AETHER SYSTEMS INC
Form 10-Q
August 14, 2003

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

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

For the Period Ended June 30, 2003

or

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

Commission File Number: 000-27707

AETHER SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**52-2186634**
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification Number)
11460 Cronridge Dr., Owings Mills, MD	**21117**
(Address of principal executive offices)	(Zip Code)

(Registrant s telephone number, including area code): **(410) 654-6400**

Securities registered Pursuant to Section 12(b) of the Act: **NONE.**

Securities Registered Pursuant to Section 12(g) of the Act:

Common Stock, Par Value $.01
Convertible Subordinated Notes Due 2005

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 ý No o

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Act) Yes ý No o

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

As of August 12, 2003, 42,767,697 shares of the Registrant s common stock, $.01 par value per share, were outstanding.

AETHER SYSTEMS, INC.

QUARTERLY REPORT ON FORM 10-Q
FOR THE QUARTER ENDED JUNE 30, 2003

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PART I FINANCIAL INFORMATION

ITEM I: FINANCIAL STATEMENTS

AETHER SYSTEMS, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(IN THOUSANDS, EXCEPT SHARE DATA)

	June 30, 2003 (Unaudited)	December 31, 2002
ASSETS		
Current assets:		
Cash and cash equivalents	$ 111,349	$ 68,593
Short-term investments	190,032	255,825
Trade accounts receivable, net	26,207	22,788
Inventory, net	8,180	19,664
Assets held for sale		5,250
Net investment in sales-type leases (current)	2,021	1,656
Prepaid expenses and other current assets	14,317	16,002
Total current assets	352,106	389,778
Restricted cash	2,000	
Property and equipment, net	15,356	19,301
Investments	1,676	2,228
Goodwill	25,369	25,369
Intangibles, net	14,526	15,027
Net investment in sales-type leases (non-current)	8,306	6,691
Other noncurrent assets, net	20,837	15,015
	$ 440,176	$ 473,409
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of notes payable	$ 16	$ 4
Accounts payable	2,342	1,902
Accrued expenses	14,543	19,963
Accrued employee compensation and benefits	5,052	7,336
Deferred revenue	17,062	14,234
Current portion of restructuring reserve	7,526	8,651
Accrued interest payable	2,529	2,529

Total current liabilities	49,070	54,619
Convertible subordinated notes payable and other notes payable, less current portion	154,933	154,942
Deferred revenue	15,497	11,789
Restructuring reserve	19,667	23,801
Other long term liabilities	782	858
Total liabilities	239,949	246,009
Stockholders equity:		
Preferred stock, $0.01 par value; 1,000,000 shares authorized; 0 shares issued and outstanding at June 30, 2003 and December 31, 2002		
Common stock, $0.01 par value; 1,000,000,000 shares authorized; 42,675,015 and 42,249,280 shares issued and outstanding at June 30, 2003 and December 31, 2002, respectively	427	422
Additional paid-in capital	2,588,335	2,586,613
Accumulated deficit	(2,391,988)	(2,364,831)
Foreign currency translation adjustment	2,273	3,722
Unrealized gain on investments available for sale	1,180	1,474
Total stockholders equity	200,227	227,400
Commitments and Contingencies		
Total liabilities and stockholders equity	$ 440,176	$ 473,409

See accompanying notes to condensed consolidated financial statements.

AETHER SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS AND COMPREHENSIVE LOSS

(IN THOUSANDS, EXCEPT PER SHARE DATA)

(unaudited)

