

SECURITIES AND EXCHANGE COMMISSION

FORM 10-Q

Quarterly report pursuant to sections 13 or 15(d)

Filing Date: **1996-11-14** | Period of Report: **1996-09-30**  
SEC Accession No. **0000891618-96-002791**

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FILER

**VERILINK CORP**

CIK: **774937** | IRS No.: **942857548** | State of Incorpor.: **DE** | Fiscal Year End: **0630**  
Type: **10-Q** | Act: **34** | File No.: **001-11809** | Film No.: **96665492**  
SIC: **3661** Telephone & telegraph apparatus

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SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 1996

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 0-19360

VERILINK CORPORATION

-----  
(Exact name of registrant as specified in its charter)

DELAWARE

94-2857548

-----  
(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

145 BAYTECH DRIVE, SAN JOSE, CALIFORNIA

95134

-----  
(Address of principal executive offices)

(Zip Code)

408-945-1199

-----  
(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  .  
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The number of shares outstanding of the issuer's common stock as of November  
12, 1996 was 13,165,614.

INDEX  
VERILINK CORPORATION  
FORM 10-Q

<TABLE>		
<S>	<C>	<C>
PART I.	FINANCIAL INFORMATION	PAGE NO.
-----	-----	-----
Item 1.	Financial Statements	
	Condensed Consolidated Balance Sheets at September 30, 1996 and June 30, 1996	3
	Condensed Consolidated Statements of Income for the three months ended September 30, 1996 and 1995	4
	Condensed Consolidated Statements of Cash Flows for the three months ended September 30, 1996 and 1995	5
	Notes to Condensed Consolidated Financial Statements	6
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	7
PART II.	OTHER INFORMATION	
-----	-----	
Item 6.	Exhibits and Reports on Form 8-K	16
SIGNATURES		17
-----		
</TABLE>		

2

3

PART I. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

VERILINK CORPORATION  
CONDENSED CONSOLIDATED BALANCE SHEETS  
(in thousands)

<TABLE>  
<CAPTION>

	September 30, ----- 1996 ----- (unaudited)	June 30, ----- 1996 -----
	<C>	<C>
<S>		
	ASSETS	
Current assets:		
Cash and cash equivalents	\$34,577	\$40,542
Short-term investments	7,871	-
Accounts receivable, net	5,575	6,182
Inventories	5,684	4,952
Deferred tax assets	815	815
Other current assets	350	508

Total current assets	54,872	52,999
	-----	-----
Property and equipment, net	1,975	1,530
Deferred tax assets	613	613
	-----	-----
Other assets	133	76
Total assets	\$57,593	\$55,218
	=====	=====

LIABILITIES AND STOCKHOLDERS' EQUITY

Current liabilities:		
Accounts payable	\$2,178	\$2,199
Accrued expenses	5,006	4,945
Income taxes payable	1,657	840
	-----	-----
Total current liabilities	8,841	7,984
Stockholders' equity	48,752	47,234
	-----	-----
Total liabilities and stockholders' equity	\$57,593	\$55,218
	=====	=====

</TABLE>

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

3

4

VERILINK CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF INCOME  
(in thousands, except per share data)  
(unaudited)

<TABLE>  
<CAPTION>

	Three Months Ended September 30,	
	1996	1995
	----	----
<S>	<C>	<C>
Sales	\$14,676	\$9,505
Cost of sales	7,122	4,608
	-----	-----
Gross profit	7,554	4,897
	-----	-----
Operating expenses:		
Research and development	2,044	1,608
Selling, general and	3,606	2,539
	-----	-----
Total operating expenses	5,650	4,147
	-----	-----
Income from operations	1,904	750
Interest and other income, net	470	22
	-----	-----
Income before income taxes	2,374	772
Provision for income taxes	926	309

Net income	----- \$1,448 =====	----- \$463 =====
Net income per share	----- \$0.10 =====	----- \$0.04 =====
Shares used to compute net income per share	14,350	10,837
</TABLE>	=====	=====

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

4

5

VERILINK CORPORATION  
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS  
(in thousands, unaudited)

<TABLE>  
<CAPTION>

	Three Months Ended September 30,	
	----- 1996 -----	----- 1995 -----
<S>	<C>	<C>
Cash flows from operating activities:		
Net income	\$1,448	\$463
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	238	209
Deferred compensation related to stock options	57	--
Changes in assets and liabilities:		
Accounts receivable	607	14
Inventories	(732)	(745)
Other assets	101	(159)
Accounts payable	(21)	(186)
Accrued expenses	61	44
Income taxes payable	817	526
	-----	-----
Net cash provided by operating activities	2,576	166
	-----	-----
Cash flows from investing activities:		
Purchase of property and equipment	(675)	(98)
Purchase of short-term investments	(7,871)	--
	-----	-----
Net cash used in investing activities	(8,546)	(98)
	-----	-----
Cash flows from financing activities:		
Proceeds from issuance of Common Stock, net	5	--
Repurchase of Common Stock	--	(15)
Repayment of long-term debt	--	(42)
	-----	-----
Net cash provided by (used in) financing activities	5	(57)
	-----	-----
Net increase (decrease) in cash and cash equivalents	(5,965)	11
Cash and cash equivalents at beginning of period	40,542	3,243

