000	368,507
Total liabilities and stockholders' equity	\$ 503,271	\$ 491,945

<sup>(1)</sup> Derived from consolidated financial statements

The accompanying notes are an integral part of these condensed consolidated financial statements.

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**INFINERA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**

(In thousands, except per share data)

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 26, 2010	June 27, 2009	June 26, 2010	June 27, 2009
<b>Revenue:</b>				
Product	\$ 98,035	\$ 61,074	\$ 184,202	\$ 120,222
Ratable product and related support and services	1,664	845	3,278	2,314
Services	11,699	7,013	19,678	12,976
<b>Total revenue</b>	<b>111,398</b>	<b>68,932</b>	<b>207,158</b>	<b>135,512</b>
<b>Cost of revenue:</b>				
Cost of product	57,668	45,699	113,108	89,564
Cost of ratable product and related support and services	929	358	1,684	1,088
Cost of services	5,520	2,617	8,062	4,632
Restructuring credit related to cost of revenue	(29)		(122)	
<b>Total cost of revenue</b>	<b>64,088</b>	<b>48,674</b>	<b>122,732</b>	<b>95,284</b>
<b>Gross profit</b>	<b>47,310</b>	<b>20,258</b>	<b>84,426</b>	<b>40,228</b>
<b>Operating expenses:</b>				
Research and development	28,923	24,800	57,406	46,834
Sales and marketing	13,682	11,458	26,719	22,581
General and administrative	14,448	11,478	30,185	21,605
Restructuring and other costs (credit)	(2)		159	
<b>Total operating expenses</b>	<b>57,051</b>	<b>47,736</b>	<b>114,469</b>	<b>91,020</b>
<b>Loss from operations</b>	<b>(9,741)</b>	<b>(27,478)</b>	<b>(30,043)</b>	<b>(50,792)</b>
<b>Other income (expense), net:</b>				
Interest income	325	597	810	1,515
Total other-than-temporary impairment losses		(2,747)		(2,747)
Portion of loss recognized in other comprehensive loss		1,814		1,814
<b>Net credit impairment losses recognized in earnings</b>		<b>(933)</b>		<b>(933)</b>
<b>Other gain (loss), net:</b>	<b>(208)</b>	<b>806</b>	<b>(524)</b>	<b>(1,008)</b>
<b>Total other income (expense), net</b>	<b>117</b>	<b>470</b>	<b>286</b>	<b>(426)</b>
<b>Loss before provision of income taxes</b>	<b>(9,624)</b>	<b>(27,008)</b>	<b>(29,757)</b>	<b>(51,218)</b>
<b>Provision for (benefit from) income taxes</b>	<b>(63)</b>	<b>103</b>	<b>(205)</b>	<b>221</b>
<b>Net loss</b>	<b>\$ (9,561)</b>	<b>\$ (27,111)</b>	<b>\$ (29,552)</b>	<b>\$ (51,439)</b>
<b>Net loss per common share, basic and diluted</b>	<b>\$ (0.10)</b>	<b>\$ (0.28)</b>	<b>\$ (0.30)</b>	<b>\$ (0.54)</b>

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Weighted average shares used in computing basic and diluted net loss per common share	98,777	95,161	98,026	94,718
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The accompanying notes are an integral part of these condensed consolidated financial statements.

**Table of Contents****INFINERA CORPORATION****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)****(Unaudited)**

	<b>Six Months Ended</b>	
	<b>June 26, 2010</b>	<b>June 27, 2009</b>
<b>Cash Flows from Operating Activities:</b>		
Net loss	\$ (29,552)	\$ (51,439)
Adjustments to reconcile net loss to net cash provided by (used in) operating activities:		
Depreciation and amortization	7,719	7,898
Non-cash restructuring and other costs	100	
Net credit impairment losses recognized in earnings		933
Amortization of premium on investments	1,521	95
Stock-based compensation expense	25,517	15,648
Unrealized loss on Put Rights	1,696	1,549
Unrealized holding gain for trading securities	(1,696)	(1,522)
Non-cash tax benefit	(364)	
Gain on disposal of assets	(31)	(46)
Other gain	(50)	
Changes in assets and liabilities:		
Accounts receivable	14,791	15,770
Inventories, net	(15,034)	(12,563)
Prepaid expenses and other current assets	515	(1,088)
Deferred inventory costs	(2,049)	(1,172)
Other non-current assets	3,101	241
Accounts payable	5,037	(81)
Accrued liabilities and other expenses	(3,161)	2,983
Deferred revenue	5,265	636
Accrued warranty	182	430
<b>Net cash provided by (used in) operating activities</b>	<b>13,507</b>	<b>(21,728)</b>
<b>Cash Flows from Investing Activities:</b>		
Purchase of available-for-sale investments	(120,235)	(83,937)
Purchase of cost-method investment	(4,500)	
Proceeds from maturities and calls of investments	108,483	38,007
Proceeds from disposal of assets	176	103
Purchase of property and equipment	(9,697)	(8,759)
Change in restricted cash	47	(1,168)
<b>Net cash used in investing activities</b>	<b>(25,726)</b>	<b>(55,754)</b>
<b>Cash Flows from Financing Activities:</b>		
Proceeds from issuance of common stock	6,718	4,762
Repurchase of common stock	(2)	(15)
Payments for purchase of assets under financing arrangement	(175)	
<b>Net cash provided by financing activities</b>	<b>6,541</b>	<b>4,747</b>
Effect of exchange rate changes on cash	(113)	116
<b>Net change in cash and cash equivalents</b>	<b>(5,791)</b>	<b>(72,619)</b>



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Cash and cash equivalents at beginning of period	109,859	166,770
Cash and cash equivalents at end of period	\$ 104,068	\$ 94,151

**Supplemental disclosures of cash flow information:**

Cash paid for income taxes	\$ 447	\$ 1,113
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The accompanying notes are an integral part of these condensed consolidated financial statements.

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**INFINERA CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(Unaudited)**

**1. Basis of Presentation**

The Company prepared its interim condensed consolidated financial statements that accompany these notes in conformity with U.S. generally accepted accounting principles ( U.S. GAAP ) and pursuant to the rules and regulations of the U.S. Securities and Exchange Commission (the SEC ), consistent in all material respects with those applied in the Company s Annual Report on Form 10-K for the fiscal year ended December 26, 2009.

The Company has made estimates and judgments affecting the amounts reported in its condensed consolidated financial statements and the accompanying notes. The Company s actual results may differ materially from these estimates. The accounting estimates that require most significant, difficult, and subjective judgment include revenue recognition, stock-based compensation, inventory valuation, allowances for doubtful accounts, accrued warranty, fair value measurement of investments, cash and cash equivalents, derivative instruments, other-than-temporary impairments related to investments and accounting for income taxes.

The interim financial information is unaudited, but reflects all normal adjustments that are, in management s opinion, necessary to provide a fair statement of results for the interim periods presented. The Company reclassified certain amounts reported in previous periods to conform to the current presentation. This interim information should be read in conjunction with the consolidated financial statements in the Company s Annual Report on Form 10-K for the fiscal year ended December 26, 2009.

**2. Recent Accounting Pronouncements**

In January 2010, the Financial Accounting Standards Board ( FASB ) issued Accounting Standards Update 2010-06 ( ASU 2010-06 ), Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements. ASU 2010-06 requires an entity to disclose separately the amounts of significant transfers in and out of Level I and II fair value measurements, and describe the reasons for the transfers. Also, it requires additional disclosure regarding purchases, sales, issuances and settlements of Level III measurements. ASU 2010-06 is effective for interim and annual periods beginning after December 15, 2009, except for the additional disclosure of Level III measurements, which is effective for fiscal years beginning after December 15, 2010. Effective in the first quarter of 2010, the Company adopted the provisions of ASU 2010-06 which resulted in the enhancement of certain disclosures but did not have a material impact on the Company s consolidated financial position, results of operations or cash flows.

FASB ASU 2009-13 updates the existing guidance on accounting for multiple-element revenue arrangements. Specifically, this guidance expands the criteria in Subtopic 605-25, Revenue Recognition-Multiple-Element Arrangements, for when individual deliverables within a multiple-element arrangement may be treated as separate units of accounting. In addition, the guidance modifies the manner in which the transaction consideration is allocated across the separately identified deliverables or units of accounting by no longer permitting the residual method of allocating arrangement consideration. This standard will be effective for the first annual period beginning on or after June 15, 2010 and may be applied retrospectively, for all periods presented or prospectively, with early adoption permitted. Effective for the first quarter of 2010, the Company elected to early adopt ASU 2009-13 with prospective application. See Note 3, Summary of Significant Accounting Policies, to the Notes to Condensed Consolidated Financial Statements for further discussion of the impact of the early adoption of this standard on the Company s consolidated financial position, results of operations or cash flows.

FASB ASU 2009-14 significantly changes the accounting for revenue arrangements that include both tangible product and software elements. This new standard amends the scope of pre-existing software revenue guidance by excluding non-software components of software-reliant tangible products in addition to software products bundled with tangible products where the software components and non-software components function together to deliver the products essential functionality. This standard will be effective for the first annual period beginning on or after June 15, 2010 and may be applied retrospectively, for all periods presented or prospectively, with early adoption permitted. Effective for the first quarter of 2010, the Company elected to early adopt ASU 2009-14 with prospective application. See Note 3, Summary of Significant Accounting Policies, to the Notes to Condensed Consolidated Financial Statements for further discussion of the impact of the early adoption of this standard on the Company s consolidated financial position, results of operations or cash flows.

**3. Summary of Significant Accounting Policies**

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There have been no material changes in the Company's significant accounting policies for the six months ended June 26, 2010 as compared to those disclosed in the Company's Annual Report on Form 10-K for the fiscal year ended December 26, 2009, except for changes in the accounting for revenue recognition as a result of new accounting standards and updates to the Company's derivative instruments policy to include cash flow hedges as described below.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

***Revenue Recognition***

In October 2009, the FASB amended the accounting standards for revenue recognition to remove tangible products containing software components and non-software components that function together to deliver the product's essential functionality from the scope of industry specific software revenue recognition guidance. In October 2009, the FASB also amended the accounting standards for multiple deliverable revenue arrangements to:

provide updated guidance on whether multiple deliverables exist, how the deliverables in an arrangement should be separated, and how the consideration should be allocated;

require an entity to allocate revenue in an arrangement using estimated selling price (ESP) of deliverables if a vendor does not have vendor-specific objective evidence (VSOE) of selling price or third-party evidence (TPE) of selling price; and

eliminate the use of the residual method and require an entity to allocate revenue using the relative selling price method.

The Company elected to early adopt this accounting guidance at the beginning of its first quarter of 2010 on a prospective basis for applicable transactions entered into or materially modified after December 26, 2009.

In connection with its adoption of these standards, the Company re-evaluated the appropriate revenue recognition treatment of its products and determined that the majority of its products, which have both software and non-software components that function together to deliver the product's essential functionality, are scoped out of the previous software specific revenue recognition guidance.

Substantially all of the Company's product sales are sold in combination with software support services comprised of either software warranty or software subscription services. The Company also periodically sells training, installation and deployment services, spares management and on-site hardware replacement services with its product sales. Training services include the right to a specified number of training classes and installation and deployment services may include customer site assessments, equipment installation and testing. Training and installation and deployment services are generally delivered over a 90-120 day period. Software warranty provides customers with maintenance releases and patches during the warranty support period. Software subscription also includes maintenance releases and patches and provides customers with rights to receive unspecified software product upgrades released during the support period. These support services are generally delivered over a one-year period. Spares management and on-site hardware replacement services include the replacement of defective units at customer sites in accordance with specified service level agreements and are generally delivered over a one-year period.

The Company recognizes product revenue when all of the following have occurred: (1) it has entered into a legally binding arrangement with the customer; (2) delivery has occurred, which is when product title and risk of loss have transferred to the customer; (3) customer payment is deemed fixed and determinable; and (4) collectability is reasonably assured.

The Company allocates revenue to each element in its multiple-element arrangements based upon their relative selling prices. The Company determines the selling price for each deliverable based on a selling price hierarchy. The selling price for a deliverable is based on its VSOE if available, TPE if VSOE is not available, or ESP if neither VSOE nor TPE is available. Revenue allocated to each element is then recognized when the basic revenue recognition criteria for that element has been met.

VSOE of selling price is used in the selling price allocation in all instances where it exists. VSOE of selling price for products and services is determined when a substantial majority of the selling prices fall within a reasonable range when sold separately. In certain instances, the Company is not able to establish VSOE for all deliverables in an arrangement with multiple elements. This mainly occurs where insufficient standalone sales transactions have occurred or where pricing for that element has not been consistent.

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TPE of selling price can be established by evaluating largely interchangeable competitor products or services in standalone sales to similarly situated customers. As the Company's products contain a significant element of proprietary technology and the solution offered differs substantially from that of competitors, it is typically difficult to obtain the reliable standalone competitive pricing necessary to establish TPE.

ESP represents the best estimate of the price at which the Company would transact a sale if the product or service was sold on a standalone basis. The Company determines ESP for a product or service by considering multiple factors including, but not limited to

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

customer type, geography, market conditions, competitive landscape, gross margin objectives and pricing practices. The determination of ESP is made through formal approval by the Company's management, taking into consideration the overall go-to-market pricing strategy.