	Three Months Ended June 30, 2003	Three Months Ended June 30, 2002	Six Months Ended June 30, 2003	Six Months Ended June 30, 2002
Subscriber revenue	$ 17,772	$ 19,881	$ 36,764	$ 32,190
Engineering services revenue	172	712	251	2,335
Software and related services revenue	5,646	5,633	11,495	11,655
Device sales	4,165	5,392	8,482	9,110
Total revenue	27,755	31,618	56,992	55,290
Cost of subscriber revenue	8,395	11,203	18,240	18,557
Cost of engineering services revenue	37	318	58	1,121
Cost of software and related services revenue	1,148	2,264	2,421	4,440
Cost of device sales	3,488	4,519	8,203	7,950
Total cost of revenue	13,068	18,304	28,922	32,068
Gross profit	14,687	13,314	28,070	23,222
Operating expenses:				
Research and development (exclusive of option and warrant expense)	4,272	6,991	8,710	15,617
General and administrative (exclusive of option and warrant expense)	10,870	15,561	22,580	32,936
Selling and marketing (exclusive of option and warrant expense)	3,400	8,885	6,785	19,039
Depreciation and amortization	4,164	10,604	8,414	21,353
Option and warrant expense:				
Research and development	133	1,166	337	2,424
General and administrative	316	638	637	1,225
Selling and marketing	72	366	156	742
Impairment of intangibles and other assets	2,202		2,644	2,377
Restructuring charge	2,378	3,025	2,904	15,581
Loss on disposal of assets	838		838	
Total operating expenses	28,645	47,236	54,005	111,294
Operating loss	(13,958)	(33,922)	(25,935)	(88,072)
Other income (expense):				
Interest income	1,841	3,129	4,205	5,629

Interest expense		(2,609)		(4,909)		(5,211)		(9,663)
Gain on extinguishment of debt				22,046				28,308
Equity in losses of investments		(33)		(833)		(92)		(3,606)
Investment losses, including impairments, net		42		(5,877)		(124)		(10,112)
Minority interest				(1,408)				108
Escrow settlement, net				2,319				2,319
Loss before cumulative effect of change in accounting principle		(14,717)		(19,455)		(27,157)		(75,089)
Cumulative effect of change in accounting principle relating to adoption of SFAS No. 142								(129,306)
Net loss	$	(14,717)	$	(19,455)	$	(27,157)	$	(204,395)
Other comprehensive income (loss):								
Unrealized gain (loss) on investments available for sale		508		(1,143)		(294)		(2,646)
Foreign currency translation adjustment		(1,905)		(128)		(1,449)		(47)
Comprehensive loss	$	(16,114)	$	(20,726)	$	(28,900)	$	(207,088)
Net loss per share-basic and diluted before cumulative effect of change in accounting principle	$	(0.35)	$	(0.46)	$	(0.64)	$	(1.78)
Cumulative effect of change in accounting principle relating to adoption of SFAS No. 142								(3.07)
Net loss per share-basic and diluted	$	(0.35)	$	(0.46)	$	(0.64)	$	(4.85)
Weighted average shares outstanding basic and diluted		42,538		42,156		42,406		42,074

See accompanying notes to condensed consolidated financial statements.

AETHER SYSTEMS, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(DOLLARS IN THOUSANDS)

(unaudited)

	Six Months Ended June 30, 2003	Six Months Ended June 30, 2002
Cash flows from operating activities:		
Net loss	$ (27,157)	$ (204,395)
Adjustments to reconcile net loss to net cash used by operating activities:		
Cumulative effect of a change in accounting principle		129,306
Depreciation and amortization	8,414	21,353
Amortization of loan fees	560	715
Provision for doubtful accounts	817	2,622
Depreciation on leased devices	385	
Equity in losses of investments	92	3,606
Option and warrant expense	1,130	4,391
Minority interest		(108)
Gain on extinguishment of debt		(28,308)
Impairment of intangibles and other assets	2,644	2,377
Loss on disposal of assets	838	
Investment losses, including impairments	124	10,112
Changes in assets and liabilities, net of acquired assets and liabilities:		
Increase in trade accounts receivable	(4,236)	(6,276)
Decrease (increase) in inventory	6,472	(527)
Increase in prepaid expenses and other assets	(5,945)	(1,035)
Increase in investment in sales-type leases	(1,980)	
Increase (decrease) in accounts payable	440	(2,743)
Decrease in accrued expenses, accrued employee compensation and benefits and interest payable	(6,504)	(5,403)
Increase in deferred revenue	6,536	1,629
(Decrease) increase in restructuring reserve and other long term liabilities	(5,332)	427
Net cash used in operating activities	(22,702)	(72,257)
Cash flows from investing activities:		
Sales and maturities of short-term investments	321,858	47,834
Purchases of short-term investments	(256,363)	(359,771)
Acquisitions, net of cash acquired		(3,259)
Proceeds from sale of property and equipment	4,412	
Purchases of property and equipment	(1,014)	(3,759)
Sales of long-term investments	340	1,587

