ENTROPIC COMMUNICATIONS INC
Form 10-Q
April 29, 2010
Table of Contents

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, 2010

or

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

Commission file number: 001-33844

ENTROPIC COMMUNICATIONS, INC.

(Exact Name of Registrant as Specified in Its Charter)

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

6290 Sequence Drive

San Diego, CA 92121

(Address of Principal Executive Offices, Including Zip Code)

Registrant s telephone number, including area code: (858) 768-3600

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 Exchange Act). ¨ Yes x No

There were 71,789,668 shares of the registrant s common stock, par value $0.001 per share, issued and outstanding as of April 26, 2010.

ENTROPIC COMMUNICATIONS, INC.

QUARTERLY REPORT ON FORM 10-Q

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2010

TABLE OF CONTENTS

PART I	**FINANCIAL INFORMATION**	
Item 1.	Financial Statements	1
	Unaudited Condensed Consolidated Balance Sheets as of March 31, 2010 and December 31, 2009	1
	Unaudited Condensed Consolidated Statements of Operations for the three months ended March 31, 2010 and 2009	2
	Unaudited Condensed Consolidated Statements of Cash Flows for the three months ended March 31, 2010 and 2009	3
	Notes to Unaudited Condensed Consolidated Financial Statements	4
Item 2.	Management s Discussion and Analysis of Financial Condition and Results of Operations	15
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	22
Item 4.	Controls and Procedures	23
PART II	**OTHER INFORMATION**	
Item 1A.	Risk Factors	24
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	47
Item 6.	Exhibits	48
SIGNATURES		49

Table of Contents

PART I FINANCIAL INFORMATION

Item 1. ***Financial Statements***

Entropic Communications, Inc.

Unaudited Condensed Consolidated Balance Sheets

(in thousands)

	March 31, 2010	December 31, 2009(1)
Assets		
Current assets:		
Cash and cash equivalents	$ 38,499	$ 35,252
Accounts receivable, net	18,188	15,468
Inventory	17,007	16,353
Prepaid expenses and other current assets	2,542	3,302
Total current assets	76,236	70,375
Property and equipment, net	11,334	11,581
Intangible assets, net	1,217	1,623
Other long-term assets	230	235
Total assets	$ 89,017	$ 83,814
Liabilities and stockholders equity		
Current liabilities:		
Accounts payable	$ 6,666	$ 5,726
Accrued payroll and benefits	3,219	3,396
Accrued expenses and other current liabilities	2,311	2,217
Deferred revenues	341	174
Total current liabilities	12,537	11,513
Stock repurchase liability	297	345
Other long-term liabilities	2,898	3,043
Stockholders equity:		
Common stock	72	71
Additional paid-in capital	313,405	310,796
Accumulated deficit	(240,149)	(241,907)
Accumulated other comprehensive loss	(43)	(47)
Total stockholders equity	73,285	68,913
Total liabilities and stockholders equity	$ 89,017	$ 83,814

(1) The condensed consolidated balance sheet at December 31, 2009 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.

Table of Contents

Entropic Communications, Inc.

Unaudited Condensed Consolidated Statements of Operations

(in thousands, except per share data)

	Three Months Ended March 31,	
	2010	**2009**
Net revenues	$ 37,451	$ 24,123
Cost of net revenues	17,701	11,904
Gross profit	19,750	12,219
Operating expenses:		
Research and development	11,538	13,323
Sales and marketing	3,778	3,637
General and administrative	2,700	2,689
Amortization of intangibles		16
Restructuring charges		1,124
Impairment of goodwill and intangible assets		208
Total operating expenses	18,016	20,997
Income (loss) from operations	1,734	(8,778)
Other income, net	25	59
Income (loss) before income taxes	1,759	(8,719)
Income tax provision	1	17
Net income (loss)	$ 1,758	$ (8,736)
Net income (loss) per share basic	$ 0.02	$ (0.13)
Net income (loss) per share diluted	$ 0.02	$ (0.13)
Weighted average number of shares used to compute net income (loss) per share basic	71,322	68,799
Weighted average number of shares used to compute net income (loss) per share diluted	73,989	68,799

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

Table of Contents

Entropic Communications, Inc.

