

CIENA CORP  
Form 10-Q  
June 01, 2007

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**  
**Washington, DC 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 April 30, 2007**

**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: 0-21969**

**Ciena Corporation**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**23-2725311**

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

**1201 Winterson Road, Linthicum, MD**

(Address of Principal Executive Offices)

**21090**

(Zip Code)

**(410) 865-8500**

(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act (Check one).

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as determined in Rule 12b-2 of the Exchange Act). YES  NO

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date:

**Class**  
common stock, \$.01 par value

**Outstanding at May 25, 2007**  
85,388,769

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**PART I FINANCIAL INFORMATION****Item 1. Financial Statements**

**CIENA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS**  
(in thousands, except per share data)  
**(unaudited)**

|                                    | Quarter Ended April 30, |            | Six Months Ended April |             |
|------------------------------------|-------------------------|------------|------------------------|-------------|
|                                    | 2006                    | 2007       | 2006                   | 30,<br>2007 |
| Revenues:                          |                         |            |                        |             |
| Products                           | \$ 117,208              | \$ 173,212 | \$ 223,149             | \$ 319,494  |
| Services                           | 13,967                  | 20,315     | 28,456                 | 39,134      |
| Total revenue                      | 131,175                 | 193,527    | 251,605                | 358,628     |
| Costs:                             |                         |            |                        |             |
| Products                           | 58,957                  | 91,319     | 119,356                | 166,298     |
| Services                           | 9,312                   | 20,378     | 18,888                 | 36,872      |
| Total cost of goods sold           | 68,269                  | 111,697    | 138,244                | 203,170     |
| Gross profit                       | 62,906                  | 81,830     | 113,361                | 155,458     |
| Operating expenses:                |                         |            |                        |             |
| Research and development           | 28,856                  | 31,642     | 58,318                 | 61,495      |
| Selling and marketing              | 26,657                  | 30,182     | 53,229                 | 55,057      |
| General and administrative         | 11,246                  | 11,707     | 21,142                 | 22,008      |
| Amortization of intangible assets  | 6,295                   | 6,295      | 12,590                 | 12,590      |
| Restructuring costs (recoveries)   | 3,014                   | (734)      | 5,029                  | (1,200)     |
| Long-lived asset impairments       | (3)                     |            | (6)                    |             |
| Recovery of doubtful accounts, net | (247)                   |            | (2,851)                | (10)        |
| Gain on lease settlement           | (5,628)                 |            | (11,648)               |             |
| Total operating expenses           | 70,190                  | 79,092     | 135,803                | 149,940     |
| Income (loss) from operations      | (7,284)                 | 2,738      | (22,442)               | 5,518       |
| Interest and other income, net     | 11,197                  | 16,897     | 20,459                 | 31,742      |
| Interest expense                   | (5,815)                 | (6,148)    | (11,868)               | (12,296)    |
| Loss on equity investments, net    |                         |            | (733)                  |             |
| Gain on extinguishment of debt     | 362                     |            | 7,052                  |             |
| Income (loss) before income taxes  | (1,540)                 | 13,487     | (7,532)                | 24,964      |
| Provision for income taxes         | 370                     | 477        | 669                    | 898         |
| Net income (loss)                  | \$ (1,910)              | \$ 13,010  | \$ (8,201)             | \$ 24,066   |

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|   |           |         |           |         |
|---|-----------|---------|-----------|---------|
| Basic net income (loss) per common share                      | \$ (0.02) | \$ 0.15 | \$ (0.10) | \$ 0.28 |
| Diluted net income (loss) per potential common share          | \$ (0.02) | \$ 0.14 | \$ (0.10) | \$ 0.26 |
| Weighted average basic common shares outstanding              | 83,518    | 85,198  | 83,251    | 85,076  |
| Weighted average dilutive potential common shares outstanding | 83,518    | 93,737  | 83,251    | 93,491  |

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

**CIENA CORPORATION**  
**CONDENSED CONSOLIDATED BALANCE SHEETS**  
(in thousands, except share data)  
(unaudited)

|  | October 31,<br>2006 | April 30,<br>2007   |
|--|---------------------|---------------------|
| <b>ASSETS</b>                                  |                     |                     |
| Current assets:                                |                     |                     |
| Cash and cash equivalents                      | \$ 220,164          | \$ 470,306          |
| Short-term investments                         | 628,393             | 646,653             |
| Accounts receivable, net                       | 107,172             | 145,495             |
| Inventories, net                               | 106,085             | 118,790             |
| Prepaid expenses and other                     | 36,372              | 43,930              |
| <b>Total current assets</b>                    | <b>1,098,186</b>    | <b>1,425,174</b>    |
| Long-term investments                          | 351,407             | 105,556             |
| Equipment, furniture and fixtures, net         | 29,427              | 37,567              |
| Goodwill                                       | 232,015             | 232,015             |
| Other intangible assets, net                   | 91,274              | 76,749              |
| Other long-term assets                         | 37,404              | 45,995              |
| <b>Total assets</b>                            | <b>\$ 1,839,713</b> | <b>\$ 1,923,056</b> |
| <br><b>LIABILITIES AND STOCKHOLDERS EQUITY</b> |                     |                     |
| Current liabilities:                           |                     |                     |
| Accounts payable                               | \$ 39,277           | \$ 69,942           |
| Accrued liabilities                            | 79,282              | 84,476              |
| Restructuring liabilities                      | 8,914               | 7,065               |
| Unfavorable lease commitments                  | 8,512               | 7,653               |
| Income taxes payable                           | 5,981               | 6,479               |
| Deferred revenue                               | 19,637              | 36,097              |
| Convertible notes payable                      |                     | 542,262             |
| <b>Total current liabilities</b>               | <b>161,603</b>      | <b>753,974</b>      |
| Long-term deferred revenue                     | 21,039              | 24,071              |
| Long-term restructuring liabilities            | 26,720              | 22,694              |
| Long-term unfavorable lease commitments        | 32,785              | 28,596              |
| Other long-term obligations                    | 1,678               | 1,594               |
| Long-term convertible notes payable            | 842,262             | 300,000             |
| <b>Total liabilities</b>                       | <b>1,086,087</b>    | <b>1,130,929</b>    |
| Commitments and contingencies                  |                     |                     |
| Stockholders equity:                           |                     |                     |

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|   |              |              |
|---|--------------|--------------|
| Preferred stock par value \$0.01; 20,000,000 shares authorized; zero shares issued and outstanding                    |              |              |
| Common stock par value \$0.01; 140,000,000 shares authorized; 84,891,656 and 85,342,240 shares issued and outstanding | 849          | 853          |
| Additional paid-in capital  | 5,505,853    | 5,520,902    |
| Unrealized gains on investments, net  | (496)        | (232)        |
| Translation adjustment  | (580)        | (1,462)      |
| Accumulated deficit   | (4,752,000)  | (4,727,934)  |
| Total stockholders equity   | 753,626      | 792,127      |
| Total liabilities and stockholders equity   | \$ 1,839,713 | \$ 1,923,056 |

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

**CIENA CORPORATION**  
**CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS**  
(in thousands)  
(unaudited)

|  | Six Months Ended April 30, |           |
|--|----------------------------|-----------|
|  | 2006                       | 2007      |
| Cash flows from operating activities:  |                            |           |
| Net income (loss)  | \$ (8,201)                 | \$ 24,066 |
| Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities: |                            |           |
| Early extinguishment of debt   | (7,052)                    |           |
| Amortization of premium (discount) on marketable securities  | 1,955                      | (3,052)   |
| Non-cash loss from equity investments  | 733                        |           |
| Depreciation and amortization of leasehold improvements  | 9,691                      | 6,298     |
| Stock compensation   | 8,118                      | 8,937     |
| Amortization of intangibles  | 14,525                     | 14,525    |
| Provision for inventory excess and obsolescence  | 4,376                      | 6,385     |
| Provision for warranty and other contractual obligations   | 6,815                      | 7,111     |
| Other  | 1,280                      | 872       |
| Changes in assets and liabilities:   |                            |           |
| Accounts receivable  | (3,813)                    | (38,323)  |
| Inventories  | (34,119)                   | (19,090)  |
| Prepaid expenses and other   | 5,264                      | (12,173)  |
| Accounts payable, accrued liabilities and other obligations  | (60,318)                   | 17,741    |
| Income taxes payable   | (133)                      | 498       |
| Deferred revenue   | 15,312                     | 19,492    |
| Net cash provided by (used in) operating activities  | (45,567)                   | 33,287    |
| Cash flows from investing activities:  |                            |           |
| Additions to equipment, furniture, fixtures and intellectual property                              | (8,531)                    | (14,438)  |
| Restricted cash  | 1,837                      | (5,549)   |
| Purchases of available for sale securities   | (130,837)                  | (213,219) |
| Maturities of available for sale securities  | 299,657                    | 444,126   |
| Minority equity investments, net   |                            | (181)     |
| Net cash provided by investing activities  | 162,126                    | 210,739   |
| Cash flows from financing activities:  |                            |           |
| Proceeds from issuance of 0.25% convertible senior notes   | 300,000                    |           |
| Repurchase of 3.75% convertible notes  | (98,410)                   |           |
| Debt issuance costs  | (7,652)                    |           |
| Purchase of call spread option   | (28,457)                   |           |
| Proceeds from exercise of stock options  | 16,171                     | 6,116     |
| Net cash provided by financing activities  | 181,652                    | 6,116     |
| Net increase in cash and cash equivalents  | 298,211                    | 250,142   |



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|  |            |            |
|--|------------|------------|
| Cash and cash equivalents at beginning of period | 358,012    | 220,164    |
| Cash and cash equivalents at end of period       | \$ 656,223 | \$ 470,306 |

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

**CIENA CORPORATION**  
**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**  
**(unaudited)**

**(1) INTERIM FINANCIAL STATEMENTS**

The interim financial statements included herein for Ciena Corporation ( Ciena ) have been prepared by Ciena, without audit, pursuant to the rules and regulations of the Securities and Exchange Commission. In the opinion of management, financial statements included in this report reflect all normal recurring adjustments which Ciena considers necessary for the fair statement of the results of operations for the interim periods covered and of the financial position of Ciena at the date of the interim balance sheet. Certain information and footnote disclosures normally included in the annual financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted pursuant to such rules and regulations. However, Ciena believes that the disclosures are adequate to understand the information presented. The operating results for interim periods are not necessarily indicative of the operating results for the entire year. These financial statements should be read in conjunction with Ciena's audited consolidated financial statements and notes thereto included in Ciena's annual report on Form 10-K for the fiscal year ended October 31, 2006.

Ciena has a 52 or 53 week fiscal year, which ends on the Saturday nearest to the last day of October in each year. For purposes of financial statement presentation, each fiscal year is described as having ended on October 31, and each fiscal quarter is described as having ended on January 31, April 30 and July 31 of each fiscal year.

**(2) SIGNIFICANT ACCOUNTING POLICIES**

*Cash and Cash Equivalents*

Ciena considers all highly liquid investments purchased with original maturities of three months or less to be cash equivalents. Restricted cash collateralizing letters of credits are included in other current assets and other long-term assets depending upon the duration of the restriction.

*Investments*

Ciena's short-term and long-term investments represent investments in marketable debt securities that are classified as available-for-sale and are reported at fair value, with unrealized gains and losses recorded in accumulated other comprehensive income. Realized gains or losses and declines in value determined to be other than temporary, if any, on available-for-sale securities, are reported in other income or expense as incurred.

Ciena also has certain other minority equity investments in privately held technology companies that are classified as other long-term assets. These investments are carried at cost because Ciena owns less than 20% of the voting equity and does not have the ability to exercise significant influence over these companies. These investments are inherently high risk as the markets for technologies or products manufactured by these companies are usually early stage at the time of the investment by Ciena and such markets may never be significant. Ciena could lose its entire investment in some or all of these companies. Ciena monitors these investments for impairment and makes appropriate reductions in carrying values when necessary.

*Inventories*

Inventories are stated at the lower of cost or market, with cost determined on the first-in, first-out basis. Ciena records a provision for excess and obsolete inventory whenever an impairment has been identified.

*Equipment, Furniture and Fixtures*

Equipment, furniture and fixtures are recorded at cost. Depreciation and amortization are computed using the straight-line method over useful lives of two years to five years for equipment, furniture and fixtures and nine months to ten years for leasehold improvements. Impairments of equipment, furniture and fixtures are determined in accordance with Statement of Financial Accounting Standards (SFAS) No. 144, Accounting for the Impairment or Disposal of Long-Lived Assets.

Internal use software and web site development costs are capitalized in accordance with Statement of Position (SOP) No. 98-1, Accounting for the Costs of Computer Software Developed or Obtained for Internal Use, and Emerging Issues Task Force (EITF) Issue No. 00-2, Accounting for Web Site Development Costs. Qualifying costs incurred during the application development stage, which consist primarily of outside services and purchased software license costs, are capitalized and amortized over the estimated useful life of the asset.



### *Goodwill and Other Intangible Assets*

Ciena has recorded goodwill and purchased intangible assets as a result of several acquisitions. Ciena accounts for goodwill in accordance with SFAS 142 Goodwill and Other Intangible Assets, which requires Ciena to test each reporting unit's goodwill for impairment on an annual basis, which Ciena has determined to be the last business day of fiscal September each year. Ciena operates its business and tests its goodwill for impairment as a single reporting unit. Testing is required between annual tests if events occur or circumstances change that would, more likely than not, reduce the fair value of the reporting unit below its carrying value.

Purchased intangible assets are carried at cost less accumulated amortization. Amortization is computed using the straight-line method over the economic lives of the respective assets, generally three to seven years. Impairments of other intangibles assets are determined in accordance SFAS 144.

### *Unfavorable Lease Commitments*

Ciena has recorded unfavorable lease commitments as a result of several acquisitions. Ciena accounts for unfavorable lease commitments in accordance with SFAS 141 Business Combinations. The value of the unfavorable lease commitments was based upon the present value of the assumed lease obligations based upon current rental rates and current interest rates at the time of the acquisitions. These unfavorable lease commitments will be paid over the respective lease terms.

### *Concentrations*

Substantially all of Ciena's cash and cash equivalents, short-term and long-term investments, are maintained at two major U.S. financial institutions. The majority of Ciena's cash equivalents consist of money market funds and overnight repurchase agreements. Deposits held with banks may exceed the amount of insurance provided on such deposits. Generally, these deposits may be redeemed upon demand and, therefore, bear minimal risk.

Additionally, Ciena's access to certain raw materials is dependent upon single and sole source suppliers. The inability of any supplier to fulfill Ciena's supply requirements could affect future results. Ciena relies on a small number of contract manufacturers to perform the majority of the manufacturing operations for its products. If Ciena cannot effectively manage these manufacturers and forecast future demand, or if they fail to deliver products or components on time, Ciena's business may suffer.

### *Revenue Recognition*

Ciena recognizes revenue in accordance with Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, which states that revenue is realized or realizable and earned when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the price to the buyer is fixed or determinable; and collectibility is reasonably assured. In instances where final acceptance of the product, system, or solution is specified by the customer, revenue is deferred until all acceptance criteria have been met. Revenue for maintenance services is generally deferred and recognized ratably over the period during which the services are to be performed.

Some of Ciena's communications networking equipment is integrated with software that is essential to the functionality of the equipment. In some cases, Ciena provides unspecified software upgrades and enhancements related to the equipment through maintenance contracts for these products. For transactions involving the sale of software, revenue is recognized in accordance with SOP 97-2, Software Revenue Recognition, including deferral of revenue recognition in instances where vendor specific objective evidence for undelivered elements is not determinable.

For arrangements that involve the delivery or performance of multiple products, services and/or rights to use assets, except as otherwise covered by SOP 97-2, the determination as to how the arrangement consideration should be measured and allocated to the separate deliverables of the arrangement is determined in accordance with EITF 00-21,

Revenue Arrangements with Multiple Deliverables. When a sale involves multiple elements, such as sales of products that include services, the entire fee from the arrangement is allocated to each respective element based on its relative fair value and recognized when revenue recognition criteria for each element are met. Fair value for each element is established based on the sales price charged when the same element is sold separately.

*Revenue Related Accruals*

Ciena provides for the estimated costs to fulfill customer warranty and other contractual obligations upon the recognition of the related revenue. The warranty liability is determined based upon actual warranty cost experience, estimates of component failure rates and management's industry experience. Ciena's sales contracts do not permit the right of return of product by the customer after the product has been accepted.

*Accounts Receivable Trade, Net*

Ciena's allowance for doubtful accounts receivable is based on its assessment, on a specific identification basis, of the collectibility of customer accounts. Ciena performs ongoing credit evaluations of its customers and generally has not required collateral or other forms of security from its customers. In determining the appropriate balance for Ciena's allowance for doubtful accounts receivable, management considers each individual customer account receivable in order to determine collectibility. In doing so, management considers creditworthiness, payment history, account activity and communication with such customer. If a customer's financial condition changes, Ciena may be required to take a charge for an allowance for doubtful accounts receivable.

*Research and Development*

Ciena charges all research and development costs to expense as incurred. Types of expense incurred in research and development include employee compensation, prototype, consulting, depreciation, facility costs and information technologies.

*Advertising Costs*

Ciena expenses all advertising costs as incurred.

*Share-Based Compensation Expense*

On November 1, 2005, Ciena adopted SFAS 123(R), Share-Based Payment, which requires the measurement and recognition of compensation expense, based on estimated fair values, for all share-based awards, made to employees and directors, including stock options, restricted stock, restricted stock units and participation in Ciena's employee stock purchase plan. In March 2005, the Securities and Exchange Commission issued SAB 107 relating to SFAS 123(R). Ciena has applied the provisions of SAB 107 in its adoption of SFAS 123(R).

SFAS 123(R) requires companies to estimate the fair value of share-based awards on the date of grant using an option-pricing model. Ciena uses the Black-Scholes option-pricing model as its method of determining fair value. This model is affected by Ciena's stock price as well as assumptions regarding a number of subjective variables. These subjective variables include, but are not limited to Ciena's expected stock price volatility over the term of the awards, and actual and projected employee stock option exercise behaviors. The value of the portion of the award that is ultimately expected to vest is recognized as expense in Ciena's consolidated statement of operations over the requisite service periods.

No tax benefits were attributed to the share-based compensation expense because a full valuation allowance was maintained for all net deferred tax assets.

*Income Taxes*

Ciena accounts for income taxes in accordance with SFAS 109, Accounting for Income Taxes. SFAS 109 describes an asset and liability approach that requires the recognition of deferred tax assets and liabilities for the expected future tax consequences attributable to differences between the carrying amounts of assets and liabilities for financial reporting purposes and their respective tax bases, and for operating loss and tax credit carry forwards. In estimating future tax consequences, SFAS 109 generally considers all expected future events other than the enactment of changes in tax laws or rates. Valuation allowances are provided, if, based upon the weight of the available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized.

*Fair Value of Financial Instruments*

The carrying amounts of Ciena's financial instruments, which include short-term and long-term investments, accounts receivable, accounts payable, and other accrued expenses, approximate their fair values due to their short maturities.

*Foreign Currency Translation*

Some of Ciena's foreign branch offices and subsidiaries use the U.S. dollar as their functional currency, because Ciena, as the U.S. parent entity, exclusively funds the operations of these branch offices and subsidiaries with U.S. dollars. For those subsidiaries using the local currency as their functional currency, assets and liabilities are translated at exchange rates in effect at the balance sheet date, and the statement of operations is translated at a monthly average rate. Resulting translation adjustments are recorded directly to a separate component of stockholders' equity. Where the U.S. dollar is the functional currency, re-measurement adjustments are recorded in other income. The net gain (loss) on foreign currency re-measurement and exchange rate changes is immaterial for separate financial statement presentation.

*Computation of Basic Net Income (Loss) per Common Share and Diluted Net Income (Loss) per Dilutive Potential Common Share*

Ciena calculates earnings per share (EPS) in accordance with the SFAS 128, Earnings per Share. This statement requires dual presentation of basic and diluted EPS on the face of the income statement for entities with a complex capital structure and requires a reconciliation of the numerator and denominator used for the basic and diluted EPS computations.

*Software Development Costs*

SFAS 86, Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed, requires the capitalization of certain software development costs incurred subsequent to the date technological feasibility is established and prior to the date the product is generally available for sale. The capitalized cost is then amortized over the estimated product life. Ciena defines technological feasibility as being attained at the time a working model is completed. To date, the period between achieving technological feasibility and the general availability of such software has been short, and software development costs qualifying for capitalization have been insignificant. Accordingly, Ciena has not capitalized any software development costs.

