

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-K

(MARK ONE)

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

FOR THE FISCAL YEAR ENDED APRIL 25, 1997

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)

CALIFORNIA  
(STATE OR OTHER JURISDICTION OF  
INCORPORATION OR ORGANIZATION)

77-0307520  
(I.R.S. EMPLOYER IDENTIFICATION NO.)

2770 SAN TOMAS EXPRESSWAY  
SANTA CLARA, CALIFORNIA 95051  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICE, INCLUDING ZIP CODE)

(408) 367-3000  
(REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE)

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:  
None

TITLE OF EACH CLASS	NAME OF EXCHANGE ON WHICH REGISTERED
none	none

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:  
Common Stock (no par value)

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 a check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

The aggregate market value of voting stock held by non-affiliates of the Registrant, as of May 31, 1997 was approximately \$497,013,000 (based on the closing price for shares of the Registrant's common stock as reported by the Nasdaq National Market System for the last trading day prior to that date). Shares of common stock held by each executive officer, director, and holder of 5% or more of the outstanding common stock have been excluded in that such persons may be deemed to be affiliates. This determination of affiliate status

is not necessarily a conclusive determination for other purposes.

On May 31, 1997 approximately 16,665,993 shares of the Registrant's common stock, no par value, were outstanding.

#### DOCUMENTS INCORPORATED BY REFERENCE

Certain information called for by Part III is incorporated by reference from designated sections of the definitive Proxy Statement for the Annual Meeting of Shareholders to be held September 25, 1997, which will be filed with the Securities and Exchange Commission not later than 120 days after April 25, 1997.

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2

This Annual Report on Form 10-K contains forward looking statements that are accompanied by cautionary statements that identify important factors that could cause actual results to differ materially from those in the forward looking statements.

#### PART I

##### ITEM 1. BUSINESS

###### OVERVIEW

Network Appliance, Inc. (the "Company" or "Network Appliance") designs, manufactures, markets and supports high performance network data storage devices which provide fast, simple, reliable and cost effective file service for data-intensive network environments. The Company pioneered the concept of the "network appliance," an extension of the industry trend towards dedicated, specialized devices which perform a single function in the network, similar to the adoption of the router for network communications management. The Company's filer products combine specialized proprietary software and state-of-the-art industry standard hardware to provide a unique solution for the NFS, Common Internet File System ("CIFS"), and HTTP server markets.

###### ACQUISITION

In March 1997, the Company acquired all outstanding shares and options to purchase shares of Internet Middleware Corporation ("IMC") common stock by issuing 187,023 shares of the Company's common stock and options to purchase shares of the Company's common stock. Certain key employees of IMC who continued as employees of the Company were also granted vested options to purchase shares of the Company's common stock at a discount to the market price of the Company's common stock immediately preceding the acquisition. In connection with the granting of these options, the Company recorded a compensation charge of \$3.2 million in the fourth quarter of fiscal 1997. The acquisition was accounted for as a purchase and, accordingly, the results of operations of IMC from the date of acquisition forward have been included in the Company's consolidated financial statements. A substantial portion of the purchase price was charged to expense as purchased in-process technology.

###### INDUSTRY BACKGROUND

In response to competitive pressures, businesses and other organizations are increasingly investing in information systems to shorten product development cycles, enhance customer responsiveness, lower costs, and improve the quality of their products and services. Networked computing offers these organizations the ability to increase productivity through the distribution of computing power across their enterprises, providing large numbers of users with access to applications, information and data. In this environment, it has become important for organizations to manage the storage of and access to large volumes of data, which increasingly represent critical information resources.

###### Data-Intensive Network Environment

Network computing environments that require large volumes of data, perform intensive processing or computation of data, or involve frequent user access to data can be characterized as "data-intensive." Increasingly, organizations are deploying data-intensive applications and services as core business resources. In addition, Internet and on-line service related businesses have grown significantly. The data-intensity of the network environment is expected to

continue to increase substantially due to the development of new applications and services and the more prevalent use of stored digital graphics, voice and video, requiring dramatically more data capacity than equivalent alphanumeric information. Examples of data-intensive applications and services include:

Data-Intensive Applications -- Data-intensive applications have become increasingly prevalent in a variety of industries. Computer-aided design, manufacturing and engineering ("CAD/CAM/CAE") are data-intensive applications in which teams of engineers collaborate on a common design for a product such as

2

3

a semiconductor device, computer system, aircraft or automobile. Software development is also inherently data-intensive, involving the creation and compilation by teams of developers of hundreds of thousands of lines of software code which must be continuously tested, revised and recompiled. Energy, seismic and satellite-related applications also involve the storage and manipulation of large quantities of graphics and imaging data. Within the securities industry, large volumes of trading and other market data need to be compiled and rapidly processed in order to support trading decisions. Airline reservation systems also involve the access to and processing of large quantities of data related to flight schedules, equipment configurations, passenger information and seat availability.

Data-Intensive Services -- Internet and public on-line services have become increasingly data intensive. Organizations are also providing internal on-line data repositories that can be accessed internally as well as by outside users. As these services have proliferated, they have become "information utilities" where increasing amounts of data are stored for broad availability to large numbers of distributed users.

