

NETWORK APPLIANCE INC

Form 10-Q

December 04, 2007

Table of Contents

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549**

**Form 10-Q**

**(Mark One)**

- ☐ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**  
**For the quarterly period ended October 26, 2007**
- or**
- ☐ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934**  
**For the transition period from            to**

**Commission file number 0-27130**

**Network Appliance, Inc.**

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

**Delaware**

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

**77-0307520**

*(IRS Employer  
Identification No.)*

**495 East Java Drive,  
Sunnyvale, California 94089**

*(Address of principal executive offices, including zip code)*

**Registrant's telephone number, including area code:**

**(408) 822-6000**

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

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

Large accelerated filer ☐ Accelerated filer ☐ Non-accelerated filer ☐

Edgar Filing: NETWORK APPLIANCE INC - Form 10-Q

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

Number of shares outstanding of the registrant's common stock, \$0.001 par value, as of the latest practicable date.

<b>Class</b>	<b>Outstanding at November 23, 2007</b>
Common Stock	344,190,695

---

## TABLE OF CONTENTS

		Page No.
	<b><u>PART I. FINANCIAL INFORMATION</u></b>	
<u>Item 1.</u>	<u>Condensed Consolidated Financial Statements (Unaudited)</u>	3
	<u>Condensed Consolidated Balance Sheets as of October 26, 2007, and April 27, 2007 (Unaudited)</u>	3
	<u>Condensed Consolidated Statements of Income for the Three and Six-Month Periods Ended October 26, 2007, and October 27, 2006 (Unaudited)</u>	4
	<u>Condensed Consolidated Statements of Cash Flows for the Six-Month Periods Ended October 26, 2007, and October 27, 2006 (Unaudited)</u>	5
	<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	6
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	22
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	38
<u>Item 4.</u>	<u>Controls and Procedures</u>	40
	<b><u>PART II. OTHER INFORMATION</u></b>	
<u>Item 1.</u>	<u>Legal Proceedings</u>	41
<u>Item 1A.</u>	<u>Risk Factors</u>	41
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	53
<u>Item 3.</u>	<u>Defaults upon Senior Securities</u>	53
<u>Item 4.</u>	<u>Submission of Matters to a Vote of Security holders</u>	53
<u>Item 5.</u>	<u>Other Information</u>	54
<u>Item 6.</u>	<u>Exhibits</u>	55
<u>SIGNATURE</u>		58
<u>EXHIBIT 10.60</u>		
<u>EXHIBIT 10.61</u>		
<u>EXHIBIT 31.1</u>		
<u>EXHIBIT 31.2</u>		
<u>EXHIBIT 32.1</u>		
<u>EXHIBIT 32.2</u>		

## TRADEMARKS

2008 Network Appliance, Inc. All rights reserved. Specifications subject to change without notice. NetApp, the Network Appliance logo, NearStore, and NetCache are registered trademarks and Network Appliance is a trademark of Network Appliance, Inc. in the United States and other countries. Windows is a registered trademark of Microsoft Corporation. UNIX is a registered trademark of The Open Group. All other brands or products are trademarks or registered trademarks of their respective holders and should be treated as such.

Table of Contents**PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements (Unaudited)****NETWORK APPLIANCE, INC.****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands, - Unaudited)**

	<b>October 26, 2007</b>	<b>April 27, 2007</b>
<b>ASSETS</b>		
<b>Current Assets:</b>		
Cash and cash equivalents	\$ 625,707	\$ 489,079
Short-term investments	357,370	819,702
Accounts receivable, net of allowances of \$2,314 at October 26, 2007, and \$2,572 at April 27, 2007	427,854	548,249
Inventories	62,690	54,880
Prepaid expenses and other assets	94,684	99,840
Short-term restricted cash and investments	84,034	118,312
Short-term deferred income taxes	116,324	110,741
Total current assets	1,768,663	2,240,803
<b>Property and Equipment, Net</b>	646,157	603,523
<b>Goodwill</b>	601,056	601,056
<b>Intangible Assets, Net</b>	69,321	83,009
<b>Long-Term Restricted Cash and Investments</b>	304,937	3,639
<b>Long-Term Deferred Income Taxes and Other Assets</b>	167,880	126,448
	\$ 3,558,014	\$ 3,658,478
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
<b>Current Liabilities:</b>		
Current portion of long-term debt	\$ 47,770	\$ 85,110
Accounts payable	119,099	144,112
Income taxes payable	9,962	53,371
Accrued compensation and related benefits	149,727	177,327
Other accrued liabilities	100,936	97,017
Deferred revenue	702,134	630,610
Total current liabilities	1,129,628	1,187,547
<b>Long-Term Debt</b>	250,000	
<b>Other Long-Term Obligations</b>	74,105	9,487
<b>Long-Term Deferred Revenue</b>	516,445	472,423
	1,970,178	1,669,457

**Stockholders' Equity:**

Common stock (425,673 shares at October 26, 2007, and 421,623 shares at April 27, 2007)	426	422
Additional paid-in capital	2,563,013	2,380,623
Treasury stock at cost (78,717 shares at October 26, 2007, and 54,593 shares at April 27, 2007)	(2,323,664)	(1,623,691)
Retained earnings	1,344,260	1,226,165
Accumulated other comprehensive income	3,801	5,502
Total stockholders' equity	1,587,836	1,989,021
	\$ 3,558,014	\$ 3,658,478

See accompanying notes to unaudited condensed consolidated financial statements.

Table of Contents**NETWORK APPLIANCE, INC.****CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(In thousands, except per share amounts, - Unaudited)**

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>October 26,</b>	<b>October 27,</b>	<b>October 26,</b>	<b>October 27,</b>
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>Revenues</b>				
Product	\$ 541,392	\$ 481,284	\$ 1,004,725	\$ 946,895
Software entitlements and maintenance	117,134	82,253	225,061	157,083
Service	133,672	88,986	251,647	169,833
Total revenues	792,198	652,523	1,481,433	1,273,811
<b>Cost of Revenues</b>				
Cost of product	217,396	186,261	404,147	374,226
Cost of software entitlements and maintenance	1,914	2,456	3,998	4,748
Cost of service	88,883	62,499	172,086	120,460
Total cost of revenues	308,193	251,216	580,231	499,434
Gross margin	484,005	401,307	901,202	774,377
<b>Operating Expenses:</b>				
Sales and marketing	255,374	204,264	500,017	399,782
Research and development	108,964	90,360	215,520	179,038
General and administrative	39,507	35,217	80,956	67,613
Restructuring recoveries				(74)
Gain on sale of assets		(25,339)		(25,339)
Total operating expenses	403,845	304,502	796,493	621,020
<b>Income from Operations</b>	80,160	96,805	104,709	153,357
<b>Other Income (Expenses), Net:</b>				
Interest income	16,296	17,478	33,332	34,134
Interest expense	(1,410)	(5,170)	(2,492)	(9,042)
Net gain (loss) on investments	13,619	(2,000)	13,619	(2,000)
Other income, net	231	1,878	1,062	2,657
Total other income, net	28,736	12,186	45,521	25,749
<b>Income Before Income Taxes</b>	108,896	108,991	150,230	179,106
<b>Provision for Income Taxes</b>	25,138	22,060	32,135	37,506
<b>Net Income</b>	\$ 83,758	\$ 86,931	\$ 118,095	\$ 141,600

**Net Income per Share:**

Basic	\$	0.24	\$	0.23	\$	0.33	\$	0.38
Diluted	\$	0.23	\$	0.22	\$	0.32	\$	0.36

**Shares Used in Net Income per Share**

**Calculations:**

Basic	355,665	370,659	360,061	372,264
Diluted	365,458	388,226	371,544	389,773

See accompanying notes to unaudited condensed consolidated financial statements.



Table of Contents**NETWORK APPLIANCE, INC.****CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS****(In thousands)**

	<b>Six Months Ended</b>	
	<b>October 26, 2007</b>	<b>October 27, 2006</b>
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 118,095	\$ 141,600
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	55,016	39,380
Amortization of intangible assets and patents	13,688	10,364
Stock-based compensation	78,781	85,445
Net loss (gain) on investments	(13,619)	2,000
Gain on sale of assets		(25,339)
Loss on disposal of equipment	245	302
Allowance for doubtful accounts	248	194
Deferred income taxes	(35,509)	(22,634)
Deferred rent	512	740
Income tax benefit from stock-based compensation	48,419	79,020
Excess tax benefit from stock-based compensation	(15,586)	(23,845)
Changes in assets and liabilities:		
Accounts receivable	165,708	50,353
Inventories	(7,703)	8,195
Prepaid expenses and other assets	(21,219)	(31,831)
Accounts payable	(40,177)	7,205
Income taxes payable	8,697	(44,085)
Accrued compensation and related benefits	(29,884)	(6,327)
Other accrued liabilities	(9,538)	(5,017)
Deferred revenue	112,397	137,682
Net cash provided by operating activities	428,571	403,402
<b>Cash Flows from Investing Activities:</b>		
Purchases of investments	(439,990)	(1,527,568)
Redemptions of investments	592,138	1,544,557
Redemptions of restricted investments	35,426	52,638
Change in restricted cash	(1,443)	405
Proceeds from sale of assets		23,914
Proceeds from sales of marketable securities	18,256	
Proceeds from sales of nonmarketable securities		17
Purchases of property and equipment	(71,158)	(76,013)
Purchases of nonmarketable securities	(4,035)	(1,333)
Net cash provided by investing activities	129,194	16,617

**Cash Flows from Financing Activities:**

Proceeds from sale of common stock related to employee stock transactions	66,067	92,460
Excess tax benefit from stock-based compensation	15,586	23,845
Proceeds from revolving credit facility	249,754	
Repayment of debt	(37,340)	(106,572)
Tax withholding payments reimbursed by restricted stock	(5,202)	(4,323)
Repurchases of common stock	(699,973)	(363,908)
Net cash used in financing activities	(411,108)	(358,498)

**Effect of Exchange Rate Changes on Cash and Cash Equivalents**

	(10,029)	561
--	----------	-----

**Net Increase in Cash and Cash Equivalents**

	136,628	62,082
--	---------	--------

**Cash and Cash Equivalents:**

Beginning of period	489,079	461,256
End of period	\$ 625,707	\$ 523,338

**Noncash Investing and Financing Activities:**

Acquisition of property and equipment on account	\$ 25,494	\$ 5,243
Common stocks received from sale of assets	\$	\$ 7,909

**Supplemental Cash Flow Information:**

Income taxes paid	\$ 11,849	\$ 27,110
Income taxes refunded	\$ 1,340	\$ 1,945
Interest paid on debt	\$ 1,947	\$ 6,256

See accompanying notes to unaudited condensed consolidated financial statements.

**Table of Contents**

**NETWORK APPLIANCE, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands, except per share data, Unaudited)**

**1. The Company**

Based in Sunnyvale, California, Network Appliance was incorporated in California in April 1992 and reincorporated in Delaware in November 2001. Network Appliance, Inc. is a supplier of enterprise storage and data management software and hardware products and services. Our solutions help global enterprises meet major information technology challenges such as managing storage growth, assuring secure and timely information access, protecting data, and controlling costs by providing innovative solutions that simplify the complexity associated with managing corporate data. Network Appliance<sup>tm</sup> solutions are the data management and storage foundation for many of the world's leading corporations and government agencies.

**2. Condensed Consolidated Financial Statements**

The accompanying interim unaudited condensed consolidated financial statements have been prepared by Network Appliance, Inc. without audit and reflect all adjustments, consisting only of normal recurring adjustments which are, in the opinion of management, necessary for a fair presentation of our financial position, results of operations, and cash flows for the interim periods presented. The statements have been prepared in accordance with accounting principles generally accepted in the United States of America ( generally accepted accounting principles ) for interim financial information and in accordance with the instructions to Form 10-Q and Article 10-01 of Regulation S-X. Accordingly, they do not include all information and footnotes required by generally accepted accounting principles for annual consolidated financial statements. These financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended April 27, 2007. The results of operations for the three- and six-month periods ended October 26, 2007, are not necessarily indicative of the operating results to be expected for the full fiscal year or future operating periods.

In the first quarter of fiscal 2008, we began to classify sales-related tax receivable balances from our customers within prepaid expenses and other current assets. These balances were included in accounts receivable, net, in previous periods (\$43,075 at April 27, 2007), and such amounts have been reclassified in the accompanying financial statements to conform to the current period classification. This reclassification had no effect on the reported amounts of net income or cash flow from operations for any period presented. In addition, we have chosen to use the term software entitlements and maintenance in our statements of income to describe the arrangements under which we provide our customers the right to receive unspecified software product upgrades and enhancements on a when-and-if-available basis, bug fixes, and patch releases; these were previously described as software upgrade and maintenance arrangements.

We operate on a 52-week or 53-week year ending on the last Friday in April. The first six months of fiscal 2008 and 2007 were both 26-week fiscal periods.

**3. Use of Estimates**

The preparation of the condensed consolidated financial statements is in conformity with generally accepted accounting principles and 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 condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include, but are not limited to, revenue recognition and allowances; allowance for doubtful accounts; valuation of

goodwill and intangibles; fair value of derivative instruments and related hedged items; accounting for income taxes; inventory write-down and contractual commitments; restructuring accruals; impairment losses on investments; fair value of options granted under our stock-based compensation plans; and loss contingencies. Actual results could differ from those estimates.

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****4. Stock-Based Compensation, Equity Incentive Programs and Stockholders Equity***Stock-Based Compensation Expense*

The stock-based compensation expenses included in the Condensed Consolidated Statement of Income for the three- and six-month periods ended October 26, 2007, and October 27, 2006, are as follows:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>October 26, 2007</b>	<b>October 27, 2006</b>	<b>October 26, 2007</b>	<b>October 27, 2006</b>
Cost of product revenue	\$ 768	\$ 1,069	\$ 1,713	\$ 1,739
Cost of service revenue	2,606	2,489	5,277	5,123
Sales and marketing	17,135	18,715	34,626	37,432
Research and development	12,332	13,022	25,507	26,890
General and administrative	5,529	7,128	11,658	14,261
Total stock-based compensation expense before income taxes	38,370	42,423	78,781	85,445
Income taxes	(4,847)	(7,447)	(12,129)	(15,281)
Total stock-based compensation expense after income taxes	\$ 33,523	\$ 34,976	\$ 66,652	\$ 70,164

The following table summarizes stock-based compensation expense associated with each type of award:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>October 26, 2007</b>	<b>October 27, 2006</b>	<b>October 26, 2007</b>	<b>October 27, 2006</b>
Employee stock options and awards	\$ 33,717	\$ 39,174	\$ 70,246	\$ 79,297
Employee stock purchase plan ( ESPP )	4,766	3,273	8,642	6,656
Amounts capitalized in inventory	(113)	(24)	(107)	(508)
Total stock-based compensation expense before income taxes	38,370	42,423	78,781	85,445
Income taxes	(4,847)	(7,447)	(12,129)	(15,281)
	\$ 33,523	\$ 34,976	\$ 66,652	\$ 70,164

Total stock-based compensation  
expense after income taxes

7

---

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Valuation Assumptions***

We estimated the fair value of stock options using the Black-Scholes model on the date of the grant. Assumptions used in the Black-Scholes valuation model were as follows:

	<b>Stock Options</b>		<b>ESPP</b>	
	<b>Three Months Ended</b>		<b>Three Months Ended</b>	
	<b>October 26, 2007</b>	<b>October 27, 2006</b>	<b>October 26, 2007</b>	<b>October 27, 2006</b>
Expected life in years(1)	4.0	4.0	0.5	0.5
Risk-free interest rate(2)	4.02% - 4.33%	4.67% - 4.79%	4.28%	5.06%
Volatility(3)	43% - 55%	36% - 38%	48%	37%
Expected dividend(4)	0%	0%	0%	0%

	<b>Stock Options</b>		<b>ESPP</b>	
	<b>Six Months Ended</b>		<b>Six Months Ended</b>	
	<b>October 26, 2007</b>	<b>October 27, 2006</b>	<b>October 26, 2007</b>	<b>October 27, 2006</b>
Expected life in years(1)	4.0	4.0	0.5	0.5
Risk-free interest rate(2)	4.02% - 5.02%	4.67% - 5.05%	4.62%	5.02%
Volatility(3)	33% - 55%	35% - 38%	42%	37%
Expected dividend(4)	0%	0%	0%	0%

- (1) The expected life of 4.0 years represented the period that our stock-option awards are expected to be outstanding and was determined based on historical experience on similar awards. The expected life of 0.5 years for the purchase plan was based on the term of the purchase period of the purchase plan.
- (2) The risk-free interest rate for the options was based upon U.S. Treasury bills with equivalent expected terms of our employee stock-option award. The risk-free interest rate for the purchase plan was based upon U.S. Treasury bills yield curve in effect at the time of grant for the expected term of the purchase period.
- (3) We used the implied volatility of traded options to estimate our stock price volatility.
- (4) The expected dividend was determined based on our history and expected dividend payouts.

We estimate our forfeiture rates based on historical voluntary termination behavior and recognized compensation expense only for those equity awards expected to vest.

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)*****Stock Options***

A summary of the combined activity under our stock option plans and agreements is as follows:

	<b>Shares Available for Grant</b>	<b>Outstanding Options Numbers of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at April 27, 2007	22,862	65,043	\$ 29.28		
Additional shares reserved for plan	7,200				
Options granted	(5,360)	5,360	30.42		
Restricted stock units granted	(75)	75			
Options exercised		(3,151)	13.48		
Restricted stock units exercised		(218)			
Options forfeitures and cancellation	2,391	(2,391)	37.12		
Restricted stock units forfeitures and cancellation	66	(66)			
Options expired	(191)				
Outstanding at October 26, 2007	26,893	64,652	\$ 29.95		
Options vested and expected to vest as of October 26, 2007		60,953	\$ 30.43	5.29	\$ 388,641
Exercisable at October 26, 2007		40,614	\$ 29.33	4.54	\$ 352,629
RSUs vested and expected to vest as of October 26, 2007		1,088	\$	1.66	\$ 34,262
Exercisable at October 26, 2007			\$		\$

The intrinsic value represents the difference between the exercise price of stock options and the market price of our stock on that day for all in-the-money options. The weighted-average fair value of options granted during the three- and six-month periods ended October 26, 2007 were \$11.18 and \$10.89, respectively. The weighted-average fair value of options granted during the three- and six-month periods ended October 27, 2006 were \$12.67 and \$11.80, respectively. The total intrinsic value of options exercised was \$23,168 and \$55,787 for the three- and six-month periods ended October 26, 2007, respectively, and \$90,948 and \$117,331 for the three- and six-month periods ended October 27, 2006, respectively. We received \$16,076 and \$42,470 from the exercise of stock options for the three- and six-month periods ended October 26, 2007, respectively, and received \$55,627 and \$74,947 from the exercise of stock options for the three- and six-month periods ended October 27, 2006, respectively.

The following table summarizes our nonvested shares (restricted stock awards) as of October 26, 2007:



	<b>Number of Shares</b>	<b>Weighted- Average Grant-Date Fair Value</b>
Nonvested at April 27, 2007	265	\$ 34.45
Awards granted		
Awards vested	(25)	27.11
Awards canceled/expired/forfeited	(44)	35.24
Nonvested at October 26, 2007	196	\$ 35.20

Although nonvested shares are legally issued, they are considered contingently returnable shares subject to repurchase by the Company when employees terminate their employment. The total fair value of shares vested

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

during the three- and six-month periods ended October 26, 2007, was \$144 and \$774, respectively. There was \$6,728 of total unrecognized compensation as of October 26, 2007 related to restricted stock awards. The unrecognized compensation will be amortized on a straight-line basis over a weighted-average remaining period of 2.6 years.

***Employee Stock Purchase Plan***

	<b>Number of Shares</b>	<b>Weighted Average Exercise Price</b>	<b>Weighted Average Remaining Contractual Term</b>	<b>Aggregate Intrinsic Value</b>
Outstanding at October 26, 2007	1,068	\$ 26.13	0.10	\$ 5,728
Vested and expected to vest at October 26, 2007	1,037	\$ 26.13	0.10	\$ 5,559

There were no employee stock purchases during the three-month periods ended October 26, 2007, and October 27, 2006. The total intrinsic value of employee stock purchases was \$5,044 and \$10,942 for the six-month periods ended October 26, 2007, and October 27, 2006, respectively. The compensation cost for options purchased under the ESPP plan was \$4,766 and \$8,642 for the three- and six month periods ended October 26, 2007, respectively, and \$3,273 and \$6,656 for the three- and six-month periods ended October 27, 2006, respectively. This compensation cost will be amortized on a straight-line basis over a weighted-average remaining period of approximately 0.10 years.

The following table shows the shares issued and their purchase price per share for the employee stock purchase plan for the six-month ESPP purchase period ended May 31, 2007:

<b>Purchase Date</b>	<b>May 31, 2007</b>
Shares issued	891
Average purchase price per share	\$ 26.50

***Stock Repurchase Program***

Common stock repurchase activities for the three- and six-month periods ended October 26, 2007, and October 27, 2006, were as follows:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>October 26, 2007</b>	<b>October 27, 2006</b>	<b>October 26, 2007</b>	<b>October 27, 2006</b>
Common stock repurchased	17,602	4,259	24,124	10,820
	\$ 499,973	\$ 143,908	\$ 699,973	\$ 363,908

Cost of common stock  
repurchased

Average price per share	\$	28.40	\$	33.79	\$	29.02	\$	33.63
-------------------------	----	-------	----	-------	----	-------	----	-------

Since the inception of the stock repurchase program through October 26, 2007, we have purchased a total of 78,717 shares of our common stock at an average price of \$29.52 per share for an aggregate purchase price of \$2,323,664. At October 26, 2007, \$699,975 remained available for repurchases under the plan. The stock repurchase program may be suspended or discontinued at any time.