*Segment Reporting*

SFAS 131, Disclosures about Segments of an Enterprise and Related Information, establishes annual and interim reporting standards for operating segments of a company. It also requires entity-wide disclosures about the products and services an entity provides, the material countries in which it holds assets and reports revenue, and its major customers. We report our financial results as a single business segment.

*Effects of Recent Accounting Pronouncements*

In September 2006, the SEC issued SAB No. 108, Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements. SAB 108 provides interpretative guidance on the process of quantifying financial statement misstatements and is effective for fiscal years ending after November 15, 2006. The adoption of this statement in fiscal 2007 did not have a material impact on Ciena's financial condition, results of operations or cash flows.

In February 2006, the Financial Accounting Standards Board (FASB) issued SFAS 155, Accounting for Certain Hybrid Financial Instruments which amends SFAS 133, Accounting for Derivative Instruments and Hedging Activities and SFAS 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. SFAS 155 simplifies the accounting for certain derivatives embedded in other financial instruments by allowing them to be accounted for as a whole if the holder elects to account for the whole instrument on a fair value basis. SFAS 155 also clarifies and amends certain other provisions of SFAS 133 and SFAS 140. SFAS 155 is effective for all financial instruments acquired, issued or subject to a remeasurement event occurring in fiscal years beginning after September 15, 2006. The adoption of this statement in fiscal 2007 did not have a material impact on Ciena's financial condition, results of operations or cash flows.

In May 2005, the FASB issued SFAS 154, *Accounting Changes and Error Corrections* which supersedes APB Opinion No. 20, *Accounting Changes* and SFAS 3, *Reporting Accounting Changes in Interim Financial Statements*. SFAS 154 changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS 154 also carries forward without change the guidance contained in APB 20 for reporting the correction of an error in previously issued financial statements and a change in accounting estimate. SFAS 154 requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. The correction of an error in previously issued financial statements is not a change in accounting principle. However, the reporting of an error correction involves adjustments to previously issued financial statements similar to those generally applicable to reporting an accounting change retroactively. Therefore, the reporting of a correction of an error by restating previously issued financial statements is also addressed by SFAS 154. SFAS 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The adoption of this statement in fiscal 2007 did not have a material impact on Ciena's financial condition, results of operations or cash flows.

In September 2006, the FASB issued SFAS 157, *Fair Value Measurements*. SFAS 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles, and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. Ciena is currently evaluating the impact the adoption of this statement could have on its financial condition, results of operations and cash flows.

In July 2006, the FASB issued FASB Interpretation (FIN) No. 48, *Accounting for Uncertainty in Income Taxes*, an interpretation of Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. FIN 48 clarifies the accounting for income taxes by prescribing the minimum recognition threshold a tax position is required to meet before being recognized in the financial statements. FIN 48 also provides guidance on derecognition, measurement, classification, interest and penalties, accounting in interim periods, disclosure and transition. The interpretation applies to all tax positions related to income taxes subject to SFAS 109. FIN 48 is effective for fiscal years beginning after December 15, 2006. Differences between the amounts recognized in the statements of financial position prior to the adoption of FIN 48 and the amounts reported after adoption should be accounted for as a cumulative-effect adjustment recorded to the beginning balance of retained earnings. Ciena is currently evaluating the impact the adoption of this statement could have on its financial condition, results of operations and cash flows.

### (3) RESTRUCTURING COSTS

Ciena has previously taken actions to align its workforce, facilities and operating costs with business opportunities. Ciena historically has committed to a restructuring plan and has incurred the associated liability concurrently in accordance with the provisions of SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*. The following table displays the activity and balances of the restructuring reserve account for the six months ending April 30, 2007 (in thousands):

|                                       | Workforce<br>reduction | Consolidation<br>of excess<br>facilities | Total     |
|---------------------------------------|------------------------|--|-----------|
| Balance at October 31, 2006           | \$                     | \$ 35,634                                | \$ 35,634 |
| Additional liability recorded         | 72 (a)                 |  | 72        |
| Adjustment to previous estimates      |                        | (1,272) (b)                              | (1,272)   |
| Cash payments                         | (72)                   | (4,603)                                  | (4,675)   |
| Balance at April 30, 2007             | \$                     | \$ 29,759                                | \$ 29,759 |
| Current restructuring liabilities     | \$                     | \$ 7,065                                 | \$ 7,065  |
| Non-current restructuring liabilities | \$                     | \$ 22,694                                | \$ 22,694 |

- (a) During the first quarter of fiscal 2007, Ciena recorded a charge of \$0.1 million related to other costs associated with a previous workforce reduction.
  
- (b) During the first quarter of fiscal 2007, Ciena recorded an adjustment of \$0.5 million related to costs associated with previously restructured facilities.  
During the second quarter of fiscal 2007, Ciena recorded an adjustment of \$0.8 million related to its return to use of a facility that had been previously restructured.



The following table displays the activity and balances of the restructuring reserve account for the six months ending April 30, 2006 (in thousands):

|                                       | Workforce<br>reduction | Consolidation<br>of excess<br>facilities | Total     |
|---------------------------------------|------------------------|--|-----------|
| Balance at October 31, 2005           | \$ 270                 | \$ 69,507                                | \$ 69,777 |
| Additional reserve recorded           | 3,974 (a)              | 1,413 (a)                                | 5,387     |
| Adjustments to previous estimates     |                        | (358) (b)                                | (358)     |
| Lease settlement                      |                        | (11,648) (c)                             | (11,648)  |
| Cash payments                         | (2,624)                | (29,648)                                 | (32,272)  |
| Balance at April 30, 2006             | \$ 1,620               | \$ 29,266                                | \$ 30,886 |
| Current restructuring liabilities     | \$ 1,620               | \$ 7,598                                 | \$ 9,218  |
| Non-current restructuring liabilities | \$                     | \$ 21,668                                | \$ 21,668 |

(a) During the first quarter of fiscal 2006, Ciena recorded a charge of \$0.7 million related to the closure of one of its facilities located in Kanata, Ontario and a charge of \$1.5 million related to a workforce reduction of 62 employees. During the second quarter of fiscal 2006, Ciena recorded a charge of \$0.7 million related to the closure of its Shrewsbury, NJ facility and a charge of \$2.5 million related to a

workforce  
reduction of 86  
employees.

- (b) During the first quarter of fiscal 2006, Ciena recorded an adjustment of \$0.2 million related to costs associated with previously restructured facilities. During the second quarter of fiscal 2006, Ciena recorded an adjustment of \$0.2 million related to costs associated with previously restructured facilities.
- (c) During the first quarter of fiscal 2006, Ciena recorded a gain of \$6.0 million related to the buy-out of the lease of its former Fremont, CA facility, which Ciena had previously restructured. During the second quarter of fiscal 2006, Ciena recorded a gain of \$5.6 million related to the buy-out of the lease of its former Cupertino, CA

facility, which  
Ciena had  
previously  
restructured.

**(4) MARKETABLE DEBT SECURITIES**

Short-term and long-term investments, exclusive of restricted cash, are comprised of the following (in thousands):

|                           | Amortized<br>Cost | April 30, 2007      |                     | Fair Value |
|---------------------------|-------------------|---------------------|---------------------|------------|
|                           |                   | Gross<br>Unrealized | Gross<br>Unrealized |            |
|                           |                   | Gains               | Losses              |            |
| Corporate bonds           | \$ 391,105        | \$ 209              | \$ 213              | \$ 391,101 |
| Asset backed obligations  | 182,913           | 64                  | 235                 | 182,742    |
| Commercial paper          | 100,316           |                     |                     | 100,316    |
| US government obligations | 53,077            | 32                  | 59                  | 53,050     |
| Certificate of deposit    | 25,000            |                     |                     | 25,000     |
|                           | \$ 752,411        | \$ 305              | \$ 507              | \$ 752,209 |
| Short-term investments    | 646,934           | 205                 | 486                 | 646,653    |
| Long-term investments     | 105,477           | 100                 | 21                  | 105,556    |
|                           | \$ 752,411        | \$ 305              | \$ 507              | \$ 752,209 |

|                           | Amortized<br>Cost | October 31, 2006    |                     | Fair Value |
|---------------------------|-------------------|---------------------|---------------------|------------|
|                           |                   | Gross<br>Unrealized | Gross<br>Unrealized |            |
|                           |                   | Gains               | Losses              |            |
| Corporate bonds           | \$ 468,152        | \$ 437              | \$ 525              | \$ 468,064 |
| Asset backed obligations  | 195,728           | 142                 | 305                 | 195,565    |
| Commercial paper          | 152,768           |                     |                     | 152,768    |
| US government obligations | 163,643           | 84                  | 324                 | 163,403    |
|                           | \$ 980,291        | \$ 663              | \$ 1,154            | \$ 979,800 |
| Short-term investments    | 629,269           | 66                  | 942                 | 628,393    |
| Long-term investments     | 351,022           | 597                 | 212                 | 351,407    |
|                           | \$ 980,291        | \$ 663              | \$ 1,154            | \$ 979,800 |

The gross unrealized losses, related to marketable debt investments, were primarily due to changes in interest rates. Ciena's management has determined that the gross unrealized losses on its marketable debt investments at April 30, 2007 and October 31, 2006 are temporary in nature because Ciena has the ability and intent to hold these investments until a recovery of fair value, which may be maturity. The following table displays gross unrealized losses at April 30, 2007 and October 31, 2006 (in thousands):

|                           | Unrealized Losses Less Than 12 Months |            | April 30, 2007<br>Unrealized Losses 12 Months or Greater |            | Total            |            |
|---------------------------|---------------------------------------|------------|--|------------|------------------|------------|
|                           | Gross Unrealized                      |            | Gross Unrealized   |            | Gross Unrealized |            |
|                           | Losses                                | Fair Value | Losses   | Fair Value | Losses           | Fair Value |
| Corporate bonds           | \$ 89                                 | \$ 204,988 | \$ 124   | \$ 47,233  | \$ 213           | \$ 252,221 |
| Asset backed obligations  | 136                                   | 93,963     | 99   | 39,441     | 235              | 133,404    |
| US government obligations | 5                                     | 7,773      | 54   | 23,960     | 59               | 31,733     |
|                           | \$ 230                                | \$ 306,724 | \$ 277   | \$ 110,634 | \$ 507           | \$ 417,358 |

  

|                           | Unrealized Losses Less Than 12 Months |            | October 31, 2006<br>Unrealized Losses 12 Months or Greater |            | Total            |            |
|---------------------------|---------------------------------------|------------|--|------------|------------------|------------|
|                           | Gross Unrealized                      |            | Gross Unrealized   |            | Gross Unrealized |            |
|                           | Losses                                | Fair Value | Losses   | Fair Value | Losses           | Fair Value |
| Corporate bonds           | \$ 400                                | \$ 196,947 | \$ 125   | \$ 26,687  | \$ 525           | \$ 223,634 |
| Asset backed obligations  | 153                                   | 92,869     | 152  | 34,828     | 305              | 127,697    |
| US government obligations | 112                                   | 38,692     | 212  | 40,839     | 324              | 79,531     |
|                           | \$ 665                                | \$ 328,508 | \$ 489   | \$ 102,354 | \$ 1,154         | \$ 430,862 |

The following table summarizes maturities of investments at April 30, 2007 (in thousands):

|                    | Amortized Cost | Estimated Fair Value |
|--------------------|----------------|----------------------|
| Less than one year | \$ 646,934     | \$ 646,653           |
| Due in 1-2 years   | 105,477        | 105,556              |
|                    | \$ 752,411     | \$ 752,209           |

##### (5) ACCOUNTS RECEIVABLE

As of April 30, 2007, trade accounts receivable, net of allowance for doubtful accounts receivable, included four customers that accounted for 20.9%, 19.7%, 15.5% and 11.4% of net trade accounts receivable, respectively. As of October 31, 2006, the trade accounts receivable, net of allowance for doubtful accounts receivable, included two customers that accounted for 25.4% and 21.8% of the net trade accounts receivable, respectively.

Ciena's allowance for doubtful accounts receivable as of October 31, 2006 and April 30, 2007 was \$0.1 million.

##### (6) INVENTORIES

Inventories are comprised of the following (in thousands):

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|   | October 31,<br>2006 | April 30,<br>2007 |
|---|---------------------|-------------------|
| Raw materials                                   | \$ 29,627           | \$ 34,234         |
| Work-in-process                                 | 9,156               | 7,562             |
| Finished goods                                  | 89,628              | 100,827           |
|   | 128,411             | 142,623           |
| Provision for inventory excess and obsolescence | (22,326)            | (23,833)          |
|   | \$ 106,085          | \$ 118,790        |

Ciena writes down its inventory for estimated obsolescence or unmarketable inventory by the difference between the cost of inventory and the estimated net realizable value based on assumptions about future demand and market conditions. During the first six months of fiscal 2007, Ciena recorded a provision for inventory of \$6.4 million, primarily related to excess inventory due to a change in forecasted sales for certain products. The following is a summary of the change in the allowance for excess inventory and obsolete inventory during the first six months of fiscal 2007 (in thousands):

|                                     | Inventory<br>Allowance |
|-------------------------------------|------------------------|
| Balance as of October 31, 2006      | \$ 22,326              |
| Provision for excess inventory, net | 6,385                  |
| Actual inventory scrapped           | (4,878)                |
| Balance as of April 30, 2007        | \$ 23,833              |

During the first six months of fiscal 2006, Ciena recorded a provision for inventory reserves of \$4.4 million, primarily related to excess inventory due to a change in forecasted sales for certain products. The following is a summary of the change in the allowance for excess inventory and obsolete inventory during the first six months of fiscal 2006 (in thousands):

|                                     | Inventory<br>Allowance |
|-------------------------------------|------------------------|
| Balance as of October 31, 2005      | \$ 22,595              |
| Provision for excess inventory, net | 4,376                  |
| Actual inventory scrapped           | (7,155)                |
| Balance as of April 30, 2006        | \$ 19,816              |

#### **(7) PREPAID EXPENSES AND OTHER**

Prepaid expenses and other are comprised of the following (in thousands):

|                             | October 31,<br>2006 | April 30,<br>2007 |
|-----------------------------|---------------------|-------------------|
| Interest receivable         | \$ 8,547            | \$ 7,102          |
| Prepaid VAT and other taxes | 9,467               | 13,964            |
| Prepaid expenses            | 8,445               | 18,225            |
| Restricted cash             | 6,990               | 3,119             |
| Other non-trade receivables | 2,923               | 1,520             |
|                             | \$ 36,372           | \$ 43,930         |

#### **(8) EQUIPMENT, FURNITURE AND FIXTURES**

Equipment, furniture and fixtures are comprised of the following (in thousands):

|                                   | October 31,<br>2006 | April 30,<br>2007 |
|-----------------------------------|---------------------|-------------------|
| Equipment, furniture and fixtures | \$ 253,953          | \$ 265,397        |
| Leasehold improvements            | 36,203              | 36,614            |

|   |           |           |
|---|-----------|-----------|
|   | 290,156   | 302,011   |
| Accumulated depreciation and amortization | (260,729) | (264,444) |
|   | \$ 29,427 | \$ 37,567 |

**(9) OTHER INTANGIBLE ASSETS**

Other intangible assets are comprised of the following (in thousands):

|   |                     | October 31,<br>2006         | Net        | Gross      | April 30,<br>2007           | Net        |
|---|---------------------|-----------------------------|------------|------------|-----------------------------|------------|
|   | Gross<br>Intangible | Accumulated<br>Amortization | Intangible | Intangible | Accumulated<br>Amortization | Intangible |
| Developed technology  | \$ 139,983          | \$ (87,577)                 | \$ 52,406  | \$ 139,983 | \$ (96,115)                 | \$ 43,868  |
| Patents and licenses  | 47,370              | (25,463)                    | 21,907     | 47,370     | (28,585)                    | 18,785     |
| Customer relationships,<br>covenants not to<br>compete, outstanding<br>purchase orders and<br>contracts | 45,981              | (29,020)                    | 16,961     | 45,981     | (31,885)                    | 14,096     |
|   | \$ 233,334          |                             | \$ 91,274  | \$ 233,334 |                             | \$ 76,749  |

The aggregate amortization expense of other intangible assets was \$14.5 million for the first six months of fiscal 2006 and 2007. The following table represents the expected future amortization of other intangible assets as follows (in thousands):

|                             |           |
|-----------------------------|-----------|
| 2007 (remaining six months) | \$ 14,525 |
| 2008                        | 27,840    |
| 2009                        | 19,254    |
| 2010                        | 14,500    |
| 2011                        | 630       |
|                             | \$ 76,749 |

**(10) OTHER BALANCE SHEET DETAILS**

Other long-term assets (in thousands):

|   | October 31,<br>2006 | April 30,<br>2007 |
|---|---------------------|-------------------|
| Maintenance spares inventory, net       | \$ 14,724           | \$ 16,904         |
| Deferred debt issuance costs            | 10,306              | 6,767             |
| Investments in privately held companies | 6,489               | 6,671             |
| Restricted cash                         | 3,227               | 12,647            |
| Other                                   | 2,658               | 3,006             |
|   | \$ 37,404           | \$ 45,995         |

Deferred debt issuance costs are amortized using the straight line method which approximates the effect of the effective interest rate method on the maturity of the related debt. Amortization of debt issuance cost, which is included in interest expense, was \$1.3 million and \$1.8 million during the first six months of fiscal 2006 and fiscal 2007, respectively. This increase reflects Ciena's April 10, 2006 issuance of 0.25% Convertible Senior Notes due May 1, 2013.

Accrued liabilities (in thousands):



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|  | October 31,<br>2006 | April 30,<br>2007 |
|--|---------------------|-------------------|
| Warranty   | \$ 31,751           | \$ 33,468         |
| Accrued compensation, payroll related tax and benefits | 24,102              | 23,861            |
| Accrued interest payable                               | 5,502               | 5,459             |
| Other  | 17,927              | 21,688            |
|  | \$ 79,282           | \$ 84,476         |

During the first six months of fiscal 2007, we recorded out of period adjustments related to a \$0.7 million adjustment to the provision for warranty and a \$0.3 million adjustment to a service expense accrual. These adjustments were not material to the financial statements for the first six months of fiscal 2007 or Ciena's fiscal year ended October 31, 2006. The following table summarizes the activity in Ciena's accrued warranty for the first six months of fiscal 2006 and 2007 (in thousands):

| Six Months Ended                 | Beginning |            |             | Balance at    |
|----------------------------------|-----------|------------|-------------|---------------|
| April 30,                        | Balance   | Provisions | Settlements | end of period |
| 2006                             | \$27,044  | 6,815      | (5,391)     | \$28,468      |
| 2007                             | \$31,751  | 7,111      | (5,394)     | \$33,468      |
| Deferred revenue (in thousands): |           |            |             |               |
|                                  |           |            | October 31, | April 30,     |
|                                  |           |            | 2006        | 2007          |
| Products                         |           |            | \$ 4,276    | \$ 18,243     |
| Services                         |           |            | 36,400      | 41,925        |
|                                  |           |            | 40,676      | 60,168        |
| Less current portion             |           |            | (19,637)    | (36,097)      |
| Long-term deferred revenue       |           |            | \$ 21,039   | \$ 24,071     |

### (11) CONVERTIBLE NOTES PAYABLE

#### *Ciena 3.75% Convertible Notes, due February 1, 2008*

On February 9, 2001, Ciena completed a public offering of 3.75% Convertible Notes, due February 1, 2008, in an aggregate principal amount of \$690.0 million. Interest is payable on February 1 and August 1 of each year. The notes may be converted into shares of Ciena's common stock at any time before their maturity or their prior redemption or repurchase by Ciena. The conversion rate is 1.3687 shares per each \$1,000 principal amount of notes, subject to adjustment in certain circumstances. Prior to maturity, Ciena has the option to redeem all or a portion of the notes that have not been previously converted at 100.536% of the principal amount. The \$542.3 million in aggregate principal amount remaining outstanding on the 3.75% convertible notes is classified as a current liability on Ciena's April 30, 2007 balance sheet.

At April 27, 2007, the fair value of the outstanding \$542.3 million in aggregate principal amount of 3.75% convertible notes was \$531.4 million, based on the quoted market price for the notes.

#### *0.25% Convertible Senior Notes due May 1, 2013*

On April 10, 2006, Ciena completed a public offering of 0.25% Convertible Senior Notes due May 1, 2013, in an aggregate principal amount of \$300.0 million. The notes bear interest at the annual rate of 0.25%, payable semi-annually on May 1 and November 1. The notes are senior unsecured obligations of Ciena and rank equally with all of Ciena's other existing and future senior unsecured debt.

