

# UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

## FORM 10-K

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

For the fiscal year ended December 31, 2009

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: 0-31857

### ALLIANCE FIBER OPTIC PRODUCTS, INC.

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of incorporation  
or organization)

77-0554122  
(IRS Employer Identification No.)

275 Gibraltar Drive, Sunnyvale, CA 94089

(Address of principal executive offices)

Issuer's telephone number: (408) 736-6900

#### Securities registered pursuant to Section 12(b) of the Act:

<u>Title of each class</u>	<u>Name of each exchange on which registered</u>
Common Stock, par value \$0.001 per share	The Nasdaq Stock Market LLC
Series A Participating Preferred Stock Purchase Rights	The Nasdaq Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes  No

Indicate by check mark whether the issuer (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and disclosure will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company   
(Do not check if a smaller reporting company)

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates (based upon the closing sale price on the Nasdaq Capital Market on June 30, 2009) was approximately \$45,537,387.

As of March 5, 2010 there were 42,458,612 shares of Common Stock, \$0.001 per share par value, outstanding.

#### DOCUMENTS INCORPORATED BY REFERENCE

Items 10 (as to directors and Section 16(a) Beneficial Ownership Reporting Compliance), 11, 12 (as to Security Ownership of Certain Beneficial Owners) and 13 of Part III incorporate by reference information from the registrant's proxy statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the registrant's 2010 Annual Meeting of Stockholders to be held on May 14, 2010.

ALLIANCE FIBER OPTIC PRODUCTS, INC.

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## PART I

### Item 1. Business

*When used in this Report, the words “expects,” “anticipates,” “believes,” “estimates,” “plans,” “intends,” “could,” “will,” “may” and similar expressions are intended to identify forward-looking statements. These are statements that relate to future periods and include statements as to our operating results, revenues, sources of revenues, cost of revenues, gross margins, profitability, the amount and mix of anticipated investments, exposure to interest or exchange rate changes, expenditures and expense levels, our liquidity and the adequacy of our capital resources, anticipated working capital and capital expenditures, the impact of the economic environment on our business and our customers, our beliefs regarding our auction rate securities and related repurchase rights, reliance on our connectivity products, our cash flow, trends in average selling prices, our reliance on the commercial success of our optical passive products, plans for future products and enhancements of existing products, features, benefits and uses of our products, demand for our products, our expectations regarding the impact of accounting changes, our success being tied to relationships with key customers, industry trends and market demand, acquisitions of complementary businesses, products or technologies, our efforts to protect our intellectual property, potential indemnification agreements, increases in the number of possible license offers and patent infringement claims, our competitive position, sources of competition, our competitive strengths, consolidation in our industry, our international strategy, our employee relations, the adequacy of our internal controls, the potential effect of recent accounting pronouncements and our critical accounting policies and estimates. Forward-looking statements are subject to risks and uncertainties that could cause actual results to differ materially from those expected. These risks and uncertainties include, but are not limited to, those risks discussed in Item 1A – Risk Factors, below, as well as risks related to the development of the metropolitan, last mile access, and enterprise networks, customer acceptance of our products, our ability to retain and obtain customers, industry-wide overcapacity and shifts in supply and demand for optical components and modules, our ability to meet customer demand and manage inventory, fluctuations in demand for our products, declines in average selling prices, the loss of one or more key customers, development of new products by us and our competitors, increased competition, inability to obtain sufficient quantities of a raw materials, loss of a key supplier, integration of acquired businesses or technologies, the impact of the economy, financial stability in foreign markets, foreign currency exchange rates, costs associated with being a public company, delisting from the Nasdaq Capital Market, failure to meet customer requirements, our ability to license intellectual property on commercially reasonable terms, economic stability, and the state of the capital markets. These forward-looking statements speak only as of the date hereof. The Company expressly disclaims any obligation or undertaking to release publicly any updates or revisions to any forward-looking statements contained herein to reflect any change in the Company’s expectations with regard thereto or any change in events, conditions or circumstances on which any such statement is based.*

*All references to “Alliance Fiber Optic Products,” “AFOP,” “we,” “us,” “our” or the “Company” mean Alliance Fiber Optic Products, Inc. and its subsidiaries, except where it is made clear that the term means only the parent company.*

*AFOP, OPIS and SPECTRAMUX are our trademarks. We may also refer to trademarks of other corporations and organizations in this document.*

### Overview

Alliance Fiber Optic Products designs, manufactures and markets a broad range of high-performance fiber optic components, and integrated modules incorporating these components, for leading and emerging communications equipment manufacturers and service providers. We offer a broad range of products including interconnect devices that are used to connect optical fibers and components, couplers and splitters that are used to divide and combine optical power, and dense wavelength division multiplexing, or DWDM, devices that separate and combine multiple specific wavelengths. Our emphasis on design for manufacturing and our comprehensive manufacturing expertise enable us to produce our products efficiently, with high quality, and in volume quantities. Our product scope and ability to integrate our components into optical modules enable us to satisfy a wide range of customer requirements throughout the optical networking market. Our customers deploy our products in long-haul networks that connect cities, metropolitan networks that connect areas within cities, last mile access networks that connect to individual businesses and homes, and enterprise networks within businesses.

### Industry Background

The popularity of the Internet and the growing number of data-intensive Internet-based applications and services has fueled a significant increase in the volume of data traffic. This traffic growth has increased the demands on

communication networks originally developed to primarily transport voice traffic. To meet this demand, many communications service providers have and are designing and installing new networks based on fiber optic technology, which provides greater data-carrying capacity, or bandwidth, and increased transmission speeds compared to existing communications networks. Until recently, most of the fiber deployed had been dedicated to long-haul networks. However, the demands for high-speed network access and bandwidth are shifting the focus towards more complex metropolitan networks and last mile access networks, which require an increasing number of connections and components.

Optical fiber is currently being deployed across the following segments of communications networks: long-haul, metropolitan, last mile access, and enterprise.

*Long-haul networks.* Long-haul networks connect the communications networks of cities around the world and transport large amounts of data and voice traffic. To solve congestion problems, service providers have invested significant resources in the deployment of optical infrastructure. As a result, current long-haul networks provide high bandwidth for transmitting data over very long distances. The build-out of long-haul networks represents an important step in improving network infrastructure to support increased demand for new services and greater traffic volumes.

*Metropolitan networks.* Metropolitan networks connect long-haul networks to last mile access networks within urban areas. Due to the increase in data traffic and the demand for enhanced services, the existing metropolitan network infrastructure has become a bottleneck for the provision of communications services to business and residential end users. As a result, service providers are making investments in infrastructure to reduce capacity constraints in metropolitan networks.

*Last mile access networks.* Last mile access networks connect business and residential end users to their service provider in order to provide increased bandwidth to the end user. Traditional access networks use the existing copper wire-based infrastructure, which is slow compared to the high-speed networks commonly used within businesses. Service providers are beginning to deploy fiber technologies in the last mile access network in order to provide high bandwidth connectivity to the end user.

*Enterprise networks.* Local area networks serving the business community have utilized fiber optic links for over a decade. Historically these links have connected vertical backbone requirements between various floors of copper-based networks within office buildings. As the bandwidth of local networks has increased, optical fiber has become a pervasive medium for horizontal network links especially in the storage network environment.

Service providers are seeking to maximize the performance and capacity of both new and existing optical networks through advances in optical technology. Wavelength division multiplexing, or WDM, has been used for several years to increase system capacity by combining different light signals at different wavelengths, on a single optical fiber. Each wavelength represents a separate high-bandwidth channel that can carry data. Multiplexing devices combine, or multiplex, these different wavelengths at one end of the optical network, and demultiplexing devices, or demultiplexer, separate them at the other end. WDM technology has been enhanced with the introduction of dense wavelength division multiplexing, or DWDM, which permits the wavelengths to be spaced more closely together. The tighter spacing allows even more wavelengths to be transmitted on one optical fiber. The use of WDM and DWDM technology is well established in the long-haul market and is increasingly utilized in the metropolitan and last mile access markets.

Fiber optic components are used within optical networks to create, combine, isolate, amplify, split, direct and perform various other functions on the optical signals. Fiber optic components are divided into two broad categories, active and passive components. Active components require power to operate and use electrical signals to create, modulate or amplify optical signals. Passive optical components connect, guide, mix, filter, route, adjust and stabilize optical signals transmitted through an optical network.

## **Market Conditions**

In periods prior to 2004, communication equipment manufacturers purchased optical transport systems and related devices in anticipation of an extremely rapid increase in demand for bandwidth. While demand for bandwidth continues to increase, this demand has grown at a far slower pace than previously anticipated. As a result, communication equipment manufacturers ended up with excess inventories of optical systems and devices that continue to create a barrier to new sales opportunities for much of the following several years. Global economic declines of the later portion of the decade impeded as stronger recovery of demand for communications equipment broadly although more demand resulted from deployment of access related systems for broadband applications in this period.

This situation has created challenges for suppliers in the optical communication industry. Due to decreased unit shipments as a result of overcapacity in the industry and the resulting competition for fewer sales opportunities, average selling prices have declined as companies compete for significantly smaller market opportunities.

Over the past four years, as mentioned the optical components industry has experienced a slight increase and resumption in business levels. Recent orders for our products have been utilized both for upgrades of existing networks and new network builds. In addition, certain large telecommunications service providers have recently announced that they plan to deploy new broadband access networks based on fiber optic technologies for residential users. These fiber-to-the-home networks, or FTTH, are expected to significantly increase the capacity and expand the types of services that can be utilized by residential users. It remains difficult, however, to predict the timing or extent of a full industry recovery and the potential impact to our business from this or any other deployment initiatives.

## Products

Our lines of optical products support the needs of current and next generation optical network systems applications. Our connectivity (formerly named Optical Path Management Solutions, or OPMS) product family provides a comprehensive line of optical interconnect devices, couplers and splitters, PLC (planar lightwave circuits) and related optical products, as well as customized integrated modules incorporating these devices. Our optical passive products (formerly named Wavelength Management Solutions, or WMS) include WDM and DWDM components and modules that utilize thin film filter technologies to separate optical signals, variable attenuators, optical switches and other optical devices utilizing micro optic lensing technology including integrated electro-optical modules incorporating these products.

The following is a discussion of our current product offerings and the products that we are developing.

**Connectivity Products.** In nearly all fiber optic networks, the optical fiber, passive optical components and active optical devices must be joined using optical interconnection systems. Our connectivity platform provides fundamental component support for these applications as well as standard and custom value added integrated solutions that address the need for higher functionality and modularity. All of our connectivity products described below are in production and are shipping to customers.

*Connectivity Modules.* The evolution of optical components is driven by the increasing need for packaging density, module performance and overall cost effectiveness. We design and package our various components to provide superior integrated connectivity modules for our customers. Our integrated modules are designed to reduce our customers' system design requirements and ease implementation.

*Optical Connectors, Adapters and Cable Assemblies.* Optical connectors and adapters are precision devices that connect fibers together. Optical cable assemblies are used to bridge relatively short distances with optical paths. We offer a broad range of industry standard connection products that support a wide range of fiber and fiber cable types. Further, with our vertically integrated design and manufacturing capability, we are able to customize these products to meet our customers' needs for compact size and special features. We specialize in providing our customers with high performance custom cable assemblies to serve in conjunction with our optical interconnection solutions at all interface points in the optical communications network.

*Fused and Planar Fiber Optical Splitters and Couplers.* Fused and planar fiber optical splitters and couplers are branching devices that are used to split optical power from a single fiber, or set of fibers, into a different set of fibers. They are often used to distribute optical signals to multiple locations for processing. These devices utilize signal and power sharing features to reduce the total cost of delivering bandwidth to end-users. Our optical splitters and couplers reduce insertion loss, or the power loss incurred when inserting components into an optical path, and deliver high performance, including uniform optical wavelength splitting.

*Optical Tap Couplers and Ultra Low Polarization Dependent Loss Tap Couplers.* Optical tap couplers are fused fiber branching devices that split off a portion of light to allow for optical monitoring and feedback. These devices are used extensively in fiber amplifier power control. They are also utilized in transmission equipment for performance monitoring and control. Our ultra low polarization dependent loss devices offer low levels of sensitivity to polarization, which is a characteristic of light that can cause a reduction in the fidelity of optical signals. These devices enable more effective monitoring and management of optical networks.

*Amplifier WDM Couplers.* Amplifier WDM couplers are used with specialized fibers to combine or separate specific wavelengths of light associated with standard telecommunications optical amplifier requirements. Our amplifier WDM couplers are stable low power loss components with high power handling capability.

*Optical Fixed Attenuators.* Optical fixed attenuators diminish the optical power within a given optical path without interference or reduction in optical signal quality. Typically, this function is embedded in an optical connector or adapter element to simplify optical network installation. We utilize attenuating fiber that reduces power while preserving performance characteristics, including optical signal quality and reliability.

*Fused Fiber WDM Couplers.* Fused fiber WDM couplers are used to combine and separate optical signals transmitted on different wavelengths. This function provides the first level of bandwidth expansion for a network by increasing a fiber's signal carrying capacity. Fused fiber WDM couplers may also be used to add additional functionality to the network such as network status monitoring. We believe our fused fiber WDM couplers provide a cost effective way to minimize loss and maximize wavelength isolation.

*Planar Lightwave Circuit Splitters.* Our optical splitters reduce insertion loss, or the power loss incurred when inserting components into an optical path, and deliver high performance. We believe these devices enable more effective monitoring and management of optical networks.

**Optical Passive Products.** As the capacity and complexity of optical networks increases, future systems face significant challenges. Performance characteristics such as stability, wavelength isolation, channel balance and power loss due to polarization become important to optimize, and product solutions which enhance these characteristics provide competitive advantage. In recent years, WDM has become the preferred method of increasing bandwidth throughout optical networks. Our filter-based products serve WDM and DWDM systems as core passive elements that direct and manage larger numbers of optical signal channels. These particular Optical Passive Products also enable network DWDM systems to manage and monitor a large number of optical signals by separating these signals into different paths that can be processed individually.

Our Optical Passive Products devices serve many system OEM customers needs for current and next generation network equipment. All of our Optical Passive Products described below are in production and are shipping to customers.

*Filter WDMs.* Our thin film filter based WDMs are used to combine and separate optical signals. Our filter-based products allow for higher isolation and narrower wavelength separations than fused fiber technology. Our filter WDMs are designed for a range of network applications including combining active and passive components and wavelength monitoring, splitting and separating tasks.

*Amplifier Filter WDMs.* Amplifier filter WDMs utilize thin film filter technology to maintain wavelength separation in demanding applications. In addition, filter technology allows for narrow wavelength separation. Our amplifier filter WDMs are designed for a range of applications, such as splitting wavelengths and connecting lasers used in signal power amplification.

*DWDMs.* Dense wave division multiplexers, or DWDMs, are integrated optical modules that combine, or multiplex, and separate, or demultiplex, multiple optical signals of different wavelengths on a single fiber. The separation of wavelengths are so narrow, or dense, that a large number of channels (greater than 10) can be combined within the band of usable wavelengths of the fiber itself. We utilize proprietary thin film technology in the development and manufacture of our DWDM products. This technology delivers excellent performance characteristics, including narrow channel separation and wide channel bandpass, which is the range of frequencies that will pass through a filter. Thin film filter technology allows for a range of solutions for 200 GHz, 100 GHz and 50 GHz International Telecom Union wavelength spacing applications, which permit 40 channels, 80 channels, and 160 channels, respectively, to be transmitted across a single fiber. We believe that our DWDMs directly address the scalable channel plans found in metropolitan and last mile access network applications.

*CWDMs.* Coarse wavelength division multiplexers, or CWDMs, are integrated optical modules that multiplex or demultiplex multiple optical signals of different wavelengths on a single fiber. Our CWDM product separate wavelength into 20 nanometers, or spacing to cover the complete fiber optical communication spectrum from 1270 nm to 1610 nm.

With the unique low insertion loss and flat band-pass profile, CWDMs provide an economic and efficient wavelength division multiplexing solution for metropolitan and access networks. Our CWDM product covers four channel, eight

channel, and sixteen channel mux and demux applications, and upgradeability for both four channel and eight channel types. We also offer optical add-drop modules, or OADMs, for CWDM networks, with the capability of adding or dropping from one to fifteen channels. In addition to the CWDM mux, demux and optical add/drop modules, we also offer complete rackmount CWDM solutions to customers so they can easily mount our CWDM products directly on their system rack. We believe our CWDM products directly address the metropolitan and access markets' competitive wavelength management needs.

*CCWDMs.* Compact coarse wavelength division multiplexers, or CCWDMs, are integrated optical modules that are designed to significantly improve optical performance, while reducing manufacturing costs, in a package less than 1/4 the size of conventional CWDM modules. Our CCWDMs feature high wavelength accuracy and stability, low insertion loss, high isolation, low polarization dependent loss and an epoxy-free optical path. Our Telcordia 1209/1221-qualified CCWDM builds on AFOP's proprietary optical bench platform, and we believe it has the smallest footprint of any comparable CWDMs. With a channel spacing of 20 nm and wide bandpass characteristics, it allows for datacom or telecom network applications with low-cost uncooled lasers. These CCWDM Mux/Demuxes are available in four or eight channels and include an expansion port for 16 channel systems.