## 5. Credit Facility and Debt

On October 5, 2007, the Company entered into a secured credit agreement (the "Credit Agreement") with JPMorgan Chase Bank, National Association, as administrative agent. The Credit Agreement provides for a revolving secured credit facility of up to \$250,000 with a term of five years. The proceeds of the term loan will be used for general corporate purposes, including stock repurchases and working capital needs. On October 10, 2007, \$250,000 was advanced to the Company and was recorded in the Long-Term Debt on the accompanying Condensed

**Table of Contents****NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Consolidated Balance Sheets. The full amount is due on the maturity date of October 5, 2012. As of October 26, 2007, we have pledged \$299,510 of long-term restricted investments in connection with the Credit Agreement.

Interest for the Credit Agreement accrues at a floating rate based on the base rate in effect from time to time, plus a margin, which totaled 5.25% at October 26, 2007.

On March 31, 2006, Network Appliance Global LTD. ( Global ), a subsidiary of the Company, entered into a loan agreement (the Loan Agreement ) with JPMorgan Chase Bank, National Association, as administrative agent. The Loan Agreement provides for a term loan available in two tranches, a tranche of \$220,000 ( Tranche A ) and a tranche of \$80,000 ( Tranche B ), for an aggregate borrowing of \$300,000. The proceeds of the term loan have been used to finance a dividend from Global to the Company under the American Jobs Creation Act. The Tranche A term loan, together with accrued and unpaid interest, is due in full on the maturity date of March 31, 2008. During the three- and six-month periods ended October 26, 2007, we made repayments of \$21,380 and \$37,340 on the term loan, respectively. As of October 26, 2007, Global have pledged \$81,313 of short-term restricted investments for the Tranche A term loan in connection with the Loan Agreement. The Tranche B term loan was fully repaid as of January 26, 2007. Loan repayments of \$47,770 are due in the remainder of fiscal 2008.

Interest for the Tranche A term loan accrues at a floating rate based on the base rate in effect from time to time, plus a margin, which totaled 5.26% at October 26, 2007.

As of October 26, 2007, Global and the Company were in compliance with all debt covenants as required by the Loan and Credit Agreements, respectively.

**6. Short-Term Investments**

The following is a summary of investments at October 26, 2007:

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Losses</b>	<b>Estimated Fair Value</b>
Corporate bonds	\$ 494,199	\$ 1,357	\$ 509	\$ 495,047
Corporate securities	14,889		5	14,884
Auction rate securities	65,139			65,139
U.S. government agencies	133,208	251	153	133,306
U.S. Treasuries	10,100		11	10,089
Municipal bonds	1,591	4		1,595
Certificate of deposits	2			2
Money market funds	33,015			33,015
Total debt and equity securities	752,143	1,612	678	753,077
Less cash equivalents	14,889		5	14,884
Less short-term restricted investments	81,524		211	81,313(1)
Less long-term restricted investments	299,484	362	336	299,510(1)

Short-term investments	\$ 356,246	\$ 1,250	\$ 126	\$ 357,370
------------------------	------------	----------	--------	------------

**Table of Contents****NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The following is a summary of investments at April 27, 2007:

	<b>Amortized Cost</b>	<b>Gross Unrealized Gains</b>	<b>Gross Unrealized Losses</b>	<b>Estimated Fair Value</b>
Corporate bonds	\$ 544,334	\$ 398	\$ 1,484	\$ 543,248
Auction rate securities	114,415			114,415
Corporate securities	113,084	24	7	113,101
U.S. government agencies	218,492	12	753	217,751
U.S. Treasuries	10,097		112	9,985
Municipal bonds	3,769		11	3,758
Marketable equity securities	4,637	8,276		12,913
Money market funds	84,961			84,961
 Total debt and equity securities	 1,093,789	 8,710	 2,367	 1,100,132
Less cash equivalents	164,347	23		164,370
Less short-term restricted investments	116,950		890	116,060(2)
 Short-term investments	 \$ 812,492	 \$ 8,687	 \$ 1,477	 \$ 819,702

(1) As of October 26, 2007, we have pledged \$81,313 of short-term restricted investments for the Tranche A term loan as defined in the Loan Agreement, and \$299,510 of long-term restricted investments for the revolving credit facility (see Note 5). In addition, we have short-term and long-term restricted cash of \$2,721 and \$5,427, respectively, relating to our foreign rent, custom, and service performance guarantees. These combined amounts are presented as short-term and long-term restricted cash and investments in the accompanying Condensed Consolidated Balance Sheets as of October 26, 2007.

(2) As of April 27, 2007, we have pledged \$116,060 of short-term restricted investments for the Tranche A term loan as defined in the Loan Agreement (see Note 5). In addition, we have short-term and long-term restricted cash of \$2,252 and \$3,639, respectively, relating to our foreign rent, custom, and service performance guarantees. These combined amounts are presented as short-term and long-term restricted cash and investments in the accompanying Condensed Consolidated Balance Sheets as of April 27, 2007.

On August 13, 2007, we sold 360 shares of common stock of Blue Coat and received net proceeds of \$18,256 and recorded \$13,619 realized gain. These shares of common stock in Blue Coat Systems, Inc. ( Blue Coat ) were received in connection with the sale of certain assets of NetCache® to Blue Coat on September 11, 2006.

We record net unrealized gains or losses on available-for-sale securities in stockholders' equity. Realized gains or losses are reflected in income which have not been material for all years presented. The following table shows the gross unrealized losses and fair values of our investments, aggregated by investment category and length of time that

individual securities have been in a continuous unrealized loss position, at October 26, 2007:

	<b>Less than 12 Months</b>		<b>12 Months or Greater</b>		<b>Total</b>	
	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>	<b>Fair Value</b>	<b>Unrealized Loss</b>
Corporate bonds	\$ 150,817	\$ 360	\$ 48,840	\$ 149	\$ 199,657	\$ 509
Corporate securities	14,884	5			14,884	5
U.S. government agencies	40,077	153			40,077	153
U.S. treasury	10,089	11			10,089	11
Municipal bonds						
Total	\$ 215,867	\$ 529	\$ 48,840	\$ 149	\$ 264,707	\$ 678

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

The unrealized losses on our investments in corporate bonds and U.S. government agencies were caused by interest rate increases. We believe that we will be able to collect all principal and interest amounts due to us at maturity given the high credit quality of these investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because we have the ability and intent to hold those investments until a recovery of fair value, which may be maturity, we do not consider these investments to be other-than temporarily impaired at October 26, 2007.

**7. Inventories**

Inventories are stated at the lower of cost (first-in, first-out basis) or market. Inventories consist of the following:

	<b>October 26, 2007</b>	<b>April 27, 2007</b>
Purchased components	\$ 10,192	\$ 19,429
Work-in-process	9	5
Finished goods	52,489	35,446
	\$ 62,690	\$ 54,880

**8. Goodwill and Intangible Assets**

Under Statement of Financial Accounting Standards ( SFAS ) No. 142, *Goodwill and Other Intangible Assets*, goodwill attributable to each of our reporting units is required to be tested for impairment by comparing the fair value of each reporting unit with its carrying value. Our reporting units are the same as our operating units. Goodwill is reviewed annually for impairment (or more frequently if indicators of impairment arise). As of October 26, 2007, and April 27, 2007, respectively, there had been no impairment of goodwill and intangible assets.

Identified intangible assets are summarized as follows:

		<b>October 26, 2007</b>			<b>April 27, 2007</b>		
	<b>Amortization Period (Years)</b>	<b>Gross Assets</b>	<b>Accumulated Amortization</b>	<b>Net Assets</b>	<b>Gross Assets</b>	<b>Accumulated Amortization</b>	<b>Net Assets</b>
<b>Identified Intangible Assets:</b>							
Patents	5	\$ 10,040	\$ (8,421)	\$ 1,619	\$ 10,040	\$ (7,429)	\$ 2,611
Existing technology	4 - 5	113,625	(60,433)	53,192	113,625	(49,878)	63,747
Trademarks/tradenames	2 - 6	5,280	(2,101)	3,179	5,280	(1,651)	3,629
Customer Contracts/relationships	1.5 - 6	17,220	(5,889)	11,331	17,220	(4,398)	12,822
Covenants Not to Compete	1.5 - 2	9,510	(9,510)		9,510	(9,310)	200



Total Identified Intangible Assets, Net	\$ 155,675	\$ (86,354)	\$ 69,321	\$ 155,675	\$ (72,666)	\$ 83,009
--	------------	-------------	-----------	------------	-------------	-----------

Amortization expense for identified intangible assets is summarized below:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>October 26, 2007</b>	<b>October 27, 2006</b>	<b>October 26, 2007</b>	<b>October 27, 2006</b>
Patents	\$ 496	\$ 496	\$ 991	\$ 991
Existing technology	5,278	3,866	10,555	7,731
Other identified intangibles	1,021	821	2,142	1,642
	\$ 6,795	\$ 5,183	\$ 13,688	\$ 10,364

**Table of Contents****NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Based on the identified intangible assets recorded at October 26, 2007, the future amortization expense of identified intangibles for the remainder of fiscal 2008 and the next four fiscal years and thereafter is as follows:

<b>Year Ending April,</b>	<b>Amount (In thousands)</b>
2008	\$ 13,488
2009	24,665
2010	19,694
2011	8,987
2012	1,633
Thereafter	854
Total	\$ 69,321

**9. Fair Value of Financial Instruments**

The carrying values of cash and cash equivalents and restricted cash and investments reported in the Condensed Consolidated Balance Sheets approximate their fair value. Our short-term investments and foreign exchange contracts are carried at fair value based on quoted market prices. Other investments in nonmarketable securities are included in other assets at October 26, 2007, and April 27, 2007, with total carrying value of \$12,917 and \$8,932, which approximate their fair values. The fair value of our debt also approximates its carrying value as of October 26, 2007, and April 27, 2007.

We do not use derivative financial instruments for speculative or trading purposes. We enter into forward foreign exchange and currency option contracts to hedge trade and intercompany receivables and payables as well as future sales and operating expenses against future movement in foreign exchange rates.

Foreign currency forward contracts obligate us to buy or sell foreign currencies at a specified future date. Option contracts give us the right to buy or sell foreign currencies and are exercised only when economically beneficial. As of October 26, 2007, we had \$389,533 of outstanding foreign exchange contracts (including \$18,090 of option contracts) that all had remaining maturities of five months or less. As of April 27, 2007, we had \$367,479 of outstanding foreign exchange contracts (including \$21,703 of option contracts). For the balance sheet hedges, these contracts are adjusted to fair value at the end of each month and are included in earnings. The premiums paid on the foreign currency option contracts are recognized as a reduction to other income when the contract is entered into. For cash flow hedges, the related gains or losses are included in other comprehensive income. Gains and losses on these foreign exchange contracts are offset by losses and gains on the underlying assets and liabilities. At October 26, 2007, and April 27, 2007, the estimated notional fair values of forward foreign exchange contracts were \$390,599 and \$368,807, respectively. The fair value of foreign exchange contracts is based on prevailing financial market information.

For the three-month period ended October 26, 2007, net gains generated by hedged assets and liabilities totaled \$4,579 were offset by losses on the related derivative instruments of \$4,443. For the six-month period ended October 26,

2007, net gains generated by hedged assets and liabilities totaled \$5,260 were offset by losses on the related derivative instruments of \$4,513. For the three-month period ended October 27, 2006, net gains generated by hedged assets and liabilities totaled \$565 and were offset by losses on the related derivative instruments of \$388. For the six-month period ended October 27, 2006, net gains generated by hedged assets and liabilities and related derivative instruments totaled \$544 and \$275, respectively.

#### **10. Net Income per Share**

During all periods presented, we had certain options outstanding, which could potentially dilute basic earnings per share in the future, but were excluded in the computation of diluted earnings per share in such periods, as their

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

effect would have been antidilutive. These certain options were antidilutive in the three- and six-month periods ended October 26, 2007, and October 27, 2006, as these options' exercise prices were above the average market prices in such periods. For the three-month periods ended October 26, 2007, and October 27, 2006, 38,130 and 23,493 shares of common stock options with a weighted average exercise price of \$39.64 and \$44.34, respectively, were excluded from the diluted net income per share computation. For the six-month periods ended October 26, 2007, and October 27, 2006, 34,747 and 24,234 shares of common stock options with a weighted average exercise price of \$40.92 and \$43.51, respectively, were excluded from the diluted net income per share computation.

As of October 26, 2007, our Board of Directors had authorized the repurchase of up to \$3,023,639 of common stock under the stock repurchase program. The repurchased shares were held as treasury stock and our outstanding shares used to calculate earnings per share had been reduced by the weighted number of repurchased shares. During the three- and six-month periods ended October 26, 2007, the repurchased shares reduced our basic and diluted net income per share by \$0.01 and \$0.01, respectively.

The following is a reconciliation of the numerators and denominators of the basic and diluted net income per share computations for the periods presented:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>October 26, 2007</b>	<b>October 27, 2006</b>	<b>October 26, 2007</b>	<b>October 27, 2006</b>
<b>Net Income (Numerator):</b>				
Net income, basic and diluted	\$ 83,758	\$ 86,931	\$ 118,095	\$ 141,600
<b>Shares (Denominator):</b>				
Weighted average common shares outstanding	355,878	371,065	360,296	372,690
Weighted average common shares outstanding subject to repurchase	(213)	(406)	(235)	(426)
Shares used in basic computation	355,665	370,659	360,061	372,264
Weighted average common shares outstanding subject to repurchase	213	406	235	426
Common shares issuable upon exercise of stock options	9,580	17,161	11,248	17,083
Shares used in diluted computation	365,458	388,226	371,544	389,773
<b>Net Income per Share:</b>				
Basic	\$ 0.24	\$ 0.23	\$ 0.33	\$ 0.38
Diluted	\$ 0.23	\$ 0.22	\$ 0.32	\$ 0.36

Basic net income per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding, excluding unvested restricted stock for that period. Diluted net income per share is computed giving effect to all dilutive potential shares that were outstanding during the period. Dilutive potential common shares consist of incremental common shares subject to repurchase, common shares issuable upon exercise of stock options, and restricted stock awards.

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****11. Comprehensive Income**

The components of comprehensive income were as follows:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>October 26, 2007</b>	<b>October 27, 2006</b>	<b>October 26, 2007</b>	<b>October 27, 2006</b>
Net income	\$ 83,758	\$ 86,931	\$ 118,095	\$ 141,600
Change in currency translation adjustment	751	235	1,199	886
Change in unrealized gain (loss) on available-for-sale investments, net of related tax effect	(5,706)	4,834	(4,660)	6,576
Change in unrealized gain (loss) on derivatives	(2,081)	(133)	1,760	835
Comprehensive income	\$ 76,722	\$ 91,867	\$ 116,394	\$ 149,897

The components of accumulated other comprehensive income were as follows:

	<b>October 26, 2007</b>	<b>April 27, 2007</b>
Accumulated translation adjustments	\$ 4,520	\$ 3,321
Accumulated unrealized gain (loss) on available-for-sale investments	809	5,469
Accumulated unrealized gain (loss) on derivatives	(1,528)	(3,288)
Total accumulated other comprehensive loss	\$ 3,801	\$ 5,502

**12. Restructuring Charges**

In fiscal 2002, as a result of unfavorable economic conditions and a reduction in information technology ( IT ) spending rates, we implemented two restructuring plans, which included reductions in our workforce and consolidations of our facilities. As of October 26, 2007, we have no outstanding balance in our restructuring liability for the first restructuring. The second restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters. In fiscal 2006, we implemented a third restructuring plan related to the move of our global services center operations from Sunnyvale to our new flagship support center at our Research Triangle Park facility in North Carolina. Of the reserve balance at October 26, 2007, \$542 was included in other accrued liabilities, and the remaining \$1,236 was classified as long-term obligations.

## Edgar Filing: NETWORK APPLIANCE INC - Form 10-Q

Our restructuring estimates are reviewed and revised periodically and may result in a substantial charge or reduction to restructuring expense should different conditions prevail than were anticipated in previous management estimates. Such estimates included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. During the three and six-month periods ended October 26, 2007, we did not record any reduction or charges in the restructuring reserve.

	<b>Total</b>
Reserve balance at April 27, 2007	\$ 2,084
Cash payments	(153)
Reserve balance at July 27, 2007	\$ 1,931
Cash payments	(153)
Reserve balance at October 26, 2007	\$ 1,778

Table of Contents**NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)****13. Commitments and Contingencies**

The following summarizes our commitments and contingencies at October 26, 2007, and the effect such obligations may have on our future periods:

	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>Thereafter</b>	<b>Total</b>
<b>Contractual Obligations:</b>							
Office operating lease payments(1)	\$ 12,333	\$ 23,456	\$ 20,145	\$ 16,442	\$ 12,274	\$ 30,005	\$ 114,655
Real estate lease payments(2)	894	5,995	9,645	9,645	9,645	162,975	198,799
Equipment operating lease payments(3)	6,585	11,732	6,216	738	1		25,272
Venture capital funding commitments(4)	147	281	269	256	22		975
Capital expenditures(5)	21,256	24,249	132	96	120		45,853
Communications and maintenance(6)	11,274	16,522	8,298	1,758	218		38,070
<b>Total Contractual Cash Obligations</b>	<b>\$ 52,489</b>	<b>\$ 82,235</b>	<b>\$ 44,705</b>	<b>\$ 28,935</b>	<b>\$ 22,280</b>	<b>\$ 192,980</b>	<b>\$ 423,624</b>
<b>Other Commercial Commitments:</b>							
Letters of credit(7)	\$ 1,614	\$ 517	\$ 121	\$	\$ 158	\$ 445	\$ 2,855

For purposes of the above table, contractual obligations for the purchase of goods and services are defined as agreements that are enforceable, are legally binding on us, and subject us to penalties if we cancel the agreement. Some of the figures we include in this table are based on management's estimates and assumptions about these obligations, including their duration, the possibility of renewal or termination, anticipated actions by management and third parties, and other factors. Because these estimates and assumptions are necessarily subjective, our actual future obligations may vary from those reflected in the table.

- (1) We lease sales offices and research and development facilities throughout the United States and internationally. These sales offices are leased under operating leases that expire on various dates through fiscal 2016. We are responsible for certain maintenance costs, taxes, and insurance under these leases. Substantially all lease agreements have fixed payment terms based on the passage of time. Some lease agreements provide us with the option to renew or terminate the lease. Our future operating lease obligations would change if we were to exercise these options and if we were to enter into additional operating lease agreements. Rent operating lease payments in the table exclude lease payments that are accrued as part of our fiscal 2002 restructurings and include only rent lease commitments that are over one year.
- (2) Included in the above contractual cash obligations pursuant to three financing arrangements with BNP Paribas LLC ( "BNP" ) are (a) lease commitments of \$894 in fiscal 2008; \$5,995 in fiscal 2009; \$9,645 in each of the fiscal



years 2010, 2011, and 2012; \$8,752 in fiscal 2013; and \$5,898 in fiscal 2014, which are based on the LIBOR rate at October 26, 2007 plus a spread, for a term of five years, and (b) at the expiration or termination of the lease, a supplemental payment obligation equal to our minimum guarantee of \$148,325 in the event that we elect not to purchase or arrange for sale of the buildings.

- (3) Equipment operating leases include servers and IT equipment used in our engineering labs and data centers.
- (4) Venture capital funding commitments include a quarterly committed management fee based on a percentage of our committed funding to be payable through June 2011.
- (5) Capital expenditures include worldwide contractual commitments to purchase equipment and to construct building and leasehold improvements, which will be recorded as property and equipment.
- (6) We are required to pay based on a minimum volume under certain communication contracts with major telecommunication companies as well as maintenance contracts with multiple vendors. Such obligations will expire in November 2011.

**Table of Contents**

**NETWORK APPLIANCE, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

- (7) The amounts outstanding under these letters of credit relate to workers' compensation, a customs guarantee, a corporate credit card program, and foreign rent guarantees.

As of October 26, 2007, we have commitments relating to two financing, construction, and leasing arrangements with BNP for office space to be located on land in Sunnyvale, California that we currently own. These arrangements require us to lease our land to BNP for a period of 50 years to construct approximately 380,000 square feet of office space costing up to \$113,500. After completion of construction, we will pay minimum lease payments, which vary based on the London Interbank Offered Rate ( LIBOR ) plus a spread (5.53% at October 26, 2007) on the cost of the facilities. We expect to begin making lease payments on the completed buildings in January and December 2008 for terms of five years. We have the option to renew the leases for two consecutive five-year periods upon approval by BNP. Upon expiration (or upon any earlier termination) of the lease terms, we must elect one of the following options: We may (i) purchase the buildings from BNP for \$48,500 and \$65,000, respectively; (ii) if certain conditions are met, arrange for the sale of the buildings by BNP to a third party for an amount equal to at least \$41,225 and \$55,250, respectively, and be liable for any deficiency between the net proceeds received from the third party and such amounts; or (iii) pay BNP supplemental payments of \$41,225 and \$55,250, respectively, in which event we may recoup some or all of such payment by arranging for a sale of either or both buildings by BNP during the ensuing two-year period.

