

NETWORK APPLIANCE INC

Form 10-Q/A

December 06, 2002

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q/A

(Mark One)

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

For the quarterly period ended July 26, 2002

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 an accelerated filer (as defined in Rule 12 b-2 of the Exchange Act). Yes No

Number of shares outstanding of the registrant's common stock, \$.001 par value, as of the latest practicable date.

Class	Outstanding at October 25, 2002
Common Stock	336,998,969

EXPLANATORY NOTE REGARDING THIS AMENDMENT ON FORM 10-Q/A

Network Appliance Inc. (the Company) is filing this Quarterly Report on Form 10-Q/A for the quarterly period ended July 26, 2002 solely for the purpose of revising certain non-cancelable operating lease commitments disclosed under the contractual obligations table on page 25 of the Form 10-Q filed on August 29, 2002. As a result of this revision, the total operating lease commitments reflect a lower future minimum payment obligation. This revision does not impact the Company's condensed consolidated balance sheet, statement of income or cash flows for any of the periods presented.

The Company is amending only the following section of the Quarterly Report on Form 10-Q to reflect the effect of the revision:

Part I, Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

This amendment does not otherwise update the disclosures set forth in such items originally filed and does not otherwise reflect events occurring after the original filing of the Quarterly Report on Form 10-Q on August 29, 2002.

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

As discussed in the Explanatory Note on the cover of this Form 10-Q/A, certain non-cancelable operating lease commitment disclosures have been revised. The accompanying Management's Discussion and Analysis reflects this revision.

All statements included or incorporated by reference in this Form 10-Q, other than statements or characterizations of historical fact, are forward-looking statements. Examples of forward-looking statements include, but are not limited to, statements concerning projected revenues and profits; research and development expenses; sales and marketing expenses; general and administrative expenses; interest income and other, net; provision for income taxes; realization of deferred tax assets; liquidity and sufficiency of existing cash, cash equivalents, and short-term investments for near-term requirements; purchase commitments; and the effect of recent accounting pronouncements on our financial condition and results of operations. These forward-looking statements are based on our current expectations, estimates and projections about our industry, management's beliefs, and certain assumptions made by us. Forward-looking statements can often be identified by words such as "anticipates," "expects," "intends," "plans," "predicts," "believes," "seeks," "estimates," "may," "will," "should," "would," "potential," "continue," or similar 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. These forward-looking statements speak only as of the date of this Form 10-Q and are based upon the information available to us at this time. Such information is subject to change, and we will not necessarily inform you of such changes. These statements are not guarantees of future performance and are subject to risks, uncertainties and assumptions that are difficult to predict. Therefore, our actual results could differ materially and adversely from those expressed in any forward-looking statements as a result of various factors, some of which are listed under the sections entitled "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations." This discussion should be read in conjunction with our Annual Report on Form 10-K/A for the year ended April 30, 2002. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Overview

Based in Sunnyvale, California, Network Appliance was incorporated in California in April 1992, and reincorporated in Delaware in November 2001. Network Appliance is a world leader in open network storage solutions for the data-intensive enterprise. NetApp network storage solutions and service offerings provide data-intensive enterprises with consolidated storage, improved data center operations, economical business continuance, and efficient remote data access across the distributed enterprise. Network Appliance's success to date has been in delivering highly cost-effective network storage solutions that reduce the complexity associated with conventional storage solutions. We believe our products have set the standard for simplicity and ease of operation, with what we believe to be one of the lowest total costs of ownership and highest returns on investment in the industry. Network Appliance solutions are the data management and storage foundation for leading enterprises, government agencies, and universities worldwide. Since its inception in 1992, Network Appliance has pioneered technology, product, and partner firsts that continue to drive the evolution of storage.

Code of Business Conduct and Ethics

We maintain a code of business conduct and ethics for directors, officers and employees, and will promptly disclose any waivers of the code for directors or executive officers. Our code of business practices addresses conflicts of interest; confidentiality; compliance with laws, rules and regulations (including insider trading laws); and related matters.