As the Company's go-to-market strategies evolve, the Company may modify its pricing practices in the future, which could result in changes in selling prices, including both VSOE and ESP. As a result, the Company's future revenue recognition for multiple element arrangements could differ materially from that recorded in the current period. The Company regularly reviews VSOE, TPE and ESP and maintains internal controls over the establishment and update of these inputs.

The Company limits the amount of revenue recognition for delivered elements to the amount that is not contingent on the future delivery of products or services, future performance obligations or subject to customer-specified return or refund privileges. The Company evaluates each deliverable in an arrangement to determine whether they represent separate units of accounting. Under the new revenue recognition guidance, more of the Company's products and services qualify as separate units of accounting based on the selling price hierarchy for determination of relative selling price.

The Company's adoption of the new accounting guidance for revenue recognition resulted in an increase in total revenues of \$7.4 million, from \$104.0 million to \$111.4 million, and \$8.3 million, from \$198.9 million to \$207.2 million in the three and six months ended June 26, 2010, respectively. In addition, the new accounting guidance for revenue recognition resulted in a decrease in net loss of \$3.1 million, from \$12.7 million to \$9.6 million, and a decrease of net loss of \$3.8 million, from \$33.4 million to \$29.6 million in the three and six months ended June 26, 2010, respectively.

These increases in revenues are primarily related to an increase in net product revenues for the periods caused by the recognition of revenue on a number of purchase orders which had been partially shipped at the end of the first and second quarters of 2010. In addition, the Company recognized product revenue from bundled arrangements which would have previously been deferred until all deliverables had been completed or recognized ratably over the longest undelivered service period as VSOE of selling price had not been established for the undelivered element. The impact of the new revenue recognition guidance in future periods will depend on the number of bundled arrangements entered into by the Company with undelivered elements for which VSOE of selling price had not been established under the existing software revenue recognition guidance.

The Company has a limited number of software offerings which are not required to deliver the tangible product's essential functionality and can be sold separately. Revenues from sales of these software products and related post-contract support will continue to be accounted for under software revenue recognition rules. The Company's multiple-element arrangements may therefore have a software deliverable that is subject to the existing software revenue recognition guidance. The revenue for these multiple-element arrangements is allocated to the software deliverable and the non-software deliverables based on the relative selling prices of all of the deliverables in the arrangement using the hierarchy in the new revenue recognition accounting guidance. Revenues related to these software offerings are not expected to be material.

Revenue arrangements entered into prior to the first quarter of 2010 continue to be accounted for under the Company's previous revenue recognition policy.

Services revenue includes software subscription services, training, installation and deployment services, spares management, on-site hardware replacement services and extended hardware warranty services. Revenue from software subscription, spares management, on-site hardware replacement services and extended hardware warranty contracts is deferred and is recognized ratably over the contractual support period, which is generally one year. Revenue related to training and installation and deployment services is recognized as the services are completed.

Contracts and customer purchase orders are generally used to determine the existence of an arrangement. In addition, shipping documents and customer acceptances, when applicable, are used to verify delivery and transfer of title. Revenue is recognized only when title and risk of loss pass to customers. In instances where acceptance of the product occurs upon formal written acceptance, revenue is deferred until such written acceptance has been received. The Company assesses whether the fee is fixed or determinable based on the payment terms associated with the transaction. Payment terms to customers generally range from net 30 to 120 days from invoice, which are considered to be standard payment terms. However, payment terms greater than 120 days but less than or equal to one year from invoice may be considered standard if payment is supported by an irrevocable commercial letter of credit (LOC) issued by a creditworthy bank or the LOC has been accepted and confirmed by a

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creditworthy bank. In the event payment terms are provided that differ from the Company's standard business practices, the fees are deemed to not be fixed or determinable and, therefore, revenue is not recognized until the fees become fixed or determinable which the Company believes is when they are legally due and payable. The Company assesses its ability to collect from its customers based primarily on the creditworthiness and past payment history of the customer.

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For sales to resellers, the same revenue recognition criteria apply. It is the Company's practice to identify an end-user prior to shipment to a reseller. The Company does not offer rights of return or price protection to its resellers.

Shipping charges billed to customers are included in product revenue and related shipping costs are included in product cost. The Company reports revenue net of any required taxes collected from customers and remitted to government authorities, with the collected taxes recorded as current liabilities until remitted to the relevant government authority.

***Derivative Instruments***

The Company is exposed to foreign currency exchange rate fluctuations in the normal course of its business. As part of its risk management strategy, the Company uses derivative instruments, specifically forward contracts, to reduce the impact of foreign exchange fluctuations on earnings. The forward contracts are with one high-quality institution and the Company monitors the creditworthiness of the counter party consistently. The Company's objective is to offset gains and losses resulting from these exposures with losses and gains on the derivative contracts used to hedge them, thereby reducing volatility of earnings or protecting fair values of assets. None of the Company's derivative instruments contain credit-risk related contingent features, any rights to reclaim cash collateral or any obligation to return cash collateral. The Company does not have any leveraged derivatives. The Company does not use derivative contracts for trading or speculative purposes.

The Company enters into foreign currency exchange forward contracts to manage its exposure to fluctuations in foreign exchange rates that arise primarily from its Euro denominated receivables. Gains and losses on these contracts are intended to offset the impact of foreign exchange rate changes on the underlying foreign currency denominated accounts receivable, and therefore, do not subject the Company to material balance sheet risk. As of June 26, 2010, the Company did not designate foreign currency exchange forward contracts related to Euro denominated receivables as hedges for accounting purposes.

The Company also uses foreign currency exchange forward contracts to hedge exposures related to forecasted sales denominated in Euro. These contracts are designated as cash flow hedges and match the underlying forecasted transactions in duration. The contracts are carried on the balance sheet at fair value, and the effective portion of the contracts' gains and losses is recorded as Accumulated other comprehensive loss until the forecasted transaction occurs. For foreign currency exchange forward contracts designated as cash flow hedges, the Company evaluates and calculates the effectiveness of each hedge quarterly, using the critical terms match method. When the forecasted transaction occurs, the Company reclassifies the related gain or loss on the cash flow hedge to revenue. If the underlying forecasted transactions do not occur, or it becomes probable that they will not occur, the gain or loss on the related cash flow hedge is recognized immediately in earnings.

***Concentration of Credit Risk***

Financial instruments that are potentially subject to concentrations of credit risk consist primarily of cash equivalents, short-term investments, long-term investments, cost-method investments and accounts receivable. Investment policies have been implemented that limit investments to investment-grade securities.

As of June 26, 2010, the Company held \$33.8 million (par value) of investments comprised of auction rate securities (ARS), which are variable-rate debt securities and have a long-term maturity with the interest rate being reset through auctions that are typically held every 7, 28 or 35 days. These securities have historically traded at par and are callable at par at the option of the issuer. Interest is typically paid at the end of each auction period or semiannually. Since February 2008, most of the auctions for these securities have failed and there is no assurance that future auctions will succeed. As a result, the Company's ability to liquidate its investment in the near term may be limited.

A portion of the Company's ARS, \$24.5 million (par value), is subject to certain rights with UBS Financial Service, Inc. (UBS), whereby the Company can sell back these ARS to UBS at par value on or after June 30, 2010 (the Put Rights). On June 30, 2010, the Company exercised its Put Rights and received net cash proceeds of \$24.5 million, equal to the par value for the remainder of its UBS ARS. This completes the full recovery of par value for these securities. See Note 17, Subsequent Event, to the Notes to Condensed Consolidated Financial Statements for more information.



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There was \$9.3 million (par value) of remaining ARS that were purchased from a single broker, who to date, has not offered to repurchase these ARS from the Company. Of these ARS, \$5.0 million and \$4.3 million (par value) are AAA and A3 rated, respectively, and are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. During the three and six months ended June 26, 2010, \$0.2 million and \$0.4 million of these ARS (par value), respectively, were called at par value. It is not clear when the Company will be able to liquidate these investments. See Note 4, Fair Value Measurements and Other-Than-Temporary Impairments, to the Notes to Condensed Consolidated Financial Statements for more information.

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**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

In May 2010, the Company invested \$4.5 million in a privately-held company. This investment has been accounted for as a cost-basis investment, as the Company owns less than 20% of the voting securities and does not have the ability to exercise significant influence over operating and financial policies of the entity. See Note 5, Cost-method Investment, to the Notes to Condensed Consolidated Financial Statements for more information.

The risk with respect to accounts receivable is mitigated by ongoing credit evaluations that the Company performs on its customers. As the Company expands its sales internationally, it may experience increased levels of customer credit risk associated with those regions. Collateral is generally not required for accounts receivable but may be used in the future to mitigate credit risk associated with customers located in certain geographical regions.

Level 3 Communications ( Level 3 ) accounted for approximately 11% and 16% of the Company's revenue in the three and six months ended June 26, 2010, respectively, and 20% and 25% of the Company's revenue in the three and six months ended June 27, 2009, respectively. In July 2009, the Company was informed by Level 3 that they intended to use another dense wavelength division multiplexing ( DWDM ) vendor in their network. The Company believes that this vendor may ultimately be given a significant portion of Level 3's new network deployments. This change may impact the revenue the Company receives from Level 3 in the future, although the Company cannot predict the timing of such impact.

During the three months ended June 26, 2010, the Company had three other customers that represented approximately 11%, 13% and 13% of total revenue, while in the three months ended June 27, 2009, only one other customer represented approximately 12% of total revenue.

During the six months ended June 26, 2010, the Company had one other customer that represented approximately 14% of total revenue and the Company had no other customer that represented over 10% of total revenue in the six months ended June 27, 2009.

As of June 26, 2010, the Company had amounts due from one customer that represented approximately 21% of the Company's accounts receivable balance. As of December 26, 2009, the Company had amounts due from two customers that each represented greater than 10% of the Company's accounts receivable balance. The combined amount of the two customer balances as of December 26, 2009 represented approximately 34% of the Company's accounts receivable balance.

The Company depends on a single or limited number of suppliers for components and raw materials. The Company generally purchases these single or limited source components and materials through standard purchase orders and does not have long-term contracts with many of these sole-source suppliers. While the Company seeks to maintain sufficient reserve stock of such products, the Company's business and results of operations could be adversely affected by a stoppage or delay in receiving such components and materials, the receipt of defective parts, an increase in the price of such components and materials or the Company's inability to obtain reduced pricing from its suppliers in response to competitive pressures.

**4. Fair Value Measurements and Other-Than-Temporary Impairments**

**Fair Value Measurements**

Pursuant to the accounting guidance for fair value measurements and its subsequent updates, fair value is defined as the price that would be received from selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. When determining the fair value measurements for assets and liabilities required or permitted to be recorded at fair value, the Company considers the principal or most advantageous market in which it would transact and it considers assumptions that market participants would use when pricing the asset or liability.

Valuation techniques used by the Company are based upon observable and unobservable inputs. Observable or market inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's assumptions about market participant assumptions based on best information available. Observable inputs are the preferred source of values. These two types of inputs create the following fair value hierarchy:

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Level I	Quoted prices in active markets for identical assets or liabilities.
Level II	Inputs other than Level I that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities. In addition, Level II could include unobservable inputs that are not significant to the fair value of the assets or liabilities.

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**INFINERA CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Level III Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company measures its cash equivalents, derivative instruments, debt securities and Put Rights at fair value and classifies its securities in accordance with the fair value hierarchy.

The Company's money market funds are classified within Level I of the fair value hierarchy and are valued based on quoted prices in active markets for identical securities.

The Company classifies its certificates of deposit, commercial paper, corporate bonds, U.S. agency notes and derivative instruments within Level II of the fair value hierarchy as follows:

*Certificates of Deposit*

The Company reviews market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day. In the absence of any observable market transactions for a particular security, the fair market value at period end would be equal to the par value. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data, and result in the classification of these securities as Level II of the fair value hierarchy.

*Commercial Paper*

The Company reviews market pricing and other observable market inputs for the same or similar securities obtained from a number of industry standard data providers. In the event that a transaction is observed for the same or similar security in the marketplace, the price on that transaction reflects the market price and fair value on that day and then follows a revised accretion schedule to determine the fair market value at period end. In the absence of any observable market transactions for a particular security, the fair market value at period end is derived by accreting from the last observable market price. These inputs represent quoted prices for similar assets or these inputs have been derived from observable market data accreted mathematically to par, and result in the classification of these securities as Level II of the fair value hierarchy.

*Corporate Bonds*

The Company reviews trading activity and pricing for each of the corporate bond securities in its portfolio as of the measurement date and determines if pricing data of sufficient frequency and volume in an active market exists in order to support Level I classification of these securities. Since sufficient quoted pricing for identical securities is not available, the Company obtains market pricing and other observable market inputs for similar securities from a number of industry standard data providers. In instances where multiple prices exist for similar securities, these prices are used as inputs into a distribution-curve to determine the fair market value at period end. As a result, the Company classifies its corporate bonds as Level II of the fair value hierarchy.

*U.S. Agency Notes*

The Company reviews trading activity and pricing for its U.S. agency notes as of the measurement date. When sufficient quoted pricing for identical securities is not available, the Company uses market pricing and other observable market inputs for similar securities obtained from a number of industry standard data providers. These inputs represent quoted prices for similar assets in active markets or these inputs have been derived from observable market data, and result in the classification of these securities as Level II of the fair value hierarchy.

