ENTROPIC COMMUNICATIONS INC
Form 10-Q
May 05, 2009
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2009

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: 001-33844

ENTROPIC COMMUNICATIONS, INC.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**33-0947630**
(State or Other Jurisdiction of Incorporation or Organization)	**(I.R.S. Employer Identification No.)**

6290 Sequence Drive

San Diego, CA 92121

(Address of Principal Executive Offices, Including Zip Code)

(858) 768-3600

(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. x Yes ¨ No

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

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

Large accelerated filer ¨	Accelerated filer x	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company ¨

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

¨ Yes x No

There were 69,716,978 shares of the registrant s common stock, par value $0.001 per share, issued and outstanding as of the close of business on April 23, 2009, the latest practicable date.

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ENTROPIC COMMUNICATIONS, INC.

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2009

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PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

Entropic Communications, Inc.

Unaudited Condensed Consolidated Balance Sheets

(in thousands)

	March 31, 2009	December 31, 2008[1]
Assets		
Current assets:		
Cash and cash equivalents	$ 30,602	$ 30,071
Marketable securities	849	4,339
Accounts receivable, net	17,181	13,915
Inventory	14,979	18,693
Prepaid expenses and other current assets	3,345	2,785
Total current assets	66,956	69,803
Property and equipment, net	12,802	13,046
Intangible assets, net	2,839	3,469
Other long-term assets	262	284
Total assets	$ 82,859	$ 86,602
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable and accrued expenses	$ 10,406	$ 7,873
Accrued payroll and benefits	3,559	3,498
Deferred revenues	185	467
Income tax payable	34	
Total current liabilities	14,184	11,838
Stock repurchase liability	677	784
Other long-term liabilities	3,088	3,231
Stockholders equity:		
Preferred stock		
Common stock	70	69
Additional paid-in capital	302,225	299,305
Accumulated deficit	(237,403)	(228,667)
Accumulated other comprehensive income	18	42
Total stockholders equity	64,910	70,749
Total liabilities and stockholders equity	$ 82,859	$ 86,602

(1) The condensed consolidated balance sheet at December 31, 2008 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by accounting principles generally accepted in the United States for

complete financial statements.

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

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Entropic Communications, Inc.

Unaudited Condensed Consolidated Statements Of Operations

(in thousands, except per share data)

	Three Months Ended March 31,	
	2009	**2008**
Net revenues	$ 24,123	$ 41,988
Cost of net revenues	11,904	22,837
Gross profit	12,219	19,151
Operating expenses:		
Research and development	13,323	13,313
Sales and marketing	3,637	4,144
General and administrative	2,689	3,523
Impairment of goodwill and intangible assets	208	
Amortization of intangibles assets	16	596
Restructuring charges	1,124	1,079
Total operating expenses	20,997	22,655
Loss from operations	(8,778)	(3,504)
Other income (expense), net	59	(198)
Net loss before income taxes	(8,719)	(3,702)
Income tax provision	17	154
Net loss	$ (8,736)	$ (3,856)
Net loss per share attributable to common stockholders basic and diluted	$ (0.13)	$ (0.06)
Weighted average number of shares used to compute loss per share attributable to common stockholders	68,799	66,662

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

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Entropic Communications, Inc.

Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)

	Three Months Ended March 31,	
	2009	**2008**
Operating activities:		
Net loss	$ (8,736)	$ (3,856)
Adjustments to reconcile net loss to net cash used in operating activities:		
Depreciation and amortization	869	660
Amortization of intangible assets	16	1,836
Amortization of developed technology	406	
Impairment of goodwill and intangible assets	208	
Stock-based compensation to consultants	2	26
Stock-based compensation to employees	2,806	3,598
Interest expense attributable to amortization of debt issuance costs		476
Impairment of assets related to restructuring charge	189	259
Loss on disposal of assets		8
Changes in operating assets and liabilities:		
Accounts receivable	(3,266)	(13,363)
Inventory	3,714	1,089
Prepaid expenses and other current assets	(560)	234
Other long-term assets	22	(64)
Accounts payable and accrued expenses	2,568	144
Accrued payroll and benefits	37	62
Deferred revenues	(282)	
Other long-term liabilities	(144)	1,154
Net cash used in operating activities	(2,151)	(7,737)
Investing activities:		
Purchases of property and equipment	(813)	(3,938)
Purchases of marketable securities		(17,120)
Sales/maturities of marketable securities	3,490	1,500
Net cash provided by (used in) investing activities	2,677	(19,558)
Financing activities:		
Principal payments on software license and capital lease obligations		(116)
Principal payments on debt obligations		(8,856)
Net proceeds from the issuance of common stock, net of issuance costs	16	1,448
Payment of equity issuance costs		(75)
Repurchase of restricted stock	(11)	(94)
Net cash provided by (used in) financing activities	5	(7,693)
Net increase (decrease) in cash and cash equivalents	531	(34,988)
Cash and cash equivalents at beginning of period	30,071	51,533
Cash and cash equivalents at end of period	$ 30,602	$ 16,545