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Note 2 to the Consolidated Financial Statements in the Annual Report on Form 10-K/A for the fiscal

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year ended April 26, 2002 describes the significant accounting policies and methods used in the preparation of the Consolidated Financial Statements. The preparation of these Consolidated Financial Statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses, and related disclosure of contingent assets and liabilities. We evaluate, on an ongoing basis, our estimates and judgments, including those related to sales returns, bad debts, excess inventory and purchase commitments, investments, long-lived assets, restructuring accruals, income taxes, and loss contingencies. We base our estimates on historical experience and assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates.

We believe the accounting policies described below, among others, are the ones that most frequently require us to make estimates and judgments, and therefore are critical to the understanding of our results of operations:

revenue recognition and allowances;

inventory write-down;

restructuring accruals;

loss contingencies;

impairment losses on investments; and

accounting for income taxes.

Revenue Recognition and Allowances

We apply the provisions of Statement of Position (SOP) 97-2, Software Revenue Recognition (as amended by SOP 98-4 and SOP 98-9), and related interpretations to all revenue transactions. We recognize revenue when:

Persuasive Evidence of an Arrangement Exists. It is our customary practice to have a purchase order prior to recognizing revenue on an arrangement.

Delivery Has Occurred. Our product is physically delivered to our customers, generally with standard transfer terms as FOB shipping point. Products shipped with acceptance criteria or return rights are not recognized as revenue until all criteria are achieved. If undelivered products or services exist that are essential to the functionality of the delivered product in an arrangement, delivery is not considered to have occurred.

The Fee Is Fixed or Determinable. Arrangements with payment terms extending beyond our standard terms and condition practices are not considered to be fixed or determinable. Revenue from such arrangements is recognized as the fees become due and payable.

Collection Is Probable. Probability of collection is assessed on a customer-by-customer basis. Customers are subjected to a credit review process that evaluates the customers' financial position and ultimately their ability to pay. If it is determined from the outset of an arrangement that collection is not probable based upon our review process, revenue is recognized upon cash receipt.

For arrangements with multiple elements, we allocate revenue to each element using the residual method based on vendor specific objective evidence of the undelivered items. We defer the portion of the arrangement fee equal to the fair value of the undelivered elements until they are delivered. Vendor specific objective evidence is based on the price charged when the element is sold separately.

A typical arrangement includes product, software subscription, and maintenance. Some arrangements include training and consulting. Software subscriptions include unspecified products upgrades and enhancements on a when-and-if-available basis, bug fixes, and patch releases, and are included in product revenues. Service maintenance includes contracts for technical support and hardware maintenance. Revenue from software subscriptions and maintenance is recognized ratably over the contractual term, generally one to three years. Revenue from training and consulting is recognized as the services are performed.

We record reductions to revenue for estimated sales returns at the time of shipment. These estimates are based on historical sales returns, changes in customer demand, and other factors. If actual future returns and allowances differ from past experience, additional allowances may be required.

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Allowance for Doubtful Accounts

We also maintain a separate allowance for doubtful accounts for estimated losses based on our assessment of the collectibility of specific customer accounts and the aging of the accounts receivable. We analyze accounts receivable and historical bad debts, customer concentrations, customer solvency, current economic and geographic trends, and changes in customer payment terms and practices when evaluating the adequacy of the allowance for doubtful accounts. If the financial condition of our customers deteriorates, resulting in an impairment of their ability to make payments, additional allowances may be required.

Inventory Write-down

We write down inventory and record purchase commitment liabilities for estimated excess and obsolete inventory equal to the difference between the cost of inventory and the estimated fair value based upon assumptions about future demand and market conditions. Although we strive for accuracy in our forecasts of future product demand, any significant unanticipated changes in demand or technological developments could have a significant impact on the value of our inventory and commitments, and our reported results. If actual market conditions are less favorable than those projected, additional write-downs and other charges against earnings may be required. If actual market conditions are more favorable, we may realize higher gross margin in the period when the written-down inventory is sold.