*Derivative Instruments*

As discussed in Note 6, Derivative Instruments, to the Notes to Condensed Consolidated Financial Statements, the Company mainly holds non-speculative foreign exchange forward contracts to hedge certain foreign currency exchange exposures. The Company estimates the fair values of derivatives based on quoted market prices or pricing models using current market rates. Where applicable, these models project future

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cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, credit risk, foreign exchange rates, and forward and spot prices for currencies. As a result, the Company classifies its derivative instruments as Level II of the fair value hierarchy.

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The Company classifies its ARS and related Put Rights within Level III of the fair value hierarchy as follows:

*Auction Rate Securities*

The Company's ARS are classified within Level III because they are valued, in part, by using inputs that are unobservable in the market and are significant to the valuation. The recent uncertainties in the credit markets have affected all of the Company's ARS and auctions for these securities have failed to settle on their respective settlement dates. In light of these developments, to determine the fair value for the Company's ARS, the Company used a combination of the market approach and income approach. The market approach uses pricing based on transactions in an inactive secondary market for similar or comparable securities. In addition, the Company performed its own discounted cash flow analysis. Management determined that it was most appropriate to value the ARS using the market approach and income approach equally given the facts and circumstances as of June 26, 2010, and therefore incorporated both valuations in the Company's fair value measurement.

The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of the Company's ARS, as of June 26, 2010, are as follows:

*Contractual cash flow*

The model assumed that the principal amount or par value for these securities will be repaid at the end of the estimated workout period. In addition, future interest payments were estimated as described in each individual prospectus and based on the then current U.S. Treasury Bill ( T-Bill ) rate adjusted for a failed auction premium of 120 basis points ( bps ) for all the Company's ARS, except for 150 bps for A3 rated securities and 350 bps for one AAA rated security.

*ARS discount rate*

The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the estimated workout period of the securities. As of the measurement date, these rates were then adjusted by a factor that ranged from 250 bps to 420 bps, representing an estimate of the market student loan spread and a discount factor to reflect the lack of liquidity and credit risk associated with these securities. Most of the Company's ARS were AAA rated, except for \$10.1 million (par value) of ARS that were downgraded to A3 rating and \$0.8 million (par value) of ARS that were downgraded to Aa1 rating during 2009. The Company's ARS are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program. The discount rate does, however, include a discount factor to reflect the issuer's credit risk and its potential inability to perform its obligations under the terms of the ARS agreements. The Company's valuation analysis indicates that the estimated credit risk element included in the discount rate was 195 bps for A3 rated securities and ranged from 100 bps to 326 bps for AAA rated securities.

*Estimated maturity*

The Company estimated the workout period of its ARS as the weighted-average life of the underlying trust loan portfolio where this information was available from servicing and other trust reports. In a small number of instances where this information was not available, the Company used the weighted-average life of the loan portfolio of a similar trust. The estimated time to maturity of the securities as of the measurement date ranged from 10.0 years to 18.0 years.

*Put Rights*

The Put Rights associated with the Company's ARS holdings with UBS are classified as Level III because they are valued, in part, by using inputs that are unobservable in the market and are significant to the valuation. The fair value of the Put Rights is equal to the difference between the fair value of the UBS ARS calculated as described above and their fair value including the impact of the Put Rights. The Company

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performed its own discounted cash flow analysis to calculate the fair value of the UBS ARS including the impact of the Put Rights.

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The significant unobservable inputs and assumptions used in the discounted cash flow model to determine the fair value of the UBS ARS including the impact of the Put Rights as of June 26, 2010 are as follows:

*Contractual cash flow*

The model assumed that the principal amount or par value for the ARS would be repaid on June 30, 2010, based on the Company's current intent to exercise its Put Rights and sell these securities to UBS on that date. In addition, future interest payments were estimated as described in each individual prospectus and based on the then current T-Bill rate as adjusted for a failed auction premium of 120 bps for all of the Company's ARS, except for 150 bps for A3 rated securities and 350 bps for one individual AAA rated security.

*Discount rate*

The model incorporated a discount rate equal to an estimate of the LIBOR rates commensurate with the expected sale date of these securities. As of the measurement date, this rate was adjusted by approximately 113 bps which represented a discount factor to reflect UBS credit risk and UBS' potential inability to perform its obligations under the Put Rights agreement.

The following tables represent the Company's fair value hierarchy for its assets and liabilities measured at fair value on a recurring basis:

	Level I	As of June 26, 2010		Total
		Level II	Level III	
(In thousands)				
<b>Assets</b>				
Money market funds	\$ 46,740	\$	\$	\$ 46,740
Certificates of deposit		720		720
Commercial paper		30,089		30,089
Corporate bonds		88,329		88,329
U.S. agency notes		34,237		34,237
ARS available-for-sale			7,709	7,709
ARS trading securities			20,284	20,284
Put Rights			4,216	4,216
Derivatives		670		670
<b>Total Assets</b>	<b>\$ 46,740</b>	<b>\$ 154,045</b>	<b>\$ 32,209</b>	<b>\$ 232,994</b>
<b>Liabilities</b>				
Derivatives	\$	\$ 91	\$	\$ 91
<b>Total Liabilities</b>	<b>\$</b>	<b>\$ 91</b>	<b>\$</b>	<b>\$ 91</b>
	Level I	As of December 26, 2009		Total
		Level II	Level III	
(In thousands)				
Money market funds	\$ 69,691	\$	\$	\$ 69,691
Certificates of deposit		720		720



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Commercial paper	33,435	33,435
Corporate bonds	42,410	42,410
U.S. agency notes	31,915	31,915
ARS available-for-sale	7,671	7,671
ARS trading securities	49,911	49,911
Put Rights	10,864	10,864
<b>Total Assets</b>	<b>\$ 69,691</b>	<b>\$ 108,480</b>
	<b>\$ 68,446</b>	<b>\$ 246,617</b>

During the three and six months ended June 26, 2010, there were no transfers of assets or liabilities between Level I and Level II and there were no transfers into or out of Level III financial assets. The following table presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable (Level III) inputs for the three and six months ended June 26, 2010 and June 27, 2009:

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	Three Months Ended				
	Total Net Gains (Losses) Included In				
	March 27, 2010	Other Income (Expense), Net	Other Comprehensive Loss (In thousands)	Calls	June 26, 2010
ARS available-for-sale	\$ 8,021	\$	\$ (151) <sup>(1)</sup>	\$ (161) <sup>(2)</sup>	\$ 7,709
ARS trading securities	47,572	(408) <sup>(3)</sup>		(26,880) <sup>(2)</sup>	20,284
Put Rights	7,753	408 <sup>(4)</sup>		(3,945) <sup>(2)</sup>	4,216
Total	\$ 63,346	\$	\$ (151)	\$ (30,986)	\$ 32,209

	Six Months Ended				
	Total Net Gains (Losses) Included In				
	December 26, 2009	Other Income (Expense), Net	Other Comprehensive Loss (In thousands)	Calls	June 26, 2010
ARS available-for-sale	\$ 7,671	\$	\$ 353 <sup>(1)</sup>	\$ (315) <sup>(2)</sup>	\$ 7,709
ARS trading securities	49,911	1,696 <sup>(3)</sup>		(31,323) <sup>(2)</sup>	20,284
Put Rights	10,864	(1,696) <sup>(4)</sup>		(4,952) <sup>(2)</sup>	4,216
Total	\$ 68,446	\$	\$ 353	\$ (36,590)	\$ 32,209

(1) Amount represents the change in the non-credit loss related OTTI recorded in Accumulated other comprehensive loss in the accompanying condensed consolidated balance sheets.

(2) Amount represents the fair market value of the securities called and the related Put Rights. Realized gains on these calls for the three and six months ended June 26, 2010 were immaterial.

(3) Unrealized holding gains for ARS trading securities were included in Other gain (loss), net in the accompanying condensed consolidated statements of operations.

(4) Amount represents the decrease in the fair value of the Put Rights recorded as Other gain (loss), net in the accompanying condensed consolidated statements of operations.

	Three Months Ended				
	Total Net Gains (Losses) Included In				
	March 28, 2009	Other Income (Expense), Net	Other Comprehensive Loss (In thousands)	Calls	June 27, 2009
ARS available-for-sale	\$ 6,892	\$ (933) <sup>(1)</sup>	\$ 1,294 <sup>(2)</sup>	\$ (50)	\$ 7,203

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ARS trading securities	49,860	550 <sup>(4)</sup>	(99)	50,311
Put Rights	13,899	418 <sup>(5)</sup>		14,317
Total	\$ 70,651	\$ 35	\$ 1,294	\$ (149) \$ 71,831

	December 27, 2008	Six Months Ended			June 27, 2009
		Other Income (Expense), Net	Other Comprehensive Loss (In thousands)	Calls	
ARS available-for-sale	\$ 7,361	\$ (933) <sup>(1)</sup>	\$ 825 <sup>(3)</sup>	\$ (50)	\$ 7,203
ARS trading securities	48,888	1,522 <sup>(4)</sup>		(99)	50,311
Put Rights	15,866	(1,549) <sup>(5)</sup>			14,317
Total	\$ 72,115	\$ (960)	\$ 825	\$ (149)	\$ 71,831

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- (1) Amount represents the credit loss related OTTI recorded as a component of Other income (expense), net in the accompanying condensed consolidated statements of operations.
- (2) For the three months ended June 27, 2009, the amount includes the reversal of \$3.1 million of an unrealized loss balance as of March 28, 2009 and the recording of \$1.8 million of non-credit loss related OTTI recorded in Accumulated other comprehensive loss in the accompanying condensed consolidated balance sheets.
- (3) For the six months ended June 27, 2009, the amount includes the reversal of \$2.6 million of an unrealized loss balance as of December 27, 2008 and the recording of \$1.8 million of non-credit loss related OTTI recorded in Accumulated other comprehensive loss in the accompanying condensed consolidated balance sheets.
- (4) Amount represents the increase in the fair value of the ARS trading securities recorded as Other gain (loss), net in the accompanying condensed consolidated statements of operations.
- (5) Amount represents the increase (decrease) in fair value of the Put Rights recorded as Other gain (loss), net in the accompanying condensed consolidated statements of operations.

Investments at fair value as of June 26, 2010 and December 26, 2009 were as follows:

	Adjusted Amortized Cost	Non-credit OTTI	June 26, 2010 Gross Unrealized Gains (In thousands)	Gross Unrealized Losses	Estimated Fair Value
Money market funds	\$ 46,740	\$	\$	\$	\$ 46,740
Certificates of deposit	720				720
Commercial paper	30,089				30,089
Corporate bonds	88,483		2	(156)	88,329
U.S. agency notes	34,237		3	(3)	34,237
ARS	8,243 <sup>(1)</sup>	(534)			7,709 <sup>(3)</sup>
<b>Total available-for-sale investments</b>	<b>\$ 208,512</b>	<b>\$ (534)</b>	<b>\$ 5</b>	<b>\$ (159)</b>	<b>\$ 207,824</b>
ARS trading securities	24,500			(4,216)	20,284 <sup>(3)</sup>
Put Rights			4,216		4,216
<b>Total investments</b>	<b>\$ 233,012</b>	<b>\$ (534)</b>	<b>\$ 4,221</b>	<b>\$ (4,375)</b>	<b>\$ 232,324</b>

	Adjusted Amortized Cost	Non-credit OTTI	December 26, 2009 Gross Unrealized Gains (In thousands)	Gross Unrealized Losses	Estimated Fair Value
Money market funds	\$ 69,691	\$	\$	\$	\$ 69,691
Certificates of deposit	720				720
Commercial paper	33,436			(1)	33,435
Corporate bonds	42,426		22	(38)	42,410
U.S. agency notes	31,905		10		31,915
ARS	8,594 <sup>(2)</sup>	(923)			7,671 <sup>(3)</sup>
<b>Total available-for-sale investments</b>	<b>\$ 186,772</b>	<b>\$ (923)</b>	<b>\$ 32</b>	<b>\$ (39)</b>	<b>\$ 185,842</b>

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ARS trading securities	60,775			(10,864)	49,911 <sup>(3)</sup>
Put Rights			10,864		10,864
Total investments	\$ 247,547	\$ (923)	\$ 10,896	\$ (10,903)	\$ 246,617

- (1) Amount represents the par value less \$1.0 million of credit-related OTTI recognized through earnings as of June 26, 2010.
- (2) Amount represents the par value less \$1.1 million of credit-related OTTI recognized through earnings as of December 26, 2009.
- (3) Amount reflects investments in a continuous loss position for twelve months or longer.

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Substantially all of the Company's investments in certificates of deposit, commercial paper, corporate bonds and U.S. agency notes have a contractual maturity term of less than one year, and ARS have contractual maturity terms of up to 38 years. The Company recorded credit-related other-than-temporary impairment ( OTTI ) for available-for-sale investments in Other income (expense), net beginning in the second quarter of 2009. Proceeds from maturities and calls of investments were \$108.5 million in the six months ended June 26, 2010. Proceeds from maturities of available-for-sale investments were \$38.0 million in the six months ended June 27, 2009. Gross realized gains (losses) on short-term and long-term investments were immaterial for both periods. The specific identification method is used to account for gains and losses on available-for-sale investments.