As of October 26, 2007, we have a commitment relating to a third financing, construction, and leasing arrangements with BNP for facility space to be located on land currently owned by us in Research Triangle Park, North Carolina. These arrangements require us to lease our land to BNP for a period of 99 years to construct approximately 120,000 square feet for a data center costing up to \$61,000. After completion of construction, we will pay minimum lease payments, which vary based on LIBOR plus a spread (5.53% at October 26, 2007) on the cost of the facility. We expect to begin making lease payments on the completed buildings in October 2008 for a term of five and half years. We have the option to renew the lease for two consecutive five-year periods upon approval by BNP. Upon expiration (or upon any earlier termination) of the lease term, we must elect one of the following options: We may (i) purchase the building from BNP for \$61,000; (ii) if certain conditions are met, arrange for the sale of the building by BNP to a third party for an amount equal to at least \$51,850, and be liable for any deficiency between the net proceeds received from the third party and \$51,850; or (iii) pay BNP a supplemental payment of \$51,850, in which event we may recoup some or all of such payment by arranging for the sale of the building by BNP during the ensuing two-year period.

All leases require us to maintain specified financial covenants with which we were in compliance as of October 26, 2007. Such specified financial covenants include a maximum ratio of Total Debt to Earnings Before Interest, Taxes, Depreciation and Amortization ( EBITDA ) and a Minimum Unencumbered Cash and Short Term Investments.

As of October 26, 2007, the notional fair value of our foreign exchange forward and foreign currency option contracts totaled \$390,599. We do not believe that these derivatives present significant credit risks, because the counterparties to the derivatives consist of major financial institutions, and we manage the notional amount of contracts entered into with any one counterparty. We do not enter into derivative financial instruments for speculative or trading purposes. Other than the risk associated with the financial condition of the counterparties, our maximum exposure related to foreign currency forward and option contracts is limited to the premiums paid on purchased options.

We have both recourse and nonrecourse lease financing arrangements with third-party leasing companies through preexisting relationships with the customers. We sell our products directly to the leasing company, and the lease arrangement is made between our customer and the leasing company. Under the terms of recourse leases, which are generally three years or less, we remain liable for the aggregate unpaid remaining lease payments to the third-party leasing company in the event that any customers default. For these recourse arrangements, revenues on the sale of our product to the leasing company are deferred and recognized into income as payments to the leasing company come due. As of October 26, 2007, and April 27, 2007, the maximum recourse exposure under such leases

**Table of Contents**

**NETWORK APPLIANCE, INC.**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

totaled approximately \$18,818 and \$10,262, respectively. Under the terms of the nonrecourse leases, we do not have any continuing obligations or liabilities. To date, we have not experienced significant losses under this lease financing program.

From time to time, we have committed to purchase various key components used in the manufacture of our products. We establish accruals for estimated losses on purchased components for which we believe it is probable that they will not be utilized in future operations. To the extent that such forecasts are not achieved, our commitments and associated accruals may change.

In addition, we are subject to various legal proceedings and claims which may arise in the normal course of business. While the outcome of these legal matters is currently not determinable, we do not believe that any current litigation or claims will have a material adverse effect on our business, cash flow, operating results, or financial condition.

We are currently undergoing federal income tax audits in the United States and several foreign tax jurisdictions. The rights to some of our intellectual property ( IP ) are owned by certain of our foreign subsidiaries, and payments are made between foreign and U.S. tax jurisdictions relating to the use of this IP in a qualified cost sharing arrangement. Recently, some other U.S. companies have had their foreign IP arrangements challenged as part of an IRS examination, which has resulted in material proposed assessments and/or pending litigation. Effective September 27, 2007, the Internal Revenue Service's Large and Mid-Sized Business Division ( LMSB ) released a Coordinated Issues Paper ( CIP ) with respect to qualified cost sharing arrangements ( CSAs ). Specifically, this CIP provides guidance to IRS personnel concerning methods that may be applied to evaluate the arm's length charge (buy-in payment) for internally developed (pre-existing) as well as acquisition-related intangible property that is made available to a qualified CSA. We have evaluated the IRS's positions in this CIP and have concluded that it will not have a material adverse impact upon our consolidated financial position and the results of operations and cash flows. Furthermore, our management does not believe, based upon information currently known to us, that the final resolution of any of our audits will have a material adverse effect upon our consolidated financial position and the results of operations and cash flows. However, if upon the conclusion of these audits the ultimate determination of our taxes owed in any of these tax jurisdictions is for an amount in excess of the tax provision we have recorded or reserved for, our overall effective tax rate may be adversely impacted in the period of adjustment.

The General Services Administration ( GSA ) is currently auditing our records under the schedule contracts it had with us to verify our compliance with various contract provisions. If the audit determines that we did not comply with such provisions, we may be required to pay the GSA a potential settlement. The exact date for completion of the audit and the subsequent negotiation process is unknown and may not be concluded for some time. Our management does not believe, based upon information currently known to us, that the final resolution of our audit will have a material adverse effect upon our consolidated financial position and the results of operations and cash flows.

On September 5, 2007, we filed a patent infringement lawsuit in the Eastern District of Texas seeking compensatory damages and a permanent injunction against Sun Microsystems. On October 25, 2007, Sun Microsystems filed a counter claim against us in the Eastern District of Texas seeking compensatory damages and a permanent injunction. On October 29, 2007, Sun filed a second lawsuit against us in the Northern District of California asserting additional patents against us. The Texas court granted a joint motion to transfer the Texas lawsuit to the Northern District of California on November 26, 2007. We are unable at this time to determine the likely outcome of these various patent litigations. In addition, as we are unable to reasonably estimate the amount or range of any potential settlement, no

accrual has been recorded as of October 26, 2007.

#### **14. Income Taxes**

In June 2006, the Financial Accounting Standards Board ( FASB ) issued FASB Interpretation ( FIN ) No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109*, which clarifies the

**Table of Contents****NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. FIN No. 48 also provides guidance on derecognition of tax benefits, classification on the balance sheet, interest and penalties, accounting in interim periods, disclosure, and transition.

The total amount of unrecognized tax benefits upon the adoption of FIN No. 48, on April 28, 2007, was \$58,326. There was no cumulative effect from the adoption of FIN No. 48; however, certain amounts were reclassified among our consolidated balance sheet accounts as follows:

Retained earnings cumulative effect	\$
Additional deferred tax assets	4,889
Reclass from current liability to long-term liability	53,437
Total increase in liability	\$ 58,326

The entire portion of the \$58,326 balance of unrecognized tax benefits at April 28, 2007, if recognized, would affect our effective tax rate.

We recognize accrued interest and penalties related to unrecognized tax benefits in the income tax provision. During the fiscal years ended 2005 through 2007, we recognized total accrued interest and penalties of approximately \$170 and have included this accrual in our FIN No. 48 disclosure balances.

We are subject to taxation in the United States, various states, and several foreign jurisdictions. Our federal income tax returns are currently being examined for the fiscal years 2003-2004. We are effectively subject to federal tax examination adjustments for tax years ending on or after fiscal year 2000, in that we have net operating loss carryforwards from these years that could be subject to adjustment, if and when utilized.

As we are in the early stages of the federal income tax return and foreign jurisdiction income tax audit process, at this time we can not make a determination as to whether or not recognition of any unrecognized tax benefits will occur within the next 12 months.

The tax years that remain subject to examination for our major tax jurisdictions are shown below:

**Tax Years Subject to Examination for Major Tax Jurisdictions at October 26, 2007**

2003	2007	United States	federal income tax
2002	2007	United States	state and local income tax
2003	2007	Australia	
2004	2007	Germany	
2005	2007	India	

2006	2007	Japan
2000	2007	The Netherlands
2004	2007	United Kingdom

The above table excludes the net operating loss carryover risk identified above with respect to federal and state tax returns.

## 15. New Accounting Pronouncements

Effective April 28, 2007, we adopted FIN No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109*. FIN No. 48 prescribes a comprehensive model for how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that we have

**Table of Contents****NETWORK APPLIANCE, INC.****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

taken or expect to take on a tax return (including a decision whether to file or not to file a return in a particular jurisdiction). FIN No. 48 is applicable to all uncertain tax positions for taxes accounted for under SFAS No. 109, *Accounting for Income Taxes*, and substantially changes the applicable accounting model. There was no cumulative effect from the adoption of FIN No. 48. As a result of the implementation of FIN No. 48, we recognize the tax liability for uncertain income tax positions on the income tax return based on the two-step process prescribed in the interpretation. The first step is to determine whether it is more likely than not that each income tax position would be sustained upon audit. The second step is to estimate and measure the tax benefit as the amount that has a greater than 50% likelihood of being realized upon ultimate settlement with the tax authority. Estimating these amounts requires us to determine the probability of various possible outcomes. We evaluate these uncertain tax positions on a quarterly basis. See Note 14, Income Taxes, for further discussion.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. SFAS No. 159 allows measurement at fair value of eligible financial assets and liabilities that are not otherwise measured at fair value. If the fair value option for an eligible item is elected, unrealized gains and losses for that item shall be reported in current earnings at each subsequent reporting date. SFAS No. 159 also establishes presentation and disclosure requirements designed to draw comparison between the different measurement attributes the company elects for similar types of assets and liabilities. This statement is effective beginning the first quarter of fiscal 2009. We are currently evaluating the effect, if any, that the adoption of SFAS No. 159 will have on our consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements*. SFAS No. 157 provides a framework for measuring fair value, clarifies the definition of fair value, and expands disclosures regarding fair value measurements. SFAS No. 157 does not require any new fair value measurements and eliminates inconsistencies in guidance found in various prior accounting pronouncements. We are required to adopt SFAS No. 157 in the first quarter of fiscal 2009. We are currently evaluating the effect that the adoption of SFAS No. 157 will have on our consolidated results of operations and financial condition, but do not expect it to have a material impact.

**16. Subsequent Events**

On November 2, 2007, we entered into a senior unsecured credit agreement (the *Unsecured Credit Agreement*) with certain lenders and BNP Paribas, as syndication agent, and JPMorgan Chase Bank, National Association, as administrative agent. The *Unsecured Credit Agreement* provides for a revolving unsecured credit facility that is comprised of commitments from various lenders who agree to make revolving loans and swingline loans and issue letters of credit of up to an aggregate amount of \$250,000 with a term of five years from the effective date of November 2, 2007. As of December 4, 2007, no amount was outstanding under this facility. The proceeds of the loans may be used for our general corporate purposes, including stock repurchases and working capital needs.

On November 29, 2007, we entered into a \$90,425 financing and operating leasing arrangement with BNP Paribas LLC ( *BNP* ) for approximately 331,650 square feet of buildings located in Sunnyvale, California. We have agreed to lease the buildings from BNP for a term expiring in December 2012. The lease can be renewed for up to two consecutive periods of 5 years each upon approval by BNP. This lease arrangement requires us to pay minimum lease payments beginning on January 2, 2008, which may vary based on a floating effective rate.





**Table of Contents**

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the

Exchange Act ) and is subject to the safe harbor provisions set forth in the Exchange Act. Forward-looking statements usually contain the words estimate, intend, plan, predict, seek, may, will, should, would, anticipate similar expressions and variations or negatives of these words. In addition, any statements that refer to expectations, projections, or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. All forward-looking statements, including, but not limited to, (1) our belief that we are well positioned in the fastest growth segments of the storage market; (2) our intention to accelerate our revenue growth by investing in go-to-market partnerships; (3) our plan to continue to strengthen our relationships with server virtualization partnerships; (4) our plan to invest in the people, processes, and systems necessary to best optimize our revenue growth; (5) higher disk content associated with high-end and mid-range storage systems and its impact on our gross margin in the future; (6) our estimate of the impact that adopting SFAS No. 123R will have on our earnings per share; (7) our estimates of future amortization of patents, trademarks, trade names, customer contracts, and relationships; (8) our service margin may experience some variability; (9) our expectation to continue to selectively add sales capacity in an effort to expand domestic and international markets; (10) our expectation that our sales and marketing expenses will increase commensurate with future revenue growth; (11) our expectation to continuously support current and future product development and enhancement efforts and to incur corresponding charges; (12) our intention to continuously broaden our existing product offerings and introduce new products; (13) our belief that our research and development and general and administrative expenses will increase in absolute dollars for the remainder of fiscal 2008; (14) our estimates regarding future amortization of covenants not to compete; (15) the restructuring balance will be paid by fiscal 2011; (16) our expectation regarding changes in interest income; (17) our expectation that interest expense will increase; (18) period-to-period changes in foreign exchange gains or losses will continue to be impacted by hedging costs associated with our forward and option activities and forecast variance; (19) our expectation that cash provided by operating activities may fluctuate in future periods; (20) the possibility we may receive less cash from stock option exercises if stock option exercise patterns change; (21) our expectations regarding our contractual cash obligations and other commercial commitments at October 26, 2007, for future periods; (22) our expectation regarding the completion of construction of our buildings under the BNP leases and the estimates regarding future minimum lease payments under the lease term; (23) our belief that any current litigation and claims will not have a material adverse impact on our operating results; (24) our belief that the results of our GSA and income tax audits will not have a materially adverse effect on us (25) our expectation that capital expenditures will increase consistent with our business growth; (26) our expectation that our existing facilities and those currently being developed will be sufficient for our needs for at least the next two years and that our contractual commitments, and any required capital expenditures over the next few years, will be funded through cash from operations and existing cash and investments; (27) our expectation that we will incur higher capital expenditures in the near future; and (28) our belief that our cash and cash equivalents, short-term investments, and cash generated from operations will satisfy our working capital needs, capital expenditures, stock repurchases, contractual obligations, and other liquidity requirements associated with our operations through at least the next 12 months; (29) our expectation that our investment would not decline significantly caused by market interest rate changes are inherently uncertain as they are based on management's current expectations and assumptions concerning future events, and they are subject to numerous known and unknown risks and uncertainties. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof and are based upon information available to us at this time. These statements are not guarantees of future performance. We disclaim any obligation to update information in any forward-looking statement.

**Second Quarter Fiscal 2008 Overview**

Revenues for the second quarter of fiscal 2008 were \$792.2 million, reflecting an increase of 21.4% year over year and an increase of 14.9% sequentially over the previous quarter. The revenue growth was driven by strength in U.S. Federal and much of Europe and Asia, and partially offset by the continued sluggishness in U.S. commercial enterprise spending. The revenue increase year over year was attributable to increased software entitlements and maintenance, increased service revenue, and an expanded portfolio with new products and solutions for enterprise

## **Table of Contents**

customers. This increase was partially offset by lower-cost-per-megabyte disks, a decline in shipments, and lower average selling prices of our older generation products. Our storage solutions provide customers with higher utilization, simpler operations, and reduced costs, and those advantages enable us to continue to gain share in a more constrained spending environment.

While we reported solid results for the second quarter of fiscal 2008, we were not immune to macroeconomic conditions. We believe that we are well positioned in the fastest growth segments of the storage market to capitalize on an IT spending recovery. However, if any storage market trends and emerging standards on which we are basing our assumptions do not materialize as anticipated, and if there is reduced or no demand for our products, our expected revenue growth rate could be materially affected.

We continued to make progress in our partner ecosystem, with 62.4% of our business coming through indirect channels. We intend to accelerate our revenue growth by investing in go-to-market partnerships, specifically through our channel programs and initiatives. We will continue to develop more new accounts, offer more installation services opportunities, and broaden our vertical market coverage. We will continue to strengthen our strategic partnerships with server virtualization partners and leverage our Storage Grid architecture to enable customers to scale their server and storage infrastructures, reduce costs, maximize asset utilization and keep data highly available. At the same time, we will continue to manage our discretionary expenses and the rate of hiring to support our targeted business model. However, continued revenue growth depends on the introduction and market acceptance of our new products and solutions and continued market demand for our products. We will continue to invest in the people, processes, and systems necessary to best optimize our revenue growth and long-term profitability. However, we cannot assure you that such investments will achieve our financial objectives.

## **Second Quarter Fiscal 2008 Financial Performance**

Our revenues for the three-month period ended October 26, 2007, were \$792.2 million, a 21.4% increase over the same period a year ago. Our revenues for the six-month period ended October 26, 2007, were \$1,481.4 million, a 16.3% increase over the same period a year ago. Our year-over-year revenue growth was driven by increases in service revenue, software entitlements and maintenance revenue, and product revenue.

Our overall gross margin decreased to 61.1% in the three-month period ended October 26, 2007, from 61.5% in the same period a year ago, but stayed flat at 60.8% for both the six-month periods ended October 26, 2007, and October 27, 2007. Our decrease in overall gross margin was primarily due to higher channel sales, partially offset by shift in revenue mix with higher margins associated with the increased revenue from software entitlements and maintenance and a higher add-on software mix and improved service margins.

In the first six months of fiscal 2008, we generated \$428.6 million of cash from operating activities as compared to \$403.4 million in the first six months of fiscal 2007. As of October 26, 2007, our cash, cash equivalents, and short-term investments decreased to \$983.1 million, compared to \$1,308.8 million as of April 27, 2007. This decrease was due primarily to \$700.0 million used to repurchase our common stock, partially offset by cash generated from operations. Our deferred revenue increased by 10.5% to \$1,218.6 million as of October 26, 2007, from \$1,103.0 million reported as of April 27, 2007, reflecting higher software entitlements and maintenance revenue and service maintenance contracts. Capital purchases of plant, property, and equipment for the first six months of fiscal 2008 and 2007 were \$71.2 million and \$76.0 million, respectively, reflecting continued worldwide capital investment to meet our business growth.

## **Critical Accounting Estimates and Policies**

Our discussion and analysis of financial condition and results of operations are based upon our Consolidated Financial Statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of such statements requires us to make estimates and assumptions that affect the reported amounts of revenues and expenses during the reporting period and the reported amounts of assets and liabilities as of the date of the financial statements. Our estimates are based on historical experience and other assumptions that we consider to be appropriate in the circumstances. However, actual future results may vary from our estimates.

## **Table of Contents**

With the exception of the changes required by FASB Interpretation No. 48 ( FIN No. 48 ) on Accounting for Income Taxes, there have been no significant changes during the three-and six-month periods ended October 26, 2007, to the items that we disclosed as our critical accounting policies and estimates in the Management's Discussion and Analysis of Financial Condition and Results of Operations section of our Annual Report on Form 10-K for the year ended April 27, 2007.

### ***Accounting for Income Taxes***

The determination of our tax provision is subject to judgments and estimates due to the complexity of the tax law that we are subject to in several tax jurisdictions. Earnings derived from our international business are generally taxed at rates that are lower than U.S. rates, resulting in a lower effective tax rate than the U.S. statutory tax rate of 35.0%. The ability to maintain our current effective tax rate is contingent on existing tax laws in both the United States and the respective countries in which our international subsidiaries are located. Future changes in domestic or international tax laws could affect the continued realization of the tax benefits we are currently receiving. In addition, a decrease in the percentage of our total earnings from our international business or a change in the mix of international business among particular tax jurisdictions could increase our overall effective tax rate.

We account for income taxes in accordance with SFAS No. 109, *Accounting for Income Taxes*. SFAS No. 109 requires that deferred tax assets and liabilities be recognized for the effect of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax purposes. SFAS No. 109 also requires that deferred tax assets be reduced by a valuation allowance if it is more likely than not that some or all of the deferred tax asset will not be realized. We have provided a valuation allowance of \$21.0 million as of October 26, 2007 and April 27, 2007, on certain of our deferred tax assets.

We are currently undergoing federal income tax audits in the United States and several foreign tax jurisdictions. The rights to some of our intellectual property ( IP ) are owned by certain of our foreign subsidiaries, and payments are made between foreign and U.S. tax jurisdictions relating to the use of this IP in a qualified cost sharing arrangement. Recently, some other U.S. companies have had their foreign IP arrangements challenged as part of an IRS examination, which has resulted in material proposed assessments and/or pending litigation. Effective September 27, 2007, the Internal Revenue Service's Large and Mid-Sized Business Division ( LMSB ) released a Coordinated Issues Paper ( CIP ) with respect to qualified cost sharing arrangements ( CSAs ). Specifically, this CIP provides guidance to IRS personnel concerning methods that may be applied to evaluate the arm's length charge (buy-in payment) for internally developed (pre-existing) as well as acquisition-related intangible property that is made available to a qualified CSA. We have evaluated the IRS's positions in this CIP and have concluded that it will not have a material adverse impact upon our consolidated financial position and the results of operations and cash flows. Furthermore, our management does not believe, based upon information currently known to us that the final resolution of any of our audits will have a material adverse effect upon our consolidated financial position and the results of operations and cash flows. However, if upon the conclusion of these audits the ultimate determination of our taxes owed in any of these tax jurisdictions is for an amount in excess of the tax provision we have recorded or reserved for, our overall effective tax rate may be adversely impacted in the period of adjustment.

On April 28, 2007, we adopted FIN No. 48, *Accounting for Uncertainty in Income Taxes – an Interpretation of FASB Statement No. 109*. FIN No. 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with Statement of Financial Accounting Standards No. 109, Accounting for Income Taxes ( SFAS 109 ). This interpretation prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. As a result of the implementation of FIN No. 48, we recognize the tax liability for uncertain income tax positions on the income tax return based on the two-step process prescribed in the interpretation. The first step is to determine whether it is more likely than not that each income tax position would be sustained upon audit. The second step is to estimate and

measure the tax benefit as the amount that has a greater than 50% likelihood of being realized upon ultimate settlement with the tax authority. Estimating these amounts requires us to determine the probability of various possible outcomes. We evaluate these uncertain tax positions on a quarterly basis. This evaluation is based on the consideration of several factors, including changes in facts or circumstances, changes in applicable tax law, settlement of issues under audit, and new exposures. If we later determine that our

**Table of Contents**

exposure is lower or that the liability is not sufficient to cover our revised expectations, we adjust the liability and effect a related change in our tax provision during the period in which we make such determination.

**New Accounting Standards**

See Note 15 of the Condensed Consolidated Financial Statements for a full description of new accounting pronouncements, including the respective expected dates of adoption and effects on results of operations and financial condition.

