ARRIS GROUP INC
Form 10-Q
November 02, 2006

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-Q
For the quarter ended September 30, 2006
of
ARRIS GROUP, INC.
A Delaware Corporation
IRS Employer Identification No. 58-2588724
SEC File Number 000-31254
3871 Lakefield Drive
Suwanee, GA 30024
(678) 473-2000

ARRIS Group, Inc. (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, and (2) has been subject to such filing requirements for the past 90 days.

ARRIS Group, Inc. is a large accelerated filer and is not a shell company.

As of October 31, 2006, 107,818,166 shares of the registrant s Common Stock, $0.01 par value, were outstanding.

ARRIS GROUP, INC.
FORM 10-Q
For the Three and Nine Months Ended September 30, 2006
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PART I. FINANCIAL INFORMATION
Item 1. FINANCIAL STATEMENTS

ARRIS GROUP, INC.
CONSOLIDATED BALANCE SHEETS
(in thousands, except share data)

	September 30, 2006 (unaudited)	December 31, 2005
ASSETS		
Current assets:		
Cash and cash equivalents	$ 179,971	$ 75,286
Short-term investments, at fair value	30,000	54,250
Total cash, cash equivalents and short-term investments	209,971	129,536
Restricted cash	6,126	6,073
Accounts receivable (net of allowances for doubtful accounts of $2,832 in 2006 and $3,729 in 2005)	120,740	83,540
Other receivables	5,621	286
Inventories, net	101,062	113,909
Prepaid assets	3,751	10,945
Other current assets	2,435	4,331
Total current assets	449,706	348,620
Property, plant and equipment (net of accumulated depreciation of $75,938 in 2006 and $69,309 in 2005)	25,338	25,557
Goodwill	150,569	150,569
Intangibles (net of accumulated amortization of $106,775 in 2006 and $106,200 in 2005)	345	920
Investments	3,438	3,321
Other assets	641	416
	$ 630,037	$ 529,403
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Accounts payable	$ 44,440	$ 35,920
Accrued compensation, benefits and related taxes	19,630	20,424
Accrued warranty	8,582	8,479
Other accrued liabilities	28,371	20,633
Total current liabilities	101,023	85,456
Accrued pension	11,947	12,636
Other long-term liabilities	5,589	5,594
Total liabilities	118,559	103,686
Stockholders equity:		

Preferred stock, par value $1.00 per share, 5.0 million shares authorized; none issued and outstanding				
Common stock, par value $0.01 per share, 320.0 million shares authorized; 107.8 million and 105.6 million shares issued and outstanding in 2006 and 2005, respectively		1,086		1,069
Capital in excess of par value		747,721		732,405
Accumulated deficit		(233,519)		(305,555)
Unrealized gain on marketable securities		1,219		1,077
Unfunded pension losses		(4,618)		(4,618)
Unrealized gain (loss) on derivatives		(227)		1,523
Cumulative translation adjustments		(184)		(184)
Total stockholders equity		511,478		425,717
	$	630,037	$	529,403

See accompanying notes to the consolidated financial statements.

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ARRIS GROUP, INC.
CONSOLIDATED STATEMENTS OF OPERATIONS
(unaudited)
(in thousands, except per share data and percentages)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	**2005**	**2006**	**2005**
Net sales	$ 228,646	$ 200,957	$ 656,980	$ 499,082
Cost of sales	165,467	145,979	473,554	366,230
Gross margin	63,179	54,978	183,426	132,852
Gross margin %	27.6%	27.4%	27.9%	26.6%
Operating expenses:				
Selling, general and administrative expenses	21,524	20,070	64,523	53,803
Research and development expenses	16,066	15,954	50,460	45,091
Restructuring and impairment charges	4	34	347	430
Amortization of intangibles	138	218	575	993
Total operating expenses	37,732	36,276	115,905	100,317
Operating income	25,447	18,702	67,521	32,535
Other expense (income):				
Interest expense	27	11	50	2,033
Loss on debt retirement				2,372
Loss (gain) on investments	32	(60)	29	15
Interest income	(2,756)	(777)	(6,357)	(2,099)
Loss (gain) in foreign currency	201	288	(943)	145
Other expense	68	83	269	366
Income from continuing operations before income taxes	27,875	19,157	74,473	29,703
Income tax expense	1,328	307	2,562	242
Net income from continuing operations	26,547	18,850	71,911	29,461
Income (loss) from discontinued operations	15	(30)	124	56
Net income	$ 26,562	$ 18,820	$ 72,035	$ 29,517
Net income per common share				
Basic:				
Income from continuing operations	$ 0.25	$ 0.18	$ 0.67	$ 0.31
Income from discontinued operations	0.00	0.00	0.00	0.00
Net income	$ 0.25	$ 0.18	$ 0.67	$ 0.31

Diluted:								
Income from continuing operations	$	0.24	$	0.18	$	0.66	$	0.31
Income from discontinued operations		0.00		0.00		0.00		0.00
Net income	$	0.24	$	0.18	$	0.66	$	0.31
Weighted average common shares:								
Basic		107,678		104,434		107,007		93,768
Diluted		109,090		107,049		109,311		95,368

See accompanying notes to the consolidated financial statements.