Cash and cash equivalents at end of period	----- \$34,577 =====	----- \$3,254 =====
Supplemental disclosures:		
Cash paid (refund) for income taxes	109	(217)

</TABLE>

5

6

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS  
(unaudited)

NOTE 1. Interim Financial Statements

The accompanying unaudited interim consolidated financial statements of Verilink Corporation (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 Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, these statements include all adjustments, consisting of normal and recurring adjustments, considered necessary for a fair presentation of the results for the periods presented. The results of operations for the three month period ended September 30, 1996 are not necessarily indicative of results which may be achieved for the entire fiscal year ending June 30, 1997. The unaudited consolidated interim financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company's Annual Report on Form 10-K for the fiscal year ended June 30, 1996 as filed with the Securities and Exchange Commission.

NOTE 2. Inventories (in thousands)

<TABLE>  
<CAPTION>

	September 30, ----- 1996 -----	June 30, ----- 1996 -----
<S>	<C>	<C>
Raw materials	\$2,856	\$2,999
Work-in-process	1,265	831
Finished goods	2,220	1,780
	-----	-----
	6,341	5,610
Less inventory reserves	(657)	(658)
	-----	-----
	\$5,684	\$4,952
	=====	=====

</TABLE>

NOTE 3. Lease Commitments

The Company leases its principal facility from Baytech Associates (Baytech) under an operating lease which expires in April 2001. Baytech is owned by the Company's two principal stockholders who are officers and directors of the Company. In September 1996, the Company entered into a new

lease agreement (Agreement) with Baytech to sublease additional operating facilities under terms and conditions reflecting prevailing market conditions at that time. The principal terms of the Agreement result in future annual minimum lease payments of approximately \$168,000 beginning December 1996 through November 2001 and additional annual payments of \$367,000 beginning between September 1997 and December 1998, depending on the timing of additional space utilization. As a part of the Agreement, the Company has agreed to assume performance responsibility under the primary lease agreement between Baytech and its lessor in the event Baytech is unable to do so.

6

7

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

RESULTS OF OPERATIONS

General

Verilink Corporation develops, manufactures and markets integrated access products for telecommunications network service providers and corporate end users. Verilink designed the Access System 2000 with modular hardware and the Company's software-based Advanced Programmable Architecture(TM) to enable its customers to access increased network capacity and to adopt new communications services in a cost-effective manner. The Access System 2000 provides integrated access to low speed services, fractional T1/E1 services, and T1, E1, T3, frame relay and SMDS services, with ATM and ISDN products under development.

Verilink sells its products through a direct sales force and non-exclusive resellers. Verilink's integrated network access products are used by network service providers such as interexchange and local exchange carriers, and providers of Internet, personal communications and cellular services. The Company also sells single purpose network access devices for selected applications. The Company's largest customers include MCI Communications Corp., CompuServe Corp., Northern Telecom, Inc. and QUALCOMM Incorporated.

The Company believes that period-to-period comparisons of its financial results are not necessarily meaningful and should not be relied upon as an indication of future performance. In addition, the Company's results of operations may fluctuate from period to period in the future.

Quarter Ended September 30, 1996 compared with Quarter Ended September 30, 1995

Sales. Sales increased by 54% to \$14,676,000 in the quarter ended September 30, 1996 from \$9,505,000 in the quarter ended September 30, 1995. The increase in total sales resulted primarily from increased sales of the Company's Access System 2000 product line which increased to \$11,199,000 or 76% of total sales in the quarter ended September 30, 1996. This compares with \$6,458,000 or 68% of total sales in the quarter ended September 30, 1995. Sales to the Company's five largest customers during the quarter ended September 30, 1996 were \$9,616,000 or 65% of total sales as compared with sales of \$5,714,000 or 60% of total sales for the five largest customers during the quarter ended September 30, 1995.

Gross Profit. Gross profit increased to \$7,554,000 in the quarter ended September 30, 1996 from \$4,897,000 in the prior year quarter primarily due to an increase in sales levels. As a percentage of sales, gross profit remained constant at 51.5% in each quarter. Although the Company experienced an improvement in the percentage related to manufacturing costs in the quarter ended September 30, 1996 as compared with the prior year quarter, the benefit was offset by increased material costs due to changes in product mix.