We engage in extensive product quality programs and processes, including actively monitoring and evaluating the quality of our component suppliers. We also provide for the estimated cost of known product failures based on known quality issues when they arise. Should actual cost of product failure differ from our estimates, revisions to the estimated liability would be required.

Restructuring Accruals

In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in workforce and a consolidation of facilities. These restructuring accruals were accounted for in accordance with Emerging Issues Task Force (EITF) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring) , and included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. These estimates are reviewed and revised periodically and may result in a substantial change to restructuring expense should different conditions prevail than were anticipated in original management estimates. See footnote 12 Restructuring Charges for further discussion.

Loss Contingencies

We are subject to the possibility of various loss contingencies arising in the ordinary course of business. We consider the likelihood of the loss or impairment of an asset or the incurrence of a liability as well as our ability to reasonably estimate the amount of loss in determining loss contingencies. An estimated loss contingency is accrued when it is probable that a liability has been incurred or an asset has been impaired and the amount of loss can be reasonably estimated. We regularly evaluate current information available to us to determine whether such accruals should be adjusted.

Impairment Losses on Investments

Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value, and such a decline is not considered temporary. Our investments in privately held companies are considered impaired when a review of the investees operations and other indicators of impairment indicate that the carrying value of the investment is not likely to be recoverable. Such indicators include, but are not limited to, limited capital resources, limited prospects of receiving additional financing, and limited prospects for liquidity of the related securities. In the first quarter of fiscal 2003, we recorded a non-cash, other-than-temporary write down of \$0.7 million related to impairments of our investments in a publicly traded company.

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Accounting for Income Taxes

The determination of our tax provision is subject to judgments and estimates due to operations in several tax jurisdictions outside the United States. Earnings derived from our international business are generally taxed at rates that are lower than U.S. rates, resulting in a reduction of our effective tax rate. The ability to maintain our current effective tax rate is contingent upon existing tax laws in both the United States and in 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 and expect to receive from international business. In addition, a decrease in the percentage of our total earnings from our international business or in the mix of international business among particular tax jurisdictions could increase our overall effective tax rate. Also, our current effective tax rate assumes that U.S. income taxes are not provided for undistributed earnings of certain non-U.S. subsidiaries. These earnings could become subject to incremental foreign withholding or federal and state income taxes should they be either deemed or actually remitted to the U.S.

The carrying value of our net deferred tax assets, which is made up primarily of income tax deductions, credits, and net operating loss carryforwards resulting from stock option exercises, assumes that we will be able to generate sufficient future income to fully utilize these tax deductions and credits. If we do not generate sufficient future income, the realization of these deferred tax assets may be impaired resulting in additional income tax expense. We have provided a valuation allowance on certain of our deferred tax assets because of uncertainty regarding their realizability due to expectation of future employee stock option exercises.

New Accounting Standards

In June 2001, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives will be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but rather will be tested at least annually for impairment. We adopted SFAS No. 142 effective May 1, 2002. Upon adoption of SFAS No. 142, we discontinued the amortization of our recorded goodwill of \$49.4 million as of that date, identified our reporting units based on our current segment reporting structure and allocated all recorded goodwill, as well as other assets and liabilities, to the reporting units. We concluded that our reporting units are the same as our operating segments. Under SFAS No. 142, 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. As of May 1, 2002, this evaluation indicated that the fair value for each of our reporting units exceeded the reporting unit's carrying amount and no impairment was recognized. On an ongoing basis, we will perform our impairment tests annually (or more frequently if indicators of impairment arise). There can be no assurance that future impairment tests will not result in a charge to earnings.

In connection with the adoption of SFAS No. 142, we also reassessed the useful lives and the classification of our purchased intangible assets and determined that they continued to be appropriate except for acquired workforce net of deferred tax liabilities of \$0.5 million, which was reclassified into goodwill.