*Add/Drop DWDM Filters.* Add/drop DWDM filter products are used to insert or extract specific wavelengths in a DWDM system. While a large number of channels can be transmitted through a single fiber network, often only selected channels of information are required at a particular location. Our 200 GHz, 100 GHz and 50 GHz add/drop components use high performance filter technology and operate with very little optical power loss in order to provide high channel separation and high stability.

*Optical Isolators* These devices use polarization rotation to block return signals from the forward optical path. They limit distortions in devices and signals caused by reflected lights in the fiber.

*Optical Bypass Switches* As the name suggests, these devices utilize beam shifting optics or mirror to switch optical signals from one fiber to another in response to a control signal provided electronically. Optical switches are used in test equipment for basic functionality and in networks to provide protection and redundancy.

*Automatic Variable Optical Attenuators.* Automatic variable optical attenuators are designed to control the optical power in a fiber. They are often combined with an active system component to maintain optical power on a network even if the input signal is changing power. Our automatic variable optical attenuators are specifically designed for application in DWDM networks for use with individual channel source elements such as add/drop transmitters. The cost and performance characteristics of our automatic variable optical attenuators are specifically targeted to allow for the use of these devices in volume as principal DWDM channel stabilization components.

## **Intellectual Property**

We rely on a combination of patent, copyright, trademark and trade secret laws, as well as confidentiality agreements and licensing arrangements, to establish and protect our proprietary rights. As of December 31, 2009, we had 61 United States patents issued or assigned to us and had 20 United States patent applications pending. Our 61 U.S. patents expire between September 2013 and April 2028. We also have 16 foreign patents issued, and 2 foreign patent application pending. Our foreign patents issued will expire between January 2010 and December 2019. We also utilize unpatented proprietary know-how and trade secrets and employ various methods to protect them.

From time to time, third parties, including our competitors, may assert patent, copyright and other intellectual property rights to technologies that are important to us. We expect we will increasingly be subject to license offers and infringement claims as the number of products and competitors in our market grows and the functions of products overlap. Patents of third parties may be determined to be valid, or some of our products may ultimately be determined to infringe them. Other companies may pursue litigation with respect to those or other claims. The results of any litigation are inherently uncertain. In the event of an adverse result in any litigation with respect to intellectual property rights relevant to our products that could arise in the future, we could be required to obtain licenses to the infringing technology, to pay substantial damages under applicable law, to cease the manufacture, use and sale of infringing products or to expend significant resources to develop non-infringing technology. Licenses may not be available from third parties either on commercially reasonable terms or at all. In addition, litigation frequently involves substantial expenditures and can require significant management attention, even if we ultimately prevail. Accordingly, any infringement claim or litigation against us could significantly harm our business, operating results, financial condition, or cash flows. As of December 31, 2009, we were not aware of infringement claims or litigation pending against us.

## Customers

We sell our products to communications equipment manufacturers that incorporate our products into their systems that they in turn sell to network service providers. In certain cases, we sell our products to other component manufacturers for resale or inclusion in their products. In the year ended December 31, 2009, we sold our products to more than 200 customers. Two customers accounted for 15.1% and 14.9% of our revenues in the year ended December 31, 2009. One customer accounted for 15.7% of our revenues in the year ended December 31, 2008. The following is a summary of our revenues generated by geographic segments (in thousands):

Revenues	Years Ended December 31,	
	2009	2008
North America	\$ 14,721	\$ 21,579
Europe	7,085	5,882
Asia	8,028	11,293
Total	<u>\$ 29,834</u>	<u>\$ 38,754</u>

## Sales, Marketing and Technical Support and Product Management

*Sales.* Our direct sales force markets and sells our products primarily in the United States. We also maintain a sales support staff in Taiwan to service customers based in the Asia Pacific region. Our direct sales force and technical marketing personnel maintain close contact with our customers and provide technical support.

*Marketing.* We have a number of marketing programs to support the sale and distribution of our products and to inform existing and potential customers about the capabilities and benefits of our products. Our marketing efforts include participating in industry trade shows and technical conferences, advertising in trade journals and communicating through our corporate website and direct mail.

*Technical Support and Product Management.* We maintain a technically knowledgeable support staff that we believe is critical to our development of long-term customer relationships. Our technical support and product management staff works closely with our customers to understand their product requirements, to assist customers with utilizing our product line, and to develop customized product solutions.

## Competition

The fiber optic component industry is highly competitive and subject to rapid technological change. We believe that the principal differentiating factors in the fiber optic component market are support for multiple optical interfaces, high optical power, wavelength selection, manufacturing capacity, reliable and compact packaging, price, product innovation and reliability of product performance. Based on our assessment of the performance and price of similar competitive product offerings, we believe that our products compare favorably, although we cannot assure you that they will continue to do so.

Our principal competitors in the components market include Oclaro Inc., JDS Uniphase Corp., Oplink Communications, Inc., and Tyco Electronics Corporation. We estimate that we had approximately 20 competitors in the components market as of December 31, 2009. We believe that we primarily compete with diversified suppliers for the majority of our product line and to a lesser extent with a large number of niche companies that offer a more limited product line. Competitors throughout the optical component industry, including those who sell active components, may rapidly become competitors in portions of our business. Competitors who provide both active and passive components may have a competitive advantage because they provide a more complete product solution than we provide. In addition, our industry has continued to experience significant consolidation, and we anticipate that further consolidation will occur. This consolidation has further increased and we believe will further increase competition. We expect significant pricing pressure from our competitors that may negatively affect our margins. We cannot assure you that we will be able to compete successfully with existing or future competitors or that competitive pressures will not seriously harm our business, operating results and financial condition.

## **Product Development**

As of December 31, 2009, we had a total of 58 engineers and technicians that are directly involved in research and development of our products located in the United States, Taiwan and China. Our engineering team has extensive design, packaging, processing, and software experience in optical components, interfaces and systems.

Our primary product development center is located in Sunnyvale, California, where we opened our Photonics Technology Center in March 2001. Our Taiwanese subsidiary also engages in product development. Our research and development expenses were \$3.0 million and \$3.3 million for the years ended December 31, 2009 and 2008, respectively. We spend a substantial proportion of our financial resources to develop new technologies and products to serve the next generation communication markets.

## **Sources and Availability of Raw Materials**

We make significant purchases of key materials, components and equipment, including ferrules, graded index lenses, or GRIN lenses, filters and other components from third party suppliers. We obtain most of our critical raw materials and components from a single or limited number of suppliers. When possible, we also develop and maintain alternative sources for essential materials and components. However, there is only one supplier of GRIN lenses. The inability to obtain sufficient quantities of these materials or components may result in delays, increased costs, and reductions in our product shipments.

## **Manufacturing**

We currently manufacture the majority of our connectivity products at our facility in Tu-Cheng City, Taiwan. We manufacture our filter-based and advanced products at our facility near Shenzhen, China.

Each of our facilities maintains comprehensive in-house manufacturing processes, including component and integrated module design, integration, production, and testing. We plan to continue to invest resources in manufacturing management, engineering and quality control.

We have established a quality management system which is designed to ensure that the products we provide to our customers meet or exceed their requirements. All of our three facilities are ISO 9001-2000 certified. In addition, our Taiwan facility is TL-9000 certified.

## **Employees**

As of December 31, 2009, we had 870 full-time employees, including 39 located in the United States, 318 in Taiwan and 513 in China. Of our 870 full-time employees, 58 are engaged in product development, 722 are engaged in manufacturing production, 19 are engaged in sales, marketing, application support and customer service, and 71 are engaged in general and administration. None of our employees are represented by a labor union. We have not experienced any work stoppages and we consider our relations with our employees to be good.

## **Additional Information**

We were incorporated in California in December 1995. In October 2000, prior to our initial public offering, we reincorporated in Delaware as Alliance Fiber Optic Products, Inc. Our internet address is [www.afop.com](http://www.afop.com). We make available free of charge through a hyperlink on our website our annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments to those reports filed or furnished pursuant to Section 13(a) of the Exchange Act as soon as reasonably practicable after the material is furnished to the SEC. Our website and the information contained therein or connected thereto is not intended to be incorporated into this Annual Report on Form 10-K.

## **Item 1A. Risk Factors**

**We have a history of losses, may experience future losses and may not be able to generate sufficient revenues in the future to achieve and sustain profitability.**

We had net income of approximately \$1.4 million and \$4.1 million in fiscal year 2009 and 2008, respectively. Although we generated a profit in these two fiscal years, we may not be able to sustain profitability in the future.

Although our cash and cash equivalents increased in 2009, we may experience negative cash flows again in the future. As of December 31, 2009, we had an accumulated deficit of approximately \$63.8 million.

We continue to experience fluctuating demand for our products. If demand for our products declines, we may not be able to decrease expense on a timely basis, or at all, to offset the decrease in revenues. We also expect declining average selling price, may negatively impact our results of operations in future periods. If demand for our products increases in the future, we expect to incur significant and increasing expenses for expansion of our manufacturing operations, research and development, sales and marketing, and administration, and in expanding direct sales and distribution channels. Given the rate at which competition in our industry intensifies and the fluctuations in demand for our products, we may not be able to adequately control our costs and expenses or achieve or maintain adequate operating margins. As a result, to maintain profitability, we will need to generate and sustain substantially higher revenues while maintaining reasonable cost and expense levels. We may not be able to sustain profitability on a quarterly or an annual basis.

**Our connectivity products have historically represented a significant part of our revenues, and if we are unsuccessful in commercially selling our optical passive products, our business will be seriously harmed.**

Sales of our connectivity products accounted for 62.5% and 63.1% of our revenues in the fiscal years ended December 31, 2009 and 2008, respectively, and substantially all of our historical revenues. We expect to depend on our connectivity products for the majority of our near-term revenues. Any significant decline in the demand for these products, or failure to increase their market acceptance, would seriously harm our business. Declining average selling prices of our products during 2009 negatively impacted our revenues and may continue to do so in the future. We believe that our future growth and a significant portion of our future revenues will depend on the commercial success of our optical passive related products, which we began shipping commercially in July 2000. Demand for these products has fluctuated over the past few years, declining sharply starting in mid fiscal 2001 and then increasing beginning in 2003. If demand does not continue to increase and our target customers do not continue to adopt and purchase our optical passive related products, our revenues may decline and we may have to write-off additional inventory that is currently on our books.

**Declining general economic or business conditions may have a negative impact on our business.**

Concerns over inflation, deflation, energy costs, geopolitical issues, the availability and cost of credit, the Federal stimulus package and budget process, the U.S. mortgage market and a declining real estate market in the U.S. have contributed to increased volatility and diminished expectations for the global economy and expectations of slower global economic growth going forward. These factors, combined with volatile oil prices, declining business and consumer confidence, a declining stock market and increased unemployment, have precipitated an economic slowdown and recession. If the economic climate in the U.S. does not improve or continues to deteriorate, our business, including our customers and our suppliers, could be negatively affected, resulting in a negative impact on our revenues.

**We depend on a small number of customers for a significant portion of our total revenues and the loss of, or a significant reduction in orders from, any of these customers, would significantly reduce our revenues and harm our operating results.**

In the years ended December 31, 2009 and 2008 our top 10 customers comprised 62.8% and 62.3% of our revenues, respectively. Two customers accounted for 15.1 % and 14.9% of our total revenues for the year ended December 31, 2009, respectively. One customer accounted for 15.7 % of our total revenues for the year ended December 31, 2008

We derive a significant portion of our revenues from a small number of customers, and we anticipate that we will continue to do so in the foreseeable future. These customers may decide not to purchase our products at all, to purchase fewer products than they did in the past, or to alter their purchasing patterns in some other way. Reduced orders from a significant customer contributed to the decrease in our revenues in 2009. The loss of any significant customer, a significant reduction in sales we make to them, or any problems collecting receivables from them would likely harm our financial condition and results of operations.

**Our quarterly and annual financial results have historically fluctuated due primarily to introduction of, demand for, and sales of our products, and future fluctuations may cause our stock price to decline.**

We believe that period-to-period comparisons of our operating results are not a good indication of our future performance. Our quarterly operating results have fluctuated in the past and are likely to fluctuate significantly in the future due to a number of factors. For example, the timing and expenses associated with product introductions and establishing additional manufacturing lines and facilities, changes in manufacturing volume, declining average selling prices of our products, the timing and extent of product sales, the mix of domestic and international sales, the mix of sales channels through which our products are sold, the mix of products sold and significant fluctuations in the demand for our products have caused our operating results to fluctuate in the past. Because we incur operating expenses based on anticipated revenue trends, and a high percentage of our expenses are fixed in the short term, any delay in generating or recognizing revenues or any decrease in revenues could significantly harm our quarterly results of operations. Other factors, many of which are more fully discussed in other risk factors below, may also cause our results to fluctuate. Many of the factors that may cause our results to fluctuate are outside of our control. If our quarterly or annual operating results do not meet the expectations of investors and securities analysts, the trading price of our common stock could significantly decline.

**Uncertainty in the credit markets has and may continue to impact the value and liquidity of our auction-rate securities, or ARS.**

Credit concerns in the capital markets have significantly reduced our ability to liquidate \$16.1 million in ARS that we classify as current assets on our balance sheet at December 31, 2009. All ARS we hold have failed to sell at auction since February 2008 due to an insufficient number of bidders. As of December 31, 2009, one of the issuers of the ARS completed seven partial calls at par and we received settlement of \$200,000 in total. In November 2008, we accepted the right to require UBS to repurchase our ARS investment at par value beginning on June 30, 2010, or the "Right". We cannot assure you that UBS will have the ability to purchase our ARS at par or at any other price in the future. Accordingly, we may not be able to exercise the Right or liquidate these securities and use the cash to finance our business. In future periods, the estimated fair value of our ARS and the Right could decline based on market conditions, which could result in impairment charges.

**If we cannot attract more optical communications equipment manufacturers to purchase our products, we may not be able to increase or sustain our revenues.**

Our future success will depend on our ability to migrate existing customers to our new products and our ability to attract additional customers. Some of our present customers are relatively new companies. The growth of our customer base could be adversely affected by:

- customer unwillingness to implement our products;
- any delays or difficulties that we may incur in completing the development and introduction of our planned products or product enhancements;
- the success of our customers;
- excess inventory in the telecommunications industry;
- new product introductions by our competitors;
- any failure of our products to perform as expected; or
- any difficulty we may incur in meeting customers' delivery requirements or product specifications.

The fluctuations in the economy have affected the telecommunications industry. Telecommunications companies have cut back on their capital expenditure budgets, which has and may continue to further decrease demand for equipment and parts, including our products. This decrease has had and may continue to have an adverse effect on the demand for fiber optic products and negatively impact the growth of our customer base.

**We are exposed to risks and increased expenses and business risk as a result of Restriction on Hazardous Substances, or RoHS directives.**

Following the lead of the European Union, or EU, various governmental agencies have either already put into place or are planning to introduce regulations that regulate the permissible levels of hazardous substances in products sold in various regions of the world. For example, the RoHS directive for EU took effect on July 1, 2006. The labeling provisions of similar legislation in China went into effect on March 1, 2007. Consequently, many suppliers of products sold into the EU have required their suppliers to be compliant with the new directive. Many of our customers have adopted this approach and have required our full compliance. Though we have devoted a significant amount of resources and effort planning and executing our RoHS program, it is possible that some of our products might be incompatible with such regulations. In such event, we could experience the following consequences: loss of revenue, damaged reputation, diversion of resources, monetary penalties, and legal action.

**The market for fiber optic components is increasingly competitive, and if we are unable to compete successfully our revenues could decline.**

The market for fiber optic components is intensely competitive. We believe that our principal competitors are the major manufacturers of optical components and integrated modules, including vendors selling to third parties and business divisions within communications equipment suppliers. Our principal competitors in the components market include Oclaro Inc. JDS Uniphase Corp., Oplink Communications Inc., and Tyco Electronics Corporation. We believe that we primarily compete with diversified suppliers for the majority of our product line and to a lesser extent with niche companies that offer a more limited product line. Competitors in any portion of our business may also rapidly become competitors in other portions of our business.

Many of our current and potential competitors have significantly greater financial, technical, marketing, purchasing, manufacturing and other resources than we do. As a result, these competitors may be able to respond more quickly to new or emerging technologies and to changes in customer requirements, to devote greater resources to the development, promotion and sale of products, to negotiate lower prices on raw materials and components, or to deliver competitive products at lower prices.

Several of our existing and potential customers are also current and potential competitors of ours. These companies may develop or acquire additional competitive products or technologies in the future and subsequently reduce or cease their purchases from us. In light of the consolidation in the optical networking industry, we also believe that the size of suppliers will be an increasingly important part of a purchaser's decision-making criteria in the future. We may not be able to compete successfully with existing or new competitors, and we cannot ensure that the competitive pressures we face will not result in lower prices for our products, loss of market share, or reduced gross margins, any of which could harm our business.