Research and Development. Research and development expense was \$2,044,000 or 13.9% of sales in the quarter ended September 30, 1996 as compared with \$1,608,000 or 16.9% of sales in the corresponding prior year quarter. The increased expense of \$436,000 between quarters was primarily related to salaries and other personnel-related expenses due to an increased staffing level. Research and development expense declined as a percentage of sales due to the increased sales levels between the comparable quarterly periods. The Company believes that a significant level of investment in product development is required to remain competitive and, accordingly, anticipates that research and development will continue to increase in amount during the remainder of fiscal 1997.

Selling, general and administrative. Selling, general and administrative expense was \$3,606,000 or 24.6% of sales in the quarter ended September 30, 1996 as compared with \$2,539,000 or 26.7% of sales in the same quarter a year ago. The increase in expense levels between periods was primarily attributable to personnel-related expenses such as salaries and benefits in the sales and marketing functions due to increased staff levels and also due to a higher

7

8

level of commission expense due to increased sales. The Company expects selling, general and administrative expense to increase in the future due to expenses associated with an increased sales force and related increases in marketing and support staff as well as increased administrative expenses related to public company reporting requirements.

Interest and Other Income. Net interest and other income increased to \$470,000 in the quarter ended September 30, 1996 from \$22,000 in the comparable prior year quarter primarily as a result of the interest earned on the net proceeds from the Company's initial public offering which was completed in June 1996.

Provision for Income Taxes. The provision for income taxes of \$926,000 for the quarter ended September 30, 1996 represents a combined estimated Federal and state effective tax rate of 39%, a rate which approximates the statutory tax rate. The tax provision of \$309,000 for the quarter ended September 30, 1995 represented an estimated effective tax rate of 40%.

#### LIQUIDITY AND CAPITAL RESOURCES

The Company raised \$36.8 million through its initial public offering of common stock in June 1996. Prior to the offering, the primary source of financing for the Company had been cash flow from operations. In addition, the Company had used proceeds from the private sale of equity securities and bank borrowings to support its operations, acquire capital equipment and finance inventory and accounts receivable growth.

The Company generated \$2,576,000 of cash from operations during the quarter ended September 30, 1996 primarily due to increased profitability. Accounts receivable declined by \$607,000 from June 1996 primarily due to the timing of shipments and collections during the quarter. The Company expects receivable balances to increase in the future due to expected sales growth and possible changes in the timing of shipments and collections. Inventory increased by \$732,000 to meet demand for the Company's products and the Company believes that such balances are likely to further increase to support anticipated future demand. Income taxes payable increased by \$817,000 primarily due to estimated taxes on earnings during the quarter not yet due and payable.



Investment activities during the quarter ended September 30, 1996 included the purchase of short-term investments of \$7,871,000. These investments are placed in highly rated commercial paper and tax-free municipal securities. The Company expects to significantly increase capital expenditures, to approximately \$6.0 to \$7.0 million, during the fiscal year ending June 30, 1997 primarily for leasehold improvements and computer and test equipment. Investment activities during the quarter ended September 30, 1996 included capital expenditures of \$675,000 for such items.

At June 30, 1996, the Company had cash and cash equivalents of \$34,577,000, short-term investments of \$7,871,000 and an unused line of credit of \$2,000,000. The Company believes that its existing cash, cash equivalents and short-term investments, along with anticipated funds from operations, will satisfy the Company's cash needs through at least the next twelve months.

#### RISK FACTORS

Forward-looking Statements. This Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including statements regarding the Company's expectations, hopes, intentions, beliefs or strategies regarding the future. Such forward-looking statements include the Company's expected sales growth, anticipated expense levels for research and development, selling, general and administrative, and capital expenditures, and the Company's expectations regarding receivables, inventory balances, liquidity and anticipated cash needs under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations." Actual results could differ materially from those projected in any forward-looking statements for the reasons detailed below and in other sections of this Report on Form 10-Q. All forward-looking statements included in this Form 10-Q are based on information available to the Company on the date of this Report on Form 10-Q, and the Company assumes no obligation to update the forward-looking statements, or to

8

9

update the reasons why actual results could differ from those projected in the forward-looking statements. You should also consult the risk factors listed from time to time in the Company's Reports on Form 10-Q, 8-K, 10-K and Annual Report to Stockholders.

Dependence on Recently Introduced Products and Products Under Development. The Company's future results of operations are highly dependent on market acceptance of existing and future applications for the Company's Access System 2000 product line. The Access System 2000 product line represented approximately 70% of sales in fiscal year 1996. Increased market acceptance of the Company's Access System 2000 products is dependent on a number of factors, not all of which are in the Company's control, including the continued growth in the use of bandwidth intensive applications, continued deployment of new telecommunications services, market acceptance of integrated access devices in general, the availability and price of competing products and technologies, and the success of the Company's sales efforts. Failure of the Company's products to achieve increased market acceptance would have a material adverse effect on the Company's business, financial condition and results of operations. Failure to introduce new products in a timely manner could cause companies to purchase products from competitors and have a material adverse effect on the Company's business, financial condition and results of operations. Due to a variety of factors, the Company may experience delays in developing its planned products. New products may require additional development work, enhancement, testing or further refinement before they can be made commercially available by the Company. The Company has in the past experienced delays in the introduction of Access System 2000 product applications and enhancements due to a variety of internal factors, such as