As of June 26, 2010, the Company held \$33.8 million (par value) of investments comprised of ARS marketable securities, which are variable-rate debt securities and have a long-term maturity with the interest rate being reset through auctions that are typically held every 7, 28 or 35 days. The securities have historically traded at par and are callable at par at the option of the issuer. Interest is typically paid at the end of each auction period or semiannually. Since February 2008, most of the auctions for these securities have failed. As of June 26, 2010, most of the ARS that the Company held were AAA rated, except for \$10.1 million (par value) of ARS that were downgraded to an A3 rating and \$0.8 million (par value) of ARS that were downgraded to Aa1 rating during 2009. The Company's ARS are mostly collateralized by student loans guaranteed by the U.S. government under the Federal Family Education Loan Program.

In October 2008, the Company elected to participate in a rights offering by UBS, one of the Company's brokers, which provided the Company with Put Rights to sell back all of its ARS purchased through UBS at par value of \$65.7 million, at any time during a two-year sale period beginning June 30, 2010. By electing to participate in the rights offering, the Company granted UBS the right, exercisable at any time prior to June 30, 2010 or during the two-year sale period, to purchase or cause the sale of the Company's ARS ( Call Right ). UBS has agreed to pay the Company the par value of its ARS within one day of settlement of any Call Right transaction. The Company's Put Rights are required to be recognized as a free-standing asset, separate from the Company's ARS. The Company elected to treat this portion of the ARS portfolio as trading securities and elected to measure the Put Rights at fair value in order to match the changes in the fair value of the ARS. This allows any changes in the fair value of the Put Rights to be offset partially with changes in the fair value of the related ARS in the Company's condensed consolidated statements of operations. The ARS covered by the UBS settlement and the related Put Rights are revalued to fair market value on a quarterly basis until the sale of these securities has been completed.

The Company recorded \$0.4 million of unrealized holding loss and \$1.7 million of unrealized holding gain related to ARS trading securities in the three and six months ended June 26, 2010, respectively, in Other gain (loss), net in the accompanying condensed consolidated statements of operations. For the three and six months ended June 26, 2010, the Company recorded an increase of \$0.4 million and a decrease of \$1.7 million, respectively, in the fair value of the Put Rights in Other gain (loss), net in the accompanying condensed consolidated statements of operations.

To date, \$41.2 million of the Company's ARS trading securities have been called at par value. During the six months ended June 26, 2010, \$36.3 million of the Company's ARS trading securities were called at par value. For the six months ended June 26, 2010, the fair value of these securities and their related Put Rights as of the transaction date were \$31.3 million and \$5.0 million, respectively.

As of June 26, 2010, \$24.5 million (par value) of the remaining UBS ARS were recorded at fair value of \$20.3 million. These trading ARS were classified as short-term investments in the accompanying condensed consolidated balance sheets at June 26, 2010 as the Company intended to sell these securities back to UBS at par value on June 30, 2010. The related Put Rights had a fair value of \$4.2 million and were also classified as short-term investments at June 26, 2010.

On June 30, 2010, the Company exercised its remaining Put Rights and received net cash proceeds of \$24.5 million. See Note 17, Subsequent Event, to the Notes to Condensed Consolidated Financial Statements for more information.

As of June 26, 2010, the remaining \$9.3 million (par value) of ARS held by the Company were not subject to the UBS settlement. In 2009, the Company deemed these securities to be other-than-temporarily impaired. See the section below titled, Other-Than-Temporary Impairments, for further discussion.



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As of June 26, 2010, the Company held \$9.3 million (par value) of available-for-sale ARS with two issuers, one of which is AAA rated and the other of which is A3 rated. These ARS have contractual maturity terms of up to 36 years. During the second quarter of 2009, the Company determined that it did not intend to sell these securities and did not believe that it was more likely than not that it would be required to sell the securities before recovery of their par value. However, given that the present value of the expected cash flows for these securities was below their par value, as of June 27, 2009, an initial OTTI of \$2.7 million, equal to the difference between the fair value and the amortized cost basis had occurred. This OTTI write-down has been separated into an amount representing credit loss, which is recognized as Other gain (loss), net in the Company's condensed consolidated statements of operations, and an amount related to all other factors, which is recorded in Accumulated other comprehensive loss in the Company's condensed consolidated balance sheets. In determining if a credit loss has occurred, the Company isolated the credit loss related portion of the discount rate used to derive the fair market value of the securities and applied this to the expected cash flows in order to determine the portion of the OTTI that was credit loss related. This credit related portion of the discount rate is based on the financial condition of the issuer, rating agency credit ratings for the security and credit related yield spreads on similar securities offered by the same issuer.

The Company recognized a credit impairment loss of \$0.9 million in the Company's condensed consolidated statements of operations for the three and six months ended June 27, 2009. The non-credit related portion of this OTTI of \$1.8 million was recognized in Accumulated other comprehensive loss in the Company's condensed consolidated balance sheet at June 27, 2009.

As of December 26, 2009, a cumulative OTTI of \$2.0 million, equal to the difference between the fair value and par value had occurred. This represented a credit impairment loss of \$1.1 million in the Company's condensed consolidated statements of operations and the non-credit related portion of \$0.9 million in Accumulated other comprehensive loss in the Company's condensed consolidated balance sheet.

These ARS had a decrease in fair value of \$0.2 million for the three months ended June 26, 2010 and a net increase in fair value of \$0.4 million for the six months ended June 26, 2010. These changes were recognized in Accumulated other comprehensive loss in the Company's condensed consolidated balance sheet. The Company did not recognize any additional OTTI credit loss on any of its securities during the three and six months ended June 26, 2010.

During the three and six months ended June 26, 2010, \$0.2 million and \$0.4 million of these ARS (par value), respectively, were called at par value. The amortized cost basis for these securities was reduced to reflect the calls during the period, resulting in a lower cost basis for these securities of \$8.2 million as of June 26, 2010.

A roll-forward of amortized cost, cumulative OTTI recognized in earnings and Accumulated other comprehensive loss is as follows:

	Amortized Cost	Cumulative OTTI in Earnings	Unrealized Gain (Loss) (In thousands)	OTTI Loss in Accumulated Other Comprehensive Income (Loss)	Accumulated Other Comprehensive Loss
Balance at December 26, 2009	\$ 8,594	\$ (1,057)	\$ 569	\$ (1,492)	\$ (923)
Unrealized gain			353		353
Call on investments	(351)	50		36	36
Balance at June 26, 2010	\$ 8,243	\$ (1,007)	\$ 922	\$ (1,456)	\$ (534)



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The Company believes that the credit risk associated with its available-for-sale ARS could change significantly in the future based on market conditions and continued uncertainties in the financial markets. The ARS student loan credit spread may be subject to significant volatility and it is difficult to predict future fluctuations. A 10% deterioration in the ARS student loan credit spread would result in \$0.3 million of additional OTTI credit loss recognized in earnings in the Company's condensed consolidated statements of operations for the second quarter of 2010.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****5. Cost-method Investment**

In May 2010, the Company invested \$4.5 million in a privately-held company. This investment is accounted for as a cost-basis investment, as the Company owns less than 20% of the voting securities and does not have the ability to exercise significant influence over operating and financial policies of the entity. The Company's investment is in an entity that is not publicly traded and, therefore, no established market for the securities exists. The fair value of a cost-method investment is not estimated if there is no identified event or change in circumstances that would have a significant adverse effect on the fair value of the investment. The Company's cost-method investment is carried at historical cost in its condensed consolidated financial statements and measured at fair value on a nonrecurring basis. If the Company believes that the carrying value of the cost basis investment is in excess of estimated fair value, the Company's policy is to record an impairment charge in Other income (expense), net in the accompanying condensed consolidated statements of operations to adjust the carrying value to estimated fair value, when the impairment is deemed other-than-temporary. The Company will regularly evaluate the carrying value of this cost-method investment for impairment. As of June 26, 2010, no event had occurred that would adversely affect the carrying value of this investment. The Company did not record any impairment charges for this cost-method investment during the three and six months ended June 26, 2010.

**6. Derivative Instruments*****Foreign Currency Exchange Forward Contracts***

The Company enters into foreign currency exchange forward contracts to manage its exposure to fluctuations in foreign exchange rates that arise primarily from its Euro denominated receivables. Gains and losses on these contracts are intended to offset the impact of foreign exchange rate changes on the underlying foreign currency denominated accounts receivable, and therefore, do not subject the Company to material balance sheet risk. The forward contracts are with one high-quality institution and the Company monitors the creditworthiness of the counterparty consistently. The forward contracts entered into during the three months and six months ended June 26, 2010 were denominated in Euros and typically had maturities of no more than 30 days. The contracts were settled for U.S. dollars at maturity at rates agreed to at inception of the contracts. As of June 26, 2010, the Company did not designate foreign currency exchange forward contracts related to Euro denominated receivables as hedges for accounting purposes, and accordingly changes in the fair value of these instruments are included in Other gain (loss), net in the accompanying condensed consolidated statements of operations. For the three and six months ended June 26, 2010, the before-tax effect of foreign currency forward contracts not designated as hedging instruments were gains of \$0.3 million and \$0.9 million, respectively, included in Other gain (loss), net in the condensed consolidated statement of operations.

***Cash Flow Hedges***

The Company uses foreign currency exchange forward contracts to hedge exposures related to forecasted sales denominated in Euro. These contracts are designated as cash flow hedges and match the underlying forecasted transactions in duration. The contracts are carried on the balance sheet at fair value, and the effective portion of the contracts' gains and losses is recorded as Accumulated other comprehensive income until the forecasted transaction occurs. For foreign currency exchange forward contracts designated as cash flow hedges, the Company evaluates and calculates the effectiveness of each hedge quarterly, using the critical terms match method. When the forecasted transaction occurs, the Company reclassifies the related gain or loss on the cash flow hedge to revenue. If the underlying forecasted transactions do not occur, or it becomes probable that they will not occur, the gain or loss on the related cash flow hedge is recognized immediately in earnings. During the three and six months ended June 26, 2010, there were no gains or losses on cash flow hedges recognized in earnings resulting from hedge ineffectiveness.

The before-tax effect of foreign currency forward contracts designated as cash flow hedges was as follows:

<b>Three Months Ended</b>	<b>Six Months Ended</b>
<b>June 26,</b>	<b>June 26, 2010</b>
<b>2010</b>	<b>(In thousands)</b>

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Gain recognized in total revenue	\$	\$	26 <sup>(1)</sup>
Gain recognized in Accumulated other comprehensive loss	\$ 428	\$	670
Gain reclassified from Accumulated other comprehensive loss to total revenue	\$ 59	\$	59

<sup>(1)</sup> Amount represents gain recognized in total revenue related to forward contracts initiated during the first quarter of 2010.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Over the next twelve months, it is expected that \$0.3 million of derivative net gain recorded in Accumulated other comprehensive loss as of June 26, 2010 will be reclassified into earnings as an adjustment to revenues. The maximum length of time over which forecasted foreign denominated revenues are hedged is 36 months.

The fair value of derivative instruments in the Company's condensed consolidated balance sheets as of June 26, 2010 was as follows:

	Notional <sup>(1)</sup>	Fair Values of Derivative Instruments	
		Prepaid Expense and Other assets (In thousands)	Other Accrued Liabilities
<b>Derivatives designated as hedging instruments:</b>			
Foreign currency exchange forward contracts	\$ 6,356	\$ 670	\$
<b>Derivatives not designated as hedging instruments:</b>			
Foreign currency exchange forward contracts	\$ 7,591		91
<b>Total derivatives</b>		<b>\$ 670</b>	<b>\$ 91</b>

<sup>(1)</sup> Represents the gross notional amount (at fair value) of the forward contracts that were outstanding as of June 26, 2010. As of December 26, 2009, there was a \$14.0 million notional amount of Euro denominated currency exchange forward contracts outstanding with an immaterial fair value amount due to the fact that the contract was entered and valued at the end of the period.

**7. Balance Sheet Components*****Inventories, Net***

Inventories, net consist of the following:

	June 26, 2010	December 26, 2009
	(In thousands)	
Raw materials	\$ 9,115	\$ 6,870
Work in process	29,160	32,054
Finished goods	45,908	29,948
<b>Total inventory</b>	<b>\$ 84,183</b>	<b>\$ 68,872</b>

Included in finished goods inventory at June 26, 2010 and December 26, 2009 were \$12.9 million and \$8.0 million, respectively, of inventory at customer locations for which product acceptance had not occurred.