New and competing technologies are emerging due to increased competition and customer demand. The introduction of products incorporating new or competing technologies or the emergence of new industry standards could make our existing products noncompetitive. For example, there are technologies for the design of wavelength division multiplexers that compete with the technology that we incorporate in our products. If our products do not incorporate technologies demanded by customers, we could lose market share causing our business to suffer.

**If we fail to effectively manage our operations, specifically given the past history of sudden and dramatic downturn in demand for our products, our operating results could be harmed.**

As of December 31, 2009, we had a total of 39 full-time employees in Sunnyvale, California, 318 full-time employees in Taiwan, and 513 full-time employees in China. Matching the scale of our operations with demand fluctuations, combined with the challenges of expanding and managing geographically dispersed operations, has placed, and will continue to place, a significant strain on our management and resources. To manage the expected fluctuations in our operations and personnel, we will be required to:

- improve existing and implement new operational, financial and management controls, reporting systems and procedures;
- hire, train, motivate and manage additional qualified personnel, especially if we experience a significant increase in demand for our products;

- effectively expand or reduce our manufacturing capacity, attempting to adjust it to customer demand; and
- effectively manage relationships with our customers, suppliers, representatives and other third parties.

In addition, we will need to coordinate our domestic and international operations and establish the necessary infrastructure to implement our international strategy. If we are not able to manage our operations in an efficient and timely manner, our business will be severely harmed.

Our success also depends, to a large degree, on the efficient and uninterrupted operation of our facilities. We have expanded our manufacturing facilities in China and manufacture many of our products there. Our facility in Taiwan also houses a substantial portion of our manufacturing operations. There is significant political tension between Taiwan and China. If there is an outbreak of hostilities between Taiwan and China, our manufacturing operations may be disrupted or we may have to relocate our manufacturing operations. Tensions between Taiwan and China may also affect our facility in China. Relocating a portion of our employees could cause temporary disruptions in our operations and divert management's attention.

**Because of the time it takes to develop fiber optic components, we incur substantial expenses for which we may not earn associated revenues.**

The development of new or enhanced fiber optic products is a complex and uncertain process. We may experience design, manufacturing, marketing and other difficulties that could delay or prevent the development, introduction or marketing of new products and enhancements. Development costs and expenses are incurred before we generate revenues from sales of products resulting from these efforts. Our total research and development expenses were approximately \$3.0 million and \$3.3 million for the years ended December 31, 2009 and 2008, respectively. We intend to continue to invest in our research and product development efforts, which could have a negative impact on our earnings in future periods if we do not earn associated revenues from such efforts.

**If we are unable to develop new products and product enhancements that achieve market acceptance, sales of our fiber optic components could decline, which could reduce our revenues.**

The communications industry is characterized by rapidly changing technology, frequent new product introductions, changes in customer requirements, evolving industry standards and, more recently, significant variations in customer demand. Our future success depends on our ability to anticipate market needs and develop products that address those needs. As a result, our products could quickly become obsolete if we fail to predict market needs accurately or develop new products or product enhancements in a timely manner. Our failure to predict market needs accurately or to develop new products or product enhancements in a timely manner will harm market acceptance and sales of our products. If the development or enhancement of these products or any other future products takes longer than we anticipate, or if we are unable to introduce these products to market, our sales will not increase. Even if we are able to develop and commercially introduce them, these new products may not achieve the widespread market acceptance necessary to provide an adequate return on our investment.

**Current and future demand for our products depends on the continued growth of the Internet and the communications industry, which is experiencing consolidation, realignment, and fluctuations in product inventory and demand for fiber optic products.**

Our future success depends on the continued growth of the Internet as a widely used medium for communications and commerce, and the growth of optical networks to meet the increased demand for capacity to transmit data, or bandwidth. If the Internet does not continue to expand as a medium for communications and commerce, the need to significantly increase bandwidth across networks and the market for fiber optic components may not continue to develop. If this growth does not continue, sales of our products may continue to decline, which would adversely affect our revenues. Our customers have experienced an oversupply of inventory due to fluctuating demand for their products that has resulted in inconsistent demand for our products. Future demand for our products is uncertain and will depend heavily on the continued growth and upgrading of optical networks, especially in the metropolitan, last mile, and enterprise access segments of the networks.

Inconsistent spending by telecommunication companies over the past several years has resulted in fluctuating demand for our products. The rate at which communication service providers and other fiber optic network users have built new fiber optic networks or installed new systems in their existing fiber optic networks has fluctuated in the past

and these fluctuations may continue in the future. These fluctuations may result in reduced demand for new or upgraded fiber optic systems that utilize our products and therefore, may result in reduced demand for our products. Declines in the development of new networks and installation of new systems have resulted in the past in a decrease in demand for our products, an increase in our inventory, and erosion in the average selling prices of our products.

The communications industry is experiencing continued consolidation and realignment, as industry participants seek to capitalize on the rapidly changing competitive landscape developing around the Internet and new communications technologies such as fiber optic networks. As the communications industry consolidates and realigns to accommodate technological and other developments, our customers may consolidate or align with other entities in a manner that results in a decrease in demand for our products.

**We are experiencing fluctuations in market demand due to overcapacity in our industry and an economy that is stymied by the current financial and economic crisis, international terrorism, war and political instability.**

The United States economy has experienced and continues to experience significant fluctuations in consumption and demand. During the past several years, telecommunication companies have mostly decreased their spending, which has resulted in excess inventory, overcapacity and a decrease in demand for our products. We may experience further decreases in the demand for our products due to a weak domestic and international economy and the impact of the current financial and economic crisis as the fiber optics industry copes with the effects of oversupply of products, international terrorism, war and political and economic instability. Even if the general economy experiences a recovery, the activity of the United States telecommunications industry may lag behind the recovery of the overall United States economy.

**The optical networking component industry has in the past, is now, and may in the future, experience declining average selling prices, which could cause our gross margins to decline.**

The optical networking component industry has in the past experienced declining average selling prices as a result of increasing competition and greater unit volumes as communication service providers continue to deploy fiber optic networks. Average selling prices are currently decreasing and may continue to decrease in the future in response to product introductions by competitors, price pressures from significant customers, greater manufacturing efficiencies achieved through increased automation in the manufacturing process and inventory build-up due to decreased demand. Average selling price declines may contribute to a decline in our gross margins which could harm our results of operations.

**We will not attract new orders for our fiber optic components unless we can deliver sufficient quantities of our products to optical communications equipment manufacturers.**

Communications service providers and optical systems manufacturers typically require that suppliers commit to provide specified quantities of products over a given period of time. If we are unable to commit to deliver quantities of our products to satisfy a customer's anticipated needs, we will lose the order and the opportunity for significant sales to that customer for a lengthy period of time. In addition, we would be unable to fill large orders if we do not have sufficient manufacturing capacity to enable us to commit to provide customers with specified quantities of products. However, if we build our manufacturing capacity and inventory in excess of demand, as we have done in the past, we may produce excess inventory that may have to be reserved or written off.

**We depend on a limited number of third parties to supply key materials, components and equipment, such as ferrules, optical filters and lenses, and if we are not able to obtain sufficient quantities of these items at acceptable prices, our ability to fill orders would be limited and our operating results could be harmed.**

We depend on third parties to supply the raw materials and components we use to manufacture our products. To be competitive, we must obtain from our suppliers, on a timely basis, sufficient quantities of raw materials and components at acceptable prices. We obtain most of our critical raw materials and components from a single or limited number of suppliers and generally do not have long-term supply contracts with them. As a result, our suppliers could terminate the supply of a particular material or component at any time without penalty. Finding alternative sources may involve significant expense and delay, if these sources can be found at all. One component, GRIN lenses, is only available from one supplier. Difficulties in obtaining raw materials or components in the future may delay or limit our product shipments, which could result in lost orders, increase our costs, reduce our control over quality and delivery schedules and require us to redesign our products. If a supplier became unable or unwilling to continue to manufacture

or ship materials or components in required volumes, we would have to identify and qualify an acceptable replacement. A delay or reduction in shipments or any need to identify and qualify replacement suppliers would harm our business.

**Because we experience long lead times for materials and components, we may not be able to effectively manage our inventory levels, which could harm our operating results.**

Because we experience long lead times for materials and components and are often required to purchase significant amounts of materials and components far in advance of product shipments, we may not effectively manage our inventory levels, which could harm our operating results. Alternatively, if we underestimate our raw material requirements, we may have inadequate inventory, which could result in delays in shipments and loss of customers. If we purchase raw materials and increase production in anticipation of orders that do not materialize or that shift to another quarter, we will, as we have in the past, have to carry or write off excess inventory and our gross margins will decline. Both situations could cause our results of operations to be below the expectations of investors and public market analysts, which could, in turn, cause the price of our common stock to decline. The time our customers require to incorporate our products into their own can vary significantly and generally exceeds several months, which further complicates our planning processes and reduces the predictability of our forecasts. Even if we receive these orders, the additional manufacturing capacity that we add to meet our customer's requirements may be underutilized in a subsequent quarter.

**We are exposed to risks and increased expenses as a result of laws requiring companies to evaluate internal controls over financial reporting.**

Section 404 of the Sarbanes-Oxley Act of 2002 requires our management to perform an assessment of our internal controls as of the end of each fiscal year, and our independent auditors to attest to the effectiveness of our internal controls over financial reporting beginning with our year ending December 31, 2010. We have implemented an ongoing program to perform the system and process evaluation and testing we believe to be necessary to comply with these requirements, however, we cannot assure you that we will be successful in our efforts. We expect to incur increased expenses and to devote additional management resources to Section 404 compliance. In the event that our chief executive officer or acting chief financial officer determines that our internal controls over financial reporting are not effective as defined under Section 404, or our auditors are not able to provide us with an unqualified report as to the effectiveness of our internal control over financial reporting in the future, investor perceptions of our company may be negatively affected and this could cause a decline in our stock price.

**We depend on key personnel to operate our business effectively in the rapidly changing fiber optic components market, and if we are unable to hire and retain appropriate management and technical personnel, our ability to develop our business could be harmed.**

Our success depends to a significant degree upon the continued contributions of the principal members of our technical sales, marketing, engineering and management personnel, many of whom perform important management functions and would be difficult to replace. We particularly depend upon the continued services of our executive officers, particularly Peter Chang, our President and Chief Executive Officer; David Hubbard, our Vice President, Sales and Marketing; Wei-shin Tsay, our senior Vice President of Product Development; Anita Ho, our Acting Chief Financial Officer, and other key engineering, sales, marketing, finance, manufacturing and support personnel. In addition, we depend upon the continued services of key management personnel at our Taiwanese and Chinese subsidiaries. None of our officers or key employees is bound by an employment agreement for any specific term, and may terminate their employment at any time. In addition, we do not have "key person" life insurance policies covering any of our employees.

Our ability to continue to attract and retain highly skilled personnel will be a critical factor in determining whether we will be successful in the future. We may have difficulty hiring skilled engineers at our manufacturing facilities in the United States, Taiwan, and China. If we are not successful in attracting, assimilating or retaining qualified personnel to fulfill our current or future needs, our business may be harmed.

**If we are not able to achieve acceptable manufacturing yields and sufficient product reliability in the production of our fiber optic components, we may incur increased costs and delays in shipping products to our customers, which could impair our operating results.**

Complex and precise processes are required for the manufacture of our products. Changes in our manufacturing processes or those of our suppliers, or the inadvertent use of defective materials, could significantly reduce our

manufacturing yields and product reliability. Because the majority of our manufacturing costs are relatively fixed, manufacturing yields are critical to our results of operations. Lower than expected production yields could delay product shipments and impair our operating results. We may not obtain acceptable yields in the future.

In some cases, our existing manufacturing techniques, which involve substantial manual labor, may not allow us to cost-effectively meet our production goals so that we maintain acceptable gross margins while meeting the cost targets of our customers. We may not achieve adequate manufacturing cost efficiencies.

Because we plan to introduce new products and product enhancements, we must effectively transfer production information from our product development department to our manufacturing group and coordinate our efforts with those of our suppliers to rapidly achieve volume production. In our experience, our yields have been lower during the early stages of introducing new product to manufacturing. If we fail to effectively manage this process or if we experience delays, disruptions or quality control problems in our manufacturing operations, our shipments of products to our customers could be delayed.

**Because the qualification and sales cycle associated with fiber optic components is lengthy and varied, it is difficult to predict the timing of a sale or whether a sale will be made, which may cause us to have excess manufacturing capacity or inventory and negatively impact our operating results.**

In the communications industry, service providers and optical systems manufacturers often undertake extensive qualification processes prior to placing orders for large quantities of products such as ours, because these products must function as part of a larger system or network. This process may range from three to six months and sometimes longer. Once they decide to use a particular supplier's product or component, these potential customers design the product into their system, which is known as a design-in win. Suppliers whose products or components are not designed in are unlikely to make sales to that customer until at least the adoption of a future redesigned system. Even then, many customers may be reluctant to incorporate entirely new products into their new systems, as this could involve significant additional redesign efforts. If we fail to achieve design-in wins in our potential customers' qualification processes, we will lose the opportunity for significant sales to those customers for a lengthy period of time.

In addition, some of our customers require that our products be subjected to standards-based qualification testing, which can take up to nine months or more. While our customers are evaluating our products and before they place an order with us, we may incur substantial sales and marketing and research and development expenses, expend significant management efforts, increase manufacturing capacity and order long lead-time supplies. Even after the evaluation process, it is possible a potential customer will not purchase our products. In addition, product purchases are frequently subject to unplanned processing and other delays, particularly with respect to larger customers for which our products represent a very small percentage of their overall purchase activity. Accordingly, our revenues and operating results may vary significantly and unexpectedly from quarter to quarter.

**If our customers do not qualify our manufacturing lines for volume shipments, our optical networking components may be dropped from supply programs and our revenues may decline.**

Customers generally will not purchase any of our products, other than limited numbers of evaluation units, before they qualify our products, approve our manufacturing process and approve our quality assurance system. Our existing manufacturing lines, as well as each new manufacturing line, must pass through various levels of approval with our customers. For example, customers may require that we be registered under international quality standards. Our products may also have to be qualified to specific customer requirements. This customer approval process determines whether the manufacturing line achieves the customers' quality, performance and reliability standards. Delays in product qualification may cause a product to be dropped from a long-term supply program and result in significant lost revenue opportunity over the term of that program.

**Our fiber optic components are deployed in large and complex communications networks and may contain defects that are not detected until after our products have been installed, which could damage our reputation and cause us to lose customers.**

Our products are designed for deployment in large and complex optical networks. Because of the nature of these products, they can only be fully tested for reliability when deployed in networks for long periods of time. Our fiber optic products may contain undetected defects when first introduced or as new versions are released, and our customers may discover defects in our products only after they have been fully deployed and operated under peak stress conditions. In addition, our products are combined with products from other vendors. As a result, should problems

occur, it may be difficult to identify the source of the problem. If we are unable to fix defects or other problems, we could experience, among other things:

- loss of customers;
- damage to our reputation;
- failure to attract new customers or achieve market acceptance;
- diversion of development and engineering resources; and
- legal actions by our customers.

The occurrence of any one or more of the foregoing factors could negatively impact our revenues.

**The market for fiber optic components is new and unpredictable, characterized by rapid technological changes, evolving industry standards, and significant changes in customer demand, which could result in decreased demand for our products, erosion of average selling prices, and could negatively impact our revenues.**

The market for fiber optic components is new and characterized by rapid technological change, frequent new product introductions, changes in customer requirements and evolving industry standards. Because this market is new, it is difficult to predict its potential size or future growth rate. Widespread adoption of optical networks, especially in the metropolitan, last mile, and enterprise access segments of the networks, is critical to our future success. Potential end-user customers who have invested substantial resources in their existing copper lines or other systems may be reluctant or slow to adopt a new approach, such as optical networks. Our success in generating revenues in this market will depend on:

- the education of potential end-user customers and network service providers about the benefits of optical networks; and
- the continued growth of the metropolitan, last mile, and enterprise access segments of the communications network.

If we fail to address changing market conditions, sales of our products may decline, which would adversely impact our revenues.

**We may be unable to successfully integrate acquired businesses or assets with our business, which may disrupt our business, divert management's attention and slow our ability to expand the range of our proprietary technologies and products.**

To expand the range of our proprietary technologies and products, we may acquire complementary businesses, technologies or products, if appropriate opportunities arise. We may be unable to identify other suitable acquisitions at reasonable prices or on reasonable terms, or consummate future acquisitions or other investments, any of which could slow our growth strategy. We may have difficulty integrating the acquired products, personnel or technologies of any company or acquisition that we may make. Similarly, we may not be able to attract or retain key management, technical or sales personnel of any other companies that we acquire or from which we acquire assets. These difficulties could disrupt our ongoing business, distract our management and employees and increase our expenses.