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

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ENTROPIC COMMUNICATIONS, INC.

Notes to Unaudited Condensed Consolidated Financial Statements

March 31, 2009

1. Organization and Summary of Significant Accounting Policies

Business

Entropic Communications, Inc. (the Company) was organized under the laws of the state of Delaware on January 31, 2001. The Company is a fabless semiconductor company that designs, develops and markets systems solutions to enable connected home entertainment.

Basis of Presentation

The accompanying interim unaudited condensed consolidated financial statements of Entropic Communications, Inc. have been prepared in accordance with accounting principles generally accepted in the United States (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X promulgated by the Securities and Exchange Commission (SEC). They do not include all of the information and footnotes required by GAAP for complete financial statements. These financial statements should be read in conjunction with the Company s audited consolidated financial statements and notes thereto as of and for the year ended December 31, 2008 included in the Company s Annual Report on Form 10-K (Annual Report) filed on February 23, 2009 with the SEC.

The interim condensed consolidated financial statements included herein are unaudited; however, they contain all normal recurring accruals and adjustments that, in the opinion of management, are necessary to present fairly the Company s consolidated financial position, results of operations and cash flows as of and for the interim periods presented. Interim results are not necessarily indicative of the results to be expected for future quarters or the full year.

The accompanying unaudited condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All inter-company accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the condensed consolidated financial statements and accompanying notes. Among the significant estimates affecting the condensed consolidated financial statements are those related to business combinations, revenue recognition, allowance for doubtful accounts, inventory reserves, long-lived assets (including goodwill and intangible assets), warranty reserves, accrued bonuses, income taxes, valuation of equity securities and stock-based compensation. On an on-going basis, management reviews its estimates based upon currently available information. Actual results could differ materially from those estimates.

Foreign Currency Remeasurement

The functional currency for the Company s foreign subsidiaries is the local currency. Assets and liabilities denominated in foreign currencies are translated using the exchange rates on the balance sheet dates. Revenues and expenses are translated using the average exchange rates prevailing during the year. Any translation adjustments resulting from this process are shown separately as a component of accumulated other comprehensive income within stockholders equity in the consolidated balance sheets. Foreign currency transaction gains and losses are reported in operating expense, net in the consolidated statements of operations.

Revenue Recognition

The Company s revenues are generated principally by sales of its semiconductor products. During each of the three month periods ended March 31, 2009 and 2008, product revenues represented more than 99% of the Company s total net revenues. The Company also generates service revenues from development contracts.

The majority of the Company s sales occur through the efforts of its direct sales force. The remainder of the Company s sales occurs through distributors. During each of the three-month period ended March 31, 2009 and 2008, more than 99% of the Company s sales occurred through

the efforts of its direct sales force.

In accordance with SEC Staff Accounting Bulletin (SAB) No. 101, *Revenue Recognition in Financial Statements*, and SAB No. 104, *Revenue Recognition*, the Company recognizes product revenues when the following fundamental criteria are met: (i) persuasive evidence of an arrangement exists, (ii) delivery has occurred or services have been rendered, (iii) the price to the customer is fixed or determinable and (iv) collection of the resulting receivable is reasonably assured. These criteria are usually met at the time of product shipment. However, the Company does not recognize revenue until all customer acceptance requirements have been met, when applicable.

A portion of the Company s sales are made through distributors, agents, or customers acting as agents under agreements allowing for pricing credits and/or rights of return. Product revenues on sales made through these distributors are not recognized until the distributors ship the product to their customers.

