

PARADYNE NETWORKS INC
Form 10-Q
April 28, 2004
Table of Contents

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 March 31, 2004

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

For the transition period from _____ to _____

Commission File No. 000-26485

Paradyne Networks, Inc.

(Exact name of registrant as specified in its charter)

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

75-2658219
*(IRS Employer
Identification No.)*

Edgar Filing: PARADYNE NETWORKS INC - Form 10-Q

8545 126th Avenue North

Largo, Florida 33773

(Address of principal executive offices, zip code)

(727) 530-2000

(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes No

The number of shares of the registrant's common stock outstanding at April 26, 2004, the latest practicable date, was 44,897,879.

Table of Contents

INDEX

PART I FINANCIAL INFORMATION

| | | |
|----------------|-------------------------------------------------------------------------------------------------------------------------------|----|
| Item 1. | <u>Financial Statements</u> | |
| | <u>Condensed Unaudited Consolidated Balance Sheets at March 31, 2004 and December 31, 2003</u> | 1 |
| | <u>Condensed Unaudited Consolidated Statements of Operations for the Three Months Ended March 31, 2004 and March 31, 2003</u> | 2 |
| | <u>Condensed Unaudited Consolidated Statements of Cash Flows for the Three months Ended March 31, 2004 and March 31, 2003</u> | 3 |
| | <u>Notes to Condensed Unaudited Consolidated Financial Statements</u> | 4 |
| Item 2. | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u> | 9 |
| Item 3. | <u>Quantitative and Qualitative Disclosures about Market Risk</u> | 13 |
| Item 4. | <u>Controls and Procedures</u> | 13 |

PART II OTHER INFORMATION

| | | |
|----------------|------------------------------------------------|----|
| Item 1. | <u>Legal Proceedings</u> | 14 |
| Item 6. | <u>Exhibits and Reports on Form 8-K</u> | 15 |
| | <u>Signatures</u> | 16 |
| | <u>Exhibits</u> | |

Table of Contents**PART I. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS**

PARADYNE NETWORKS, INC.

CONDENSED UNAUDITED CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS, EXCEPT PER SHARE DATA)

| | <u>MARCH 31,</u> <u>2004</u> | <u>DECEMBER 31,</u> <u>2003</u> |
|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------------------------|------------------------------------|
| ASSETS | | |
| Current assets: | | |
| Cash and cash equivalents | \$ 46,036 | \$ 46,775 |
| Accounts receivable less allowance for doubtful accounts of \$1,347 and \$1,346 at March 31, 2004 and December 31, 2003, respectively | 10,944 | 7,119 |
| Inventories | 14,643 | 16,419 |
| Prepaid expenses and other current assets | 1,475 | 1,578 |
| | <u>73,098</u> | <u>71,891</u> |
| Total current assets | 73,098 | 71,891 |
| Property, plant and equipment, net | 4,784 | 5,595 |
| Intangible assets, net | 4,563 | 4,869 |
| Other assets | 457 | 87 |
| | <u>82,902</u> | <u>82,442</u> |
| Total assets | \$ 82,902 | \$ 82,442 |
| LIABILITIES AND STOCKHOLDERS EQUITY | | |
| Current liabilities: | | |
| Accounts payable | \$ 6,036 | \$ 5,486 |
| Payroll and benefit related liabilities | 2,155 | 2,636 |
| Other current liabilities | 4,903 | 4,745 |
| | <u>13,094</u> | <u>12,867</u> |
| Total current liabilities | 13,094 | 12,867 |
| | <u>13,094</u> | <u>12,867</u> |
| Total liabilities | \$ 13,094 | \$ 12,867 |
| Stockholders' equity: | | |
| Preferred stock, par value \$.001; 5,000,000 shares authorized, none issued | | |
| Common stock, par value \$.001; 80,000,000 shares authorized, 44,853,520 and 44,486,373 shares issued and outstanding as of March 31, 2004 and December 31, 2003, respectively | 45 | 44 |
| Additional paid-in capital | 142,917 | 141,912 |
| Accumulated deficit | (73,347) | (72,560) |
| Notes receivable for common stock | (16) | (16) |
| Other equity adjustments | 209 | 195 |
| | <u>69,808</u> | <u>69,575</u> |
| Total stockholders' equity | 69,808 | 69,575 |

Edgar Filing: PARADYNE NETWORKS INC - Form 10-Q

| | | |
|--------------------------------------------|------------------|------------------|
| Total liabilities and stockholders' equity | <u>\$ 82,902</u> | <u>\$ 82,442</u> |
|--------------------------------------------|------------------|------------------|

See accompanying Notes to Condensed Unaudited Consolidated Financial Statements

Table of Contents

PARADYNE NETWORKS, INC.

CONDENSED UNAUDITED CONSOLIDATED STATEMENTS OF OPERATIONS

(IN THOUSANDS, EXCEPT PER SHARE DATA)

| | THREE MONTHS ENDED MARCH 31, | |
|-------------------------------------------------------------------|---------------------------------|------------|
| | 2004 | 2003 |
| Revenues: | | |
| Sales | \$ 20,815 | \$ 17,734 |
| Services | 1,482 | 1,564 |
| Total revenues | 22,297 | 19,298 |
| Total cost of sales | 13,080 | 9,565 |
| Gross margin | 9,217 | 9,733 |
| Operating expenses: | | |
| Research and development | 3,758 | 5,609 |
| Selling, general & administrative | 5,806 | 7,250 |
| Amortization of intangible assets and deferred stock compensation | 343 | 423 |
| Business restructuring charges | 269 | |
| Total operating expenses | \$ 10,176 | \$ 13,282 |
| Operating loss | (959) | (3,549) |
| Other (income) expenses: | | |
| Interest, net | (127) | (154) |
| Other, net | (45) | 93 |
| Loss before provision for income taxes | (787) | (3,488) |
| Net loss | \$ (787) | \$ (3,488) |
| Weighted average number of common shares outstanding | | |
| Basic | 44,801 | 42,862 |
| Diluted | 44,801 | 42,862 |
| Loss per common share | | |
| Basic | \$ (0.02) | \$ (0.08) |
| Diluted | (0.02) | (0.08) |
| Consolidated Statements of Comprehensive Income (Loss) | | |
| Net loss | (787) | (3,488) |
| Translation adjustments | (23) | 143 |
| Comprehensive loss | \$ (810) | \$ (3,345) |

See accompanying Notes to Condensed Unaudited Consolidated Financial Statements

Table of Contents

PARADYNE NETWORKS, INC.