The amounts allocated to existing technology are being amortized over an estimated useful life of three years. Estimated future amortization expense is \$4.1 million for the remaining nine months of fiscal 2003. For fiscal 2004, estimated future amortization expense is \$3.0 million.

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A reconciliation of our previously reported net income (loss) and net income (loss) per share to amounts for the exclusion of goodwill amortization net of the related income tax effect follows:

	Three Months Ended	
	July 26, 2002	July 27, 2001
	(In thousands)	
Net income (loss), as reported	\$ 16,165	\$ (513)
Add: Goodwill amortization, including acquired workforce		3,794
	<u> </u>	<u> </u>
Adjusted net income (loss)	\$ 16,165	\$ 3,281
	<u> </u>	<u> </u>
Basic net income (loss) per share, as reported	\$ 0.05	\$ (0.00)
Goodwill amortization, including acquired workforce		0.01
	<u> </u>	<u> </u>
Adjusted basic net income per share	\$ 0.05	\$ 0.01
	<u> </u>	<u> </u>
Diluted net income (loss) per share, as reported	\$ 0.05	\$ (0.00)
Goodwill amortization, including acquired workforce		0.01
	<u> </u>	<u> </u>
Adjusted diluted net income per share	\$ 0.05	\$ 0.01
	<u> </u>	<u> </u>

On May 1, 2002, we adopted SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*, which addresses financial accounting and reporting for the impairment or disposal of long-lived assets. The adoption did not have a significant effect on our financial position and results of operations.

In June 2002, FASB issued SFAS No. 146, *Accounting for Costs Associated with Exit or Disposal Activities*, which addresses accounting for restructuring and similar costs. SFAS No. 146 supersedes previous accounting guidance, principally EITF Issue No. 94-3. We will adopt the provisions of SFAS No. 146 for restructuring activities initiated after December 31, 2002. SFAS No. 146 requires that the liability for costs associated with an exit or disposal activity be recognized when the liability is incurred. Under EITF Issue No. 94-3, a liability for an exit cost was recognized at the date of the Company's commitment to an exit plan. SFAS No. 146 also establishes that the liability should initially be measured and recorded at fair value. Accordingly, SFAS No. 146 may affect the timing of recognizing future restructuring costs as well as the amounts recognized.

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

	Three Months Ended	
	July 26, 2002	July 27, 2001
Revenues:	100.0%	100.0%
Product Revenue	90.3	92.5
Service Revenue	9.7	7.5
Cost of Revenues:		
Cost of Product Revenue	30.1	37.6
Cost of Service Revenue	7.5	6.3
Gross Profit	<u>62.4</u>	<u>56.1</u>
Operating Expenses:		
Sales and Marketing	34.7	35.8
Research and Development	13.5	14.5
General and Administrative	3.6	5.1
Amortization of Intangible Assets	0.7	2.6
Stock Compensation	0.5	1.4
Total Operating Expenses	<u>53.0</u>	<u>59.4</u>
Income (Loss) From Operations	9.4	(3.3)
Other Income, Net	1.0	2.8
Income (Loss) Before Income Taxes	10.4	(0.5)
Provision (Benefit) for Income Taxes	2.6	(0.2)
Net Income (Loss)	<u>7.8%</u>	<u>(0.3)%</u>

Product Revenues Product revenues increased by 0.7% to \$186.7 million for the first quarter of fiscal 2003, from \$185.5 million for the first quarter of fiscal 2002. The increase in product revenues was primarily in North America and Europe. This increase in product revenues for the first quarter of fiscal 2003 was specifically attributable to increased software licenses while offset by a decrease in units shipped, as compared to the first quarter of fiscal 2002.