The Company records reductions to revenues for estimated product returns and pricing adjustments, such as competitive pricing programs, in the same period that the related revenue is recorded. The amount of these reductions is based on historical sales returns and other factors known at the time. If actual returns differ significantly from the Company s estimates, such differences would be recorded in the Company s results of operations for the period in which the actual returns become known. To date, changes in estimated returns have not been material to net revenues in any related period.

The Company also has entered into an inventory hubbing arrangement with a key customer. Pursuant to this arrangement, the Company delivers products to the designated third party warehouse based upon the customer s projected needs, but does not recognize product revenue unless and until the customer removes the Company s products from the third party warehouse to incorporate into its own products.

The Company derives revenues from development contracts that involve new and unproven technologies. Revenues under these contracts are deferred until customer acceptance is obtained, and other contract-specific terms have been completed in accordance with the completed contract method of AICPA Statement of Position 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*. Provisions for losses related to development contracts, if any, are recognized in the period in which the loss first becomes probable and reasonably estimable. The costs associated with development contracts are included in cost of service revenue. The Company defers the cost of services provided under its development contracts.

The Company has a development agreement that provides for royalties in exchange for an exclusive right to manufacture and sell certain products. The Company has determined that it is not able to estimate reliably the royalties earned in the period the sales occur. Thus, the Company records revenues based on cash receipts. The royalty revenues recorded during the three months ended March 31, 2009 and 2008, were $559,600 and $966,000, respectively.

The Company has also entered into arrangements to license its hardware and software, also referred to as the nodes , with certain members of the Multimedia over Coax Alliance (MoCA) for a period of three years and provide upgrades when and if they become available. The agreements limit the rights to use the nodes to test compliance of the members own product to the MoCA specification. For these arrangements, the Company follows American Institute of Certified Public Accountants (AICPA) Statement of Position 97-2, *Software Revenue Recognition*. The Company defers all of the license revenues when the nodes are delivered and recognizes the revenues on a straight-line basis over the three-year term.

Concentration of Credit Risk

Financial instruments that potentially subject the Company to concentration of credit risk consist primarily of cash and cash equivalents, marketable securities, accounts receivable, leases payable and lines of credit. The Company s policy is to place its cash and cash equivalents with high quality financial institutions in order to limit its credit exposure. Credit is extended based on an evaluation of the customer s financial condition and a cash deposit is generally not required. The Company estimates potential losses on trade receivables on an ongoing basis.

The Company invests cash in deposits and money market funds with major financial institutions, U.S. government obligations and debt securities of corporations with investment grade credit ratings in a variety of industries. It is the Company s policy to invest in instruments that have a final maturity of no longer than two years, with a portfolio weighted average maturity of no longer than 12 months.

Inventories

Inventories are stated at the lower of cost (first-in, first-out) or market. Lower of cost or market adjustments reduce the carrying value of the related inventory and take into consideration reductions in sales prices, excess inventory levels and obsolete inventory. These adjustments are done on a part-by-part basis. Once established, these adjustments are considered permanent and are not reversed until the related inventory is sold or disposed.

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Goodwill and Intangible Assets

The Company records goodwill and other intangible assets in accordance with Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets* (SFAS 142). The purchase method of accounting for acquisitions requires extensive use of accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired. The Company uses the discounted cash flow method to estimate the value of intangible assets acquired. The estimates used to value and amortize intangible assets are consistent with the plans and estimates that the Company uses to manage its business and are based on available historical information and industry estimates and averages.

SFAS 142 requires that goodwill and certain intangible assets be assessed for impairment on an annual basis, or more frequently if indicators of impairment exist, using fair value measurement techniques. SFAS 142 requires an interim goodwill impairment test if it is more likely than not that the fair value of a reporting unit is less than the carrying amount. The Company operates with one reporting unit. The goodwill impairment test compares the implied fair value of the reporting unit s goodwill with the carrying amount of that goodwill to measure the amount of the impairment loss, if any. The implied fair value of goodwill is determined in the same manner as in a business combination. Determining the fair value of the implied goodwill is judgmental in nature and often involves the use of significant estimates and assumptions. These estimates and assumptions could have a significant impact on whether or not an impairment charge is recognized and also the magnitude of any such charge. Estimates of fair value are primarily determined using discounted cash flows and market comparisons. These approaches use significant estimates and assumptions, including the size and timing of deployments by the Company s customers and related projections and timing of future cash flows, discount rates reflecting the risk inherent in future cash flows, perpetual growth rates, stage of products in development, determination of appropriate market comparables, and determination of whether a premium or discount should be applied to comparables.