***Property, Plant and Equipment, Net***

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Property, plant and equipment, net is comprised of the following:

	June 26, 2010	December 26, 2009
	(In thousands)	
Computer hardware	\$ 6,532	\$ 5,976
Computer software	6,270	5,984
Laboratory and manufacturing equipment	85,113	77,831
Furniture and fixtures	651	651
Leasehold improvements	16,912	16,384
	\$ 115,478	\$ 106,826
Less accumulated depreciation and amortization	(70,417)	(63,170)
Property, plant and equipment, net	\$ 45,061	\$ 43,656

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Accrued Expenses**

Accrued expenses are comprised of the following:

	June 26, 2010	December 26, 2009
(In thousands)		
Loss contingency related to non-cancelable purchase commitments	\$ 3,019	\$ 2,029
Taxes payable	1,614	3,907
Restructuring accrual	140	644
Royalties	3,627	1,673
Other accrued expenses	6,209	5,676
Total accrued expenses	\$ 14,609	\$ 13,929

**8. Restructuring and Other Related Costs**

In July 2009, the Company announced a restructuring plan under which it closed its Maryland-based semiconductor fabrication plant (the Maryland FAB ) and consolidated these activities into its primary fabrication plant location in Sunnyvale, California (the Sunnyvale FAB ). This consolidation of activities into one location was expected to facilitate collaboration across integration platforms in support of the Company's next generation products. As a result, during 2009, the Company recorded \$3.9 million of restructuring and other related costs including severance and related expenses, equipment and facilities-related costs, operating lease termination costs, and other exit costs. Equipment and facilities-related costs consist of increased depreciation expense related to restructured assets caused by shortening the useful life or updating the salvage value of depreciable fixed assets to coincide with the end of production under the approved restructuring plan. The Company substantially completed its restructuring actions in the fourth quarter of 2009.

The types of restructuring and other related costs (credits) recorded were the following:

	Three Months Ended June 26, 2010			Six Months Ended June 26, 2010		
	Cost of Revenue	Operating Expenses	Total	Cost of Revenue	Operating Expenses	Total
(In thousands)						
Severance and related expenses (credits)	\$ (129)	\$	\$ (129)	\$ (144)	\$ 55	\$ (89)
Equipment and facilities-related expenses (credits)	100		100	22		22
Lease termination		(2)	(2)		104	104
Total	\$ (29)	\$ (2)	\$ (31)	\$ (122)	\$ 159	\$ 37

Cumulative restructuring and other related costs through June 26, 2010 totaled \$3.9 million.

The following table sets forth the activity and balance of the restructuring liability account for severance and operating lease and contract termination costs for the six months ended June 26, 2010:

	<b>Severance and Related Expenses (In thousands)</b>
Balance at December 26, 2009	\$ 644
Provision	211
Payments	(565)
Change in estimates	(150)
Balance at June 26, 2010	\$ 140

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****9. Comprehensive Loss**

The components of Accumulated other comprehensive loss are as follows:

	June 26, 2010	December 26, 2009
	(In thousands)	
Accumulated net unrealized loss on foreign currency translation adjustment	\$ (604)	\$ (565)
Accumulated unrealized gain on cash flow hedges	670	
Accumulated unrealized non-credit related other-than-temporary impairment losses on available-for-sale investments	(534)	(923)
Accumulated unrealized holding loss on all other available-for-sale investments	(154)	(7)
Accumulated tax effect on items in accumulated other comprehensive loss	(680)	(315)
Total accumulated other comprehensive loss	\$ (1,302)	\$ (1,810)

The following table reconciles net loss to comprehensive loss:

	Three Months Ended		Six Months Ended	
	June 26, 2010	June 27, 2009	June 26, 2010	June 27, 2009
	(In thousands)			
Net loss	\$ (9,561)	\$ (27,111)	\$ (29,552)	\$ (51,439)
Change in foreign currency translation gain (loss)	(120)	226	(39)	117
Accumulated unrealized gain on cash flow hedges	428		670	
Change in unrealized non-credit related other-than-temporary impairment losses on available-for-sale investments	(57)		(147)	
Change in unrealized gain (loss) on all other available-for-sale investments	(136)	1,609	389	1,063
Change in tax effect on items in accumulated other comprehensive loss	(94)		(365)	
Total comprehensive loss	\$ (9,540)	\$ (25,276)	\$ (29,044)	\$ (50,259)

**10. Basic and Diluted Net Loss Per Common Share**

Basic net loss per common share is computed by dividing net loss by the weighted average number of vested common shares outstanding during the period. Diluted net loss per common share was computed using net loss and the weighted average number of common shares outstanding plus potentially dilutive common shares outstanding during the period. Potentially dilutive common shares include the assumed exercise of outstanding stock options, assumed vesting of outstanding restricted stock units, assumed exercise of outstanding warrants, and assumed issuance of stock under the employee stock purchase plan using the treasury stock method.



**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following table sets forth the computation of net loss per common share:

	Three Months Ended		Six Months Ended	
	June 26, 2010	June 27, 2009	June 26, 2010	June 27, 2009
	(In thousands, except per share amounts)			
<b>Numerator Basic and Diluted</b>				
Net loss	\$ (9,561)	\$ (27,111)	\$ (29,552)	\$ (51,439)
<b>Denominator</b>				
Basic weighted average common shares outstanding	98,777	95,161	98,026	94,718
Effect of dilutive securities:				
Employee equity plans				
Warrants to purchase common stock				
Diluted weighted average common shares outstanding	\$ 98,777	\$ 95,161	\$ 98,026	\$ 94,718
Net loss per common share basic and diluted	\$ (0.10)	\$ (0.28)	\$ (0.30)	\$ (0.54)

As of June 26, 2010 and June 27, 2009, the Company had securities outstanding that could potentially dilute basic net loss per common share in the future, but were excluded from the computation of diluted loss per common share in the periods presented as their effect would have been anti-dilutive. Potentially dilutive outstanding securities were as follows:

	June 26, 2010	June 27, 2009
	(In thousands)	
Stock options outstanding	10,394	12,411
Restricted stock units	7,137	4,089
Performance stock units	3,321	1,181
Employee stock purchase plan shares	645	585
Warrants to purchase common stock	124	224

**11. Litigation and Contingencies****Legal Matters**

On May 9, 2006, the Company and Level 3 Communications (Level 3) were sued by Cheetah Omni, LLC (Cheetah) in the U.S. District Court for the Eastern District of Texas Texarkana Division for alleged infringement of patent No. 6,795,605 (the 605 Patent), and a continuation thereof. On May 16, 2006, Cheetah filed an amended complaint, which requested an order to enjoin the sale of the Company's DTN System and to recover all damages caused by the alleged willful infringement including any and all compensatory damages available by law, such as actual and punitive damages, attorneys' fees, associated interest and Cheetah's costs incurred in the lawsuit. Cheetah's complaint does not request a specific dollar amount for these compensatory damages. The Company is contractually obligated to indemnify Level 3 for damages suffered by Level 3 to the extent its product supplied by the Company is found to infringe, and it has assumed the defense of this matter. On July 20, 2006, the Company and Level 3 filed an amended response denying all infringement claims under the 605 Patent and asserting that the claims of the 605 Patent are invalid and that the DTN System does not infringe the 605 Patent. On November 28, 2006, Cheetah filed a second amended complaint and added patent No. 7,142,347 (the 347 Patent) to the lawsuit. On December 18, 2006, the Company and Level 3 filed responses to Cheetah's second amended complaint denying all infringement claims under the 347 Patent and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims are invalid and that the DTN System does not infringe the patents.

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On January 30, 2007, Cheetah filed a third amended complaint adding additional assertions of infringement for the two patents in suit. On February 16, 2007, the Company and Level 3 filed responses to Cheetah's third amended complaint denying all infringement claims, and the Company and Level 3 asserted counterclaims against Cheetah asserting that the claims of the patents are invalid and that the DTN System does not infringe the patents.

On March 14, 2007, the Company submitted requests to the U.S. Patent and Trademark Office for *inter partes* reexamination of the 605 Patent and the 347 Patent asking the U.S. Patent and Trademark Office to reexamine the patents based on prior art in order to invalidate the patents or limit the scope of each patent's claims. On March 21, 2007, the Company and Level 3 filed a motion with the court to stay all proceedings in the lawsuit pending the reexamination of the 605 Patent and the 347 Patent.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

On April 11, 2007, the Company, Level 3 and Cheetah filed a joint motion with the court, agreeing to the following: (1) to stay all proceedings in the lawsuit pending a determination by the U.S. Patent and Trademark Office as to whether it will reexamine the 605 Patent and the 347 Patent; and (2) if the U.S. Patent and Trademark Office decides to reexamine either the 605 Patent and the 347 Patent, to stay all proceedings in the lawsuit pending final resolution of the reexamination(s) by the U.S. Patent and Trademark Office. On April 12, 2007, the court granted the motion staying all proceedings in the lawsuit. On June 26, 2007, the U.S. Patent and Trademark Office also ordered reexamination of the 605 Patent. On August 1, 2007, the U.S. Patent and Trademark Office ordered reexamination of the 347 Patent. As a result, all proceedings in this lawsuit are stayed until the final resolution of these reexaminations.

In a communication the Company received from the U.S. Patent and Trademark Office dated December 4, 2009, the Company was advised that various claims in the 347 Patent reexamination have been allowed, while other claims have been rejected. In a communication the Company received from the U.S. Patent and Trademark Office dated June 22, 2010, the Company was advised that various claims in the 605 Patent reexamination have been allowed, while other claims have been rejected. The Company has appealed the allowance of certain claims in the 347 Patent reexamination to the Board of Patent Appeals and Interferences at the U.S. Patent and Trademark Office and will have an opportunity to appeal the allowance of certain claims in the 605 Patent reexamination. The Company does not know when the U.S. Patent and Trademark Office reexamination process will be completed.

On January 26, 2010, Cheetah's counsel filed a motion requesting the Court to lift the stay in order to litigate those claims relating to the 347 Patent reexamination that the U.S. Patent and Trademark Office allowed. The court denied the motion on April 16, 2010 and the stay remains in effect. On April 30, 2010, Cheetah filed a motion for reconsideration of the order denying Cheetah's motion to lift the stay. On May 17, 2010, the Company filed its opposition to Cheetah's motion for reconsideration and is awaiting the Court's decision regarding Cheetah's motion for reconsideration.

The Company believes the suit is without merit and intends to defend itself vigorously, but it is unable to predict the likelihood of an unfavorable outcome.

On May 14, 2010, Aloft Media, LLC (Aloft) filed a complaint in the U.S. District Court for the Eastern District of Texas Tyler Division alleging that the Company infringes U.S. Patent Nos. 7,593,910 and 7,596,538. On August 2, 2010, the Company filed its answer to Aloft's complaint denying all infringement claims. The Company believes the suit is without merit and intends to defend itself vigorously, but it is unable to predict the likelihood of an unfavorable outcome.

In addition to the matters described above, 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 effect on its consolidated financial position, results of operations, or cash flows.

**12. Stockholders' Equity*****Stock Option Exchange Program***

On June 11, 2009, the Company's stockholders approved a one-time stock option exchange program (the Option Exchange Program). On January 25, 2010, the Company launched the Option Exchange Program pursuant to which eligible employees were able to exchange certain outstanding stock options under the Company's 2007 Equity Incentive Plan with an exercise price greater than or equal to \$8.16 per share and a grant date on or before January 25, 2009, for a lesser amount of new restricted stock units (RSUs) or for new stock options for senior executives. The Option Exchange Program was available for employees of the Company residing in the U.S., India and the U.K. who held eligible options. The Option Exchange Program expired on February 22, 2010, and there were options to purchase 4,926,790 shares tendered for exchange. All surrendered options were canceled effective as of the expiration of the Option Exchange Program, and immediately thereafter, the Company granted (i) new options to purchase an aggregate of 1,564,727 shares of the Company's common stock with an exercise price of \$7.61 per share and (ii) RSUs for 814,017 shares of the Company's common stock. The Option Exchange Program did not result in any significant incremental stock-based compensation expense.



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## INFINERA CORPORATION

## NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)

*Equity Incentive Plans*

As of June 26, 2010, there were a total of 9.0 million shares available for grant under the Company's 2007 Equity Incentive Plan. The following tables summarize the Company's stock award activity and related information for the six months ended June 26, 2010:

	Number of Options (In thousands, except per share data)	Weighted- Average Exercise Price Per Share	Aggregate Intrinsic Value
<b>Outstanding at December 26, 2009</b>	14,568	\$ 8.25	\$ 35,462
Options granted	606	\$ 8.11	
Options granted in connection with the stock option exchange program	1,565	\$ 7.61	
Options exercised	(820)	\$ 3.38	\$ 4,784
Options canceled	(598)	\$ 8.24	
Options canceled in connection with the stock option exchange program	(4,927)	\$ 13.53	

<b>Outstanding at June 26, 2010</b>	10,394	\$ 6.03	\$ 17,483
Vested and expected to vest	10,278		\$ 17,461

	Number of Restricted Stock Units (In thousands, except per share data)	Weighted- Average Grant Date Fair Value Per Share	Aggregate Intrinsic Value
<b>Outstanding at December 26, 2009</b>	5,066	\$ 9.44	\$ 45,287
RSUs granted	2,374	\$ 8.95	
RSUs released	(888)	\$ 8.31	\$ 7,750
RSUs granted in connection with the stock option exchange program	814	\$ 7.61	
RSUs canceled	(229)	\$ 8.66	

<b>Outstanding at June 26, 2010</b>	7,137	\$ 8.37	\$ 49,240
Expected to vest	6,618		\$ 45,665

	Number of Performance Stock Units (In thousands, except per share data)	Weighted- Average Grant Date Fair Value Per Share	Aggregate Intrinsic Value
<b>Outstanding at December 26, 2009</b>	3,304	\$ 10.51	\$ 29,451
PSUs granted			
PSUs released			
PSUs canceled	(165)	\$ 10.19	

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<b>Outstanding at June 26, 2010</b>	3,139	\$ 10.53	\$ 21,662
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Expected to vest	2,998		\$ 20,689
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The aggregate intrinsic value of unexercised options, unreleased RSUs and PSUs is calculated as the difference between the closing price of the Company's common stock of \$6.90 at June 25, 2010 and the exercise prices of the underlying equity awards. The aggregate intrinsic value of the options which have been exercised and RSUs released is calculated as the difference between the fair market value of the common stock at the date of exercise or release and the exercise price of the underlying equity awards.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Employee Stock Options**

During the three months ended June 26, 2010, the Company granted options to employees and members of the board of directors to purchase an aggregate of 0.5 million shares of common stock at a weighted-average exercise price of \$8.31 per share. During the six months ended June 26, 2010, the Company granted options to employees and members of the board of directors to purchase an aggregate of 2.2 million shares at a weighted-average price of \$7.75 per share. The options granted during the six months ended June 26, 2010 included 1.6 million shares of common stock granted in connection with the Option Exchange Program, at a weighted-average exercise price of \$7.61 per share. Options granted during these periods have exercise prices equal to the closing market prices of the Company's common stock on the dates these options were granted. The weighted-average remaining contractual term of options exercisable was 6.1 years as of June 26, 2010. Amortization of stock-based compensation for the three and six months ended June 26, 2010 was approximately \$3.9 million and \$7.9 million, respectively, net of estimated forfeitures.