Unaudited Condensed Consolidated Statements of Cash Flows

(in thousands)

	Three Months Ended March 31,	
	2010	**2009**
Operating activities:		
Net income (loss)	$ 1,758	$ (8,736)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:		
Depreciation and amortization	856	869
Amortization of intangible assets	406	422
Impairment of goodwill and intangible assets		208
Stock-based compensation to consultants	60	2
Stock-based compensation to employees	2,132	2,806
Impairment of assets related to restructuring charge		189
Changes in operating assets and liabilities:		
Accounts receivable	(2,720)	(3,266)
Inventory	(653)	3,714
Prepaid expenses and other current assets	759	(560)
Other long-term assets	4	22
Accounts payable	942	1,653
Accrued payroll and benefits	(179)	37
Accrued expenses and other current liabilities	96	915
Deferred revenues	167	(282)
Other long-term liabilities	(146)	(144)
Net cash provided by (used in) operating activities	3,482	(2,151)
Investing activities:		
Purchases of property and equipment	(609)	(813)
Sales/maturities of marketable securities		3,490
Net cash (used in) provided by investing activities	(609)	2,677
Financing activities:		
Net proceeds from the issuance of common stock, net of issuance costs	370	16
Repurchase of restricted stock		(11)
Net cash provided by financing activities	370	5
Net effect of exchange rates on cash	4	
Net increase in cash and cash equivalents	3,247	531
Cash and cash equivalents at beginning of period	35,252	30,071
Cash and cash equivalents at end of period	$ 38,499	$ 30,602

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

ENTROPIC COMMUNICATIONS, INC.

Notes to Unaudited Condensed Consolidated Financial Statements

March 31, 2010

1. Organization and Summary of Significant Accounting Policies

Business

Entropic Communications, Inc. was organized under the laws of the state of Delaware on January 31, 2001. We are a leading fabless semiconductor company that designs, develops and markets systems solutions to enable connected home entertainment. Our technologies significantly change the way high-definition and standard-definition television-quality video, or HD video and SD video, respectively, and other multimedia content such as movies, music, games and photos are brought into and delivered throughout the home.

Basis of Presentation

The accompanying interim unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States, or 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, or 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 our audited consolidated financial statements and notes for the year ended December 31, 2009 which are included in our Annual Report on Form 10-K filed on February 4, 2010 with the SEC, or the Annual Report.

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 our 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 our accounts and those of our 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 these 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 ongoing basis, management reviews its estimates based upon currently available information. Actual results could differ materially from those estimates.

Foreign Currency Translation

The functional currency for our foreign subsidiaries is the local currency. Assets and liabilities denominated in foreign currencies are translated using the exchange rates on the balance sheet dates. Net 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 loss within stockholders equity in the condensed consolidated balance sheets. Foreign currency transaction gains and losses are reported in operating expenses, net in the condensed consolidated statements of operations.

Revenue Recognition

Our net revenues are generated principally by sales of our semiconductor products. During the three months ended March 31, 2010 and 2009, product net revenues represented more than 99% of our total net revenues.

Our sales primarily occur through the efforts of our direct sales force. The remainder of our sales occurs through sales representatives and distributors. During the three months ended March 31, 2010 and 2009, more than 99% of our sales occurred through the efforts of our direct sales force.

We recognize 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, we do not recognize revenue until all customer acceptance requirements have been met, when applicable.

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

Revenues derived from billing customers for shipping and handling costs are classified as a component of net revenues. Costs of shipping and handling charged by suppliers are classified as a component of cost of net revenues.

We record reductions to net 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 our estimates, such differences would be recorded in our 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.

We are party to an inventory hubbing agreement with a key customer. Pursuant to this agreement, we deliver products to the designated third-party warehouse based upon the customer s projected needs, but do not recognize product revenue unless and until the customer removes our products from the third-party warehouse to incorporate into its own products.

We receive royalties in exchange for an exclusive right to manufacture and sell certain products. We have determined that we are not able to reliably estimate the royalties earned in the period the sales occur and, as a result, we record net revenues based on cash receipts. The royalty revenues recorded during the three months ended March 31, 2010 and 2009 were $0.3 million and $0.6 million, respectively, and are included in net revenues on the accompanying condensed consolidated statements of operations.

We have entered into agreements to license our hardware and software, also referred to as the nodes, to certain members of the Multimedia over Coax Alliance, or MoCA, for a period of three years and to provide upgrades when and if they become available. The agreements limit the rights to use the nodes to test compliance of the members own products to the MoCA specification. For any agreements entered into on or prior to December 31, 2009, we deferred all of the license revenues when the nodes are delivered and recognized the revenues on a straight-line basis over the term of the agreement. For agreements entered into after December 31, 2009 we will consider the accounting for any new node agreements under the new multiple deliverable guidance, as applicable.