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ARRIS GROUP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(unaudited)
(in thousands)

	Nine Months Ended September 30, 2006	Nine Months Ended September 30, 2005
Operating activities:		
Net income	$ 72,035	$ 29,517
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Depreciation	7,235	7,941
Amortization of intangibles	575	993
Equity compensation expense	7,068	4,341
Excess tax benefits from stock-based compensation plans	(538)	
Amortization of deferred finance fees		305
Provision for doubtful accounts	(248)	(355)
Gain related to previously written off receivables	(1,573)	
Loss (gain) on disposal of fixed assets	(2)	131
Loss on investments	32	75
Loss on debt retirement		2,372
Impairment of long-lived assets		291
Gain on discontinued product lines	(124)	(56)
Changes in operating assets and liabilities, net of effect of acquisitions and dispositions:		
Accounts receivable	(37,515)	(39,525)
Other receivables	(5,335)	(467)
Inventory	12,847	2,824
Accounts payable and accrued liabilities	15,590	(7,249)
Other, net	7,162	(10,242)
Net cash provided by (used in) operating activities	77,209	(9,104)
Investing activities:		
Purchases of property, plant and equipment	(7,080)	(7,555)
Cash proceeds from sale of property, plant and equipment	22	40
Cash paid for acquisition, net of cash acquired		(89)
Purchases of short-term investments	(51,900)	(51,250)
Disposals of short-term investments	76,150	83,032
Purchases of equity investments		(259)
Net cash provided by investing activities	17,192	23,919
Financing activities:		
Excess tax benefits from stock-based compensation plans	538	
Proceeds from issuance of common stock and other	9,746	8,307
Net cash provided by financing activities	10,284	8,307

Net increase in cash and cash equivalents	104,685	23,122
Cash and cash equivalents at beginning of period	75,286	25,072
Cash and cash equivalents at end of period	$ 179,971	$ 48,194
Noncash investing and financing activities		
Net tangible assets acquired, excluding cash	$	799
Investment in acquired company		(1,325)
Net liabilities assumed		(76)
Intangible assets acquired		691
Cash paid for acquisition, net of cash acquired	$	89
Equity issued in exchange for 4½% convertible subordinate notes due 2008	$	$ 75,000
Equity issued for make-whole interest payment 4½% convertible subordinated notes due 2008	$	$ 2,372

See accompanying notes to the consolidated financial statements.

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ARRIS GROUP, INC.
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Note 1. Organization and Basis of Presentation

ARRIS Group, Inc. (together with its consolidated subsidiaries, except as the context otherwise indicates, ARRIS or the Company), is an international communications technology company, headquartered in Suwanee, Georgia. ARRIS operates in one business segment, Communications, providing a range of customers with network and system products and services, primarily hybrid fiber-coax networks and systems, for the communications industry. ARRIS is a leading developer, manufacturer and supplier of telephony, data, video, construction, rebuild and maintenance equipment for the broadband communications industry. The Company provides its customers with products and services that enable reliable, high-speed, two-way broadband transmission of video, telephony, and data.

The consolidated financial statements reflect all adjustments (consisting of normal recurring accruals) that are, in the opinion of management, necessary for a fair presentation of the consolidated financial statements for the periods shown. Additionally, certain prior period amounts have been reclassified to conform to the 2006 financial statement presentation. Interim results of operations are not necessarily indicative of results to be expected from a twelve-month period. These financial statements should be read in conjunction with the Company s most recently audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2005, as filed with the United States Securities and Exchange Commission (SEC).