reallocation of priorities, difficulty in hiring sufficient numbers of qualified personnel and unforeseen technical obstacles, as well as to changes in customer requirements. Although the Company does not believe that such delays have had a material adverse effect on its customer relationships, such delays have deferred the receipt of revenue from the products involved. If the Company's Access System 2000 products have performance, reliability or quality shortcomings, then the Company may experience reduced orders, higher manufacturing costs, delays in collecting accounts receivable and additional warranty and service expenses. See "-- Need to Expand Sales Organization."

Customer Concentration. A small number of customers have accounted for a majority of the Company's sales in each of the past several fiscal years. In fiscal 1996, MCI and CompuServe accounted for 29% and 18% of the Company's sales, respectively, and the Company's top five customers accounted for 64% of the Company's sales. In fiscal 1995, MCI and CompuServe each accounted for 14% of the Company's sales and the Company's top five customers accounted for 47% of sales. In fiscal 1994, MCI accounted for 20% of the Company's sales, and the Company's top five customers accounted for 46% of sales. Other than MCI and CompuServe, no customer accounted for more than 10% of the Company's revenue in fiscal 1996 or fiscal 1995. There can be no assurance that the Company's current customers will continue to place orders with the Company, that orders by existing customers will continue at the levels of previous periods, or that the Company will be able to obtain orders from new customers. The Company's customers are typically not contractually obligated to purchase any quantity of products in any particular period. Product sales to major customers have varied widely from year to year. In some cases, major customers have abruptly terminated purchases of the Company's products. For example, sales of the Company's single purpose network access products to AT&T Paradyne represented 24% of sales in fiscal 1993, but declined to 11% and 2% of sales in fiscal 1994 and 1995, respectively, due to the decision by AT&T Paradyne to focus its sales efforts on competing products developed within the AT&T organization. In addition, sales to Stratacom, Inc. for provision of network management capabilities in a system sold to another AT&T business unit accounted for 9% of the Company's sales during fiscal 1995. Sales to Stratacom ceased during the second half of fiscal 1995 due to the decision by such AT&T business unit to internally provide such management functionality in its system. Loss of, or a material reduction in orders by, one or more of the Company's major customers would materially adversely affect the Company's business, financial condition and results of operations. See "-- Competition."

Fluctuations in Quarterly Operating Results. The Company's sales are subject to quarterly and annual fluctuations due to a number of factors. Most of the Company's sales are in the form of large orders with short delivery times. The Company's ability to affect and judge the timing of individual customer orders is limited. Recently, the Company has experienced large fluctuations in sales from quarter to quarter due to a wide variety of factors, such as delay, cancellation or acceleration of customer projects, and other factors discussed below. The Company's sales for a given

quarter may depend to a significant degree upon planned product shipments to a single customer, often related to specific equipment deployment projects. The Company has experienced both acceleration and slowdown in orders related to such projects, causing changes in the sales level of a given quarter relative to both the preceding and subsequent quarters. Sales to MCI and CompuServe, the Company's two largest current customers, have varied by as much as \$1.0 million and \$700,000, respectively, between consecutive quarters, and sales to other current customers have also varied by as much as \$1.0 million from quarter to quarter.

Delays or lost sales can be caused by other factors beyond the Company's control, including late deliveries by other vendors of components in

a customer's system, changes in implementation priorities, slower than anticipated growth in demand for the services that the Company's products support and delays in obtaining regulatory approvals for new services. Delays and lost sales have occurred in the past and may occur in the future. Operating results in recent periods have been adversely affected by delays in receipt of significant purchase orders from customers. In addition, the Company has in the past experienced delays as a result of the need to modify its products to comply with unique customer specifications. These and similar delays or lost sales could materially adversely affect the Company's business, financial condition and results of operations. See "-- Customer Concentration," and "-- Dependence on Component Availability and Key Suppliers."

The Company's backlog at the beginning of each quarter typically is not sufficient to achieve expected sales for that quarter. To achieve its sales objective, the Company is dependent upon obtaining orders in a quarter for shipment in that quarter. Furthermore, the Company's agreements with its customers typically provide that they may change delivery schedules and cancel orders within specified timeframes, typically up to 30 days prior to the scheduled shipment date, without significant penalty. The Company's customers have in the past built, and may in the future build, significant inventory in order to facilitate more rapid deployment of anticipated major projects or for other reasons. Decisions by such customers to reduce their inventory levels could lead to reductions in purchases from the Company. These reductions, in turn, could cause fluctuations in the Company's operating results and could have an adverse effect on the Company's business, financial condition and results of operations in the periods in which the inventory is reduced.