CONDENSED UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS

(IN THOUSANDS)

| | THREE MONTHS ENDED MARCH 31, | |
|---------------------------------------------------------------------------------------|-----------------------------------------|------------------|
| | 2004 | 2003 |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | |
| Net loss | \$ (787) | \$ (3,488) |
| Adjustments to reconcile net loss to cash provided by (used in) operating activities: | | |
| Income from reversal of reserves due to sale of inventory | | (762) |
| Loss on sale of assets | 3 | |
| Increase (decrease) in allowance for bad debts | 1 | (268) |
| Depreciation and amortization | 1,316 | 1,959 |
| (Increase) decrease in assets, net of effects of acquisition: | | |
| Receivables | (3,826) | 4,307 |
| Inventories | 1,776 | 1,426 |
| Other assets | (267) | 1,063 |
| Decrease in liabilities, net of effects of acquisition: | | |
| Accounts payable | 550 | (1,908) |
| Payroll and related liabilities | (481) | (1,250) |
| Other current liabilities | 158 | (2,067) |
| Net cash (used in) provided by operating activities | <u>\$ (1,557)</u> | <u>\$ (988)</u> |
| CASH FLOWS PROVIDED BY (USED IN) INVESTING ACTIVITIES: | | |
| Capital expenditures | (163) | (181) |
| Net cash provided by (used in) investing activities | <u>\$ (163)</u> | <u>\$ (181)</u> |
| CASH FLOWS PROVIDED BY (USED IN) FINANCING ACTIVITIES: | | |
| Net proceeds from stock transactions | 1,004 | 25 |
| Repayments under other debt obligations | | (165) |
| Net cash provided by financing activities | <u>1,004</u> | <u>(140)</u> |
| Effect of foreign exchange rate changes on cash | (23) | 143 |
| Net increase (decrease) in cash and cash equivalents | (739) | (1,166) |
| Cash and cash equivalents at beginning of period | 46,775 | 47,706 |
| Cash and cash equivalents at end of period | <u>\$ 46,036</u> | <u>\$ 46,540</u> |

See accompanying Notes to Condensed Unaudited Consolidated Financial Statements

Table of Contents

Paradyne Networks, Inc.

Notes to Condensed Unaudited Consolidated Financial Statements (in thousands, except per share data)

1. Business and Basis of Presentation:

Paradyne Networks, Inc. (the Company) designs, manufactures, and markets data communications and networking products for network service providers and business customers. The Company's products enable business customers to efficiently access wide area network services and allow network service providers to provide customers with high-speed services for data, voice, video and multimedia applications.

The accompanying condensed unaudited consolidated financial statements include the results of the Company and its wholly-owned subsidiaries: Paradyne Corporation; Paradyne Canada Ltd.; Paradyne International Ltd.; Paradyne Worldwide Corp.; Ark Electronic Products, Inc.; Paradyne Finance Corporation; Paradyne International Sales Ltd.; Paradyne Networks do Brazil LTDA.; Paradyne Services, LLC and Elastic Networks Inc. Intercompany accounts and transactions have been eliminated in consolidation.

The accompanying condensed unaudited consolidated financial statements of the Company have been prepared in accordance with generally accepted accounting principles for interim financial information and with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. However, in the opinion of management, such statements reflect all adjustments, consisting of only normal, recurring adjustments, necessary for a fair presentation of interim period results. These financial statements should be read in conjunction with the December 31, 2003 audited financial statements and notes thereto included in the Company's Annual Report on Form 10-K as filed with the Securities and Exchange Commission on March 15, 2004.

The results of operations for the interim periods are not necessarily indicative of results to be expected for the entire year or for other future interim periods.

Stock Options

The Company applies APB Opinion No. 25 and related interpretations for accounting for stock options. Accordingly, no compensation costs at the grant dates are recorded for options granted at fair market value. Had compensation cost for the Company's option plans been determined based on the fair value at the grant dates as prescribed by SFAS No. 123, Accounting for Stock Based Compensation, the Company's net income and net income per share on a pro forma basis would have been:

| THREE MONTHS ENDED | |
|---------------------------|-------------|
| MARCH 31, | |
| <hr/> | |
| 2004 | 2003 |

Edgar Filing: PARADYNE NETWORKS INC - Form 10-Q

| | | |
|---------------------------------------------------------------------------------------------------------------------------------------------|------------|------------|
| Net income (loss), as reported | \$ (787) | \$ (3,488) |
| Add: Stock-based employee compensaton expense included in reported net income, net of related taxes | 38 | 117 |
| Deduct: Total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (2,604) | (2,762) |
| Pro forma net income (loss) | \$ (3,353) | \$ (6,133) |
| Earnings per share basic as reported | \$ (0.02) | \$ (0.08) |
| Earnings per share diluted as reported | \$ (0.02) | \$ (0.08) |
| Earnings per share basic and diluted pro forma | \$ (0.07) | \$ (0.14) |

Table of Contents*Product Warranty*

The Company generally provides a return to factory warranty for a period of one year from the date of sale. A current charge to income is recorded at the time of sale to reflect the amount the Company estimates will be needed to cover future warranty obligations for products sold during the year. The accrued liability for warranty costs is included in the caption "other current liabilities" in the accompanying consolidated balance sheets. The estimate of such costs is based upon historical and anticipated requirements. The following table summarizes the activity for the product warranty reserve for the three months ended March 31, 2003 and 2004:

| | <u>2004</u> | <u>2003</u> |
|----------------------------------------------------------------|-----------------|-----------------|
| Beginning balance at January 1, 2004 and 2003 | \$ 747 | \$ 1,416 |
| Product warranty expenses accrued | 85 | 198 |
| Product warranty expenses incurred and charged against reserve | (117) | (198) |
| Adjustment for changes in estimates | (66) | |
| | <u> </u> | <u> </u> |
| Ending balance at March 31, 2004 and 2003 | <u>\$ 649</u> | <u>\$ 1,416</u> |

Liquidity

The Company has incurred losses from operations in each of the two years presented in these consolidated financial statements due to the continuing slowdown in the telecommunications environment. At March 31, 2004, management believes that available cash and cash equivalents together with future cash flow from operations will be sufficient to meet the Company's obligations as they become due for the next twelve months.

Loss Per Share

Basic loss per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding during the year. Diluted earnings per share assumes the exercise of stock options for which market price exceeds exercise price, less shares assumed purchased by the Company with related proceeds and associated tax benefits.

Options of 14,443,829 and 13,189,016 for the three months ending March 31, 2003 and 2004, respectively, are not included in the March 31, 2003 and 2004 calculation of loss per share due to their antidilutive effect.