#### Issues in Data Management and Network Computing

Organizations utilizing data-intensive applications and services in network computing environments generally share a common set of requirements in order to derive the benefits that they are designed to provide. In this context, data management has become increasingly complex and challenging. Specifically, three significant problem areas have emerged: (i) data access performance; (ii) data administration; and (iii) data availability and reliability.

Data Access Performance -- Traditionally, management information systems ("MIS") managers and network providers improved performance on a network by increasing central processing unit ("CPU") performance or increasing the underlying network bandwidth. In today's data-intensive network environment, performance of applications and services is increasingly limited by the time to read or write to hard disk drives. Improvements in performance for most applications and services have been limited by disk input/output ("I/O") performance, which because of the mechanical nature of disk drives, has not improved as rapidly as CPU performance or network bandwidth.

Data Administration -- A key requirement in data administration is the management of hardware and software systems that store the data. In the data-intensive network environment, data management is difficult and complex due to the large number of users accessing the data, the multiple servers storing the data and the large volume of data. Furthermore, because data may be widely distributed throughout the network, administrative functions such as back-up or expansion of the file system become substantially more difficult. Finally, the budgetary constraints of most organizations require that this increasingly complex administration be accomplished cost-effectively, without increased staffing.

Data Availability and Reliability -- As the data-intensive network environment grows, data availability becomes critical to the organization's productivity, time-to-market and responsiveness to customers. Achieving a high level of data availability is particularly difficult because hard disk drives are mechanical devices, which are prone to failure over extended periods of intensive use. An organization may experience costly down-time or loss of data from the failure of a single low-cost, network-attached disk drive. This is particularly important to network service providers whose business is providing network-stored data to their users. Therefore, it is imperative that systems which are repositories of network-based data and services have low failure rates, rapid recovery times and the ability to provide uninterrupted service in the event of failure of a disk drive.

## File Servers

The requirements of the data-intensive network environment have contributed to the growing importance of the network file service function, the process of reading and writing files to and from shared data storage over the network. Until recently, the file service function had been performed exclusively by larger, general purpose computer systems which also executed other tasks such as print serving, application processing and communications functions. As networks evolved, network managers increasingly dedicated general purpose

3

4

systems specifically to the file service task in order to enhance performance, simplify administration and reduce vulnerability to other application-related failures. These dedicated systems became known as "file servers."

Systems vendors have offered a variety of specially configured and add-on solutions for general purpose systems deployed as file servers. Selected vendors have also introduced highly specialized, hardware-intensive systems architected to exclusively perform the file service task. These approaches, such as the use of hardware accelerators and the introduction of specialized hardware architectures, were generally optimized for throughput (the number of I/O requests processed by the CPU). Although these file server approaches addressed throughput issues, they were not designed to address the specific problem of response time (the speed at which an I/O request is satisfied) which is critical in the data-intensive network environment. In addition, because these approaches lack the flexibility to easily integrate additional network, file system and/or disk interfaces or protocols associated with today's heterogeneous networks, these approaches do not directly address the reliability issues associated with data storage on a network. Consequently, users are searching for cost-effective, flexible solutions to address data access performance, data administration and data availability and reliability issues in the data-intensive network environment.

### THE NETWORK APPLIANCE SOLUTION

Network Appliance pioneered the concept of a "network appliance," a fast, simple, reliable and cost-effective device designed to perform a specific network data management function. The network appliance concept is part of the trend towards the specialization of network devices, including the development of routers, dedicated devices that manage network communications functions previously performed by general purpose computer systems. The Company's network appliance product line consists of network data storage appliances or "filers," developed to address the specific market requirements of data-intensive network environments. These products utilize an efficient software kernel optimized to exclusively perform the file service task. Unlike previous file server approaches, these products are not burdened by a general purpose operating system or file system overhead. By using a proprietary software architecture, Network Appliance is able to use industry standard hardware components rather than specialized hardware. The core elements of the Network Appliance solution are:

Fast Response Time -- Network Appliance uses its proprietary Write Anywhere File Layout ("WAFL") software architecture and a sophisticated caching scheme coupled with industry standard processor architectures and I/O buses to achieve response time over the network substantially faster than competing products. Faster response times result in faster execution of applications and services in data-intensive network environments. The filer's response time is significantly faster than either general purpose computers or specialized hardware-centric file servers. In addition, the Company's products are characterized by less variation in response times under increasing aggregate loads than competing products.

Network Appliance believes its approach enables its customers to meet the performance needs of future data-intensive applications and services. The Company's technology has allowed it to achieve substantial improvements in response time by adopting faster industry standard microprocessors, while competitive solutions have been generally limited by disk access time. For example, successive releases of Network Appliance software on the Intel 486 or Pentium(R)-based platforms, in addition to supporting incremental functionality, have succeeded in reducing response times.

Ease of Administration -- Network Appliance products are easy to use and install. Installation by a systems administrator typically requires less than an hour. Administration requires knowledge of approximately 40 system commands, versus the hundreds of commands typical of alternative products. Network Appliance's Snapshot feature allows on-line back-up of an active file system without interrupting users. This feature also allows users on-line access to earlier versions of their data without involving the systems administrator. During fiscal 1997, the Company introduced a Web-based graphical user interface ("GUI") administration tool called FilerView(TM) which allows for filer administration using a standard web browser. Together, these features simplify administration, permit more efficient use of personnel resources and increase data availability.