**Results of Operations**

The following table sets forth certain consolidated statements of income data as a percentage of total revenues for the periods indicated:

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>October 26, 2007</b>	<b>October 27, 2006</b>	<b>October 26, 2007</b>	<b>October 27, 2006</b>
Revenues:				
Product	68.3%	73.8%	67.8%	74.4%
Software entitlements and maintenance	14.8	12.6	15.2	12.3
Service	16.9	13.6	17.0	13.3
	100.0	100.0	100.0	100.0
Cost of Revenues:				
Cost of product	27.5	28.5	27.3	29.3
Cost of software entitlements and maintenance	0.2	0.4	0.3	0.4
Cost of service	11.2	9.6	11.6	9.5
Gross Profit	61.1	61.5	60.8	60.8
Operating Expenses:				
Sales and marketing	32.2	31.4	33.7	31.4
Research and development	13.8	13.8	14.5	14.1
General and administrative	5.0	5.4	5.5	5.3
Restructuring charges (recoveries)				
Gain on sale of assets		(3.9)		(2.0)
Total Operating Expenses	51.0	46.7	53.7	48.8
Income from Operations	10.1	14.8	7.1	12.0
Other Income (Expenses), Net:				
Interest income	2.1	2.7	2.3	2.7
Interest expense	(0.2)	(0.8)	(0.2)	(0.7)
Net gain (loss) on investments	1.7	(0.3)	0.9	(0.2)
Other income (expenses), net		0.3	0.1	0.2



Edgar Filing: NETWORK APPLIANCE INC - Form 10-Q

Total Other Income, Net	3.6	1.9	3.1	2.0
Income Before Income Taxes	13.7	16.7	10.2	14.0
Provision for Income Taxes	3.1	3.4	2.2	2.9
Net Income	10.6%	13.3%	8.0%	11.1%

25

---

**Table of Contents**

***Discussion and Analysis of Results of Operations***

**Total Revenues** Total revenues increased by 21.4% to \$792.2 million for the three-month period ended October 26, 2007, from \$652.5 million for the three-month period ended October 27, 2006. Total revenues increased by 16.3% to \$1,481.4 million for the six-month period ended October 26, 2007, from \$1,273.8 million for the six-month period ended October 27, 2006.

**Product Revenues** Product revenues increased by 12.5% to \$541.4 million for the three-month period ended October 26, 2007, from \$481.3 million for the three-month period ended October 27, 2006. Product revenues increased by 6.1% to \$1,004.7 million for the six-month period ended October 26, 2007, from \$946.9 million for the six-month period ended October 27, 2006.

Product revenues were impacted by the following factors:

Increased revenues from our current product portfolio. Product revenue increased \$60.1 million in the three-month period ended October 26, 2007, as compared to the same period a year ago, with a \$67.9 million increase due to higher unit volume, offset by \$7.8 million decrease due to price and configuration of existing products. Of the \$67.9 million volume increase, \$201.6 million revenue increase was due to new products, while offset by a \$133.7 million decrease in overall revenues associated with lower shipment volumes on existing products. Product revenue grew \$57.8 million for the six-month period ended October 26, 2007, as compared to the same period in the prior year, with an \$89.0 million increase due to unit volume and partially offset by a decrease of \$31.1 million due to price and configuration of existing products. Of the \$89.0 million volume increase, \$308.9 million revenue increase was due to new products, while offset by a \$219.9 million decrease in overall revenue associated with lower shipment volumes on existing products. Price changes, volumes, and product model mix can have an effect on changes in product revenues; the impact of these forces is significantly affected by the configuration of systems shipped.

Revenues of the FAS 3000 and FAS 6000 enterprise storage systems increased 28.9% and 78.9%, respectively, for the three-month period ended October 26, 2007, compared to the same period in the prior year, and increased 22.3% and 119.9%, respectively, for the six-month period ended October 26, 2007, compared to the same period in the prior year.

Our petabytes shipped increased 85.6% and 69.2% year over year for the three- and six-month periods ended October 26, 2007, respectively, to 137.8 petabytes, and 248.6 petabytes, respectively, due to increased penetration in primary and secondary storage, i.e., enterprise data centers, data protection, disaster recovery, archival, and compliance requirements. This increase in petabytes shipped was attributable to an increase in petabytes from 500-gigabyte ATA drives. ATA drives accounted for 59.7% and 58.4% of our total petabytes shipped in the three- and six-month periods ended October 26, 2007, respectively, compared to 52.1% and 53.2% in the three- and six-month periods ended October 27, 2006, respectively. Fibre Channel petabytes were up 48.2% and 45.4% for the three- and six-month periods ended October 26, 2007, respectively, to 38.2% and 40.3% of our total shipped.

Price declines per petabyte for our hardware products as disks are a significant component of our storage systems. As performance has improved on our devices, the related price we can charge per petabyte of storage has decreased as well.

Revenues from our older generation products declined by \$186.0 million and \$361.8 million in the three- and six-month periods ended October 26, 2007, respectively, compared to same periods a year ago. Revenue generated by FAS 900 series systems and NearStore® R200 systems decreased by 99.8% and 99.7%,

respectively for the three-month period ended October 26, 2007, compared to the same period a year ago. Revenue generated by FAS 900 and R200 series systems decreased by 96.2% and 99.4%, respectively, for the six-month period ended October 26, 2007, compared to the same period a year ago. In addition, revenue also declined by \$31.3 million and \$15.8 million in the three- and six-month periods ended October 26, 2007, respectively, compared to the same periods in the prior year due to products that we no longer ship, including our NetCache products.

**Table of Contents**

Increased sales through indirect channels in absolute dollars, including sales through our resellers, distributors, and OEM partners, represented 62.4% and 62.0% of total revenues for the three- and six-month periods ended October 26, 2007, respectively, and 58.9% and 57.3% of total revenues for the three- and six-month periods ended October 27, 2006, respectively.

Our systems are highly configurable to respond to customer requirements in the open systems storage markets that we serve. As a result, the wide variation in customized configuration can significantly impact revenue, cost of revenues, and gross margin performance. Price changes, volumes, and product model mix can have an effect on changes in product revenues; the impact on these forces is significantly affected by the configuration of systems shipped.

*Software Entitlements and Maintenance Revenues* Software entitlements and maintenance revenues increased by 42.4% to \$117.1 million for the three-month period ended October 26, 2007, from \$82.3 million for the three-month period ended October 27, 2006. Software entitlements and maintenance revenues increased by 43.3% to \$225.1 million for the six-month period ended October 26, 2007, from \$157.1 million for the six-month period ended October 27, 2006. The year over year increases were due to a larger installed base of customers who have purchased or renewed software entitlements and maintenance. Software entitlements and maintenance revenues represented 14.8% and 15.2% of total revenues for the three- and six-month periods ended October 26, 2007, and 12.6% and 12.3% of total revenues for the three- and six-month periods ended October 27, 2006.

*Service Revenues* Service revenues, which include hardware support, professional services, and educational services, increased by 50.2% to \$133.7 million for the three-month period ended October 26, 2007, from \$89.0 million in the three-month period ended October 27, 2006. Service revenues increased by 48.2% to \$251.6 million in the six-month period ended October 26, 2007, from \$169.8 million in the six-month period ended October 27, 2006.

The increase in absolute dollars was due to the following factors:

Professional service revenue increased by 58.8% in the three-month period ended October 26, 2007, compared to the same period a year ago, and increased by 54.2% in the six-month period ended October 26, 2007, compared to the same period a year ago. The increase was due to higher customers' demand for our professional services in connection with the integration of our solutions into their IT environment.

Service maintenance revenue increased by 50.2% and 47.8% in the three- and six-month periods ended October 26, 2007, compared to the same periods a year ago due to a growing installed base, resulting in new customer support contracts and renewals in addition to increased service contracts.

While it is an element of our strategy to expand and offer more comprehensive global enterprise support and service solutions, we cannot assure you that service revenue will grow at the current rate in the remainder of fiscal 2008 or beyond.

A large portion of our service revenues is deferred and, in most cases, recognized ratably over the service obligation periods, which are typically one to three years. Service revenues represented 16.9% and 17.0% of total revenues for the three- and six-month periods ended October 26, 2007, respectively, and 13.6% and 13.3% of total revenues for the three- and six-month periods ended October 27, 2006, respectively.

*International Total Revenues* International total revenues (including U.S. exports) increased by 25.6% and 19.8% for the three- and six-month periods ended October 26, 2007, respectively, as compared to the same periods in fiscal 2007. Total revenues from Europe were \$237.7 million and \$456.2 million, or 30.0% and 30.8% of total revenues, respectively, for the three- and six-month periods ended October 26, 2007, compared to \$191.4 million and \$386.3, or

29.3% and 30.3% of total revenues, for the three- and six-month periods ended October 27, 2006. Total revenues from Asia were \$94.3 million and \$181.8 million, or 11.9% and 12.3% of total revenues, respectively, for the three- and six-month periods ended October 26, 2007, compared to \$72.9 million and \$146.1 million, or 11.2% and 11.5% of total revenues, respectively, for the three- and six-month periods ended October 27, 2006. The increase in international sales was primarily driven by the same factors outlined under the Total Revenue discussion, as compared to the same periods in the prior fiscal year. We cannot assure you that we will be able to maintain or increase international revenues in the remainder of fiscal 2008 or beyond.

**Table of Contents**

*Product Gross Margin* Product gross margin decreased to 59.8% for the three-month period ended October 26, 2007, from 61.3% for the same period a year ago. Product gross margin decreased to 59.8% for the six-month period ended October 26, 2007, from 60.5% for the same period a year ago.

Product gross margin was impacted by:

Sales price reductions due to competitive pricing pressure and selective pricing discounts

Increased sales through certain indirect channels, which may generate lower gross margins than our direct sales in certain geographic regions

Higher disk content with an expanded storage capacity for the higher-end storage systems, as resale of disk drives generates lower gross margins

Higher average selling prices for certain of our newer products

We expect that higher disk content associated with high-end and mid-range storage systems will negatively affect our gross margin in the future if not offset by increases in software revenue and new higher-margin products.

Stock-based compensation expense included in cost of product revenues was \$0.8 million and \$1.7 million for the three- and six-month periods ended October 26, 2007, respectively, compared to \$1.1 million and \$1.7 million for the three- and six-month periods ended October 27, 2006, respectively. Amortization of existing technology included in cost of product revenues was \$5.3 million and \$10.6 million for the three- and six-month periods ended October 26, 2007, respectively, and \$3.9 million and \$7.7 million for the three- and six-month periods ended October 27, 2006, respectively. Estimated future amortization of existing technology to cost of product revenues will be \$10.6 million for the remainder of fiscal 2008, \$20.4 million for fiscal year 2009, \$15.9 million for fiscal year 2010, \$6.3 million for fiscal year 2011, and none thereafter.

*Software Entitlements and Maintenance Gross Margin* Software entitlements and maintenance gross margins increased to 98.4% for the three-month period ended October 26, 2007, from 97.0% for the three-month period ended October 27, 2006. Software entitlements and maintenance gross margins increased to 98.2% for the six-month period ended October 26, 2007, from 97.0% for the six-month period ended October 27, 2006. The improved software entitlements and maintenance gross margins year over year was due to increased software entitlements and maintenance revenue, a larger installed base renewals, upgrades and lower royalties costs associated with the NetCache products we no longer ship.

*Service Gross Margin* Service gross margin increased to 33.5% for the three-month period ended October 26, 2007, as compared to 29.8% for the three-month period ended October 27, 2006. Service gross margin increased to 31.6% for the six-month period ended October 26, 2007, as compared to 29.1% in the same period in fiscal 2007. Cost of service revenue increased by 42.2% to \$88.9 million for the three-month period ended October 26, 2007, from \$62.5 million for the three-month period ended October 27, 2006. Cost of service revenue increased by 42.9% to \$172.1 million for the six-month period ended October 26, 2007, from \$120.5 million for the six-month period ended October 27, 2006. Stock-based compensation expense of \$2.6 million and \$5.3 million was included in the cost of service revenue for the three- and six-month periods ended October 26, 2007, respectively, and \$2.5 million and \$5.1 million was included in the cost of service revenue for the three- and six-month periods ended October 27, 2006, respectively.

The improvement in service gross margins year over year was primarily impacted by an increase in services revenues, improved productivity, partially offset by continued spending in our service infrastructure to support our customers.

This spending included additional professional support engineers, increased support center activities, and global service partnership programs. Service gross margins will typically be impacted by factors such as timing of technical support service initiations and renewals and additional investments in our customer support infrastructure. In the remainder of fiscal 2008, we expect service margins to experience some variability over time as we continue to build out our service capability and capacity to support our growing customer base and new products.

*Sales and Marketing* Sales and marketing expenses consist primarily of salaries, commissions, advertising and promotional expenses, stock-based compensation expense, and certain customer service and support costs. Sales and marketing expenses increased 25.0% to \$255.4 million for the three-month period ended October 26,

## **Table of Contents**

2007, from \$204.3 million for the same period ended October 27, 2006. These expenses as a percentage of revenue increased to 32.2% for the three-month period ended October 26, 2007, from 31.4% for the three-month period ended October 27, 2006. Sales and marketing expenses increased 25.1% to \$500.0 million for the six-month period ended October 26, 2007, from \$399.8 million for the same period a year ago. These expenses were 33.7% and 31.4% of total revenues for the six-month periods ended October 26, 2007, and October 27, 2006, respectively. The increase in absolute dollars was attributed to increased commission expenses resulting from increased revenues, higher performance-based payroll expenses due to higher headcount, higher partner program expenses, and the continued worldwide investment in our sales and global service organizations associated with selling complete enterprise solutions.

Stock compensation expense included in sales and marketing expenses for the three- and six-month periods ended October 26, 2007, was \$17.1 million and \$34.6 million, respectively, compared to stock compensation expense of \$18.7 million and \$37.4 million for the three- and six-month periods ended October 27, 2006, respectively.

Amortization of trademarks/trade names and customer contracts/relationships included in sales and marketing expenses was \$1.0 million and \$0.6 million for the three-month periods ended October 26, 2007, and October 27, 2006, respectively and was \$1.9 million and \$1.2 million for the six-month periods ended October 26, 2007, and October 27, 2006, respectively. Based on identified intangibles related to our acquisitions recorded at October 26, 2007, estimated future amortization such as trademarks, and customer relationships included in sales and marketing expenses will be \$1.9 million for the remainder of fiscal 2008, \$3.8 million for fiscal 2009, \$3.6 million for fiscal 2010, \$2.7 million for fiscal 2011, \$1.6 million for fiscal 2012, and \$0.9 million thereafter.

We expect to continue to selectively add sales capacity in an effort to expand domestic and international markets, introduce new products, and establish and expand new distribution channels. We expect to increase our sales and marketing expenses commensurate with future revenue growth. We believe that our sales and marketing expenses will increase in absolute dollars for the remainder of fiscal 2008 due to increased headcount, sales- and marketing-related programs to support future revenue growth, and real estate lease payments, partially offset by cost control and reduction in discretionary spending efforts.

*Research and Development* Research and development expenses consist primarily of salaries and benefits, stock-based compensation, prototype expenses, nonrecurring engineering charges, fees paid to outside consultants, and amortization of capitalized patents.

Research and development expenses increased 20.6% to \$109.0 million for the three- and six-month periods ended October 26, 2007, from \$90.4 million for the same period ended October 27, 2006. These expenses as a percentage of revenue were 13.8% for both three-month periods ended October 26, 2007, and October 27, 2006. Research and development expenses increased 20.4% to \$215.5 million for the six-month period ended October 26, 2007, from \$179.0 million for the same period ended October 27, 2006. These expenses represented 14.5% and 14.1% of total revenues for the first six months of fiscal 2008 and 2007, respectively. The increase in absolute dollars was primarily a result of increased headcount-related salaries and incentive compensation, ongoing support of current and future product development and enhancement efforts. For the second quarters and the first six-months of fiscal 2008 and 2007, no software development costs were capitalized.

Stock compensation expense included in research and development expenses for the three- and six-month periods ended October 26, 2007, was \$12.3 million and \$25.5 million, compared to stock compensation expense of \$13.0 million and \$26.9 million for the three- and six-month periods ended October 27, 2006. Included in research and development expenses is capitalized patents amortization of \$0.5 million and \$1.0 million for the three- and six-month periods ended October 26, 2007, respectively, as compared to \$0.5 million and \$1.0 million for the three- and six-month periods ended October 27, 2006. Based on capitalized patents recorded at October 26, 2007, estimated future capitalized patent amortization expenses for the remainder of fiscal 2008 will be \$1.0 million, \$0.5 million for



fiscal year 2009, \$0.2 million in fiscal 2010, and none thereafter.

We believe that our future performance will depend in large part on our ability to maintain and enhance our current product line, develop new products that achieve market acceptance, maintain technological competitiveness, and meet an expanding range of customer requirements. We expect to continuously support current and future product development and enhancement efforts and to incur prototyping expenses and nonrecurring engineering

## **Table of Contents**

charges associated with the development of new products and technologies. We intend to continuously broaden our existing product offerings and to introduce new products that expand our solutions portfolio.

We believe that our research and development expenses will increase in absolute dollars for the remainder of fiscal 2008, primarily due to ongoing costs associated with the development of new products and technologies, headcount growth, real estate lease payments, and the operating impact of potential future acquisitions.

*General and Administrative* General and administrative expenses increased 12.2% to \$39.5 million for the three-month period ended October 26, 2007, from \$35.2 million for the same period ended October 27, 2006. These expenses as a percentage of revenue decreased to 5.0% for the second quarter of fiscal 2008 from 5.4% for the same period in the prior year. General and administrative expenses increased 19.7% to \$81.0 million for the six-month period ended October 26, 2007, from \$67.6 million for the same period ended October 27, 2006. These expenses represented 5.5% and 5.3% of total revenues for the six-month periods ended October 26, 2007, and October 27, 2006, respectively. This increase in absolute dollars was primarily due to higher payroll expenses, increased headcount, higher expenses on prior acquisition-related costs, and increased professional and legal fees for general corporate matters.

We believe that our general and administrative expenses will increase in absolute dollars for the remainder of fiscal 2008 in order to support and enhance our existing infrastructure and real estate lease payments, partially offset by cost control and reduction in discretionary spending efforts. Stock compensation expense included in general and administrative expenses for the three- and six-month periods ended October 26, 2007, was \$5.5 million and \$11.7 million, compared to stock compensation expense of \$7.1 million and \$14.3 million for the three- and six-month periods ended October 27, 2006. Amortization of covenants not to compete included in general and administrative expenses was \$0.1 million and \$0.2 million for the three- and six-month periods ended October 26, 2007, respectively, as compared to \$0.2 million and \$0.5 million for the three- and six-month periods ended October 27, 2006, respectively. Based on identified intangibles related to our acquisitions recorded at October 26, 2007, there is no further future amortization of covenants not to compete relating to our acquisitions.

*Restructuring Charges* In fiscal 2002, as a result of unfavorable economic conditions and a reduction in information technology ( IT ) spending rates, we implemented two restructuring plans, which included reductions in our workforce and consolidations of our facilities. As of October 26, 2007, we have no outstanding balance in our restructuring liability for the first restructuring. The second restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters. In fiscal 2006, we implemented a third restructuring plan related to the move of our global services center operations from Sunnyvale to our new flagship support center at our Research Triangle Park facility in North Carolina.

Our restructuring estimates are reviewed and revised periodically and may result in a substantial charge or reduction to restructuring expense should different conditions prevail than were anticipated in previous management estimates. Such estimates included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. During the three- and six-month periods ended October 26, 2007, we did not record any reduction in restructuring reserve resulting from a change in the estimates of our third restructuring plan.

Of the reserve balance at October 26, 2007, \$0.5 million was included in other accrued liabilities, and the remaining \$1.2 million was classified as long-term obligations. The balance of the reserve relates to facilities and is expected to be paid by fiscal 2011.

The following analysis sets forth the significant components of the restructuring reserve at October 26, 2007 (in thousands):

	<b>Total</b>
Reserve balance at April 27, 2007	\$ 2,084
Cash payments	(153)
Reserve balance at July 27, 2007	\$ 1,931
Cash payments	(153)
Reserve balance at October 26, 2007	\$ 1,778

**Table of Contents**

*Gain on Sale of Assets* We recorded a gain of \$25.3 million for the three- and six-month periods ended October 27, 2006, as a result of the sale of certain of our assets to Blue Coat.

*Operating Income* Operating income as a percentage of revenue decreased to 10.1% for the three-month period ended October 26, 2007, from 14.8% for the same period ended October 27, 2006. Operating income as a percentage of revenue decreased to 7.1% for the six-month period ended October 26, 2007, from 12.0% for the same period ended October 27, 2006. Operating income for the three- and six-month periods ended October 27, 2006, included a gain on sale of assets of \$25.3 million. Our operating expense levels are based in part on our expectations as to future revenue growth, and a significant percentage of our operating expenses is fixed and difficult to reduce within a short period of time. As a result, if revenue levels are below expectations or previously higher levels, our fixed expenses could adversely affect our operating income and cash flow until revenues increase or until such fixed expenses are reduced to a level commensurate with revenues. We cannot assure you that we will be able to maintain or increase revenues for the remainder of fiscal 2008 or beyond.

*Interest Income* Interest income was \$16.3 million and \$33.3 million for the three- and six-month periods ended October 26, 2007, respectively, as compared to \$17.5 million and \$34.1 million for the three- and six-month periods ended October 27, 2006. The decrease in interest income was primarily driven by lower average interest rates on our investment portfolio and lower cash and investment balances. We expect period-to-period changes in interest income will continue to be impacted by the volatility of market interest rates, cash and investment balances, timing of our stock repurchases, capital expenditures and payments of our future contractual obligations.