Product revenues were favorably impacted by the following factors:

increased sales from industry verticals including, energy, telecommunications, financial services, manufacturing, life sciences, and the government;

a higher average selling price of our new products: our F800 series, F87 filer products, as well as R100 nearline storage appliances and software features;

competitive pricing advantage as a result of lower total cost of ownership in four aspects: lower acquisition cost, reduced administrative overhead, minimized service cost, and reduced downtime of critical business applications;

data management software offering a unique set of features to ensure mission-critical availability, while reducing the complexity of enterprise storage management;

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higher sales of software subscription upgrades, representing 7.2% and 5.8% of total revenues for the first quarter of fiscal 2003 and 2002, respectively;

increased revenue from NearStore™ appliances for business continuance and online recovery;

introduction of the new NetCache® C2100 mid-range content delivery platform and solutions for enterprise and service provider customers; and

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increased sales through indirect channels, including sales through our OEM partners, representing 42.1% and 41.7% of total net revenues for the first quarter of fiscal 2003 and 2002, respectively.

Product revenues were negatively impacted by the following factors:

continued weakness in demand for our products resulting from unfavorable economic conditions and capital spending environment;

continued weakness in technology spending from Internet- and technology-related customers;

declining average selling price of the F700 filers and older caching products; and

declining unit sales of our older products.

Service Revenues Service revenues increased by 34.2% to \$20.1 million in the first quarter of fiscal 2003, from \$15.0 million in the first quarter of fiscal 2002. Service revenues are generally deferred and, in most cases, recognized ratably over the service period obligations, which are typically one to three years. The increase in service revenues (representing 9.7 % and 7.5% of total revenues for the first quarter of fiscal 2003 and 2002, respectively) was primarily related to a growing installed base resulting in new customer support contracts in addition to support contract renewals by existing customers.

International total revenues (including United States exports) decreased by 0.8% for the first quarter of fiscal 2003 as compared to the first quarter of fiscal 2002. International total revenues were \$77.5 million, or 37.5% of total revenues for the first quarter of fiscal 2003. The decline in international sales was primarily a result of a slower demand in the Asia Pacific markets offset by our increased sales and marketing efforts internationally.

Product Gross Margin Product Gross margin increased to 66.7% for the first quarter of fiscal 2003, from 59.4% for the first quarter of fiscal 2002.

Product gross margin was favorably impacted by:

lower costs of key components and subsystems;

favorable product and software mix;

a faster-than-expected shift to our new high-density storage subsystem due to a favorable average selling price on the enclosures, electronics and power systems sold with the disk systems, and efficient hardware packaging;

higher average selling prices for our new products; and

growth in software subscription upgrades and software licenses due primarily to a larger installed base.

Product gross margin was negatively impacted by:

sales price reductions due to competitive pricing pressure and selective pricing discounts;

lower average selling price of certain add-on software options;

higher disk content with an expanded storage capacity for the higher-end filers including the F840 and F880 filers; and

a vacation benefit in the first quarter of fiscal 2002 due to a partial holiday shutdown.

Service Gross Margin Service gross margin increased to 23.0% for the first quarter of fiscal 2003 as compared to 15.2% in the first quarter of fiscal 2002. Investments in customer service increased by 21.8% to \$15.5 million in the first quarter of fiscal 2003, from \$12.7 million in the first quarter of fiscal 2002. The improvement in service gross margin in the first quarter of fiscal 2003 was primarily due to operational and cost efficiencies in the global customer service organizations. The lower service gross margin in the first quarter of fiscal 2002 was due to the ramping up of our service infrastructure in anticipation of service revenue growth.

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Sales and Marketing Sales and marketing expenses consist primarily of salaries, commissions, advertising and promotional expenses, and certain customer service and support costs. Sales and marketing expenses increased 0.4% to \$71.9 million for the first quarter of fiscal 2003, from \$71.6 million for the first quarter of fiscal 2002. These expenses were 34.7% and 35.8% of total revenues for the first quarter of fiscal

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2003 and fiscal 2002, respectively. The slight increase in absolute dollars was attributed to the continued worldwide investment in our sales and customer service organizations, offset by the various cost control and reduction measures, restructuring impact, and a favorable impact from a change in health insurance estimates. Sales and marketing headcount decreased to 1,265 at July 26, 2002 from 1,316 at July 27, 2001 primarily due to the restructuring impact. We expect to continue to selectively add sales capacity in an effort to expand domestic and international markets, introduce new products, establish and expand new distribution channels, and increase product and company awareness. We expect to increase our sales and marketing expenses commensurate with future revenue growth.