Purchase of long-term investments				(497)
Increase in other intangible assets		(2,372)		(50)
Net cash provided by (used in) investing activities		66,861		(317,915)
Cash flows from financing activities:				
Increase in restricted cash		(2,000)		
Proceeds from issuance of common stock		597		561
Repayment of notes payable including buyback of convertible debt				(16,912)
Net cash provided by (used in) financing activities		(1,403)		(16,351)
Net increase (decrease) in cash and cash equivalents		42,756		(406,523)
Cash and cash equivalents, at beginning of period		68,593		522,177
Cash and cash equivalents, at end of period	$	111,349	$	115,654
Supplemental disclosure of cash flow information:				
Cash paid during the period for interest	$	4,651	$	8,848

Supplemental disclosure of non-cash investing and financing activities:

For the six months ended June 30, 2003 and 2002, the Company incurred unrealized holding losses associated with its investments available for sale totaling approximately $294,000 and $2.6 million, respectively. These amounts have been reported as decreases in stockholders equity.

In connection with the acquisition of certain assets of @Track Communications, Inc. on March 18, 2002, the Company issued a note payable for $12.0 million. Such amount has been allocated to the fair value of the assets purchased.

During the six months ended June 30, 2003, the Company transferred $5.0 million of equipment under an operating lease from inventory to property and equipment.

See accompanying notes to condensed consolidated financial statements.

AETHER SYSTEMS, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NOTE (1) ORGANIZATION, DESCRIPTION OF THE BUSINESS AND BASIS OF PRESENTATION

(a) ORGANIZATION AND DESCRIPTION OF THE BUSINESS

Aether Systems, Inc. (the Company or Aether) provides the services, software and support necessary for businesses to extend critical information to virtually any wireless or mobile environment. The Company develops, deploys and manages wireless solutions built on industry standard technology referred to as Aether Fusion and backed by the Company s expertise in wireless hosting, software and services.

The Company operates in three business segments: enterprise mobility solutions, mobile government, and transportation.

(b) BASIS OF PRESENTATION

The condensed consolidated financial statements include the accounts of Aether Systems, Inc. and its subsidiaries. The condensed consolidated balance sheet as of June 30, 2003 and the condensed consolidated statements of operations and other comprehensive loss for the three and six months ended June 30, 2003 and 2002, and the condensed consolidated statements of cash flows for the six months ended June 30, 2003 and 2002, have been prepared by the Company, without audit. In the opinion of management, all adjustments have been made, which include normal recurring adjustments necessary to present fairly the condensed consolidated financial statements. Operating results for the three and six months ended June 30, 2003 are not necessarily indicative of the operating results for the full year. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted. The Company believes that the disclosures provided are adequate to make the information presented not misleading. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements and related notes included in the Company s Annual Report for the year ended December 31, 2002 on Form 10-K.

NOTE (2) SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

(a) USE OF ESTIMATES

The preparation of condensed consolidated financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the condensed consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from those estimates. Estimates are used in accounting for, among other things, long-term contracts, allowances for uncollectible receivables, inventory obsolescence and warranty reserves, recoverability of long-lived assets and investments, depreciation and amortization, employee benefits, restructuring accruals, taxes and contingencies. Estimates and assumptions are reviewed periodically and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary.