At the election of the holder, the notes may be converted prior to maturity into shares of Ciena common stock at the initial conversion rate of 25.3001 shares per \$1,000 in principal amount, which is equivalent to an initial conversion price of \$39.5255 per share. The notes may not be redeemed by Ciena prior to May 5, 2009. At any time on or after May 5, 2009, if the closing sale price of Ciena's common stock for at least 20 trading days in any 30 consecutive trading day period ending on the date one day prior to the date of the notice of redemption exceeds 130% of the conversion price, Ciena may redeem the notes in whole or in part, at a redemption price in cash equal to the principal amount to be redeemed, plus accrued and unpaid interest.

If Ciena undergoes a fundamental change (as that term is defined in the indenture), holders of notes will have the right, subject to certain exemptions, to require Ciena to purchase for cash any or all of their notes at a price equal to the principal amount, plus accrued and unpaid interest. If the holder elects to convert his or her notes in connection

with a specified fundamental change, in certain circumstances, Ciena will be required to increase the applicable conversion rate, depending on the price paid per share for Ciena common stock and the effective date of the fundamental change transaction.

At April 27, 2007, the fair value of the outstanding \$300.0 million in aggregate principal amount of 0.25% convertible senior notes outstanding was \$281.3 million, based on the quoted market price for the notes.

**(12) INCOME (LOSS) PER SHARE CALCULATION**

The following table (in thousands except per share amounts) is a reconciliation of the numerator and denominator of the basic net income (loss) per common share ( Basic EPS ) and the diluted net income (loss) per dilutive potential common share ( Diluted EPS ). Basic EPS is computed using the weighted average number of common shares outstanding. Diluted EPS is computed using the weighted average number of (i) common shares outstanding, (ii) shares issuable upon vesting of restricted stock units, (iii) shares issuable upon exercise of outstanding stock options, employee stock purchase plan options and warrants using the treasury stock method; and (iv) shares underlying the 0.25% convertible senior notes.

**Numerator**

|  | Quarter Ended April<br>30, |           | Six Months Ended April<br>30, |           |
|--|----------------------------|-----------|-------------------------------|-----------|
|  | 2006                       | 2007      | 2006                          | 2007      |
| Net income (loss)  | \$ (1,910)                 | \$ 13,010 | \$ (8,201)                    | \$ 24,066 |
| Add: Interest expense associated with 0.25% convertible senior notes |                            | 188       |                               | 376       |
| Net income (loss) used to calculate Diluted EPS                      | \$ (1,910)                 | \$ 13,198 | \$ (8,201)                    | \$ 24,442 |

**Denominator**

|  | Quarter Ended April<br>30, |        | Six Months Ended April<br>30, |        |
|--|----------------------------|--------|-------------------------------|--------|
|  | 2006                       | 2007   | 2006                          | 2007   |
| Basic weighted average shares outstanding  | 83,518                     | 85,198 | 83,251                        | 85,076 |
| Add: Shares underlying outstanding stock options, employees stock purchase plan options, warrants and restricted stock units |                            | 949    |                               | 825    |
| Add: Shares underlying 0.25% convertible senior notes  |                            | 7,590  |                               | 7,590  |
| Dilutive weighted average shares outstanding   | 83,518                     | 93,737 | 83,251                        | 93,491 |

**EPS**

|             | Quarter Ended April<br>30, |         | Six Months Ended April<br>30, |         |
|-------------|----------------------------|---------|-------------------------------|---------|
|             | 2006                       | 2007    | 2006                          | 2007    |
| Basic EPS   | \$ (0.02)                  | \$ 0.15 | \$ (0.10)                     | \$ 0.28 |
| Diluted EPS | \$ (0.02)                  | \$ 0.14 | \$ (0.10)                     | \$ 0.26 |

*Explanation of Shares Excluded due to Anti-Dilutive Effect*

For the quarter and six months ended April 30, 2006, approximately 7.7 million and 7.5 million shares, respectively, representing the weighted average number of shares underlying outstanding stock options, restricted stock units, warrants and convertible notes, are considered anti-dilutive because Ciena incurred net losses during these periods.

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For each of the quarter and six months ended April 30, 2007, approximately 4.3 million shares, representing the weighted average number of shares underlying outstanding stock options, employee stock purchase plan options, restricted stock units, and warrants are considered anti-dilutive because the exercise price of these equity awards is greater than the average per share closing price on the NASDAQ Stock Market during this period. In addition, for each of the quarter and six months ended April 30, 2007, approximately 0.7 million shares, representing the weighted average number of shares issuable upon conversion of Ciena's 3.75% convertible notes, are considered anti-dilutive pursuant to SFAS 128 because the related interest expense on a per common share if converted basis exceeds Basic EPS for the periods.

The following table (in thousands except per share amounts) summarizes the shares excluded from the calculation of the denominator for Basic and Diluted EPS due to their anti-dilutive effect:

**Shares excluded from EPS Denominator due to anti-dilutive effect**

|  | Quarter Ended April |       | Six Months Ended April |       |
|--|---------------------|-------|------------------------|-------|
|  | 30,<br>2006         | 2007  | 30,<br>2006            | 2007  |
| Shares underlying outstanding stock options,<br>employee stock purchase plan options, warrants and<br>restricted stock units | 5,399               | 4,345 | 5,901                  | 4,266 |
| Shares underlying 3.75% convertible notes  | 742                 | 742   | 769                    | 742   |
| Shares underlying 0.25% convertible notes  | 1,602               |       | 797                    |       |
| Total excluded due to anti-dilutive effect   | 7,743               | 5,087 | 7,467                  | 5,008 |

**(13) STOCKHOLDERS EQUITY**

*Call Spread Option*

Concurrent with Ciena's April 10, 2006 issuance of 0.25% Convertible Senior Notes due May 1, 2013, Ciena purchased a call spread option on its common stock from an affiliate of the underwriter. The call spread option is designed to mitigate dilution from the conversion of the notes to the extent that the market price per share of Ciena common stock upon exercise is greater than the conversion price, subject to a cap.

The call spread option covers approximately 7.6 million shares of Ciena common stock, which is the number of shares issuable upon conversion of the notes in full. The call spread option effectively has a lower strike price of \$39.5255 and a higher strike price of \$45.54025 and is exercisable and expires on May 1, 2013, the maturity date of the notes. At its election, Ciena can exercise the call spread option on a net cash basis, a net share basis or a full physical settlement. A net cash settlement would result in Ciena receiving an amount ranging from \$0, if the market price per share of Ciena common stock upon exercise is equal to or below the lower strike price, to approximately \$45.7 million, if the market price per share of Ciena common stock upon exercise is at or above the higher strike price. Settlement of the call spread option on a net share basis would result in Ciena receiving a number of shares ranging from 0, if the market price per share of Ciena common stock upon exercise is equal to or below the lower strike price, up to approximately 1.0 million shares, if the market price per share of Ciena common stock upon exercise is equal to the higher strike price. The value of the consideration of a net share settlement will be equal to the value upon a net cash settlement. If the market price is between the lower strike price and the higher strike price, in lieu of a net share or net cash settlement, Ciena may elect to receive the full number of shares underlying the call spread option upon payment by Ciena of an aggregate option exercise price of \$300.0 million. Should there be an early unwind of the call spread option, the amount of cash or net shares to be received by Ciena will be dependent upon the existing overall market conditions, and on Ciena's stock price, the volatility of Ciena's stock and the remaining term of the call spread option.

The number of shares subject to the call spread option and the lower price and higher strike prices are subject to customary adjustments. The \$28.5 million cost of the call spread option was recorded as a reduction in additional paid in capital.

**(14) SHARE-BASED COMPENSATION EXPENSE**

During fiscal 2005, the Board of Directors determined that all future grants of stock options, restricted stock units, or other forms of equity-based compensation will solely be issued under the Ciena Corporation 2000 Equity Incentive Plan (the 2000 Plan) and the 2003 Employee Stock Purchase Plan (the ESPP).

*Ciena Corporation 2000 Equity Incentive Plan*

The 2000 Plan, which is a shareholder approved plan, was assumed by Ciena as a result of its merger with ONI. It authorizes the issuance of stock options, restricted stock, restricted stock units and stock bonuses to employees, officers, directors, consultants, independent contractors and advisors. The Compensation Committee of the Board of

Directors has broad discretion to establish the terms and conditions for equity awards, including number of shares, vesting and required service or other performance criteria. The maximum term of any award under the 2000 Plan is ten years. The exercise price of options may not be less than 85% of the fair market value of the stock at the date of grant, or 100% of the fair market value for qualified options.

Under the terms of the 2000 Plan, the number of shares authorized for issuance will increase by 5.0% of the number of Ciena shares issued and outstanding on January 1 of each year, unless the Compensation Committee reduces the amount of the increase in any year. By action of the Compensation Committee, no additional shares were added to the Plan on January 1, 2005, 2006 or 2007. In addition, any shares subject to outstanding options or other awards under the ONI 1997 Stock Plan, ONI 1998 Equity Incentive Plan, or ONI 1999 Equity Incentive Plan that are forfeited upon cancellation of the award are available for issuance under the 2000 Plan. As of April 30, 2007, there were 4.2 million shares authorized and available for issuance under the 2000 Plan.

#### Stock Options

The following table is a summary of Ciena's stock option activity (shares in thousands):

|                                | Options Outstanding | Weighted Average Exercise Price |
|--------------------------------|---------------------|---------------------------------|
| Balance as of October 31, 2006 | 7,110               | \$ 48.52                        |
| Granted                        | 428                 | 27.25                           |
| Exercised                      | (243)               | 19.48                           |
| Canceled                       | (303)               | 38.46                           |
| Balance as of April 30, 2007   | 6,992               | \$ 48.66                        |

The total intrinsic value of options exercised during the first six months of fiscal 2007 was \$2.3 million.

The following table summarizes information with respect to stock options outstanding at April 30, 2007, based on Ciena's closing stock price on April 27, 2007 of \$30.19 per share (shares and intrinsic value in thousands):

| Range of Exercise Price | Options Outstanding at April 30, 2007 |   |                                 | Vested Options at April 30, 2007 |   |                                 |
|-------------------------|---------------------------------------|---|---------------------------------|----------------------------------|---|---------------------------------|
|                         | Number                                | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price | Number                           | Weighted Average Remaining Contractual Life (Years) | Weighted Average Exercise Price |
| \$ 0.01 - \$ 16.52      | 877                                   | 7.71  | \$ 14.37                        | 393                              | 7.07  | \$ 12.29                        |
| \$ 16.53 - \$ 17.44     | 811                                   | 8.03  | 17.19                           | 345                              | 7.81  | 17.10                           |
| \$ 17.44 - \$ 22.97     | 809                                   | 7.27  | 21.72                           | 767                              | 7.18  | 21.75                           |
| \$ 22.97 - \$ 31.37     | 972                                   | 8.19  | 27.58                           | 488                              | 6.80  | 27.50                           |
| \$ 31.37 - \$ 31.72     | 1,020                                 | 5.67  | 31.70                           | 998                              | 5.59  | 31.71                           |
| \$ 31.72 - \$ 46.98     | 690                                   | 6.03  | 40.81                           | 658                              | 5.89  | 41.14                           |
| \$ 46.98 - \$ 83.14     | 770                                   | 4.93  | 60.50                           | 770                              | 4.93  | 60.50                           |
| \$ 83.14 - \$ 1,046.50  | 1,043                                 | 3.74  | 155.55                          | 1,043                            | 3.74  | 155.55                          |
| \$ 0.01 - \$ 1,046.50   | 6,992                                 | 6.40  | \$ 48.66                        | 5,462                            | 5.76  | \$ 56.45                        |
|                         |                                       |   | \$ 33,813                       |                                  |   | \$ 19,355                       |

As of April 30, 2007, total unrecognized compensation expense related to unvested stock options was \$13.6 million. This expense is expected to be recognized over a weighted-average period of 1.7 years.



*Restricted Stock Units*

A restricted stock unit is a right to receive a share of Ciena common stock when the unit vests. Ciena calculates the fair value of each restricted stock unit based on the fair value of the common stock and recognizes the expense ratably over the requisite period. The following table is a summary of Ciena's restricted stock unit activity, based on Ciena's closing stock price on April 27, 2007 of \$30.19 per share (shares and fair value in thousands):

|                                | Restricted<br>Stock<br>Units<br>Outstanding | Weighted<br>Average<br>Grant<br>Date<br>Fair Value<br>Per Share | Aggregate<br>Fair Value |
|--------------------------------|---|---|-------------------------|
| Balance as of October 31, 2006 | 162   | \$ 22.99  | \$ 3,829                |
| Granted                        | 1,179                                       |   |                         |
| Converted                      | (77)  |   |                         |
| Canceled or forfeited          | (29)  |   |                         |
| Balance as of April 30, 2007   | 1,235                                       | \$ 27.23  | \$ 37,274               |

The total fair value of restricted stock units converted during the first six months of fiscal 2007 was \$2.5 million.

As of April 30, 2007, total unrecognized compensation expense related to restricted stock units was \$30.3 million. This expense is expected to be recognized over a weighted-average period of 2.0 years.

*2003 Employee Stock Purchase Plan*

In March 2003, Ciena shareholders approved the ESPP, which has a ten-year term and originally authorized the issuance of 2.9 million shares. At the 2005 annual meeting, Ciena shareholders approved an amendment increasing the number of shares available to 3.6 million and adopting an evergreen provision that on December 31 of each year provides for an increase in the number of shares available by up to 0.6 million shares, provided that the total number of shares available shall not exceed 3.6 million. Pursuant to the evergreen provision, the maximum number of shares that may be added to the ESPP during the remainder of its ten-year term is 3.4 million.

Under the ESPP, eligible employees may enroll in an offer period during certain open enrollment periods. New offer periods begin March 16 and September 16 of each year. Prior to the offer period commencing September 15, 2006, (i) each offer period consisted of four, six-month purchase periods during which employee payroll deductions were accumulated and used to purchase shares of common stock; and (ii) the purchase price of the shares was 15% less than the fair market value on either the first day of an offer period or the last day of a purchase period, whichever was lower. In addition, if the fair market value on the purchase date was less than the fair market value on the first day of an offer period, then participants automatically commenced a new offer period.

On May 30, 2006, the Compensation Committee amended the ESPP, effective September 15, 2006, to shorten the offer period under the ESPP to six months. As a result of this change, the offer period and any purchase period will be the same six-month period. Under the amended ESPP, the applicable purchase price equals 95% of the fair market value of Ciena common stock on the last day of each purchase period. Employees enrolled with offer periods commenced prior to September 15, 2006, will be permitted to complete the remaining purchase periods in their current offer period. These amendments were intended to enable the ESPP to be considered a non-compensatory plan under FAS 123(R) for future offering periods.

|                                | ESPP shares<br>available for<br>issuance | Intrinsic value<br>at<br>exercise date |
|--------------------------------|--|--|
| Balance as of October 31, 2006 | 2,976                                    |  |

|                              |       |    |       |
|------------------------------|-------|----|-------|
| Evergreen provision          | 571   |    |       |
| Issued                       | (119) | \$ | 1,137 |
| Balance as of April 30, 2007 | 3,428 |    |       |

As of April 30, 2007, unrecognized compensation expense related to the ESPP was \$0.2 million. This expense is expected to be recognized over a weighted-average period of 0.8 years.

*Share-Based Compensation under SFAS 123(R) for the first quarter of fiscal 2006 and first quarter of fiscal 2007*

On November 1, 2005, Ciena adopted SFAS 123(R), which requires the measurement and recognition of compensation expense, based on estimated fair values, for all share-based payments awards made to Ciena's employees and directors including stock options, restricted stock, restricted stock unit awards and stock purchased under Ciena's ESPP.

The following table summarizes share-based compensation expense under SFAS 123(R) for the quarters and six months ended April 30, 2006 and April 30, 2007, which was allocated as follows (in thousands):

|  | Quarter Ended April<br>30, |          | Six Months Ended April<br>30 |          |
|--|----------------------------|----------|------------------------------|----------|
|  | 2006                       | 2007     | 2006                         | 2007     |
| Product costs  | \$ 375                     | \$ 362   | \$ 510                       | \$ 583   |
| Service costs  | 205                        | 285      | 393                          | 478      |
| Share-based compensation expense included in cost of sales     | 580                        | 647      | 903                          | 1,061    |
| Research and development                                       | 1,421                      | 1,085    | 3,058                        | 1,828    |
| Sales and marketing  | 948                        | 1,866    | 1,994                        | 2,906    |
| General and administrative                                     | 1,007                      | 1,892    | 1,828                        | 2,892    |
| Share-based compensation expense included in operating expense | 3,376                      | 4,843    | 6,880                        | 7,626    |
| Stock-based compensation expense capitalized in inventory, net | (21)                       | 158      | 335                          | 250      |
| Total share-based compensation                                 | \$ 3,935                   | \$ 5,648 | \$ 8,118                     | \$ 8,937 |

As share-based compensation expense recognized in the condensed consolidated statement of operations is based on awards ultimately expected to vest, it has been reduced for estimated forfeitures. Forfeitures were estimated based on Ciena's historical experience.

***Fair Value and Assumptions Used to Calculate Fair Value under SFAS 123(R)****Assumptions for Option-Based Awards under SFAS 123(R)*

The fair value of each option award is estimated on the date of grant using the Black-Scholes option-pricing model, with the following weighted average assumptions:

|                         | Quarter Ended April 30, |             | Six Months Ended April 30, |             |
|-------------------------|-------------------------|-------------|----------------------------|-------------|
|                         | 2006                    | 2007        | 2006                       | 2007        |
| Expected volatility     | 61.5%                   | 55.8%       | 61.5%                      | 55.8%       |
| Risk-free interest rate | 4.6% - 5.0%             | 4.4% - 4.7% | 4.3% - 5.0%                | 4.4% - 5.0% |
| Expected life (years)   | 5.5 - 6.1               | 6.0 - 6.1   | 5.5 - 6.1                  | 6.0 - 6.4   |
| Expected dividend yield | 0.0%                    | 0.0%        | 0.0%                       | 0.0%        |

Consistent with SFAS 123(R) and SAB 107, Ciena considered the implied volatility and historical volatility of its stock price in determining its expected volatility, and, finding both to be equally reliable, determined that a combination of both would result in the best estimate of expected volatility.

The risk-free interest rate assumption is based upon observed interest rates appropriate for the term of Ciena's employee stock options.

The expected life of employee stock options represents the weighted-average period the stock options are expected to remain outstanding. Because Ciena considers its options to be plain vanilla, it calculated the expected term using the simplified method as prescribed in SAB 107. Under SAB 107, options are considered to be plain vanilla if they have the following basic characteristics: granted at-the-money; exerciseability is conditioned upon service through the vesting date; termination of service prior to vesting results in forfeiture; limited exercise period following termination of service; and options are non-transferable and non-hedgeable.

The dividend yield assumption is based on Ciena's history and expectation of dividend payouts.

*Assumptions for Restricted Stock Unit Awards under SFAS 123(R)*

The fair value of each restricted stock unit award is based on the fair value of the common stock on the date of grant. The weighted average fair value of each restricted stock unit granted under Ciena's stock option plans for the three months and six months ended April 30, 2006 was \$31.29 and \$18.13, respectively. The weighted average fair value of each restricted stock unit granted under Ciena's stock option plans for the three months and six months ended April 30, 2007 was \$25.65 and \$27.83, respectively.

*Assumptions for Employee Stock Purchase Plan Awards under SFAS 123(R)*

The amendments to the ESPP for offer periods on or after September 15, 2006 described above were intended to enable the ESPP to be considered a non-compensatory plan under FAS 123(R) for future offering periods. Employees enrolled with offer periods that commenced prior to September 15, 2006, however, are permitted to complete the remaining purchase periods in their current offer period. For these continuing offer periods, the fair value is determined as of the grant date, using the graded vesting approach. Under the graded vesting approach, the 24-month ESPP offer period, which consists of four, six-month purchase periods, is treated for valuation purpose as four separate option tranches with individual lives of six, 12, 18 and 24 months, each commencing on the initial grant date. Each tranche is expensed straight-line over its individual life.