Research and Development Research and development expenses consist primarily of salaries and benefits, prototype expenses, non-recurring engineering charges, and fees paid to outside consultants. Research and development expenses decreased 4.2% to \$27.9 million for the first quarter of fiscal 2003 from \$29.1 million for the first quarter of fiscal 2002. These expenses represented 13.5% and 14.5% of total revenues for the first quarter of fiscal 2003 and 2002, respectively. Research and development expenses decreased in absolute dollars, primarily as a result of cost control, reduction in discretionary spending efforts, restructuring impact, lower headcount, and a favorable impact from a change in health insurance estimates, partially offset by a vacation benefit in the first quarter of fiscal 2002 due to a partial holiday shutdown. Research and development headcount decreased to 522 at July 26, 2002 from 567 at July 27, 2001. We expect to continuously support current and future product development and enhancement efforts, and incur prototyping expenses and non-recurring engineering charges associated with the development of new products and technologies.

During the first quarter of fiscal 2003, we continued our enterprise focus by expanding our data management and content delivery solutions with the introduction of the NetCache C2100. This new appliance combines scalability, high data reliability, and greater storage capacity providing superior performance and density. The NetCache C2100 supports multiple applications on a single unit, including streaming media, acceleration of business applications such as ERP and CRM, and Internet access management.

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 intend to continuously expand our existing product offerings and introduce new products, and expect that expenditures for these purposes will increase in absolute dollars. For both the first quarter of fiscal 2003 and 2002, no software development costs were capitalized.

General and Administrative General and administrative expenses decreased 27.5% to \$7.4 million for first quarter of fiscal 2003, from \$10.3 million for the first quarter of fiscal 2002. These expenses represented 3.6% and 5.1% of total revenues for the first quarter of fiscal 2003 and 2002, respectively. Decreases in absolute dollars were primarily due to a benefit from the successful collection of previously accrued customer-specific bad debt allowance of approximately \$1.5 million, cost control, reduction in discretionary spending efforts, restructuring impact, and reduced headcount, partially offset by expenses associated with initiatives to enhance and implement an enterprise-wide ERP system and a vacation benefit in the first quarter of fiscal 2002 due to a partial holiday shutdown. General and administrative headcount decreased to 256 at July 26, 2002 from 261 at July 27, 2001. We believe that our general and administrative expenses will not increase significantly in absolute dollars in fiscal 2003 as compared to the prior year.

Amortization of Goodwill Due to the adoption of SFAS No. 142, goodwill is no longer amortized in the first quarter of fiscal 2003 as compared to amortization expense of \$3.8 million in the first quarter of fiscal 2002.

Amortization of Purchased Intangible Assets Intangible assets as of July 26, 2002, including existing technology, are amortized over estimated useful lives of three years. Amortization of existing technology included in operating expenses was \$1.4 million for both the first quarter of fiscal 2003 and 2002. Estimated future amortization expense is \$4.1 million for the remaining nine months of fiscal 2003. For fiscal 2004, estimated future amortization expense is \$3.0 million.

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Stock Compensation We account for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board (APB) No. 25, Accounting for Stock Issued to Employees, and comply with the provisions of SFAS No. 123, Accounting for Stock-Based Compensation, for non-employee compensation awards. Accordingly, we recognize the intrinsic value for employees and the fair value for non-employees as stock compensation expense over the vesting terms of the awards. Stock compensation expenses were \$1.0 million and \$2.7 million in the first quarter of fiscal 2003 and 2002, respectively. This decrease was primarily attributable to the decrease of stock compensation expenses as a result of forfeitures of unvested options assumed in the WebManage Technologies, Inc. acquisition and the release of 66,124 contingently issuable milestone shares relating to Orca valued at \$1.4 million in the first quarter of fiscal 2002, partially offset by additional stock compensation relating to the fair value of options granted to a member of the Board of Directors valued at \$0.3 million. We expect additional stock compensation may result from 99,187 contingently issuable shares relating to Orca, to be measured on the date the performance criteria are met.