4

5

High Levels of Data Availability and Reliability -- Network Appliance products are designed to provide high levels of data availability. Traditional servers do not have an integrated facility to efficiently and reliably maintain the availability of data upon disk drive failure. The approach to provide increased data-availability for these systems has been to incrementally add RAID (redundant array of independent disks) devices which are costly and are often performance-limiting. Network Appliance's unique software integration of RAID provides a solution at no incremental cost that yields more reliable data with no performance penalties. In the event of a disk drive failure, the Network Appliance filer will reconstruct the failed data on a spare drive which may be hot-swapped with the failed drive without any interruption of data availability to client users. Upon disruption of the system, Network Appliance servers automatically reboot (with full data availability) at a speed of approximately one to three minutes regardless of storage capacity (versus alternative systems that may take up to one minute per gigabyte to reboot with full data availability). The Network Appliance architecture allows system administrators to add storage capacity or replace a failed disk drive without service interruption or loss of data.

Scalability -- The architecture of Network Appliance products is designed to be scalable so that performance, both in response time as well as in aggregate throughput and storage capacity can cost-effectively grow on an incremental basis. Adding an additional server to a network under this architecture is as simple as adding an additional disk drive to many other systems. The system can be easily expanded to terabytes of data, while maintaining a relatively consistent response time.

Compatibility with Networking Environment -- Network Appliance products are compatible with major network and peripheral interfaces and protocols. This is accomplished through the use of industry standard I/O bus architectures, providing compatibility with common network interfaces and protocols and disk interconnects. Network Appliance's software is designed to be extendable to additional network environments and interface standards, as appropriate.

Cost-Effectiveness -- By combining Network Appliance's software-centric architecture with state-of-the-art industry-standard microprocessors and hard disk products, Network Appliance is able to achieve fast response times at a low cost per unit of storage.

Multiprotocol Capabilities -- The addition of multiprotocol capabilities through recently developed software began the Company's entry into the HTTP, and CIFS markets (CIFS is the standard file service protocol for Microsoft Windows(R) products). The Company's product family now enables different types of clients -- such as PCs, UNIX workstations and standard web browsers -- to simultaneously access information on a single server.

## STRATEGIES

Network Appliance's goal is to be a leader in the network data storage appliance market, building on the initial success of its NFS filers. The Company seeks to achieve this goal by employing the following core strategies:

Focus on Software Differentiation -- Network Appliance seeks to continue to differentiate its products by focusing on the development and enhancements to its specialized proprietary software. Network Appliance believes this approach allows it to cost-effectively integrate desirable features such as intelligent caching, the WAFL architecture, software integrated RAID and automated on-line restoration of deleted or changed files through its Snapshot feature.

Embrace Industry Standards -- Network Appliance will continue to integrate its specialized software solutions with state-of-the-art industry standard hardware components and software interfaces. Industry standard hardware is generally less expensive and more readily available than proprietary hardware. For instance, since its first product introduction, successive generations of Network Appliance products have migrated from industry standard architecture ("ISA") to peripheral connect interchange ("PCI")-bus. Network Appliance believes this approach allows more rapid and cost-effective development and the delivery of high performance products at attractive prices. Utilizing industry standard interfaces enables Network Appliance products to be adaptable to a variety of network environments.

5

6

Broaden Penetration Into NFS Market -- Network Appliance's initial focus was to provide NFS file servers for departmental and enterprise applications. The Company's current focus is to expand its product offerings to include a wider range of price, performance and storage capacities, as well as penetrating additional vertical markets.

Develop New Markets -- During fiscal 1997, Network Appliance developed multiprotocol software capable of providing simultaneous NFS and CIFS file service. This product was designed to meet file server requirements for the Windows NT market and to address the need to unify UNIX and Windows network file services. The Windows NT market has been characterized by trends toward the distributing and downsizing of centralized data-intensive applications, the consolidation of smaller, independent PC-based LANs and the emergence of multimedia as a significant corporate communications and training tool. Network Appliance began shipping the first release of the Windows Networking file protocol option in the third quarter of fiscal 1997.

In the predominantly Windows environment, Network Appliance's filers can help proliferate Windows NT adoption at the enterprise level by providing much higher capacities for network data access consolidation for Windows and UNIX desktops, allowing the deployment of Windows NT(R) servers primarily for application services. This not only helps scale application performance, by off-loading network file service operations, but also contributes to easier data administration through using the 40 standard commands which allows system administrators to focus on user and application related issues.

Also during fiscal 1997, Network Appliance released its Web Filer(TM) software. Web Filer is compatible with all standard Web servers, enables users to update pages while the filer is simultaneously handling Web (HTTP) requests and improves the performance of Internet networks, including corporate intranets. Web Filer operates on any Network Appliance filer, either as a single function HTTP data access server, or in a multiprotocol environment for file and web data access. With the release of Web Filer, a single Network Appliance filer can simultaneously support three different network file sharing protocols, including NFS for UNIX clients, Microsoft's CIFS protocol for Windows 3.1, Windows 95 and Windows NT clients and HTTP for any standard Web browser. By supporting all three types of clients in a single, high-speed, data-access server, Network Appliance enables corporations to avoid costly and complex data replication and add-on client software, while simplifying system and network administration.