Note 2. Impact of Recently Issued Accounting Standards

In September 2006, the Financial Accounting Standards Board (FASB) issued SFAS No. 158, *Employers Accounting for Defined Benefit Pension and Other Postretirement Plans.* Effective for the fiscal year ending 2006, the Company will be required to fully recognize the funded status of its defined benefit plan and provide required disclosures. Effective for the fiscal year ending 2008, the Company will be required to measure each plan s assets and liabilities as of the end of the fiscal year instead of the Company s current measurement date of September 30. The Company is currently evaluating the impact of adopting SFAS No. 158 on its financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles (GAAP), and expands disclosures about fair value measurements. This Statement provides guidance with respect to other accounting pronouncements that require or permit fair value measurements, the FASB having previously concluded in those accounting pronouncements that fair value is the relevant measurement attribute. Accordingly, this Statement does not require any new fair value measurements; however, for some entities, the application of SFAS No. 157 will change current practice. The provisions of SFAS No. 157 are effective as of January 1, 2008. The Company is currently evaluating the impact of adopting SFAS No. 157 on its financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin (SAB) No. 108, *Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements*, which provides interpretive guidance regarding the consideration given to prior year misstatements when determining materiality in current year financial statements. SAB No. 108 is effective for fiscal years ending after November 15, 2006. When applicable, the Company will evaluate the impact of SAB No. 108 on its consolidated financial statements.

In July 2006, the FASB issued FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109, Accounting for Income Taxes,* which clarifies the accounting for uncertainty in income taxes. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The Interpretation requires that the Company recognize in the financial statements the impact of certain tax positions, based on the technical merits of the position. FIN 48 also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods and disclosure. The provisions of FIN 48 are

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effective for fiscal years beginning after December 15, 2006 with the cumulative effect of the change in accounting principle recorded as an adjustment to opening retained earnings. The Company is currently evaluating the impact of adopting FIN 48 on its financial statements.

In June 2006, the FASB ratified Emerging Issues Task Force (EITF) Issue No. 06-3, *How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross Versus Net Presentation).* This standard allows companies to present in their statements of income any taxes assessed by a governmental authority that are directly imposed on revenue-producing transactions between a seller and a customer, such as sales, use, value-added and some excise taxes, on either a gross (included in revenue and costs) or a net (excluded from revenue) basis. This standard is effective for interim periods beginning after December 15, 2006. The Company presents these transactions on a net basis, and therefore the adoption of this standard will have no impact on its financial statements.

Note 3. Stock-Based Compensation

The Company elected to early adopt the fair value recognition provisions of SFAS No. 123R, *Share-Based Payments*, on July 1, 2005, using the modified prospective approach. Prior to the adoption date, ARRIS used the intrinsic value method for valuing its awards of stock options and restricted stock and recorded the related compensation expense, if any, in accordance with APB Opinion No. 25, *Accounting for Stock Issued to Employees* and related interpretations. With the exception of some stock options subject to variable accounting, no other stock-based employee or director compensation cost for stock options was reflected in net income (loss) prior to July 1, 2005, as all options granted had exercise prices equal to the market value of the underlying common stock on the date of grant. The Company records equity compensation expense related to its restricted stock awards and director stock units over the related service periods.

The following table compares the nine months ended September 30, 2006 and 2005, had the Company applied the provisions of SFAS No. 123R in the first and second quarters of 2005:

	Nine Months Ended September 30, (in thousands, except per share data) (unaudited)	
	2006	**2005**
Net income as reported	$ 72,035	$ 29,517
Add: Stock-based employee compensation included in reported net income, net of taxes	7,068	4,341
Deduct: Total stock-based employee compensation expense determined under fair value based methods for all awards, net of taxes	(7,068)	(14,237)*
Net income, pro forma	$ 72,035	$ 19,621
Net income per common share:		
Basic as reported	$ 0.67	$ 0.31
Basic pro forma	$ 0.67	$ 0.21
Diluted as reported	$ 0.66	$ 0.31

Diluted pro forma	$	0.66	$	0.21

* Includes approximately $5.7 million of expense related to the acceleration of out-of-the-money options in the second quarter of 2005.

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Note 4. Pension Benefits

Components of Net Periodic Pension Benefit Cost

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
			(in thousands) (unaudited)	
Service cost	$ 130	$ 114	$ 390	$ 344
Interest cost	370	353	1,108	1,060
Expected gain on plan assets	(282)	(261)	(844)	(784)
Amortization of prior service cost	120	119	358	358
Amortization of net (gain) loss	2	(34)	6	(103)
Net periodic pension cost	$ 340	$ 291	$ 1,018	$ 875

Employer Contributions

No minimum funding contributions are required in 2006; however, the Company made a voluntary contribution of $1.6 million during the third quarter 2006. During the three and nine months ended September 30, 2006, the total contributions to the plan, including the voluntary and recurring contributions, were $1.7 million and $1.7 million, respectively, compared to contributions of $0.8 million and $0.8 million for the same periods in 2005.