*Interest Expense* Interest expense was \$1.4 million and \$2.5 million for the three- and six-month periods ended October 26, 2007, respectively, as compared to \$5.2 million and \$9.0 million for the three- and six-month periods ended October 27, 2006. The decrease in fiscal 2008 was primarily due to lower debt balance at October 26, 2007, as compared to October 27, 2006. We expect interest expense to increase as a result of higher debt balances associated with the revolving secured and unsecured credit facilities (see Note 5 and Note 16).

*Other Income* Other income was \$0.2 million and \$1.1 million for the three- and six-month periods ended October 26, 2007, respectively. Other income for the three-month period ended October 26, 2007, included net exchange gains from foreign currency of \$0.1 million and other income of \$0.1 million. Other income for the six-month period ended October 26, 2007, included net exchange gains from foreign currency of \$0.8 million and other income of \$0.3 million. Other income was \$1.9 million and \$2.7 million for the three- and six-month periods ended October 27, 2006. Other income for the second quarter of fiscal 2007 included net exchange gains from foreign currency of \$0.2 million and other income of \$1.7 million. Other income included net exchange gains from foreign currency of \$0.8 million and other income of \$1.9 million for the six-month period ended October 27, 2006. We believe that period-to-period changes in foreign exchange gains or losses will continue to be impacted by hedging costs associated with our forward and option activities and forecast variance.

*Net Gain (Loss) on Investments* Net gain (loss) on investments included a gain of \$13.6 million related to the sale of shares of Blue Coat common stock for the three- and six-month periods ended October 26, 2007. Net gain (loss) on investments included an other-than-temporary write-down of \$2.0 million related to the impairment of our investment in a privately held company for the three- and six-month periods ended October 27, 2006.

*Provision for Income Taxes* For the three- and six-month periods ended October 26, 2007, we applied to pretax income an annual effective tax rate before discrete reporting items of 18.3% and 18.2%, respectively. The decrease to the annual effective tax rate year over year is primarily attributable to a relative decrease in the tax impact of nondeductible stock compensation under SFAS No. 123R, brought about in part by our decision to cease granting incentive stock options. Since we have replaced the granting of incentive stock options with the granting of nonqualified stock options, this gives rise to the recognition of more deferred tax assets as SFAS No. 123R expense

occurs. After taking into account the tax effect of discrete items reported, the effective tax rates applied to the pretax income for the three- and six-month periods ended October 26, 2007, were 23.1% and 21.4%, respectively. For the three- and six-month periods ended October 27, 2006, we applied an annual effective tax rate of 20.2% and 20.9%, respectively.

**Table of Contents**

Our estimate of the effective tax rate is based on the application of existing tax laws to current projections of our annual consolidated income, including projections of the mix of income (loss) earned among our entities and tax jurisdictions in which they operate.

**Liquidity and Capital Resources**

The following sections discuss the effects of changes in our balance sheet and cash flow, contractual obligations and other commercial commitments, stock repurchase program, capital commitments, and other sources and uses of cash flow on our liquidity and capital resources.

***Balance Sheet and Operating Cash Flows***

As of October 26, 2007, as compared to April 27, 2007, our cash, cash equivalents, and short-term investments decreased by \$325.7 million to \$983.1 million. We derive our liquidity and capital resources primarily from our cash flow from operations and from working capital. Working capital decreased by \$414.2 million to \$639.0 million as of October 26, 2007, compared to \$1,053.3 million as of April 27, 2007 due to higher stock repurchase activities in the six-month period ended October 26, 2007.

During the six-month period ended October 26, 2007, we generated cash flows from operating activities of \$428.6 million, as compared with \$403.4 million in the same period in fiscal 2007. We recorded net income of \$118.1 million for the six-month period ended October 26, 2007, as compared to \$141.6 million for the same period a year ago. A summary of the significant changes in noncash adjustments affecting net income is as follows:

Stock-based compensation expense was \$78.8 million in the six-month period ended October 26, 2007, compared to \$85.4 million in the same period a year ago.

Depreciation expense was \$55.0 million and \$39.4 million in the six-month periods ended October 26, 2007, and October 27, 2006, respectively. The increase was due to continued capital expansion to meet our business growth.

Amortization of intangibles and patents was \$13.7 million and \$10.4 million in the six-month periods ended October 26, 2007, and October 27, 2006, respectively. The increase was attributed to the Topio acquisition.

Gain on sale of Blue Coat common shares was \$13.6 million in the six-month period ended October 26, 2007.

Gain on sale of certain assets to Blue Coat was \$25.3 million in the six-month period ended October 27, 2006.

An increase in net deferred tax assets of \$35.5 million in the six-month period ended October 26, 2007, compared to \$22.6 million in six-month period ended October 27, 2006, primarily due to an increase in book versus tax difference associated primarily with increases in deferred revenue and stock compensation tax benefits.

In addition to net income and noncash adjustments for the first six-months of fiscal 2008, the primary factors that impacted the period-to-period change in cash flows relating to operating activities included the following:

Decrease in accounts receivable of \$165.7 million in the first six-months of fiscal 2008 was due to stronger collection activities and more linear shipments. A decrease of \$50.4 million in accounts receivable in the first six months of fiscal 2007 was due to more linear shipments.

An increase in deferred revenues of \$112.4 million and \$137.7 million in the first six months of fiscal 2008 and 2007, respectively, was due to higher software entitlements and maintenance and service revenue and long-term service contracts, as well as renewals of existing maintenance agreements in the first six months of fiscal 2008 and fiscal 2007.

Increase in income taxes payable of \$8.7 million in the first six months of fiscal 2008 was attributed to the tax provision of \$32.1 million, tax refund of \$1.3 million, offset by \$12.9 million book-tax differences and stock compensation tax benefits, and \$11.8 million income tax payments. Income tax payable decreased

**Table of Contents**

\$44.1 million in the first six months of fiscal 2007 due to tax provision of \$37.5 million and tax refund of \$1.9 million, partially offset by tax payments of \$27.1 million, which included an \$18.7 million federal income tax payment made for the fiscal year 2006 tax year relating to the income tax on foreign dividend repatriation and \$56.4 million book-tax differences and stock compensation tax benefits.

The above factors were partially offset by the effects of:

Accrued compensation and related benefits decreased by \$29.9 million and \$6.3 million in the first six-months of fiscal 2008 and 2007, respectively. The changes for both periods were due to payout of commission and performance-based payroll expenses accrued in the last quarter of each fiscal year and paid in the first six-months of each subsequent fiscal year.

Accounts payable decreased by \$40.2 million in the first six months of fiscal 2008 due to timing of payment activities. Accounts payable increased \$7.2 million in the first six months of fiscal 2007 due primarily to elevated purchasing activity required to support our business growth and facilities expansion projects.

We expect that cash provided by operating activities may fluctuate in future periods as a result of a number of factors, including fluctuations in our operating results, shipment linearity, accounts receivable collections, inventory management, and the timing of tax and other payments.

***Cash Flows from Investing Activities***

Capital expenditures for the six-month period ended October 26, 2007, were \$71.2 million as compared to \$76.0 million for the same period a year ago. We received net proceeds of \$152.1 million and \$17.0 million in the six-month period ended October 26, 2007, and October 27, 2006, respectively, for net purchases/redemptions of short-term investments. We redeemed \$35.4 million and \$52.6 million of restricted investments and its interest income pledged with JP Morgan Chase to repay the term loan with JP Morgan Chase in the six-month periods ended October 26, 2007 and October 27, 2006, respectively (see Note 5.) Investing activities in the six-month periods ended October 26, 2007, and October 27, 2006, also included new investments in privately held companies of \$4.0 million and \$1.3 million, respectively. In the second quarter of fiscal 2008, we received \$18.3 million from the sale of shares of Blue Coat common stock. In the second quarter of fiscal 2007, we received \$23.9 million in cash in connection with the sale of certain assets to Blue Coat.

***Cash Flows from Financing Activities***

We used \$411.1 million and \$358.5 million in the six-month periods ended October 26, 2007, and October 27, 2006, respectively, for net financing activities, which included repayment of debt, sales of common stock related to employee stock transactions, and common stock repurchases. We made repayments of \$37.4 million and \$106.6 million for our debt during the six-month periods ended October 26, 2007, and October 27, 2006, respectively. We repurchased 24.1 million and 10.8 million shares of common stock at a total of \$700.0 million and \$363.9 million during the six-month periods ended October 26, 2007, and October 27, 2006, respectively. Other financing activities provided \$66.1 million and \$92.5 million in the six-month periods ended October 26, 2007, and October 27, 2006, respectively, from sales of common stock related to employee stock option exercises and employee stock purchases. Tax benefits, related to tax deductions in excess of the stock-based compensation expense recognized, of \$15.6 million and \$23.8 million were presented as financing cash flows for the six-month periods ended October 26, 2007, and October 27, 2006, respectively, in accordance with SFAS No. 123R. During the six-month periods ended October 26, 2007, and October 27, 2006, we withheld shares with an aggregate value of \$5.2 million and \$4.3 million, respectively, in connection with the exercising of certain employees' restricted stock for purposes of satisfying those employees' federal, state, and local withholding tax obligations. The increase in the amounts withheld year over year



was due to the release of restricted stock units assumed in connection with the Decru acquisition. During the six-month period ended October 26, 2007, we borrowed \$250.0 million through a revolving credit facility.

The change in cash flow from financing was primarily due to the effects of higher common stock repurchases, partially offset by proceeds from the issuance of common stock under employee equity programs compared to the same period in the prior year. Net proceeds from the issuance of common stock related to employee participation in

**Table of Contents**

employee stock programs have historically been a significant component of our liquidity. The extent to which our employees participate in these programs generally increases or decreases based upon changes in the market price of our common stock. As a result, our cash flow resulting from the issuance of common stock related to employee participation in employee stock programs will vary.

Additionally, income tax benefit associated with dispositions of employee stock transactions has historically been another significant source of our liquidity. If stock option exercise patterns change, we may receive less cash from stock option exercises and may not receive the same level of tax benefits in the future, which could cause our cash payments for income taxes to increase. In addition, if our stock price declines, we may receive less tax benefits, which could also cause our income tax payments to increase.

***Stock Repurchase Program***

At October 26, 2007, \$700.0 million remained available for future repurchases under plans approved as of that date. The stock repurchase program may be suspended or discontinued at any time.

***Credit Facility and Debt***

In October 2007, we received proceeds from a secured credit agreement totaling \$250.0 million, due October 5, 2012, to finance general corporate purposes, including stock repurchases and working capital needs ( *Credit Agreement* ). (See Note 5 of the Condensed Consolidated Financial Statements.) No loan repayments under the Credit Agreement are due in the remainder of fiscal 2008. The obligations under the Credit Agreement are collateralized by certain investments with a value totaling \$299.5 million as of October 26, 2007. Interest on the loans under the Credit Agreement accrues at a floating rate based on a base rate in effect from time to time, plus a margin. The interest rate at October 26, 2007 was 5.25%. In accordance with the payment terms of the Credit Agreement, interest payments will be approximately \$6.6 million in the remainder of fiscal 2008. As of October 26, 2007, we were in compliance with the liquidity and leverage requirements of the Credit Agreement.

In March 2006, we received proceeds from a term loan agreement totaling \$300.0 million to finance a dividend under the Jobs Act ( *Loan Agreement* ). (See Note 5 of the Condensed Consolidated Financial Statements.) Loan repayments under the Loan Agreement of \$47.8 million are due in the remainder of fiscal 2008. The obligations under the Loan Agreement are collateralized by certain investments with a value totaling \$81.3 million as of October 26, 2007. Interest on the loans under the Loan Agreement accrues at a floating rate based on the base rate in effect from time to time, plus margin. The interest rate at October 26, 2007 was 5.26%. In accordance with the payment terms of the Loan Agreement, interest payments will be approximately \$0.8 million in the remainder of fiscal 2008. As of October 26, 2007, we were in compliance with the liquidity and leverage ratio as required by the Loan Agreement with the lenders.

**Table of Contents*****Contractual Obligations***

The following summarizes our contractual obligations at October 26, 2007, and the effect such obligations are expected to have on our liquidity and cash flow in future periods, (in thousands):

<b>Contractual Obligations:</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>Thereafter</b>	<b>Total</b>
Office operating lease payments(1)	\$ 12,333	\$ 23,456	\$ 20,145	\$ 16,442	\$ 12,274	\$ 30,005	\$ 114,655
Real estates lease payments(2)	894	5,995	9,645	9,645	9,645	162,975	198,799
Equipment operating lease payments	6,585	11,732	6,216	738	1		25,272
Venture capital funding commitments(3)	147	281	269	256	22		975
Purchase commitment(4)							
Capital Expenditures(5)	21,256	24,249	132	96	120		45,853
Communications & Maintenance(6)	11,274	16,522	8,298	1,758	218		38,070
Restructuring Charges(7)	274	576	598	330			1,778
Long-term Debt(8)	55,145	13,125	13,125	13,125	13,125	254,375	362,020
<b>Total Contractual Cash Obligations</b>	<b>\$ 107,908</b>	<b>\$ 95,936</b>	<b>\$ 58,428</b>	<b>\$ 42,390</b>	<b>\$ 35,405</b>	<b>\$ 447,355</b>	<b>\$ 787,422</b>

For purposes of the above table, contractual obligations for the purchase of goods and services are defined as agreements that are enforceable, are legally binding on us, and subject us to penalties if we cancel the agreement. Some of the figures we include in this table are based on management's estimates and assumptions about these obligations, including their duration, the possibility of renewal or termination, anticipated actions by management and third parties, and other factors. Because these estimates and assumptions are necessarily subjective, our actual future obligations may vary from those reflected in the table.

<b>Other Commercial Commitments:</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>	<b>Thereafter</b>	<b>Total</b>
Letters of credit(7)	\$ 1,614	\$ 517	\$ 121	\$	\$ 158	\$ 445	\$ 2,855

- (1) We enter into operating leases in the normal course of business. We lease sales offices, research and development facilities, and other property and equipment under operating leases throughout the United States and internationally, which expire on various dates through fiscal year 2016. Substantially all lease agreements have fixed payment terms based on the passage of time and contain payment escalation clauses. Some lease agreements provide us with the option to renew or terminate the lease. Our future operating lease obligations would change if we were to exercise these options and if we were to enter into additional operating lease agreements. Facilities operating lease payments exclude the leases impacted by the restructurings described in Note 12. The amounts for the leases impacted by the restructurings are included in subparagraph (7) below. The net increase in the office operating lease (1) payments was primarily due to several domestic lease extensions during the second quarter of fiscal 2008.

(2)

Included in the above contractual cash obligations pursuant to three financing arrangements with BNP Paribas LLC ( BNP ) are (a) lease commitments of \$0.9 million in fiscal 2008; \$6.0 million in fiscal 2009; \$9.6 million in each of the fiscal years 2010, 2011, and 2012; \$8.8 million in fiscal 2013; and \$5.9 million in fiscal 2014; which are based on the LIBOR rate at October 26, 2007 plus a spread, for a term of five years, and (b) at the expiration or termination of the lease, a supplemental payment obligation equal to our minimum guarantee of \$148.3 million in the event that we elect not to purchase (2) or arrange for sale of the buildings. See Note 13.

- (3) Equipment operating leases include servers and IT equipment used in our engineering labs and data centers.
- (4) Venture capital funding commitments include a quarterly committed management fee based on a percentage of our committed funding to be payable through June 2011.

**Table of Contents**

- (5) Capital expenditures include worldwide contractual commitments to purchase equipment and to construct building and leasehold improvements, which will be (5) recorded as property and equipment.
- (6) We are required to pay based on a minimum volume under certain communication contracts with major telecommunication companies as well as maintenance (6) contracts with multiple vendors. Such obligations will expire in November 2011.
- (7) These amounts are included on our Consolidated Balance Sheets under Long-Term Obligations and Other Accrued Liabilities, which is comprised of committed (7) lease payments and operating expenses net of committed and estimated sublease income.
- (8) Included in these amounts are the JP Morgan Chase loan (see Note 5) on our Consolidated Balance Sheets under Current Portion of Long-Term Debt. This amount also includes estimated interest payments of \$0.8 million for the remainder of fiscal 2008. The decrease from April 27, 2007, represented a loan repayment of \$37.3 million, plus interest of \$1.9 million for the first six months of fiscal 2008. In addition, included in these amounts are the \$250.0 million secured credit agreement entered into with JP Morgan Chase. Estimated interest payments for the credit agreement is \$63.4 million for the (8) remainder of fiscal 2008 through fiscal 2013.
- (9) The amounts outstanding under these letters of credit relate to workers compensation, a customs guarantee, a corporate credit card program, and a (9) foreign rent guarantee.

As discussed in Note 14 of the Notes to the Consolidated Financial Statements, we adopted the provisions of FIN No. 48. At October 26, 2007, we have a liability of \$63.4 million, for which we are unable to make a reasonably reliable estimate when cash settlement with a taxing authority will occur. Accordingly, this amount has been excluded from the table above.

As of October 26, 2007, we have commitments relating to two financing, construction, and leasing arrangements with BNP for office space to be located on land in Sunnyvale, California that we currently own. These arrangements require us to lease our land to BNP for a period of 50 years to construct approximately 380,000 square feet of office space costing up to \$113.5 million. After completion of construction, we will pay minimum lease payments, which vary based on the London Interbank Offered Rate ( LIBOR ) plus a spread (5.53% at October 26, 2007) on the cost of the facilities. We expect to begin making lease payments on the completed buildings in January and December 2008 for terms of five years. We have the option to renew the leases for two consecutive five-year periods upon approval by BNP. Upon expiration (or upon any earlier termination) of the lease terms, we must elect one of the following options: We may (i) purchase the buildings from BNP for \$48.5 million and \$65.0 million, respectively; (ii) if certain conditions are met, arrange for the sale of the buildings by BNP to a third party for an amount equal to at least \$41.2 million and \$55.3 million, respectively, and be liable for any deficiency between the net proceeds received from the third party and such amounts; or (iii) pay BNP supplemental payments of \$41.2 million and \$55.3 million, respectively, in which event we may recoup some or all of such payment by arranging for a sale of either or both buildings by BNP during the ensuing two-year period.

As of October 26, 2007, we have a commitment relating to a third financing, construction, and leasing arrangements with BNP for facility space to be located on land currently owned by us in Research Triangle Park, North Carolina. These arrangements require us to lease our land to BNP for a period of 99 years to construct approximately 120,000 square feet for a data center costing up to \$61.0 million. After completion of construction, we will pay minimum lease payments, which vary based on LIBOR plus a spread (5.53% at October 26, 2007) on the cost of the facility. We expect to begin making lease payments on the completed buildings in October 2008 for a term of five and half years. We have the option to renew the lease for two consecutive five-year periods upon approval by BNP. Upon

expiration (or upon any earlier termination) of the lease term, we must elect one of the following options: We may (i) purchase the building from BNP for \$61.0 million; (ii) if certain conditions are met, arrange for the sale of the building by BNP to a third party for an amount equal to at least \$51.9 million, and be liable for any deficiency between the net proceeds received from the third party and \$51.9 million; or (iii) pay BNP a supplemental payment of \$51.9 million, in which event we may recoup some or all of such payment by arranging for the sale of the building by BNP during the ensuing two-year period.

All leases also require us to maintain specified financial covenants with which we were in compliance as of October 26, 2007. Such specified financial covenants include a maximum ratio of Total Debt to Earnings Before

**Table of Contents**

Interest, Taxes, Depreciation and Amortization ( EBITDA ), and a Minimum Unencumbered Cash and Short Term Investments.

As of October 26, 2007, the notional fair value of our foreign exchange forward and foreign currency option contracts totaled \$390.6 million. We do not believe that these derivatives present significant credit risks, because the counterparties to the derivatives consist of major financial institutions, and we manage the notional amount of contracts entered into with any one counterparty. We do not enter into derivative financial instruments for speculative or trading purposes. Other than the risk associated with the financial condition of the counterparties, our maximum exposure related to foreign currency forward and option contracts is limited to the premiums paid on purchased options.

On September 5, 2007, we filed a patent infringement lawsuit in the Eastern District of Texas seeking compensatory damages and a permanent injunction against Sun Microsystems. On October 25, 2007, Sun Microsystems filed a counter claim against us in the Eastern District of Texas seeking compensatory damages and a permanent injunction. On October 29, 2007, Sun filed a second lawsuit against us in the Northern District of California asserting additional patents against us. The Texas court granted a joint motion to transfer the Texas lawsuit to the Northern District of California on November 26, 2007. We are unable at this time to determine the likely outcome of these various patent litigations. In addition, as we are unable to reasonably estimate the amount or range of the potential settlement, no accrual has been recorded as of October 26, 2007.

In addition, we are subject to various legal proceedings and claims which may arise in the normal course of business. While the outcome of these legal matters is currently not determinable, we do not believe that any current litigation or claims will have a material adverse effect on our business, cash flow, operating results, or financial condition.

***Capital Expenditure Requirements***

We expect capital expenditures to increase in the future consistent with the growth in our business, as we continue to invest in people, land, buildings, capital equipment, and enhancements to our worldwide infrastructure. We expect that our existing facilities and those being developed in Sunnyvale, California; RTP, North Carolina; and worldwide are adequate for our requirements over at least the next two years and that additional space will be available as needed. We expect to finance these construction projects, including our commitments under facilities and equipment operating leases, and any required capital expenditures over the next few years through cash from operations and existing cash, cash equivalents, and investments.

***Off-Balance Sheet Arrangements***

As of October 26, 2007, our financial guarantees of \$2.9 million that were not recorded on our balance sheet consisted of standby letters of credit related to workers' compensation, a customs guarantee, a corporate credit card program, and guarantees for foreign rental obligations.