2. Recently Issued Financial Accounting Standards:

Edgar Filing: PARADYNE NETWORKS INC - Form 10-Q

In May 2003, the FASB issued FAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, which requires that an issuer classify certain financial instruments as a liability or an asset. Previously, many financial instruments with characteristics of both liabilities and equity were classified as equity. Financial instruments subject to FAS 150 include financial instruments with any of the following features:

An unconditional redemption obligation at a specified or determinable date, or upon an event that is certain to occur;

An obligation to repurchase shares, or indexed to such an obligation, that may require physical share or net cash settlement;

An unconditional, or for new issuances conditional, obligation that may be settled by issuing a variable number of equity shares if either (a) a fixed monetary amount is known at inception, (b) the variability is indexed to something other than the fair value of the issuer's equity shares, or (c) the variability moves inversely to changes in the fair value of the issuer's shares.

The standard requires that all such instruments be classified as a liability, or an asset in certain circumstances, and initially measured at fair value. Forward contracts that require a fixed physical share settlement and mandatory redeemable financial instruments must be subsequently remeasured at fair value on each reporting date. This standard is effective for all financial instruments entered into or modified after May 31, 2003, and for all other financial instruments, at the beginning of the first interim period beginning after June 15, 2003. The Company has adopted this standard beginning in the third quarter of 2003 and the implementation did not have a significant impact on the results of operation, financial position or cash flow.

Table of Contents

On November 5, 2003, some classification and measurement provisions in FAS 150 were deferred for an indefinite period for certain mandatorily redeemable noncontrolling interests (MRNI) associated with finite-lived subsidiaries. The instruments covered by this deferral would be redeemable only upon the liquidation or termination of the finite-lived subsidiary and would apply to both existing and future arrangements. For all other MRNI (i.e., those that are a liability under FAS 150 to the subsidiary and also a liability when consolidated by the parent) only the measurement provisions of FAS 150 were deferred for an indefinite period if the security was created on or before November 5, 2003. If within the scope of FAS 150, these MRNI must be classified as a liability but their initial and subsequent measurement would be determined by pre-FAS 150 GAAP. For MRNI in this category that are created after November 5, 2003, all of the provisions of FAS 150 (including the measurement provisions) were applicable without any deferral. For SEC registrants, the disclosure provisions of FAS 150 are expected to apply without any deferral. Therefore, companies will be expected to disclose the amount that would be paid if the settlement were to occur at the reporting date for the MRNI described above. The deferral of certain MRNI currently has no impact on our financial results.

On December 24, 2003, the FASB published a revision to FIN 46 (FIN 46R), to clarify some of the provisions of FIN 46 and exempt certain entities from its requirements. Under FIN 46R, a legal entity is considered a variable interest entity (VIE), with some exceptions if specific criteria are met, if it does not have sufficient equity at risk to finance its own activities without relying on financial support from other parties. Additional criteria must be applied to determine if this condition is met or if the equity holders, as a group, lack any one of three stipulated characteristics of a controlling financial interest. If the legal entity is a VIE, then the reporting entity determined to be the primary beneficiary of the VIE must consolidate it. Even if the reporting entity is not obligated to consolidate a VIE, then certain disclosures must be made about the VIE if the reporting entity has significant variable interest. The effective date of the interpretation was modified under FIN 46R. A reporting entity is required to apply the provisions of FIN 46R to all VIEs that previously were subject to certain previously issued special purpose entity accounting pronouncements for all reporting periods ending after December 14, 2003. For all other VIEs, a reporting entity is required to adopt the provisions of FIN 46R for all reporting periods after March 15, 2004. Based on its review under the existing approved guidance, and based on its belief that it does not have any VIEs as of March 31, 2004, the Company believes FIN 46R will not impact the accounting for certain unconsolidated affiliates.

3. Inventories:

Inventories at March 31, 2004 and December 31, 2003 are summarized as follows:

| | MARCH 31, 2004 | DECEMBER 31, 2003 |
|-----------------|---------------------------|------------------------------|
| Raw Materials | \$ 10,700 | \$ 13,610 |
| Work In Process | 1,767 | 1,900 |
| Finished Goods | 2,176 | 909 |
| | \$ 14,643 | \$ 16,419 |

During the first quarter of 2004 and 2003, the Company reversed reserves creating \$0 and \$762 of margin, respectively, relating to the sale of previously reserved inventory. Included in the Company's March 31, 2004 net inventory balance is \$34,354 in reserves for inventory.

4. Earnings Per Share:

Edgar Filing: PARADYNE NETWORKS INC - Form 10-Q

The following table summarizes the weighted average shares outstanding for basic and diluted earnings per share for the periods presented:

| | THREE MONTHS ENDED | |
|-------------------------------------------------------|---------------------------|-------------|
| | MARCH 31, | |
| | 2004 | 2003 |
| Net Income (loss) | \$ (787) | \$ (3,488) |
| Weighted average number of common shares outstanding: | | |
| Basic | 44,801 | 42,862 |
| Dilutive effect of stock options | | |
| Diluted | 44,801 | 42,862 |
| Earnings per common share: | | |
| Basic | \$ (0.02) | \$ (0.08) |
| Dilutive effect of stock options | | |
| Diluted | \$ (0.02) | \$ (0.08) |

Table of Contents**5. Accrued Business Restructuring:**

During the first quarter of 2004, the Company recorded business restructuring charges of \$269. These charges primarily related to additional expense requirements to fund the severance settlements for three employees from our international operations. Although these employees were part of our June 2003 business restructuring; the actual severance arrangements made under the laws of the applicable countries were higher than those allowed by the Company's standard policy.

During the first quarter of 2004, the Company paid \$218 related to business restructuring. The remaining \$635 accrued as of March 31, 2004, all of which is expected to be paid during 2004, relates to severance, abandoned facilities and excess equipment. The following table summarizes the activity in the business restructuring accrual for the first quarter of 2004:

| | Severance Related | Abandoned Facilities and Equipment Related | Total |
|-----------------------------------------------------------|------------------------------|---------------------------------------------------------------|-------------------|
| | <u> </u> | <u> </u> | <u> </u> |
| Beginning Balance at January 31, 2004 | 88 | 496 | 584 |
| Additions to accrual | 246 | 23 | 269 |
| Less payments made related to prior period restructurings | (82) | (136) | (218) |
| | <u> </u> | <u> </u> | <u> </u> |
| Ending balance at March 31, 2004 | \$ 252 | \$ 383 | \$ 635 |
| | <u> </u> | <u> </u> | <u> </u> |

