Grant Thornton

Financial Statements
Xtera Communications Ltd.

For the year ended 30 September 2010

Company No 4260336

Company information

Company registration number:	4260336
Registered office:	Devonshire House 60 Goswell Street LONDON EC1M 7AD
Directors:	P Colan J Hopper
Bankers:	HSBC Bank plc 79 Piccadilly LONDON W1V 9JN HSBC Bank USA National Association One HSBC Plaza ROCHESTER New York USA 14639
Solicitors:	Morgan Denton Jones LLP Park House Greyfriars Road CARDIFF CF10 3AF
Auditor:	Grant Thornton UK LLP Chartered Accountants Statutory Auditor Grant Thornton House Kettering Parkway Kettering Venture Park KETTERING Northants NN15 6XR

Index to the financial statements

Report of the directors

The directors present their report together with the financial statements for the year ended 30 September 2010

Principal activities

The principal activity during the year was the design, manufacture, marketing and sale of optical transmission equipment for telecommunications applications

Business review and future developments

Turnover for the year was £12,408,880 (2009 - £9,732,983) Gross margin decreased between periods by approximately 6% due to continual price pressure within the market Operational expenditures were within budget and reflect cost reductions implemented during fiscal 2009 Profit for the year was £1,438,426 (2009 - £128,561) and is consistent with management's expectations

Fiscal 2010 reflects the benefits of our significant cost reduction actions taken late in fiscal 2009 A combination of headcount reductions resulting in lower operational expenditures as well as cost reductions in materials realized by utilizing more efficient and lower cost contract manufacturer drove profit higher While turnover in fiscal 2010 was 27% higher than fiscal 2009, gross margin increased by a lesser percentage due to pricing pressure on the existing product portfolio Cost of materials was relatively flat between periods Customers are cautiously approaching new projects as the economic recession has slowed growth in their business Additionally, customers are delaying projects to allow their business demands to catch up with their existing capacity

The main focus of the company for fiscal 2011 is the successful deployment of our first 40G network solution Additionally, we continue development of our 100G networks solution that will be commercially available in late fiscal 2011 or early fiscal 2012 The 40G and 100G product lines will allow the Company to remain a leader in the submarine telecommunications equipment market We will continue to secure additional deployments, expand existing deployments and maximize gross margin The addition of the 40G network solution will provide additional leverage to maintain or increase our level of gross margin Competitive and economic forces will be a significant challenge to any increase in turnover although migration toward the 40G network solution will allow us to maintain or grow turnover, especially in the last half of fiscal 2011 Operational costs are expected to be similar to fiscal 2010

Results and dividends

The profit and loss account for the year is set out on page 11

The directors cannot recommend a dividend for the year ended 30 September 2010 (2009 - £nil)

Key performance indicators

Financial

1 Turnover is a key measure of the company's performance Sales for the year were £12 4m (2009 - £9 7m)

2 Gross profit is a key indicator of the company's performance The gross profit for the financial year was £5 0m (2009 - £4 5m)

3 Net worth is seen as an important target for the business At the year end, the level of shareholders' funds was £1 8m (2009 - £0 3m)

Financial risk management objectives and policies

The company actively monitors a mixture of long-term and short-term debt finance, including trade creditors, that is designed to ensure the company has sufficient available funds for operations and planned grants

The company's operations and debt financing expose it to a variety of financial risks that include currency risk, interest rate risk and credit risk Given the size of the company, responsibility for monitoring financial risk management is in the hands of the Board The Board seeks to limit the adverse effects on the financial performance of the company by monitoring levels of debt finance and the related finance costs The company does not use derivative financial instruments to manage financial risks and as such, no hedge accounting is applied

Currency risk

The company is exposed to transaction foreign exchange risk The directors seek, whenever possible, to use sterling as the currency denomination when transacting with foreign suppliers If considered necessary, transaction exposures, including those associated with forecast transactions, are hedged when known, principally using forward currency contracts Whilst the aim is to achieve an economic hedge the company does not adopt an accounting policy of hedge accounting for these financial statements