Restructuring charges In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in workforce and a consolidation of facilities. As a result of the restructuring in August 2001, we incurred a charge of \$8.0 million. The restructuring charge included \$4.8 million of severance-related amounts, \$2.7 million of committed excess facilities and facility closure expenses, and \$0.5 million in fixed assets write-offs. The reserve balance of \$0.5 million at July 26, 2002 was included in other accrued liabilities.

During fiscal 2002, we purchased our Sunnyvale headquarters site and terminated the operating leases. As a result, an adjustment was made to reduce the previously recorded estimated facilities lease losses by \$1.5 million.

The following analysis sets forth the significant components of the second quarter fiscal 2002 restructuring at July 26, 2002 (in thousands):

	Severance- related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge (August 2001)	\$ 4,796	\$ 528	\$ 2,656	\$ 7,980
Cash payments	(4,497)		(803)	(5,300)
Non-cash portion		(528)	(40)	(568)
Adjustments	(95)		(1,509)	(1,604)
Reserve balance at July 26, 2002	\$ 204	\$	\$ 304	\$ 508

In April 2002, we completed a restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters. As a result of this restructuring, we incurred a charge of \$5.9 million. The restructuring charge included \$0.8 million of severance-related amounts, \$4.6 million of committed excess facilities and facility closure expenses, and \$0.5 million in fixed assets write-offs. Of the reserve balance at July 26, 2002, \$0.8 million was included in other accrued liabilities and the remaining \$3.5 million was classified as long-term obligations.

The following analysis sets forth the significant components of the fourth quarter fiscal 2002 restructuring at July 26, 2002 (in thousands):

	Severance- related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge (April 2002)	\$ 813	\$ 473	\$4,564	\$ 5,850
Cash payments	(706)		(317)	(1,023)
Non-cash portion		(473)		(473)
Reserve balance at July 26, 2002	\$ 107	\$	\$4,247	\$ 4,354

We expect annual cost savings of approximately \$29.8 million as a result of the restructuring and reduction in workforce actions taken in the second and fourth quarters of fiscal 2002. Our estimates are

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reviewed and revised periodically and may change should different conditions prevail than were anticipated in original management estimates.

Interest income Interest income was \$3.2 million and \$5.5 million for the first quarter of fiscal 2003 and 2002, respectively. The decrease in interest income was primarily due to lower average interest rates, and lower investment balances as we utilized \$249.8 million to purchase the land and buildings at our Sunnyvale facility in April 2002.

Other income (expense), net The first quarter of fiscal 2003 included a net loss of \$1.0 million from foreign currency transactions as compared to an insignificant gain for the first quarter of fiscal 2002.

Impairment loss on investments Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value, and such a decline is not considered temporary. In the first quarter of fiscal 2003, we recorded a noncash, other-than-temporary write down of \$0.7 million related to the impairment of our investment in a publicly traded company.

Gain on sale of intangible asset We recorded a gain on sale of intangible asset of \$0.6 million in the first quarter of fiscal 2003 related to the sale of our ContentReporter software. We intend to resell this software through a licensing arrangement.

Provision (Benefit), for Income Taxes For the first quarter of fiscal 2003, we applied an annual tax rate of 25% to pretax income. Our estimate is based on existing tax laws and our current projections of income (loss) and distributions of income (loss) among different entities and tax jurisdictions, and is subject to change, based primarily on varying levels of profitability.