**If our common stock is not relisted on the Nasdaq Global Market, we will be subject to certain provisions of the California General Corporation Law that may affect our charter documents and result in additional expenses.**

Beginning at the commencement of trading on November 8, 2002, the listing of our common stock was transferred from the Nasdaq Global Market to the Nasdaq Capital Market. As a result, we may become subject to certain sections of the California General Corporation Law that will affect our charter documents if our common stock is not returned to being listed on the Nasdaq Global Market. A recent Delaware decision has called into question the applicability of the California General Corporation Law to Delaware corporations. However, if the California General Corporation Law applies to our company, we will not be able to continue to have a classified board or continue to eliminate cumulative

voting by our stockholders. In addition, certain provisions of our Certificate of Incorporation that call for supermajority voting may need to be approved by stockholders every two years or be eliminated. Also, in the event of reorganization, stockholders will have dissenting stockholder rights under both California and Delaware law. Any of these changes will result in additional expense as we will have to comply with certain provisions of the California General Corporation Law as well as the Delaware General Corporation Law. We included these provisions in our charter documents in order to delay or discourage a change of control or changes in our management. Because of the California General Corporation Law, we may not be able to avail ourselves of these provisions.

**If we are unable to maintain our listing on the Nasdaq Capital Market, the price and liquidity of our common stock may decline.**

There can be no assurance that we will be able to satisfy all of the quantitative maintenance criteria for continued listing on the Nasdaq Capital Market, including a requirement that we maintain a continued minimum bid price of \$1.00 per share. Accordingly, if the closing bid price of our common stock falls and remains below \$1.00 for 30 consecutive trading days, as it has for significant periods of time in the past, our common stock may not remain listed on the Nasdaq Capital Market. If we fail to maintain continued listing on the Nasdaq Capital Market and must move to a market with less liquidity, our financial condition could be harmed and our stock price would likely decline. If we are delisted, it could have a material adverse effect on the market price of our common stock as well as the liquidity of the trading market for our common stock.

Many companies that face delisting as a result of closing bid prices that are below the Nasdaq Capital Market's continued listing standards seek to maintain the listing of their securities by effecting reverse stock splits. However, reverse stock splits do not always result in a sustained closing bid price per share. We may consider the merits of implementing a reverse split and evaluate other courses of action as we believe may be appropriate.

**If we fail to protect our intellectual property rights, competitors may be able to use our technologies, which could weaken our competitive position, reduce our revenues or increase our costs.**

The fiber optic component market is a highly competitive industry in which we, and most other participants, rely on a combination of patent, copyright, trademark and trade secret laws, confidentiality procedures and licensing arrangements to establish and protect proprietary rights. The competitive nature of our industry, rapidly changing technology, frequent new product introductions, changes in customer requirements and evolving industry standards heighten the importance of protecting proprietary technology rights. Since the United States Patent and Trademark Office keeps patent applications confidential until a patent is issued, our pending patent applications may attempt to protect proprietary technology claimed in a third party patent application. Our existing and future patents may not be sufficiently broad to protect our proprietary technologies as policing unauthorized use of our products is difficult and we cannot be certain that the steps we have taken will prevent the misappropriation or unauthorized use of our technologies, particularly in foreign countries where the laws may not protect our proprietary rights as fully as United States laws. Our competitors and suppliers may independently develop similar technology, duplicate our products, or design around any of our patents or other intellectual property. If we are unable to adequately protect our proprietary technology rights, others may be able to use our proprietary technology without having to compensate us, which could reduce our revenues and negatively impact our ability to compete effectively.

Litigation may be necessary to enforce our intellectual property rights or to determine the validity or scope of the proprietary rights of others. As a result of any such litigation, we could lose our proprietary rights and incur substantial unexpected operating costs. Any action we take to protect our intellectual property rights could be costly and could absorb significant management time and attention. In addition, failure to adequately protect our trademark rights could impair our brand identity and our ability to compete effectively.

**We may be subject to intellectual property infringement claims that are costly to defend and could limit our ability to use some technologies in the future.**

Our industry is very competitive and is characterized by frequent intellectual property litigation based on allegations of infringement of intellectual property rights. Numerous patents in our industry have already been issued, and as the market further develops and participants in our industry obtain additional intellectual property protection, litigation is likely to become more frequent. From time to time, third parties may assert patent, copyright, trademark and other intellectual property rights to technologies or rights that are important to our business. In addition, we have and we may continue to enter into agreements to indemnify our customers for any expenses or liabilities resulting from claimed

infringements of patents, trademarks or copyrights of third parties. Any litigation arising from claims asserting that our products infringe or may infringe the proprietary rights of third parties, whether the litigation is with or without merit, could be time-consuming, resulting in significant expenses and diverting the efforts of our technical and management personnel. We do not have insurance against our alleged or actual infringement of intellectual property of others. These claims could cause us to stop selling our products, which incorporate the challenged intellectual property, and could also result in product shipment delays or require us to redesign or modify our products or to enter into licensing agreements. These licensing agreements, if required, would increase our product costs and may not be available on terms acceptable to us, if at all.

Although we are not aware of any intellectual property lawsuits filed against us, we may be a party to litigation regarding intellectual property in the future. We may not prevail in any such actions, given their complex technical issues and inherent uncertainties. Insurance may not cover potential claims of this type or may not be adequate to indemnify us for all liability that may be imposed. If there is a successful claim of infringement or we fail to develop non-infringing technology or license the proprietary rights on a timely basis, our business could be harmed.

**Because our manufacturing operations are located in active earthquake fault zones in California and Taiwan, and our Taiwan locations are susceptible to the effects of a typhoon, we face the risk that a natural disaster could limit our ability to supply products.**

Two of our primary manufacturing operations in Taiwan and our headquarters in California are located in active earthquake fault zones. These regions have experienced large earthquakes in the past and may likely experience them in the future. In September 2001, a typhoon hit Taiwan causing businesses, including our manufacturing facility, and the financial markets to close for two days. Because the majority of our manufacturing operations are located in Taiwan, a large earthquake or typhoon in Taiwan could disrupt our manufacturing operations for an extended period of time, which would limit our ability to supply our products to our customers in sufficient quantities on a timely basis, harming our customer relationships.

#### **Item 1B. Unresolved Staff Comments**

None

#### **Item 2. Properties**

In the United States, we lease a total of approximately 34,800 square feet of administrative, sales, marketing, product development and manufacturing space in one building located in Sunnyvale, California pursuant to a lease that expires in July 2010. We are currently in the process of evaluating our future facility requirements in California, and we have begun lease negotiations on specific properties.

In Taiwan, we lease a total of approximately 38,800 square feet in one facility located in Tu-Cheng City, Taiwan. This lease expires at various times from May 2010 to December 2011. We intend to renew this lease prior to its expiration date. In December 2000, the Company purchased approximately 8,200 square feet of space immediately adjacent to the leased facility for \$0.8 million, bringing the total square footage to approximately 47,000 square feet. Of this total, 33,400 square feet is used for manufacturing and 13,600 square feet is used for administration and product development.

In July 2007, we renewed the lease for our 62,000 square foot facility in the Shenzhen area of China, which will expire in July 2012. In February 2007, we entered into a lease for an 8,200 square foot facility in Shenzhen, which lease will expire in January 2012.

In August 2009, we expanded our facility in the Shenzhen area of China. We replaced the existing two leases with a new lease for a 132,993 square foot facility in Shenzhen, which lease will expire in October 2014.

#### **Item 3. Legal Proceedings**

From time to time we may be involved in litigation relating to claims arising in the ordinary course of business. As of the date of this Form 10-K, there are no material legal proceedings pending against us or, to the best of our knowledge, threatened against us.

#### **Item 4. (Removed and Reserved)**

##### **Executive Officers of the Registrant**

Our executive officers as of December 31, 2009 are as follows:

*Peter C. Chang*, has served as our Chairman of the Board, Chief Executive Officer, President and Secretary since our formation in December 1995. From 1990 through 1995, Mr. Chang was Division Manager at Hon Hai Holding. From 1984 through 1988, he was an engineer at AlliedSignal Inc. and from 1988 through 1990 was a member of the technology staff at Lucent Bell Labs. Mr. Chang received a B.S. in Mechanical Engineering from the National Taiwan University and an M.S. in Mechanical Engineering from Notre Dame University.

*David A. Hubbard*, has served as our Vice President, Sales and Marketing since October 1996. From February 1995 to September 1996, Mr. Hubbard was Director of Marketing/Business Development at Tracor/AEL Industries. From 1985 to 1995 Mr. Hubbard held several product line and business management positions at Tyco Electronics/AMP inc. Mr. Hubbard received his M.S. from University of Connecticut and his B.S. from State University of New York.

*Wei-Shin Tsay, Ph.D.*, has served as our Senior Vice President, Product Development since August 2000. From 1996 through August 2000, Dr. Tsay held various management positions in engineering, operations, and marketing at JDS Uniphase. From 1994 through 1996, Dr. Tsay held various product management positions at Lucent Microelectronics/Optoelectronics Strategic Business Unit. From 1982 through 1994, Dr. Tsay held various engineering and technical management positions at Bell Labs. Dr. Tsay received an M.S. in Manufacturing Systems Engineering from Lehigh University, a Ph.D. in physics from the University of Rochester and a B.S. in Physics at the National Tsing-Hua University in Hsin-Chu, Taiwan.

*Anita K. Ho*, has served as our Acting Chief Financial Officer since July 2002. From October 2000 to July 2007, Ms. Ho has also served as our Corporate Controller. From 1998 to 2000, Ms. Ho was a Finance Manager at 3Com Corporation. From 1995 through 1998, Ms. Ho was a member of the finance staff at 3Com Corporation. Ms. Ho received a B.S. in Accounting from Soochow University in Taipei, Taiwan.

## PART II

### Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company's common stock, par value \$0.001, was traded on the Nasdaq Global Market under the ticker symbol "AFOP" until November 8, 2002, when it began to trade on the Nasdaq Capital Market under the same ticker symbol. The following table summarizes the high and low closing prices for our common stock as reported on the Nasdaq Capital Market.

	<u>High</u>	<u>Low</u>
2009		
First Quarter	\$0.76	\$0.62
Second Quarter	\$1.25	\$0.67
Third Quarter	\$1.40	\$1.00
Fourth Quarter	\$1.28	\$1.06
2008		
First Quarter	\$2.02	\$1.19
Second Quarter	\$1.63	\$1.26
Third Quarter	\$1.45	\$0.98
Fourth Quarter	\$1.00	\$0.57

As of March 5, 2010, the Company's common stock was held by 67 stockholders of record (not including beneficial holders of common stock held in street name). The Company has never declared or paid dividends on its capital stock and does not anticipate paying any dividends in the foreseeable future.

### Securities Authorized for Issuance Under Equity Compensation Plans

Information regarding securities authorized for issuance under our equity compensation plans can be found under Item 12 of this Annual Report on Form 10-K.

### Item 6. Selected Financial Data

Not required.

### Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with our Consolidated Financial Statements and Notes thereto.

### Recent Accounting Pronouncements

See Note 1 to the Consolidated Financial Statements for a full description of recent accounting pronouncements, including the expected dates of adoption and estimated effects on results of operations and financial condition, which is incorporated herein by reference.

### Critical Accounting Policies and Estimates

There have been no significant changes in the Company's critical accounting policies during the twelve months ended December 31, 2009 as compared to what was previously disclosed in the Company's Form 10-K for the fiscal year ended December 31, 2008 as filed with the SEC.

#### *General*

Management's discussion and analysis of our financial condition and results of operations are based on our Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities. On an ongoing basis, we evaluate our estimates, including those related to revenue recognition, bad debts, inventories, asset impairments, income taxes, contingencies, and litigation. We base our estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis for making judgments about the carrying values for assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

We believe the following critical accounting policies affect management's more significant judgments and estimates used in the preparation of our Consolidated Financial Statements:

#### *Revenue Recognition*

We recognize revenue upon shipment of our products to customers, provided that we have received a purchase order, the price is fixed, collection of the resulting receivable is reasonably assured and transfer of title and risk of loss has occurred. Subsequent to the sale of our products, we have no obligation to provide any modification or customization upgrades, enhancements or post contract customer support.

#### *Stock-based Compensation Expense*

On January 1, 2006, we adopted Accounting for Stock-based Compensation, which requires the measurement and recognition of compensation expense for all share-based payment awards made to our employees and directors including employee stock options and employee stock purchases pursuant to our Employee Stock Purchase Plan ("ESPP") based on estimated fair values. We adopted ASC 718 "Share-Based Payment" using the modified prospective transition method, which requires the application of the accounting standard as of January 1, 2006, the first day of our 2006 fiscal year.

Stock-based compensation expense recognized under ASC 718 were \$0.1 million and \$0.2 million for the years ended December 31, 2009 and 2008, respectively, as determined by the Binomial Lattice valuation model, and represents stock-based compensation expense related to share based compensation arrangements under our stock option plan and our ESPP.

#### *Allowance for Doubtful Accounts*

Allowances are provided for estimated returns and potential uncollectable trade receivable. Provisions for return allowances are recorded at the time revenue is recognized based on our historical returns, current economic trends and changes in customer demand. Such allowances are adjusted periodically to reflect actual and anticipated experience. Material differences may result in the amount and timing of our revenue for any period if management made different judgments or utilized different estimates.

#### *Inventory*

Inventories are stated at the lower of cost or market, with cost being determined using standard cost, which approximates actual cost on a first-in, first-out basis. Market value is determined as the lower of replacement cost or net realizable value. Provisions are made for excess and obsolete inventory based on historical usage and management's estimates of future demand. Inventory reserves, once established, are only reversed upon sale or disposition of related inventory.

#### *Valuation of Long-Lived Assets*

We review the valuation of long-lived assets and assess the impairment of the assets whenever events or changes in circumstances indicate that the carrying value may not be recoverable due to: significant underperformance relative to expected historical or projected future operating results; significant changes in the manner of our use of the assets or the strategy for the overall business; and significant negative industry or economic trends. When we determine that the carrying value of long-lived assets may not be recoverable based on the existence of one or more of the above indicators of impairment, we measure any impairment based on a projected discounted cash flow method using a

discount rate determined by our management to be commensurate with the risk inherent in our current business model. We did not record any asset impairment charge for the years ended December 31, 2009 and 2008, respectively.

### *Income Taxes*

We adopted ASC 740, *Accounting for Uncertainty in Income Taxes* on January 1, 2007. It is our policy to record income tax interest and penalties in the income tax provision. We did not have any material unrecognized tax benefits or uncertain tax positions at December 31, 2009.

### **Overview**

We were founded in December 1995 and commenced operations to design, manufacture and market fiber optic interconnect products, which we call our connectivity products, or what we previously called our OPMS products. We have broadened our connectivity product line to include attenuators, planar lightwave circuit splitters, and fused fiber products. In early 1999, we started forming a new product line based in part on our proprietary technology. We started selling our optical passive products, or what we previously called our DWDM products, and other wavelength management products in July 2000. Since introduction, sales of optical passive products have fluctuated with the overall market for these products.

We market and sell our products predominantly through our direct sales force. From our inception through December 31, 2009, we derived the majority of our revenues from our connectivity product line. Our optical passive products contributed as a percentage of revenues 37.5% and 36.9% for the years ended December 31, 2009 and 2008, respectively. In the years ended December 31, 2009 and 2008, our top 10 customers comprised 63% and 62% of our revenues, respectively. Two customers accounted for 15.1% and 14.9% of our revenues in 2009, respectively. One customer accounted for 15.7% of our revenues in 2008. Our cost of revenues consists of raw materials, components, direct labor, manufacturing overhead and production start-up costs. We expect that our cost of revenues as a percentage of revenues will fluctuate from period to period based on a number of factors including:

- changes in manufacturing volume;
- costs incurred in establishing additional manufacturing lines and facilities;
- inventory write-downs and impairment charges related to manufacturing assets;
- mix of products sold;
- changes in our pricing and pricing by our competitors;
- mix of sales channels through which our products are sold; and
- mix of domestic and international sales.

Research and development expenses consist primarily of salaries and related personnel expenses, fees paid to outside service providers, materials costs, test units, facilities, overhead and other expenses related to the design, development, testing and enhancement of our products. We expense our research and development costs as they are incurred. We believe that a significant level of investment for product research and development is required to remain competitive. We expect research and development expenses may increase as we intend to continue to invest in our research and product development efforts during 2010.

Sales and marketing expenses consist primarily of salaries, commissions and related expenses for personnel engaged in marketing, sales and technical support functions, as well as the costs associated with trade shows, promotional activities and travel expenses. We intend to continue to invest amounts similar to our spending levels in 2009 in our sales and marketing efforts, both domestically and internationally, in order to increase market awareness and to generate sales of our products. However, we cannot be certain that our expenditures will result in higher revenues. In addition, we believe our future success depends upon establishing successful relationships with a variety of key customers.

General and administrative expenses consist primarily of salaries and related expenses for executive, finance, administrative, accounting and human resources personnel, insurance and professional fees for legal and accounting support. We expect general and administrative expenses will remain relatively flat due in part to continued emphasis on expense control.

We own 98.5% of the outstanding common stock of Alliance Fiber Optic Products, Ltd (formally named Transian Technology Ltd. Co.), a Taiwan corporation. This majority owned subsidiary is engaged in design and manufacturing of our products.

In December 2000, we established a subsidiary, Alliance Fiber Optic Products, in the People's Republic of China, which we have developed as a manufacturing facility. We commenced production at this facility in the third quarter of 2003.