**(15) COMPREHENSIVE INCOME (LOSS)**

The components of comprehensive income (loss) were as follows (in thousands):

|  | Quarter Ended April<br>30, |           | Six Months Ended April<br>30, |           |
|--|----------------------------|-----------|-------------------------------|-----------|
|  | 2006                       | 2007      | 2006                          | 2007      |
| Net income (loss)  | \$ (1,910)                 | \$ 13,010 | \$ (8,201)                    | \$ 24,066 |
| Change in unrealized loss on available-for-sale securities | 567                        | 769       | 1,807                         | 264       |
| Change in accumulated translation adjustments              | (17)                       | (720)     | (27)                          | (882)     |
| Total comprehensive income (loss)                          | \$ (1,360)                 | \$ 13,059 | \$ (6,421)                    | \$ 23,448 |

**(16) ENTITY WIDE DISCLOSURES**

The following table reflects Ciena's geographic distribution of revenue from customers, identifying the specific country where revenue attributable to that country during the applicable period is greater than 10% of total revenue. Except as otherwise identified below, revenue attributable to geographic regions outside of the United States is reflected as International revenue. For the periods below, Ciena's geographic distribution of revenue was as follows (in thousands, except percentage data):

|                | Quarter Ended April 30, |       |            |       | Six Months Ended April 30, |       |            |       |
|----------------|-------------------------|-------|------------|-------|----------------------------|-------|------------|-------|
|                | 2006                    | %*    | 2007       | %*    | 2006                       | %*    | 2007       | %*    |
| United States  | \$ 95,379               | 72.7  | \$ 139,663 | 72.1  | \$ 198,049                 | 78.7  | \$ 259,266 | 72.3  |
| United Kingdom | n/a                     |       | 28,550     | 14.8  | n/a                        |       | 49,196     | 13.7  |
| International  | 35,796                  | 27.3  | 25,314     | 13.1  | 53,556                     | 21.3  | 50,166     | 14.0  |
| Total          | \$ 131,175              | 100.0 | \$ 193,527 | 100.0 | \$ 251,605                 | 100.0 | \$ 358,628 | 100.0 |

\* Denotes % of total revenue

n/a Denotes less than 10% for the

period

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The following table reflects Ciena's geographic distribution of equipment, furniture and fixtures. Other than the United States, no specific country has assets attributable that are greater than 10% of total equipment, furniture and fixtures. Equipment, furniture and fixtures attributable to geographic regions outside of the United States are reflected as International. For the periods below, Ciena's geographic distribution of equipment, furniture and fixtures was as follows (in thousands, except percentage data):

|               | October 31, |       | April 30, |       |
|---------------|-------------|-------|-----------|-------|
|               | 2006        | %*    | 2007      | %*    |
| United States | \$ 21,934   | 74.5  | \$ 28,742 | 76.5  |
| International | 7,493       | 25.5  | 8,825     | 23.5  |
| Total         | \$ 29,427   | 100.0 | \$ 37,567 | 100.0 |

\* Denotes % of total equipment, furniture and fixtures

For the periods below, product portfolio distribution of revenue was as follows (in thousands, except percentage data):

|                                       | Quarter Ended April 30, |       |            |       | Six Months Ended April 30, |       |            |       |
|---------------------------------------|-------------------------|-------|------------|-------|----------------------------|-------|------------|-------|
|                                       | 2006                    | %*    | 2007       | %*    | 2006                       | %*    | 2007       | %*    |
| Converged Ethernet infrastructure (1) | \$ 94,784               | 72.3  | \$ 160,425 | 82.9  | \$ 175,742                 | 69.9  | \$ 297,298 | 82.9  |
| Ethernet access (2)                   | 22,424                  | 17.1  | 12,787     | 6.6   | 47,407                     | 18.8  | 22,196     | 6.2   |
| Global network services               | 13,967                  | 10.6  | 20,315     | 10.5  | 28,456                     | 11.3  | 39,134     | 10.9  |
| Total                                 | \$ 131,175              | 100.0 | \$ 193,527 | 100.0 | \$ 251,605                 | 100.0 | \$ 358,628 | 100.0 |

\* Denotes % of total revenue

(1) Converged Ethernet infrastructure incorporates all products previously in our Optical Networking and Data Networking product groups and related software.

- (2) Ethernet access includes all products and related software previously in our Broadband Access product group, as well as our recently announced CN 3000 Ethernet Access Series.

For the periods below, customers accounting for at least 10% of Ciena's revenue were as follows (in thousands, except percentage data):

|           | Quarter Ended April 30, |      |           |      | Six Months Ended April 30, |      |            |      |
|-----------|-------------------------|------|-----------|------|----------------------------|------|------------|------|
|           | 2006                    | %*   | 2007      | %*   | 2006                       | %*   | 2007       | %*   |
| Company A | \$ n/a                  | n/a  | \$ n/a    | n/a  | \$ 26,281                  | 10.5 | \$ n/a     | n/a  |
| Company B | 18,101                  | 13.8 | n/a       | n/a  | 41,595                     | 16.5 | 37,088     | 10.3 |
| Company C | 23,114                  | 17.6 | 39,519    | 20.4 | 32,092                     | 12.8 | 71,475     | 19.9 |
| Company D | 13,247                  | 10.1 | n/a       | n/a  | n/a                        | n/a  | n/a        | n/a  |
| Company E | n/a                     | n/a  | n/a       | n/a  | 25,247                     | 10.0 | n/a        | n/a  |
| Company F | n/a                     | n/a  | 26,214    | 13.5 | n/a                        | n/a  | 57,206     | 16.0 |
| Company G | n/a                     | n/a  | 27,590    | 14.3 | n/a                        | n/a  | n/a        | n/a  |
| Total     | \$ 54,462               | 41.5 | \$ 93,323 | 48.2 | \$ 125,215                 | 49.8 | \$ 165,769 | 46.2 |

\* Denotes % of total revenue

n/a Denotes revenue represented less than 10% of total revenue for the period

## (17) CONTINGENCIES

### *Foreign Tax Contingencies*

Ciena has received assessment notices totaling \$6.6 million from the Mexican tax authorities asserting deficiencies in payments between 2001 and 2005 related primarily to income taxes and import taxes and duties. In October 2006, Ciena filed administrative petitions disputing these assessments that the Mexican tax authorities subsequently denied. Ciena is filing judicial petitions appealing the assessments. As of April 30, 2007, Ciena had accrued liabilities of \$0.8 million related to these contingencies, which are reported as a component of other current accrued liabilities. As of October 31, 2006, Ciena had accrued liabilities of \$0.7 million related to these contingencies, which are reported as a component of other current accrued liabilities. As of April 30, 2007, Ciena estimates that in connection with this contingency it could be exposed to possible losses of up to \$5.8 million for which it has not accrued liabilities. Ciena has not accrued these liabilities because it does not deem such losses probable. Ciena continues to evaluate the likelihood of probable and reasonably possible losses, if any, related to these assessments. As a result, future increases or decreases to our accrued liabilities may be necessary and will be recorded in the period when such amounts are probable and estimable.





***Litigation***

On October 3, 2000, Stanford University and Litton Systems filed a complaint in the United States District Court for the Central District of California against Ciena and several other defendants, alleging that optical fiber amplifiers incorporated into certain of those parties' products infringe U.S. Patent No. 4,859,016 (the '016 Patent'). The complaint seeks injunctive relief, royalties and damages. On October 10, 2003, the court stayed the case pending final resolution of matters before the U.S. Patent and Trademark Office (the PTO), including a request for and disposition of a reexamination of the '016 Patent. On October 16, 2003 and November 2, 2004, the PTO granted reexaminations of the '016 Patent, resulting in a continuation of the stay of the case. On September 11, 2006, the PTO issued a Notice of Intent to Issue a Reexamination Certificate and Statement of Reasons for Patentability/Confirmation, stating its intent to confirm certain claims of the '016 Patent. Thereafter, on September 19, 2006, Litton Systems filed a status report in which it requested that the district court lift the stay of the case, which request was denied by the district court on October 13, 2006. We believe that we have valid defenses to the lawsuit and intend to defend it vigorously in the event the stay of the case is lifted.

As a result of our merger with ONI Systems Corp. in June 2002, Ciena became a defendant in a securities class action lawsuit. Beginning in August 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York. These complaints name ONI, Hugh C. Martin, ONI's former chairman, president and chief executive officer; Chris A. Davis, ONI's former executive vice president, chief financial officer and administrative officer; and certain underwriters of ONI's initial public offering as defendants. The complaints were consolidated into a single action, and a consolidated amended complaint was filed on April 24, 2002. The amended complaint alleges, among other things, that the underwriter defendants violated the securities laws by failing to disclose alleged compensation arrangements (such as undisclosed commissions or stock stabilization practices) in the initial public offering's registration statement and by engaging in manipulative practices to artificially inflate the price of ONI's common stock after the initial public offering. The amended complaint also alleges that ONI and the named former officers violated the securities laws on the basis of an alleged failure to disclose the underwriters' alleged compensation arrangements and manipulative practices. No specific amount of damages has been claimed. Similar complaints have been filed against more than 300 other issuers that have had initial public offerings since 1998, and all of these actions have been included in a single coordinated proceeding. Mr. Martin and Ms. Davis have been dismissed from the action without prejudice pursuant to a tolling agreement. In July 2004, following mediated settlement negotiations, the plaintiffs, the issuer defendants (including Ciena), and their insurers entered into a settlement agreement, whereby the plaintiffs' cases against the issuers would be dismissed, the insurers would agree to guarantee a recovery by the plaintiffs from the underwriter defendants of at least \$1 billion, and the issuer defendants would agree to assign or surrender to the plaintiffs certain claims the issuers may have against the underwriters. The settlement agreement did not require Ciena to pay any amount toward the settlement or to make any other payments. In October 2004, the district court certified a class with respect to the Section 10(b) claims in six focus cases selected out of all of the consolidated cases, which cases did not include Ciena, and which decision was appealed by the underwriter defendants to the U.S. Court of Appeals for the Second Circuit. On February 15, 2005, the district court granted the motion filed by the plaintiffs and issuer defendants for preliminary approval of the settlement agreement, subject to certain modifications to the proposed bar order, and on August 31, 2005, the district court issued a preliminary order approving the revised stipulated settlement agreement. On December 5, 2006, the U.S. Court of Appeals for the Second Circuit vacated the district court's grant of class certification in the six focus cases. On April 6, 2007, the Second Circuit denied plaintiffs' petition for rehearing. In light of the Second Circuit's decision, the issuer defendants have informed the district court that the settlement cannot be approved as currently constituted because the defined settlement class cannot be certified. It is unclear whether or not the issuer defendants will be able to renegotiate a settlement with the plaintiffs and insurers that complies with the Second Circuit's mandate. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the matter at this time.

On April 9, 2007, QPSX Developments 5 Pty. Ltd. (a subsidiary of Ipernica Ltd.) filed a complaint in the United States District Court for the Eastern District of Texas against Ciena and several other defendants, alleging that certain of the parties' products infringe U.S. Patent No. 5,689,499. The complaint seeks injunctive relief and damages. We

believe that we have valid defenses to the lawsuit and intend to defend it vigorously.

In addition to the matters described above, we are subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material effect on our results of operations, financial position or cash flows.

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*Some of the statements contained, or incorporated by reference, in this quarterly report discuss future events or expectations, contain projections of results of operations or financial condition, changes in the markets for our products and services, or state other forward-looking information. Ciena's forward-looking information is based on various factors and was derived using numerous assumptions. In some cases, you can identify these forward-looking statements by words like may, will, should, expect, plan, anticipate, believe, estimate, predict, potential or continue or the negative of those words and other comparable words. You should be aware that these statements only reflect our current predictions and beliefs. These statements are subject to known and unknown risks, uncertainties and other factors, and actual events or results may differ materially. Important factors that could cause our actual results to be materially different from the forward-looking statements are disclosed throughout this report, particularly under the heading Risk Factors in Item 1A of Part II of this report below. You should review these risk factors and the rest of this quarterly report in combination with the more detailed description of our business in our annual report on Form 10-K, which we filed with the Securities and Exchange Commission on January 10, 2007, for a more complete understanding of the risks associated with an investment in Ciena's securities. Ciena undertakes no obligation to revise or update any forward-looking statements.*

**Overview**

Ciena Corporation is a supplier of communications networking equipment, software and services that support the delivery and transport of voice, video and data services. Our products are used in communications networks operated by telecommunications service providers, cable operators, governments and enterprises around the globe. We specialize in transitioning legacy communications networks to converged, next-generation architectures, capable of efficiently delivering a broader mix of high-bandwidth services. By improving network productivity, reducing costs and enabling integrated services offerings, our products create business and operational value for our customers.

We introduced our FlexSelect Architecture in response to market demand for cost-efficient, next-generation networks capable of delivering multiple traffic types over a single, converged, multiservice network infrastructure. This standards-based, service-oriented network architecture facilitates our customers' transition to next-generation networks. It combines programmable hardware with service-oriented management functionality, automating delivery and management of a broad mix of services including SONET/SDH, Ethernet, storage and video. The products and features we have introduced under our FlexSelect Architecture enable enhanced network flexibility, adaptability and management, allowing delivery of a broader mix of services and the addition of new services through networks that are more cost-effective to deploy, scale and manage. Our FlexSelect Architecture enables the transition of legacy network infrastructures to an on-demand, service-selectable network that enables cost-effective delivery of services, while preserving the value of customer investment in legacy and existing architectures.

During the second quarter of fiscal 2007, we announced enhancements to our FlexSelect Architecture under our FlexSelect for Ethernet strategy. FlexSelect for Ethernet seeks to apply the attributes of our FlexSelect Architecture approach—network flexibility, adaptability, manageability and assuredness—to carrier Ethernet to simplify and converge the network and deliver high-performance services. In support of our FlexSelect for Ethernet strategy, we introduced two new Ethernet-based product platforms during the second quarter: the CN 3000 Ethernet Access Series and CN 5060 Multiservice Carrier Ethernet Platform. Part of our research and development strategy is to continue to extend Ethernet functionality across our products, developing a comprehensive performance-grade Ethernet portfolio.

As we pursue our FlexSelect Architecture vision, features and functionalities are converging across our product platforms, causing the lines between our product lines to blur and making our historical groupings less relevant in assessing underlying market trends and the effect they have on our business. As a reflection of that convergence, and in an attempt to provide more meaningful data and better reflect the growing significance of application-specific scenarios and other factors as they relate to our financial performance, in this report we discuss our revenue and our business in three major groupings as follows:



*Converged Ethernet Infrastructure.* This group incorporates all products previously in our Optical Networking and Data Networking product groups and related software.

*Ethernet Access.* This group includes all products and related software previously in our Broadband Access product group, as well as our recently announced CN 3000 Ethernet Access Series.

*Global Network Services.* This group continues to include revenue associated with our service, support and training activities.

Revenue was \$193.5 million for the second quarter of fiscal 2007, representing a 47.5% increase from \$131.2 million in the second quarter of fiscal 2006 and a 17.2% sequential increase from \$165.1 million in the first quarter of fiscal 2007. Increased revenue was due primarily to increased sales of converged Ethernet infrastructure products to telecommunications carriers, as these customers continue to invest in their communications networks to address network capacity needs and transition existing networks to support a broader mix of services. Based on our current level of demand, we expect our revenue to continue to increase in the second half of fiscal 2007, albeit at a lower sequential growth rate than that achieved during the second quarter of fiscal 2007. We expect a sizable portion of our revenue growth will come from larger network builds. These projects are often characterized by large and sporadic equipment orders and contract terms that may result in the recognition of significant amounts of revenue at one time. The effect of these larger builds and other factors described elsewhere in this report could cause our revenue results to fluctuate on a quarterly basis.

Consolidation among some of our largest customers continues to affect our concentration of revenue. For the second quarter of fiscal 2007, three customers each accounted for greater than 10% of our revenue and 48.2% in the aggregate. Increased concentration of our revenue over the long term may result in additional risks to our business, including reliance on fewer customers for a larger portion of our revenue, exposure to greater pricing pressure and increased susceptibility to changes in network strategies or reductions in capital expenditures affecting network investments.

Gross margin for the second quarter of fiscal 2007 was 42.3%, down from 44.6% in the first quarter of fiscal 2007. For the second quarter of fiscal 2007, product gross margin was 47.3% and services gross margin was (0.3%). The loss associated with our services revenue was primarily the result of deployment cost overruns incurred in assisting a customer with a large network build and the effect of an increased mix of lower margin installation services. Another contributing factor was increased deployment overhead costs associated with the expansion of our internal resources related to deployment activities for international network infrastructure projects. Our gross margin remains susceptible to fluctuation as a result of customer and product mix in any given quarter and the effect of any changes in our services gross margin.

Operating expense for the second quarter of fiscal 2007 was \$79.1 million, an increase from \$70.8 million in the first quarter of fiscal 2007. As expected, operating expense increased sequentially in absolute terms, but decreased as a percentage of revenue. Operating expense for the second quarter of fiscal 2007 reflects a \$5.3 million increase in sales and marketing expense, primarily related to higher compensation costs. We expect quarterly operating expense to continue to decline as a percentage of revenue during the remainder of fiscal 2007, although it may increase slightly in absolute terms.

Income from operations for the second quarter of fiscal 2007 decreased sequentially from \$2.8 million to \$2.7 million. Net income for the second quarter of fiscal 2007 was \$13.0 million, or \$0.14 per diluted share. This compares with net income of \$11.1 million, or \$0.12 per diluted share, for the first quarter of fiscal 2007.

We generated \$44.6 million in cash from operations during the second quarter of fiscal 2007. This was due to \$31.4 million in cash from net income (adjusted for non-cash charges) and a \$13.2 million net increase in cash resulting from changes in working capital. This compares with \$11.3 million in cash used for operations during the first quarter of fiscal 2007, consisting of \$33.8 million in cash from net income (adjusted for non-cash charges) and a \$45.1 million net decrease in cash resulting from changes in working capital.

At the end of the second quarter of fiscal 2007, \$542.3 million in aggregate principal amount remained outstanding on our 3.75% convertible notes. This remaining principal balance becomes due and payable on February 1, 2008. See

Note 11 to our financial statements for a discussion of our convertible notes and Liquidity and Capital Resources below for a discussion of our cash and cash equivalents, short-term investments and long-term investments at April 30, 2007. We may seek to raise additional capital by issuing additional convertible debt, the proceeds of which could be used to fund the repayment at maturity or earlier repurchase of all or a portion of these convertible notes.

As of April 30, 2007, headcount was 1,683 up from 1,588 at January 31, 2007 and 1,388 at April 30, 2006.

**Results of Operations****Three months ended April 30, 2006 compared to three months ended April 30, 2007***Revenue, cost of goods sold and gross profit*

Cost of goods sold consists of component costs, direct compensation costs, warranty and other contractual obligations, royalties, license fees, direct technical support costs, cost of excess and obsolete inventory and overhead related to manufacturing, technical support and engineering, furnishing and installation ( EF&I ) operations.