We provide rebates on our products to certain customers. At the time of the sale, we accrue 100% of the potential rebate as a reduction to net revenue and do not apply a breakage factor. The amount of these reductions is based upon the terms included in various rebate agreements. We reverse the accrual for unclaimed rebate amounts as specific rebate programs contractually end or when we believe unclaimed rebates are no longer subject to payment and will not be paid. For the three months ended March 31, 2010 and 2009, we reduced net revenue by $22,000 and $0.2 million, respectively, in connection with our rebate programs.

We occasionally enter into agreements where revenue is derived from multiple deliverables including any mix of products and/or services. These products and/or services are generally delivered from approximately three months to two years after the execution date. Revenue recognition for agreements with multiple deliverables is based on the individual units of accounting determined to exist in the agreement. A delivered item is considered a separate unit of accounting when the delivered item has value to the customer on a stand-alone basis. Items are considered to have stand-alone value when they are sold separately by any vendor or when the customer could resell the item on a stand-alone basis.

For multiple deliverable agreements entered into after December 31, 2009, consideration is allocated at the inception of the agreement to all deliverables based on their relative selling price. The relative selling price for each deliverable is determined using vendor specific objective evidence, or VSOE, of selling price or third-party evidence of selling price if VSOE does not exist. If neither VSOE nor third-party evidence of selling price exists, we use our best estimate of the selling price for the deliverable. To date, multiple deliverable contacts have not been material to net revenues in any related period and our adoption of the new accounting guidance for determining multiple element arrangements effective January 1, 2010 did not have an impact on our operating results.

Table of Contents

For multiple deliverable agreements entered into on or prior to December 31, 2009, consideration was generally allocated to each unit of accounting based upon its relative fair value when objective and reliable evidence of fair value existed for all units of accounting in the agreement. The fair value of an item was generally the price charged for the product, if the item was regularly sold on a stand-alone basis.

In order to establish VSOE of selling price, we must regularly sell the product and/or service on a standalone basis with a substantial majority priced within a relatively narrow range. VSOE of selling price is usually the midpoint of that range. If there is not a sufficient number of standalone sales and VSOE of selling price cannot be determined, then we consider whether third-party evidence can be used to establish the selling price. If neither VSOE nor third-party evidence of selling price exists, effective January 1, 2010 we determine our best estimate of selling price using average selling prices over a rolling 12-month period as well as market conditions. If the product or service has no history of sales, we rely upon sales prices set by our pricing committee, adjusted for applicable discounts.

We recognize revenue for delivered elements only when we determine there are no uncertainties regarding customer acceptance. Changes in the allocation of the sales price between delivered and undelivered elements can impact the revenue recognition but do not change the total revenue recognized on any agreement.

Concentration of Credit Risk

Financial instruments that potentially subject us to concentration of credit risk consist primarily of cash and cash equivalents, accounts receivable, leases payable and lines of credit. Our policy is to place our cash and cash equivalents with high quality financial institutions in order to limit our credit exposure. We extend credit to our customers based on an evaluation of the customer s financial condition and a cash deposit is generally not required. We estimate potential losses on trade receivables on an ongoing basis.

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 and, in general, represent excess inventory value on hand compared to our 12-month demand projections. Once established, these adjustments are considered permanent and are not reversed until the related inventory is sold or disposed.

Intangible Assets

We record intangible assets based on the fair value of the assets acquired. In determining the fair value of the assets acquired, we utilize extensive accounting estimates and judgments to allocate the purchase price to the fair value of the net tangible and intangible assets acquired. We use 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 we use to manage our business and are based on available historical information and industry estimates and averages.

We assess intangible assets for impairment using fair value measurement techniques on an annual basis or more frequently if indicators of impairment exist. During the three months ended March 31, 2009, we implemented a restructuring plan. See Note 2 regarding our March 2009 restructuring plan. As part of the restructuring plan, we closed our Kfar Saba, Israel office and terminated all of the employees at that location. As a result of this location closure, we reassessed the intangible assets associated with our Kfar Saba, Israel office and recorded an impairment charge for the remaining $0.2 million of core technology intangible assets associated with our 2007 acquisition of Arabella Software, Ltd., or Arabella.

Guarantees and Indemnifications

In the ordinary course of business, we have 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 financial statements.