6. Pending Litigation:

The Company is subject to legal proceedings, claims and liabilities that arise in the ordinary course of business. Due to inherent uncertainties of the litigation process and the judicial system, the Company is unable to predict the outcome of these legal proceedings. The Company has provided, however, for all loss contingencies where it believes it is probable and reasonably estimable (in accordance with SFAS No. 5) that a liability has been incurred. Following the Company's September 28, 2000 press release regarding third quarter of 2000 results, several securities class action suits (collectively, the Florida Securities Actions) against Paradyne and certain of its officers and directors, Andrew May, Paradyne's Chief Executive Officer and President at the time, Patrick Murphy, Paradyne's Chief Financial Officer and Senior Vice President, and Thomas Epley, Paradyne's then Chairman of the Board (collectively, the Defendants), were filed in October 2000 in the United States District Court for the Middle District of Florida, Tampa Division (the Court). Sean E. Belanger, the Company's current President, Chief Executive Officer and Chairman of the Board, was added as a Defendant in the litigation in April 2001. These actions were later consolidated into one case and the Court appointed Frank Gruttadauria and Larry Spitcaufsky as the lead plaintiffs and the law firms of Milberg Weiss Bershad Hynes & Lerach, LLP and Barrack Rodos & Bacine as the lead counsel. The amended consolidated complaint alleges violations by the Defendants of the securities anti-fraud provisions of the federal securities laws, specifically Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. It further alleges that the individual Defendants are liable under Section 20(a) of the Securities Exchange Act as control persons of

Table of Contents

Paradyne. The plaintiffs purport to represent a class of investors during a purported class period of September 28, 1999 through September 28, 2000 and allege, in effect, that the Defendants during that time, through material misrepresentations and omissions, fraudulently or recklessly inflated the market price of the Company's stock by allegedly erroneously reporting that the Company was performing well, that its inventories were properly stated, and that its customer base and product demand were solid. The Securities Actions seek damages in an unspecified amount for the purported class for the alleged inflated amount of the stock price during the class period. The Defendants filed a motion on May 25, 2001, asking the Court to dismiss the complaint, with prejudice, after which the Plaintiffs filed a memorandum of law in opposition to Defendant's dismissal motion on July 2, 2001. The Defendant's dismissal motion was denied by the Court on April 4, 2002. By order dated October 24, 2002, the Court granted plaintiffs' motion to certify a class, but accepted Defendants' arguments that the class should begin no earlier than March 20, 2000, instead of September 28, 1999 as plaintiffs had proposed. The class certified consists of purchasers of Paradyne stock from March 20, 2000 through September 29, 2000.

On October 14, 2003, the parties filed a notice with the Court that they had reached an agreement to settle the Florida Securities Actions. In exchange for a payment of \$3 million, to be funded solely by the Company's insurer, the plaintiff class agreed to release the Defendants and dismiss the Florida Securities Actions. Defendants admitted no liability in making this settlement. The settlement is subject to the following conditions: notice to the plaintiff class of the terms of the settlement, an opportunity to opt out of the settlement, and final approval by the Court. There can be no assurances that each of these conditions will be satisfied. The Company has engaged the law firm of Holland and Knight, LLP as its legal counsel in this litigation.

A second stockholder purported class action suit was filed in December 2001 in the federal court in the Southern District of New York against the Company, some of the Company's executive officers and the former Chairman of the Board, and the underwriters of the Company's initial public offering (collectively, the IPO Defendants). This action (New York Securities Action) alleges that the IPO Defendants, during the period from July 15, 1999 through December 6, 2000, violated federal securities laws by allocating shares of the initial public offering to favored customers in exchange for their promise to purchase shares in the secondary market at escalating prices. The New York Securities Action seeks damages in an unspecified amount for the purported class for the losses suffered during the class period as a result of an alleged inflated stock price. On June 5, 2003, the IPO Defendants agreed to participate in a global settlement of this case (along with the settlement of hundreds of other similar IPO allocation cases pending in the Southern District of New York). Any settlement owed by the Company will be funded exclusively by a portion of the proceeds of the Company's directors' and officers' insurance policy and will result in the dismissal of this lawsuit and release by the plaintiff stockholder class of the IPO Defendants.

In July 2000, the Lemelson Medical, Educational & Research Foundation Limited Partnership (Lemelson) filed suit in the Federal District Court in the District of Arizona against the Company and approximately ninety other defendants. The suit alleges that all the defendants are violating more than a dozen patents owned by the third party which allegedly cover the fields of machine vision used extensively in pick-and-place manufacturing of circuit boards and bar code scanning. The Company purchased this equipment from vendors, whom it believes may have an obligation to indemnify it in the event that the equipment infringes any third-party patents. The complaint seeks damages in an unspecified amount for the purported patent infringements. The complaint does not specify which defendants or activities allegedly violated which particular patents. The Company has responded with a Motion for More Definite Statement designed to identify the allegedly infringing activities as well as the particular patents and claims allegedly being infringed by it. Since the Company's filing of its Motion for More Definite Statement, the entire case has been stayed in order to allow an earlier-filed case with common factual and legal issues to proceed. On January 23, 2004, the U.S. District Court for the District of Nevada found, in a related case, that the Lemelson patents at issue in the case involving the Company are invalid and unenforceable. The Court's ruling, however, is subject to post-trial motions and appeal. The Company cannot be sure that it will prevail in this action and any adverse outcome could require it, among other things, to pay royalties to the third party patent owner. Given the lack of specificity in the complaint, it is not currently possible to calculate the potential for, or extent of, any liability resulting from this claim. The Company also cannot be sure that it will not receive other claims alleging infringement in the future. The Company has engaged the law firm of Fee and Jeffries, P. A. as its legal counsel in this litigation.

Other than the legal proceedings described above, in the normal course of business, the Company is subject to proceedings, lawsuits and other claims. While these other legal matters could affect the operating results of any one quarter when resolved in future periods, it is management's opinion that after final disposition, any monetary liability or financial impact to Paradyne, beyond that provided in the condensed unaudited consolidated balance sheet at March 31, 2004, would not be material to the annual consolidated financial statements.

Table of Contents

7. Subsequent Event:

In mid-April 2004, the Company made a decision to migrate research and development functions from its facility in Raleigh, North Carolina to its facilities in Largo, Florida. The Company has begun discussions with its Raleigh-based employees with job offers to relocate to Largo and will close the Raleigh facility after all project and employee transition is completed. Although we do not know how many employees will accept the Company's offer to relocate to Largo, and are therefore unable to assess the impact of any potential severance payments, we estimate that the maximum cost to the Company for severance benefits related to the closing of the facility will be \$100.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and other sections of this Form 10-Q contain forward-looking statements that involve a number of risks and uncertainties. These forward-looking statements are made pursuant to the safe-harbor provisions of the Private Securities Litigation Reform Act of 1995 and are made based on management's current expectations or beliefs as well as assumptions made by, and information currently available to, management. All statements regarding future events, our future financial performance and operating results, our business strategy and our financing plans are forward-looking statements. In many cases, you can identify forward-looking statements by terminology such as may, will, should, expects, intends, plans, anticipates, believes, estimates, predicts, potential, or continue, or the negative comparable terminology. These statements are only predictions. Known and unknown risks, uncertainties and other factors could cause our actual results to differ materially from those projected in the forward-looking statements.