In April 1997, Network Appliance released NetCache(TM), a Web proxy-caching software product made available through the Company's recent acquisition of IMC. NetCache improves Web access times and reduces network traffic by creating read-only copies of Web pages that reside closer to users. NetCache is designed for enterprise-wide corporate intranets and for Internet Service Providers who have multiple points-of-presence and data centers. By caching copies of Web content on multiple locations throughout the network, NetCache reduces access times, particularly for users located in remote offices who access the corporate intranet over a wide-area network connection. NetCache also reduces telecommunications costs by eliminating the need for multiple end-user requests for the same data. With support for traffic analysis, the new product also improves network auditing and security. Network Appliance intends to release an appliance version of the software in the future.

Expand Distribution -- Network Appliance seeks to market and distribute its products and technology globally. In North America and in much of Europe, the Company employs a multi-tiered distribution strategy which focuses on product

sales to end-users through a direct sales force, as well as selected value-added resellers in certain geographies. In the Pacific Rim and in portions of Europe, Network Appliance products are sold through resellers, which are supported by Network Appliance channel managers and technical support personnel. In addition, the Company seeks to distribute its products through original equipment manufacturers ("OEMs") and, where appropriate, through licensing arrangements with computer systems companies.

#### SALES AND MARKETING

Network Appliance has established multiple distribution channels to accelerate market penetration of its products. The Company initially marketed its products primarily through indirect sales channels both domestically and internationally. In fiscal 1995, the Company shifted its emphasis domestically to direct sales

6

7

and significantly expanded its direct sales force. The Company continues to rely primarily on indirect sales in the Pacific Rim and in some portions of Europe. Network Appliance has approximately 20 sales offices within North America. Additionally, the Company has international offices in London, Paris, Munich, Milan and Sydney.

No customers accounted for 10% or more of the Company's net sales in fiscal 1997 or 1996. In fiscal 1995, sales to ITOCHU and MTI each accounted for approximately 10% of net sales. The Company entered into a Distributor Agreement with ITOCHU under which the Company granted ITOCHU a nonexclusive, nontransferable license to, among other things, market and distribute certain of the Company's products in Japan, with payments to the Company in U.S. dollars and a term that is automatically renewed each year. The Distributor Agreement had an initial term through March 31, 1994, which is automatically renewed for additional one year terms unless terminated 45 days prior to the end of a term. The agreement may also be terminated with or without cause upon 90 days written notice by either party and upon certain events of default by either party. The Company generally has not entered into long-term volume purchase contracts with its other end user customers or resellers. The Company terminated its relationship with MTI in the second quarter of fiscal 1996.

#### BACKLOG

The Company manufactures its products based upon forecast of customers' demand. Orders are generally placed by customers on an as-needed basis and products are typically shipped within one to four weeks following receipt of an order. In general, customers may cancel or reschedule orders without penalty. For these reasons, the Company does not believe "orders" constitute a firm "backlog" and believes it is not a meaningful indicator of revenues nor material to an understanding of its business.

#### PRODUCTS

In May 1997, the Company transformed its entire product line by adding the NetApp(TM) F520 departmental filer, the NetApp F230 workgroup filer and the NetApp F630, an enterprise-class filer that offers double the throughput and capacity of its predecessor. The Company also introduced the F210 entry-level filer for small workgroups. All filers are based on a PCI-bus architecture and come packaged in rack mountable enclosures. The NetApp F210 and F230 filers are based on Pentium processors. The NetApp F520 and NetApp F630 are based on Digital's Alpha processor. Since the third quarter of fiscal 1997, customers have had the option of purchasing filers that include from one to three software protocols -- NFS, CIFS and HTTP. NetApp filer list prices range from approximately \$15,000 to \$400,000, depending primarily on product configuration.

NetCache, the Web proxy caching software made available through the IMC acquisition, was designed for heterogeneous Windows NT and UNIX server infrastructures, can scale to growing demands, features a software architecture optimized for a large volume of HTTP connections and provides proxy caching for a number of data-sharing technologies, including HTTP, FTP, Gopher, and SSL tunneling. The software is currently available for Windows NT, SPARC Solaris and Digital UNIX. A single underlying software code base and user interface support each product. NetCache supports environments with T1 speed (1.544 Mbps) connections or greater. Network Appliance also offers NetCache Lite, a scaled-back version of NetCache, which supports environments with up to a 256

Kbps connection to the Internet (roughly two ISDN lines). Network Appliance intends to release an appliance version of the proxy caching software in the future.

In the third quarter of fiscal 1997, Network Appliance began production shipments of Data ONTAP(TM) Release 4.0, which is based on the Company's specialized proprietary software architecture. Release 4.0 enables NetApp filers to simultaneously access UNIX, Windows and Web network files. Release 4.0 added new features, including ATM, full duplex Ethernet connectivity and FilerView, which offers HTML/Java(R)-based server administration.

In June 1997, Network Appliance released Data ONTAP Release 4.1 which features improved CIFS throughput. Data ONTAP Release 4.1 is standard on all new filer products shipped as of June 1997. Installed base customers running previous versions of the software can upgrade to Release 4.1 at no charge if they are

7

8

on the Company's Software Subscription Program, or by paying a per-incident upgrade price. Some customers are eligible for a free upgrade depending on the date of their filer purchase.