Interest rate risk

The company has both interest bearing assets and interest bearing liabilities Interest bearing assets include only short-term deposits, which earn interest at a fixed rate, and cash balances, which earn interest at a floating rate

Credit risk

The company seeks to manage its credit risk by dealing with established customers or otherwise checking the credit-worthiness of new customers, establishing clear contractual relationships with those customers, having credit insurance protection and by identifying and addressing any credit issues arising in a timely manner

Research and development

The company continued with its programme of research and development and this activity is continuing in 2010/2011 Research and development expenditure for the year was £1,767,324 (2009 - £1,866,331) of which an amount of £273,134 (2009 - £138,991) was included in the research and development tax claim submitted to HM Revenue & Customs

Directors

The directors who served the company during the year were as follows

J Hopper
P Colan

Statement of directors' responsibilities

The directors are responsible for preparing the Report of the Directors and the financial statements in accordance with applicable law and regulations

Company law requires the directors to prepare financial statements for each financial period Under that law the directors have elected to prepare financial statements in accordance with United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) The financial statements are required by law to give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period In preparing these financial statements, the directors are required to

- select suitable accounting policies and then apply them consistently
- make judgments and estimates that are reasonable and prudent
- state whether applicable UK Accounting Standards have been followed, subject to any material departures disclosed and explained in the financial statements
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the company will continue in business

The directors are responsible for keeping adequate accounting records that disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006 They are also responsible for safeguarding the assets of the company and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities

In so far as each of the directors is aware

- there is no relevant audit information of which the company's auditor is unaware, and
- the directors have taken all steps that they ought to have taken to make themselves aware of any relevant audit information and to establish that the auditor is aware of that information

Auditor

Grant Thornton UK LLP, having expressed their willingness to continue in office, will be deemed reappointed for the next financial year in accordance with section 487(2) of the Companies Act 2006 unless the company receives notice under section 488(1) of the Companies Act 2006

ON BEHALF OF THE BOARD

P Colan
Director
15 February 2011

Grant Thornton

Independent Auditor's Report to the Members of Xtera Communications Ltd.

(registered number 4260336)

We have audited the financial statements of Xtera Communications Ltd for the year ended 30 September 2010 which comprise the principal accounting policies, profit and loss account, balance sheet and the related notes The financial reporting framework that has been applied in their preparation is applicable law and United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice)

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006 Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members as a body, for our audit work, for this report, or for the opinions we have formed

Respective responsibilities of directors and auditor

As explained more fully in the Directors' Responsibilities Statement set out on page 5, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view Our responsibility is to audit the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland) Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors

Scope of the audit of the financial statements

An audit involves obtaining evidence about the amounts and disclosures in the financial statements sufficient to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error This includes an assessment of whether the accounting policies are appropriate to the company's circumstances and have been consistently applied and adequately disclosed, the reasonableness of significant accounting estimates made by directors, and the overall presentation of the financial statements

Opinion on financial statements

In our opinion the financial statements

- give a true and fair view of the state of the company's affairs as at 30 September 2010 and of its profit for the year then ended,
- have been properly prepared in accordance with United Kingdom Generally Accepted Accounting Practice, and
- have been prepared in accordance with the requirements of the Companies Act 2006

Grant Thornton

Independent Auditor's Report to the Members of Xtera Communications Ltd.