As of October 26, 2007, the notional fair value of our foreign exchange forward and foreign currency option contracts totaled \$390.6 million. We do not believe that these derivatives present significant credit risks, because the counterparties to the derivatives consist of major financial institutions, and we manage the notional amount of contracts entered into with any one counterparty. We do not enter into derivative financial instruments for speculative or trading purposes. Other than the risk associated with the financial condition of the counterparties, our maximum exposure related to foreign currency forward and option contracts is limited to the premiums paid.

We have entered into indemnification agreements with third parties in the ordinary course of business. Generally, these indemnification agreements require us to reimburse losses suffered by the third party due to various events, such

as lawsuits arising from patent or copyright infringement. These indemnification obligations are considered off-balance sheet arrangements in accordance with FASB Interpretation 45, of FIN No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*.

We have commitments related to two lease arrangements with BNP for approximately 380,000 square feet of office space to be located on land we currently own in Sunnyvale, California. We also have a third commitment



## **Table of Contents**

related to a lease arrangement with BNP for approximately 120,000 square feet of data center to be located on land that we currently own in Research Triangle Park, North Carolina (as further described above under "Contractual Obligations"). We have evaluated our accounting for these leases under the provisions of FIN No. 46R and have determined the following:

BNP is a leasing company for BNP Paribas in the United States. BNP is not a special purpose entity organized for the sole purpose of facilitating the lease to us. The obligation to absorb expected losses and receive expected residual returns rests with the parent, BNP Paribas. Therefore, we are not the primary beneficiary of BNP as we do not absorb the majority of BNP's expected losses or expected residual returns; and

BNP has represented in the Closing Agreement (filed as Exhibit 10.40) that the fair value of the property leased to us by BNP is less than half of the total of the fair values of all assets of BNP, excluding any assets of BNP held within a silo. Further, the property leased to Network Appliance is not held within a silo. The definition of "held within a silo" means that BNP has obtained funds equal to or in excess of 95% of the fair value of the leased asset to acquire or maintain its investment in such asset through nonrecourse financing or other contractual arrangements, the effect of which is to leave such asset (or proceeds thereof) as the only significant asset of BNP at risk for the repayment of such funds.

Accordingly, under the current FIN No. 46R standard, we are not required to consolidate either the leasing entity or the specific assets that we lease under the BNP lease. Our future minimum lease payments under these real estates leases will amount to a total of \$198.8 million reported under our Note 13, "Commitments and Contingencies."

## ***Liquidity and Capital Resource Requirements***

Key factors affecting our cash flows include our ability to effectively manage our working capital, in particular, accounts receivable and inventories and future demand for our products and related pricing. We expect to incur higher capital expenditures in the near future to expand our operations. We will from time to time acquire products and businesses complementary to our business. In the future, we may continue to repurchase our common stock, which would reduce cash, cash equivalents, and/or short-term investments available to fund future operations and meet other liquidity requirements. Based on past performance and current expectations, we believe that our cash and cash equivalents, short-term investments, cash generated from operations, and credit facilities will satisfy our working capital needs, capital expenditures, stock repurchases, contractual obligations, and other liquidity requirements associated with our operations for at least the next twelve months. However, should we need to investigate other financing alternatives, we cannot be certain that additional financing will be available on satisfactory terms.

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

We are exposed to market risk related to fluctuations in interest rates, market prices, and foreign currency exchange rates. We use certain derivative financial instruments to manage these risks. We do not use derivative financial instruments for speculative or trading purposes. All financial instruments are used in accordance with management-approved policies.

## **Market Risk and Market Interest Risk**

***Interest and Investment Income*** As of October 26, 2007, we had available-for-sale investments of \$738.2 million, which included restricted investments in connection with our debt and credit facility. Our investment portfolio primarily consists of investments with original maturities at the date of purchase of greater than three months, which are classified as available-for-sale. These investments, consisting primarily of corporate bonds, corporate securities, government, municipal debt securities, and auction-rate securities are subject to interest rate and interest income risk

and will decrease in value if market interest rates increase. A hypothetical 10 percent increase in market interest rates from levels at October 26, 2007, would cause the fair value of these available-for-sale investments to decline by approximately \$3.8 million. Because we have the ability to hold these investments until maturity, we would not expect any significant decline in value of our investments caused by market interest

## **Table of Contents**

rate changes. Declines in interest rates over time will, however, reduce our interest income. We do not use derivative financial instruments in our investment portfolio.

Our investment policy is to limit the amount of credit exposure through diversification and investment in highly rated securities. We further mitigate concentrations of credit risk in our investments by limiting our investments in the debt securities of a single issuer and by diversifying risk across geographies and type of issuer. We have not experienced any material losses on our available-for-sale investments.

*Lease Commitments* As of October 26, 2007, we have two arrangements with BNP to lease our land for a period of 50 years to construct approximately 380,000 square feet of office space and a parking structure costing up to \$113.5 million. We also have a third arrangement with BNP to lease our land for a period of 99 years to construct approximately 120,000 square feet of data center costing up to \$61.0 million. After completion of construction, we will pay minimum lease payments which vary based on London Interbank Offered Rate ( LIBOR ) plus a spread. We expect to pay lease payments on the first lease on January 2008 for a term of five years, the second lease on December 2008 for a term of five years, and the third lease on October 2008 for a term of five years. We have the option to renew all three leases for two consecutive five-year periods upon approval by BNP. A hypothetical 10 percent increase in market interest rates from levels at October 26, 2007, would increase our total lease payments under the initial five-year term by approximately \$4.5 million. We do not currently hedge against market interest rate increases. As additional cash flow generated from operations is invested at current market rates, it will offer a natural hedge against interest rate risk from our lease commitments in the event of a significant change in market interest rate.

*Debt Obligation* We have an outstanding variable rate term loan totaling \$47.8 million as of October 26, 2007. Under terms of these arrangements, we expect to make interest payments at LIBOR plus a spread. A hypothetical 10 percent increase in market interest rates from levels at October 26, 2007, would increase our total interest payments by approximately \$0.2 million. We also have an outstanding secured credit facility totaling \$250.0 million as of October 26, 2007. Under terms of these arrangements, we expect to make interest payments at LIBOR plus a spread. A hypothetical 10 percent increase in market interest rates from levels at October 26, 2007, would increase our total interest payments by approximately \$6.4 million. We do not currently use derivatives to manage interest rate risk. As additional cash flow generated from operations is invested at current market rates, it will offer a natural hedge against interest rate risk from our debt in the event of a significant change in market interest rate.

*Nonmarketable Securities* We have from time to time made cash investments in companies with distinctive technologies that are potentially strategically important to us. Our investments in nonmarketable securities would be negatively affected by an adverse change in equity market prices, although the impact cannot be directly quantified. Such a change, or any negative change in the financial performance or prospects of the companies whose nonmarketable securities we own, would harm the ability of these companies to raise additional capital and the likelihood of our being able to realize any gains or return of our investments through liquidity events such as initial public offerings, acquisitions, and private sales. These types of investments involve a high degree of risk, and there can be no assurance that any company we invest in will grow or be successful. We do not currently engage in any hedging activities to reduce or eliminate equity price risk with respect to such nonmarketable investment. Accordingly, we could lose all or part of this investment if there is an adverse change in the market price of the company we invest in. Our investments in nonmarketable securities had a carrying amount of \$12.9 million as of October 26, 2007, and \$8.9 million as of April 27, 2007. If we determine that an other-than-temporary decline in fair value exists for a nonmarketable equity security, we write down the investment to its fair value and record the related write-down as an investment loss in our Consolidated Statements of Income.

## **Foreign Currency Exchange Rate Risk and Foreign Exchange Forward Contracts**

We hedge risks associated with foreign currency transactions to minimize the impact of changes in foreign currency exchange rates on earnings. We utilize forward and option contracts to hedge against the short-term impact of foreign currency fluctuations on certain assets and liabilities denominated in foreign currencies. All balance sheet hedges are marked to market through earnings every period. We also use foreign exchange forward contracts to hedge foreign currency forecasted transactions related to certain sales and operating expenses. These derivatives are

**Table of Contents**

designated as cash flow hedges under SFAS No. 133. For cash flow hedges outstanding at October 26, 2007, the gains or losses were included in other comprehensive income.

We do not enter into foreign exchange contracts for speculative or trading purposes. In entering into forward and option foreign exchange contracts, we have assumed the risk that might arise from the possible inability of counterparties to meet the terms of their contracts. We attempt to limit our exposure to credit risk by executing foreign exchange contracts with creditworthy multinational commercial banks. All contracts have a maturity of less than one year.

The following table provides information about our foreign exchange forward and currency option contracts outstanding on October 26, 2007 (in thousands):

Currency	Buy/Sell	Foreign Currency Amount	Notional Contract Value in USD	Notional Fair Value in USD
<b>Forward Contracts:</b>				
EUR	Sell	156,860	\$ 225,096	\$ 225,902
GBP	Sell	35,079	\$ 71,817	\$ 71,922
CAD	Sell	16,570	\$ 17,228	\$ 17,228
Other	Sell	N/A	\$ 18,556	\$ 18,557
AUD	Buy	29,923	\$ 27,347	\$ 27,346
Other	Buy	N/A	\$ 11,399	\$ 11,400
<b>Option Contracts:</b>				
EUR	Sell	10,000	\$ 14,398	\$ 14,521
GBP	Sell	1,800	\$ 3,692	\$ 3,723

**Item 4. Controls and Procedures**

Disclosure controls are controls and procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report, is recorded, processed, summarized, and reported within the time periods specified in the U.S. Securities and Exchange Commission's rules and forms. Disclosure controls and procedures are also designed to ensure that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of October 26, 2007, the end of the fiscal period covered by this quarterly report (the "Evaluation Date"). Based on this evaluation, our principal executive officer and principal financial officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective such that the information relating to Network Appliance, including our consolidated subsidiaries, required to be disclosed in our Securities and Exchange Commission ("SEC") reports (i) is recorded, processed, summarized, and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to Network Appliance management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents**

**PART II. OTHER INFORMATION**

**Item 1. *Legal Proceedings***

On September 5, 2007, we filed a patent infringement lawsuit in the Eastern District of Texas seeking compensatory damages and a permanent injunction against Sun Microsystems. On October 25, 2007, Sun Microsystems filed a counter claim against us in the Eastern District of Texas seeking compensatory damages and a permanent injunction. On October 29, 2007, Sun filed a second lawsuit against us in the Northern District of California asserting additional patents against us. The Texas court granted a joint motion to transfer the Texas lawsuit to the Northern District of California on November 26, 2007. We are unable at this time to determine the likely outcome of these various patent litigations. In addition, as we are unable to reasonably estimate the amount or range of the potential settlement, no accrual has been recorded as of October 26, 2007.

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

The following risk factors and other information included in this Form 10-Q should be carefully considered. The risks and uncertainties described below are not the only ones we face. Additional risks and uncertainties not presently known to us or that we presently deem less significant may also impair our business operations. If any of the following risks actually occurs, our business, operating results, and financial condition could be materially adversely affected.

***Factors beyond our control could cause our quarterly results to fluctuate, which could adversely impact our common stock price.***

We believe that period-to-period comparisons of our results of operations are not necessarily meaningful and should not be relied upon as indicators of future performance. Many of the factors that could cause our quarterly operating results to fluctuate significantly in the future are beyond our control and include, but are not limited to, the following:

Changes in general economic conditions and specific economic conditions in the computer, storage, and networking industries

General decrease in global corporate spending on information technology leading to a decline in demand for our products

A shift in federal government spending patterns

The possible effects of terrorist activity and international conflicts, which could lead to business interruptions and difficulty in forecasting

The level of competition in our target product markets

Our reliance on a limited number of suppliers due to industry consolidation, which could subject us to periodic supply-and-demand, price rigidity, and quality issues with our components

The size, timing, and cancellation of significant orders

Product configuration and mix

The extent to which our customers renew their service and maintenance contracts with us

Market acceptance of new products and product enhancements

Announcements, introductions, and transitions of new products by us or our competitors

Deferrals of customer orders in anticipation of new products or product enhancements introduced by us or our competitors

Changes in our pricing in response to competitive pricing actions

Our ability to develop, introduce, and market new products and enhancements in a timely manner



**Table of Contents**

Supply constraints

Technological changes in our target product markets

The levels of expenditure on research and development and sales and marketing programs

Our ability to achieve targeted cost reductions

Excess or inadequate facilities

Disruptions resulting from new systems and processes as we continue to enhance and adapt our system infrastructure to accommodate future growth

Future accounting pronouncements and changes in accounting policies

Seasonality

In addition, sales for any future quarter may vary and accordingly be different from what we forecast. We manufacture products based on a combination of specific order requirements and forecasts of our customer demands. Products are typically shipped within one to four weeks following receipt of an order. In certain circumstances, customers may cancel or reschedule orders without penalty. Product sales are also difficult to forecast because the storage and data management market is rapidly evolving, and our sales cycle varies substantially from customer to customer.

We derive a majority of our revenue in any given quarter from orders booked in the same quarter. Bookings typically follow intraquarter seasonality patterns weighted toward the back end of the quarter. If we do not achieve bookings in the latter part of a quarter consistent with our quarterly financial targets, our financial results will be adversely impacted. If revenues do not meet our expectations, our operating profit may be negatively impacted because portions of our expenses are fixed and difficult to reduce in a short period of time. If our revenues are lower than expected, our fixed expenses could adversely affect our net income and cash flow until revenues increase or until such fixed expenses are reduced to a level commensurate with revenues.

Due to all of the foregoing factors, it is possible that in one or more future quarters our results may fall below our forecasts and the expectations of public market analysts and investors. In such event, the trading price of our common stock would likely decrease.

***We cannot assure you that our OEM relationship with IBM will generate significant revenue.***

In April 2005, we announced a strategic partner relationship with IBM. As part of the relationship, we entered into an original equipment manufacturing ( OEM ) agreement that enables IBM to sell IBM branded solutions based on Network Appliance unified solutions, including NearStore and the NetApp® V-Series systems, as well as associated software offerings. While this agreement is an element of our strategy to expand our reach into more customers and countries, we do not have an exclusive relationship with IBM, and there is no minimum commitment for any given period of time; therefore we cannot assure you that this relationship will contribute any revenue in future years. In addition, we have no control over the products that IBM selects to sell, or its release schedule and timing of those products; nor do we control its pricing. In the event that sales through IBM will increase, we may experience distribution channel conflicts between our direct sales force and IBM or among our channel partners. If we fail to minimize channel conflicts, our operating results and financial condition could be harmed. In addition, since this agreement is relatively new, we do not have a history upon which to base our analysis of its future success.

Currently we do not and cannot assure you that this OEM relationship will generate significant revenue or that this strategic partnership will continue to be in effect for any specific period of time.

***If we are unable to maintain our existing relationships and develop new relationships with major strategic partners, our revenue may be impacted negatively.***

An element of our strategy to increase revenue is to strategically partner with major third-party software and hardware vendors that integrate our products into their products and also comarket our products with these vendors. We have significant partner relationships with database, business application, and backup management companies,

**Table of Contents**

including Microsoft, Oracle, SAP, and Symantec. A number of these strategic partners are industry leaders that offer us expanded access to segments of the storage market. There is intense competition for attractive strategic partners, and even if we can establish strategic relationships with these partners, we cannot assure you that these partnerships will generate significant revenue or that the partnerships will continue to be in effect for any specific period of time.

We intend to continue to establish and maintain business relationships with technology companies to accelerate the development and marketing of our storage solutions. To the extent that we are unsuccessful in developing new relationships and maintaining our existing relationships, our future revenue and operating results could be impacted negatively. In addition, the loss of a strategic partner could have a material adverse effect on our revenue and earnings.

***We cannot assure you that we are able to maintain existing resellers and attract new resellers and that channel conflicts will not materially adversely affect our channel relationships. In addition, we do not have exclusive relationships with our resellers and accordingly there is a risk that those resellers may give higher priority to products of other suppliers, which could materially adversely affect our operating results.***

We market and sell our storage solutions directly through our worldwide sales force and indirectly through channels such as value-added resellers ( VAR ), systems integrators, distributors, OEMs, and strategic business partners, and we derive a significant portion of our revenue from these indirect channel partners. In the six-month period ended October 26, 2007, our indirect channels accounted for 62.0% of our consolidated revenues.

However, in order for us to maintain our current revenue sources and grow our revenue as we have forecasted, we must effectively manage our relationships with these indirect channel partners. To do so, we must attract and retain a sufficient number of qualified channel partners to successfully market our products. However, because we also sell our products directly to customers through our sales force, on occasion we compete with our indirect channels for sales of our products to our end customers, competition that could result in conflicts with these indirect channel partners and make it harder for us to attract and retain these indirect channel partners. At the same time, our indirect channel partners may offer products that are competitive to ours. In addition, because our reseller partners generally offer products from several different companies, including products of our competitors, these resellers may give higher priority to the marketing, sales, and support of our competitors' products than ours. If we fail to effectively manage our relationships with these indirect channel partners to minimize channel conflict and continue to evaluate and meet our indirect sales partners' needs with respect to our products, we will not be able to maintain or increase our revenue as we have forecasted, which would have a materially adverse effect on our business, financial condition, and results of operations. Additionally, if we do not manage distribution of our products and services and support effectively, or if our resellers' financial conditions or operations weaken, our revenues and gross margins could be adversely affected.

***The U.S. government has contributed to our revenue growth and has become an important customer for us.***

The U.S. government has become an important customer for the storage market and for us; however, government demand is unpredictable, and there is no guarantee of future revenue growth from the U.S. government. Government agencies are subject to budgetary processes and expenditure constraints that could lead to delays or decreased capital expenditures in IT spending on infrastructures. If the government or individual agencies within the government reduce or shift their capital spending pattern, our financial results may be harmed. We cannot assure you that revenue from the U.S. government will continue to grow in the future.

The General Services Administration ( GSA ) is currently auditing our records under the schedule contracts it had with us to verify our compliance with various contract provisions. If the audit determines that we did not comply with such provisions, we may be required to pay the GSA a potential settlement. The exact date for completion of the audit and the subsequent negotiation process is unknown and may not be concluded for some time. Our management does not

believe, based upon information currently known to us, that the final resolution of our audit will have a material adverse effect upon our consolidated financial position and the results of operations and cash flows.

**Table of Contents**

***The marketplace for our common stock has fluctuated significantly in the past and will likely continue to do so in the future.***

The market price for our common stock has experienced substantial volatility in the past, and several factors could cause the price to fluctuate substantially in the future. These factors include but are not limited to:

Fluctuations in our operating results

Variations between our operating results and either the guidance we have furnished to the public or the published expectations of securities analysts

Fluctuations in the valuation of companies perceived by investors to be comparable to us

Changes in analysts' recommendations or projections

Inquiries by the SEC, NASDAQ, law enforcement, or other regulatory bodies

Economic developments in the storage and data management market as a whole

International conflicts and acts of terrorism

Announcements of new products, applications, or product enhancements by us or our competitors

Changes in our relationships with our suppliers, customers, and channel and strategic partners

General market conditions

In addition, the stock market has experienced volatility that has particularly affected the market prices of equity securities of many technology companies. Additionally, certain macroeconomic factors such as changes in interest rates, the market climate for the technology sector, and levels of corporate spending on information technology could also have an impact on the trading price of our stock. As a result, the market price of our common stock may fluctuate significantly in the future, and any broad market decline, as well as our own operating results, may materially and adversely affect the market price of our common stock.

Macroeconomic conditions and an IT spending slowdown in the United States as well as variations in our expected operating performance may continue to cause volatility in our stock price. We are unable to predict changes in general economic conditions and when global IT spending rates will be affected. Furthermore, if there are future reductions in either domestic or international IT spending rates, or if IT spending rates do not increase, our revenues, operating results, and stock price may continue to be adversely affected.

***Our forecasts of our revenues and earnings outlook may be inaccurate and could materially and adversely impact our business or our planned results of operations.***

Our revenues are difficult to forecast. We use a pipeline system, a common industry practice, to forecast revenues and trends in our business. Sales personnel monitor the status of potential business and estimate when a customer will make a purchase decision, the dollar amount of the sale and the products or services to be sold. These estimates are aggregated periodically to generate a sales pipeline. Our pipeline estimates may prove to be unreliable either in a particular quarter or over a longer period of time, in part because the conversion rate of the pipeline into contracts varies from customer to customer, can be difficult to estimate, and requires management judgment. Small deviations

from our forecasted conversion rate may result in inaccurate plans and budgets and materially adversely impact our business or our planned results of operations. In particular, a slowdown in IT spending or weak economic conditions or evolving technology generally can reduce the conversion rate in a particular quarter as our customers' purchasing decisions are delayed, reduced in amount, or cancelled. Moreover, even after contracts have been executed, extensive analysis is required before the timing of revenue recognition can be reliably determined; this delay reflects both the complexity of the revenue recognition rules applicable to software and the effect that the multiple element arrangements and other terms and conditions can have when these rules are applied.

**Table of Contents**

***If we are unable to develop and introduce new products and respond to technological change, if our new products do not achieve market acceptance, or if we fail to manage the transition between our new and old products, or if we cannot provide the level of service and support for our new products, our operating results could be materially and adversely affected.***

Our future growth depends upon the successful development and introduction of new hardware and software products. Due to the complexity of storage subsystems and storage security appliances and the difficulty in gauging the engineering effort required to produce new products, such products are subject to significant technical risks. However, our new products may not achieve market acceptance. Additional product introductions in future periods may also impact our sales of existing products. In addition, our new products must respond to technological changes and evolving industry standards. If we are unable, for technological or other reasons, to develop and introduce new products in a timely manner in response to changing market conditions or customer requirements, or if such products do not achieve market acceptance, our operating results could be materially and adversely affected.