The Company's industry is characterized by declining prices of existing products, therefore continual improvement of manufacturing efficiencies and introduction of new products and enhancements to existing products are required to maintain gross margins. In response to customer demands or competitive pressures, or to pursue new product or market opportunities, the Company may take certain pricing or marketing actions, such as price reductions, volume discounts, or provision of services at below-market rates. These actions could materially and adversely affect the Company's operating results.

Operating results may also fluctuate due to factors such as the timing of new product announcements and introductions by the Company, its major customers or its competitors, delays in new product introductions by the Company, market acceptance of new or enhanced versions of the Company's products, changes in the product or customer mix of sales, changes in the level of operating expenses, competitive pricing pressures, the gain or loss of significant customers, increased research and development and sales and marketing expenses associated with new product introductions, and general economic conditions. All of the above factors are difficult for the Company to forecast, and these or other factors can materially adversely affect the Company's business, financial condition and results of operations for one quarter or a series of quarters. The Company's expense levels are based in part on its expectations regarding future sales and are fixed in the short term to a large extent. Therefore, the Company may be unable to adjust spending in a timely manner to compensate for any unexpected shortfall in sales. Any significant decline in demand relative to the Company's expectations or any material delay of customer orders could have a material adverse effect on the Company's business, financial condition and results of operations. There can be no assurance that the Company will be able to sustain profitability on a quarterly or annual basis. In addition, it is possible that in some future quarter, the Company's operating results may be below the expectations of public market analysts and investors. In such event the price of the Company's Common Stock would likely be materially and adversely affected. See "-- Potential Volatility of Stock Price."

**Need to Expand Sales Organization.** Currently the Company sells its products to a small number of customers through a relatively small sales force. The Company's strategy is to distribute its products to a broader customer base,

which will require the Company to significantly expand its sales force. There can be no assurance that the Company will be able to recruit, train, motivate and manage additional qualified sales personnel with the requisite experience and knowledge. Availability of qualified sales personnel is limited, and competition for experienced sales personnel in the network access and telecommunications equipment industries is intense. The failure to timely expand the Company's sales force could have a material adverse effect on the Company's business, financial condition and results of operations. See "-- Customer Concentration," "-- Management of Growth" and "-- Dependence on Key Personnel."

Dependence on Component Availability and Key Suppliers. On-time delivery of the Company's products depends upon the availability of components and subsystems used in its products. The Company depends in part upon suppliers to manufacture, assemble and deliver components in a timely and satisfactory manner. The Company obtains several components and licenses certain embedded software from single sources. There can be no assurance that these suppliers will continue to be able and willing to meet the Company's requirements for any such components. The Company generally does not have any long-term contracts with such suppliers, other than software vendors. Any significant interruption in the supply of, or degradation in the quality of, any such item could have a material adverse effect on the Company's results of operations. The Company has no current plans to significantly expand its supplier base.

Purchase orders from the Company's customers frequently require delivery quickly after placement of the order. Because the Company does not maintain significant component inventories, delay in shipment by a supplier could lead to lost sales. The Company uses internal forecasts to determine its general materials and components requirements. Lead times for materials and components may vary significantly, and depend on factors such as specific supplier performance, contract terms and general market demand for components. If orders vary from forecasts, the Company may experience excess or inadequate inventory of certain materials and components. From time to time, the Company has experienced shortages and allocations of certain components, resulting in delays in fulfillment of customer orders. Such shortages and allocations could have a material adverse effect on the Company's business, financial condition and results of operations. See "-- Fluctuations in Quarterly Operating Results."

Competition. The market for network access and telecommunications equipment is highly competitive, and the Company expects competition to increase in the future. This market is subject to rapid technological change, regulatory developments and emerging industry standards. The Company faces different competitive environments for its Access System 2000 products than for its single purpose network access products.

The market for integrated access devices such as the Company's Access System 2000 is newly emerging and is subject to rapid change. The Company believes that the primary competitive factors in this market are the development and rapid introduction of new product features, price/performance, support for multiple types of communications services, network management, reliability and safety, and quality of customer support. There can be no assurance that the Company's new products and products under development will be able to compete successfully with respect to these or other factors. The Company's principal competition to date for its current Access System 2000 products has been from Digital Link Corporation, Kentrox, a division of ADC Telecommunications (both in Kentrox's own products and products supplied to Kentrox by Premisys Communications, Inc.), and Larscom, Inc., a subsidiary of Axel Johnson. As the Company develops new products for the Access System 2000 line, the Company expects to increasingly compete with Premisys. The Company expects additional competition from companies that are currently competitors in the market for the Company's single purpose network access products, as such companies develop new products. In addition, the Company expects competition from companies in the computer networking market and other related markets such

as Newbridge Networks Corporation and Ascend Communications, Inc. To the extent that current or potential competitors can expand their current offerings to include products that have functionality similar to the Company's products and planned products, the Company's business, financial condition and results of operations could be materially adversely affected.