## Results of Operations

The following table sets forth the relationship between various components of operations, stated as a percentage of revenues, for the periods indicated.

	Years Ended December 31,	
	2009	2008
Revenues	100.0%	100.0%
Cost of revenues	68.7	68.6
Gross profit	31.3	31.4
Operating expenses:		
Research and development	10.0	8.6
Sales and marketing	7.6	6.2
General and administrative	11.2	9.0
Total operating expenses	28.8	23.8
Income from operations	2.5	7.6
Interest and other income, net	2.6	3.4
Net income before tax	5.1	11.0
Income tax	0.3	0.5
Net income	4.8%	10.5%

## Comparison of Fiscal Year 2009 and Fiscal Year 2008

*Revenues.* Revenues were \$29.8 million and \$38.8 million for the years ended December 31, 2009 and 2008, respectively. Connectivity products revenue decreased to \$18.7 million in 2009 from \$24.5 million in 2008. Optical passive products revenue decreased to \$11.2 million in 2009 from \$14.3 million in 2008. Revenues decreased mainly due to a softening in demand for both connectivity and passive products. Revenues from sales to a significant customer declined sequentially and on a year over year basis based on reduced order levels and changing product allocations. Declines in average selling prices were a secondary cause of the decrease in revenues and resulted from pricing pressure from customers, competitive pricing by other suppliers and general product maturity. We expect we may experience similar levels of average selling price declines in the future.

*Cost of Revenues.* Cost of revenues in fiscal year 2009 decreased to \$20.5 million from \$26.6 million in fiscal year 2008. Cost of revenues as a percentage of net revenues increased to 68.7% in fiscal year 2009 from 68.6% in fiscal year 2008. The decrease of cost of revenues in 2009 was mainly due to lower sales. The increase as a percentage of revenues was due to product mixes for both connectivity and optical passive products.

*Gross Profit.* Gross profit for the year ended December 31, 2009 was \$9.3 million, or 31.3% of revenues, compared with gross profit of \$12.2 million, or 31.4% of revenues in fiscal year 2008. The connectivity products gross profit decreased to \$6.2 million in 2009 from \$8.4 million in 2008. The optical passive products gross profit decreased to \$3.1

million from \$3.8 million in 2008. For the year ended December 31, 2009, the utilization of our factories was reduced due to the decreased volume shipments of our products, which contributed to lower gross margins. We expect our gross profit as a percentage of revenues in 2010 to remain at levels similar to 2009 levels. However, our average selling prices are declining, which we believe will negatively impact our gross profit and may offset any benefits from improved absorption.

*Research and Development Expenses.* Research and development expenses decreased to \$3.0 million in fiscal year 2009 from \$3.3 million in fiscal year 2008. As a percentage of revenues, research and development expenses increased to 10.0% in 2009 from 8.6% in 2008 and the increase was a result of decreased revenues. The decrease in absolute dollars was primarily due to lower headcount and cost control measures. We expect research and development expenses on our product development efforts may increase as we intend to continue to invest in our research and product development efforts.

*Sales and Marketing Expenses.* Sales and marketing expenses decreased to \$2.3 million in fiscal year 2009 from \$2.4 million in fiscal year 2008. The decrease was mainly due to cost control measures. As a percentage of revenues, sales and marketing expenses increased to 7.6% in 2009 from 6.2% in 2008 and the increase was a result of decreased revenues. We expect sales and marketing expenses will remain relatively flat in dollars due in part to continued emphasis on expense control.

*General and Administrative Expenses.* General and administrative expenses decreased to \$3.3 million in fiscal year 2009 from \$3.5 million in fiscal year 2008. The decrease was mainly due to cost control measures. As a percentage of revenues, general and administrative expenses increased to 11.2% in 2009 from 9.0% in 2008 and the increase was a result of decreased revenues. We expect general and administrative expenses will remain relatively flat in dollars due in part to continued emphasis on expense control.

*Stock-Based Compensation.* Total stock-based compensation was \$0.1 million and \$0.2 million for the years ended December 31, 2009 and 2008, respectively.

*Interest and Other Income, Net.* Interest and other income, net, was \$0.8 million and \$1.3 million for the years ended December 31, 2009 and 2008, respectively. These amounts consisted primarily of interest income, which fluctuated based on cash balances and changes in interest rates. The decrease in 2009 was due to lower interest income because of lower interest rates. The amounts also included a loss of \$0.8 million to reduce the value of our ARS investments classified as trading securities, offset by a gain of \$0.8 million from the estimated fair value of the ARS Right as of December 31, 2009.

*Provision for Taxes.* Our effective alternative minimum tax, or AMT, rate was 20% for federal and 6.7% for state in fiscal 2009. The tax expense was the result of estimated income tax accruals for fiscal 2009 and 2008.

Under a new California tax law, effective retroactively to the beginning of 2008, our net operating loss deduction was suspended for 2008 and 2009. Beginning in 2008, the carryforward period for NOLs is extended from 10 to 20 years. Beginning in 2011, we will be permitted to carry back NOLs for two years. Carrybacks will be limited to 50% of NOLs for 2011 and 75% for 2012. Full carrybacks will be allowed beginning in 2013. In addition, our utilization of tax credits is limited to 50% of tax liability in 2008 and 2009 as a result of the new law.

As of December 31, 2009, we had approximately \$35.1 million and \$20.4 million of net operating loss carryforwards for federal and state tax purposes, respectively, which will expire in 2022 for federal and in 2014 for state purposes, if not utilized. We have provided a full valuation allowance against our net deferred tax assets because realization of our deferred tax assets is uncertain due to our history of losses.

## **Liquidity and Capital Resources**

### **Comparison of Fiscal Year 2009 and Fiscal Year 2008**

Net cash provided by operating activities was \$2.8 million and \$4.4 million in 2009 and 2008, respectively. The decrease in our cash provided by operations in 2009 was primarily due to decrease in net income of \$2.6 million, an increased in accounts receivable of \$0.2 million, an increased in prepaid expenses of \$0.1 million, and a decrease in accrued liabilities of \$0.3 million, which was offset by a decrease in inventory of \$0.6 million, an increase in accounts payable of \$0.1 million. The decrease in our cash provided by operations in 2008 was primarily due to an increase in inventory of \$0.6 million, a decrease in accounts payable of \$1.0 million and a decrease in accrued liabilities of \$0.2

million, which was offset by an increase in net income of \$0.7 million and a decrease in accounts receivable of \$0.7 million.

Cash used in investing activities was \$6.5 million in 2009 and cash provided by investing activities was \$2.2 million in 2008. In 2009, we spent \$0.9 million to acquire property and equipment and the net purchase of short-term securities was \$5.6 million. In 2008, we spent \$1.2 million to acquire property and equipment and the net proceeds from sale and maturity of short-term securities was \$3.4 million.

Cash generated by financing activities was \$0.2 million and \$0.4 million in 2009 and 2008, respectively. Cash generated by financing activities in 2009 and 2008 was comprised of proceeds from the exercise of options to purchase shares of our common stock and common stock issued through our ESPP.

Between November 2004 and September 2007, we entered into two mortgage loans of \$0.7 million total with an interest rate of 3.20% and three equipment loans of \$0.7 million total with an interest rate of 3.68% in Taiwan. The loans are secured by the building and equipment we own in Taiwan.

Our principal source of liquidity as of December 31, 2009 consisted of \$26.2 million in cash and cash equivalents and interest bearing marketable securities. We also hold \$16.1 million in ARS and associated Rights which are not saleable by us at the date hereof. Accordingly, we do not consider the ARS or the Rights as sources of liquidity at this time. We believe that our current cash, cash equivalents and short-term investments will be sufficient to meet our anticipated cash needs for working capital and capital expenditures for at least the next 12 months. However, our future growth, including potential acquisitions, may require additional funding. If cash generated from operations is insufficient to satisfy our long-term liquidity requirements, we may need to raise capital through additional equity or debt financings, additional credit facilities, strategic relationships or other arrangements. If additional funds are raised through the issuance of securities, these securities could have rights, preferences and privileges senior to holders of common stock, and the terms of any debt facility could impose restrictions on our operations. The sale of additional equity or debt securities could result in additional dilution to our stockholders, and additional financing may not be available in amounts or on terms acceptable to us, if at all. If we are unable to obtain additional financing, we may be required to reduce our research and development and marketing expenses. Strategic arrangements, if necessary to raise additional funds, may require us to relinquish our rights to certain of our technologies or products. Our failure to raise capital when needed could harm our business, financial condition and operating results.

## **Contractual Obligations**

Our long-term debt obligations are for principal and interest on mortgage and equipment loans from financial institutions in Taiwan.

In July 2004, we moved into our corporate headquarters in Sunnyvale, California. The lease has a six-year term commencing on July 22, 2004. We are currently in the process of evaluating our future facility requirements in California, and we have begun lease negotiations on specific properties.

In Taiwan, we lease a total of approximately 38,800 square feet in one facility located in Tu-Cheng City, Taiwan. This lease expires at various times from May 2010 to December 2011. In December 2000, we purchased approximately 8,200 square feet of space immediately adjacent to the leased facility for \$0.8 million, bringing the total square footage to approximately 47,000 square feet.

In July 2007, we renewed the lease for our 62,000 square foot facility in the Shenzhen area of China, which will expire in July 2012. In February 2007, we entered into a lease for an 8,200 square feet facility in Shenzhen, which lease will expire in January 2012. In August 2009, we expanded our facility in the Shenzhen area of China. We replaced the existing two leases with a new lease for a 132,993 square foot facility in Shenzhen, which lease will expire in October 2014.

The following summarizes our contractual obligations at December 31, 2009 (in thousands):

Contractual obligations	Payments Due By Period			
	Total	Less than 1 year	1-3 Years	4-5 Years
Debt obligations including interest payments	\$ 438	\$ 122	\$ 194	\$ 122
Operating lease obligations	1,297	658	350	289
Total	<u>\$ 1,735</u>	<u>\$ 780</u>	<u>\$ 544</u>	<u>\$ 411</u>

### Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements, as such term is defined in rules promulgated by the Securities and Exchange Commission, that have or are reasonably likely to have a current or future material effect on our financial condition, changes in financial condition, revenues or expenses, results of operations, liquidity, capital expenditures or capital resources.

### Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not required.

### Item 8. Financial Statements and Supplementary Data

#### INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

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## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders of Alliance Fiber Optic Products, Inc.

We have audited the accompanying consolidated balance sheets of Alliance Fiber Optic Products, Inc. as of December 31, 2009 and 2008, and the related statements of operations, stockholders' equity, and cash flows for each of the years in the two-year period ended December 31, 2009. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Alliance Fiber Optic Products, Inc. as of December 31, 2009 and 2008, and the results of their operations and its cash flows for each of the years in the two-year period ended December 31, 2009 in conformity with accounting principles generally accepted in the United States of America.

/s/Stonefield Josephson, Inc.

Stonefield Josephson, Inc.

San Francisco, California

March 18, 2010

## ALLIANCE FIBER OPTIC PRODUCTS, INC.

Consolidated Balance Sheets  
(in thousands, except share data)

	December 31,	
	2009	2008
<b>Assets</b>		
<b>Current assets:</b>		
Cash and cash equivalents	\$ 8,525	\$ 12,185
Short-term investments	31,968	11,769
Other current assets	1,778	-
Accounts receivable, net	4,952	4,708
Inventories	4,984	5,614
Prepaid expense and other current assets	515	379
Total current assets	52,722	34,655
Long-term investments	-	13,718
Property and equipment, net	4,434	4,653
Other assets	233	2,772
Total assets	\$ 57,389	\$ 55,798
<b>Liabilities and Stockholders' Equity</b>		
<b>Current liabilities:</b>		
Accounts payable	\$ 3,701	\$ 3,572
Accrued expenses	3,822	3,237
Current portion of bank loan	114	137
Total current liabilities	7,637	6,946
<b>Long-term liabilities:</b>		
Bank Loan	305	413
Other Long-term liabilities	508	478
Total long-term liabilities	813	891
Total liabilities	8,450	7,837
<b>Commitments and contingencies (Note 9)</b>		
<b>Stockholders' equity:</b>		
Common stock, \$0.001 par value: 250,000,000 shares authorized; 42,447,112 and 42,001,635 shares issued and outstanding at December 31, 2009 and 2008, respectively	42	42
Additional paid-in-capital	112,131	111,687
Accumulated deficit	(63,796)	(64,380)
Accumulated other comprehensive Income	562	612
Total stockholders' equity	48,939	47,961
Total liabilities and stockholders' equity	\$ 57,389	\$ 55,798

The accompanying notes are an integral part of these Consolidated Financial Statements.

## ALLIANCE FIBER OPTIC PRODUCTS, INC.

### Consolidated Statements of Operations

(in thousands, except per share data)

	Years Ended December 31,	
	2009	2008
Revenues	\$ 29,834	\$ 38,754
Cost of revenues	20,504	26,589
Gross profit	9,330	12,165
Operating expenses:		
Research and development	2,972	3,322
Sales and marketing	2,276	2,406
General and administrative	3,331	3,487
Total operating expenses	8,579	9,215
Income from operations	751	2,950
Interest and other income, net	766	1,315
Net income before tax	1,517	4,265
Income tax	84	199
Net income	1,433	4,066
Net income per share:		
Basic	\$ 0.03	\$ 0.10
Diluted	\$ 0.03	\$ 0.10
Shares used in computing net income per share:		
Basic	42,026	41,601
Diluted	42,279	41,657

The accompanying notes are an integral part of these Consolidated Financial Statements.

ALLIANCE FIBER OPTIC PRODUCTS, INC.  
Consolidated Statements of Cash Flows  
(in thousands)

	Years Ended December 31,	
	2009	2008
Cash flows from operating activities:		
Net income	\$ 1,433	\$ 4,066
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	1,049	1,060
Amortization of stock based compensation	112	161
Loss on disposal of property and equipment	93	10
Provision for inventory valuation	(18)	(180)
Provision (credit) for doubtful accounts and sales returns	-	(42)
Changes in assets and liabilities:		
Accounts receivable	(244)	727
Inventories	648	(431)
Prepaid expenses and other current assets	(136)	102
Other assets	(43)	36
Accounts payable	129	(951)
Accrued expenses	(264)	(151)
Other long-term liabilities	30	29
Net cash provided by operating activities	2,789	4,436
Cash flows from investing activities:		
Purchase of short-term investments	(17,627)	(34,889)
Proceeds from sales and maturities of short-term investments	12,023	38,343
Purchase of property and equipment	(895)	(1,207)
Net cash (used in) provided by investing activities	(6,499)	2,247
Cash flows from financing activities:		
Proceeds from issuance of common stock under ESPP	291	379
Proceeds from the exercise of common stock options	41	141
Repayment of bank borrowings	(139)	(141)
Net cash provided by financing activities	193	379
Effect of exchange rate changes on cash and cash equivalents	(143)	178
Net (decrease) increase in cash and cash equivalents	(3,660)	7,240
Cash and cash equivalents at beginning of year	12,185	4,945
Cash and cash equivalents at end of year	\$ 8,525	\$ 12,185
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ (11)	\$ (17)
Cash paid for income taxes	\$ (111)	\$ (50)
Supplemental disclosure of non-cash financing activities:		
Dividend payable to stockholders	\$ (849)	\$ -

The accompanying notes are an integral part of these Consolidated Financial Statements.

**ALLIANCE FIBER OPTIC PRODUCTS, INC.**  
**Consolidated Statements of Stockholders' Equity**  
(in thousands)

	Common Stock		Additional Paid-in Capital	Deferred Stock-based Compensation	Accumulated Deficit	Accumulated Other Comprehensive Income/(Loss)	Total	Comprehensive Income
	Shares	Amount						
<b>Balance at December 31, 2007</b>	<u>41,367</u>	<u>\$ 41</u>	<u>\$ 110,310</u>	<u>\$ 696</u>	<u>\$ (68,446)</u>	<u>\$ 306</u>	<u>\$ 42,907</u>	
Issuance of Common Stock upon exercise of options	237	-	141	-	-	-	141	
Issuance of Common Stock upon purchase of ESPP	398	1	379	-	-	-	380	
Deferred stock-based compensation	-	-	-	161	-	-	161	
Comprehensive Income:								
Net income for the year	-	-	-	-	4,066	-	4,066	\$ 4,066
Unrealized gain on short-term investments	-	-	-	-	-	(12)	(12)	(12)
Currency translation adjustments	-	-	-	-	-	318	318	318
Comprehensive Income								<u>\$ 4,372</u>
<b>Balance at December 31, 2008</b>	<u>42,002</u>	<u>\$ 42</u>	<u>\$ 110,830</u>	<u>\$ 857</u>	<u>\$ (64,380)</u>	<u>\$ 612</u>	<u>\$ 47,961</u>	
Issuance of Common Stock upon exercise of options	49	-	41	-	-	-	41	
Issuance of Common Stock upon purchase of ESPP	396	-	291	-	-	-	291	
Deferred stock-based compensation	-	-	-	112	-	-	112	
Issuance of stock dividends	-	-	-	-	(849)	-	(849)	
Comprehensive income:								
Net income for the year	-	-	-	-	1,433	-	1,433	\$ 1,433
Unrealized loss on short-term investments	-	-	-	-	-	(2)	(2)	(2)
Currency translation adjustments	-	-	-	-	-	(48)	(48)	(48)
Comprehensive Income								<u>\$ 1,383</u>
<b>Balance at December 31, 2009</b>	<u>42,447</u>	<u>\$ 42</u>	<u>\$ 111,162</u>	<u>\$ 969</u>	<u>\$ (63,796)</u>	<u>\$ 562</u>	<u>\$ 48,939</u>	

The accompanying notes are an integral part of these Consolidated Financial Statements.