The table below (in thousands, except percentage data) sets forth the changes in revenue, cost of goods sold and gross profit from the second quarter of fiscal 2006 to the second quarter of fiscal 2007.

|                          | 2006       | Quarter Ended April 30,<br>%* | 2007       | %*    | Increase<br>(decrease) | %**   |
|--------------------------|------------|-------------------------------|------------|-------|------------------------|-------|
| Revenue:                 |            |                               |            |       |                        |       |
| Products                 | \$ 117,208 | 89.4                          | \$ 173,212 | 89.5  | \$ 56,004              | 47.8  |
| Services                 | 13,967     | 10.6                          | 20,315     | 10.5  | 6,348                  | 45.4  |
| Total revenue            | 131,175    | 100.0                         | 193,527    | 100.0 | 62,352                 | 47.5  |
| Costs:                   |            |                               |            |       |                        |       |
| Products                 | 58,957     | 44.9                          | 91,319     | 47.2  | 32,362                 | 54.9  |
| Services                 | 9,312      | 7.1                           | 20,378     | 10.5  | 11,066                 | 118.8 |
| Total cost of goods sold | 68,269     | 52.0                          | 111,697    | 57.7  | 43,428                 | 63.6  |
| Gross profit             | \$ 62,906  | 48.0                          | \$ 81,830  | 42.3  | \$ 18,924              | 30.1  |

\* Denotes % of total revenue

\*\* Denotes % change from 2006 to 2007

The table below (in thousands, except percentage data) sets forth the changes in product revenue, product cost of goods sold and product gross profit from the second quarter of fiscal 2006 to the second quarter of fiscal 2007.

|                            | 2006       | Quarter Ended April 30,<br>%* | 2007       | %*    | Increase<br>(decrease) | %**  |
|----------------------------|------------|-------------------------------|------------|-------|------------------------|------|
| Product revenue            | \$ 117,208 | 100.0                         | \$ 173,212 | 100.0 | \$ 56,004              | 47.8 |
| Product cost of goods sold | 58,957     | 50.3                          | 91,319     | 52.7  | 32,362                 | 54.9 |
| Product gross profit       | \$ 58,251  | 49.7                          | \$ 81,893  | 47.3  | \$ 23,642              | 40.6 |

\* Denotes % of product revenue

\*\* Denotes % change from 2006 to 2007



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The table below (in thousands, except percentage data) sets forth the changes in service revenue, service cost of goods sold and service gross profit (loss) from the second quarter of fiscal 2006 to the second quarter of fiscal 2007 .

|                            | 2006      | Quarter Ended April 30,<br>%* | 2007      | %*    | Increase<br>(decrease) | %**     |
|----------------------------|-----------|-------------------------------|-----------|-------|------------------------|---------|
| Service revenue            | \$ 13,967 | 100.0                         | \$ 20,315 | 100.0 | \$ 6,348               | 45.4    |
| Service cost of goods sold | 9,312     | 66.7                          | 20,378    | 100.3 | 11,066                 | 118.8   |
| Service gross profit       | \$ 4,655  | 33.3                          | \$ (63)   | (0.3) | \$ (4,718)             | (101.4) |

\* Denotes % of service revenue

\*\* Denotes % change from 2006 to 2007

Revenue from sales to customers outside of the United States is reflected as International in the geographic distribution of revenue below. The table below (in thousands, except percentage data) sets forth the changes in geographic distribution of revenue from the second quarter of fiscal 2006 to the second quarter of fiscal 2007.

|               | 2006       | Quarter Ended April 30,<br>%* | 2007       | Quarter Ended April 30,<br>%* | Increase<br>(decrease) | %**  |
|---------------|------------|-------------------------------|------------|-------------------------------|------------------------|------|
| United States | \$ 95,379  | 72.7                          | \$ 139,663 | 72.2                          | \$ 44,284              | 46.4 |
| International | 35,796     | 27.3                          | 53,864     | 27.8                          | 18,068                 | 50.5 |
| Total         | \$ 131,175 | 100.0                         | \$ 193,527 | 100.0                         | \$ 62,352              | 47.5 |

\* Denotes % of total revenue

\*\* Denotes % change from 2006 to 2007

During the quarter ended April 30, 2006 and 2007, certain customers each accounted for at least 10% of our revenue as follows (in thousands, except percentage data):

|           | 2006      | Quarter Ended April 30,<br>%* | 2007      | Quarter Ended April 30,<br>%* |
|-----------|-----------|-------------------------------|-----------|-------------------------------|
| Company B | \$ 18,101 | 13.8                          | \$ n/a    | n/a                           |
| Company C | 23,114    | 17.6                          | 39,519    | 20.4                          |
| Company D | 13,247    | 10.1                          | n/a       | n/a                           |
| Company F | n/a       | n/a                           | 26,214    | 13.5                          |
| Company G | n/a       | n/a                           | 27,590    | 14.3                          |
| Total     | \$ 54,462 | 41.5                          | \$ 93,323 | 48.2                          |

\* Denotes % of total revenue

n/a Denotes revenue represented less than 10% of total revenue for the period

#### Revenue

**Product revenue** increased from the second quarter of fiscal 2006 to the second quarter of fiscal 2007, due to a \$65.6 million increase in sales of our converged Ethernet infrastructure products. This primarily reflects increases of \$53.9 million in sales of core transport products, \$23.0 million of core switching and \$7.7 million of the CN 4200 FlexSelect Advanced Service Platform, offset by reductions in revenue from our data networking products and other transport and switching products. Sales of our Ethernet access products decreased \$9.6 million during the second quarter of fiscal 2007 in comparison to the prior period as a result of a decline in sales of our broadband access products.

**Service revenue** increased from the second quarter of fiscal 2006 to the second quarter of fiscal 2007, primarily due to increases of \$3.4 million in deployment service sales and \$2.2 million in maintenance and support services.

**United States revenue** increased from the second quarter of fiscal 2006 to the second quarter of fiscal 2007, due a \$51.0 million increase in sales of our converged Ethernet infrastructure products. This primarily reflects increases of \$42.5 million in sales of core transport and \$23.0 million of core switching, offset by reductions in revenue from our data networking products and other transport and switching products. Sales of our Ethernet access products decreased \$9.7 million during the second quarter of fiscal 2007 in comparison to the prior period as a result of a decline in sales of our broadband access products.

**International revenue** increased from the second quarter of fiscal 2006 to the second quarter of fiscal 2007, due to a \$14.6 million increase in sales of our converged Ethernet infrastructure products. This primarily reflects increases of \$11.4 million in sales of core transport products and \$9.8 million of CN 4200 FlexSelect Advanced Service Platform, offset by reductions in revenue from our other transport and switching products. International revenue for the second quarter of fiscal 2007 also reflects a \$3.4 million increase in service revenue, primarily for deployment.

*Gross profit*

**Gross profit as a percentage of revenue** decreased from the second quarter of fiscal 2006 to the second quarter of fiscal 2007 largely due to product and customer mix during the quarter and the decline in services gross margin. Gross margin levels during the second quarter of fiscal 2006 represented an unusually favorable customer and product mix.

**Gross profit on products as a percentage of product revenue** decreased from the second quarter of fiscal 2006 to the second quarter of fiscal 2007, primarily due to product and customer mix.

**Gross profit on services as a percentage of services revenue** decreased significantly from the second quarter of fiscal 2006 to the second quarter of fiscal 2007. Services gross margin was adversely affected during the second quarter of fiscal 2007 by deployment cost overruns incurred in assisting a customer with a large network build and the effect of an increased mix of lower margin installation services. In addition, as expected, services gross margin during the second quarter of fiscal 2007 was negatively affected by increased deployment overhead costs associated with the expansion of our internal resources related to deployment activities for international network infrastructure projects. We expect to continue to encounter these higher costs during the remainder of fiscal 2007 as we transition certain deployment activities from third parties to internal resources.

*Operating expenses*

The table below (in thousands, except percentage data) sets forth the changes in operating expenses from the second quarter of fiscal 2006 to the second quarter of fiscal 2007.

|                                    | 2006      | Quarter Ended April 30,<br>%* | 2007      | %*    | Increase<br>(decrease) | %**     |
|------------------------------------|-----------|-------------------------------|-----------|-------|------------------------|---------|
| Research and development           | \$ 28,856 | 22.0                          | \$ 31,642 | 16.4  | \$ 2,786               | 9.7     |
| Selling and marketing              | 26,657    | 20.3                          | 30,182    | 15.6  | 3,525                  | 13.2    |
| General and administrative         | 11,246    | 8.6                           | 11,707    | 6.0   | 461                    | 4.1     |
| Amortization of intangible assets  | 6,295     | 4.8                           | 6,295     | 3.3   |                        | 0.0     |
| Restructuring costs (recoveries)   | 3,014     | 2.3                           | (734)     | (0.4) | (3,748)                | (124.4) |
| Long-lived asset impairment        | (3)       |                               |           |       | 3                      | (100.0) |
| Recovery of doubtful accounts, net | (247)     | (0.2)                         |           |       | 247                    | (100.0) |
| Gain on lease settlement           | (5,628)   | (4.3)                         |           |       | 5,628                  | (100.0) |
| Total operating expenses           | \$ 70,190 | 53.5                          | \$ 79,092 | 40.9  | \$ 8,902               | 12.7    |

\* Denotes % of total revenue

\*\* Denotes % change from 2006 to 2007

**Research and development expense** increased from the second quarter of fiscal 2006 to the second quarter of fiscal 2007, primarily due to increased headcount at our India development center, increasing employee compensation by \$1.5 million. Prototype expense also increased by \$1.3 million which was partially offset by a decrease in consulting expense of \$0.4 million.

**Selling and marketing expense** increased from the second quarter of fiscal 2006 to the second quarter of fiscal 2007, primarily due to increases of \$2.5 million in employee compensation, \$0.5 million in tradeshow activities and \$0.3 million in travel expense, partially offset by a decrease of \$0.4 million in demonstration equipment costs.

**General and administrative expense** increased from the second quarter of fiscal 2006 to the second quarter of fiscal 2007, primarily due to an increase of \$2.3 million in employee compensation, partially offset by a \$2.1 million decrease in legal fees, primarily associated with our patent litigation with Nortel Networks that was settled in fiscal 2006.

**Amortization of intangible assets costs** was unchanged from the second quarter of fiscal 2006 to the second quarter of fiscal 2007.

**Restructuring costs** during the second quarter of fiscal 2007 reflect an adjustment primarily related to the return to use of a facility that Ciena had previously restructured. Restructuring costs incurred during the second quarter of 2006 were related to a work force reduction of approximately 86 employees and the closure of a facility located in Shrewsbury, NJ.

**Recovery of doubtful accounts, net** for the second quarter of fiscal 2006 was related to the payment of amounts due from customers from whom payment was previously deemed doubtful due to the customers financial condition.

**Gain on lease settlement** for the second quarter of fiscal 2006 was related to the termination of our obligations under the lease for our former Cupertino, CA facility.

*Other items*

The table below (in thousands, except percentage data) sets forth the changes in other items from the second quarter of fiscal 2006 to the second quarter of fiscal 2007.

|                                   | 2006      | Quarter Ended April 30,<br>%* | 2007      | %*  | Increase<br>(decrease) | %**     |
|-----------------------------------|-----------|-------------------------------|-----------|-----|------------------------|---------|
| Interest and other income,<br>net | \$ 11,197 | 8.5                           | \$ 16,897 | 8.7 | \$ 5,700               | 50.9    |
| Interest expense                  | \$ 5,815  | 4.4                           | \$ 6,148  | 3.2 | \$ 333                 | 5.7     |
| Gain on extinguishment of<br>debt | \$ 362    | 0.3                           | \$        |     | \$ (362)               | (100.0) |
| Provision for income taxes        | \$ 370    | 0.3                           | \$ 477    | 0.2 | \$ 107                 | 28.9    |

\* Denotes % of total revenue

\*\* Denotes % change from 2006 to 2007

**Interest and other income, net** increased from the second quarter of fiscal 2006 to the second quarter of fiscal 2007 due to the impact of higher interest rates and an increase in average cash and investment balances primarily due to the proceeds of our April 10, 2006 issuance of 0.25% convertible senior notes. The remaining principal balance of \$542.3 million on our 3.75% convertible notes becomes due and payable on February 1, 2008. The repayment of this amount will decrease our cash and investment balance significantly, reducing our interest income and expense.

**Interest expense** increased slightly from the second quarter of 2006 to the second quarter of 2007, primarily due to our April 10, 2006 issuance of 0.25% convertible notes, partially offset by our repurchase of \$106.5 million in aggregate principal amount of our outstanding 3.75% convertible notes in the first quarter of fiscal 2006.

**Provision for income taxes** for the second quarter of fiscal 2006 and the second quarter of fiscal 2007 was primarily attributable to foreign tax related to Ciena's foreign operations. We will continue to maintain a valuation allowance against all net deferred tax assets until sufficient evidence exists to support its reversal.

***Six months ended April 30, 2006 compared to six months ended April 30, 2007****Revenue, cost of goods sold and gross profit*

The table below (in thousands, except percentage data) sets forth the changes in revenue, cost of goods sold and gross profit from the first six months of fiscal 2006 to the first six months of fiscal 2007.

|               | 2006       | Six Months Ended April 30,<br>%* | 2007       | %*    | Increase<br>(decrease) | %**  |
|---------------|------------|----------------------------------|------------|-------|------------------------|------|
| Revenue:      |            |                                  |            |       |                        |      |
| Products      | \$ 223,149 | 88.7                             | \$ 319,494 | 89.1  | \$ 96,345              | 43.2 |
| Services      | 28,456     | 11.3                             | 39,134     | 10.9  | 10,678                 | 37.5 |
| Total revenue | \$ 251,605 | 100.0                            | \$ 358,628 | 100.0 | 107,023                | 42.5 |
| Costs:        |            |                                  |            |       |                        |      |
| Products      | 119,356    | 47.4                             | 166,298    | 46.4  | 46,942                 | 39.3 |
| Services      | 18,888     | 7.5                              | 36,872     | 10.3  | 17,984                 | 95.2 |

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|                          |            |      |            |      |           |      |
|--------------------------|------------|------|------------|------|-----------|------|
| Total cost of goods sold | 138,244    | 54.9 | 203,170    | 56.7 | 64,926    | 47.0 |
| Gross profit             | \$ 113,361 | 45.1 | \$ 155,458 | 43.3 | \$ 42,097 | 37.1 |

\* Denotes % of total revenue

\*\* Denotes % change from 2006 to 2007

The table below (in thousands, except percentage data) sets forth the changes in product revenue, product cost of goods sold and product gross profit from the first six months of fiscal 2006 to the first six months of fiscal 2007.

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|                            | 2006       | Six Months Ended April 30,<br>%* | 2007       | %*    | Increase<br>(decrease) | %**  |
|----------------------------|------------|----------------------------------|------------|-------|------------------------|------|
| Product revenue            | \$ 223,149 | 100.0                            | \$ 319,494 | 100.0 | \$ 96,345              | 43.2 |
| Product cost of goods sold | 119,356    | 53.5                             | 166,298    | 52.1  | 46,942                 | 39.3 |
| Product gross profit       | \$ 103,793 | 46.5                             | \$ 153,196 | 47.9  | \$ 49,403              | 47.6 |

\* Denotes % of product revenue

\*\* Denotes % change from 2006 to 2007

The table below (in thousands, except percentage data) sets forth the changes in service revenue, service cost of goods sold and service gross profit (loss) from the first six months of fiscal 2006 to the first six months of fiscal 2007.

|                            | 2006      | Six Months Ended April 30,<br>%* | 2007      | %*    | Increase<br>(decrease) | %**    |
|----------------------------|-----------|----------------------------------|-----------|-------|------------------------|--------|
| Service revenue            | \$ 28,456 | 100.0                            | \$ 39,134 | 100.0 | \$ 10,678              | 37.5   |
| Service cost of goods sold | 18,888    | 66.4                             | 36,872    | 94.2  | 17,984                 | 95.2   |
| Service gross profit       | \$ 9,568  | 33.6                             | \$ 2,262  | 5.8   | \$ (7,306)             | (76.4) |

\* Denotes % of service revenue

\*\* Denotes % change from 2006 to 2007

Revenue from sales to customers outside of the United States is reflected as International in the geographic distribution of revenue below. The table below (in thousands, except percentage data) sets forth the changes in geographic distribution of revenue from the first six months of fiscal 2006 to the first six months of fiscal 2007.

|               | 2006       | Six Months Ended April 30,<br>%* | 2007       | %*    | Increase<br>(decrease) | %**  |
|---------------|------------|----------------------------------|------------|-------|------------------------|------|
| United States | \$ 198,049 | 78.7                             | \$ 259,266 | 72.3  | \$ 61,217              | 30.9 |
| International | 53,556     | 21.3                             | 99,362     | 27.7  | 45,806                 | 85.5 |
| Total         | \$ 251,605 | 100.0                            | \$ 358,628 | 100.0 | \$ 107,023             | 42.5 |

\* Denotes % of total revenue

\*\* Denotes % change from



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2006 to 2007

During the first six months of fiscal 2006 and the first six months of fiscal 2007, certain customers each accounted for at least 10% of our revenue as follows (in thousands, except percentage data):

|           | Six Months Ended April 30, |      |            |      |
|-----------|----------------------------|------|------------|------|
|           | 2006                       | %*   | 2007       | %*   |
| Company A | \$ 26,281                  | 10.5 | \$ n/a     | n/a  |
| Company B | 41,595                     | 16.5 | 37,088     | 10.3 |
| Company C | 32,092                     | 12.8 | 71,475     | 19.9 |
| Company E | 25,247                     | 10.0 | n/a        | n/a  |
| Company F | n/a                        | n/a  | 57,206     | 16.0 |
| Total     | \$ 125,215                 | 49.8 | \$ 165,769 | 46.2 |

\* Denotes % of total revenue

n/a Denotes revenue represented less than 10% of total revenue for the period

*Revenue*

**Product revenue** increased from the first six months of fiscal 2006 to the first six months of fiscal 2007, due to a \$121.6 million increase in sales of our converged Ethernet infrastructure products. This reflects increased sales of \$67.2 million in core transport, \$47.4 million of core switching and \$31.6 million of CN 4200 FlexSelect Advanced Service Platform, offset by reductions in revenue from our data networking products and other transport and switching products. Sales of Ethernet access products decreased \$25.2 million in the first six months of fiscal 2007 in comparison to the prior period as a result of a decline in sales of our broadband access products.

**Service revenue** increased from the first six months of fiscal 2006 to the first six months of fiscal 2007, primarily due to increases of \$6.9 million in deployment service sales and \$2.6 million in maintenance and support services.

**United States revenue** increased from the first six months of fiscal 2006 to the first six months of fiscal 2007, due to increased sales of \$50.8 million of core transport and \$47.2 million of core switching, offset by reductions in revenue from our data networking products and other transport and switching products. Sales of our Ethernet access products decreased \$25.3 million during the first six months of fiscal 2007 in comparison to the prior period as a result of a decline in sales of our broadband access products.

**International revenue** increased from the first six months of fiscal 2006 to the first six months of fiscal 2007, due to increases of \$16.4 million in sales of core transport products and \$29.8 million of CN 4200 FlexSelect Advanced Service Platform, offset by reductions in revenue from our other transport and switching products. International revenue for the first six months of fiscal 2007 also reflects a \$6.6 million increase in service revenue, primarily for deployment.

*Gross profit*

**Gross profit as a percentage of revenue** decreased from the first six months of fiscal 2006 to the first six months of fiscal 2007 largely due to the effect of product and customer mix and our significant reduction in services gross margin.

**Gross profit on products as a percentage of product revenue** increased from the first six months of fiscal 2006 to the first six months of fiscal 2007, primarily due to product and customer mix.

**Gross profit on services as a percentage of services revenue** decreased from the first six months of fiscal 2006 to the first six months of fiscal 2007 as a result of the factors described in the quarterly analysis above.

*Operating expenses*

The table below (in thousands, except percentage data) sets forth the changes in operating expenses from the first six months of fiscal 2006 to the first six months of fiscal 2007.

|                                      | Six Months Ended April 30, |       |           |       | Increase<br>(decrease) | %**     |
|--------------------------------------|----------------------------|-------|-----------|-------|------------------------|---------|
|                                      | 2006                       | %*    | 2007      | %*    |                        |         |
| Research and development             | \$ 58,318                  | 23.2  | \$ 61,495 | 17.1  | \$ 3,177               | 5.4     |
| Selling and marketing                | 53,229                     | 21.2  | 55,057    | 15.4  | 1,828                  | 3.4     |
| General and administrative           | 21,142                     | 8.4   | 22,008    | 6.1   | 866                    | 4.1     |
| Amortization of intangible<br>assets | 12,590                     | 5.0   | 12,590    | 3.5   |                        | 0.0     |
| Restructuring costs<br>(recoveries)  | 5,029                      | 2.0   | (1,200)   | (0.3) | (6,229)                | (123.9) |
| Long-lived asset impairment          | (6)                        |       |           |       | 6                      | (100.0) |
|                                      | (2,851)                    | (1.1) | (10)      |       | 2,841                  | (99.6)  |

|                                    |            |       |            |      |           |         |
|------------------------------------|------------|-------|------------|------|-----------|---------|
| Recovery of doubtful accounts, net |            |       |            |      |           |         |
| Gain on lease settlement           | (11,648)   | (4.6) |            |      | 11,648    | (100.0) |
| Total operating expenses           | \$ 135,803 | 54.1  | \$ 149,940 | 41.8 | \$ 14,137 | 10.4    |

\* Denotes % of total revenue

\*\* Denotes % change from 2006 to 2007

**Research and development expense** increased from the first six months of fiscal 2006 to the first six months of fiscal 2007, primarily due to increased headcount at our India development center, increasing employee compensation by \$2.1 million. Prototype expense and travel related expense also increased by \$2.4 and \$0.3 million, respectively. These increases were partially offset by decreases of \$1.1 million in depreciation and \$0.8 million in consulting expense.

**Selling and marketing expense** increased from the first six months of fiscal 2006 to the first six months of fiscal 2007 primarily due to increases of \$2.7 million in employee compensation, \$0.2 million in tradeshow activities and \$0.2 million in travel. This increase was partially offset by a decrease of \$1.5 million in demonstration equipment costs.

**General and administrative expense** increased from the first six months of fiscal 2006 to the first six months of fiscal 2007 primarily due to an increase of \$3.7 million in employee compensation and \$0.3 million in travel related expenses. This was partially offset by a decrease of \$2.8 million in legal expense and \$0.4 million in audit related expenditures. Included in legal fees for the first six months of fiscal 2006 were costs associated with our patent litigation with Nortel Networks.