(registered number 4260336)

Opinion on other matters prescribed by the Companies Act 2006

In our opinion the information given in the Report of the Directors for the financial period for which the financial statements are prepared is consistent with the financial statements

Matters on which we are required to report by exception

We have nothing to report in respect of the following matters where the Companies Act 2006 requires us to report to you if, in our opinion

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us, or
- the financial statements are not in agreement with the accounting records and returns, or
- certain disclosures of directors' remuneration specified by law are not made, or
- we have not received all the information and explanations we require for our audit

Grant Thornton UK LLP

John Corbishley
Senior Statutory Auditor
for and on behalf of Grant Thornton UK LLP
Statutory Auditor, Chartered Accountants
Kettering

21 February 2011.

Principal accounting policies

Basis of preparation

The financial statements have been prepared under the historical cost convention

The financial statements have been prepared on a going concern basis, which assumes that the company will continue to trade for the foreseeable future During the year the company generated a profit after tax of £1 4m (2009 - £0 1m) and had an accumulated profit and loss account deficit of £28 9m at 30 September 2010

The directors have obtained confirmation that the parent company, Xtera Communications Inc , will continue, as far as they are able, to provide financial support for the company through the group creditor balances which will enable it to continue its activities for the foreseeable future As a result, the directors believe that the company will remain financially viable and therefore that it is appropriate that these financial statements are prepared on the going concern basis This basis of preparation assumes that the company will continue in operational existence for a period of at least twelve months from the date of approval of these financial statements, the validity of which depends on Xtera Communications Ltd not being required to repay the balance to Xtera Communications Inc The financial statements do not include any adjustments that might arise if the going concern basis is not appropriate

Turnover

The company recognises its revenue in accordance with the *Revenue Recognition* of the FASB ASC and UK GAAP Revenue is recognised when persuasive evidence of an arrangement exists, delivery has occurred, the sales price is fixed or determinable and collection is reasonably assured Delivery does not occur until products have been shipped or services have been provided to the customer and title and risk of loss have transferred to the customer The company also provides for estimated costs that may be incurred for product warranties and for sales returns When other significant obligations or acceptance terms remain after products are delivered, revenue is recognised only after such obligations are fulfilled Revenue is recognised net of cash discounts and sales tax

Contracts for optical network solutions often involve multiple deliverables which may include any combination of products, solutions, installation or other services Revenue under multiple element arrangements is recognised in accordance with the *Accounting for Revenue Arrangements with Multiple Deliverables* of the FASB ASC A multiple-element arrangement is separated into more than one unit of accounting if all of the following criteria are met

- The delivered item(s) has value to the client on a stand-alone basis,
- There is objective and reliable evidence of the fair value of the undelivered item(s), and
- If the arrangement includes a general right of return relative to the delivered item(s), delivery or performance of the undelivered item(s) is considered probable and substantially in the control of the company

Turnover (continued)

If these criteria are not met, the arrangement is accounted for as one unit of accounting which would result in revenue being recognised on a straight-line basis or being deferred until the earlier of when such criteria are met or when the last undelivered element is delivered This occurrence could materially impact the company's financial results because of the significant dollar amount of many of its contracts and the significant portion of total revenues that a single contract may represent in any particular period If these criteria are met for each element and there is objective and reliable evidence of fair value for all units of accounting in an arrangement, the arrangement consideration is allocated to the separate units of accounting based on each unit's relative fair value As installation of products is typically included in multiple element arrangements, revenue is generally recognised once installation is complete

Deferred revenue is recorded when cash has been received from the customer and the arrangement does not qualify for revenue recognition under the revenue recognition policies described above Costs incurred for projects not completed are deferred and recorded as a cost upon recognition of the related revenue

Tangible fixed assets

The cost of fixed assets is their purchase cost, together with any incidental expenses of acquisition

Depreciation is calculated so as to write off the cost of tangible fixed assets, less their estimated residual values, over the expected useful economic lives of the assets concerned on a straight-line basis The principal annual rates used for this purpose are

Leasehold improvements	-	over the lifetime of the lease term
Test equipment	-	over 2 - 3 years
Office equipment and fittings	-	over 1 - 3 years
Computer equipment	-	over 2 - 3 years

Stocks

Stocks are valued at the lower of cost and net realisable value, after making due allowance for obsolete and slow moving items