(b) ACCOUNTS RECEIVABLE

Accounts receivable consists of the following:

(IN THOUSANDS)		June 30, 2003		December 31, 2002
Billed	$	29,454	$	26,155
Unbilled		3,726		4,322
Allowance for doubtful accounts		(6,973)		(7,689)
Total Accounts Receivable	$	26,207	$	22,788

The Company believes all unbilled accounts receivable included above will be billed within the next twelve months. In addition, the Company has unbilled accounts receivable of approximately $416,000 relating to a long-term contract. This amount will not be billed in the next twelve months and is included in other non-current assets.

(c) IMPAIRMENTS

Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but instead tested for impairment at least annually. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values. Long-lived assets, such as property and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset.

In connection with the adoption of SFAS No. 142, Goodwill and Other Intangibles on January 1, 2002, the Company was required to perform a transitional impairment analysis and reflect the changes as of January 1, 2002. The Company completed its analysis in the third quarter of 2002 and recorded a charge through cumulative effect of change in accounting principle of $129.3 million. As such, the Company s condensed consolidated financial statements for the six months ended June 30, 2002 have been adjusted to reflect this change.

(d) STOCK OPTIONS AND WARRANTS

The Company applies the intrinsic-value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees , and related interpretations including FASB Interpretation No. 44, Accounting for Certain Transactions involving Stock Compensation, an interpretation of APB Opinion No. 25 , issued March 2000, to account for its fixed-plan stock options and restricted stock granted to employees. Under this method, compensation expense is recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. SFAS No. 123, Accounting for Stock-Based Compensation , established accounting and disclosure requirements using a fair-value-based method of accounting for stock-based employee compensation plans. As allowed by SFAS No. 123, the Company has elected to continue to apply the intrinsic-value-based method of accounting described above, and has adopted only the disclosure requirements of SFAS No. 123. The following table illustrates the effect on net income if the fair-value-based method had been applied to all outstanding and unvested awards in each period:

(IN THOUSANDS, EXCEPT PER SHARE DATA)	Three Months Ended June 30, 2003	Three Months Ended June 30, 2002	Six Months Ended June 30, 2003	Six Months Ended June 30, 2002
Net loss as reported	$ (14,717)	$ (19,455)	$ (27,157)	$ (204,395)
Add stock-based employee compensation expense included in reported net income	521	2,170	1,130	4,391
Deduct total stock-based employee compensation expense determined under fair-value-based method for all awards	(6,818)	(12,662)	(12,810)	(33,991)
Pro forma net loss	$ (21,014)	$ (29,947)	$ (38,837)	$ (233,995)
Pro forma net loss per share	$ (0.49)	$ (0.71)	$ (0.92)	$ (5.56)

(e) EARNINGS PER SHARE

Basic net income (loss) per share is computed by dividing net income (loss) available to common stockholders for the period by the weighted average number of common shares outstanding during the period. Diluted net income (loss) per share is computed by dividing the net income (loss) for the period by the weighted average number of common and dilutive common equivalent shares outstanding during the period. As of June 30, 2003 and June 30, 2002, options to purchase approximately 5.5 million and 7.2 million shares of common stock were outstanding. As the Company has had a net loss in each of the periods presented, basic and diluted net loss per share are the same.

(f) RECLASSIFICATIONS

Certain fiscal year 2002 amounts have been reclassified to conform to the current year presentation. None of these reclassifications had a material effect on the Company s financial statements.

(g) RECENT ACCOUNTING PRONOUNCEMENTS

i) SFAS No. 145

In April 2002, the FASB issued SFAS No. 145, Rescission of FASB Statements No. 4, 44, and 64, Amendment of FASB Statement No. 13, and Technical Corrections. SFAS No. 145 rescinded FASB No. 4 and 64 in relation to reporting gains and losses from extinguishment of debt. The Statement amended SFAS No. 4 and 64 and requires gains and losses from extinguishment of debt to be classified as extraordinary items only if they meet the criteria in Opinion 30. Applying the provisions of Opinion 30 differentiates between normal recurring operations of a company and transactions that are unusual or infrequent in nature. In connection with the adoption of SFAS No. 145, the Company reclassified $22.0 and $28.3 million of extraordinary gains from early extinguishment of debt to other income (expense) for the three and six months ended June 30, 2002, respectively.