**Amortization of intangible assets costs** was unchanged from the first six months of fiscal 2006 to the first six months of fiscal 2007.

**Restructuring costs** during the first six months of fiscal 2007 reflect an adjustment primarily related to the return to use of a facility that Ciena had previously restructured. Also included in restructuring costs for first six months of fiscal 2007 was a charge of \$0.1 million related to other costs associated with a previous workforce reduction, offset by a \$1.3 million adjustment related to costs associated with previously restructured facilities. Restructuring costs incurred during the first six months of fiscal 2006 were related to a work force reduction of approximately 148 employees and the closure of a facility in Kanata, Ontario and Shrewsbury, NJ.

**Recovery of doubtful accounts, net** for the first six months of fiscal 2006 was related to the payment of amounts due from customers from whom payment was previously deemed doubtful due to the customers financial condition.

**Gain on lease settlement** for the first six months of fiscal 2006 was related to the termination of our obligations under the leases for our former Fremont, CA and Cupertino, CA facilities.

*Other items*

The table below (in thousands, except percentage data) sets forth the changes in other items from the first six months of fiscal 2006 to the first six months of fiscal 2007.

|                                      | 2006     | Six Months Ended April 30,<br>%* | 2007     | %*  | Increase<br>(decrease) | %**     |
|--------------------------------------|----------|----------------------------------|----------|-----|------------------------|---------|
| Interest and other income,<br>net    | \$20,459 | 8.1                              | \$31,742 | 8.9 | \$ 11,283              | 55.1    |
| Interest expense                     | \$11,868 | 4.7                              | \$12,296 | 3.4 | \$ 428                 | 3.6     |
| Gain (loss) on equity<br>investments | \$ (733) | (0.3)                            | \$       |     | \$ 733                 | (100.0) |
| Gain on extinguishment of<br>debt    | \$ 7,052 | 2.8                              | \$       |     | \$ (7,052)             | (100.0) |
| Provision for income taxes           | \$ 669   | 0.3                              | \$ 898   | 0.3 | \$ 229                 | 34.2    |

\* Denotes % of total revenue

\*\* Denotes % change from 2006 to 2007

**Interest and other income, net** increased from the first six months of fiscal 2006 to the first six months of fiscal 2007 due to the impact of higher interest rates and higher average cash and investments balances primarily due to the proceeds of our April 10, 2006 issuance of 0.25% convertible senior notes.

**Interest expense** increased slightly from the first six months of fiscal 2006 to the first six months of fiscal 2007 primarily due to our April 10, 2006 issuance of 0.25% convertible notes, partially offset by our repurchase of

\$106.5 million in aggregate principal amount of our outstanding 3.75% convertible notes in the first quarter of fiscal 2006.

**Loss on equity investments** for the first six months of fiscal 2006 was due to a decline in the value of our investments in privately held technology companies that was determined to be other than temporary.

**Gain on extinguishment of debt** for the first six months of fiscal 2006 resulted from our repurchase of \$106.5 million of our outstanding 3.75% convertible notes in open market transactions for \$98.4 million. We recorded a gain on the extinguishment of debt in the amount of \$7.1 million, which consists of the \$8.1 million gain from the repurchase of the notes, less \$1.0 million of associated debt issuance costs.

**Provision for income taxes** for the first six months of fiscal 2006 and the first six months of fiscal 2007 was primarily attributable to foreign tax related to Ciena's foreign operations. We will continue to maintain a valuation allowance against all net deferred tax assets until sufficient evidence exists to support its reversal.

**Liquidity and Capital Resources**

At April 30, 2007, our principal source of liquidity was cash and cash equivalents, short-term investments and long-term investments. The following table summarizes our cash and cash equivalents, short-term investments and long-term investments (in thousands):

|  | October 31,<br>2006 | April 30,<br>2007 | Increase<br>(decrease) |
|--|---------------------|-------------------|------------------------|
| Cash and cash equivalents  | \$ 220,164          | \$ 470,306        | \$ 250,142             |
| Short-term investments   | 628,393             | 646,653           | 18,260                 |
| Long-term investments  | 351,407             | 105,556           | (245,851)              |
| Total cash, cash equivalents, short-term and long-term investments | \$ 1,199,964        | \$ 1,222,515      | \$ 22,551              |

The increase in total cash, cash equivalents and short-term and long-term investments during the first six months of fiscal 2007 was primarily related to the collection of our accounts receivable, our net income and the effect of non-cash items described in *Operating Activities* below. Based on past performance and current expectations, we believe that our cash and cash equivalents, short-term investments, long-term investments and cash generated from operations will satisfy our working capital needs, capital expenditures and other liquidity requirements associated with our existing operations through at least the next 12 months.

The following sections review the significant activities that had an impact on our cash during the first six months of fiscal 2007.

***Operating Activities***

The following tables set forth (in thousands) significant components of our \$33.3 million of cash generated by operating activities for the first six months of fiscal 2007.

*Net income*

|            | Six Months<br>Ended<br>April 30,<br>2007 |
|------------|--|
| Net income | \$ 24,066                                |

Our net income for the first six months of fiscal 2007 included the significant non-cash items summarized in the following table (in thousands):

|  |           |
|--|-----------|
| Amortization of intangibles  | \$ 14,525 |
| Share-based compensation costs                                     | 8,937     |
| Depreciation and amortization of equipment, furniture and fixtures | 6,298     |
| Provision for inventory excess and obsolescence                    | 6,385     |
| Provision for warranty   | 7,111     |
| Total significant non-cash charges                                 | \$ 43,256 |

*Accounts Receivable, Net*

Cash consumed by accounts receivable, net increased by \$38.3 million from the end of fiscal 2006 to April 30, 2007. Our accounts receivable balance increased due to higher sales volume, contractual acceptance terms for turnkey deployments affecting the timing of invoicing, and longer payment terms, primarily associated with our international revenue. The increase in our accounts receivable caused our days sales outstanding ( DSO ) to increase from 68 days for fiscal 2006 to 73 days for the first six months of fiscal 2007. We expect that our accounts receivable, net may

fluctuate from quarter to quarter, but generally will increase during the remainder of fiscal 2007, as a result of our expected increase in sales volume and longer customer payment terms.

The following table sets forth (in thousands) changes to our accounts receivable, net of allowance for doubtful accounts receivable, from the end of fiscal 2006 through the first six months of fiscal 2007.

|                          | October 31,<br>2006 | April 30,<br>2007 | Increase<br>(decrease) |
|--------------------------|---------------------|-------------------|------------------------|
| Accounts receivable, net | \$ 107,172          | \$ 145,495        | \$ 38,323              |

*Inventory, Net*

Excluding the non-cash effect of a \$6.4 million provision for excess and obsolescence, cash consumed by inventory for the first six months of fiscal 2007 was \$19.1 million. Ciena's inventory turns increased from 2.5 for fiscal 2006 to 2.8 for the first six months of fiscal 2007. The following table sets forth (in thousands) changes to the components of our inventory from the end of fiscal 2006 through the first six months of fiscal 2007.

|   | October 31,<br>2006 | April 30,<br>2007 | Increase<br>(decrease) |
|---|---------------------|-------------------|------------------------|
| Raw materials                                   | \$ 29,627           | \$ 34,234         | \$ 4,607               |
| Work-in-process                                 | 9,156               | 7,562             | (1,594)                |
| Finished goods                                  | 89,628              | 100,827           | 11,199                 |
| Gross inventory                                 | 128,411             | 142,623           | 14,212                 |
| Provision for inventory excess and obsolescence | (22,326)            | (23,833)          | (1,507)                |
| Inventory, net                                  | \$ 106,085          | \$ 118,790        | \$ 12,705              |

*Accounts payable*

During the first six months of fiscal 2007, we modified our standard vendor payment terms and payment practices from net 30 days to net 45 days. This change, combined with large shipments of inventory toward the end of the second quarter of fiscal 2007, caused an increase in our accounts payable balance by \$30.7 million. The following table sets forth (in thousands) changes in our accounts payable from the end of fiscal 2006 through the first six months of fiscal 2007:

|                  | October 31,<br>2006 | April 30,<br>2007 | Increase<br>(decrease) |
|------------------|---------------------|-------------------|------------------------|
| Accounts payable | \$ 39,277           | \$ 69,942         | \$ 30,665              |

*Restructuring and unfavorable lease commitments*

During the first six months of fiscal 2007, we paid \$4.6 million on leases related to restructured facilities and \$4.9 million on leases associated with unfavorable lease commitments. The following table reflects (in thousands) the balance of liabilities for our restructured facilities and unfavorable lease commitments and the change in these balances from the end of fiscal 2006 through the first six months of fiscal 2007.

|   | October<br>31,<br>2006 | April 30,<br>2007 | Increase<br>(decrease) |
|---|------------------------|-------------------|------------------------|
| Restructuring liabilities   | \$ 8,914               | \$ 7,065          | \$ (1,849)             |
| Unfavorable lease commitments                                     | 8,512                  | 7,653             | (859)                  |
| Long-term restructuring liabilities                               | 26,720                 | 22,694            | (4,026)                |
| Long-term unfavorable lease commitments                           | 32,785                 | 28,596            | (4,189)                |
| Total restructuring liabilities and unfavorable lease commitments | \$ 76,931              | \$ 66,008         | \$ (10,923)            |



*Interest Payable on Ciena's Convertible Notes*

Interest on Ciena's outstanding 3.75% convertible notes, due February 1, 2008, is payable on February 1 and August 1 of each year. Ciena paid \$10.2 million on the 3.75% convertible notes during the first six months of fiscal 2007.

Interest on Ciena's outstanding 0.25% convertible senior notes, due May 1, 2013, is payable on May 1 and November 1 of each year, commencing on November 1, 2006. Ciena paid \$0.4 million on the 0.25% convertible notes during the first six months of fiscal 2007.

The following table reflects (in thousands) the balance of interest payable and the change in this balance from the end of fiscal 2006 through the first six months of fiscal 2007.

|                          | October 31,<br>2006 | April 30,<br>2007 | Increase<br>(decrease) |
|--------------------------|---------------------|-------------------|------------------------|
| Accrued interest payable | \$5,502             | \$5,459           | \$(43)                 |
| <i>Deferred revenue</i>  |                     |                   |                        |

During the first six months of fiscal 2007, deferred revenue increased by \$19.5 million. The increase in product deferred revenue was due to payments received in advance of our ability to recognize revenue. The increase in service deferred revenue is related to payment for service contracts that will be recognized over the contract term. The following table reflects (in thousands) the balance of deferred revenue and the change in this balance from the end of fiscal 2006 through the first six months of fiscal 2007.

|                        | October 31,<br>2006 | April 30,<br>2007 | Increase<br>(decrease) |
|------------------------|---------------------|-------------------|------------------------|
| Products               | \$ 4,276            | \$ 18,243         | \$ 13,967              |
| Services               | 36,400              | 41,925            | 5,525                  |
| Total deferred revenue | \$ 40,676           | \$ 60,168         | \$ 19,492              |

### **Financing Activities**

Cash provided by financing activities during the first six months of fiscal 2007 was related to the exercise of employee stock options for exercise prices aggregating \$6.1 million.

### **Contractual Obligations**

During the second quarter of fiscal 2007, we did not experience material changes, outside of the ordinary course of business, in our contractual obligations from those reported in our Form 10-K for the year ended October 31, 2006. The following is a summary of our future minimum payments under contractual obligations as of April 30, 2007 (in thousands):

|                          | Total        | Less than<br>one year | One to<br>three<br>years | Three to<br>five<br>years | Thereafter |
|--------------------------|--------------|-----------------------|--------------------------|---------------------------|------------|
| Convertible notes (1)    | \$ 867,472   | \$ 563,347            | \$ 1,500                 | \$ 1,500                  | \$ 301,125 |
| Operating leases         | 123,153      | 26,017                | 47,777                   | 29,798                    | 19,561     |
| Purchase obligations (2) | 101,220      | 101,220               |                          |                           |            |
| Total                    | \$ 1,091,845 | \$ 690,584            | \$ 49,277                | \$ 31,298                 | \$ 320,686 |

(1) The \$542.3 million in outstanding principal balance on our 3.75% convertible notes becomes due and payable on February 1,

2008.

- (2) Purchase obligations relate to amounts we are obligated to pay to our contract manufacturers and component suppliers for inventory.

Some of our commercial commitments and other obligations, including some of the future minimum payments set forth above, are secured by standby letters of credit. The following is a summary of our commitments secured by standby letters of credit by commitment expiration date as of April 30, 2007 (in thousands):

|                           | Total     | Less than<br>one<br>year | One to<br>three<br>years | Three to<br>five<br>years | Thereafter |
|---------------------------|-----------|--------------------------|--------------------------|---------------------------|------------|
| Standby letters of credit | \$ 14,299 | \$ 8,931                 | \$ 5,368                 | \$                        | \$         |

### **Off-Balance Sheet Arrangements**

Ciena does not engage in any off-balance sheet financing arrangements. In particular, we do not have any interest in so-called limited purpose entities, which include special purpose entities (SPEs) and structured finance entities.

### **Critical Accounting Policies and Estimates**

The preparation of consolidated financial statements requires Ciena to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we reevaluate our estimates, including those related to bad debts, inventories, investments, intangible assets, goodwill, income taxes, warranty obligations, restructuring, and contingencies and litigation. Ciena bases its estimates on historical experience and on various other assumptions that we believe to be reasonable under the circumstances. Among other things, these estimates form the basis for judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

### **Revenue Recognition**

Ciena recognizes revenue in accordance with Staff Accounting Bulletin (SAB) No. 104, Revenue Recognition, which states that revenue is realized or realizable and earned when all of the following criteria are met: persuasive evidence of an arrangement exists; delivery has occurred or services have been rendered; the price to the buyer is fixed or determinable; and collectibility is reasonably assured. In instances where final acceptance of the product, system, or solution is specified by the customer, revenue is deferred until all acceptance criteria have been met. Revenue for maintenance services is generally deferred and recognized ratably over the period during which the services are to be performed.

Some of our communications networking equipment is integrated with software that is essential to the functionality of the equipment. We provide unspecified software upgrades and enhancements related to the equipment through our maintenance contracts for these products. Accordingly, we account for revenue in accordance with Statement of Position No. 97-2, Software Revenue Recognition, and all related interpretations. Revenue is recognized when persuasive evidence of an arrangement exists, delivery has occurred, the fee is fixed or determinable, and collectibility is reasonably assured. In instances where final acceptance of the product is specified by the customer, revenue is deferred until all acceptance criteria have been met. Customer purchase agreements and customer purchase orders are generally used to determine the existence of an arrangement. Shipping documents and customer acceptance, when applicable, are used to verify delivery. We assess whether the fee is fixed or determinable based on the payment terms associated with the transaction and whether the sales price is subject to refund or adjustment. We assess collectibility based primarily on the creditworthiness of the customer as determined by credit checks and analysis, as well as the customer's payment history. When a sale involves multiple elements, such as sales of products that include services, the entire fee from the arrangement is allocated to each respective element based on its relative fair value and recognized when revenue recognition criteria for each element are met. The amount of product and service revenue recognized is affected by our judgments as to whether an arrangement includes multiple elements and, if so, whether vendor-specific objective evidence of fair value exists. Changes to the elements in an arrangement and our ability to establish vendor-specific objective evidence for those elements could affect the timing of revenue recognition. Our total deferred revenue for products was \$4.3 million and \$18.2 million as of October 31, 2006 and April 30, 2007, respectively. Our service revenue is deferred and recognized ratably over the period during which the services are to be performed. Our total deferred revenue for services was \$36.4 million and \$42.0 million as of October 31, 2006 and April 30, 2007, respectively.

### **Share-Based Compensation**

On November 1, 2005, Ciena adopted SFAS 123(R), Shared-Based Payment, which requires the measurement and recognition of compensation expense, based on estimated fair values, for all share-based awards, made to employees and directors, including stock options, restricted stock, restricted stock units and participation in Ciena's employee stock purchase plan. Share-based compensation expense recognized in Ciena's consolidated statement of operations includes compensation expense for share-based awards granted (i) prior to, but not yet vested as of October 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123, and (ii) subsequent to October 31, 2005, based on the grant date fair value estimated in accordance with the provisions of SFAS 123(R).



We estimate the fair value of stock options granted using the Black-Scholes option-pricing model. This option pricing model requires the input of highly subjective assumptions, including the option's expected life and the price volatility of the underlying stock. The expected life of employee stock options represents the weighted-average period the stock options are expected to remain outstanding. Because Ciena considers its options to be plain vanilla we calculate the expected term using the simplified method as prescribed in Staff Accounting Bulletin (SAB) 107. Under SAB 107, options are considered to be plain vanilla if they have the following basic characteristics: granted at-the-money; exercisability is conditioned upon service through the vesting date; termination of service prior to vesting results in forfeiture; limited exercise period following termination of service; and options are non-transferable and non-hedgeable. The expected stock price volatility was determined using a combination of historical and implied volatility of Ciena's common stock. The fair value is then amortized ratably over the requisite service periods of the awards, which is generally the vesting period. Because share-based compensation expense is based on awards that are ultimately expected to vest, the amount of expense takes into account estimated forfeitures. SFAS 123(R) requires forfeitures to be estimated at the time of grant and revised, if necessary, in subsequent periods if actual forfeitures differ from those estimates. Changes in these inputs and assumptions can materially affect the measure of estimated fair value of our share-based compensation. See Note 14 for information regarding Ciena's treatment of share based compensation.

#### ***Reserve for Inventory Obsolescence***

Ciena writes down inventory that has become obsolete or unmarketable by an amount equal to the difference between the cost of inventory and the estimated market value based on assumptions about future demand and market conditions. During the first six months of fiscal 2007, Ciena recorded a charge of \$6.4 million primarily related to excess inventory due to a change in forecasted sales for certain products. In an effort to limit our exposure to delivery delays and to satisfy customer needs for shorter delivery terms, we have transitioned certain manufacturing operations from the build-to-order model we have used in recent years, to a build-to-forecast model across our product lines. This change in our inventory purchases exposes us to the risk that our customers will not order those products for which we have forecasted sales, or will purchase less than we have forecasted. If actual market conditions differ from those we have assumed, we may be required to take additional inventory write-downs or benefits.

#### ***Restructuring***

As part of its restructuring costs, Ciena provides for the estimated cost of the net lease expense for facilities that are no longer being used. The provision is equal to the fair value of the minimum future lease payments under our contracted lease obligations, offset by the fair value of the estimated sublease payments that we may receive. As of April 30, 2007, Ciena's accrued restructuring liability related to net lease expense and other related charges was \$29.8 million. The total minimum lease payments for these restructured facilities are \$40.0 million. These lease payments will be made over the remaining lives of our leases, which range from one month to twelve years. If actual market conditions are different than those we have projected, we are required to recognize additional restructuring costs or benefits associated with these facilities. During fiscal 2006, we recognized net adjustments resulting in restructuring costs of \$9.2 million, which included a \$10.0 million adjustment during the third quarter of fiscal 2006 relating to our unused San Jose, CA facilities. Activity during fiscal 2007 is insignificant.

#### ***Allowance for Doubtful Accounts***

Ciena's allowance for doubtful accounts receivable is based on our assessment, on a specific identification basis, of the collectibility of customer accounts. Ciena performs ongoing credit evaluations of its customers and generally has not required collateral or other forms of security from its customers. In determining the appropriate balance for Ciena's allowance for doubtful accounts receivable, management considers each individual customer account receivable in order to determine collectibility. In doing so, management considers creditworthiness, payment history, account activity and communication with such customer. If a customer's financial condition changes, Ciena may be required to take a charge for an allowance for doubtful accounts receivable.

#### ***Goodwill***

At April 30, 2007, Ciena's consolidated balance sheet included \$232.0 million in goodwill. In accordance with SFAS 142, Ciena tests its goodwill for impairment on an annual basis, which Ciena has determined to be the last business day of fiscal September each year, and between annual tests if an event occurs or circumstances change that

would, more likely than not, reduce the fair value of the reporting unit below its carrying value. If actual market conditions differ or forecasts change at the time of our annual assessment in fiscal 2007 or in periods prior to our annual assessment, we may be required to record additional goodwill impairment charges.

### ***Intangible Assets***

As of April 30, 2007, Ciena's consolidated balance sheet included \$76.7 million in other intangible assets, net. We account for the impairment or disposal of long-lived assets such as equipment, furniture, fixtures, and other intangible assets in accordance with the provisions of SFAS 144. In accordance with SFAS 144, Ciena tests each intangible asset for impairment whenever events or changes in circumstances indicate that the asset's carrying amount may not be recoverable. If actual market conditions differ or forecasts change, we may be required to record additional impairment charges in future periods.