Note 5. Guarantees

Warranty

ARRIS provides warranties of various lengths to customers based on the specific product and the terms of individual agreements. The Company provides for the estimated cost of product warranties based on historical trends, the embedded base of product in the field, failure rates, and repair costs at the time revenue is recognized. Expenses related to product defects and unusual product warranty problems are recorded in the period that the problem is identified. While the Company engages in extensive product quality programs and processes, including actively monitoring and evaluating the quality of its suppliers, the estimated warranty obligation could be affected by changes in ongoing product failure rates, material usage and service delivery costs incurred in correcting a product failure, as well as specific product failures outside of ARRIS baseline experience. If actual product failure rates, material usage or service delivery costs differ from estimates, revisions (which could be material) would be recorded against the warranty liability. ARRIS evaluates its warranty obligations on an individual product basis.

The Company offers extended warranties and support service agreements on certain products. Revenue from these agreements is deferred at the time the cash is collected and recognized on a straight-line basis over the contract period. Costs of services performed under these types of contracts are charged to expense as incurred, which approximates the timing of the revenue stream.

Information regarding the changes in ARRIS aggregate product warranty liabilities for the nine months ended September 30, 2006 is as follows (in thousands):

Balance at December 31, 2005	$ 8,479
Accruals related to warranties (including changes in estimates)	2,910
Settlements made (in cash or in kind)	(2,807)
Balance at September 30, 2006 (unaudited)	$ 8,582

Note 6. Restructuring and Impairment Charges

During 2001, the Company announced a restructuring plan to outsource the functions of most of its manufacturing facilities. As of September 30, 2006, approximately $0.4 million related to lease commitments remained in an accrual to be paid. ARRIS expects the remaining payments to be made by the end of October 2007 (end of lease).

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During the first quarter of 2004, ARRIS consolidated two facilities in Georgia, giving the Company the ability to house many of its core technology, marketing, and corporate headquarters functions in a single building. This consolidation resulted in a restructuring charge of $6.2 million in the first quarter of 2004 related to lease commitments and the write-off of leasehold improvements and other fixed assets. As of September 30, 2006, approximately $2.2 million related to the lease commitments remained in the restructuring accrual to be paid. ARRIS expects the remaining payments to be made by the second quarter of 2009 (end of lease).

	(in thousands)
Balance as of December 31, 2005	$ 3,121
First quarter payments	(380)
First quarter adjustments to accrual	228
Second quarter payments	(404)
Second quarter adjustments to accrual	(5)
Third quarter payments	(395)
Third quarter adjustments to accrual	
Balance as of September 30, 2006 (unaudited)	$ 2,165

Note 7. Inventories

Inventories are stated at the lower of average cost, approximating first-in, first-out, or market. The cost of finished goods is comprised of material, labor, and overhead.

The components of inventory are as follows, net of reserves (in thousands):

	September 30, 2006 (unaudited)	**December 31, 2005**
Raw material	$ 904	$ 788
Finished goods	100,158	113,121
Total net inventories	$ 101,062	$ 113,909

Note 8. Property, Plant and Equipment

Property, plant and equipment, at cost, consisted of the following (in thousands):

	September 30, 2006 (unaudited)	**December 31, 2005**
Land	$ 1,822	$ 1,822
Building and leasehold improvements	11,388	11,126
Machinery and equipment	88,066	81,918
	101,276	94,866
Less: Accumulated depreciation	(75,938)	(69,309)
Total property, plant and equipment, net	$ 25,338	$ 25,557

Note 9. Goodwill and Intangible Assets

The Company s goodwill and indefinite lived intangible assets are reviewed annually for impairment or more frequently if impairment indicators arise. The annual valuation is performed during the fourth quarter of each year and is based upon management s analysis including an independent valuation. Separable intangible assets that are not deemed to have an indefinite life are amortized over their useful lives. Each of the Company s intangible assets has an amortization period of three years.

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The carrying amount of goodwill at both September 30, 2006 and December 31, 2005 was $150.6 million.
The gross carrying amount and accumulated amortization of the Company s intangible assets, other than goodwill, as of September 30, 2006 and December 31, 2005 are as follows (in thousands):

	September 30, 2006 (unaudited)			December 31, 2005		
	Gross Amount	Accumulated Amortization	Net Book Value	Gross Amount	Accumulated Amortization	Net Book Value
Existing technology acquired:						
Arris Interactive L.L.C	$ 51,500	$ (51,500)		$ 51,500	$ (51,500)	$
Cadant, Inc.	53,000	(53,000)		53,000	(53,000)	
Com21	1,929	(1,929)		1,929	(1,527)	402