As new or enhanced products are introduced, we must successfully manage the transition from older products in order to minimize disruption in customers' ordering patterns, avoid excessive levels of older product inventories, and ensure that enough supplies of new products can be delivered to meet customers' demands.

As we enter into new or emerging markets, we will likely increase demands on our service and support operations and may be exposed to additional competition. We may not be able to provide products, service, and support to effectively compete for these market opportunities. Further, provision of greater levels of services from us may result in a delay in the timing of revenue recognition.

***Our gross margins may vary based on the configuration of our product and service solutions, and such variation may make it more difficult to forecast our earnings.***

We derive a significant portion of our sales from the resale of disk drives as components of our storage systems, and the resale market for hard disk drives is highly competitive and subject to intense pricing pressures. Our sales of disk drives generate lower gross margin percentages than those of our storage systems. As a result, as we sell more highly configured systems with greater disk drive content, overall gross margin percentages may be negatively affected.

Our gross margins have been and may continue to be affected by a variety of other factors, including:

Demand for storage and data management products

Discount levels and price competition

Direct versus indirect and OEM sales

Product and add-on software mix

The mix of services as a percentage of revenue

The mix and average selling prices of products

The mix of disk content

New product introductions and enhancements

Excess inventory purchase commitments as a result of changes in demand forecasts and possible product and software defects as we transition our products

The cost of components, manufacturing labor, and quality

Changes in service gross margins may result from various factors such as continued investments in our customer support infrastructure and changes in the mix between technical support services and professional services, as well as the timing of technical support service contract initiations and renewals.



**Table of Contents**

***An increase in competition could materially and adversely affect our operating results.***

The storage markets are intensely competitive and are characterized by rapidly changing technology. In the storage market, our primary and nearline storage system products and our associated storage software portfolio compete primarily with storage system products and data management software from EMC, HDS, HP, IBM, and Sun/StorageTek. We also see Dell, Inc. as a competitor in the storage marketplace, primarily through its business partnership with EMC, allowing Dell to resell EMC storage hardware and software products. We have also historically encountered less-frequent competition from companies including LSI Logic. In the secondary storage market, which includes the disk-to-disk backup, compliance, and business continuity segments, our solutions compete primarily against products from EMC and Sun/StorageTek. Our NearStore VTL appliances also compete with traditional tape backup solutions in the broader data backup/recovery space. Additionally, a number of small, new companies are currently attempting to enter the storage systems and data management software markets and the near-line and NearStore VTL storage markets, some of which may become significant competitors in the future.

There has been a trend toward industry consolidation in our markets for several years. We expect this trend to continue as companies attempt to strengthen or hold their market positions in an evolving industry and as companies are acquired or are unable to continue operations. We believe that industry consolidation may result in stronger competitors that are better able to compete as sole-source vendors for customers. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current or future competitors. Competitive pressures we face could materially and adversely affect our operating results.

***We rely on a limited number of suppliers, and any disruption or termination of these supply arrangements could delay shipment of our products and could materially and adversely affect our operating results.***

We rely on a limited number of suppliers for components such as disk drives, computer boards, and microprocessors utilized in the assembly of our products. In recent years, rapid industry consolidation has led to fewer component suppliers, which could subject us to periodic supply constraints and price rigidity.

Our reliance on a limited number of suppliers involves several risks, including:

A potential inability to obtain an adequate supply of required components because we do not have long-term supply commitments

Supplier capacity constraints

Price increases

Timely delivery

Component quality

Component quality risk is particularly significant with respect to our suppliers of disk drives. In order to meet product performance requirements, we must obtain disk drives of extremely high quality and capacity. In addition, there are periodic supply-and-demand issues for disk drives, microprocessors, and semiconductor memory components, which could result in component shortages, selective supply allocations, and increased prices of such components. We cannot assure you that we will be able to obtain our full requirements of such components in the future or that prices of such components will not increase. In addition, problems with respect to yield and quality of such components and

timeliness of deliveries could occur. Disruption or termination of the supply of these components could delay shipments of our products and could materially and adversely affect our operating results. Such delays could also damage relationships with current and prospective customers and suppliers.

In addition, we license certain technology and software from third parties that are incorporated into our products. If we are unable to obtain or license the technology and software on a timely basis, we will not be able to deliver products to our customers in a timely manner.

**Table of Contents**

***The loss of any contract manufacturers or the failure to accurately forecast demand for our products or successfully manage our relationships with our contract manufacturers could negatively impact our ability to manufacture and sell our products.***

We currently rely on several contract manufacturers to manufacture our products. Our reliance on our third-party contract manufacturers reduces our control over the manufacturing process, exposing us to risks, including reduced control over quality assurance, production costs, and product supply. If we should fail to effectively manage our relationships with our contract manufacturers, or if our contract manufacturers experience delays, disruptions, capacity constraints, or quality control problems in their manufacturing operations, our ability to ship products to our customers could be impaired, and our competitive position and reputation could be harmed. Qualifying a new contract manufacturer and commencing volume production are expensive and time-consuming. If we are required to change contract manufacturers or assume internal manufacturing operations, we may lose revenue and damage our customer relationships. If we inaccurately forecast demand for our products, we may have excess or inadequate inventory or incur cancellation charges or penalties, which could adversely impact our operating results. As of October 26, 2007, we have no purchase commitment under these agreements.

We intend to regularly introduce new products and product enhancements, which will require us to rapidly achieve volume production by coordinating with our contract manufacturers and suppliers. We may need to increase our material purchases, contract manufacturing capacity, and quality functions to meet anticipated demand. The inability of our contract manufacturers to provide us with adequate supplies of high-quality products or the inability to obtain raw materials, could cause a delay in our ability to fulfill orders.

***Our future financial performance depends on growth in the storage and data management markets. If these markets do not continue to grow at the rates at which we forecast growth, our operating results will be materially and adversely impacted.***

All of our products address the storage and data management markets. Accordingly, our future financial performance will depend in large part on continued growth in the storage and data management markets and on our ability to adapt to emerging standards in these markets. We cannot assure you that the markets for storage and data management will continue to grow or that emerging standards in these markets will not adversely affect the growth of UNIX®, Windows®, and the World Wide Web server markets upon which we depend.

For example, we provide our open access data retention solutions to customers within the financial services, healthcare, pharmaceuticals, and government market segments, industries that are subject to various evolving governmental regulations with respect to data access, reliability, and permanence (such as Rule 17(a)(4) of the Securities Exchange Act of 1934, as amended) in the United States and in the other countries in which we operate. If our products do not meet and continue to comply with these evolving governmental regulations in this regard, customers in these market and geographical segments will not purchase our products, and therefore we will not be able to expand our product offerings in these market and geographical segments at the rates for which we have forecast.

***We are also exposed to unfavorable economic and market conditions and the uncertain geopolitical environment.***

Our operating results may be adversely affected by unfavorable economic and market conditions and the uncertain geopolitical environment. A reduction in demand for storage and data management caused by weakening economic conditions and decreases in corporate spending will result in decreased revenues and lower revenue growth rates. The network storage market growth declined significantly beginning in the third quarter of fiscal 2001 through fiscal 2003, causing both our revenues and operating results to decline. If the storage and data management markets grow more slowly than anticipated, or if emerging standards other than those adopted by us become increasingly accepted by

these markets, our operating results could be materially and adversely affected.

Turmoil in the geopolitical environment in many parts of the world, including terrorist activities and military actions, and changes in energy costs may continue to put pressure on global economic conditions. If the economic and market conditions in the United States and globally do not improve, or if they deteriorate, we may experience material impacts on our business, operating results, and financial condition.

**Table of Contents**

***Our effective tax rate may increase or fluctuate, which could increase our income tax expense and reduce our net income.***

Our effective tax rate could be adversely affected by several factors, many of which are outside of our control, including:

Earnings being lower than anticipated in countries where we are taxed at lower rates as compared to the U.S. statutory tax rate

Material differences between forecasted and actual tax rates as a result of a shift in the mix of pretax profits and losses by tax jurisdiction, our ability to use tax credits, or effective tax rates by tax jurisdiction different than our estimates

Changing tax laws, accounting standards, including SFAS No. 123R and FIN No. 48, regulations, and interpretations in multiple tax jurisdictions in which we operate, as well as the requirements of certain tax rulings

An increase in expenses not deductible for tax purposes, including certain stock-based compensation expense, write-offs of acquired in-process research and development, and impairment of goodwill

The tax effects of purchase accounting for acquisitions and restructuring charges that may cause fluctuations between reporting periods

Changes in the valuation of our deferred tax assets and liabilities

Changes in tax laws or the interpretation of such tax laws

Tax assessments or any related tax interest or penalties, could significantly affect our income tax expense for the period in which the settlements take place

A change in our decision to indefinitely reinvest foreign earnings

The price of our common stock could decline to the extent that our financial results are materially affected by an adverse change in our effective tax rate. We are currently undergoing federal income tax audits in the United States and several foreign tax jurisdictions. The rights to some of our intellectual property ( IP ) are owned by certain of our foreign subsidiaries, and payments are made between U.S. and foreign tax jurisdictions relating to the use of this IP in a qualified cost sharing arrangement. Recently, some other U.S. companies have had their foreign IP arrangements challenged as part of an IRS examination, which has resulted in material proposed assessments and/or pending litigation. Our management does not believe, based upon information currently known to us that the final resolution of any of our audits will have a material adverse effect upon our consolidated financial position and the results of operations and cash flows. If the ultimate determination of our taxes owed in any of these tax jurisdictions is for an amount in excess of the tax provision we have recorded or reserved for, our operating results, cash flows, and financial condition could be adversely affected.

***We may face increased risks and uncertainties related to our current or future acquisitions and nonmarketable securities, and these investments may not achieve our objectives.***

As part of our strategy, we are continuously evaluating opportunities to buy other businesses or technologies that would complement our current products, expand the breadth of our markets, or enhance our technical capabilities. We

may engage in future acquisitions that dilute our stockholders' investments and cause us to use cash, to incur debt, or to assume contingent liabilities.

Acquisitions of companies entail numerous risks, and we may not be able to successfully integrate acquired operations and products or to realize anticipated synergies, economies of scale, or other value. Integration risks and issues may include, but are not limited to, key personnel retention and assimilation, management distraction, technical development, and unexpected costs and liabilities, including goodwill impairment charges. In addition, we may be unable to recover strategic investments in development stage entities. Any such problems could have a material adverse effect on our business, financial condition, and results of operation.

## **Table of Contents**

On occasion, we invest in nonmarketable securities of private companies. As of October 26, 2007, the carrying value of our investments in nonmarketable securities totaled \$12.9 million. Investments in nonmarketable securities are inherently risky, and some of these companies are likely to fail. Their success (or lack thereof) is dependent on these companies' product development, market acceptance, operational efficiency, and other key business success factors. In addition, depending on these companies' future prospects, they may not be able to raise additional funds when needed, or they may receive lower valuations, with less favorable investment terms than in previous financings, and our investments in them would likely become impaired.

### ***Risks inherent in our international operations could have a material adverse effect on our operating results.***

We conduct business internationally. For the six-month period ended October 26, 2007, 43.1% of our total revenues was from international customers (including U.S. exports). Accordingly, our future operating results could be materially and adversely affected by a variety of factors, some of which are beyond our control, including regulatory, political, or economic conditions in a specific country or region, trade protection measures and other regulatory requirements, government spending patterns, and acts of terrorism and international conflicts.

Because a significant portion of our business is conducted outside the United States, we face exposure to adverse movements in foreign currency exchange rates. These exposures may change over time as business practices evolve, and they could have a material adverse impact on our financial results and cash flows. Our international sales are denominated in U.S. dollars and in foreign currencies. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and therefore potentially less competitive in foreign markets. Conversely, lowering our price in local currency may result in lower U.S.-based revenue. A decrease in the value of the U.S. dollar relative to foreign currencies could increase the cost of local operating expenses. Additionally, we have exposures to emerging market currencies, which can have extreme currency volatility. We utilize forward and option contracts to hedge our foreign currency exposure associated with certain assets and liabilities as well as anticipated foreign currency cash flows. All balance sheet hedges are marked to market through earnings every quarter, while gains and losses on cash flow hedges are recorded in other comprehensive income until forecasted transactions occur, at which time such realized gains and losses are recognized in earnings. These hedges attempt to reduce, but do not always entirely eliminate, the impact of currency exchange movements. Factors that could have an impact on the effectiveness of our hedging program include the accuracy of forecasts and the volatility of foreign currency markets. There can be no assurance that such hedging strategies will be successful and that currency exchange rate fluctuations will not have a material adverse effect on our operating results.

Additional risks inherent in our international business activities generally include, among others, longer accounts receivable payment cycles and difficulties in managing international operations. Such factors could materially and adversely affect our future international sales and consequently our operating results.

We receive significant tax benefits from sales to our non-U.S. customers. These benefits are contingent upon existing tax regulations in the United States and in the countries in which our international operations are located. Future changes in domestic or international tax regulations could adversely affect our ability to continue to realize these tax benefits. Our effective tax rate could also be adversely affected by different and evolving interpretations of existing law or regulations. Potentially adverse tax consequences could negatively impact the operating and financial results from international operations. International operations currently benefit from a tax ruling concluded in the Netherlands.

Our operating results have not been significantly affected by seasonality in the past. In the future, as we expand our presence internationally, we may experience more seasonality in the sale of our products. For example, sales to European customers tend to be weaker in the summer months, which is our first fiscal quarter.

We cannot assure you that we will be able to maintain or increase international market demand for our products.



**Table of Contents**

***If we fail to manage our expanding business effectively, our operating results could be materially and adversely affected.***

Our future operating results depend to a large extent on management's ability to successfully manage expansion and growth, including but not limited to expanding international operations, forecasting revenues, addressing new markets, controlling expenses, implementing and enhancing infrastructure, investing in people, facilities and capital equipment, and managing our assets. An unexpected decline in the growth rate of revenues without a corresponding and timely reduction in expense growth or a failure to manage other aspects of growth could materially and adversely affect our operating results.

In addition, continued expansion could strain our current management, financial, manufacturing, and other systems and may require us to implement and improve those systems. If we experience any problems with any improvement or expansion of these systems, procedures, or controls, or if these systems, procedures, or controls are not designed, implemented, or improved in a cost-effective and timely manner, our operations may be materially and adversely affected. In addition, any failure to implement, improve, and expand such systems, procedures, and controls in a timely and efficient manner could harm our growth strategy and materially and adversely affect our financial condition and ability to achieve our business objectives.

***As we continue to grow our business, we are likely to incur costs earlier than some of the anticipated benefits, which could harm our operating results. A significant percentage of our expenses is fixed, which could materially and adversely affect our net income.***

We are increasing our investment in engineering, sales, service support, and other functions to grow our business. We are likely to recognize the costs associated with these increased investments earlier than some of the anticipated benefits, and the return on these investments may be lower, or may develop more slowly, than we expect, which could harm our business.

Our expense levels are based in part on our expectations as to future sales, and a significant percentage of our expenses is fixed. As a result, if sales levels are below expectations or previously higher levels, net income will be disproportionately affected in a material and adverse manner.

***We depend on the ability of our personnel, raw materials, equipment, and products to move reasonably unimpeded around the world. Our business could be materially and adversely affected as a result of a natural disaster, terrorist acts, or other catastrophic events.***

Any political, military, world health, or other issue that hinders this movement or restricts the import or export of materials could lead to significant business disruptions. Furthermore, any strike, economic failure, or other material disruption caused by fire, floods, hurricanes, power loss, power shortages, telecommunications failures, break-ins, and similar events could also adversely affect our ability to conduct business. If such disruptions result in cancellations of customer orders or contribute to a general decrease in economic activity or corporate spending on information technology, or directly impact our marketing, manufacturing, financial, and logistics functions, our results of operations and financial condition could be materially adversely affected. In addition, our headquarters are located in Northern California, an area susceptible to earthquakes. If any significant disaster were to occur, our ability to operate our business could be impaired.

***We depend on attracting and retaining qualified technical and sales personnel. If we are unable to attract and retain such personnel, our operating results could be materially and adversely impacted.***

Our continued success depends, in part, on our ability to identify, attract, motivate, and retain qualified technical and sales personnel. Because our future success is dependent on our ability to continue to enhance and introduce new products, we are particularly dependent on our ability to identify, attract, motivate, and retain qualified engineers with the requisite education, background, and industry experience. Competition for qualified engineers, particularly in Silicon Valley, can be intense. The loss of the services of a significant number of our engineers or salespeople could be disruptive to our development efforts or business relationships and could materially and adversely affect our operating results.

**Table of Contents**

***Undetected software errors, hardware errors, or failures found in new products may result in loss of or delay in market acceptance of our products, which could increase our costs and reduce our revenues. Product quality problems could lead to reduced revenue, gross margins, and net income.***

Our products may contain undetected software errors, hardware errors, or failures when first introduced or as new versions are released. Despite testing by us and by current and potential customers, errors may not be found in new products until after commencement of commercial shipments, resulting in loss of or delay in market acceptance, which could materially and adversely affect our operating results.

If we fail to remedy a product defect, we may experience a failure of a product line, temporary or permanent withdrawal from a product or market, damage to our reputation, inventory costs, or product reengineering expenses, any of which could have a material impact on our revenue, margins, and net income.

In addition, we may be subject to losses that may result or are alleged to result from defects in our products, which could subject us to claims for damages, including consequential damages. Based on our historical experience, we believe that the risk of exposure to product liability claims is currently low. However, should we experience increased exposure to product liability claims, our business could be adversely impacted.

***We are exposed to various risks related to legal proceedings or claims and protection of intellectual property rights, which could adversely affect our operating results.***

We are a party to lawsuits in the normal course of our business. Litigation can be expensive, lengthy, and disruptive to normal business operations. Moreover, the results of complex legal proceedings are difficult to predict. An unfavorable resolution of a particular lawsuit could have a material adverse effect on our business, operating results, or financial condition.

If we are unable to protect our intellectual property, we may be subject to increased competition that could materially and adversely affect our operating results. Our success depends significantly upon our proprietary technology. We rely on a combination of copyright and trademark laws, trade secrets, confidentiality procedures, contractual provisions, and patents to protect our proprietary rights. We seek to protect our software, documentation, and other written materials under trade secret, copyright, and patent laws, which afford only limited protection. Some U.S. trademarks and some U.S.-registered trademarks are registered internationally as well. We will continue to evaluate the registration of additional trademarks as appropriate. We generally enter into confidentiality agreements with our employees and with our resellers, strategic partners, and customers. We currently have multiple U.S. and international patent applications pending and multiple U.S. patents issued. The pending applications may not be approved, and if patents are issued, such patents may be challenged. If such challenges are brought, the patents may be invalidated. We cannot assure you that we will develop proprietary products or technologies that are patentable, that any issued patent will provide us with any competitive advantages or will not be challenged by third parties, or that the patents of others will not materially and adversely affect our ability to do business.

Litigation may be necessary to protect our proprietary technology. Any such litigation may be time consuming and costly. Despite our efforts to protect our proprietary rights, unauthorized parties may attempt to copy aspects of our products or to obtain and use information that we regard as proprietary. In addition, the laws of some foreign countries do not protect proprietary rights to as great an extent as do the laws of the United States. We cannot assure you that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology, duplicate our products, or design around patents issued to us or other intellectual property rights of ours.

We are subject to intellectual property infringement claims. We may, from time to time, receive claims that we are infringing third parties' intellectual property rights. Third parties may in the future claim infringement by us with respect to current or future products, patents, trademarks, or other proprietary rights. We expect that companies in the appliance market will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims could be time consuming, result in costly litigation, cause product shipment delays, require us to redesign our products, or require us to enter into royalty or licensing agreements, any of which could materially and

**Table of Contents**

adversely affect our operating results. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all.

***Our business is subject to increasingly complex corporate governance, public disclosure, accounting, and tax requirements that have increased both our costs and the risk of noncompliance.***

Because our common stock is publicly traded, we are subject to certain rules and regulations of federal, state, and financial market exchange entities charged with the protection of investors and the oversight of companies whose securities are publicly traded. These entities, including the Public Company Accounting Oversight Board, the SEC, and NASDAQ, have implemented new requirements and regulations and continue developing additional regulations and requirements in response to recent corporate scandals and laws enacted by Congress, most notably the Sarbanes-Oxley Act of 2002. Our efforts to comply with these new regulations have resulted in, and are likely to continue resulting in, increased general and administrative expenses and diversion of management time and attention from revenue-generating activities to compliance activities.

We have recently completed our evaluation of our internal controls over financial reporting as required by Section 404 of the Sarbanes-Oxley Act of 2002. Although our assessment, testing, and evaluation resulted in our conclusion that as of April 27, 2007, our internal controls over financial reporting were effective, we cannot predict the outcome of our testing in future periods. If our internal controls are ineffective in future periods, our business and reputation could be harmed. We may incur additional expenses and commitment of management's time in connection with further evaluations, either of which could materially increase our operating expenses and accordingly reduce our net income.

Because new and modified laws, regulations, and standards are subject to varying interpretations in many cases due to their lack of specificity, their application in practice may evolve over time as new guidance is provided by regulatory and governing bodies. This evolution may result in continuing uncertainty regarding compliance matters and additional costs necessitated by ongoing revisions to our disclosure and governance practices.