The Company believes that the market for its single purpose network access products is mature. The Company believes that the principal competitive factors in this market are price, installed base and quality of customer support. In this market, the Company primarily competes with Adtran, Inc., Digital Link, Kentrox and Larscom. There can be no assurance that such companies or other competitors will not introduce new products at a lower price and/or that provide greater functionality than the Company's single purpose network access products. In addition, the Company anticipates that competitors and customers may develop products that could be used for selected applications for which the

Company's products are currently provided. Successful, timely development of such products could reduce the level of demand for the Company's products. The Company does not expect to spend significant resources, if any, on research and development of its single purpose network access products. There can be no assurance that the Company's single purpose network access products will be competitive in the future.

Many of the Company's current and potential competitors have substantially greater technical, financial, manufacturing and marketing resources than the Company. In addition, many of the Company's competitors have long-established relationships with network service providers. There can be no assurance that the Company will have the financial resources, technical expertise, manufacturing, marketing, distribution and support capabilities to compete successfully in the future.

Rapid Technological Change. The network access and telecommunications equipment markets are characterized by rapidly changing technologies and frequent new product introductions. The rapid development of new technologies increases the risk that current or new competitors could develop products that would reduce the competitiveness of the Company's products. The Company's success will depend to a substantial degree upon its ability to respond to changes in technology and customer requirements. This will require the timely selection, development and marketing of new products and enhancements on a cost-effective basis. The development of new, technologically advanced products is a complex and uncertain process, requiring high levels of innovation. The development of new products for the integrated access market requires competence in the general areas of telephony, data networking, network management and wireless telephony as well as specific technologies such as SMDS, ATM and ISDN. Further, the communications industry is characterized by the need to design products which meet industry standards for safety, emissions and network interconnection. With new and emerging technologies and service offerings from network service providers, such standards are often changing or unavailable. As a result, there is a potential for product development delay due to the need for compliance with new or modified standards. The introduction of new and enhanced products also requires that the Company manage transitions from older products in order to minimize disruptions in customer orders, avoid excess inventory of old products and ensure that adequate supplies of new products can be delivered to meet customer orders. There can be no assurance that the Company will be successful in developing, introducing or managing the transition to new or enhanced products or that any such products will be responsive to technological changes or will gain market acceptance. The Company's business, financial condition and results of operations would be materially adversely affected if the Company were to be unsuccessful, or to incur significant delays, in developing and introducing such new products or

enhancements. See "-- Dependence on Recently Introduced Products and Products under Development."

Management of Growth. The Company has recently experienced and may continue to experience growth in the number of its employees and the scope of its operations. In particular, the Company intends to increase its sales, marketing and support staff. These increases will result in increased responsibilities for management. To manage potential future growth effectively, the Company must improve its operational, financial and management information systems and must hire, train, motivate and manage a growing number of employees. The future success of the Company also will depend on its ability to increase its customer support capability and to attract and retain qualified technical, sales, marketing and management personnel, for whom competition is intense. In particular, the current availability of qualified sales and engineering personnel is quite limited, and competition among companies for such personnel is intense. The Company is currently attempting to hire a number of sales and engineering personnel and has experienced delays in filling such positions. During strong business cycles, the Company expects to experience continued difficulty in filling its needs for qualified sales, engineering and other personnel. There can be no assurance that the Company will be able to effectively achieve or manage any such growth, and failure to do so could delay product development cycles or otherwise have a material adverse effect on the Company's business, financial condition and results of operations. See "-- Need to Expand Sales Organization," "-- Dependence on Key Personnel."

Compliance with Regulations and Evolving Industry Standards. The market for the Company's products is characterized by the need to meet a significant number of communications regulations and standards, some of which are evolving as new technologies are deployed. In the United States, the Company's products must comply with various regulations defined by the Federal Communications Commission and standards established by Underwriters Laboratories and Bell Communications Research. For some public carrier services, installed equipment does not fully comply with current industry standards, and this noncompliance must be addressed in the design of the Company's

products. Standards for new services such as frame relay and ATM are still evolving. As these standards evolve, the Company will be required to modify its products or develop and support new versions of its products. The failure of the Company's products to comply, or delays in compliance, with the various existing and evolving industry standards could delay introduction of the Company's products, which could have a material adverse effect on the Company's business, financial condition and results of operations.

Government regulatory policies are likely to continue to have a major impact on the pricing of existing as well as new public network services and therefore are expected to affect demand for such services and the telecommunications products that support such services. Tariff rates, whether determined by network service providers or in response to regulatory directives, may affect the cost effectiveness of deploying communication services. Such policies also affect demand for telecommunications equipment, including the Company's products.