#### CUSTOMER SERVICE AND SUPPORT

Network Appliance's customer service and support organization provides customers with technical support, education and training. Network Appliance believes that providing a high level of customer service and technical support is critical to customer satisfaction and the Company's success. In providing service and support to customers, the Company uses its own products extensively. Warranty coverage includes 24 hour telephone support plus next business day hardware repair. For an additional charge, the Company also offers upgraded service during the warranty period, providing for faster on-site hardware repair. The standard hardware warranty for most parts includes one year of part replacement for failed components. Software support, including bug fixes and new release updates are provided at no extra charge for 90 days after product shipment. Support for software is available beyond the initial period through the software subscription program.

Post-warranty service programs include: cooperative maintenance where the customer purchases spares and performs self-maintenance tasks, a full-service program involving a combination of telephone-based support and on-site repair, and a software subscription program that includes telephone support and software upgrades. The Company charges for service programs on an annual subscription basis, with discounts to sites with multiple filers. On-site support is primarily provided by independent parties both in North America and internationally.

#### MANUFACTURING

Network Appliance's manufacturing operations, located in Santa Clara, California, consist of procurement of materials, product assembly, product assurance, quality control and final test. Network Appliance relies on many suppliers for the procurement of materials, as well as several key subcontractors for the production of certain board level assemblies. The Company's manufacturing strategy has been to develop close relationships with its suppliers, exchanging critical information and implementing joint quality training programs. This manufacturing strategy minimizes capital investment and overhead expenditures and creates flexibility by providing the capacity for rapid expansion. During May 1997, Network Appliance was awarded the ISO 9001 certification.

The Company relies upon a limited number of suppliers of several key components utilized in the assembly of the Company's products. The Company purchases disk drives and enclosures from Digital Equipment Corporation and from other vendors. The Company's reliance on its suppliers involves several risks, including a potential inability to obtain an adequate supply of required components, price increases, timely delivery and component quality. This risk is particularly significant with respect to suppliers of disk drives because in order to meet product performance requirements, the Company must obtain disk drives with extremely high quality and capacity. In addition, there are periodic supply and demand issues for disk drives and for semiconductor memory components, which could result in component shortages, selective supply

allocations and increased prices of such components. Although to date the Company has been able to purchase its requirements of such components, there is no assurance that the Company will be able to obtain its full requirements of such components in the future or that prices of such components will not increase. In addition, there can be no assurance that problems with respect to yield and quality of such components and timeliness of deliveries will not occur. Disruption or termination of the supply of these components could delay shipments of the Company's products and could have a material adverse effect on the Company's business, operating results and financial condition. Such delays could also damage relationships with current and prospective customers.

The Company's resellers sometimes purchase minimally configured systems from the Company and source additional disk drives and memory components from other vendors. In addition, certain end-users also purchase disk drives and memories from other suppliers. Since these components do not undergo the Company's rigorous sourcing and testing procedures, they may experience more failures when deployed in the

8

9

Company's products. Any such higher failure rate could negatively impact the Company's reputation and, as a result, could materially adversely affect its business, operating results and financial condition.

#### RESEARCH AND DEVELOPMENT

Since its inception, Network Appliance has made substantial investments in research and development. Network Appliance believes that its future performance will depend in large part on its ability to maintain and enhance its current product line, develop new products that achieve market acceptance, maintain technological competitiveness and meet an expanding range of customer requirements. The Company intends to expand its existing product offerings and to introduce new products for the network file server market.

As part of the Company's ongoing development process, the Company introduced a significant software release during fiscal 1997 -- Data ONTAP release 4.0. In July 1997, The Company released Data ONTAP Release 4.1. The Company also worked extensively in bringing four new products to market in May 1997 -- the NetApp F210, NetApp F230, NetApp F520 and NetApp F630. The Company also released NetCache software in April 1997. In addition, the Company has under development new network file servers. The Company's future growth depends upon the success of these and other new products, however there can be no assurance that these or other new products will attain market acceptance. Due to the complexity of network file servers and the difficulty in gauging the engineering effort required to produce new products, new products are subject to significant technical risks. There can be no assurance that new products will be introduced on a timely basis or at all. In the past, the Company has experienced delays in the shipments of its new products principally due to an inability to qualify component parts from disk drive and other suppliers, resulting in delay or loss of product sales. If new products are delayed or do not achieve market acceptance, the Company's business, operating results and financial condition will be materially adversely affected.

The network file server market is characterized by rapid technological change, changing customer needs, frequent new product introductions and evolving industry standards. The introduction of products embodying new technologies and the emergence of new industry standards could render the Company's existing products obsolete and unmarketable. The Company's future success will depend upon its ability to develop and introduce new products (including new software releases and enhancements) on a timely basis that keep pace with technological developments and emerging industry standards and address the increasingly sophisticated needs of its customers. There can be no assurance that the Company will be successful in developing and marketing new products that respond to technological changes or evolving industry standards, that the Company will not experience difficulties that could delay or prevent the successful development, introduction and marketing of new products, or that its new products will adequately meet the requirements of the marketplace and achieve market acceptance. If the Company is 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, the Company's business, operating results and financial condition will be materially adversely affected.

Network file server products like those offered by the Company may contain

undetected software errors or failures when first introduced or as new versions are released. There can be no assurance that, despite testing by the Company and by current and potential customers, errors will not be found in new products after commencement of commercial shipments, resulting in loss of or delay in market acceptance, which could have a material adverse effect upon the Company's business, operating results and financial condition.