***Our ability to forecast earnings is limited by the impact of new accounting requirements such as SFAS No. 123R.***

The Financial Accounting Standards Board requires companies to recognize the fair value of stock options and other share-based payment compensation to employees as compensation expense in the statement of income. Option pricing models require the input of highly subjective assumptions, including the expected stock price volatility, expected life, and forfeiture rate. We have chosen to base our estimate of future volatility using the implied volatility of traded options to purchase the Company's common stock as permitted by SAB No. 107. As of April 29, 2006, the contractual life of our stock options was shortened to seven years from ten years for options issued on or after this date, and to the extent that the shorter life changes employees' exercise behavior, it may change the expected term of an option going forward. SFAS No. 123R requires us to use estimated forfeitures, and therefore the adoption of SFAS No. 123R could have a material impact on the timing of and, based on the accuracy of estimates of future actual forfeitures, the amount of stock-based compensation expense. Given the unpredictable nature of the Black Scholes variables and other management assumptions such as number of options to be granted, underlying strike price, and associated income tax impacts, it is very difficult to estimate stock-based compensation expense for any given quarter or year. Any changes in these highly subjective assumptions may significantly impact our ability to make accurate forecasts of future earnings and volatility of our stock price. If another party asserts that the fair value of our employee stock options is misstated, securities class action litigation could be brought against us, or the market price of our common stock could decline, or both could occur. As a result, we could incur significant losses, and our operating results may be below our expectations and those of investors and stock market analysts.

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

The table below sets forth information with respect to common repurchases by Network Appliance, Inc. for the second quarter of fiscal 2008:

Period	Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of the Repurchase Program(1)	Approximate Dollar Value of Shares That May Yet be Purchased Under the Repurchase Program(2)
July 28, 2007 – August 24, 2007	7,656,931	\$ 29.39	68,771,916	\$ 974,948,323
August 25, 2007 – September 21, 2007	2,775,000	\$ 27.02	71,546,916	\$ 899,975,313
September 22, 2007 – October 26, 2007	7,170,360	\$ 27.89	78,717,276	\$ 699,975,313
Total	17,602,291	\$ 28.40	78,717,276	\$ 699,975,313

(1) This amount represented total number of shares purchased under our publicly announced repurchase programs since inception.

(2) On May 13, 2003, our Board of Directors had authorized a stock repurchase program. As of October 26, 2007, our Board of Directors had authorized the repurchase of up to \$3,023,638,730 of common stock under this program. During the three-month period ended October 26, 2007, we repurchased 17,602,291 shares of our common stock at a weighted-average price of \$28.40 per share for an aggregate purchase price of \$499,973,010. As of October 26, 2007, we had repurchased 78,717,276 shares of our common stock at a weighted-average price of \$29.52 per share for an aggregate purchase price of \$2,323,663,519 since inception of the stock repurchase program, and the remaining authorized amount for stock repurchases under this program was \$699,975,313 with no termination date.

**Item 3. *Defaults upon Senior Securities***

None

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

On September 19, 2007, we held our 2007 Annual Meeting of Stockholders. Voting results are summarized below:

Proposal I To elect the following individuals to serve as members of the Board of Directors for the ensuing year or until their respective successors are duly elected and qualified:

<b>Name</b>	<b>Votes For</b>	<b>Abstain</b>
Daniel J. Warmenhoven	312,916,224	12,169,272
Donald T. Valentine	312,534,861	12,550,635
Jeffry R. Allen	312,812,970	12,272,526
Carol A. Bartz	310,486,917	14,598,579
Alan L. Earhart	314,904,816	10,180,680
Edward Kozel	313,826,086	11,259,410
Mark Leslie	315,348,594	9,736,902
Nicholas G. Moore	314,825,931	10,259,565
George T. Shaheen	315,404,207	9,681,289
Robert T. Wall	311,037,351	14,048,145

Proposal II To approve various amendments to the Company's 1999 Stock Option Plan (1999 Plan).

<b>Votes For</b>	<b>Against</b>	<b>Abstain</b>	<b>Brokers Non Vote</b>
160,875,951	117,150,174	2,008,945	45,050,426

**Table of Contents**

Proposal III To approve an amendment to the Company's 1999 Stock Option Plan (1999 Plan) to increase the share reserve by an additional 7,200,000 shares of Common Stock.

<b>Votes For</b>	<b>Against</b>	<b>Abstain</b>	<b>Brokers Non Vote</b>
153,140,813	124,886,231	2,008,027	45,050,425

Proposal IV To approve an amendment to the Company's Employee Stock Purchase Plan (Purchase Plan) to increase the share reserve under the Purchase Plan by an additional 1,600,000 shares of Common Stock.

<b>Votes For</b>	<b>Against</b>	<b>Abstain</b>	<b>Brokers Non Vote</b>
256,061,048	22,098,298	1,875,724	45,050,426

Proposal V To approve an amendment to Executive Compensation Plan for the incentive compensation payouts.

<b>Votes For</b>	<b>Against</b>	<b>Abstain</b>	<b>Brokers Non Vote</b>
272,906,152	5,225,980	1,903,248	45,050,116

Proposal VI To ratify the appointment of Deloitte & Touche LLP as independent auditors of the Company for the fiscal year ending April 25, 2008.

<b>Votes For</b>	<b>Against</b>	<b>Abstain</b>
318,581,757	4,440,859	2,062,880

**Item 5. Other Information**

The information required by this item is incorporated by reference from our Proxy Statement for the 2007 Annual Meeting of Shareholders.



**Table of Contents**

**Item 6. Exhibits**

<b>Exhibit No</b>	<b>Description</b>
2.1(7)	Agreement and Plan of Merger of Network Appliance, Inc. (a Delaware corporation) and Network Appliance, Inc. (a California corporation).
2.2(10)	Agreement and Plan of Merger dated as of November 3, 2003, by and among Network Appliance, Inc., Nagano Sub, Inc., and Spinnaker Networks, Inc.
2.3(10)	Amendment to Merger Agreement, dated as of February 9, 2004, by and among Network Appliance, Inc., Nagano Sub, Inc., and Spinnaker Networks, Inc.
2.4(16)	Agreement and Plan of Merger and Reorganization, dated as of June 15, 2005, by and among Network Appliance Inc., Dolphin Acquisition Corp, and Decru, Inc.
3.1(7)	Certificate of Incorporation of the Company.
3.2(7)	Bylaws of the Company.
3.3(18)	Certificate of Amendment to the Bylaws of the Company.
4.1(7)	Reference is made to Exhibits 3.1 and 3.2.
10.1(29)*	The Company's Amended and Restated Employee Stock Purchase Plan.
10.2(8)*	The Company's Amended and Restated 1995 Stock Incentive Plan.
10.3(2)	The Company's Special Non-Officer Stock Option Plan.
10.4(29)*	The Company's Amended and Restated 1999 Stock Incentive Plan.
10.5 (3)	OEM Distribution and License Agreement, dated October 27, 1998, by and between Dell Products L.P. and the Company.
10.6(4)	OEM Distribution and License Agreement, dated November 6, 1998, by and between Fujitsu Limited and the Company.
10.15 (6)	Patent Cross License Agreement dated December 11, 2000, by and between Intel Corporation and the Company.
10.16(1)*	Form of Indemnification Agreement entered into between the Company and its directors and officers.
10.17(9)	Short Form Termination of Operative Documents, dated April 24, 2002, by and between BNP Leasing Corporation and the Company.
10.18(11)*	Spinnaker Networks, Inc. 2000 Stock Plan.
10.19(14)*	Alacritus, Inc. 2005 Stock Plan.
10.20(13)*	The Company's Fiscal Year 2005 Incentive Compensation Plan.
10.21(15)*	The Company's Deferred Compensation Plan.
10.22(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1995 Stock Option Plan.
10.23(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1995 Stock Option Plan (Chairman of the Board or any Board Committee Chairperson).
10.24(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1995 Stock Option Plan (Restricted Stock Agreement).
10.25(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (Restricted Stock Unit Agreement).
10.26(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan.
10.27(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (Change of Control).
10.28(23)	

Edgar Filing: NETWORK APPLIANCE INC - Form 10-Q

	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (China).
10.29(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (Non-Employee Director Automatic Stock Option - Annual).
10.30(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (Non-Employee Director Automatic Stock Option - Initial).
10.31(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (France).

**Table of Contents**

<b>Exhibit No</b>	<b>Description</b>
10.32(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (India).
10.33(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (United Kingdom).
10.34(19)	Form of Stock Option Grant Notice and Option Agreement under the Decru, Inc. Amended and Restated 2001 Equity Incentive Plan and the 2001 Equity Incentive Plan filed under Attachment II.
10.35(19)	Form of Stock Option Grant Notice and Option Agreement under the Decru, Inc. 2001 Equity Incentive Plan and the 2001 Equity Incentive Plan filed under Attachment II.
10.36(19)	Form of Early Exercise Stock Purchase Agreement under the Decru, Inc. 2001 Equity Incentive Plan.
10.37(19)	Form of Restricted Stock Bonus Grant Notice and Agreement under the Decru, Inc. 2001 Equity Incentive Plan.
10.38(20)	Asset Purchase Agreement dated June 20, 2003, by and between Auspex Systems, Inc. and the Company.
10.39(21)	Purchase and Sale Agreement dated July 27, 2004 by and between Cisco Systems, Inc. and the Company.
10.40(22)	Closing Certificate and Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.41(22)	Construction Management Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.42(22)	Lease Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.43(22)	Purchase Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.44(22)	Ground Lease, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.45(24)	Loan Agreement, dated March 31, 2006, by and between the Lenders party hereto and JP Morgan Chase Bank and Network Appliance Global Ltd.
10.46(27)	Closing Certificate and Agreement, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.47(27)	Construction Management Agreement, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.48(27)	Lease Agreement, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.49(27)	Purchase Agreement, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.50(27)	Ground Lease, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.51(26)*	SANPro Systems, Inc. 2001 U.S. Stock Option Plan.
10.52(26)*	Topio, Inc. 2004 Israeli Share Option Plan.
10.53(27)	Master Confirmation, dated December 6, 2006, by and between JP Morgan Securities Inc. and the Company.
10.54(28)	Master Confirmation, dated March 19, 2007, by and between JP Morgan Securities Inc. and the Company.
10.55(30)	Closing Certificate and Agreement, dated July 17, 2007, by and between BNP Leasing Corporation and the Company.

Edgar Filing: NETWORK APPLIANCE INC - Form 10-Q

- 10.56(30) Construction Management Agreement, dated July 17, 2007, by and between BNP Leasing Corporation and the Company.
- 10.57(30) Lease Agreement, dated July 17, 2007, by and between BNP Leasing Corporation and the Company.
- 10.58(30) Purchase Agreement, dated July 17, 2007, by and between BNP Leasing Corporation and the Company.
- 10.59(30) Ground Lease, dated July 17, 2007, by and between BNP Leasing Corporation and the Company.
- 10.60 Master Confirmation, dated August 13, 2007, by and between Bank of America, N.A. and the Company.

**Table of Contents**

<b>Exhibit No</b>	<b>Description</b>
10.61	Secured Credit Agreement, dated October 5, 2007, by and between the Lenders party hereto and JP Morgan Chase Bank and the Company.
31.1	Certification of the Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

- (1) Previously filed as an exhibit to the Company's Registration Statement on Form S-1 (No. 33-97864).
- (2) Previously filed as an exhibit with the Company's Annual Report on Form 10-K dated July 23, 1997.
- (3) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated December 11, 1998.
- (4) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated March 11, 1999.
- (5) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated December 11, 2000.
- (6) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated March 12, 2001.
- (7) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated December 4, 2001.
- (8) Previously filed as an exhibit with the Company's Proxy Statement dated August 21, 1998.
- (9) Previously filed as an exhibit with the Company's Annual Report on Form 10-K dated June 28, 2002.
- (10) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated February 27, 2004.
- (11) Previously filed as an exhibit with the Company's Form S-8 registration statement dated March 1, 2004.
- (12) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated May 4, 2005.
- (13) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated May 18, 2005.
- (14) Previously filed as an exhibit to the Company's Form S-8 registration statement dated June 2, 2005.
- (15) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated July 7, 2005.
- (16) Previously filed as an exhibit to the Company's Proxy Statement dated July 8, 2005.
- (17) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated September 2, 2005.

- (18) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated May 19, 2006.
- (19) Previously filed as an exhibit to the Company's Form S-8 registration statement dated September 2, 2005.
- (20) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated September 3, 2003.
- (21) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated August 31, 2004.
- (22) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated March 7, 2006.
- (23) Previously filed as an exhibit to the Company's Annual Report on Form 10-K dated July 8, 2005.
- (24) Previously filed as an exhibit to the Company's Annual Report on Form 10-K dated July 11, 2006.
- (25) Previously filed as an exhibit to the Company's Form S-8 registration statement dated October 31, 2006.
- (26) Previously filed as an exhibit to the Company's Form S-8 registration statement dated January 5, 2007.
- (27) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated March 7, 2007.
- (28) Previously filed as an exhibit to the Company's Annual Report on Form 10-K dated June 26, 2007.
- (29) Previously filed as an exhibit to the Company's Proxy Statement dated July 25, 2007.
- (30) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated September 5, 2007.

Specified portions of this agreement have been omitted and have been filed separately with the Commission pursuant to a request for confidential treatment.

\* Identifies management plan or compensatory plan or arrangement.

**Table of Contents**

**SIGNATURE**

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NETWORK APPLIANCE, INC.  
(Registrant)

/s/ STEVEN J. GOMO

Steven J. Gomo  
*Executive Vice President of Finance and  
Chief Financial Officer*

Date: December 4, 2007

**Table of Contents**

**EXHIBIT INDEX**

<b>Exhibit No</b>	<b>Description</b>
2.1(7)	Agreement and Plan of Merger of Network Appliance, Inc. (a Delaware corporation) and Network Appliance, Inc. (a California corporation).
2.2(10)	Agreement and Plan of Merger dated as of November 3, 2003, by and among Network Appliance, Inc., Nagano Sub, Inc., and Spinnaker Networks, Inc.
2.3(10)	Amendment to Merger Agreement, dated as of February 9, 2004, by and among Network Appliance, Inc., Nagano Sub, Inc., and Spinnaker Networks, Inc.
2.4(16)	Agreement and Plan of Merger and Reorganization, dated as of June 15, 2005, by and among Network Appliance Inc., Dolphin Acquisition Corp, and Decru, Inc.
3.1(7)	Certificate of Incorporation of the Company.
3.2(7)	Bylaws of the Company.
3.3(18)	Certificate of Amendment to the Bylaws of the Company.
4.1(7)	Reference is made to Exhibits 3.1 and 3.2.
10.1(29)*	The Company's Amended and Restated Employee Stock Purchase Plan.
10.2(8)*	The Company's Amended and Restated 1995 Stock Incentive Plan.
10.3(2)	The Company's Special Non-Officer Stock Option Plan.
10.4(29)*	The Company's Amended and Restated 1999 Stock Incentive Plan.
10.5 (3)	OEM Distribution and License Agreement, dated October 27, 1998, by and between Dell Products L.P. and the Company.
10.6(4)	OEM Distribution and License Agreement, dated November 6, 1998, by and between Fujitsu Limited and the Company.
10.15 (6)	Patent Cross License Agreement dated December 11, 2000, by and between Intel Corporation and the Company.
10.16(1)*	Form of Indemnification Agreement entered into between the Company and its directors and officers.
10.17(9)	Short Form Termination of Operative Documents, dated April 24, 2002, by and between BNP Leasing Corporation and the Company.
10.18(11)*	Spinnaker Networks, Inc. 2000 Stock Plan.
10.19(14)*	Alacritus, Inc. 2005 Stock Plan.
10.20(13)*	The Company's Fiscal Year 2005 Incentive Compensation Plan.
10.21(15)*	The Company's Deferred Compensation Plan.
10.22(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1995 Stock Option Plan.
10.23(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1995 Stock Option Plan (Chairman of the Board or any Board Committee Chairperson).
10.24(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1995 Stock Option Plan (Restricted Stock Agreement).
10.25(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (Restricted Stock Unit Agreement).
10.26(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan.
10.27(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (Change of Control).
10.28(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (China).



Edgar Filing: NETWORK APPLIANCE INC - Form 10-Q

10.29(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (Non-Employee Director Automatic Stock Option - Annual).
10.30(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (Non-Employee Director Automatic Stock Option - Initial).
10.31(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (France).
10.32(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (India).

---

**Table of Contents**

<b>Exhibit No</b>	<b>Description</b>
10.33(23)	Form of Stock Option Agreement approved for use under the Company's amended and restated 1999 Stock Option Plan (United Kingdom).
10.34(19)	Form of Stock Option Grant Notice and Option Agreement under the Decru, Inc. Amended and Restated 2001 Equity Incentive Plan and the 2001 Equity Incentive Plan filed under Attachment II.
10.35(19)	Form of Stock Option Grant Notice and Option Agreement under the Decru, Inc. 2001 Equity Incentive Plan and the 2001 Equity Incentive Plan filed under Attachment II.
10.36(19)	Form of Early Exercise Stock Purchase Agreement under the Decru, Inc. 2001 Equity Incentive Plan.
10.37(19)	Form of Restricted Stock Bonus Grant Notice and Agreement under the Decru, Inc. 2001 Equity Incentive Plan.
10.38(20)	Asset Purchase Agreement dated June 20, 2003, by and between Auspex Systems, Inc. and the Company.
10.39(21)	Purchase and Sale Agreement dated July 27, 2004 by and between Cisco Systems, Inc. and the Company.
10.40(22)	Closing Certificate and Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.41(22)	Construction Management Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.42(22)	Lease Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.43(22)	Purchase Agreement, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.44(22)	Ground Lease, dated December 15, 2005, by and between BNP Leasing Corporation and the Company.
10.45(24)	Loan Agreement, dated March 31, 2006, by and between the Lenders party hereto and JP Morgan Chase Bank and Network Appliance Global Ltd.
10.46(27)	Closing Certificate and Agreement, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.47(27)	Construction Management Agreement, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.48(27)	Lease Agreement, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.49(27)	Purchase Agreement, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.50(27)	Ground Lease, dated December 14, 2006, by and between BNP Leasing Corporation and the Company.
10.51(26)*	SANPro Systems, Inc. 2001 U.S. Stock Option Plan.
10.52(26)*	Topio, Inc. 2004 Israeli Share Option Plan.
10.53(27)	Master Confirmation, dated December 6, 2006, by and between JP Morgan Securities Inc. and the Company.
10.54(28)	Master Confirmation, dated March 19, 2007, by and between JP Morgan Securities Inc. and the Company.
10.55(30)	Closing Certificate and Agreement, dated July 17, 2007, by and between BNP Leasing Corporation and the Company.
10.56(30)	Construction Management Agreement, dated July 17, 2007, by and between BNP Leasing Corporation and the Company.

Edgar Filing: NETWORK APPLIANCE INC - Form 10-Q

10.57(30)	Lease Agreement, dated July 17, 2007, by and between BNP Leasing Corporation and the Company.
10.58(30)	Purchase Agreement, dated July 17, 2007, by and between BNP Leasing Corporation and the Company.
10.59(30)	Ground Lease, dated July 17, 2007, by and between BNP Leasing Corporation and the Company.
10.60	Master Confirmation, dated August 13, 2007, by and between Bank of America, N.A. and the Company.
10.61	Secured Credit Agreement, dated October 5, 2007, by and between the Lenders party hereto and JP Morgan Chase Bank and the Company.

---

**Table of Contents**

<b>Exhibit No</b>	<b>Description</b>
31.1	Certification of the Chief Executive Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
31.2	Certification of the Chief Financial Officer pursuant to Section 302(a) of the Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. section 1350, as adopted pursuant to section 906 of the Sarbanes-Oxley Act of 2002.

- (1) Previously filed as an exhibit to the Company's Registration Statement on Form S-1 (No. 33-97864).
- (2) Previously filed as an exhibit with the Company's Annual Report on Form 10-K dated July 23, 1997.
- (3) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated December 11, 1998.
- (4) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated March 11, 1999.
- (5) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated December 11, 2000.
- (6) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated March 12, 2001.
- (7) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated December 4, 2001.
- (8) Previously filed as an exhibit with the Company's Proxy Statement dated August 21, 1998.
- (9) Previously filed as an exhibit with the Company's Annual Report on Form 10-K dated June 28, 2002.
- (10) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated February 27, 2004.
- (11) Previously filed as an exhibit with the Company's Form S-8 registration statement dated March 1, 2004.
- (12) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated May 4, 2005.
- (13) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated May 18, 2005.
- (14) Previously filed as an exhibit to the Company's Form S-8 registration statement dated June 2, 2005.
- (15) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated July 7, 2005.
- (16) Previously filed as an exhibit to the Company's Proxy Statement dated July 8, 2005.
- (17) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated September 2, 2005.
- (18) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated May 19, 2006.

Edgar Filing: NETWORK APPLIANCE INC - Form 10-Q

- (19) Previously filed as an exhibit to the Company's Form S-8 registration statement dated September 2, 2005.
- (20) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated September 3, 2003.
- (21) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated August 31, 2004.
- (22) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated March 7, 2006.
- (23) Previously filed as an exhibit to the Company's Annual Report on Form 10-K dated July 8, 2005.
- (24) Previously filed as an exhibit to the Company's Annual Report on Form 10-K dated July 11, 2006.
- (25) Previously filed as an exhibit to the Company's Form S-8 registration statement dated October 31, 2006.
- (26) Previously filed as an exhibit to the Company's Form S-8 registration statement dated January 5, 2007.
- (27) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated March 7, 2007.
- (28) Previously filed as an exhibit to the Company's Annual Report on Form 10-K dated June 26, 2007.
- (29) Previously filed as an exhibit to the Company's Proxy Statement dated July 25, 2007.
- (30) Previously filed as an exhibit to the Company's Quarterly Report on Form 10-Q dated September 5, 2007.

Specified portions of this agreement have been omitted and have been filed separately with the Commission pursuant to a request for confidential treatment.

\* Identifies management plan or compensatory plan or arrangement.