Risks Associated With Entry into International Markets. The Company has had minimal direct sales to international customers to date. The Company has little experience in international markets, but intends to expand the sales of its products outside of the United States and to enter certain international markets, which will require significant management attention and financial resources. Conducting business outside of the United States is subject to certain risks, including longer payment cycles, unexpected changes in regulatory requirements and tariffs, difficulties in staffing and managing

foreign operations, greater difficulty in accounts receivable collection and potentially adverse tax consequences. To the extent any Company sales are denominated in foreign currency, the Company's sales and results of operations may also be directly affected by fluctuations in foreign currency exchange rates. In order to sell its products internationally, the Company must meet standards established by telecommunications authorities in various countries, as well as recommendations of the Consultative Committee on International Telegraph and Telephony. A delay in obtaining, or the failure to obtain, certification of its products in countries outside the United States could delay or preclude the Company's marketing and sales efforts in such countries, which could have a material adverse effect on the Company's business, financial condition and results of operations.

**Risk of Third Party Claims of Infringement.** The network access and telecommunications equipment industries are characterized by the existence of a large number of patents and frequent litigation based on allegations of patent infringement. From time to time, third parties may assert exclusive patent, copyright, trademark and other intellectual property rights to technologies that are important to the Company. The Company has not conducted a formal patent search relating to the technology used in its products, due in part to the high cost and limited benefits of a formal search. In addition, since patent applications in the United States are not publicly disclosed until the patent issues and foreign patent applications generally are not publicly disclosed for at least a portion of the time that they are pending, applications may have been filed which, if issued as patents, would relate to the Company's products. Software comprises a substantial portion of the technology in the Company's products. The scope of protection accorded to patents covering software-related inventions is evolving and is subject to a degree of uncertainty which may increase the risk and cost to the Company if the Company discovers third party patents related to its software products or if such patents are asserted against the Company in the future. Patents have been granted recently on fundamental technologies in software, and patents may issue which relate to fundamental technologies incorporated into the Company's products. The Company may receive communications from third parties in the future asserting that the Company's products infringe or may infringe the proprietary rights of third parties. In its distribution agreements, the Company typically agrees to indemnify its customers for any expenses or liabilities, generally without limitation, resulting from claimed infringements of patents, trademarks or copyrights of third parties. In the event of litigation to determine the validity of any third-party claims, such litigation, whether or not determined in favor of the Company, could result in significant expense to the Company and divert the efforts of the Company's technical and management personnel from productive tasks. In the event of an adverse ruling in such litigation, the Company might be required to discontinue the use and sale of infringing products, expend significant resources to develop non-infringing technology or obtain licenses from third parties. There can be no assurance that licenses from third parties would be available on acceptable terms, if at all. In the event of a successful claim against the Company and the failure of the Company to develop or license a substitute technology, the Company's business, financial condition and results of operations would be materially adversely affected.

**Limited Protection of Intellectual Property.** The Company relies upon a combination of patent, trade secret, copyright and trademark laws and contractual restrictions to establish and protect proprietary rights in its products and

technologies. The Company has been issued certain U.S. and Canadian patents with respect to limited aspects of its single purpose network access technology. The Company has not obtained significant patent protection for its Access System 2000 technology. There can be no assurance that third parties

have not or will not develop equivalent technologies or products without infringing the Company's patents or that the Company's patents would be held valid and enforceable by a court having jurisdiction over a dispute involving such patents. The Company has also entered into confidentiality and invention assignment agreements with its employees, and enters into non-disclosure agreements with its suppliers, distributors and appropriate customers so as to limit access to and disclosure of its proprietary information. There can be no assurance that these statutory and contractual arrangements will deter misappropriation of the Company's technologies or discourage independent third-party development of similar technologies. In the event such arrangements are insufficient, the Company's business, financial condition and results of operations could be materially adversely affected. The laws of certain foreign countries in which the Company's products are or may be developed, manufactured or sold may not protect the Company's products or intellectual property rights to the same extent as do the laws of the United States and thus make the possibility of misappropriation of the Company's technology and products more likely.

**Dependence on Key Personnel.** The Company's future success will depend to a large extent on the continued contributions of its executive officers and key management, sales and technical personnel, including Leigh S. Belden, the Company's President and Chief Executive Officer, and Steven C. Taylor, the Company's Chief Technical Officer. The Company does not maintain key man life insurance on any of such persons and none of such persons has an employment agreement with the Company, except for insurance on and contracts with Mr. Belden and Mr. Taylor. Each of the Company's executive officers, and key management, sales and technical personnel would be difficult to replace. The loss of the services of one or more of the Company's executive officers or key personnel, or the inability to continue to attract qualified personnel could delay product development cycles or otherwise have a material adverse effect on the Company's business, financial condition and results of operations. See "-- Management of Growth."