As of June 26, 2010, the total stock-based compensation cost related to options granted to employees and directors but not yet amortized was \$22.7 million, net of estimated forfeitures of \$0.6 million. These costs will be amortized on a straight-line basis over a weighted-average period of approximately 2.1 years. Total fair value of stock options granted to employees and members of the board of directors that vested during the three and six months ended June 26, 2010 was approximately \$3.3 million and \$6.1 million, respectively, based on the grant date fair value.

Excluding options granted in connection with the one-time stock Option Exchange Program, the ranges of estimated values of employee and director stock options granted, as well as ranges of assumptions used in calculating these values during the three and six months ended June 26, 2010 and June 27, 2009, were based on estimates as follows:

	Three Months Ended		Six Months Ended	
	June 26, 2010	June 27, 2009	June 26, 2010	June 27, 2009
<b>Employee and Director Stock Options</b>				
Volatility	56% - 58%	63%	56% - 61%	63% - 72.5%
Risk-free interest rate	2.08% - 2.90%	2.52%	2.08% - 2.90%	2.13% - 2.52%
Expected life	4.8 - 5.4 years	6.1 years	4.8 - 5.4 years	5.5 - 6.1 years
Estimated fair value	\$3.64 - \$4.83	\$5.00 - \$5.27	\$3.60 - \$5.05	\$4.06 - \$5.87

**Employee Stock Purchase Plan**

Stock-based compensation costs related to the Company's employee stock purchase plan ( ESPP ) were approximately \$0.6 million and \$1.3 million for the three and six months ended June 26, 2010, respectively, and approximately \$0.8 million and \$1.5 million for the three and six months ended June 27, 2009, respectively. The fair value of the ESPP shares was estimated at the date of grant using the following assumptions:

	Three Months Ended		Six Months Ended	
	June 26, 2010	June 27, 2009	June 26, 2010	June 27, 2009
<b>Employee Stock Purchase Plan</b>				
Volatility	45.0%	95.0%	45.0%	95.0%
Risk-free interest rate	0.20%	0.54%	0.20%	0.54%
Expected life	0.5 years	0.5 years	0.5 years	0.5 years
Estimated fair value	\$2.13	\$2.83	\$2.13	\$2.83

**Restricted Stock Units**

During the three and six months ended June 26, 2010, the Company granted RSUs to employees to receive an aggregate of 2.1 million and 3.2 million shares of common stock, respectively, at no cost. Included in the RSUs granted in the six months ended June 26, 2010 are 0.8 million shares granted in connection with the Option Exchange Program. The Company accounted for the fair value of the RSUs using the closing

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market price of the Company's common stock on the date of grant. Amortization of stock-based compensation related to RSUs in the three and six months ended June 26, 2010 was approximately \$6.2 million and \$11.6 million, respectively. As of June 26, 2010, total stock-based compensation cost related to RSUs granted to employees and members of the board of directors but not yet amortized was approximately \$52.7 million, net of estimated forfeitures of \$5.7 million. These costs will be amortized on a straight-line basis over a weighted-average period of 2.6 years.



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The number of shares to be issued upon vesting of PSUs range from 0.5 to 2.0 times the number of PSUs granted depending on the relative performance of the Company's common stock price compared to NASDAQ over a three-year or four-year period. Amortization of stock-based compensation related to PSUs in the three and six months ended June 26, 2010 was approximately \$2.1 million and \$4.8 million, respectively. As of June 26, 2010, total stock-based compensation cost related to PSUs granted to members of the Company's board of directors and executive officers but not yet amortized was approximately \$19.6 million, net of estimated forfeitures of \$0.9 million. These costs will be amortized on a straight-line basis over a weighted-average period of 2.1 years.

The grant date fair value of PSUs was estimated using the Monte Carlo simulation model with the following assumptions:

	<b>Six Months Ended June 27, 2009</b>
<b>Performance Stock Unit Grants</b>	
Infinera volatility	70% - 75%
NASDAQ volatility	30% - 35%
Risk-free interest rate	1.25% - 1.71%
Correlation between Infinera and NASDAQ	0.56 - 0.60
Estimated fair value	\$9.65 - \$10.76

**Common Stock Warrants**

As of June 26, 2010, there were warrants to purchase 0.1 million shares of common stock outstanding with exercise prices ranging from \$5.40 to \$8.96 per share and a weighted-average exercise price of \$6.30 per share. These warrants expire between 2011 and 2013.

**Stock-Based Compensation**

The following table summarizes the effects of stock-based compensation related to awards granted to employees and members of the Company's board of directors on the Company's condensed consolidated balance sheets and statements of operations for the periods presented:

	<b>June 26, 2010</b>	<b>December 26, 2009</b>
	<b>(In thousands)</b>	
Stock-based compensation effects in inventory	\$ 3,012	\$ 2,879
Stock-based compensation effects in deferred inventory cost	\$ 246	\$ 201

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 26, 2010</b>	<b>June 27, 2009</b>	<b>June 26, 2010</b>	<b>June 27, 2009</b>
	<b>(In thousands)</b>			
<b>Stock-based compensation effects in loss before income taxes</b>				
Cost of revenue	\$ 564	\$ 477	\$ 1,133	\$ 856
Research and development	3,350	2,419	6,773	4,151
Sales and marketing	2,192	1,599	4,039	3,013
General and administration	5,198	3,513	10,907	6,158

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	11,304	8,008	22,852	14,178
Cost of revenue amortization from balance sheet*	1,303	904	2,665	1,470
Total stock-based compensation expense	\$ 12,607	\$ 8,912	\$ 25,517	\$ 15,648

\* Stock-based compensation expense deferred to inventory and deferred inventory costs in prior periods and recognized in the current period.

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****13. Income Taxes**

During the three and six months ended June 26, 2010, an income tax benefit of \$0.1 million and \$0.4 million, respectively, were allocated to the tax provision from continuing operations, related to the tax effects of items credited directly to other comprehensive income ( OCI ). Generally, the amount of tax expense or benefit allocated to continuing operations is determined without regard to the tax effects of other categories of income or loss, such as OCI. However, an exception to the general rule is provided within the intra-period tax allocation rules when there is a pre-tax loss from continuing operations and there are items charged or credited to other categories, including OCI, in the current year. The intra-period tax allocation rules related to items charged or credited directly to OCI can result in disproportionate tax effects that remain in OCI until certain events occur.

Exclusive of these intra-period allocations discussed above, the Company recorded an immaterial amount and \$0.2 million of tax expense during the three and six months ended June 26, 2010, for resulting effective tax rates of (0.3)% and (0.5)%, on pre-tax book losses of \$9.6 million and \$29.8 million, in the respective periods. The effective tax rate differs from the statutory rate of 35% based upon unbenefited U.S. losses, non-deductible stock-based compensation expense, and foreign taxes provided on foreign subsidiary earnings.

The realization of tax benefits of deferred tax assets is dependent upon future levels of taxable income, of an appropriate character, in the periods the items are scheduled to be deductible or taxable. Based on the available objective evidence, management believes it is more likely than not that the domestic net deferred tax assets will not be realizable. Accordingly, the Company has provided a full valuation allowance against its domestic deferred tax assets, net of deferred tax liabilities, as of June 26, 2010 and December 26, 2009. In determining future taxable income, the Company makes assumptions to forecast federal, state and international operating income, the reversal of temporary differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with the Company's forecasts used to manage its business. The Company intends to maintain the remaining valuation allowance until sufficient positive evidence exists to support a reversal of, or decrease, in the valuation allowance.

**14. Segment Information**

Operating segments are defined as components of an enterprise about which separate financial information is available that is evaluated regularly by the chief operating decision maker, or decision making group, in deciding how to allocate resources and in assessing performance. The Company's chief operating decision maker is the Company's chief executive officer. The Company's chief executive officer reviews financial information presented on a consolidated basis, accompanied by information about revenue by geographic region for purposes of allocating resources and evaluating financial performance. The Company has one business activity, and there are no segment managers who are held accountable for operations, operating results and plans for levels or components below the consolidated unit level. Accordingly, the Company is considered to be in a single reporting segment and operating unit structure.

Revenue by geographic region is based on the shipping address of the customer. The following table sets forth revenue and long-lived assets by geographic region:

**Revenue**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 26,</b>	<b>June 27,</b>	<b>June 26,</b>	<b>June 27,</b>
	<b>2010</b>	<b>2009</b>	<b>2010</b>	<b>2009</b>
	<b>(In thousands)</b>			
Americas:				
United States	\$ 89,742	\$ 44,296	\$ 165,707	\$ 93,620
Other Americas	576		870	
	\$ 90,318	\$ 44,296	\$ 166,577	\$ 93,620

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Europe, Middle East and Africa	16,109	19,666	33,851	35,329
Asia Pacific	4,971	4,970	6,730	6,563
<b>Total revenue</b>	<b>\$ 111,398</b>	<b>\$ 68,932</b>	<b>\$ 207,158</b>	<b>\$ 135,512</b>

**Table of Contents****INFINERA CORPORATION****NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Property, plant and equipment, net**

	June 26, 2010	December 26, 2009
	(In thousands)	
United States	\$ 42,812	\$ 41,405
Asia Pacific	2,249	2,251
<b>Total property, plant and equipment, net</b>	<b>\$ 45,061</b>	<b>\$ 43,656</b>

**15. Guarantees*****Product Warranties***

Upon delivery of products, the Company provides for the estimated cost to repair or replace products or the related components that may be returned under hardware warranty. In general, hardware warranty periods range from 1 to 5 years. Hardware warranties provide the purchaser with protection in the event that the product does not perform to product specifications. During the warranty period, the purchaser's sole and exclusive remedy in the event of such defect or failure to perform is limited to the correction of the defect or failure by repair, refurbishment or replacement, at the Company's sole option and expense. The Company estimates its hardware warranty obligations based on the Company's historical experience of known product failure rates, use of materials to repair or replace defective products, and service delivery costs incurred in correcting product failures. In addition, from time to time, specific hardware warranty accruals may be made if unforeseen technical problems arise with specific products. Management periodically assesses the adequacy of the Company's recorded warranty liabilities and adjusts the amounts as necessary.

Activity related to product warranty was as follows:

	Three Months Ended		Six Months Ended	
	June 26, 2010	June 27, 2009	June 26, 2010	June 27, 2009
	(In thousands)			
Beginning balance	\$ 10,650	\$ 9,702	\$ 11,140	\$ 9,940
Charges to operations	3,622	3,872	6,663	6,592
Utilization	(2,400)	(1,617)	(4,666)	(2,979)
Change in estimate <sup>(1)</sup>	(550)	(1,587)	(1,815)	(3,183)
<b>Balance at the end of the period</b>	<b>\$ 11,322</b>	<b>\$ 10,370</b>	<b>\$ 11,322</b>	<b>\$ 10,370</b>

<sup>(1)</sup> The Company records hardware warranty liabilities based on the latest quality and cost information available as of that date. The favorable changes in estimate shown here are due to continued improvements in overall actual failure rates and the impact of these improvements on the Company's estimate of expected future returns and changes in the estimated cost of replacing failed units using either repaired or new units.

**16. Related Party Transactions**

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The Company's former Chief Financial Officer, Mr. Duston M. Williams and the Company have signed a consulting agreement, dated January 26, 2010, pursuant to which Mr. Williams will remain a consultant to the Company from June 26, 2010 until April 1, 2011. In exchange for providing these consulting services to the Company, Mr. Williams will receive the following compensation: (a) he shall continue to vest in the grant of 170,000 RSUs that were granted to him on August 10, 2009, which shall vest and be settled in full no later than March 15, 2011; (b) he shall be paid under the Company's 2010 Bonus Plan at 100% of the pro-rated amount for the actual performance for the Company for the six months from January 1, 2010 through June 26, 2010, and (c) provided he remains a qualified beneficiary, if he timely elects continuation of COBRA coverage, the Company will reimburse the COBRA premiums for continued health (i.e., medical, dental, and vision) coverage for him and his eligible dependants for a period commencing on July 1, 2010 (the COBRA Commencement Date), and ending on the earlier to occur of (x) six (6) months following the COBRA Commencement Date and (y) the date upon which Mr. Williams becomes eligible to be covered under another health insurance plan by a subsequent employer. Except for the grant of restricted stock units described above, Mr. Williams shall not vest in any other equity awards after June 26, 2010.