Operating lease agreements

Rentals applicable to operating leases where substantially all of the benefits and risks of ownership remain with the lessor are charged against profits on a straight line basis over the period of the lease

Deferred taxation

Deferred tax is recognised in respect of all timing differences that have originated but not reversed at the balance sheet date where transactions or events have occurred at that date that will result in an obligation to pay more, or a right to pay less or to receive more tax, with the following exceptions

Provision is made for tax on gains arising from the revaluation (and similar fair value adjustments) of fixed assets, and gains on disposal of fixed assets that have been rolled over into replacement assets, only to the extent that, at the balance sheet date, there is a binding agreement to dispose of the assets concerned However, no provision is made where, on the basis of all available evidence at the balance sheet date, it is more likely than not that the taxable gain will be rolled over into replacement assets and charged to tax only where the replacement assets are sold

Deferred tax assets are recognised only to the extent that the directors consider that it is more likely than not that there will be suitable taxable profits from which the future reversal of the underlying timing differences can be deducted

Deferred taxation (continued)

Deferred tax is measured on an undiscounted basis at the tax rates that are expected to apply in the periods in which timing differences reverse, based on tax rates and laws enacted or substantively enacted at the balance sheet date

Foreign currencies

Balances denominated in foreign currencies are translated at the rate of exchange ruling at the balance sheet date Transactions in foreign currencies are recorded at the rate ruling at the date of transaction Differences arising on settlement or translation are charged or credited to the profit and loss account as incurred

Pension costs

The company contributes to employees' personal pension plans, which are money purchase schemes Contributions are charged to the profit and loss account as incurred

Research and development

Expenditure on research and development is charged to the profit and loss account as incurred

Cash flow statement

The company has taken the exemption available to small companies under FRS1 (revised 1996), 'cash flow statements', not to prepare a cash flow statement

Financial instruments

Financial liabilities and equity instruments are classified according to the substance of the contractual arrangements entered into An equity instrument is any contract that evidences a residual interest in the assets of the entity after deducting all of its financial liabilities

Where the contractual obligations of financial instruments (including share capital) are equivalent to a similar debt instrument, those financial instruments are classed as financial liabilities Financial liabilities are presented as such in the balance sheet Finance costs and gains or losses relating to financial liabilities are included in the profit and loss account Finance costs are calculated so as to produce a constant rate of return on the outstanding liability

Where the contractual terms of share capital do not have any terms meeting the definition of a financial liability then this is classed as an equity instrument Dividends and distributions relating to equity instruments are debited direct to equity

Profit and loss account

	Note	2010 £	2009 £
Turnover	1	**12,408,880**	9,732,983
Cost of sales		**(7,439,411)**	(5,277,233)
Gross profit		**4,969,469**	4,455,750
Other operating charges	2	**(3,223,613)**	(4,502,736)
Operating profit/(loss)		**1,745,856**	(46,986)
Net interest	3	**(318,930)**	175,547
Profit on ordinary activities before taxation		**1,426,926**	128,561
Tax on profit on ordinary activities	6	**11,500**	-
Profit for the financial year	15	**1,438,426**	128,561

All of the activities of the company in the current year are classed as continuing

The company has no recognised gains or losses other than the result for the year as set out above

Balance sheet

	Note	2010 £	£	2009 £	£
Fixed assets					
Tangible assets	7		**218,103**		89,377
Current assets					
Debtors amounts due in less than one year	8	**2,593,134**		3,385,312	
Debtors amounts due in more than one year	8	**2,758,196**		-	
Cash at bank and in hand		**713,494**		885,703	
		6,064,824		4,271,015	
Creditors amounts falling due within one year	9	**(366,484)**		(258,144)	
Net current assets			**5,698,340**		4,012,871
Total assets less current liabilities			**5,916,443**		4,102,248
Creditors amounts falling due after more than one year	10		**(3,990,277)**		(3,769,573)
Provisions for liabilities	11		**(155,065)**		-
Net assets			**1,771,101**		332,675
Capital and reserves					
Called up share capital	13		**5,109**		5,109
Share premium account	14		**20,344,530**		20,344,530
Other reserves	14		**10,287,160**		10,287,160
Profit and loss account	14		**(28,865,698)**		(30,304,124)
Shareholder's funds	15		**1,771,101**		332,675

These financial statements were approved by the directors and authorised for issue on 15 February 2011 and are signed on their behalf by

J Hopper
Director

Company registration number 4260336

The accompanying accounting policies and notes form part of these financial statements.