### ***Investments***

As of April 30, 2007 Ciena's marketable debt investments had unrealized losses of \$0.5 million. The gross unrealized losses, related to marketable debt investments, were primarily due to changes in interest rates. Ciena's management has determined that the gross unrealized losses on its marketable debt investments at April 30, 2007 are temporary in nature because Ciena has the ability and intent to hold these investments until a recovery of fair value, which may be maturity.

As of April 30, 2007, Ciena's minority investments in privately held technology companies were \$6.7 million. These investments are generally carried at cost because Ciena owns less than 20% of the voting equity and does not have the ability to exercise significant influence over any of these companies. These investments are inherently high risk as the market for technologies or products manufactured by these companies are usually early stage at the time of the investment by Ciena and such markets may never materialize or become significant. Ciena could lose its entire investment in some or all of these companies. Ciena monitors these investments for impairment and makes appropriate reductions in carrying values when necessary. If market conditions, expected financial performance or the competitive position of the companies in which we invest deteriorate, Ciena may be required to record an additional charge in future periods.

### ***Deferred Tax Valuation Allowance***

As of April 30, 2007, Ciena has recorded a valuation allowance of \$1.2 billion against our net deferred tax assets of \$1.2 billion. We calculated the valuation allowance in accordance with the provisions of SFAS 109, Accounting for Income Taxes, which requires an assessment of both positive and negative evidence when measuring the need for a valuation allowance. Evidence such as operating results during the most recent three-year period is given more weight than forecasted results, due to our current lack of visibility and the degree of uncertainty that we will achieve the level of future profitability needed to record the deferred assets. Our cumulative loss in the most recent three-year period represents sufficient negative evidence to require a valuation allowance under the provisions of SFAS 109. We intend to maintain a valuation allowance until sufficient positive evidence exists to support its reversal.

### ***Warranty***

The liability for product warranties, included in other accrued liabilities, was \$33.5 million as of April 30, 2007. Our products are generally covered by a warranty for periods ranging from one to five years. Ciena accrues for warranty costs as part of our cost of sales based on associated material costs, technical support labor costs, and associated overhead. Material cost is estimated based primarily upon historical trends in the volume of product returns within the warranty period and the cost to repair or replace the equipment. Technical support labor cost is estimated based primarily upon historical trends and the cost to support the customer cases within the warranty period.

### ***Item 3. Quantitative and Qualitative Disclosures About Market Risk***

The following discussion about Ciena's market risk disclosures involves forward-looking statements. Actual results could differ materially from those projected in the forward-looking statements. Ciena is exposed to market risk related to changes in interest rates and foreign currency exchange rates. Ciena does not use derivative financial instruments for speculative or trading purposes.

***Interest Rate Sensitivity.*** Ciena maintains a short-term and long-term investment portfolio. See Note 4 to the financial statements for information relating to fair value. These available-for-sale securities are subject to interest rate risk and will fall in value if market interest rates increase. If market interest rates were to increase immediately and uniformly by 10% from levels at April 30, 2007, the fair value of the portfolio would decline by approximately \$46.8 million.





**Foreign Currency Exchange Risk.** As a global concern, Ciena faces exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve and if our exposure increases, adverse movement in foreign currency exchange rates could have a material adverse impact on Ciena's financial results. Historically, Ciena's primary exposures have been related to non-dollar denominated operating expenses in Europe and Asia where Ciena sells primarily in U.S. dollars. Ciena is prepared to hedge against fluctuations in foreign currency if this exposure becomes material. As of April 30, 2007, the assets and liabilities of Ciena related to non-dollar denominated currencies were not material. Therefore, we do not expect an increase or decrease of 10% in the foreign exchange rate would have a material impact on Ciena's financial position.

**Item 4. Controls and Procedures**

**Disclosure Controls and Procedures**

As of the end of the period covered by this report, Ciena carried out an evaluation under the supervision and with the participation of Ciena's management, including Ciena's Chief Executive Officer and Chief Financial Officer, of Ciena's disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended). Based upon this evaluation, Ciena's Chief Executive Officer and Chief Financial Officer concluded that Ciena's disclosure controls and procedures were effective as of the end of the period covered by this report.

**Changes in Internal Control over Financial Reporting**

There was no change in Ciena's internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934, as amended) during the most recently completed fiscal quarter that has materially affected, or is reasonably likely to materially affect, Ciena's internal control over financial reporting.

**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings**

On October 3, 2000, Stanford University and Litton Systems filed a complaint in the United States District Court for the Central District of California against Ciena and several other defendants, alleging that optical fiber amplifiers incorporated into certain of those parties' products infringe U.S. Patent No. 4,859,016 (the '016 Patent'). The complaint seeks injunctive relief, royalties and damages. On October 10, 2003, the court stayed the case pending final resolution of matters before the U.S. Patent and Trademark Office (the PTO), including a request for and disposition of a reexamination of the '016 Patent. On October 16, 2003 and November 2, 2004, the PTO granted reexaminations of the '016 Patent, resulting in a continuation of the stay of the case. On September 11, 2006, the PTO issued a Notice of Intent to Issue a Reexamination Certificate and Statement of Reasons for Patentability/Confirmation, stating its intent to confirm certain claims of the '016 Patent. Thereafter, on September 19, 2006, Litton Systems filed a status report in which it requested that the district court lift the stay of the case, which request was denied by the district court on October 13, 2006. We believe that we have valid defenses to the lawsuit and intend to defend it vigorously in the event the stay of the case is lifted.

As a result of our merger with ONI Systems Corp. in June 2002, Ciena became a defendant in a securities class action lawsuit. Beginning in August 2001, a number of substantially identical class action complaints alleging violations of the federal securities laws were filed in the United States District Court for the Southern District of New York. These complaints name ONI, Hugh C. Martin, ONI's former chairman, president and chief executive officer; Chris A. Davis, ONI's former executive vice president, chief financial officer and administrative officer; and certain underwriters of ONI's initial public offering as defendants. The complaints were consolidated into a single action, and a consolidated amended complaint was filed on April 24, 2002. The amended complaint alleges, among other things, that the underwriter defendants violated the securities laws by failing to disclose alleged compensation arrangements (such as undisclosed commissions or stock stabilization practices) in the initial public offering's registration statement and by engaging in manipulative practices to artificially inflate the price of ONI's common stock after the initial public offering. The amended complaint also alleges that ONI and the named former officers violated the securities laws on the basis of an alleged failure to disclose the underwriters' alleged compensation arrangements and manipulative practices. No specific amount of damages has been claimed. Similar complaints have been filed against more than 300 other issuers that have had initial public offerings since 1998, and all of these actions have been included in a single coordinated proceeding. Mr. Martin and Ms. Davis have been dismissed from the action without prejudice pursuant to a tolling agreement. In July 2004, following mediated settlement negotiations, the plaintiffs, the issuer defendants (including Ciena), and their insurers entered into a settlement agreement, whereby the plaintiffs' cases against the issuers would be dismissed, the insurers would agree to guarantee a recovery by the plaintiffs from the underwriter defendants of at least \$1 billion, and the issuer defendants would agree to assign or surrender to the plaintiffs certain claims the issuers may have against the underwriters. The settlement agreement did not require Ciena to pay any amount toward the settlement or to make any other payments. In October 2004, the district court certified a class with respect to the Section 10(b) claims in six focus cases selected out of all of the consolidated cases, which cases did not include Ciena, and which decision was appealed by the underwriter defendants to the U.S. Court of Appeals for the Second Circuit. On February 15, 2005, the district court granted the motion filed by the plaintiffs and issuer defendants for preliminary approval of the settlement agreement, subject to certain modifications to the proposed bar order, and on August 31, 2005, the district court issued a preliminary order approving the revised stipulated settlement agreement. On December 5, 2006, the U.S. Court of Appeals for the Second Circuit vacated the district court's grant of class certification in the six focus cases. On April 6, 2007, the Second Circuit denied plaintiffs' petition for rehearing. In light of the Second Circuit's decision, the issuer defendants have informed the district court that the settlement cannot be approved as currently constituted because the defined settlement class cannot be certified. It is unclear whether or not the issuer defendants will be able to renegotiate a settlement with the plaintiffs and insurers that complies with the Second Circuit's mandate. Due to the inherent uncertainties of litigation, we cannot accurately predict the ultimate outcome of the matter at this time.

On April 9, 2007, QPSX Developments 5 Pty. Ltd. (a subsidiary of Ipernica Ltd.) filed a complaint in the United States District Court for the Eastern District of Texas against Ciena and several other defendants, alleging that certain of the parties' products infringe U.S. Patent No. 5,689,499. The complaint seeks injunctive relief and damages. We believe that we have valid defenses to the lawsuit and intend to defend it vigorously.

In addition to the matters described above, we are subject to various legal proceedings, claims and litigation arising in the ordinary course of business. While the outcome of these matters is currently not determinable, we do not expect that the ultimate costs to resolve these matters will have a material effect on our results of operations, financial position or cash flows.

**Item 1A. Risk Factors**

Investing in our securities involves a high degree of risk. In addition to the other information contained in this report, you should consider the following risk factors before investing in our securities.

**We face intense competition that could hurt our sales and profitability.**

The markets in which we compete for sales of networking equipment, software and services are extremely competitive, particularly the market for sales to telecommunications service providers. Competition in these markets is based on any one or a combination of the following factors: price, functionality, manufacturing capability, installation, services, existing business and customer relationships, scalability and the ability of products and services to meet the immediate and future network requirements of customers. A small number of very large companies have historically dominated the communications networking equipment industry. Many of our competitors have substantially greater financial, technical and marketing resources, greater manufacturing capacity and better established relationships with telecommunications carriers and other potential customers than we do. Recent consolidation activity among large networking equipment providers has caused some of our competitors to grow even larger, which may magnify their strategic advantages. On November 30, 2006, Alcatel completed its acquisition of Lucent. In June 2006, Nokia and Siemens agreed to combine their communications service provider businesses to create a new joint venture, and in January 2006, Ericsson completed its acquisition of certain key assets of Marconi Corporation plc's telecommunications business. These mergers may adversely affect our competitive position.

We also compete with a number of smaller companies that provide significant competition for a specific product, application, customer segment or geographic market. These competitors often base their products on the latest available technologies. Due to the narrower focus of their efforts, these competitors may achieve commercial availability of their products more quickly and may be more attractive to customers.

Increased competition in our markets has resulted in aggressive business tactics, including:  
significant price competition, particularly from competitors in Asia;

early announcements of competing products and extensive marketing efforts;

one-stop shopping options;

competitors offering to repurchase our equipment from existing customers;

customer financing assistance;

marketing and advertising assistance;

competitors offering equity ownership positions to customers; and

intellectual property assertions and disputes.

The tactics described above can be particularly effective in an increasingly concentrated base of potential customers such as telecommunications service providers. If we fail to compete successfully in our markets our sales and profitability would suffer.

**Our revenue and operating results can fluctuate unpredictably from quarter to quarter.**

Our revenue can fluctuate unpredictably from quarter to quarter. Fluctuations in our revenue can lead to even greater fluctuations in our operating results. Our budgeted expense levels depend in part on our expectations of future revenue. Any substantial adjustment to expenses to account for lower levels of revenue is difficult and takes time. Consequently, if our revenue declines, our levels of inventory, operating expense and general overhead would be high relative to revenue, resulting in additional operating losses.

Other factors contribute to fluctuations in our revenue and operating results, including:

the level of demand for our products and the timing and size of customer orders, particularly from large telecommunications carrier customers;

satisfaction of contractual customer acceptance criteria and related revenue recognition requirements;

delays, changes to or cancellation of orders from customers;

the availability of an adequate supply of components and sufficient manufacturing capacity;

the introduction of new products by us or our competitors;

the effects of consolidation of our customers, including our exposure to any changes in network strategy or reductions in capital expenditures for network infrastructure equipment;

readiness of customer sites for installation; and

changes in general economic conditions as well as those specific to our market segments.

Many of these factors are beyond our control, particularly in the case of large carrier orders and multi-vendor or multi-technology network infrastructure builds where the achievement of certain performance thresholds for acceptance is subject to the readiness and performance of the customer or other providers, and changes in customer requirements or installation plans. As a consequence, our revenue and operating results for a particular quarter may be difficult to predict and our prior results are not necessarily indicative of results likely in future periods. Any one or a combination of the factors above may cause our revenue and operating results to fluctuate from quarter to quarter.

**Our gross margin may fluctuate from quarter to quarter and may be adversely affected by a number of factors, some of which are beyond our control.**

Our gross margin fluctuates from quarter to quarter and may be adversely affected by numerous factors, including: increased price competition;

customer, product and service mix in any period;

the effect of fluctuation in our services gross margin, which may decrease during the remainder of fiscal 2007 due to expected higher costs relating to the expansion of our internal resources for certain deployment activities;

sales volume during the period;

charges for excess or obsolete inventory;

changes in the price or availability of components for our products;

our ability to continue to reduce product manufacturing costs;

introduction of new products, with initial sales at relatively small volumes with resulting higher production costs; and

increased warranty or repair costs.

The factors discussed above regarding fluctuations in revenue and operating results can also affect our gross margin. Fluctuations in gross margin may make it difficult to maintain profitability. As a consequence, our gross margin for a particular quarter may be difficult to predict and our prior results are not necessarily indicative of results

likely in future periods.

**A small number of telecommunication service provider customers account for a significant portion of our revenue, which could adversely affect our business, financial condition and results of operations.**

Primarily as a result of recent combinations between large service providers, our revenue has become increasingly concentrated among a relatively small number of customers. For the second quarter of fiscal 2007, three customers each accounted for greater than 10% of our revenue and 48.2% in the aggregate.

Consolidation of large telecommunication service providers is resulting in increased concentration of customer purchasing power and may result in a smaller number of large network infrastructure builds. This in turn may lead to constraints on pricing, fluctuations in revenue, increases in costs to meet demands of large customers and pressure to accept onerous contract terms. In addition, because a significant part of our revenue remains concentrated among telecommunications service providers, our business could be exposed to risks associated with a market-wide change in business prospects, competitive pressures or other conditions affecting telecommunications carriers. Any of these developments, or the loss of, or significant reductions in spending by, one or more of our large customers could have a material adverse effect on our business, financial condition and results of operations.

**Network equipment sales to large communications service providers often involve lengthy sales cycles and protracted contract negotiations and may require us to assume terms or conditions that negatively affect our pricing, payment and timing of revenue recognition.**

In recent years we have sought to add large communication service providers as customers for our products, software and services. Our future success will depend on our ability to maintain and expand our sales to these existing customers and add new customers. Sales to large communications service providers typically involve lengthy sales cycles, protracted or difficult contract negotiations, and extensive product testing and network certification. We are sometimes required to assume terms or conditions that negatively affect pricing, payment and the timing of revenue recognition in order to consummate a sale. This may negatively affect the timing of revenue recognition, which would, in turn, negatively affect our revenue and results of operations. Communications service providers may ultimately insist upon terms and conditions that we deem too onerous or not in our best interest. Moreover, our customers are typically not contractually obligated to purchase a certain amount of products or services from us and often have the right to reduce, delay or even cancel previous orders. As a result, we may incur substantial expenses and devote time and resources to potential relationships that never materialize or result in lower than anticipated sales.

**Investment of research and development resources in technologies for which there is not a matching market opportunity, or failure to sufficiently or timely invest in technologies for which there is market demand, would adversely affect our revenue and profitability.**

The market for communications networking equipment is characterized by rapidly evolving technologies and changes in market demand. To succeed in this market, we must continue to invest in research and development to enhance our existing products and create new ones. There is often a lengthy period between commencing a development initiative and bringing the new or revised product to market, and during this time, technology or the market may move in directions we did not anticipate. There is a significant possibility, therefore, that at least some of our development decisions will not turn out as anticipated, and that our investment in a project will be unprofitable. There is also a possibility that we may miss a market opportunity because we fail to invest, or invest too late, in a new product or an enhancement of an existing product that could have been highly profitable. Changes in the market may also cause us to discontinue previously planned investments in products, which can have a disruptive effect on relationships with customers that were anticipating the availability of a new product or feature. If we fail to make the right investments and to make them at the right time, our competitive position may suffer and our revenue and profitability could be harmed.

**Product performance problems could damage our business reputation and negatively affect our results of operations.**

The development and production of new products, and enhancements to existing products, are complicated and often involve problems with software, components and manufacturing methods. Due to the complexity of these products, some of them can be fully tested only when deployed in communications networks or with other equipment. We have introduced new or upgraded products recently and expect to continue to enhance and extend our product portfolio. Product performance problems are often more acute for initial deployments of new products and product enhancements. In addition, initial deployments of new or enhanced products, particularly into the networks of telecommunications carriers, often require costly and rigorous testing and satisfaction by certain standard setting organizations. Modifying our products to enable customers to integrate them into a new type of network architecture can entail added costs and risks. If significant reliability, quality, or network monitoring problems develop as a result of our product development, manufacturing or integration, a number of negative effects on our business could result,

including:

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increased costs associated with addressing software or hardware defects, including service and warranty expenses;

payment of liquidated damages for performance failures or delays;

high inventory obsolescence expense;

delays in collecting accounts receivable;

cancellation or reduction in orders from customers; and

damage to our reputation or legal actions by customers or end users.

Because we outsource manufacturing to contract manufacturers and use a direct order fulfillment model for certain of our products, we may be subject to product performance problems resulting from the acts or omissions of these third parties. These product performance problems could damage our business reputation and negatively affect our business and results of operations.

**We may be required to write off significant amounts of inventory as a result of our inventory purchase practices, the convergence of our product lines and our supplier transitions.**

To avoid delays and meet customer demand for shorter delivery terms, we place orders with our contract manufacturers and suppliers to manufacture components and complete assemblies based on forecasts of customer demand. As a result, our inventory purchases exposes us to the risk that our customers will not order those products for which we have forecasted sales, or will purchase fewer than the number of products we have forecasted. Our purchase agreements generally do not require that a customer guarantee any minimum purchase level and customers often may modify, reduce or cancel purchase quantities. As a result, we may purchase inventory based on forecasted sales and in anticipation of purchases that never come to fruition. Historically, we have been required to write off inventory as a result of the factors above. As features and functionalities converge across our product lines, we face an increased risk that customers may elect to forego purchases of a product we have inventoried in favor of purchasing another product.

In addition, we may be exposed to write offs due to significant inventory purchases deemed necessary in connection with the transition from one supplier to another, or resulting from a supplier's decision to discontinue the manufacture of certain components necessary for our products. We may also be required to write off inventory as a result of the effect of environmental regulations such as the Restriction of the Use of Certain Hazardous Substances (RoHS), adopted by the European Union. As a result of previous component purchases that we based on forecasted sales, we currently hold inventory that includes non-compliant components. If we are unable to locate alternate demand for these non-compliant components outside of the European Union, we may be required to write off or write down this inventory. If we are required to write off or write down inventory, we may incur an accounting charge that could materially affect our results of operations for the quarter in which such charge occurs.

**Shortages in component supply or manufacturing capacity could increase our costs, adversely affect our results of operations and constrain our ability to grow our business.**

As we have expanded our product portfolio, increased our use of contract manufacturers and increased our product sales in recent years, manufacturing capacity and supply constraints related to components and subsystems have become increasingly significant issues for us. We have encountered component shortages that have affected our operations and ability to deliver products in a timely manner. Growth in customer demand for the communications networking products supplied by us, our competitors and other third parties, has resulted in supply constraints among providers of some components used in our products. In addition, environmental regulations, such as RoHS adopted by the European Union, have resulted in increased demand for compliant components from suppliers. As a result, we may experience delays or difficulty obtaining compliant components from suppliers. Component shortages and manufacturing capacity constraints may also arise, or be exacerbated by difficulties with our suppliers or contract manufacturers, or our failure to adequately forecast our component or manufacturing needs. If shortages or delays

occur or persist, the price of required components may increase, or the components may not be available at all. If we are unable to secure the components or subsystems that we require at reasonable prices, or are unable to secure manufacturing capacity adequate to meet our needs, we may experience delivery delays and may be unable to satisfy our contractual obligations to customers. These delays may cause us to incur liquidated damages to customers and negatively affect our revenue and gross margin. Shortages in component supply or manufacturing capacity could also limit our opportunities to pursue additional growth or revenue opportunities and could harm our business reputation and customer relationships.