**Control of the Company; Antitakeover Effects of Certain Charter Provisions.** The current officers, directors and holders of five percent or more of the Company's Common Stock own approximately 43% of the outstanding Common Stock. Accordingly, these stockholders, if they were to act as a group, would be able to elect all of the Company's directors, increase the authorized capital and otherwise control the policies of the Company. The Company's Board of Directors has the authority to issue up to 1,000,000 shares of Preferred Stock and to determine the price, rights, preferences and privileges of those shares without any further vote or action by the stockholders. The rights of the holders of Common Stock will be subject to, and may be adversely affected by, the rights of the holders of any Preferred Stock that may be issued in the future. The issuance of shares of Preferred Stock, while potentially providing desirable flexibility in connection with possible acquisitions and other corporate purposes, could have the effect of making it more difficult for a third party to acquire a majority of the outstanding voting stock of the Company. The Company has no present intention to issue shares of Preferred Stock. In addition, the Company is subject to the anti-takeover provisions of Section 203 of the Delaware General Corporation Law, which will prohibit the Company from engaging in a "business combination" with an "interested stockholder" for a period of three years after the date of the transaction in which the person became an interested stockholder, unless the business combination is approved in a prescribed manner. The application of Section 203 also could have the effect of delaying or preventing a change of control of the Company. Furthermore, certain provisions of the Company's Amended and Restated Certificate of Incorporation, including provisions that provide for the Board of Directors to be divided into three classes to serve for staggered three-year terms, may have the effect of delaying or preventing a change of control of the Company, which could adversely affect the market price of the Company's Common Stock.

**Potential Volatility of Stock Price.** The trading price of the Company's Common Stock could be subject to wide fluctuations in response to quarter to quarter variations in operating results, announcements of technological innovations or new products by the Company or its competitors, developments with respect to patents or proprietary rights, general conditions in the telecommunication network access and equipment industries, changes in earnings estimates by analysts, or other events or factors. In addition, the stock market has experienced extreme price and volume fluctuations, which have



particularly affected the market prices of many technology companies and which have often been unrelated to the operating performance of such companies. The Company's sales or operating results in future quarters may be below the expectations of public market securities analysts and investors. In such event, the

14

15

price of the Company's Common Stock would likely decline, perhaps substantially. These Company-specific factors or broad market fluctuations may materially adversely affect the market price of the Company's Common Stock.

Shares Eligible for Future Sale. Sales of substantial amounts of Common Stock in the public market after the date of this Report on Form 10-Q could adversely affect the prevailing market price of the Common Stock. As of November 12, 1996, there were 13,165,614 shares of Common Stock outstanding. Beginning 180 days after June 10, 1996, approximately 2,671,758 shares, which are "restricted" shares ("Restricted Shares") under the Securities Act of 1933, as amended (the "Securities Act"), will first become eligible for sale in the public market pursuant to Rules 144 and 701 promulgated under the Securities Act, as a result of the expiration of certain lock-up agreements with the Company's underwriters, or due to a combination of the foregoing. Of the Restricted Shares that will first become eligible for sale in the public market approximately 180 days after June 10, 1996, approximately 848,000 shares will be subject to certain volume limitations and other resale restrictions pursuant to Rule 144. Beginning 270 days after June 10, 1996, approximately 4,812,838 additional shares will become eligible for sale subject to the provisions of Rule 144 upon the expiration of agreements not to sell such shares entered into between the Company's underwriters and such stockholders. In addition, options to purchase an additional approximately 318,014 shares will be vested and exercisable, and the shares issuable upon exercise thereof eligible for sale 180 days following June 10, 1996, upon expiration of certain lock-up agreements. In addition, the Commission has proposed revisions to Rule 144 and Rule 144(k), the effect of which would be to shorten the holding period under Rule 144 from two years to one year and to shorten the holding period under Rule 144(k) from three years to two years. If enacted, these proposed revisions would increase, potentially substantially, the number of shares that would be available for sale in the public market 180 days after June 10, 1996. Any shares subject to lock-up agreements may be released at any time without notice by Hambrecht & Quist LLC.

The Company has filed a registration statement on Form S-8 registering approximately 1,524,498 shares of Common Stock reserved for issuance under its Amended and Restated 1993 Stock Option Plan and 300,000 shares of Common Stock reserved for issuance under its Employee Stock Purchase Plan. Shares of Common Stock issued pursuant to these plans will be available for sale in the public market, subject to expiration of the lock-up agreement with the Company's underwriters and to Rule 144 volume limitations applicable to affiliates.

15

16

## PART II. OTHER INFORMATION

### ITEM 6. EXHIBITS AND REPORTS ON FORM 8-K

None.

16

17

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.

VERILINK CORPORATION

November 13, 1996

By: /s/ Timothy G. Conley

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Timothy G. Conley,  
Vice President, Finance and Chief  
Financial Officer (Duly Authorized  
Officer and Principal Financial Officer)

17

18

VERILINK CORPORATION

INDEX TO EXHIBITS

Exhibit	Description
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27.1	Financial Data Schedule

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