Notes to the financial statements

1 Turnover and profit on ordinary activities before taxation

The turnover and profit before tax are attributable to the one principal activity of the company
The company's turnover for the year was £12,408,880 (2009 - £9,732,983) and was generated wholly from operations in the UK

2 Other operating charges

	2010	2009
	£	£
Distribution costs	**1,456,289**	1,866,331
Administrative expenses	**1,767,324**	2,636,405
Net operating expenses	**3,223,613**	4,502,736

3 Net interest (payable)/ receivable and similar charges

	2010	2009
	£	£
Interest payable on non-bank borrowing	**(195,208)**	(420,534)
Foreign exchange losses	**(123,923)**	-
	(319,131)	(420,534)
Interest receivable	**201**	2,369
Foreign exchange gains	**-**	593,712
	(318,930)	175,547

4 Operating profit/(loss)

Operating profit/(loss) is stated after charging

	2010	2009
	£	£
Depreciation of owned fixed assets	**64,542**	122,431
Auditor's remuneration		
Audit fees	**16,500**	16,500
Research and development expenditure	**1,767,324**	1,866,331
Operating leases		
Land and buildings	**135,348**	139,548
Other assets	**-**	1,507

5 Directors and employees

The average number of staff employed by the company during the financial year amounted to

	2010 No	2009 No
Sales and marketing	**5**	5
Research and development	**18**	15
Administration	**1**	1
Operations	**3**	3
	27	24

The aggregate payroll costs of the above were

	2010 £	2009 £
Wages and salaries	**1,907,556**	1,725,875
Social security costs	**213,760**	214,661
Other pension costs	**38,859**	37,266
	2,160,175	1,977,802

Remuneration in respect of directors was £nil (2009 - £nil)

No directors accrued benefits under company pension schemes in the year (2009 - none)

6 Taxation on profit on ordinary activities

The tax credit represents

	2010 £	2009 £
Corporation tax @ 28% (2009 - 28%)	**25**	-
Adjustments in respect of prior year	**(11,525)**	-
Total current tax	**(11,500)**	-

The tax assessed on the profit on ordinary activities for the year is lower (2009 - lower) than the standard rate of corporation tax in the UK of 28% (2009 - 28%)

	2010 £	2009 £
Profit on ordinary activities before taxation	**1,426,926**	128,561
Profit on activities by rate of tax	**399,540**	35,997
Expenses not deductible for tax purposes	**1,127**	2,870
Differences between depreciation and capital allowances	**(70,695)**	(60,113)
Utilisation of tax losses	**(329,947)**	(84,656)
Research and development expenditure	**-**	(11,675)
Other short term timing differences	**-**	117,577
Adjustments to tax in respect of previous periods	**(11,525)**	-
Total current tax	**(11,500)**	-

Unrelieved tax losses of £22 8m (2009 - £23 9m) remain available to offset against future taxable trading profits

7 Tangible fixed assets

	Construction under progress	Leasehold improve-ments	Test equipment	Office equipment and fittings	Computer equipment	Total
	£	£	£	£	£	£
Cost						
At 1 October 2009	-	39,987	1,707,315	97,558	255,343	2,100,203
Additions	185,340	-	623	-	7,305	193,268
At 30 September 2010	185,340	39,987	1,707,938	97,558	262,648	2,293,471
Depreciation						
At 1 October 2009	-	23,985	1,649,174	90,543	247,124	2,010,826
Charge for the year	-	2,131	51,175	4,101	7,135	64,542
At 30 September 2010	-	26,116	1,700,349	94,644	254,259	2,075,368
Net book value						
At 30 September 2010	**185,340**	**13,871**	**7,589**	**2,914**	**8,389**	**218,103**
At 30 September 2009	-	16,002	58,141	7,015	8,219	89,377