## **ALLIANCE FIBER OPTIC PRODUCTS, INC.**

### **Notes to Consolidated Financial Statements**

#### **1. The Company and Summary of Significant Accounting Policies**

##### **The Company**

Alliance Fiber Optic Products, Inc. (the "Company") was incorporated in California on December 12, 1995 and reincorporated in Delaware on October 19, 2000. The Company designs, manufactures and markets fiber optic components for communications equipment manufacturers. The Company's headquarters are located in Sunnyvale, California, and it has operations in Taiwan and China.

##### **Use of estimates**

The preparation of financial statements in accordance with generally accepted accounting principles in the United States of America 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 date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates involve those required in the assessment of allowance for sales returns, doubtful accounts and/or potential excess obsolete inventory. Actual results could differ from those estimates.

##### **Basis of presentation**

The consolidated financial statements include the accounts of the Company and its subsidiaries. All material intercompany accounts and transactions have been eliminated in consolidation.

##### **Foreign currency translation**

The Company's operations through foreign subsidiaries use the local currency as their functional currency. All assets and liabilities of the subsidiaries are translated at rates of exchange on the balance sheet date. Revenues and expenses are translated at the average rate of exchange for the period. Gains and losses resulting from foreign currency translation are recorded as a separate component of other comprehensive income in stockholders' equity. Foreign currency transaction gains and losses are recorded in interest and other income and have not been material.

##### **Cash, cash equivalents, short-term investments and long-term investments**

The Company considers all highly liquid instruments with a maturity of three months or less when purchased to be cash equivalents. Cash and cash equivalents consist of cash deposited in money market, certificate of deposit, and checking accounts.

The Company accounts for its investments under the provisions of ASC 320 "Investments - Debt and Equity Securities." Investments in highly liquid financial instruments with remaining maturities greater than three months and maturities of less than one year are classified as short-term investments. Financial instruments with remaining maturities greater than one year are classified as long-term investments. Investments in related party companies are included in "Other Assets" in the Consolidated Balance Sheets. All investments are classified as available-for-sale and are reported at fair value using the specific identification method with net unrealized gain/(loss) reported, net of tax as other comprehensive gain/(loss) in stockholders' equity. The fair value of the Company's available-for-sale securities are based on quoted market prices or other methodologies for those investments with no quoted market prices at the balance sheet dates.

The Company's financial instruments also include accounts receivable, accounts payable and debts, and are carried at cost, which approximates their fair value because of the short-term maturity of these instruments.

## **ALLIANCE FIBER OPTIC PRODUCTS, INC.**

### **Notes to Consolidated Financial Statements**

#### **Fair value of financial instruments**

In September 2006, the Financial Accounting Standards Board (“the FASB”) issued ASC 820 “Fair Value Measurements.” ASC 820 defines fair value, establishes a framework for measuring fair value, and enhances fair value measurement disclosure. In October 2008, the FASB issued Financial Staff Position ASC 820 “Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active”. ASC 820 clarifies the application of ASC 820 in a market that is not active, and provides guidance on the key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. Effective January 1, 2008, the Company adopted the measurement and disclosure requirements related to financial assets and financial liabilities.

ASC 820 delayed the effective date for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of fiscal 2010.

In February 2007, the FASB issued ASC 825, “The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115.” Under ASC 825, a company may choose, at specified election dates, to measure eligible items at fair value and report unrealized gains and losses on items for which the fair value option has been elected in earnings at each subsequent reporting date. The Company adopted ASC 825 effective January 1, 2008 and has elected the fair value option for its Auction Rate Securities (“ARS”), as of December 1, 2008. In conjunction with the adoption of ASC 825, the Company accounted for its unrealized loss on its auction rate securities ARS of \$0.8 million and \$2.6 million in earnings in the year ended December 31, 2009 and 2008, respectively. There is no cumulative effect of a change in accounting principle as a result of adoption of ASC 825 as there was no other comprehensive income/loss from Auction Rate Securities before the adoption of ASC 825.

#### **Allowance for doubtful accounts**

The Company performs periodic credit evaluations of customers’ financial condition. The Company maintains allowances for doubtful accounts for estimated losses resulting from the inability or unwillingness of customers to make required payments. When the Company becomes aware that a specific customer is unable to meet its financial obligations, for example, as a result of bankruptcy or deterioration in the customer’s operating results or financial position, the Company records a specific allowance to reflect the level of credit risk in the customer’s outstanding receivable balance. In addition, the Company records additional allowances based on certain percentages of aged receivable balances. These percentages are determined by a variety of factors including, but not limited to, current economic trends, historical payment and bad debt write-off experience. The Company is not able to predict changes in the financial condition of customers, and if circumstances related to customers deteriorate, estimates of the recoverability of trade receivables could be materially affected and the Company may be required to record additional allowances. Alternatively, if the Company provides more allowances than the Company needs, the Company may reverse a portion of such provisions in future periods based on actual collection experience.

#### **Inventories**

Inventories are stated at the lower of cost or market, with cost being determined using standard cost, which approximates actual cost on a first-in, first-out basis. Market value is determined as the lower of replacement cost or net realizable value. Provisions are made for excess and obsolete inventory based on historical usage and management’s estimates of future demand. Inventory reserves, once established, are only reversed upon sale or disposition of related inventory.

#### **Property and equipment**

Property and equipment are stated at cost less accumulated depreciation and impairment charges. Depreciation is computed using the straight-line method using estimated useful lives of two to five years for machinery and equipment and five years for furniture and fixtures. Amortization of leasehold improvements is computed using the straight-line

## **ALLIANCE FIBER OPTIC PRODUCTS, INC.**

### **Notes to Consolidated Financial Statements**

method over the shorter of the estimated life of the assets, generally two to four years, or the lease term. Depreciation and amortization expense was \$1.0 million in 2009 and \$1.1 million in 2008.

#### **Revenue recognition**

The Company recognizes revenue upon shipment of its products to its customers, provided that the Company has received a purchase order, the price is fixed, collection of the resulting receivable is reasonably assured and transfer of title and risk of loss has occurred. Subsequent to the sale of its products, the Company has no obligation to provide any modification or customization upgrades, enhancements or post contract customer support.

Allowances are provided for estimated returns. A provision for estimated sales return allowances is recorded at the time revenue is recognized based on historical returns, current economic trends and changes in customer demand. Such allowances are adjusted periodically to reflect actual and anticipated experience. Such adjustments, which are recorded against revenue in the period, could be material.

#### **Shipping and handling expenses**

Shipping and handling expenses are included in cost of revenue.

#### **Research and development expenses**

Research and development costs are expensed as incurred.

#### **Advertising expenses**

Advertising costs are expensed as incurred and have not been material.

#### **Sales taxes**

The Company accounts for taxes charged to our customers and collected on behalf of the taxing authorities and recognize revenue on the sales on a net basis.

#### **Income taxes**

The Company accounts for deferred income taxes under the liability approach whereby the expected future tax consequences of temporary differences between the book and tax basis of assets and liabilities are recognized as deferred tax assets and liabilities. A valuation allowance is established for any deferred tax assets for which realization is uncertain.

The Company files income tax returns in the U.S. federal jurisdiction, and various state and foreign jurisdictions. The Company is no longer subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years before 2005. As of December 31, 2009, the Company was not under any examinations by nor had it received notices of examination from tax authorities.

The Company adopted ASC 740, Accounting for Uncertainty in Income Taxes on January 1, 2007. As a result of the implementation of ASC 740, the Company did not recognize any unrecognized tax benefits. The components of income tax provisions by jurisdiction are as follows (in thousands):

## ALLIANCE FIBER OPTIC PRODUCTS, INC.

### Notes to Consolidated Financial Statements

	Years Ended December 31,	
	2009	2008
Federal	\$ 16	\$ 80
State	68	119
Total	<u>\$ 84</u>	<u>\$ 199</u>

#### Stock-based compensation

The Company estimates the fair value of the share-based payment awards on the date of grant using an option pricing model. The value of awards that are ultimately expected to vest is recognized as expense over the requisite employee service period.

#### Comprehensive income

Comprehensive income is defined as the change in equity of a company from transactions and other events and circumstances excluding transactions resulting from investments from owners and distributions to owners. Comprehensive income consists of cumulative translation adjustments and unrealized gain on short-term investments and is disclosed in the consolidated statements of stockholders' equity.

#### Recent accounting pronouncements

In June 2009, the FASB issued ASC 105, Generally Accepted Accounting Principles, which establishes the FASB Accounting Standards Codification (the "Codification") as the source of authoritative accounting principles to be applied by nongovernmental entities in the preparation of financial statements in conformity with U.S. GAAP. Rules and interpretive releases of the SEC under authority of federal securities laws are also sources of authoritative U.S. GAAP for SEC registrants. All guidance contained in the Codification carries an equal level of authority. ASC 105 is effective for financial statements issued for interim and annual periods ending after September 15, 2009. The Codification will supersede all existing non-SEC accounting and reporting standards. All other non-grandfathered, non-SEC accounting literature not included in the Codification will become non-authoritative. Following ASC 105, the FASB will not issue new standards in the form of Statements, FASB Staff Positions, or Emerging Issues Task Force Abstracts. Instead, it will issue Accounting Standards Updates. The FASB will not consider Accounting Standards Updates as authoritative in their own right. Accounting Standards Updates will serve only to update the Codification, provide background information about the guidance and provide the bases for conclusions on the change(s) in the Codification. The Company adopted ASC 105 in its Form 10-K for the year ended December 31, 2009. The adoption did not have an impact on the Company's consolidated results of operations and financial condition for the year ended December 31, 2009.

In April 2009, the FASB issued guidance on determining fair value when the volume and level of activity for an asset or liability has significantly decreased, and in identifying transactions that are not orderly. Based on the guidance, if an entity determines that the level of activity for an asset or liability has significantly decreased and that a transaction is not orderly, further analysis of transactions or quoted prices is needed, and a significant adjustment to the transaction or quoted prices may be necessary to estimate fair value. The guidance was effective on a prospective basis for interim and annual periods ending after June 15, 2009. The adoption of this guidance had no material impact on the Company's financial results and results of operations.

In April 2009, the FASB issued additional requirements regarding interim disclosures about the fair value of financial instruments which were previously only disclosed on an annual basis. Entities are now required to disclose the fair value of financial instruments which are not recorded at fair value in the financial statements in both their interim and annual financial statements. The new requirements were effective for interim and annual periods ending after June 15, 2009 on a prospective basis. There was no impact on the Company's financial results as this relates only to additional disclosures.

## **ALLIANCE FIBER OPTIC PRODUCTS, INC.**

### **Notes to Consolidated Financial Statements**

In May 2009, the FASB issued ASC 855, Subsequent Events. ASC 855 establishes accounting principles and requirements for subsequent events. Specifically, ASC 855 sets forth the following: (a) the period after the balance sheet date during which management of an entity shall evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (b) the circumstances under which an entity shall recognize events or transactions occurring after the balance sheet date in its financial statements and (c) the disclosures that an entity shall make about events or transactions that occurred after the balance sheet date. ASC 855 requires entities to recognize in the financial statement, the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the balance sheet, including estimates inherent in the process of preparing financial statements. Conversely, entities shall not recognize subsequent events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after the balance sheet date but before financial statements are issued or are available to be issued. Entities shall disclose the date through which subsequent events have been evaluated, as well as whether that date is the date the financial statements were issued or the date the financial statements were available to be issued. Entities shall also disclose the nature and financial effect of nonrecognized subsequent events if such disclosure keeps the financial statements from being misleading. The Company adopted ASC 855, effective June 30, 2009.

In August 2009, the FASB issued Update No. 2009-05, "Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value" ("ASU 2009-05"). ASU 2009-05 amends ASC 820, Fair Value Measurements and Disclosures to provide further guidance on how to measure the fair value of a liability. It primarily does three things: 1) sets forth the types of valuation techniques to be used to value a liability when a quoted price in an active market for the identical liability is not available, 2) clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability and 3) clarifies that both a quoted price in an active market for the identical liability at the measurement date and the quoted price for the identical liability when traded as an asset in an active market when no adjustments to the quoted price of the asset are required are Level 1 fair value measurements. This standard is effective beginning fourth quarter of 2008 for the Company. The adoption of this standard update is not expected to impact the Company's financial results.

## **2. Stock-based compensation**

Effective January 1, 2006, the Company adopted ASC 718, "Share-based Payment", which establishes accounting for share-based payment ("SBP") awards exchanged for employee services and requires companies to expense the estimated fair value of these awards over the requisite employee service period.

ASC 718 requires companies to record compensation expense for stock options measured at fair value, on the date of grant, using an option-pricing model. The fair value of stock options is determined using the Binomial Lattice Model instead of the Black-Scholes Model previously utilized under ASC 718. The Company believes that the revised model represents a more likely projection of actual outcomes.

As of December 31, 2009, there were \$0.03 million of total unrecognized compensation cost related to share-based compensation arrangements granted under the Company's option plans.

At December 31, 2009 the Company had two stock-based compensation plans. They are: (a) 1997 Stock Option Plan and (b) 2000 Stock Incentive Plan, which are described below.

### **(a) 1997 Stock Option Plan**

In May 1997, the Company adopted its 1997 Stock Plan under which 3,000,000 shares of common stock were reserved for issuance to eligible employees, directors and consultants upon exercise of stock options and stock purchase rights. During the year ended December 31, 2000, an additional 5,200,000 shares were reserved for issuance under the 1997 Stock Plan. Incentive stock options are granted at a price not less than 100% of the fair market value of the Company's common stock and at a price of not less than 110% of the fair market value for grants to any person who owned more than 10% of the voting power of all classes of stock on the date of grant. Nonstatutory

**ALLIANCE FIBER OPTIC PRODUCTS, INC.**

**Notes to Consolidated Financial Statements**

stock options are granted at a price not less than 85% of the fair market value of the common stock and at a price not less than 110% of the fair market value for grants to a person who owned more than 10% of the voting power of all classes of stock on the date of the grant. Options granted under the 1997 Stock Plan generally vest over four years and are exercisable for not more than ten years (five years for grants to any person who owned more than 10% of the voting power of all classes of stock on the date of the grant). In November 2000, the 1997 Stock Plan was replaced by the 2000 Stock Incentive Plan.

(b) 2000 Stock Incentive Plan

In November 2000, the Company adopted its 2000 Stock Incentive Plan under which 1,500,000 shares of common stock were reserved for issuance to eligible employees, directors and consultants upon exercise of stock options and stock purchase rights. On January 1 of each year, beginning on January 1, 2001, the number of shares available for grant will automatically increase by the lesser of: (i) 1,700,000 shares; (ii) 5% of the fully diluted outstanding shares of stock on that date; or (iii) a lesser amount as may be determined by the Board of Directors. The Board of Directors determined not to increase the number of shares available under the plan on January 1, 2009 and 2008, respectively. Incentive stock options and nonstatutory stock options are granted at 100% of the fair market value of the Company's common stock on the date of grant.

Options granted under the 2000 Stock Incentive Plan generally vest over four years and are exercisable for not more than ten years.

The following information relates to stock option activity for the year ended December 31, 2009:

Options	Year Ended December 31, 2009			
	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life	Aggregate Intrinsic Value
Outstanding at December 31, 2008	4,856,083	\$ 1.40		
Granted	120,000	1.12		
Exercised	(49,750)	0.83		
Forfeited	(63,000)	1.32		
Outstanding at December 31, 2009	<u>4,863,333</u>	\$ 1.40	4.9 Years	<u>\$ 860,047</u>
Vested and expected to vest at December 31, 2009	<u>4,840,996</u>	\$ 1.40	4.9 Years	<u>\$ 858,130</u>
Exercisable at December 31, 2009	<u>4,637,600</u>	\$ 1.40	4.7 Years	<u>\$ 844,260</u>

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the fourth quarter of fiscal 2009 and 2008 and the exercise price, multiplied by the number of in-the-money options) that would have been received by the option holders had all option holders exercised their options on December 31, 2009 and 2008. This amount changes based on the fair market value of the Company's stock. The total intrinsic value of options exercised for the years ended December 31, 2009 and 2008 were \$18,420 and \$286,000, respectively.

The dividend rate was 0% for the year ended December 31, 2009 and 2008.

## ALLIANCE FIBER OPTIC PRODUCTS, INC.

### Notes to Consolidated Financial Statements

Cash received from option exercises during the year ended December 31, 2009 and 2008 was \$41,000 and \$141,000, respectively, and is included within the financing activities section in the accompanying consolidated statements of cash flows.