The Company's total expenses for research and development for fiscal years 1997, 1996 and 1995 were \$9.0 million, \$4.8 million and \$2.6 million, respectively. The Company anticipates that research and development expenses will increase in absolute dollars in future periods.

#### COMPETITION

The network file server market is intensely competitive and characterized by rapidly changing technology. The Company experiences substantial competition from specialized network file server companies, such as Auspex Systems, Inc. ("Auspex"). The Company also competes against traditional suppliers of UNIX systems and PC products that are used as network file servers including Sun Microsystems, Digital Equipment

9

10

Corporation, Hewlett-Packard Company, Silicon Graphics, Inc. and IBM Corporation, among others. In addition, certain of these large traditional suppliers of general purpose computers may in the future offer specialized file server products which are more directly competitive with those of the Company. The Company also expects new and emerging competition in the network file server market, including competition from manufacturers of PC-based file servers based upon Windows NT and other emerging standards. While the Company believes that the price-performance characteristics of its products are currently competitive, increased competition is likely to result in price reductions, reduced gross margin and loss of market share, any of which could materially adversely affect the Company's business, operating results and financial condition. Many of the Company's current and potential competitors have significantly greater financial, technical, marketing and other resources than the Company. As a result, they may be able to respond more quickly to new or emerging technologies and changes in customer requirements, or devote greater resources to the development, promotion, sale and support of their products than the Company. 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. In addition, the Company derives a significant portion of its sales from the resale of disk drives as components of its filers and therefore experiences competition from disk drive resellers. The market for the resale of disk drives is highly competitive and subject to intense price pressures. There can be no assurance that the Company will be able to compete successfully against current or future competitors or that competitive pressures faced by the Company will not materially adversely affect its business, operating results and financial condition.

The Company believes that the principal competitive factors affecting its market include product features such as response time, scalability and ease of use, price, multiprotocol capabilities and customer service and support. Although the Company believes that its products currently compete favorably with respect to these factors, there can be no assurance that the Company can maintain its competitive position against current and potential competitors, especially those with significantly greater financial, marketing, service, support, technical and other resources.

#### PROPRIETARY RIGHTS

Network Appliance's success depends significantly upon its proprietary technology. The Company currently relies on a combination of copyright and trademark laws, trade secrets, confidentiality procedures and contractual provisions to protect its proprietary rights. The Company seeks to protect its software, documentation and other written materials under trade secret and copyright laws, which afford only limited protection. The Company has registered its FAServer trademark and will continue to evaluate the registration of additional trademarks as appropriate. The Company generally enters into confidentiality agreements with its employees and with its resellers and customers. The Company currently has four U.S. patent applications pending and three corresponding international patent applications pending. There can be no

assurance that the pending applications will be approved, or that if issued, such patents will not be challenged, and if such challenges are brought, that such patents will not be invalidated. There can be no assurance that the Company will develop proprietary products or technologies that are patentable, that any issued patent will provide the Company with any competitive advantages or will not be challenged by third parties, or that the patents of others will not have a material adverse effect on the Company's ability to do business. Litigation may be necessary to protect the Company's proprietary technology. Any such litigation may be time-consuming and costly. Despite the Company's efforts to protect its proprietary rights, unauthorized parties may attempt to copy aspects of the Company's products or to obtain and use information that the Company regards 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. There can be no assurance that the Company's means of protecting its proprietary rights will be adequate or that the Company's competitors will not independently develop similar technology, duplicate the Company's products or design around patents issued to the Company or other intellectual property rights of the Company.

There have also been substantial amounts of litigation in the computer industry regarding intellectual property rights. In the first quarter of fiscal 1997, the Company settled litigation related to the alleged infringement of third party rights and other claims, which resulted in the Company recording a pre-tax

10

11

expense of \$4.3 million (\$3.5 million in payments to the plaintiffs and \$0.8 million in legal fees). In addition, the Company has from time to time received claims that it is infringing third parties' intellectual property rights, and there can be no assurance that third parties will not in the future claim infringement by the Company with respect to current or future products, trademarks or other proprietary rights. The Company expects that companies in the file server market will increasingly be subject to infringement claims as the number of products and competitors in the Company's 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 the Company to redesign its products or require the Company to enter into royalty or licensing agreements, any of which could have a material adverse effect upon the Company's business, operating results and financial condition. Such royalty or licensing agreements, if required, may not be available on terms acceptable to the Company or at all.

#### EMPLOYEES

As of May 31, 1997, Network Appliance had a total of approximately 265 employees. Of the total, 122 were in sales and marketing, 18 in customer support, 61 in research and development, 28 in finance and administration and 36 in operations. The Company's future performance also depends in significant part upon the continued service of its key technical and senior management personnel, none of whom is bound by an employment agreement. The loss of the services of one or more of the Company's officers or other key employees could have a material adverse effect on the Company's business, operating results and financial condition. The Company's future success also depends on its continuing ability to attract and retain highly qualified technical and management personnel. Competition for such personnel is intense, and there can be no assurance that the Company can retain its key technical and management employees or that it can attract, assimilate or retain other highly qualified technical and management personnel in the future. The Company has not experienced any work stoppages and considers its relations with its employees to be good.