During the three months ended March 31, 2009, the Company implemented a restructuring plan. See Note 2 regarding the Company s March 2009 restructuring plan. As part of the restructuring plan, the Company closed its Kfar Saba, Israel office and terminated all of the employees at that location. As a result of this location closure, the Company reassessed the intangible assets associated with the Kfar Saba, Israel office and, in accordance with SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144), fully charged off the remaining $208,000 of developed technology intangible assets associated with the Company s 2007 acquisition of Arabella Software, Ltd. (Arabella).

Guarantees and Indemnifications

In the ordinary course of business, the Company has entered into agreements with customers that include indemnity provisions. To date, there have been no known events or circumstances that have resulted in any significant costs related to these indemnification provisions, and as a result, no liabilities have been recorded in the accompanying interim unaudited financial statements.

Rebates

The Company accounts for rebates in accordance with Emerging Issues Task Force, or EITF, Issue No. 01-9, *Accounting for Consideration Given by a Vendor to a Customer (Including a Reseller of the Vendor s Products)*, and, accordingly, at the time of the sale, the Company accrues 100% of the potential rebate as a reduction to revenue and do not apply a breakage factor. The amount of these reductions is based upon the terms included in various rebate agreements. The Company reverses the accrual for unclaimed rebate amounts as specific rebate programs contractually end or when the Company believes unclaimed rebates are no longer subject to payment and will not be paid. For the three months ended March 31, 2009 and 2008, the Company reduced net revenues by $227,000 and $264,000, respectively, in connection with its rebate programs.

Warranty Accrual

The Company generally provides a warranty on its products for a period of one year; however it may be longer for certain customers. Accordingly, the Company establishes provisions for estimated product warranty costs at the time revenue is recognized as cost of net revenues. The warranty accrual is based on management s best estimate of expected costs associated with product failure and historical product failures. When the actual product failure rates, cost of replacements and rework costs differ from the Company s estimates, revisions to the estimated warranty accrual are made. Actual claims are charged against the warranty reserve.

Research and Development Costs

Research and development costs are expensed as incurred and primarily include costs related to personnel, outside services, which consist primarily of contract labor services, fabrication masks, architecture licenses, engineering design development software and hardware tools,

allocated facilities expenses and depreciation of equipment used in research and development.

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Income Taxes

The Company utilizes the liability method of accounting for income taxes as set forth in SFAS No. 109, *Accounting for Income Taxes* (SFAS 109). Under the liability method, deferred taxes are determined based on the temporary differences between the financial statement and tax basis of assets and liabilities using tax rates expected to be in effect during the years in which the basis differences reverse. A valuation allowance is recorded when it is more likely than not that some of the deferred tax assets will not be realized.

The Company also follows Financial Accounting Standards Board (FASB) issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes An Interpretation of FASB Statement No. 109* (FIN 48), which provides detailed guidance for the financial statement recognition, measurement and disclosure of uncertain tax positions recognized in an enterprise s financial statements in accordance with SFAS 109. Income tax positions must meet a more-likely-than-not recognition threshold at the effective date to be recognized upon the adoption of FIN 48 and in subsequent periods. The Company recognizes potential accrued interest and penalties related to unrecognized tax benefits within operations as income tax expense.

Stock-Based Compensation

The Company has stock incentive plans under which incentive stock options have been granted to employees and restricted stock units and non-qualified stock options have been granted to employees and non-employees. The Company also has an employee stock purchase plan for all eligible employees.

The Company follows the provisions of SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS 123R), including the provisions of SAB No. 107 (SAB 107) and SAB No. 110 (SAB 110) for stock-based compensation. Under SFAS 123R, stock-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as expense over the employee s requisite service period. The Company has no awards with market or performance conditions. The Company adopted the provisions of SFAS 123R using the prospective transition method. Accordingly, prior periods have not been revised for comparative purposes.

The valuation provisions of SFAS 123R apply to awards granted after the effective date, January 1, 2006, and to awards that were outstanding on the effective date and are subsequently modified or canceled. Prior to the adoption of SFAS 123R, the Company used the intrinsic value method prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25), related interpretations, and the disclosure-only provisions of SFAS No. 123, *Accounting for Stock-Based Compensation*, for employee stock options and recorded compensation cost for options granted at exercise prices that were less than the market value of the Company s common stock at the date of grant. Pursuant to SFAS 123R, as the Company utilized the minimum value method through December 31, 2005, the Company will continue to recognize compensation expense relating to unvested awards as of the date of adoption using APB 25, which is the same accounting principle originally applied to those awards.