**We may not be successful in selling our products into new markets and developing and managing new sales channels.**

We continue to take steps to sell our expanded product portfolio into new geographic markets and to a broader customer base, including enterprises, cable operators, wireless operators and federal, state and local governments. We have less experience in these markets and believe, in order to succeed in these markets, we must develop and manage new sales channels and distribution arrangements. We expect these relationships to be an increasingly important part of the growth of our business and our efforts to increase revenue. Because we have only limited experience in developing and managing such channels, we may not be successful in reaching additional customer segments, expanding into new geographic regions, or reducing the financial risks of entering new markets and pursuing new customer segments. We may expend time, money and other resources on channel relationships that are ultimately unsuccessful. In addition, sales to federal, state and local governments require compliance with complex procurement regulations with which we have little experience. We may be unable to increase our sales to government contractors if we determine that we cannot comply with applicable regulations. Our failure to comply with regulations for existing contracts could result in civil, criminal or administrative proceedings involving fines and suspension or debarment from federal government contracts. Failure to manage additional sales channels effectively would limit our ability to succeed in these new markets and could adversely affect our ability to grow our customer base and revenue.

**We may experience delays in the development and enhancement of our products that may negatively affect our competitive position and business.**

Because our products are based on complex technology, we can experience unanticipated delays in developing, improving, manufacturing or deploying them. Each step in the development life cycle of our products presents serious risks of failure, rework or delay, any one of which could decrease the timing and cost-effective development of such products and could affect customer acceptance of such products. Unexpected intellectual property disputes, failure of critical design elements, and a host of other execution risks may delay or even prevent the introduction of these products. Our development efforts may also be affected, particularly in the near term, by the transfer of some of our research and development activity to our facility in India. Modification of research and development strategies and changes in allocation of resources could be disruptive to our development efforts. If we do not develop and successfully introduce products in a timely manner, our competitive position may suffer and our business, financial condition and results of operations would be harmed.

**We must manage our relationships with contract manufacturers to ensure that our product requirements are met timely and effectively.**

We rely on contract manufacturers to perform the majority of the manufacturing operations for our products and components and we are increasingly utilizing overseas suppliers, particularly in Asia. The qualification of our contract manufacturers is a costly and time-consuming process, and these manufacturers build products for other companies, including our competitors. We are constantly reviewing our manufacturing capability, including the work of our contract manufacturers, to ensure that our production requirements are met in terms of cost, capacity, quality and reliability. From time to time, we may decide to transfer the manufacturing of a product from one contract manufacturer to another, to better meet our production needs. Efforts to transfer to a new contract manufacturer or consolidate our use of suppliers may result in temporary increases in inventory volumes purchased in order to ensure continued supply. We may not effectively manage these contract manufacturer transitions and our new contract manufacturers may not perform as well as expected. Our reliance upon contract manufacturers could also expose us to risks that could harm our business related to difficulties with lead times, on-time delivery, quality assurance and product changes required to meet evolving environmental standards and regulations, such as RoHS. In addition, we do not have contracts in place with some of these providers and do not have guaranteed supply of components or manufacturing capacity. Our inability to effectively manage our relationships with our contract manufacturers, particularly overseas, could negatively affect our business and results of operations.

**We depend on sole and limited source suppliers for our product components and the loss of a source or lack of availability of key components could increase our costs and harm our customer relationships.**

We depend on a limited number of suppliers for our product components and subsystems, as well as for equipment used to manufacture and test our products. Our products include several components for which reliable, high-volume

suppliers are particularly limited. Some key optical and electronic components we use in our products are currently available only from sole or limited sources. As a result of this concentration in our supply chain, particularly for optical components, our business and operations would be negatively affected if our suppliers were to experience any significant disruption affecting the price, quality, availability or timely delivery of components. Concentration in our supply chain can exacerbate our exposure to risks associated with vendors discontinuing the manufacture of certain components for our products. The loss of a source, or lack of availability, of key components could require us to redesign products that use those components, which would increase our costs and negatively affect our product gross margin. The partial or complete loss of a sole or limited source supplier could result in lost revenue, added costs and deployment delays that could harm our business and customer relationships.

**Our failure to manage our relationships with service delivery partners effectively could adversely impact our financial results and relationship with customers.**

We rely on a number of service delivery partners, both domestic and international, to complement our global service and support resources. We rely upon third party service delivery partners for the installation of our equipment in some larger network builds, which often include more onerous customization, installation, testing and acceptance terms. In order to ensure that we timely install our products and satisfy obligations to our customers, we must identify, train and certify additional appropriate partners. The certification of these partners can be costly and time-consuming, and these partners service products for other companies, including our competitors. We may not be able to effectively manage our relationships with our partners and we cannot be certain that they will be able to deliver our services in the manner or time required. If our service partners are unsuccessful in delivering services:

we may suffer delays in recognizing revenue in cases where revenue recognition is dependent upon product installation, testing and acceptance;

our services revenue and gross margin may be adversely affected; and

our relationship with customers could suffer.

Difficulties with service delivery partners could cause us to continue to transition a larger share of deployment and other services from third parties to internal resources, thereby increasing our related fixed costs and negatively affecting our services gross margin and results of operations.

**We may incur significant costs and our competitive position may suffer as a result of our efforts to protect and enforce our intellectual property rights or respond to claims of infringement from others.**

Despite efforts to protect our proprietary rights, unauthorized parties may attempt to copy or otherwise obtain and use our products or technology. This is likely to become an increasingly important issue as we expand our product development into India and the manufacture of products and components to contract manufacturers in Asia. These and other international operations could expose us to a lower level of intellectual property protection than in the United States. Monitoring unauthorized use of our products is difficult, and we cannot be certain that the steps that we are taking will prevent unauthorized use of our technology. If competitors are able to use our technology, our ability to compete effectively could be harmed.

In recent years, we have filed suit to enforce our intellectual property rights. From time to time we have also been subject to litigation and other third party intellectual property claims, including as a result of our indemnification obligations to customers or resellers that purchase our products. The frequency of these assertions is increasing as patent holders, including entities that are not in our industry and that purchase patents as an investment or to monetize such rights by obtaining royalties, use infringement assertions as a competitive tactic and a source of additional revenue. Intellectual property claims can significantly divert the time and attention of our personnel and result in costly litigation. Intellectual property infringement claims can also require us to pay substantial royalties, enter into license agreements or develop non-infringing technology. Accordingly, the costs associated with third party intellectual property claims could adversely affect our business, results of operations and financial condition.

**Our international operations could expose us to additional risks and result in increased operating expense.**

We market, sell and service our products globally. We have established offices around the world, including in North America, Europe, Latin America and the Asia Pacific region. We have also established a development operation in India to pursue offshore development resources and are increasingly relying upon overseas suppliers, particularly in Asia, for materials sourcing of components and contract manufacturing of our products. We expect that our international activities will be dynamic during fiscal 2007, and we may enter new markets and withdraw from or reduce operations in others. These changes to our international operations will require significant management attention and financial resources. In some countries, our success will depend in part on our ability to form relationships with local partners. Our inability to identify appropriate partners or reach mutually satisfactory arrangements for international sales of our products could impact our ability to maintain or increase international market demand for our products.



International operations are subject to inherent risks, and our future results could be adversely affected by a number of factors, including:

greater difficulty in collecting accounts receivable and longer collection periods;

difficulties and costs of staffing and managing foreign operations;

the impact of recessions in economies outside the United States;

reduced protection for intellectual property rights in some countries;

adverse tax and customs consequences, particularly as related to transfer-pricing issues;

social, political and economic instability;

trade protection measures, export compliance, qualification to transact business and other regulatory requirements;

effects of changes in currency exchange rates; and

natural disasters and epidemics.

**Our efforts to offshore certain development resources and operations to India may not be successful and may expose us to unanticipated costs or liabilities.**

We have established a development operation in India and expect to increase hiring of personnel for this facility during fiscal 2007. We have limited experience in offshoring our business functions, particularly development operations, and there is no assurance that our plan will enable us to achieve meaningful cost reductions or greater resource efficiency. Further, offshoring to India involves significant risks, including:

difficulty hiring and retaining appropriate engineering resources due to increased competition for such resources;

the knowledge transfer related to our technology and exposure to misappropriation of intellectual property or confidential information, including information that is proprietary to us, our customers and other third parties;

heightened exposure to changes in the economic, security and political conditions of India;

currency exchange and tax risks associated with offshore operations; and

development efforts that do not meet our requirements because of language, cultural or other differences associated with international operations, resulting in errors or delays.

Difficulties resulting from the factors above and other risks associated with offshoring could expose us to increased expense, impair our development efforts, harm our competitive position and damage our reputation. Our efforts to offshore certain development resources to India could be disruptive to our business and may cause us to incur substantial unanticipated costs or expose us to unforeseen liabilities.

**Our exposure to the credit risks of our customers and resellers may make it difficult to collect receivables and could adversely affect our operating results and financial condition.**

In the course of our sales to customers, we may have difficulty collecting receivables and could be exposed to risks associated with uncollectible accounts. We may be exposed to similar risks relating to third party resellers and other sales channel partners. While we monitor these situations carefully and attempt to take appropriate measures to protect ourselves, it is possible that we may have to write down or write off doubtful accounts. Such write-downs or write-offs could negatively affect our operating results for the period in which they occur, and, if large, could have a

material adverse effect on our operating results and financial condition.

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**Efforts to restructure our operations and align our resources with market opportunities could disrupt our business and affect our results of operations.**

We have taken several steps, including reductions in force, office closures, and internal reorganizations to reduce the size and cost of our operations and to better match our resources with our market opportunities. We continue to make changes to our operations and allocation of resources in order to improve efficiency and match our resources with market opportunities. These changes could be disruptive to our business. In addition, our efforts in prior periods to reduce cost and improve efficiency have resulted in the recording of accounting charges. These include inventory and technology-related write-offs, workforce reduction costs and charges relating to consolidation of excess facilities. If we are required to take a substantial charge related to restructuring efforts, our results of operations would be adversely affected in the period in which we take such charge.

**If we are unable to attract and retain qualified personnel, we may be unable to manage our business effectively.**

Competition to attract and retain highly skilled technical and other personnel with experience in our industry is increasing in intensity and our employees have been the subject of targeted hiring by our competitors. We may experience difficulty retaining and motivating existing employees and attracting qualified personnel to fill key positions. It may be difficult to replace members of our management team or other key personnel, and the loss of such individuals could be disruptive to our business. Because we generally do not have employment contracts with our employees, we must rely upon providing competitive compensation packages and a high-quality work environment in order to retain and motivate employees. If we are unable to attract and retain qualified personnel, we may be unable to manage our business effectively.

**We may be required to assume warranty, service, development and other unexpected obligations in connection with our resale of complementary products of other companies.**

We have entered into agreements with strategic partners that permit us to distribute the products of other companies. As part of our strategy to diversify our product portfolio and customer base, we may enter into additional resale and original equipment manufacturer agreements in the future. To the extent we succeed in reselling the products of these companies, we may be required by customers to assume certain warranty, service and development obligations. While our suppliers often agree to support us with respect to these obligations, we may be required to extend greater protection in order to effect a sale. Moreover, some of the companies whose products we resell are relatively small companies with limited financial resources. If they are unable to satisfy these obligations, we may have to expend our own resources to do so. This risk is amplified because the equipment that we are selling has been designed and manufactured by other third parties and may be subject to warranty claims, the magnitude of which we are unable to evaluate fully. We may be required to assume warranty, service, development and other unexpected obligations in connection with our resale of complementary products of other companies.

**Strategic acquisitions and investments may expose us to increased costs and unexpected liabilities.**

We may acquire or make strategic investments in other companies to add or expand the markets we address and diversify our customer base. We may also engage in these transactions to acquire or accelerate the development of products incorporating new technologies sought after by our customers. To do so, we may use cash, issue equity that would dilute our current shareholders' ownership, incur debt or assume indebtedness. Strategic investments and acquisitions involve numerous risks, including:

difficulties in integrating the operations, technologies and products of the acquired companies;

diversion of management's attention;

potential difficulties in completing projects of the acquired company and costs related to in-process projects;

the potential loss of key employees of the acquired company;

subsequent amortization expenses related to intangible assets and charges associated with impairment of goodwill;

ineffective internal controls over financial reporting for purposes of Section 404 of the Sarbanes-Oxley Act;

dependence on unfamiliar supply partners; and

exposure to unanticipated liabilities, including intellectual property infringement claims.

As a result of these and other risks, any acquisitions or strategic investments may not reap the intended benefits and may ultimately have a negative impact on our business, results of operation and financial condition.

**We may be required to take further write-downs of goodwill and other intangible assets.**

As of April 30, 2007, we had \$232.0 million of goodwill on our balance sheet. This amount primarily represents the remaining excess of the total purchase price of our acquisitions over the fair value of the net assets acquired. At April 30, 2007, we had \$76.7 million of other intangible assets on our balance sheet. The amount primarily reflects purchased technology from our acquisitions. At April 30, 2007, goodwill and other intangible assets represented approximately 16.1% of our total assets. During the fourth quarter of 2005, we incurred a goodwill impairment charge of approximately \$176.6 million and an impairment of other intangibles of \$45.7 million. If we are required to record additional impairment charges related to goodwill and other intangible assets, such charges would have the effect of decreasing our earnings or increasing our losses in such period. If we are required to take a substantial impairment charge, our earnings per share or net loss per share could be materially adversely affected in such period.

**We may be adversely affected by fluctuations in currency exchange rates.**

Historically, our primary exposure to currency exchange rates has been related to non-U.S. dollar denominated operating expenses in Europe, Asia and Canada where we sell primarily in U.S. dollars. As we increase our international sales and utilization of international suppliers, we expect to transact additional business in currencies other than the U.S. dollar. As a result, we will be subject to the possibility of greater effects of foreign exchange translation on our financial statements. For those countries outside the United States where we have significant sales, a devaluation in the local currency would result in reduced revenue and operating profit and reduce the value of our local inventory presented in our financial statements. In addition, fluctuations in foreign currency exchange rates may make our products more expensive for customers to purchase or increase our operating costs, thereby adversely affecting our competitiveness. To date, we have not significantly hedged against foreign currency fluctuations; however, we may pursue hedging alternatives in the future. Although exposure to currency fluctuations to date has not had an adverse effect on our business, there can be no assurance that exchange rate fluctuations in the future will not have a material adverse effect on our revenue from international sales and, consequently, our business, operating results and financial condition.

**Failure to maintain effective internal controls over financial reporting could have a material adverse effect on our business, operating results and stock price.**

Section 404 of the Sarbanes-Oxley Act of 2002 requires that we include in our annual report a report containing management's assessment of the effectiveness of our internal controls over financial reporting as of the end of our fiscal year and a statement as to whether or not such internal controls are effective. Such report must also contain a statement that our independent registered public accounting firm has issued an attestation report on management's assessment of such internal controls. Compliance with these requirements has resulted in, and is likely to continue to result in, significant costs and the commitment of time and operational resources. Growth of our business, including our broader product portfolio and increased transaction volume, will necessitate ongoing changes to our internal control systems, processes and infrastructure, including our information systems. Our increasingly global operations, including our development facility in India and offices abroad, will pose additional challenges to our internal control systems as their operations become more significant. We cannot be certain that our current design for internal control over financial reporting, and any modifications necessary to reflect changes in our business, will be sufficient to enable management or our independent registered public accounting firm to determine that our internal controls are effective for any period, or on an ongoing basis. If we or our independent registered public accounting firm are unable to assert that our internal controls over financial reporting are effective our business may be harmed. Market perception of our financial condition and the trading price of our stock may be adversely affected and customer perception of our business may suffer.

**Our business is dependent upon the proper functioning of our information systems and upgrading these systems may result in disruption to our operating processes and internal controls.**

The efficient operation of our business is dependent on the successful operation of our information systems. In particular, we rely on our information systems to process financial information, manage inventory and administer our sales transactions. In an effort to improve the efficiency of our operations, achieve greater automation and support the growth of our business, we are in the process of upgrading certain information systems and expect to implement a new version of our Oracle management information system at the beginning of fiscal 2008. As a result of these changes,

we anticipate that we will have to modify a number of our operational processes and internal control procedures to conform to the work-flows of new or upgraded information systems. We will also have to undergo a process of validating the data in any new system to ensure its integrity and will need to train our personnel. We cannot assure you that these changes to our information systems will occur without some level of disruption of our operating processes and controls. Any material disruption, malfunction or similar problems with our information systems could negatively impact our business operations.

**Obligations associated with our outstanding indebtedness on our convertible notes may adversely affect our business.**

At April 30, 2007, indebtedness on our outstanding convertible notes totaled \$842.3 million in aggregate principal, of which \$542.3 million in aggregate principal amount on our 3.75% convertible notes becomes due and payable on February 1, 2008. Our indebtedness and repayment obligations could have important negative consequences, including:

increasing our vulnerability to general adverse economic and industry conditions;

limiting our ability to obtain additional financing;

reducing the availability of cash resources available for other purposes, including capital expenditures;

limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we compete; and

placing us at a possible competitive disadvantage to competitors that have better access to capital resources.

We may also add additional indebtedness such as equipment loans, working capital lines of credit and other long term debt.

**Our stock price is volatile.**

Our common stock price has experienced substantial volatility in the past, and may remain volatile in the future. Volatility can arise as a result of a number of the factors discussed in this Risk Factors section, as well as divergence between our actual or anticipated financial results and published expectations of analysts, and announcements that we, our competitors, or our customers may make. Volatility in our common stock price and liquidity in our common stock may also be negatively affected by the one-for-seven reverse stock split of our common stock completed on September 22, 2006.

***Item 2. Unregistered Sales of Equity Securities and Use of Proceeds***

On February 15, 2007, we issued 12,958 shares of common stock in connection with the exercise of a common stock warrant by FMR Corp. The warrant was originally issued by ONI Systems Corp. and was assumed by us as a result of our acquisition of ONI in June 2002. The exercise was accomplished via net exercise, whereby the warrant holder surrenders its right to receive a portion of the shares of common stock in lieu of payment of the aggregate exercise price. The right to receive 6,015 shares of common stock was surrendered and we did not receive any proceeds from the net exercise of these warrants. The shares were issued in reliance upon the exemption from registration under Section 4(2) of the Securities Act of 1933, as amended, in that the issuance did not involve a public offering, and, alternatively, on Section 3(a)(9) thereof, in that no commission or other remuneration was paid for soliciting the conversion of the warrants.

***Item 3. Defaults Upon Senior Securities***

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

Ciena's annual meeting of shareholders was held on March 14, 2007. At the annual meeting, Ciena shareholders voted on the following matters:

|  | <b>For</b> | <b>Withheld</b> |
|--|------------|-----------------|
| 1. Election to the Board of Directors of Class I Directors |            |                 |
| Lawton W. Fitt   | 72,055,113 | 1,889,527       |
| Patrick H. Nettles   | 71,897,148 | 2,047,492       |
| Michael J. Rowny   | 72,110,975 | 1,833,665       |

|   | <b>For</b> | <b>Against</b> | <b>Abstain</b> |
|---|------------|----------------|----------------|
| 2. Ratification of the Board of Directors' election of Bruce L. Claflin as a Class III Director in accordance with Ciena's Principles of Corporate Governance | 71,937,122 | 950,962        | 1,056,556      |

In addition to the directors referred to in the proposals above, the following directors continued to hold office after the annual meeting: Harvey B. Cash, Judith M. O'Brien, Gary B. Smith, Stephen P. Bradley and Gerald H. Taylor.

|  | <b>For</b> | <b>Against</b> | <b>Abstain</b> |
|--|------------|----------------|----------------|
| 3. Ratification of the appointment of PricewaterhouseCoopers LLP as Ciena's independent registered public account firm for the fiscal year ending October 31, 2007 | 72,500,920 | 593,315        | 850,405        |

**Item 5. Other Information**

Not applicable.

**Item 6. Exhibits**

| Exhibit | Description   |
|---------|---|
| 10.1    | Separation Agreement dated April 5, 2007 between Ciena Corporation and Joseph R. Chinnici*  |
| 31.1    | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2    | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1    | Certification of Chief Executive Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                                   |
| 32.2    | Certification of Chief Financial Officer Pursuant to 18 U.S.C. Section 1350 as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.                                   |

\* Represents management contract or compensatory plan or arrangement

**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.

CIENA CORPORATION

Date: June 1, 2007

By: /s/ Gary B. Smith

Gary B. Smith  
President, Chief Executive Officer  
and Director  
(Duly Authorized Officer)

Date: June 1, 2007

By: /s/ Joseph R. Chinnici

Joseph R. Chinnici  
Senior Vice President, Finance and  
Chief Financial Officer  
(Principal Financial Officer)

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