#### OTHER FACTORS AFFECTING THE COMPANY

History of Operating Losses; Potential Fluctuations in Quarterly Results -- The Company was organized in April 1992 and first shipped products in June 1993. The Company had an accumulated deficit of \$624,000 as of April 25, 1997. While the Company generated net income in fiscal 1997 and in fiscal 1996, it incurred significant losses in fiscal 1995 and in each of its prior fiscal years. There can be no assurance that the Company will remain profitable on a quarterly or annual basis.

The Company's quarterly operating results have in the past varied and may in the future vary significantly depending on a number of factors, including the

level of competition; the size and timing of significant orders; product configuration and mix; market acceptance of new products and product enhancements; new product announcements or introductions by the Company or its competitors; deferrals of customer orders in anticipation of new products or product enhancements; changes in pricing by the Company or its competitors; the ability of the Company to develop, introduce and market new products and product enhancements on a timely basis; hardware component costs; supply constraints; the Company's success in expanding its sales and marketing programs; technological changes in the network file server market; the mix of sales among the Company's sales channels; levels of expenditure on research and development; changes in Company strategy; personnel changes; general economic trends and other factors. Although the Company has not experienced seasonality in the past, because of the significant seasonal effects experienced within the industry and the Company's goal to expand international sales, there can be no assurance that the Company's future operating results will not be adversely affected by seasonality.

Sales for any future quarter are not predictable with any significant degree of certainty. The Company generally operates with limited order backlog because its products typically are shipped shortly after orders are received. As a result, product sales in any quarter are generally dependent on orders booked and shipped in that quarter. Product sales are also difficult to forecast because the network file server market is rapidly evolving and the Company's sales cycle varies substantially from customer to customer. A significant portion of the Company's revenues in any quarter may be derived from sales to a limited number of customers. Any significant deferral of these sales could have a material adverse effect on the Company's results of operations

11

12

in any particular quarter; and to the extent that significant sales occur earlier than expected, operating results for subsequent quarters may be adversely affected. The Company's expense levels are based, in part, on its expectations as to future sales. As a result, if sales levels are below expectations, net income may be disproportionately affected. Although the Company has experienced significant revenue growth in recent periods, the Company does not believe such growth is indicative of future operating results. The Company believes that period-to-period comparisons of its results of operations are not necessarily meaningful and should not be relied upon as an indicator of future performance. Due to all of the foregoing factors, it is possible that in some future quarter the Company's operating results may be below the expectations of public market analysts and investors. In such event, the price of the Company's common stock would likely be materially adversely affected.

Dependence on Growth in the Network File Server Market -- All of the Company's filer products address the network file server market. The Company's future financial performance will depend in large part on continued growth in the network file server market and on emerging standards in this market. There can be no assurance that the market for network file servers will continue to grow or that emerging standards in the network file server market, such as Windows NT, will not adversely affect the growth of the NFS server market on which the Company has focused to date. If the network file server market fails to grow, grows more slowly than anticipated, or if network file servers based on emerging standards other than those adopted by the Company become increasingly accepted by the market, the Company's business, operating results and financial condition would be materially adversely affected. During recent years, segments of the computer industry have experienced significant economic downturns characterized by decreased product demand, production overcapacity, price erosion, work slowdowns and layoffs. The Company's operations may in the future experience substantial fluctuations from period-to-period as a consequence of such industry patterns, general economic conditions affecting the timing of orders from major customers and other factors affecting capital spending. There can be no assurance that such factors will not have a material adverse effect on the Company's business, operating results and financial condition.

Expansion of International Operations -- The Company believes that its continued growth and profitability will require successful expansion of its international operations and sales and therefore the Company has committed significant resources to such expansion. Sales by the Company's foreign subsidiaries represented approximately 11% of the Company's net sales in fiscal 1997 and less than 10% of net sales in fiscal 1996 and 1995. In order to successfully expand international sales in fiscal 1998 and subsequent periods,

the Company must establish foreign operations, hire additional personnel and recruit additional international distributors and resellers. This will require significant management attention and financial resources and could materially adversely affect the Company's business, operating results and financial condition. To the extent that the Company is unable to effect these additions in a timely manner, the Company's growth, if any, in international sales will be limited, and the Company's business, operating results and financial condition could be materially adversely affected. In addition, there can be no assurance that the Company will be able to maintain or increase international market demand for the Company's products. The Company currently sells a significant portion of its products internationally through resellers, most significantly, ITOCHU. There can be no assurance that ITOCHU or any of the Company's international resellers or customers will continue to distribute or purchase the Company's products.

The Company's 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 the Company's products more expensive and, therefore, potentially less competitive in those markets. For international sales denominated in foreign currencies, the Company is subject to risks associated with currency fluctuations. Additional risks inherent in the Company's international business activities generally include unexpected changes in regulatory requirements, tariffs and other trade barriers, if any, in foreign countries, longer accounts receivable payment cycles, difficulties in managing international operations, potentially adverse tax consequences including restrictions on the repatriation of earnings, and the burdens of complying with a wide variety of foreign laws. There can be no assurance that such factors will not have a material adverse effect on the Company's future international sales and, consequently, the Company's business, operating results and financial condition.