8 Debtors

	2010	2009
	£	£
Amounts due within one year:		
Trade debtors	**1,202,971**	6,369
Other debtors	**27,324**	11,669
Amounts recoverable on contracts	**1,289,106**	3,310,399
Prepayments and accrued income	**73,733**	56,875
	2,593,134	3,385,312
Amounts due after more than one year		
Amounts recoverable on contracts	**2,758,196**	-

9 Creditors: amounts falling due within one year

	2010	2009
	£	£
Trade creditors	**79,822**	122,622
Social security and other taxes	**74,508**	54,869
Amounts due to group undertakings	-	19,117
Accruals and deferred income	**212,154**	61,536
	366,484	258,144

10 Creditors: amounts falling due after more than one year

	2010	2009
	£	£
Amounts due to group undertakings	3,990,277	3,769,573

11 Provisions for liabilities

	Warranty provision
	£
At 1 October 2009	-
Created in the year	155,065
At 30 September 2010	155,065

12 Deferred taxation

The company's provision for deferred taxation consists of the tax effect of timing differences in respect of

	2010		2009	
	Provided	Unprovided	Provided	Unprovided
	£	£	£	£
Accelerated capital allowances	-	279,612	-	350,307
Short term timing differences	-	186,890	-	186,846
Tax losses carried forward	-	6,372,840	-	6,701,920
Net deferred tax asset	-	6,839,342	-	7,239,073

13 Share capital

Authorised share capital

	2010	2009
	£	£
13,192 Ordinary shares of £1 each	13,192	13,192

Allotted, called up and fully paid

	2010		2009	
	No	£	No	£
Ordinary shares of £1 each	5,109	5,109	5,109	5,109

14 Reserves

	Share premium account £	Capital reserve £	Profit and loss account £
At 1 October 2009	20,344,530	10,287,160	(30,304,124)
Profit for the year	-	-	1,438,426
At 30 September 2010	**20,344,530**	**10,287,160**	**(28,865,698)**

15 Reconciliation of movements in shareholders' funds

	2010 £	2009 £
Profit for the financial year	**1,438,426**	128,561
	1,438,426	128,561
Opening shareholder's funds	**332,675**	204,114
Closing shareholder's funds	**1,771,101**	332,675

16 Retirement benefits

Defined contribution scheme
The company operates a defined contribution scheme for its directors and employees The assets of the scheme are held separately from those of the company in an independently administered fund The pension charge for the year was £38,859 (2009 - £37,266) and £8,977 (2009 - £8,780) was included in creditors at the year end

17 Capital commitments

The company had no capital commitments at 30 September 2010 or 30 September 2009

18 Contingent liabilities

There were no contingent liabilities at 30 September 2010 or 30 September 2009

19 Leasing commitments

At 30 September 2010 the company had annual commitments under non-cancellable operating leases as set out below

	2010 Land and buildings £	2009 Land and Buildings £
Operating leases which expire		
Within two to five years	**124,000**	124,000

20 Transactions with related parties

As a subsidiary undertaking, 100% of whose voting rights are controlled within the group, the company has taken advantage of the exemption not to disclose transactions with entities that are part of the group, in accordance with FRS8

21 Controlling related party

The company's immediate parent undertaking is Azea Networks Inc, which is incorporated in the State of Delaware, USA and its ultimate parent undertaking and controlling party is Xtera Communications Inc, which is incorporated in the State of Delaware, USA, and this is the largest and smallest group of which the company is a member and for which group financial statements are prepared Copies of these group financial statements may be obtained from the company secretary