(ii) Financial Interpretation No. 45

In November 2002, the FASB issued FASB Interpretation No. 45, Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others. Interpretation No. 45 discusses the necessary disclosures to be made by a guarantor in its financial statements about its obligations under certain guarantees that it has issued. It also discusses that the guarantor must recognize a liability, at fair value at the inception of the guarantee, for the obligation incurred in issuing the guarantee.

The Company has certain guarantees disclosable under FIN 45 as follows:

The Company has guaranteed the payment of sublease rentals to our landlord on several properties the Company sublet. The maximum guarantee on these properties is approximately $2.9 million.

In the Company s Mobile Government segment, the Company may have to pay liquidated damages in some cases if the Company s sub-contractors do not perform on time. In addition, the Company sometimes indemnifies certain of its customers against damages, if any, they might incur as a result of a claim brought against them related to third party software imbedded in the Company s products. The Company is unable to estimate the maximum exposure of such indemnifications due to the inherent uncertainty and the varying nature of the contractual terms.

Under FIN 45, the Company s product warranties are considered guarantees. The following table provides the changes in the Company s product warranties:

Warranty liability balance at December 31, 2002	$	788
Liabilities accrued for warranties issued during the three months ended March 31, 2003		925
Warranty claims paid during the three months ended March 31, 2003		(134)
Liabilities accrued for warranties issued during the three months ended June 30, 2003		299
Warranty claims paid during the three months ended June 30, 2003		(326)
Warranty liability balance at June 30, 2003	$	1,552

(iii) Financial Interpretation No. 46

In January 2003, the FASB issued Interpretation No. 46, Consolidation of Variable Interest Entities, an interpretation of ARB No. 51. This interpretation addresses the consolidation by business enterprises of variable interest entities as defined in the interpretation. The interpretation applies immediately to variable interests in variable interest entities created or obtained after January 31, 2003. Since January 31, 2003, the Company has not entered into any arrangements that it believes are variable interest entities. For arrangements entered into prior to January 31, 2003, the Company is required to adopt the provisions of FIN 46 at the beginning of the third quarter of fiscal 2003. The Company does not expect the application of this interpretation to have a material effect on its financial statements.

(iv) EITF 00-21

In November 2002, the Emerging Issues Task Force issued its final consensus on Revenue Arrangements with Multiple Deliverables. This guidance is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. Alternatively, entities may elect to report the change in accounting as a cumulative-effect adjustment. EITF 00-21 discusses criteria necessary to determine when an arrangement may be viewed to have separate units of accounting (and thus revenue) and when an arrangement should be viewed as a single unit of accounting. The application of this EITF is not expected to have a material effect on the Company s financial statements.

(v) SFAS No. 150

In May 2003, the FASB issued SFAS No. 150, Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity. The Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. The Statement is effective immediately for financial instruments entered into or modified after May 31, 2003, and for instruments entered into or modified prior to May 31, 2003, must be adopted by the Company at the beginning of the third quarter of fiscal 2003. Since May 31, 2003, the Company has not entered into any financial instruments that it believes would be subject to the provisions of SFAS No. 150. The Company does not expect the implementation this statement to have a material impact on its financial statements.

NOTE (3) ASSET PURCHASES AND SALES

On March 15, 2002, the Company expanded its products, services, and customer base in the transportation and logistics market through the acquisition of certain assets and licenses from @Track. @Track was a leading provider of wireless-based vehicle fleet management and intelligent mobile-asset-tracking solutions. The purchase consideration (excluding approximately $800,000 of purchase related expenses) was $15.0 million consisting of $3.0 million in cash and a $12.0 million note payable. The note bore interest at an annual rate of 5.75% and was repaid in three equal, monthly cash installments from May 2002 through July 2002. This acquisition has been accounted for under the purchase method of accounting and, accordingly, the assets acquired and liabilities assumed have been recorded at their estimated fair value as of the acquisition date. The allocation of the purchase price for this acquisition, which was determined based on a third party appraisal, is summarized as follows:

Current assets	$	1,153