Information relating to stock options outstanding at December 31, 2009 is as follows:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Number Outstanding As of 12/31/09	Weighted Average Remaining Contractual Term	Weighted Average Exercise Price	Number Exercisable As of 12/31/09	Weighted Average Exercise Price
\$0.40 - \$0.88	794,650	2.66	\$ 0.81	771,316	\$ 0.80
\$0.90 - \$0.90	914,550	5.83	\$ 0.90	886,900	\$ 0.90
\$0.91 - \$0.96	1,052,300	4.42	\$ 0.94	1,052,300	\$ 0.94
\$1.00 - \$1.74	832,750	5.09	\$ 1.52	732,501	\$ 1.56
\$1.83 - \$2.06	943,250	6.95	\$ 2.00	868,750	\$ 2.00
\$2.10 - \$6.38	325,833	2.84	\$ 3.62	325,833	\$ 3.62
	<u>4,863,333</u>	4.90	\$ 1.40	<u>4,637,600</u>	\$ 1.40

Options exercisable as of December 31, 2009 and 2008 were 4,637,600 and 4,563,897 at an average exercise price of \$1.40 and \$1.39 per share, respectively.

#### Employee Stock Purchase Plan

In November 2000, the Company adopted its 2000 Employee Stock Purchase Plan (the "Plan"). The Company reserved 1,500,000 shares of common stock for issuance under the Plan. On the first day of January each year beginning January 1, 2001, additional shares of common stock are reserved for issuance under the Plan as determined by the Board of Directors. The plan limits the annual increase to the lesser of 1% of the Company's issued and outstanding common stock or 1,000,000 shares. The Plan provides eligible employees with the opportunity to acquire shares of common stock at a price of 85% of the lower of the fair market value of the common stock on the first day of the offering period or the last day of the offering period, whichever is lower. The Plan is structured as a qualified employee stock purchase plan under Section 423 of the Internal Revenue Code of 1986, as amended. However, the Plan is not intended to be a qualified pension, profit sharing or stock bonus plan under Section 401(a) of the 1986 Code and is not subject to the provisions of the Employee Retirement Security Act of 1974. The Board may amend, suspend, or terminate the Plan at any time without notice. A total of 395,727 and 397,715 shares were issued under the Plan in 2009 and 2008, respectively.

The following information relates to the Plan:

Weighted average fair value per share of shares purchased	\$ 0.87
Total compensation expense for ESPP	\$ 92,504
Total amount of cash received from the purchase of stock through ESPP	\$ 290,859
Total intrinsic value of ESPP stock purchased as of December 31, 2009	\$ 184,013

There were 395,768 shares available for future issuance under the Employee Stock Purchase Plan as of December 31, 2009.

## ALLIANCE FIBER OPTIC PRODUCTS, INC.

### Notes to Consolidated Financial Statements

The following table summarizes employee stock-based compensation expense resulting from stock options and employee stock purchase plan (in thousands):

	Years Ended December 31,	
	2009	2008
Included in cost of revenue:	\$ 48	\$ 74
Included in operating expenses:		
Research and development	22	32
Sales and marketing	11	22
General and administrative	31	33
Total	64	87
Total stock-based compensation expense	\$ 112	\$ 161

### 3. Net income per share

Basic net income per share is computed by dividing net income for the period by the weighted average number of shares of common stock outstanding during the period. Diluted net income per share is computed by dividing the net income for the period by the combination of dilutive common share equivalents, comprised of shares issuable under the Company's stock-based compensation plans, and the weighted average number of common shares outstanding during the period. There were no incremental dilutive common share equivalents in the periods presented.

The following table sets forth the computation of basic and diluted net income per share for the years indicated (in thousands, except per share amounts):

	Years Ended December 31,	
	2009	2008
Numerator:		
Net income attributable to common stockholders	\$ 1,433	\$ 4,066
Denominator:		
Shares used in computing net income per share:		
Weighted average of common shares outstanding		
Basic	42,026	41,601
Diluted	42,279	41,657
Net income per share attributable to common stockholder:		
Basic	\$ 0.03	\$ 0.10
Diluted	\$ 0.03	\$ 0.10

The following outstanding options were excluded from the computation of diluted net income per share (in thousands) as the effect would have been anti-dilutive:

	Years Ended December 31,	
	2009	2008
Options to purchase common stock and shares subject to repurchase	253	56

**ALLIANCE FIBER OPTIC PRODUCTS, INC.**

**Notes to Consolidated Financial Statements**

**4. Balance Sheet Components (in thousands)**

	December 31,	
	2009	2008
Cash and cash equivalents:		
Cash	\$ 4,274	\$ 3,217
Money market instruments and funds	4,251	8,968
	<u>\$ 8,525</u>	<u>\$ 12,185</u>
Accounts receivable, net:		
Accounts receivable	\$ 5,073	\$ 4,829
Less: Allowance for doubtful accounts and sales returns	(121)	(121)
	<u>\$ 4,952</u>	<u>\$ 4,708</u>
Allowance for doubtful accounts and sales returns:		
Balance at beginning of year	\$ 121	\$ 163
Utilized	-	(42)
Balance at end of year	<u>\$ 121</u>	<u>\$ 121</u>
Inventories:		
Finished goods	\$ 1,595	\$ 1,880
Work-in-process	1,721	1,393
Raw materials	1,668	2,341
	<u>\$ 4,984</u>	<u>\$ 5,614</u>
Accrued expenses:		
Compensation costs	\$ 2,135	\$ 1,983
Professional fees	123	111
Outside commission	197	209
Royalties	40	43
ESPP	91	94
Deferred rent	34	89
Warranty	45	42
Operating related (Taiwan and China)	200	445
Income tax	(29)	101
Dividend payable	849	-
Others	137	120
	<u>\$ 3,822</u>	<u>\$ 3,237</u>
Other long-term liabilities:		
Accrued pension liability (Taiwan)	\$ 463	\$ 433
Other liabilities	45	45
	<u>\$ 508</u>	<u>\$ 478</u>
Accumulated other comprehensive Income:		
Cumulative translation adjustments	\$ 562	\$ 611
Unrealized gain on short-term investments	-	1
	<u>\$ 562</u>	<u>\$ 612</u>

**ALLIANCE FIBER OPTIC PRODUCTS, INC.**

**Notes to Consolidated Financial Statements**

**5. Property and Equipment, Net**

(in thousands)	December 31,	
	2009	2008
Machinery and equipment	\$ 9,574	\$ 9,778
Furniture and fixtures	524	523
Leasehold improvements	1,000	967
Building and equipment prepayments	1,240	928
	<u>\$ 12,338</u>	<u>\$ 12,196</u>
Less: Accumulated depreciation	(7,904)	(7,543)
Total property and equipment, net	<u>\$ 4,434</u>	<u>\$ 4,653</u>

**6. Income Taxes**

The components of income before income taxes are as follows (in thousands):

	Years Ended December 31,	
	2009	2008
Income subject to domestic income taxes only	\$ 743	\$ 2,774
Income subject to foreign income taxes only	774	1,491
Total	<u>\$ 1,517</u>	<u>\$ 4,265</u>

The following is a reconciliation of the effective tax rates and the United States statutory federal income tax rate:

	Years Ended December 31,	
	2009	2008
Statutory federal income tax rate	(34.0) %	(34.0) %
State income tax	(5.9)	(5.9)
Stock compensation	(2.9)	(1.2)
Net operating loss carryforward	38.6	34.5
Minimum tax credit	(4.0)	0.3
Research and development credits	0.5	0.2
Manufacturers investment credits	1.6	2.3
Valuation allowance	(0.5)	1.9
Other taxes	1.1	(2.8)
Effective tax rate	<u>(5.5) %</u>	<u>(4.7) %</u>

Deferred tax assets consisted of the following (in thousands):

**ALLIANCE FIBER OPTIC PRODUCTS, INC.**

**Notes to Consolidated Financial Statements**

	December 31,	
	2009	2008
Deferred tax assets:		
Net operating loss carryforwards	\$ 13,394	\$ 13,982
Credit carryforwards	2,251	2,297
Depreciation	4	5
Stock compensation	370	326
Accruals and allowances	706	705
Total	16,725	17,315
Less: valuation allowances	(16,725)	(17,315)
Net deferred tax assets	\$ -	\$ -

	December 31,	
	2009	2008
Valuation allowances on deferred tax assets:		
Balance at beginning of year	\$ 17,315	\$ 18,210
Addition	-	-
Utilized	(590)	(895)
Balance at end of year	\$ 16,725	\$ 17,315

Based upon the weight of available evidence, which includes the Company's historical operating performance and the accumulated deficit, the Company provided a full valuation allowance against the net deferred tax assets.

As of December 31, 2009, the Company had net operating loss carryforwards of approximately \$35.1 million for federal and \$20.4 million for state tax purposes. If not utilized, these carryforwards will begin to expire in 2022 for federal and in 2014 for state purposes.

As of December 31, 2009, the Company had research credit carryforwards of approximately \$1.2 million and \$0.9 million for federal and state income tax purposes, respectively. If not utilized, the federal carryforward will expire in various amounts beginning in 2019. The California tax credit can be carried forward indefinitely.

Internal Revenue Code Section 382 limits the use of net operating loss and tax credit carryforwards in certain situations where changes occur in the stock ownership of a company. In the event the Company has had a change in ownership, utilization of the carryforwards could be restricted.

**7. Concentrations of Certain Risks**

Financial instruments that potentially subject the Company to significant concentrations of credit risk consist primarily of cash, cash equivalents, short-term investments, long-term investment and accounts receivable. The Company limits the amount of deposits in any one financial institution and any one financial instrument. The Company invests its excess cash principally in certificates of deposit, debt instruments issued by high-credit quality financial institutions and corporations and money market accounts with financial institutions in the United States.

The Company performs periodic credit evaluations of its customers' financial condition, and limits the amount of credit extended when deemed necessary, but generally does not require collateral.

## ALLIANCE FIBER OPTIC PRODUCTS, INC.

### Notes to Consolidated Financial Statements

At December 31, 2009, three customers accounted for 16.0%, 15.6% and 11.7% of the Company's accounts receivable, respectively. At December 31, 2008, two customers accounted for 23.6% and 13.2% of the Company's accounts receivable, respectively.

Two customers accounted for 15.1% and 14.9% of revenues in the year ended December 31, 2009, respectively. One customer accounted for 15.7% of revenues in the year ended December 31, 2008. Certain components used in manufacturing the Company's products have relatively few alternative sources of supply, and establishing additional or replacement suppliers for such components cannot be accomplished quickly.

#### 8. Geographic Segment Information

The Company operates in a single industry segment. This industry segment is characterized by rapid technological change and significant competition.

The following is a summary of the Company's revenues generated by geographic segments, revenues generated by product lines and identifiable assets located in these segments (in thousands):

	Years Ended December 31,	
	2009	2008
Revenues		
North America	\$ 14,721	\$ 21,579
Europe	7,085	5,882
Asia	8,028	11,293
Total	<u>\$ 29,834</u>	<u>\$ 38,754</u>

	Years Ended December 31,	
	2009	2008
Revenues		
Connectivity Products	\$ 18,658	\$ 24,455
Optical Passive Products	11,176	14,299
Total	<u>\$ 29,834</u>	<u>\$ 38,754</u>

	December 31,	
	2009	2008
Property and Equipment, net		
United States	\$ 93	\$ 133
Taiwan	2,321	2,793
China	2,020	1,727
Total	<u>\$ 4,434</u>	<u>\$ 4,653</u>

#### 9. Commitments and Contingencies

**Litigation:** From time to time, the Company may be involved in litigation in the normal course of business. As of the date of these financial statements, the Company is not aware of any material legal proceedings pending or threatened against the Company.

**Off-Balance Sheet Arrangements:** The Company had no off-balance sheet arrangements as of December 31, 2009.

**Indemnification and Product Warranty:** The Company indemnifies certain customers, suppliers and subcontractors for attorney fees and damages and costs awarded against these parties in certain circumstances in

## ALLIANCE FIBER OPTIC PRODUCTS, INC.

### Notes to Consolidated Financial Statements

which products are alleged to infringe third party intellectual property rights, including patents, trade secrets, trademarks or copyrights. In all cases, there are limits on and exceptions to the potential liability for indemnification relating to intellectual property infringement claims. The Company cannot estimate the amount of potential future payments, if any, that might be required to make as a result of these agreements. As of December 31, 2009, the Company has not paid any claim or been required to defend any action related to indemnification obligations, and accordingly, the Company has not accrued any amounts for such indemnification obligations. However, the Company may record charges in the future as a result of these indemnification obligations.

The Company generally warrants products against defects in materials and workmanship and non-conformance to specifications for varying lengths of time. If there is a material increase in customer claims compared with historical experience, or if costs of servicing warranty claims are greater than expected, the Company may record a charge against cost of revenues.

**Operating Leases:** The Company leases certain office space under long-term operating leases expiring at various dates through 2014. Total rent expense under these operating leases was approximately \$0.8 million and \$0.9 million for the years ended December 31, 2009 and 2008, respectively.

Total future minimum lease payments under operating leases as of December 31, 2009 are summarized below (in thousands):

Years ending December 31,	
2010	658
2011	184
2012	166
2013	165
2014	124
Total	<u>\$ 1,297</u>

**Letter of Credit:** The Company had a letter of credit of \$0.4 million which expired on April 12, 2009.

#### 10. Bank Loan

In November 2004, the Company entered into a ten-year loan of \$0.5 million in Taiwan with an interest rate of 2.3% for the first two years and 3.6% for the following years. In November 2006, the Company entered into a seven-year loan of \$0.2 million in Taiwan with an interest rate of 2.8%. Both loans are secured by the Company's building in Taiwan. The net book value of the building was \$0.5 million as of December 31, 2009.

In April 2005, the Company entered into a five-year equipment loan of \$0.2 million in Taiwan with an interest rate of 2.9% for the first year and 3.7% for the following years. In September 2007, the Company entered into a three-year equipment loan of \$0.04 million and a five-year equipment loan of \$0.1 million with an interest rate of 3.68% for the first year for both loans.

## ALLIANCE FIBER OPTIC PRODUCTS, INC.

### Notes to Consolidated Financial Statements

Payments due under bank loans as of December 31, 2009 are as follows (in thousands):

Years ending December 31,	
2010	122
2011	100
2012	94
2013	74
2014 and after	48
Total payment	<u>438</u>
Less: Amounts representing interest	<u>(19)</u>
Present value of net remaining payments	419
Less: current portion	<u>(114)</u>
Long-term portion	<u><u>\$ 305</u></u>

#### 11. Related Party Transactions

As of March 5, 2010, based on information filed with the SEC, Foxconn Holding Limited was a holder of 18.9% of the Company's common stock. In the normal course of business, the Company sells products to and purchases raw materials from Hon Hai Precision Company Limited, who is the parent company of Foxconn Holding Limited. These transactions were made at prices and terms consistent with those of unrelated third parties. Sales of products to Hon Hai Precision Industry Company Limited were \$0.01 and \$1.1 million in the years ended December 31, 2009 and 2008, respectively. Purchases of raw materials from Hon Hai Precision Company Limited were \$2.0 million and \$3.9 million in the years ended December 31, 2009 and 2008 respectively. Amounts due from Hon Hai Precision Company Limited were \$0 and \$0.01 million at December 31, 2009 and 2008, respectively. Amounts due to Hon Hai Precision Company Limited were \$0.7 million and \$0.3 million at December 31, 2009 and 2008, respectively.

#### 12. Fair Value of Financial Instruments

Effective January 1, 2008, the Company adopted ASC 820 which provides a definition of fair value, establishes a hierarchy for measuring fair value under generally accepted accounting principles, and requires certain disclosures about fair values used in the financial statements. ASC 820 does not extend the use of fair value beyond what is currently required by other pronouncements, and it does not pertain to stock-based compensation under ASC 718, *Share-Based Payments* or to leases under ASC 840, *Accounting for Leases*.

In February 2008, FASB Staff Position ASC 820 was issued. This FSP provides a one year deferral of the effective date of ASC 820 for non-financial assets and non-financial liabilities, except those that are recognized or disclosed in the financial statements at fair value at least annually. Therefore, the Company has adopted the provisions of ASC 820 with respect to financial assets and liabilities only.

ASC 820 defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Valuation techniques used to measure fair value under ASC 820 must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value, which are the following:

- Level 1 – Quoted prices in active markets for identical assets or liabilities.