On May 19, 2010, the Company entered into a consulting agreement with Mr. Reed Hundt, a former member of the Company's board of directors, pursuant to which Mr. Hundt will remain a consultant to the Company from May 19, 2010 until November 30, 2011. In exchange for Mr. Hundt's consulting services to the Company, Mr. Hundt was granted 35,000 shares of RSUs which shall vest through November 2011, subject to Mr. Hundt's continued services with the Company.

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**INFINERA CORPORATION**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**17. Subsequent Event**

In October 2008, the Company elected to participate in a rights offering by UBS, which provided the Company with Put Rights to sell back all of its ARS purchased from UBS at par value of \$65.7 million, at anytime during a two-year period beginning June 30, 2010. As of June 26, 2010, \$24.5 million (par value) of UBS ARS were recorded at fair value of \$20.3 million. On June 30, 2010, the Company exercised the Put Rights and received net cash proceeds of \$24.5 million, representing a full recovery of par value. After this transaction, the Company's ARS portfolio consisted of the remaining \$9.3 million (par value as of June 26, 2010) of available-for-sale ARS.

**Table of Contents****Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This quarterly report on Form 10-Q contains forward-looking statements that involve risks and uncertainties, as well as assumptions that, if they never materialize or prove incorrect, could cause our results to differ materially from those expressed or implied by such forward-looking statements. Such forward-looking statements include any expectation of earnings, revenues, gross margins, costs, restructuring charges and associated costs, or other financial items; any statements of the plans, strategies and objectives of management for future operations and personnel; factors that may affect our operating results, including sales and equipment deployment; statements concerning new products or services; statements related to capital expenditures; statements related to future economic conditions or performance; statements related to market growth and demand; statements related to repayment of our adjustable rate securities and the impact of liquidity of our adjustable rate securities on our operations; statements related to payments made pursuant to our restructuring plan; statements related to the effect of any litigation on our operations; statements as to industry trends and other matters that do not relate strictly to historical facts or statements of assumptions underlying any of the foregoing. These statements are often identified by the use of words such as anticipate, believe, continue, could, estimate, expect, intend, may, or will, and similar expressions or variations. These statements are based on the beliefs and assumptions of our management based on information currently available to management. Such forward-looking statements are subject to risks, uncertainties and other factors that could cause actual results and the timing of certain events to differ materially from future results expressed or implied by such forward-looking statements. Factors that could cause or contribute to such differences include, but are not limited to, those identified below, and those discussed in the section titled Risk Factors included elsewhere in this Form 10-Q and in our other SEC filings, including our annual report on Form 10-K for the fiscal year ended December 26, 2009 filed on March 1, 2010. Such forward-looking statements speak only as of the date of this report. We disclaim any obligation to update any forward-looking statements to reflect events or circumstances after the date of such statements. The following discussion and analysis should be read in conjunction with our condensed consolidated financial statements and notes thereto included elsewhere in this quarterly report on Form 10-Q.*

**Executive Overview**

Infinera was founded in December 2000 with a unique vision for optical networking. Prior to Infinera, service provider optical networks were built from fairly commoditized products, broadly known as dense wavelength division multiplexing ( DWDM ) systems. The pace of bandwidth growth in service provider networks has been significant over the last few years. Thus each year, service providers generally have been consuming more space, more power, and more of their human resources to deploy and manage their optical networks. The Infinera vision is that photonic integration offers a solution to this problem. Photonic integration is predicated upon the belief that, it is possible to generate a Moore's Law-like continuous improvement in capacity per device (or chip) to help service providers scale their network bandwidth without significant increases in space, power or operational workload.

Infinera's flagship product offering is an optical telecom system, the Digital Transport Node System ( DTN System ). The DTN System uses photonic integrated circuits, or PICs, to generate 100 Gigabits per second ( Gbps ) of optical capacity per line card. This capacity is then digitally virtualized so that it can be allocated, using software, to a variety of service types. The DTN System includes intelligent software that is designed to simplify and speed the delivery and control of optical services, and to enable advanced feature capabilities. Photonic integration provides the basis for the DTN System's power and space advantages relative to conventional DWDM systems, while the DTN System's bandwidth virtualization capability and software intelligence are architected to allow Infinera customers to simplify and speed their operations tasks, and ultimately to improve operational efficiency.

Infinera's digital optical network architecture is made possible by what we believe to be the world's only commercially-deployed, large-scale PIC. Our PICs transmit and receive 100Gbps of optical capacity and incorporate the functionality of over 60 discrete optical devices into a pair of indium phosphide chips. Their function is to convert 100 Gbps of optical capacity into electronic signals. Once electronic, these signals can be virtualized and allocated to a number of services using digital technology. The PICs enable the DTN System to deliver a wide range of transport services, with optional advanced features, quickly and easily. By contrast, competitive DWDM platforms, which do not have access to PIC technology, generally require photonics equipment to add new services to the network. Photonic engineering can be considerably slower and more difficult than digital engineering; as a result, we believe competitive platforms have less flexibility, take longer to provision, and are harder to operate than the DTN System.

In 2009, we expanded our addressable market by introducing a new product, the ATN System, which extends the benefits of an Infinera network into smaller locations in the metro access network. We also introduced new submarine network capabilities into the DTN System. As a result, Infinera now offers end-to-end optical networking solutions from the metro edge, through the regional and long-haul terrestrial network, all the way to the submarine network terminal.

Our goal is to be a leading provider of optical communications systems to operators of optical networks, including telecom carriers, cable operators, internet or content service providers, and others. Our revenue growth will depend on the continued





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acceptance of our products, growth of communications traffic and the proliferation of next-generation bandwidth-intensive services, which are expected to drive the need for increased levels of bandwidth. Our ability to increase revenue and achieve profitability will be directly affected by the level of acceptance of our products in the long-haul and metro DWDM markets and by our ability to cost-effectively develop and sell innovative products that leverage our technology advantages.

As of June 26, 2010, we have sold our network systems for deployment in optical networks of 75 customers worldwide, including Cox Communications, Deutsche Telekom, Global Crossing, Interoute and Level 3. We do not have long-term purchase commitments with our customers. To date, a few of our customers have accounted for a significant portion of our revenue. In particular, Level 3 accounted for approximately 11% and 16% of our revenue in the three and six months ended June 26, 2010, respectively, and 20% and 25% of our revenue in the three and six months ended June 27, 2009, respectively. In July 2009, we were informed by Level 3 that they intended to use another DWDM vendor in their network. We believe that this vendor may ultimately be given a significant portion of Level 3's new network deployments. This change may impact the revenue we receive from Level 3 in the future, although we cannot predict the timing of such impact.

During the three months ended June 26, 2010, we had three other customers each represented approximately 11%, 13% and 13% of total revenue, while only one other customer represented approximately 12% of total revenue.

During the six months ended June 26, 2010, we had one other customer that represented approximately 14% of total revenue and we had no other customer that represented over 10% of total revenue in the six months ended June 27, 2009.

We are headquartered in Sunnyvale, California, with employees located throughout North America, Europe and the Asia Pacific region. We expect to continue to add personnel in the United States and internationally to develop our products and provide additional geographic sales and technical support coverage. We primarily sell our products through our direct sales force, with a small portion sold indirectly through resellers. We derived 98% of our revenue from direct sales to customers for each of the three and six months ended June 26, 2010, respectively, and 85% and 90% of our revenue for the three and six months ended June 27, 2009, respectively. We expect to continue generating a substantial portion of our revenue from direct sales in the future.

We will continue to make significant investments in our business, and currently management believes that operating expenses, including stock-based compensation expense, will be approximately \$240 million to \$245 million for fiscal year 2010.

In July 2009, we announced a restructuring plan under which we closed our Maryland FAB and consolidated these activities into our Sunnyvale FAB. This consolidation of activities into one location was expected to facilitate collaboration across integration platforms in support of our next generation products. As a result, during 2009, we recorded \$3.9 million of restructuring and other related costs including severance and related expenses, equipment and facilities-related costs, operating lease termination costs, and other exit costs. Equipment and facilities-related costs primarily consist of increased depreciation expense related to restructured assets caused by shortening the useful life or updating the salvage value of depreciable fixed assets to coincide with the end of production under the approved restructuring plan. We substantially completed our restructuring actions in the fourth quarter of 2009. Cumulative restructuring and other related costs through June 26, 2010 totaled \$3.9 million. Minimal future payments primarily associated with severance and related expenses are expected to be made through the end of 2010. See Note 8, Restructuring and Other Related Costs, to the Notes to Condensed Consolidated Financial Statements for more information.

### **Critical Accounting Policies and Estimates**

Management's Discussion and Analysis of Financial Condition and Results of Operations is based upon our condensed consolidated financial statements, which we have prepared in accordance with U.S. GAAP. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. Management bases its estimates on historical experience and on various other assumptions that it believes to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

An accounting policy is deemed to be critical if it requires an accounting estimate to be made based on assumptions about matters that are highly uncertain at the time the estimate is made, if different estimates reasonably could have been used, or if changes in the estimate that are reasonably likely to occur could materially impact the financial statements. Management believes that there have been no significant changes during the six months ended June 26, 2010 to the items that we disclosed as our critical accounting

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policies and estimates in Management's Discussion and Analysis of Financial Condition and Results of Operations in our Annual Report on Form 10-K for the fiscal year ended December 26, 2009, with the exception of our accounting policies for revenue recognition and derivative instruments as described in Note 3, Summary of Significant Accounting Policies, of the Notes to Condensed Consolidated Financial Statements.

**Recent Accounting Pronouncements**

For additional information on the recent accounting pronouncements impacting our business, see Note 2, Recent Accounting Pronouncements, and Note 3, Summary of Significant Accounting Policies, to the Notes to Condensed Consolidated Financial Statements.

**Results of Operations**

The following sets forth, for the periods presented, certain unaudited condensed consolidated statements of operations information:

	June 26, 2010	Three Months Ended % of total revenue (In thousands, except %)	June 27, 2009	% of total revenue
<b>Revenue:</b>				
Product	\$ 98,035	88%	\$ 61,074	89%
Ratable product and related support and services	1,664	1%	845	1%
Services	11,699	11%	7,013	10%
<b>Total revenue</b>	<b>\$ 111,398</b>	<b>100%</b>	<b>68,932</b>	<b>100%</b>
<b>Cost of revenue:</b>				
Product	\$ 57,668	52%	45,699	66%
Ratable product and related support and services	929	1%	358	1%
Services	5,520	5%	2,617	4%
Restructuring credit related to cost of revenue	(29)	%		%
<b>Total cost of revenue</b>	<b>\$ 64,088</b>	<b>58%</b>	<b>48,674</b>	<b>71%</b>
<b>Gross profit</b>	<b>\$ 47,310</b>	<b>42%</b>	<b>\$ 20,258</b>	<b>29%</b>
	June 26, 2010	Six Months Ended % of total revenue (In thousands, except %)	June 27, 2009	% of total revenue
<b>Revenue:</b>				
Product	\$ 184,202	89%	\$ 120,222	89%
Ratable product and related support and services	3,278	2%	2,314	2%
Services	19,678	9%	12,976	9%
<b>Total revenue</b>	<b>\$ 207,158</b>	<b>100%</b>	<b>135,512</b>	<b>100%</b>
<b>Cost of revenue:</b>				
Product	\$ 113,108	54%	89,564	66%
Ratable product and related support and services	1,684	1%	1,088	1%
Services	8,062	4%	4,632	3%
Restructuring credit related to cost of revenue	(122)	%		%
<b>Total cost of revenue</b>	<b>\$ 122,732</b>	<b>59%</b>	<b>95,284</b>	<b>70%</b>
<b>Gross profit</b>	<b>\$ 84,426</b>	<b>41%</b>	<b>\$ 40,228</b>	<b>30%</b>



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The following table summarizes our revenue by geography and sales channel for the periods presented:

	Three Months Ended		Six Months Ended	
	June 26, 2010	June 27, 2009	June 26, 2010	June 27, 2009
(In thousands, except %)				
<b>Total revenue by geography</b>				
Domestic	\$ 89,742	\$ 44,296	\$ 165,707	\$ 93,620
International	21,656	24,636	41,451	41,892
	\$ 111,398	\$ 68,932	\$ 207,158	\$ 135,512
<b>% Revenue by geography</b>				
Domestic	81%	64%	80%	69%
International	19%	36%	20%	31%
	100%	100%	100%	100%
<b>Total revenue by sales channel</b>				
Direct	\$ 109,199	\$ 58,297	\$ 202,491	\$ 122,394
Indirect	2,199	10,635	4,667	13,118
	\$ 111,398	\$ 68,932	\$ 207,158	\$ 135,512
<b>% Revenue by sales channel</b>				
Direct	98%	85%	98%	90%
Indirect	2%	15%	2%	10%
	100%	100%	100%	100%

**Revenue**

Total revenue increased to \$111.4 million for the three months ended June 26, 2010 from \$68.9 million for the corresponding period in 2009. We have experienced a recovery in overall demand and, in particular, demand from existing customers in the second quarter of 2010 as compared to the same period in 2009. Revenue levels in the first half of 2009 were significantly impacted by the downturn in the economy as new and existing customers delayed purchasing decisions and limited their new purchases. As the economic environment has improved, we have experienced increased business activity with many of our customers, including strong demand from our internet content providers and cable customers in North America. While we expect this trend to continue into the third quarter of 2010, we lack the visibility necessary to accurately predict future revenues beyond this one-quarter time horizon.