The information contained in this Form 10-Q is not a complete description of our business or the risks associated with an investment in us. Readers are referred to documents filed by Paradyne with the Securities and Exchange Commission, specifically our most recent Form 10-K and other filings, which identify important risk factors that could cause actual results to differ from those contained in the forward-looking statements, including: the timing and amount of expense reduction; the uncertainty of litigation, including putative stockholder class actions; a reliance on international sales; competition in highly competitive markets; rapid technological change that could render Paradyne's products obsolete; the uncertain acceptance of new telecommunications services based on DSL technology; substantial dependence on network service providers who may reduce or discontinue their purchase of products or services at any time; the timing and amount of, or cancellation or rescheduling of, orders of Paradyne's products to existing and new customers; possible inability to sustain revenue growth or profitability; dependence on only a few customers for a substantial portion of Paradyne's revenue; highly competitive markets; reliance on sales of access products to Lucent Technologies and Avaya Inc.; dependence on sole and single-source suppliers and the reliability of the raw materials supplied by them to manufacture products under customer contracts; dependence on development relationships that could threaten our ability to sell products; a long and unpredictable sales cycle; the number of DSL lines actually deployed by DSL customers as compared to forecasts; Paradyne's ability to manufacture adequate quantities of products at forecasted costs under customer contracts; the engaging in acquisitions, such as the acquisition of Elastic Networks and an uncertain ability to successfully integrate any new operations, technologies, products or personnel; the need to protect Elastic Networks' intellectual property; and Paradyne's ability to manufacture products in accordance with its published specifications. In addition to these risks, we are also dependent on Alcatel Microelectronics N.V.'s (now STMicroelectronics) completion of joint development and production of the Dual Mode ADSL/R chipsets, and our ability to realize any revenue from the sale thereof, or to subsequently receive licensing revenues from customers of STMicroelectronics for the use of Paradyne's ReachDSL technology.

Overview

We are a leading developer, manufacturer and distributor of broadband and narrowband network access products for network service providers, or NSPs, and business customers. We offer solutions for NSPs that utilize existing telephone lines and enable them to offer high speed, cost effective voice, data and video solutions at speeds up to one gigabit per second. Our equipment has been sold to over 70% of the Fortune 500® companies.

We market and sell our products worldwide to NSPs and business customers through a multi-tier distribution system that includes direct sales, strategic partner sales, NSP sales and traditional distributor or value added reseller sales. There were no customers in the first quarter of 2004 who contributed 10% or more of our total revenues; however, AT&T, Graybar Electronics (one of our NSP distributors), Puerto Rico Telephone, Cavalier Telephone, and Shanghi Telecom were major customers, representing, in the aggregate, approximately 24.6% of our total revenues for the first quarter of 2004. A loss or a significant reduction or delay in sales to any of our major customers could materially and adversely affect our business, financial condition and results of operations.

Table of Contents

Revenue from equipment sales is recognized when the following has occurred: evidence of a sales arrangement exists; delivery has occurred or services have been rendered; our price to the buyer is fixed or determinable; and collectibility is reasonably assured. No revenue is recognized on products shipped on a trial basis. Charges for warranty work are included in cost of equipment sales. We believe that our accrued warranty reserve is sufficient to meet our responsibilities for potential future warranty work on products sold. Revenue from services, which consists mainly of technical support services, is recognized when the services are performed or earned and all substantial contractual obligations have been satisfied. Amounts billed to customers in sales transactions related to shipping and handling are classified as product revenue. License and royalty revenues are recognized when we have completed delivery of technical specifications and performed substantially all required services under the related agreement.

Results of Operations

Three Months Ended March 31, 2004 Compared to Three Months Ended March 31, 2003

Revenues. Total revenues increased \$3.0 million, or 16%, to \$22.3 million for the three months ended March 31, 2004 from \$19.3 million for the same period in 2003. The increase in total revenues was mostly attributable to an increase in sales of broadband products to our existing major customers. As a percentage of total revenues, equipment sales were 93% of total revenues for the three months ended March 31, 2004 and 92% for the three months ended March 31, 2003. This small increase in percentage is mostly attributable to the increases in equipment sales.

Gross Margin. Gross margin decreased \$0.5 million, or 5%, to \$9.2 million for the three months ended March 31, 2004 from \$9.7 million for the three months ended March 31, 2003. The decrease in gross margin was, in part, attributable to the sale of a higher concentration of products with lower margins compared to the three months ended March 31, 2003 as well as lower average selling price on certain products. Gross margin as a percentage of total revenues decreased to 41% for the three months ended March 31, 2004 from 50% in the same period in 2003. The decrease in gross margin as a percentage of total revenues was principally due to a change in product mix and lower average selling prices on certain products.

Research and Development Expenses. Research and development expenses decreased \$1.8 million, or 33%, to \$3.8 million for the three months ended March 31, 2004 from \$5.6 million for the same period in 2003. \$1.1 million of the decrease primarily resulted from decreases in personnel related expenses as a result of a company-wide business restructuring in June 2003 and the closing of a development facility in Atlanta, Georgia, together affecting 48 research and development employees. \$0.3 million of the decrease resulted from a decrease in depreciation expense resulting from the disposal of assets from the closed facility and approximately \$0.4 million of the decrease resulted from lower spending for research and development prototype supplies and system software. Research and development expenses as a percentage of total revenues decreased to 17% for the first quarter of 2004 from 29% for the first quarter of 2003. This decrease in percentage was primarily attributable to the decrease in research and development expenses in addition to the increase in total revenues for the first quarter of 2004.

Selling, General and Administrative (SG&A) Expenses. SG&A expenses decreased \$1.4 million, or 20%, to \$5.8 million for the three months ended March 31, 2004 from \$7.3 million for the three months ended March 31, 2003. The decrease for the three months ended March 31, 2004 was primarily due to a \$1.1 million decrease in expenses related to personnel and travel (SG&A personnel decreased by 22 people from the first quarter of 2003 mostly due to a business restructuring in the second quarter of 2003 and the closure of the Atlanta facility) and to a \$0.3 million decrease in facility and other related expenses. SG&A expenses as a percentage of total revenues decreased to 26% for the first quarter of 2004 from 38% for the same period in 2003. This decrease in percentage was primarily attributable to the decrease in SG&A expenses in addition to the increase in total revenues for the first quarter of 2004.