Liquidity and Capital Resources

We derive our liquidity and capital resources primarily from our cash flow from operations and from working capital, which increased by \$27.0 million to \$490.6 million as of July 26, 2002, compared to \$463.6 million as of April 30, 2002. As of July 26, 2002, as compared to the April 30, 2002 balances, our cash, cash equivalents, and short-term investments increased by \$24.7 million to \$478.8 million. We generated cash from operating activities totaling \$26.9 million and \$5.9 million for the first quarter of fiscal 2003 and 2002, respectively. Net cash provided by operating activities in the first quarter of fiscal 2003 was principally related to net income of \$16.2 million, decreases in accounts receivable, and increases in accounts payable, other accrued liabilities, income taxes payable, deferred revenue, coupled with depreciation, impairment loss on investments, amortization of intangibles and stock compensation, partially offset by decreased accrued compensation and related benefits and increases in inventories and prepaid expenses and other assets.

We used \$14.4 million and \$6.8 million of cash in the first quarter of fiscal 2003 and 2002, respectively, for capital expenditures. The increase was primarily attributed to upgrades of our ERP infrastructure, computer-related purchases, and building improvements. We have received net proceeds of \$18.5 million and used \$38.5 million in the first quarter of fiscal 2003 and 2002, respectively, for net purchases of short-term investments. Investing activities in the first quarter of fiscal 2003 and 2002 also included new investments in privately-held companies of \$0.3 million and \$0.2 million, respectively.

We received \$10.3 million and \$6.9 million in the first quarter of fiscal 2003 and 2002, respectively, from financing activities. The increase in the first quarter of fiscal 2003 was primarily due to the elimination of a restricted cash requirement resulting from the termination of our operating leases in April 2002, partially offset by lower proceeds from stock option exercises as a result of the decline in our stock price.

Our capital and liquidity requirements depend on numerous factors, including risks relating to fluctuating operating results, continued growth in the network storage and content delivery markets, customer and market acceptance of our products, dependence on new products, rapid technological change, dependence on qualified technical and sales personnel, risk inherent in our international operations, competition, reliance on a limited number of suppliers and contract manufacturers, dependence on proprietary technology, intellectual property rights, the value of our investments in equity securities and real estate, and other factors. We believe that our existing liquidity and capital resources are sufficient to fund our operations for at least the next twelve months.

Table of Contents***Contractual Obligations***

The following summarizes our contractual obligations at July 26, 2002, and the effect such obligations are expected to have on our liquidity and cash flow in future periods, (in thousands):

	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>Thereafter</u>	<u>Total</u>
Operating lease payments	\$ 7,743	\$ 9,281	\$ 7,833	\$ 5,565	\$ 2,957	\$ 11,475	\$ 44,854
Venture capital funding commitments	850	1,133	1,133	1,134			4,250
Purchase commitments	3,365						3,365
	<u>\$ 11,958</u>	<u>\$ 10,414</u>	<u>\$ 8,966</u>	<u>\$ 6,699</u>	<u>\$ 2,957</u>	<u>\$ 11,475</u>	<u>\$ 52,469</u>

Risk Factors

The following risk factors and other information included in this Form 10-Q/A 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 occur, our business, operating results, and financial condition could be materially adversely affected.

Factors beyond our control could cause our quarterly results to fluctuate.

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 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;
- the 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;
- 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 pricing by us or our competitors;

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

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 facilities; and

seasonality.

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In addition, sales for any future quarter may vary and accordingly be inconsistent with our plans. 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 network storage market is rapidly evolving and our sales cycle varies substantially from customer to customer.

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

Our gross margins may vary based on the configuration of our products.

We derive a significant portion of our sales from the resale of disk drives as components of our filers, 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 filer products. As a result, as we sell more highly configured systems with greater disk drive content, overall gross margin percentages will be negatively affected. Conversely, we believe our increased licensing of add-on software products may favorably impact gross margins.

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

demand for storage and content delivery products;

discount levels and price competition;

direct versus indirect sales;

the mix of software as a percentage of revenue;

the mix of services as a percentage of revenue;

the mix and average selling prices of products;

new product introductions and enhancements;