Table of Contents

Warranty Accrual

We generally provide a warranty on our products for a period of one year; however, it may be longer for certain customers. Accordingly, we establish provisions for estimated product warranty costs at the time revenue is recognized based upon our historical activity and, additionally, for any known product warranty issues. Warranty provisions are recorded as a cost of net revenues. The determination of such provisions requires us to make estimates of product return rates and expected costs to replace or rework the products under warranty. When the actual product failure rates, cost of replacements and rework costs differ from our 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 support expenses and depreciation of equipment used in research and development.

Software Development Costs

Software development costs are capitalized beginning when technological feasibility has been established and ending when a product is available for sale to customers. To date, the period between achieving technological feasibility and when the software is made available for sale to customers has been relatively short and software development costs qualifying for capitalization have not been significant. As such, all software development costs have been expensed as incurred in research and development expense.

Income Taxes

We estimate income taxes based on the various jurisdictions where we conduct business. Significant judgment is required in determining our worldwide income tax provision. We estimate the current tax liability and assess temporary differences that result from differing treatments of certain items for tax and accounting purposes. These differences result in deferred tax assets and liabilities, which are reflected in our balance sheets. We then assess the likelihood that deferred tax assets will be realized. A valuation allowance is recorded when it is more likely than not that some of the deferred tax assets will not be realized. When a valuation allowance is established or increased, we record a corresponding tax expense in our statements of operations. We review the need for a valuation allowance each interim period to reflect uncertainties about whether we will be able to utilize deferred tax assets before they expire. The valuation allowance analysis is based on estimates of taxable income for the jurisdictions in which we operate and the periods over which our deferred tax assets will be realizable. Changes in our valuation allowance could result in material increases or decreases in our income tax expense in the period such changes occur, which could have a material impact on our operating results.

We recognize and measure benefits for uncertain tax positions using a two-step approach. The first step is to evaluate the tax position taken or expected to be taken in a tax return by determining if the weight of available evidence indicates that it is more likely than not that the tax position will be sustained upon audit, including resolution of any related appeals or litigation processes. For tax positions that are more likely than not of being sustained upon audit, the second step is to measure the tax benefit as the largest amount that has more than a 50% chance of being realized upon settlement. Significant judgment is required to evaluate uncertain tax positions. We evaluate uncertain tax positions on a quarterly basis. The evaluations are based upon a number of factors, including changes in facts or circumstances, changes in tax law, correspondence with tax authorities during the course of audits and effective settlement of audit issues. Changes in the recognition or measurement of uncertain tax positions could result in material increases or decreases our income tax expense in the period such changes occur, which could have a material impact on our effective tax rate and operating results.

Stock-Based Compensation

We have 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. We also have an employee stock purchase plan for all eligible employees.

Table of Contents

Our stock-based compensation cost is measured at the grant date, based on the estimated fair value of the award, and is recognized as an expense over the employee s requisite service period. We have no stock-based compensation awards with market or performance conditions. The stock-based compensation expense attributable to awards under our 2007 Employee Stock Purchase Plan, or ESPP, was determined using the Black-Scholes option pricing model.

We also grant awards to non-employees and determine the fair value of such 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 (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 completed.

We recognize 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, we follow the with and without approach excluding any indirect effects to be realized until after the utilization of all other tax benefits available to us.

Segment Reporting

We are organized as, and operate 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. Our chief operating decision maker is our chief executive officer, or CEO. Our 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. Our assets are primarily located in the United States and not allocated to any specific region. Therefore, geographic information is presented only for total revenue.

Recently Issued Accounting Standards

There have been no recent accounting pronouncements or changes in accounting pronouncements during the three months ended March 31, 2010, as compared to the recent accounting pronouncements described in the Annual Report that are of material significance, or have potential material significance, to us.

2. Supplemental Financial Information

Fair Value of Financial Instruments

We hold certain financial assets, including cash equivalents and marketable securities that are required to be measured at fair value on a recurring basis. Cash equivalents generally include U.S. Treasury money market funds. Marketable securities are carried at amortized cost which approximates fair value.

We use a three-tier fair value hierarchy, which prioritizes the inputs used in measuring fair value. These tiers include: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists, therefore requiring an entity to develop its own assumptions.

As of March 31, 2010 and December 31, 2009, we had $8.1 million of cash equivalents, which were measured using Level 1 inputs. There were no financial assets measured using Level 2 or Level 3 inputs.

Inventory

The components of inventory were as follows (in thousands):

	As of March 31, 2010	As of December 31, 2009

Work in process	$ 7,861	$ 4,177
Finished goods		