Amortization of Intangible Assets and Deferred Stock Compensation. The amortization of intangible assets and deferred stock compensation decreased by \$0.1 million to \$0.3 million for the three months ended March 31, 2004 from \$0.4 million for the same period in 2003. The amortization of intangible assets which occurred in the three months ended March 31, 2004 related to developed technology and customer relationship intangibles that were recorded as part of the acquisition of Elastic Networks in March 2002 and as part of the acquisition of certain assets from Jetstream Communications on May 20, 2002. It is expected that amortization of intangible assets will be approximately \$0.3 million for the second quarter of 2004. The amortization of deferred stock compensation is related to the granting of stock options to key employees at prices deemed to be below fair market value for financial reporting purposes. For the three months ended March 31, 2004, amortization of deferred stock compensation was less than \$50 thousand, and for the three months ended March 31, 2003 it was \$0.1 million, all of which was related to SG&A.

Business Restructuring Charges. During the first quarter of 2004, the Company recorded business restructuring charges of \$0.3 million. These charges related to additional expense requirements to fund the severance settlements for three employees from our international operations. There were no restructuring charges during the first quarter of 2003.

Table of Contents

Interest and Other (Income) Expense, Net. Interest and other (income) expense, net, increased \$0.1 million to \$0.2 million of income for the three months ended March 31, 2004 from \$0.1 million of income for the same period in 2003. Interest and other (income) expense, net, is related to interest income on short term investments, income from fees, interest on notes payable and borrowings under lines of credit and foreign exchange gains and losses.

Provision (Benefit) For Income Taxes. Benefit for income taxes was \$0 for the first quarter of 2004 and 2003.

Liquidity and Capital Resources

Net cash used in operations for the three months ended March 31, 2004 totaled \$1.6 million. The net loss of \$0.8 million was adjusted for non-cash impacting items such as depreciation, amortization, loss on sale of assets and allowance for bad debts resulting in adjusted net income of \$0.5 million. Cash from operating activities was decreased by an increase in accounts receivable of \$3.8 million, principally due to higher end of quarter revenues in the first quarter of 2004 than in the fourth quarter of 2003. Cash from operating activities was increased by \$1.8 million as a result of reductions in inventory due to improved inventory management.

Cash used in investing of \$0.2 million reflects capital expenditures for the quarter. The low level of capital expenditures reflects the very tight controls placed on cash expenditures as a result of a slowdown in business activity. Net cash provided by financing activities during the first quarter of 2004 of \$1.0 million was the result of proceeds from stock transactions, including exercises of stock options and purchases of stock through the Employee Stock Purchase Plan. We had \$46.0 million of cash and cash equivalents at March 31, 2004, representing a decrease of \$0.8 million from \$46.8 million at December 31, 2003. Working capital increased \$1.0 million from \$59.0 million at December 31, 2003 to \$60.0 million at March 31, 2004.

We believe that our current cash position will be sufficient to meet our working capital needs for at least the next twelve months.

Recent Trends and Developments

During recent months, there has been an industry-wide increase in sales of broadband products that utilize certain common parts. This increased demand has resulted in the allocation of some parts by one of our suppliers. If this trend continues with our other suppliers, we could be subject to parts shortages and/or increased costs. Parts shortages and/or increased costs could lead to delays in shipments to our customers as well as reduced product margins.

Inflation

Because of the relatively low levels of inflation experienced in 2003 and 2004 to date, inflation did not have a significant effect on our results in such periods.

Critical Accounting Policies and Estimates

Our critical accounting policies are those where we have made the most difficult, subjective or complex judgments in making estimates, where these estimates can significantly impact our financial results under different assumptions and conditions. Our critical accounting policies are:

Revenue Recognition/Allowance for Doubtful Accounts

Inventories

Business Restructuring

Warranty Obligations

Revenue Recognition/Allowance for Doubtful Accounts

Our revenue recognition policy follows SEC Staff Accounting Bulletin No. 104, Revenue Recognition in Financial Statements, which summarizes existing accounting literature, and requires that four criteria be met prior to recognizing revenue. These four criteria, which are the core of our accounting policy (see Note 2 Revenue Recognition in our Notes to Consolidated Financial Statements), are that: (1) evidence of a sales arrangement exists; (2) delivery has occurred or services have been

Table of Contents

rendered; (3) our price to the buyer is fixed or determinable; and (4) collectibility is reasonably assured. It is the fourth criteria that require us to make significant estimates. In those cases where all four criteria are not met, we defer recognition of revenue until the period these criteria are satisfied. In some cases where collectibility is an issue, we defer revenue recognition until the cash is actually received.

We estimate amounts potentially owing to customers for incentive offerings, special pricing agreements, price protection, promotions, volume incentives, and in very limited cases, to resellers for stock rotation. These estimates are taken as reductions to revenue pending completion of the various programs. In periods of slower sales growth, some of these incentives may be increased which will also decrease the amount of revenues we record. Additionally, we reduce revenue for estimated bad debts or for estimated customer billing adjustments based on past experience. We use our best judgment to estimate these reductions to revenue based on facts available at the balance sheet date.

Inventories

Because of the long lead times to obtain raw materials in our industry, we must maintain sufficient quantities of inventory of our many products to meet expected demand. If actual demand is much lower than forecasted, we may not be able to dispose of our inventory at or above its cost. We write down our inventory for estimated excess and obsolete amounts to the lower of cost or market. With the significant decline in customer demand, for example, we significantly wrote down our inventory in both 2000 and 2001. In 2002 and 2003, we sold some of those products that had previously been written down. As a result we reversed a portion of the reserves previously established related to these products. If future demand is lower than currently estimated, additional write-downs may be required. As a result of the large write-downs in 2000 and 2001, we hold inventory with large reserves associated with them. With these large volumes of inventories and reserves and with sales of this older inventory, we are constantly reviewing the reasonableness of our estimates. Each quarter our operations and financial staff conducts a comprehensive review of the valuation of our inventory and the associated reserves.

Business Restructuring

Through the end of 2002, we recorded restructuring charges following the principles of SEC Staff Accounting Bulletin No. 100, Restructuring and Impairment Charges, Emerging Issues Task Force (EITF) 94-3 and FAS 112. Under EITF 94-3 and SAB 100, we can accrue restructuring costs in a period provided: (1) management commits to a plan of termination prior to the date of the financial statements and establishes the benefit employees will receive, (2) the benefit arrangement is communicated to employees prior to the date of the financial statements, (3) the plan of termination specifically identifies the number and job classifications of employees to be terminated, and (4) the plan of termination will be completed in a reasonably short period of time such that significant changes are unlikely. Following these criteria we estimated the cost to be incurred in implementing our 2002 fourth quarter business restructuring.