Total revenue increased to \$207.2 million for the six months ended June 26, 2010 from \$135.5 million for the corresponding period in 2009. We have experienced a recovery in overall demand and, in particular, demand from existing customers in the first half of 2010 as compared to the same period in 2009. Revenue levels in the first half of 2009 were significantly impacted by the downturn in the economy as new and existing customers delayed purchasing decisions and limited their new purchases. As the economic environment has improved, we have experienced increased business activity with many of our customers, including strong demand from our internet content provider and cable customers in North America.

International revenue decreased to 19% of total revenue in the three months ended June 26, 2010 from 36% of total revenue in the corresponding period in 2009, and decreased to 20% of total revenue in the six months ended June 26, 2010 from 31% of total revenue in the corresponding period in 2009. The decreases were primarily attributable to increased levels of sales to domestic customers during the periods. While we expect international revenues to continue to grow in absolute dollars on a long-term basis as we increase our sales activities in Europe, Asia Pacific and other regions, this metric may fluctuate as a percentage of total revenue depending on the size and timing of deployments both internationally and in the United States.

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Total product revenue increased to \$98.0 million for the three months ended June 26, 2010 from \$61.1 million for the corresponding period in 2009. Total product revenue increased to \$184.2 million for the six months ended June 26, 2010 from \$120.2 million for the corresponding period in 2009. The increase in product revenue in the three and six months ended June 26, 2010 was primarily due to increased sales of our DTN System to new and existing customers reflecting an overall improvement in the economic environment.

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Product and related support services revenue that is recognized ratably includes sales of products and services that were deferred under previous accounting standards, prior to our adoption of ASU 2009-13 and ASU 2009-14 as discussed in Note 3, Summary of Significant Accounting Policies, to the Notes to Condensed Consolidated Financial Statements, because VSOE of fair value had not been established for the undelivered elements. Total ratable revenue levels increased to \$1.7 million for the three months ended June 26, 2010 from \$0.8 million for the corresponding period in 2009. Total ratable revenue levels increased to \$3.3 million for the six months ended June 26, 2010 from \$2.3 million for the corresponding period in 2009. The increase in ratable revenue in the three and six months ended June 26, 2010 was primarily due to the recognition of the previously deferred ratable product revenue.

Total services revenue increased to \$11.7 million for the three months ended June 26, 2010 from \$7.0 million for the corresponding period in 2009 primarily reflecting the recognition of \$2.5 million of incremental deployment services revenue. In addition, we recognized increased revenues from our spares management service of \$1.0 million and our extended hardware warranty service of \$1.0 million. Total services revenue increased to \$19.7 million for the six months ended June 26, 2010 from \$13.0 million for the corresponding period in 2009 primarily reflecting the recognition of \$3.4 million of incremental deployment services revenue. In addition, we recognized increased revenues from our spares management service of \$1.7 million and our extended hardware warranty service of \$1.7 million. We expect to continue to grow our extended hardware warranty and spares management services revenues in future periods.

*Cost of Revenue and Gross Margin*

Gross margin increased to 42% in the three months ended June 26, 2010 from 29% in the corresponding period in 2009. Gross margin increased to 41% in the six months ended June 26, 2010 from 30% in the corresponding period in 2009. The significant increase in gross margin in the three and six months ended June 26, 2010 was primarily due to the growth in sales of our higher gross margin tributary adaptor modules coupled with an overall growth in product and services revenue, as compared to the corresponding periods in 2009, which were significantly affected by the economic downturn. This was somewhat offset by reduced services margins due to increased levels of lower margin deployments in the three and six months ended June 26, 2010. In addition, gross margin in the first half of 2009 was negatively impacted as described below.

During the three months ended June 27, 2009, we recognized revenue and costs related to a number of large negative margin common equipment deployments. This resulted in a significant overall negative gross margin impact, even though some of the inventory sold had been written-down for LCM adjustments in the first quarter of 2009. In addition, gross margin was negatively impacted by the usage of significant common equipment discounts during the period.

During the six months ended June 27, 2009, we recognized revenue and costs related to a large number of negative margin common equipment deployments resulting in a significant overall negative gross margin impact. In addition, gross margin was negatively impacted by the usage of significant common equipment discounts during the first half of 2009.

*Operating Expenses*

	June 26, 2010	Three Months Ended % of total revenue (In thousands, except %)	June 27, 2009	% of total revenue
Operating expenses:				
Research and development	\$ 28,923	26%	\$ 24,800	36%
Sales and marketing	13,682	12%	11,458	16%
General and administrative	14,448	13%	11,478	17%
Restructuring and other costs	(2)	%		%
Total operating expenses	\$ 57,051	51%	\$ 47,736	69%

	June 26, 2010	Six Months Ended % of total revenue (In thousands, except %)	June 27, 2009	% of total revenue
Operating expenses:				
Research and development	\$ 57,406	28%	\$ 46,834	34%

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Sales and marketing	26,719	13%	22,581	17%
General and administrative	30,185	14%	21,605	16%
Restructuring and other costs	159	%		%
Total operating expenses	\$ 114,469	55%	\$ 91,020	67%



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The following table summarizes the stock-based compensation expense included in our operating expenses:

	Three Months Ended		Six Months Ended	
	June 26, 2010	June 27, 2009	June 26, 2010	June 27, 2009
	(In thousands)			
Research and development	\$ 3,350	\$ 2,419	\$ 6,773	\$ 4,151
Sales and marketing	2,192	1,599	4,039	3,013
General and administration	5,198	3,513	10,907	6,158
Total	\$ 10,740	\$ 7,531	\$ 21,719	\$ 13,322

*Research and Development Expenses*

Research and development expenses increased by \$4.1 million in the three months ended June 26, 2010 compared to the corresponding period in 2009 primarily due to increased headcount and personnel-related costs of \$4.2 million comprised of \$3.3 million of cash compensation and \$0.9 million of stock-based compensation expense. In addition, in the three months ended June 26, 2010, we incurred \$0.6 million of increased spending on equipment and software, offset by a reduction of \$0.5 million in prototype and new product spending as compared to the same period in 2009.

Research and development expenses increased by \$10.6 million in the six months ended June 26, 2010 compared to the corresponding period in 2009 primarily due to increased headcount and personnel-related costs of \$7.8 million comprised of \$5.2 million of cash compensation and \$2.6 million of stock-based compensation expense. In addition, in the six months ended June 26, 2010, we incurred \$2.1 million of increased prototype and new product spending and \$0.9 million of increased spending on equipment and software expenses as compared to the same period in 2009.

*Sales and Marketing Expenses*

Sales and marketing expenses increased by \$2.2 million in the three months ended June 26, 2010 compared to the corresponding period in 2009 primarily due to an increase of \$1.2 million in cash compensation and personnel expenses, \$0.3 million in travel and entertainment expenses and increased stock-based compensation expense of \$0.6 million.

Sales and marketing expenses increased by \$4.1 million in the six months ended June 26, 2010 compared to the corresponding period in 2009 primarily due to an increase of \$2.8 million in cash compensation and personnel expenses, \$0.3 million in travel and entertainment expenses and increased stock-based compensation expense of \$1.0 million.

*General and Administrative Expenses*

General and administrative expenses increased by \$3.0 million in the three months ended June 26, 2010 compared to the corresponding period in 2009 primarily due to an increase of \$1.8 million of cash compensation, \$1.6 million of stock-based compensation expense and \$0.6 million of depreciation and other costs. These increases were offset by a decrease in outside professional service fees of \$1.0 million.

General and administrative expenses increased by \$8.6 million in the six months ended June 26, 2010 compared to the corresponding period in 2009 primarily due to an increase of \$4.7 million of stock-based compensation expense, \$3.1 million of cash compensation, \$0.4 million of depreciation and amortization, and \$0.4 million of outside professional service fees and other costs.

*Restructuring and Other Costs*

In the three and six months ended June 26, 2010, we incurred an immaterial credit amount and \$0.2 million, respectively, of restructuring and other costs associated with the closure of our Maryland FAB as described above and in Note 8, Restructuring and Other Related Costs, to the Notes to Condensed Consolidated Financial Statements. These expenses related to operating lease and contract termination costs and severance and related expenses.



**Table of Contents***Other Income (Expense), Net*

	Three Months Ended		Six Months Ended	
	June 26, 2010	June 27, 2009	June 26, 2010	June 27, 2009
	(In thousands)			
Interest income	\$ 325	\$ 597	\$ 810	\$ 1,515
Total other-than-temporary impairment losses		(2,747)		(2,747)
Portion of loss recognized in other comprehensive loss		1,814		1,814
Net credit impairment losses recognized in earnings	\$	\$ (933)	\$	\$ (933)
Other gain (loss), net	(208)	806	(524)	(1,008)
Total income (expense), net	\$ 117	\$ 470	\$ 286	\$ (426)

Interest income decreased by \$0.3 million in the three months ended June 26, 2010 compared to the corresponding period in 2009 and decreased by \$0.7 million in the six months ended June 26, 2010 compared to the corresponding period in 2009. These decreases were due to lower interest rates on investments and lower investment balances.

We recognized net credit impairment losses of \$0.9 million in the three and six months ended June 27, 2009, related to the OTTI of our available-for-sale ARS, as discussed in Note 4, Fair Value Measurements and Other-Than-Temporary Impairments, of the Notes to Condensed Consolidated Financial Statements.

Other gain (loss), net for the three months ended June 26, 2010 included a \$0.4 million increase in the fair value of the Put Rights offset by a \$0.4 million unrealized holding loss related to ARS trading securities compared to a \$0.4 million gain related to an increase in the fair value of the Put Rights and a \$0.6 million unrealized holding gain related to ARS trading securities for the corresponding period in 2009. Additionally, in the three months ended June 26, 2010 and June 27, 2009, we recorded \$0.4 million and \$0.2 million, respectively, of unrealized and realized losses due to foreign currency exchange re-measurement.

Other gain (loss), net for the six months ended June 26, 2010 included a \$1.7 million decrease in the fair value of the Put Rights offset by a \$1.7 million unrealized holding gain related to ARS trading securities compared to a \$1.5 million loss due to a decrease in fair value of the Put Rights offset by a \$1.5 million unrealized holding gain to ARS trading securities for the corresponding period in 2009. Additionally, in the six months ended June 26, 2010 and June 27, 2009, we recorded \$0.8 million and \$1.0 million, respectively, of unrealized and realized losses due to foreign currency exchange re-measurement.

*Income Tax Provision (Benefit)*

During the three and six months ended June 26, 2010, an income tax benefit of \$0.1 million and \$0.4 million, respectively, were allocated to the tax provision from continuing operations, related to the tax effects of items credited directly to OCI. Generally, the amount of tax expense or benefit allocated to continuing operations is determined without regard to the tax effects of other categories of income or loss, such as OCI. However, an exception to the general rule is provided within the intra-period tax allocation rules when there is a pre-tax loss from continuing operations and there are items charged or credited to other categories, including OCI, in the current year. The intra-period tax allocation rules related to items charged or credited directly to OCI can result in disproportionate tax effects that remain in OCI until certain events occur.

Exclusive of these intra-period allocation tax benefits discussed above, we recorded an immaterial amount and \$0.2 million of tax expense during the three and six months ended June 26, 2010, respectively. The resulting effective tax rates of (0.3)% and (0.5)%, respectively, compared to (0.4)% and (0.4)% for the three and six months ended June 27, 2009, respectively. The effective tax rates for all periods differ from the statutory rate of 35% based upon unbenefited U.S. losses, non-deductible stock-based compensation, and foreign taxes provided on foreign subsidiary earnings.

The realization of tax benefits of deferred tax assets is dependent upon future levels of taxable income, of an appropriate character, in the periods the items are scheduled to be deductible or taxable. Based on the available objective evidence, management believes it is more likely than not that the domestic net deferred tax assets will not be realizable. Accordingly, we have provided a full valuation allowance against our domestic deferred tax assets, net of deferred tax liabilities, as of June 26, 2010 and December 26, 2009. In determining future taxable income, we make

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assumptions to forecast federal, state and international operating income, the reversal of temporary differences, and the implementation of any feasible and prudent tax planning strategies. The assumptions require significant judgment regarding the forecasts of future taxable income, and are consistent with the forecasts used to manage our business. We intend to maintain the remaining valuation allowance until sufficient positive evidence exists to support a reversal of, or decrease, in the valuation allowance.

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**Liquidity and Capital Resources**

	<b>Six Months Ended</b>	
	<b>June 26,</b>	<b>June 27,</b>
	<b>2010</b>	<b>2009</b>
	<b>(In thousands)</b>	
Net cash flow provided by (used in):		
Operating activities	\$ 13,507	\$ (21,7