The stock-based compensation for the Company s 2007 Employee Stock Purchase Plan (ESPP) was determined using the Black-Scholes option pricing model and the provisions of FASB Technical Bulletin No. 97-1, *Accounting under Statement 123 for Certain Employee Stock Purchase Plans with a Look-Back Option*, as amended by SFAS 123R.

The Company accounts for stock-based compensation awards granted to non-employees in accordance with EITF Issue No. 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services* (EITF 96-18). Under EITF 96-18, the Company determines the fair value of the stock-based compensation awards granted as either the fair value of the consideration received or the fair value of the equity instruments issued, whichever is more reliably measurable. If the fair value of the equity instruments issued is used, it is measured using the stock price and other measurement assumptions as of the earlier of either (1) the date at which a commitment for performance by the counterparty to earn the equity instruments is reached, or (2) the date at which the counterparty s performance is complete.

The Company recognizes excess tax benefits associated with stock-based compensation to stockholders equity only when realized. When assessing whether excess tax benefits relating to stock-based compensation have been realized, the Company follows the with and without approach excluding any indirect effects to be realized until after the utilization of all other tax benefits available to the Company.

Segment Reporting

SFAS No. 131, *Disclosures about Segments of an Enterprise and Related Information* (SFAS 131), establishes standards for the way public business enterprises report information about operating segments in annual consolidated financial statements and requires that those enterprises report selected information about operating segments in interim financial reports. SFAS 131 also establishes standards for related disclosures

about products and services, geographic areas and major customers.

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Operating segments are defined as components of an enterprise for which separate financial information is available and evaluated regularly by the chief operating decision maker, or decision-making group, in deciding how to allocate resources and in assessing performance. The Company is organized as, and operates in, one reportable segment: the design, development and sale of silicon integrated circuits. Products within this segment are embedded in electronic devices used to enable the delivery of multiple streams of high definition video and other multimedia content for entertainment purposes into and throughout the home. The Company s chief operating decision maker is its Chief Executive Officer (CEO). The CEO reviews financial information presented on a consolidated basis evaluating financial performance and allocating resources. There are no segment managers who are held accountable for operations below the consolidated financial statement level. The Company s assets are primarily located in the United States of America and not allocated to any specific region. Therefore, geographic information is presented only for total revenue.

Recently Issued Accounting Standards

In December 2007, the FASB issued SFAS No. 141R, *Business Combinations*, (SFAS 141R). SFAS 141R establishes principles and requirements for how the acquirer of a business recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed and any noncontrolling interest in the acquiree. The statement also provides guidance for recognizing and measuring the goodwill acquired in the business combination and determines what information to disclose to enable users of the financial statement to evaluate the nature and financial effects of the business combination. SFAS 141R is effective for financial statements issued for fiscal years beginning after December 15, 2008. The impact of adoption of the Company s consolidated financial statements will depend on the terms of any future business transactions.

On February 6, 2008, the FASB issued a final FASB Staff Position, or (FSP), on SFAS 157-b, *Effective Date of FASB Statement No. 157*, (SFAS 157). This FSP delays the effective date of SFAS 157 for all non-financial assets and liabilities, except those that are recognized or disclosed at fair value in the financial statements on a recurring basis. The effective date of SFAS 157 for non-financial assets and liabilities has been delayed by one year to years beginning after November 15, 2008. The Company does not believe the adoption of this statement will have any material impact on our future consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133*, (SFAS 161). SFAS 161 requires enhanced disclosure related to derivatives and hedging activities and thereby seeks to improve the transparency of financial reporting. Under SFAS 161, entities are required to provide enhanced disclosures relating to: (a) how and why an entity uses derivative instruments; (b) how derivative instruments and related hedge items are accounted for under SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities*, or SFAS 133, and its related interpretations; and (c) how derivative instruments and related hedged items affect an entity s financial position, financial performance, and cash flows. SFAS 161 must be applied prospectively to all derivative instruments and non-derivative instruments that are designated and qualify as hedging instruments and related hedged items accounted for under SFAS 133 for all financial statements issued for fiscal years and interim period