Subsequent to 2002, the accounting for restructuring is governed by SFAS 112 and newly adopted SFAS 146. The major business restructuring liabilities we have incurred over the past few years has been for termination benefits. Since we have a written benefit plan with defined termination benefits based on years of service, the accounting for termination benefits is generally accounted for under SFAS 112.

Warranty Obligations

We generally provide a 12-month warranty to customers for products sold. We also have some outstanding warranty obligations for prior year sales of products with 24 and 60-month warranties. Although we have recorded a warranty liability that we estimate is adequate based on

historical experience, it is possible that we could experience higher than expected warranty claims, which would subject us to increased costs. In some cases these claims could be due to defective raw materials purchased from our vendors. If our vendors were unable to reimburse us for the cost of repairing or replacing the defective product, we would have to bear this cost to the customer.

Recently Issued Financial Accounting Standards

In May 2003, the FASB issued FAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity, which requires that an issuer classify certain financial instruments as a liability or an asset. Previously, many financial instruments with characteristics of both liabilities and equity were classified as equity. Financial instruments subject to FAS 150 include financial instruments with any of the following features:

An unconditional redemption obligation at a specified or determinable date, or upon an event that is certain to occur;

Table of Contents

An obligation to repurchase shares, or indexed to such an obligation, that may require physical share or net cash settlement;

An unconditional, or for new issuances conditional, obligation that may be settled by issuing a variable number of equity shares if either (a) a fixed monetary amount is known at inception, (b) the variability is indexed to something other than the fair value of the issuer's equity shares, or (c) the variability moves inversely to changes in the fair value of the issuer's shares.

The standard requires that all such instruments be classified as a liability, or an asset in certain circumstances, and initially measured at fair value. Forward contracts that require a fixed physical share settlement and mandatory redeemable financial instruments must be subsequently remeasured at fair value on each reporting date. This standard is effective for all financial instruments entered into or modified after May 31, 2003, and for all other financial instruments, at the beginning of the first interim period beginning after June 15, 2003. We adopted this standard beginning in the third quarter of 2003 and the implementation did not have a significant impact on the results of operation, financial position or cash flow.

On November 5, 2003, some classification and measurement provisions in FAS 150 were deferred for an indefinite period for certain mandatorily redeemable noncontrolling interests (MRNI) associated with finite-lived subsidiaries. The instruments covered by this deferral would be redeemable only upon the liquidation or termination of the finite-lived subsidiary and would apply to both existing and future arrangements. For all other MRNI (i.e., those that are a liability under FAS 150 to the subsidiary and also a liability when consolidated by the parent), only the measurement provisions of FAS 150 were deferred for an indefinite period if the security was created on or before November 5, 2003. If within the scope of FAS 150, these MRNI must be classified as a liability but their initial and subsequent measurement would be determined by pre-FAS 150 GAAP. For MRNI in this category that are created after November 5, 2003, all of the provisions of FAS 150 (including the measurement provisions) were applicable without any deferral. For SEC registrants, the disclosure provisions of FAS 150 are expected to apply without any deferral. Therefore, companies will be expected to disclose the amount that would be paid if the settlement were to occur at the reporting date for the MRNI described above. The deferral of certain MRNI currently has no impact on our financial results.

On December 24, 2003, the FASB published a revision to FIN 46 (FIN 46R), to clarify some of the provisions of FIN 46 and exempt certain entities from its requirements. Under FIN 46R, a legal entity is considered a variable interest entity (VIE), with some exceptions if specific criteria are met, if it does not have sufficient equity at risk to finance its own activities without relying on financial support from other parties. Additional criteria must be applied to determine if this condition is met or if the equity holders, as a group, lack any one of three stipulated characteristics of a controlling financial interest. If the legal entity is a VIE, then the reporting entity determined to be the primary beneficiary of the VIE must consolidate it. Even if the reporting entity is not obligated to consolidate a VIE, then certain disclosures must be made about the VIE if the reporting entity has significant variable interest. The effective date of the interpretation was modified under FIN 46R. A reporting entity is required to apply the provisions of FIN 46R to all VIEs that previously were subject to certain previously issued special purpose entity accounting pronouncements for all reporting periods ending after December 14, 2003. For all other VIEs, a reporting entity is required to adopt the provisions of FIN 46R for all reporting periods after May 15, 2004. Based on our review under the existing approved guidance and based on our belief that we do not have any VIEs as of March 31, 2004, we believe the FIN 46R will not impact the accounting for certain unconsolidated affiliates.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

We do not engage in investing in or trading market risk sensitive instruments. We also do not purchase, for investing, hedging, or for purposes other than trading, instruments that are likely to expose us to market risk, whether interest rate, foreign currency exchange, commodity price or equity price risk, except as noted in the following paragraph. We have not entered into any forward or futures contracts, purchased any options or entered into any interest rate swaps. Additionally, we do not currently engage in foreign currency hedging transactions to manage exposure for transactions denominated in currencies other than U.S. dollars.

Edgar Filing: PARADYNE NETWORKS INC - Form 10-Q

We did not have any indebtedness as of March 31, 2004. If we were to borrow from our revolving line of credit facility with Foothill Capital Corporation, we would be exposed to changes in interest rates. We are also exposed to changes in interest rates from investments in some held-to-maturity securities. Under our current policies, we do not use interest rate derivative instruments to manage exposure to interest rate changes.

ITEM 4. CONTROLS AND PROCEDURES.

(a) Evaluation of Disclosure Controls and Procedures.

Table of Contents

We carried out an evaluation, under the supervision and with the participation of our management, including our chief executive officer and chief financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures pursuant to Rule 13a-15 of the Securities Exchange Act of 1934 (the Exchange Act). Based upon that evaluation, the chief executive officer and chief financial officer concluded that our disclosure controls and procedures were effective, as of March 31, 2004, in timely alerting them to material information relating to our Company (including its consolidated subsidiaries) required to be included in our Exchange Act filings.

(b) Changes in Internal Controls.