## ALLIANCE FIBER OPTIC PRODUCTS, INC.

### Notes to Consolidated Financial Statements

- Level 2 – Inputs other than Level 1 that are observable, either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.
- Level 3 — Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

The Company measures the following financial assets at fair value on a recurring basis. The fair value of these financial assets at December 31, 2009 (in thousands) was as follows:

	Fair Value Measurements at Reporting Date Using			
	Balance at December 31, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Cash equivalents:				
Money market mutual funds	\$ 4,251	\$ 4,251	\$ -	\$ -
Marketable Securities:				
Time deposits	11,519	11,519	-	-
Corporate bonds	6,127	6,127	-	-
Auction rate securities	14,322	-	-	14,322
Auction rate securities - Rights	1,778	-	-	1,778
Total	\$ 37,997	\$ 21,897	\$ -	\$ 16,100

As of December 31, 2009, the Company held investments in corporate bonds, certificates of deposit, money market securities, and auction rate securities (“ARS”). The Company’s cash and cash equivalents are comprised of investments with original maturities of 90 days or less from the date of purchase and these investment instruments are classified within Level 1 of the fair value hierarchy because they are valued based on quoted market prices in active markets. The Company’s short-term investments are comprised of corporate bonds, certificates of deposit and ARS with original maturities of 91 days or more from the date of purchase. These investment instruments are classified within Level 1 of the fair value hierarchy because they are valued based on quoted market prices in active markets with the exception of ARS which are classified as Level 3.

As of December 31, 2009, the Company held investments in ARS that are required to be measured at fair value on a recurring basis. Since February 2008, all ARS investments in the Company’s portfolio have experienced failed auctions. Due to the lack of liquidity, the Company reclassified its ARS portfolio from short-term available-for-sale to long-term available-for-sale investment securities as of March 31, 2008. The Company’s ARS investments have been classified within Level 3 as their valuation requires substantial judgment and estimation of factors that are not currently observable in the market due to the lack of trading. This valuation may be revised in future periods as market conditions evolve. The Company estimated the fair value of its ARS based on estimates contained in broker statements that were compiled utilizing Level 3 inputs including, but not limited to factors such as tax status, credit quality, duration, insurance wraps and the portfolio composition of The Federal Family Education Loan Program loans.

As of December 31, 2009, the Pennsylvania Higher Education Assistance Agency completed seven partial calls of the ARS at par and the Company received settlement of \$200,000 in total. On June 30, 2009, the Company reclassified the ARS and the related Right (as defined below) from long-term investments to short-term investments and current other assets.

## ALLIANCE FIBER OPTIC PRODUCTS, INC.

### Notes to Consolidated Financial Statements

In November 2008, the Company accepted an offer from UBS, the Company's investment advisor, granting the Company the right to require UBS to purchase the Company's ARS at their par value of \$16.3 million anytime during the two-year period beginning June 30, 2010 ("Right"). UBS has also established a program which allows the Company to establish a no net cost line of credit and borrow up to 75 percent of the market value of the ARS at interest rates equal to the return the Company would receive on the underlying ARS securities. Management reviewed the UBS offer, credit rating, and financial stability and believed that UBS will purchase the Company's ARS at par value beginning on June 30, 2010. The Right represents an instrument by which the Company may require UBS to repurchase its ARS at par value. The Company has valued the Right as the difference between the par value and the fair value of its ARS as adjusted for any bearer risk associated with UBS' financial ability to repurchase the Company's ARS beginning on June 30, 2010. Upon election for fair value option for the Right under ASC 825-10, the Company will continue to measure the value of the Right at the difference between par value and fair value in subsequent periods.

In conjunction with the adoption of ASC 825, the Company elected the fair value option for its ARS and the Right. Since the Right is directly related to the Company's ARS investments, the Company elected the fair value option for these financial assets and they have been classified within Level 3 as ARS investments. In conjunction with the adoption of ASC 825, the Company elected a one-time transfer of ARS subject to settlements from available-for-sale to the trading category. As of December 31, 2009, the Company has recognized the Right as other current assets on the balance sheet and recorded a gain of \$0.8 million as other income.

The following table provides a reconciliation of the beginning and ending balance for the assets measured at fair value using significant unobservable inputs (level 3) (in thousands):

	Significant Unobservable Inputs (Level 3)
Fair value December 31, 2008	\$ 16,300
Sales of short-term investments	(200)
Gain on short-term investment	804
Loss on other assets	(804)
Fair value December 31, 2009	<u>\$ 16,100</u>

#### Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure

None

#### Item 9A (T). Controls and Procedures

*Evaluation of disclosure controls and procedures.* We maintain "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, or the Exchange Act, that are designed to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized, and reported within the time periods specified in Securities and Exchange Commission rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Acting Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating our disclosure controls and procedures, management recognized that disclosure controls and procedures, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the disclosure controls and procedures are met. Our disclosure controls and procedures have been designed to meet reasonable assurance standards. Additionally, in designing disclosure controls and procedures, our management necessarily was required to apply its judgment in

## **ALLIANCE FIBER OPTIC PRODUCTS, INC.**

### **Notes to Consolidated Financial Statements**

evaluating the cost-benefit relationship of possible disclosure controls and procedures. The design of any disclosure controls and procedures also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions.

Based on their evaluation as of the end of the period covered by this Annual Report on Form 10-K, our Chief Executive Officer and Acting Chief Financial Officer have concluded that, as of such date, our disclosure controls and procedures were effective at the reasonable assurance level.

*Management's Annual Report on Internal Control over Financial Reporting.* Our management is responsible for establishing and maintaining internal control over our financial reporting. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Projections of any evaluation of the effectiveness of internal control to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with policies or procedures may deteriorate.

As of the end of the fiscal year, an evaluation was performed under the supervision and with the participation of our management, including the Chief Executive Officer and Acting Chief Financial Officer, of the effectiveness of our internal control over financial reporting (as defined in Section 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934, as amended, and sections 302 and 404 of the Sarbanes-Oxley Act) based on the framework in Internal Control—Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission.

As part of this evaluation, we analyzed and tested our processes for control effectiveness (controls which reasonably assure accurate and complete financial information in accordance with GAAP), prevention of acts of fraud and transactions being approved by management. When necessary, we confirmed that appropriate corrective action (including process improvements) had been undertaken.

Based on the evaluation as of the end of the fiscal year 2009, the Company's Chief Executive Officer and Acting Chief Financial Officer have concluded that our internal controls over financial reporting were effective.

This annual report does not include an attestation report of our registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by our registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit us to provide only management's report in this annual report.

#### **Item 9B. Other Information**

Not Applicable.

## PART III

### Item 10. Directors, Executive Officers and Corporate Governance

The information required by this item is incorporated by reference from the information under the caption "Election of Directors" contained in the Company's Proxy Statement to be filed with the Securities and Exchange Commission in connection with the solicitation of proxies for the Company's 2010 Annual Meeting of Stockholders to be held on May 14, 2010 (the "Proxy Statement"). Certain information required by this item concerning executive officers is set forth in Part I of this Report under the caption "Executive Officers of the Registrant."

Item 405 of Regulation S-K calls for disclosure of any known late filing or failure by an insider to file a report required by Section 16(a) of the Exchange Act. This disclosure is contained in the section entitled "Section 16(a) Beneficial Ownership Reporting Compliance" in the Proxy Statement and is incorporated herein by reference.

The Company has a separately designated standing Audit Committee established in accordance with Section 3(a)(58)(A) of the Exchange Act. The members of the Audit Committee are Richard Black (Chairperson), James C. Yeh and Ray Sun, all of whom meet the independence standards established by The Nasdaq Stock Market for serving on an audit committee. The Board of Directors has determined that Richard Black is an "audit committee financial expert" as defined by SEC regulations.

The Company's Board of Directors adopted a Code of Ethics for all of its directors and officers on March 24, 2004. The Company's Code of Ethics is available on the Company's website at <http://www.afop.com>. To date, there have been no waivers under the Company's Code of Ethics. The Company will post any waivers, if and when granted, under its Code of Ethics, on the Company's website at <http://www.afop.com>.

### Item 11. Executive Compensation

The information required by this item is incorporated by reference from the information under the captions "Election of Directors — Director Compensation," and "Executive Compensation," contained in the Proxy Statement.

### Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this item is incorporated by reference from the information under the caption "Security Ownership of Certain Beneficial Owners and Management" contained in the Proxy Statement.

### Equity Compensation Plan Information

Set forth in the table below is certain information regarding the Company's equity compensation plans as of December 31, 2009:

<u>Plan category</u>	<u>Number of securities to be issued upon exercise of outstanding options, warrants and rights</u> (a)	<u>Weighted-average exercise price of outstanding options, warrants and rights</u> (b)	<u>Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a))</u> (c)
Equity compensation plans approved by security holders	4,863,333 (1)	\$ 1.40	4,449,009 (2)
Equity compensation plans not approved by security holders	-	-	-
Total	<u>4,863,333</u>	<u>\$ 1.40</u>	<u>4,449,009</u>

(1) Includes shares to be issued upon exercise of outstanding options granted under the 1997 Stock Plan and the 2000 Stock Incentive Plan. Options to purchase shares of the Company's Common Stock are no longer granted under the 1997 Stock Plan.

(2) Includes:

(i) 4,053,241 shares reserved for issuance under the Company's 2000 Stock Incentive Plan. The number of shares reserved for issuance under the Company's 2000 Stock Incentive Plan will be increased on the first day of the Company's fiscal year by the lesser of 1,700,000 shares, 5% of the fully diluted outstanding shares of the Company's common stock on that date or a lesser amount determined by the Company's Board of Directors. There was no increase on January 1, 2008 because the Board determined there were enough shares available for issuance in 2008 pursuant to the Plan. Stock options, restricted stock, restricted stock units or stock appreciation rights may be awarded under the 2000 Stock Incentive Plan.

(ii) 395,768 shares reserved for issuance under the Company's 2000 Employee Stock Purchase Plan (the "ESPP"). The number of shares reserved for issuance under the ESPP increases on the first day of the Company's fiscal year by an amount as may be determined by the Board of Directors, or, if less, the lesser of 1,000,000 shares or 1.0% of the outstanding common stock on that date. The ESPP permits eligible employees to contribute up to 20% of cash compensation toward the semi-annual purchase of the Company's common stock. The purchase price per share is 85% of the fair market value on the last trading day prior to the beginning of the six-month period at which an eligible employee is enrolled; or the fair market value on the last trading day of the month in which the six-month period expired, whichever is lower.

### **Item 13. Certain Relationships and Related Transactions, and Director Independence**

The information required by this item is incorporated by reference from the information contained under the caption "Certain Relationships and Related Party Transactions", and "Election of Directors – Director Independence" contained in the Proxy Statement.

### **Item 14. Principal Accounting Fees and Services**

The information required by this item is incorporated by reference from the information set forth under the caption "Ratification of the Appointment of Independent Registered Public Accounting Firm—Principal Accountant Fees and Services" and "Pre-Approval Policies and Procedures" in the Proxy Statement.

## **PART IV**

### **Item 15. Exhibits and Financial Statement Schedules**

(a) The following documents are filed as part of this report:

(1) Financial Statements

Reference is made to the index to Consolidated Financial Statements under Item 8 of Part II hereof.

(2) Financial Statement Schedules

Schedules have been omitted because they are not applicable or the information required to be set forth therein is included in the Consolidated Financial Statements or Notes thereto.

(3) Exhibits

See the List of Exhibits, which follows the signature pages of this report and is incorporated herein by reference.



## EXHIBIT INDEX

<b><u>Exhibit Number</u></b>	<b><u>Description of Document</u></b>
3(i).1	Amended and Restated Certificate of Incorporation (incorporated by reference to Exhibit 3(i).3 to the Company's Registration Statement on Form S-1 (File No. 333-45482)).
3(i).2	Certificate of Designation of Series A Participating Preferred Stock (incorporated by reference to Exhibit 3(i).2 to Company's 10-K for year ended December 31, 2002).
3(ii).1	Restated Bylaws of the Registrant (incorporated by reference to Exhibit 3(ii).3 to the Company's Registration Statement on Form S-1 (File No. 333-45482)).
4.1	Form of Common Stock Certificate (incorporated by reference to Exhibit 4.1 to the Company's Quarterly Report on Form 10-Q for the quarterly period ended September 30, 2002).
4.2	Amended and Restated Rights Agreement dated as of August 31, 2000 (incorporated by reference to Exhibit 4.2 to the Company's Registration Statement on Form S-1 (File No. 333-45482)).
4.3	Rights Agreement dated as of May 29, 2001 between the Company and Mellon Investor Services, LLC (incorporated by reference to Exhibit 4.1 to the Company's Form 8-A (File No. 0-31857)).
10.1#	1997 Stock Plan and form of agreements thereunder (incorporated by reference to Exhibit 10.1 to the Company's Registration Statement on Form S-1 (File No. 333-45482)).
10.2#	Form of Indemnification Agreement between the Company and its officers and directors (incorporated by reference to Exhibit 10.2 to the Company's Registration Statement on Form S-1 (File No. 333-45482)).
10.3#	Alliance Fiber Optic Products, Inc. 2000 Stock Incentive Plan (incorporated by reference to Exhibit 10.5 to Amendment No. 3 to the Company's Registration Statement on Form S-1 (File No. 333-45482)).
10.4#	Alliance Fiber Optic Products, Inc. Amended and Restated 2000 Employee Stock Purchase Plan (incorporated by reference to Exhibit 10.6 to the Company's Quarterly Report on Form 10-QSB for the period ended March 31, 2004).
10.5#	Alliance Fiber Optic Products, Inc. 1997 Stock Plan Stock Option Agreement dated May 2, 2000 between Peter C. Chang and the Company (incorporated by reference to Exhibit 10.7 to Amendment No. 1 to the Company's Registration Statement on Form S-1 (File No. 333-45482)).
10.6#	Lease Agreement dated April 5, 2004 by and between Moffett Office Park Investors LLC and Alliance Fiber Optic Products, Inc. (incorporated by reference to Exhibit 10.13 to Company's Quarterly Report on Form 10-QSB for period ended June 30, 2004).
10.7#	Form of 2000 Stock Incentive Plan Option Agreement
21.1	Subsidiaries of the Company (incorporated by reference to Exhibit 21.1 to the Company's Annual Report on Form 10-K for the year ended December 31, 2000).
23.1	Consent of Stonefield Josephson, Inc., Independent Registered Public Accounting Firm.
24.1	Power of Attorney (see page 55 of this Form 10-K)
31.1	Rule 13a-14(a) certification of Chief Executive Officer.
31.2	Rule 13a-14(a) certification of Acting Chief Financial Officer.
32.1**	Statement of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350).
32.2**	Statement of Acting Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350).

\*\* In accordance with Item 601(b)(32)(ii) of Regulation S-K and SEC Release No. 34-47986, the certifications furnished in Exhibits 32.1 and 32.2 hereto are deemed to accompany this Form 10-K and will not be deemed "filed" for purpose of Section 18 of the Exchange Act. Such certifications will not be deemed to be incorporated by reference into any filing under the Securities Act or the Exchange Act, except to the extent that the registrant specifically incorporates it by reference.

# Indicates management contract or compensatory plan or arrangement.

**CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

We hereby consent to the incorporation by reference in the Registration Statements on Form S-8 (Nos. 333-141656, 333-158316, 333-50998, 333-50926, 333-54864, 333-54874, 333-119710, 333-119711, 333-123648, 333-123649 and 333-132801) of Alliance Fiber Optic Products, Inc. of our report dated March 18, 2010, with respect to the consolidated balance sheets of Alliance Fiber Optic Products, Inc. as of December 31, 2009 and 2008, and the related consolidated statements of operations, stockholder's equity, and cash flows for each of the years in the two-year period ended December 31, 2009.

/s/Stonefield Josephson, Inc.

San Francisco, California  
March 18, 2010

**Certification of the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for the Period Ended December 31, 2009**

**CERTIFICATION**

I, Peter C. Chang, certify that:

1. I have reviewed this annual report on Form 10-K of Alliance Fiber Optic Products, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 19, 2010

By /s/Peter C. Chang  
Peter C. Chang  
Chief Executive Officer  
(Principal Executive Officer)

**Certification of the Acting Chief Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 for the Period Ended December 31, 2009**

**CERTIFICATION**

I, Anita K. Ho, certify that:

1. I have reviewed this annual report on Form 10-K of Alliance Fiber Optic Products, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.
  - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting.
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: March 19, 2010

By /s/Anita K. Ho  
Anita K. Ho  
Acting Chief Financial Officer  
(Principal Accounting Officer)

**STATEMENT OF CHIEF EXECUTIVE OFFICER UNDER 18 U.S.C. § 1350**

I, Peter C. Chang, the chief executive officer of Alliance Fiber Optic Products, Inc. (the "Company"), certify for the purposes of section 1350 of chapter 63 of title 18 of the United States Code that, to the best of my knowledge,

(i) the Annual Report of the Company on Form 10-K for the period ended December 31, 2009 (the "Report"), fully complies with the requirements of section 13(a) or section 15 (d) of the Securities Exchange Act of 1934, and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Peter C. Chang  
Peter C. Chang

March 19, 2010

**STATEMENT OF ACTING CHIEF FINANCIAL OFFICER UNDER 18 U.S.C. § 1350**

I, Anita K. Ho, the acting chief financial officer of Alliance Fiber Optic Products, Inc. (the "Company"), certify for the purposes of section 1350 of chapter 63 of title 18 of the United States Code that, to the best of my knowledge,

(i) the Annual Report of the Company on Form 10-K for the period ended December 31, 2009 (the "Report"), fully complies with the requirements of section 13(a) or section 15(d) of the Securities Exchange Act of 1934, and

(ii) the information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

/s/ Anita K. Ho

Anita K. Ho

March 19, 2010