There have been no changes in our internal controls over financial reporting during the quarter ended March 31, 2004 which has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II

OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Following Paradyne's September 28, 2000 press release regarding contemplated third quarter results, several securities class action suits (collectively, the Florida Securities Actions) against Paradyne, Andrew May, Paradyne's Chief Executive Officer and President at the time, Patrick Murphy, Paradyne's Chief Financial Officer and Senior Vice President, Thomas Epley, Paradyne's then Chairman of the Board, and Sean Belanger, Chairman of the Board, Chief Executive Officer and President (collectively, the Defendants), were filed in October 2000 in the United States District Court for the Middle District of Florida, Tampa Division. Plaintiffs include the following stockholders: Steven Barrios, Hayes Ho, Jacob Turner, Robert Preston, Ron Walker, Jerold B. Hoffman and Amy K. Hoffman. The Florida Securities Actions allege violations by the Defendants of the securities anti-fraud provisions of the federal securities laws, specifically Section 10(b) of the Securities Exchange Act of 1934, as amended, and Rule 10b-5 promulgated thereunder. The Florida Securities Actions further allege that the individual defendants May, Murphy and Epley are liable under Section 20(a) of the Securities Exchange Act as control persons of Paradyne . The plaintiffs purport to represent a class of investors during a purported class period of September 28, 1999 through September 28, 2000 and allege, in effect, that the Defendants during that time, through material misrepresentations and omissions, fraudulently or recklessly inflated the market price of Paradyne's stock by allegedly erroneously reporting that Paradyne was performing well, that its inventories were properly stated, and that its customer base and product demand were solid. The Florida Securities Actions seek damages under the fraud-on-the-market theory in an unspecified amount for the purported class for the alleged inflated amount of the stock price during the class period. The Defendants filed a motion on May 25, 2001, asking the Court to dismiss the complaint, with prejudice, after which the Plaintiffs filed a memorandum of law in opposition to Defendant's dismissal motion on July 2, 2001. This motion was denied by the Court on April 4, 2002. By order dated October 24, 2002, the Court granted plaintiffs' motion to certify a class, but accepted Defendants' arguments that the class should begin no earlier than March 20, 2000, instead of September 28, 1999 as plaintiffs had proposed. The class certified consists of purchasers of Paradyne stock from March 20, 2000 through September 29, 2000.

On October 14, 2003, the parties filed a notice with the Court that they had reached an agreement to settle the Florida Securities Actions. In exchange for a payment of \$3 million, to be funded solely by Paradyne's insurer, the plaintiff class has agreed to release the Defendants and dismiss the Florida Securities Actions. Defendants admitted no liability in making this settlement. The settlement is subject to the following conditions: notice to the plaintiff class of the terms of the settlement, an opportunity to opt out of the settlement, and final approval by the Court. There can be no assurances that each of these conditions will be satisfied. We have engaged the law firm of Holland and Knight, LLP as our legal counsel in this litigation.

A second stockholder purported class action suit was filed in December 2001 in the federal court in the Southern District of New York against us, some of our executive officers and the former Chairman of our board, and the underwriters of our initial public offering (collectively, the "IPO Defendants"). That action ("New York Securities Action") alleges that defendants, during the period from July 15, 1999 through December 6, 2000, violated federal securities laws by allocating shares of our initial public offering to favored customers in exchange for their promise to purchase shares in the secondary market at escalating prices. The New York Securities Action seeks damages in an unspecified amount for the purported class for the losses suffered during the class period as a result of an alleged inflated stock price. On June 5, 2003, the IPO Defendants agreed to participate in a global settlement of this case (along with the settlement of hundreds of other similar IPO allocation cases pending in the Southern District of New York). Any settlement owed by us will be funded exclusively by a portion of the proceeds of the Company's directors and officers insurance policy and will result in the dismissal of this lawsuit and release by the plaintiff stockholder class of the IPO Defendants.

Table of Contents

In July 2000, the Lemelson Medical, Educational & Research Foundation Limited Partnership (Lemelson) filed suit in the Federal District Court in the District of Arizona against us and approximately ninety other defendants. The suit alleges that all the defendants are violating more than a dozen patents owned by the third party which allegedly cover the fields of machine vision used extensively in pick-and-place manufacturing of circuit boards and bar code scanning. We purchased this equipment from vendors, whom we believe may have an obligation to indemnify us in the event that the equipment infringes any third-party patents. The complaint seeks damages in an unspecified amount for the purported patent infringements. The complaint does not specify which defendants or activities allegedly violated which particular patents. We have responded with a Motion for More Definite Statement designed to identify the allegedly infringing activities as well as the particular patents and claims allegedly being infringed by it. Since our filing of our Motion for More Definite Statement, the entire case has been stayed in order to allow an earlier-filed case with common factual and legal issues to proceed. On January 23, 2004, the U.S. District Court for the District of Nevada found, in a related case, that the Lemelson patents at issue in the case involving the Company are invalid and unenforceable. The Court's ruling, however, is subject to post-trial motions and appeal. We cannot be sure that we will prevail in this action and any adverse outcome could require us, among other things, to pay royalties to the third party patent owner. Given the lack of specificity in the complaint, it is not currently possible to calculate the potential for, or extent of, any liability resulting from this claim. We also cannot be sure that we will not receive other claims alleging infringement in the future. We have engaged the law firm of Fee and Jeffries, P. A. as our legal counsel in this litigation.

Other than the legal proceedings described above, in the normal course of business, we are subject to proceedings, lawsuits and other claims. While these other legal matters could affect the operating results of any one quarter when resolved in future periods, it is our opinion that after final disposition, any monetary liability or financial impact to us, beyond that provided in the consolidated balance sheet at December 31, 2003, would not be material to the annual consolidated financial statements or the financial condition of the Company.

ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

(a) Exhibits

| Item | Description |
|-------------|-------------------------------------------------------------------------------------------------------------------------|
| 31.1 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

(b) Reports on Form 8-K

On January 20, 2004, we filed a Current report on Form 8-K pursuant to Items 5 and 7, updating our Risk Factors.

On January 29, 2004, we filed a Current report on Form 8-K pursuant to Item 12, announcing our financial results for the quarter ended December 31, 2003.

Edgar Filing: PARADYNE NETWORKS INC - Form 10-Q

On February 17, 2004, we filed a Current Report on Form 8-K pursuant to Item 5, announcing the sale by funds affiliated with the Texas Pacific Group (TPG) of approximately 11 million shares of the Company s common stock, representing all of TPG s ownership in the Company.

Table of Contents

SIGNATURES

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

PARADYNE NETWORKS, INC.

Date: April 27, 2004

By: /s/ Sean E. Belanger

Sean E. Belanger
Chairman, President and Chief
Executive Officer

Date: April 27, 2004

By: /s/ Patrick M. Murphy

Patrick M. Murphy
Senior Vice President,
Chief Financial Officer,
Secretary and Treasurer
(Principal Financial and Accounting Officer)