12

13

Product Concentration; Changing Product Mix -- The Company derives substantially all of its revenues from the sale of its network filer product line. As a result, a reduction in the demand for filer products due to increased competition, a general decline in the market for network file servers or other factors would have a material adverse effect on the Company's business, operating results and financial condition. Prior to fiscal 1996, the Company derived substantially all of its revenue from the sale of its FAServer 450 and 1400 products. The mix of products sold by the Company has changed substantially with the introduction of the NetApp F220, NetApp F330 and NetApp F540. In May 1997, the Company transformed its product line by introducing four new products: the NetApp F210, NetApp F230, NetApp F520 and NetApp F630. Additional product introductions in future years are expected to impact the sales of existing products. If the Company is unable to introduce new products in a timely manner, effectively manage the introduction of new products and any related inventory transitions or if such products do not achieve market acceptance, the Company's business, operating results and financial condition could be materially adversely affected.

Concentration of Sales -- Historically, a significant portion of the Company's sales have been made to a limited number of end user customers and resellers. In fiscal 1997 and 1996, no customers accounted for 10% or more of net sales. In fiscal 1995, sales to resellers ITOCHU Corporation ("ITOCHU") and MTI Technology Corporation ("MTI") each accounted for approximately 10% of net sales. The Company's relationship with MTI terminated in the second quarter of fiscal 1996. The Company generally has not entered into long term volume purchase contracts with its end user customers or resellers, and such end user customers or resellers may have certain rights to extend or delay the shipment of their orders. The loss of a major end user customer or reseller, the reduction, delay or cancellation of orders or a delay in shipment of the Company's products to such end user customer or reseller could materially adversely affect the Company's business, operating results and financial condition. In addition, should one or more of these resellers choose to promote products competitive with the Company's products, the Company's business, operating results and financial condition could be materially adversely affected.

Recent Management Additions and Management of Expanding Operations -- Certain of the Company's senior management joined the Company during the last year. The Company's Chief Financial Officer/Vice President of Operations joined in December 1996 and its Vice President of Marketing joined in

May 1996. The Company is in the process of implementing a number of new financial and management controls, reporting systems and procedures. In addition to its senior management, the Company has recently hired a significant number of employees, including sales staff, and plans to further increase its total employee base. The Company also plans to expand the geographic scope of its customer base and operations. This expansion has resulted and will continue to result in substantial demands on the Company's management systems and resources. The Company's ability to compete effectively and to manage future expansion of its operations, if any, will require the Company to continue to improve its financial and management controls, reporting systems and procedures on a timely basis and effectively expand, train and manage its work force. If the Company's efforts are not successful, the Company's business, operating results and financial condition could be materially adversely affected.

Possible Volatility of Stock Price -- The trading price of the Company's common stock could be subject to wide fluctuations in response to a number of factors, including quarterly variations in operating results, announcements of technological innovations or new products, applications or product enhancements by the Company or its competitors, changes in financial estimates by securities analysts and other events. In addition, the stock market has experienced volatility that has particularly affected the market prices of equity securities of many high technology companies and that often has been unrelated or disproportionate to the operating performance of such companies. These broad market fluctuations may adversely affect the market price of the Company's common stock.

Effect of Certain Charter Provisions; Anti-takeover Effects of Provisions of the Bylaws -- The Company's Board of Directors has the authority to issue up to 5,000,000 shares of Preferred Stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the shareholders. The rights of the holders of common stock will be subject to, and may be adversely affected by, the rights of the holders of any Preferred Stock that may be issued in the future. The issuance of Preferred Stock could have the effect of making it more difficult for a third party to acquire a

majority of the outstanding voting stock of the Company. Further, certain provisions of the Company's Bylaws pertaining to the future elimination of cumulative voting and shareholder action by written consent, and the requirement that shareholders may call a special meeting of shareholders only upon a request of shareholders owning at least 50% of the Company's common stock, could delay or make more difficult a proxy contest involving the Company, which could adversely affect the market price of the Company's common stock.

ITEM 2. PROPERTIES

Network Appliance's principal administrative, sales, marketing, manufacturing and research and development facility is located in approximately 95,000 square feet of space in Santa Clara, California. This facility is leased through May 2000. The Company leases other sales offices throughout the U.S. and in Europe. The Company believes that the existing facilities are adequate for its current needs and that additional space will be available as needed.

ITEM 3. LEGAL PROCEEDINGS

None.

ITEM 4. SUBMISSIONS OF MATTERS TO A VOTE OF SECURITY-HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year covered by this Annual Report on Form 10-K.

EXECUTIVE OFFICERS

The executive officers of the Company, and their ages as of May 31, 1997, are as follows:

NAME	AGE	POSITION
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Daniel J. Warmenhoven....	46	President, Chief Executive Officer and Director
M. Helen Bradley.....	42	Vice President, Engineering
Jeffrey R. Allen.....	45	Vice President, Finance and Operations, Chief Financial Officer and Secretary
Thomas F. Mendoza.....	45	Vice President, World Wide Sales
Charles E. Simmons.....	48	Vice President, Marketing

DANIEL J. WARMENHOVEN joined the Company in October 1994 as President and Chief Executive Officer, and has been a member of the Board of Directors since October 1994. Prior to joining the Company, Mr. Warmenhoven served in various capacities, including President, Chief Executive Officer and Chairman of the Board of Directors of Network Equipment Technologies, Inc., a telecommunications company, from November 1989 to January 1994. Mr. Warmenhoven holds a B.S. degree in electrical engineering from Princeton University.

M. HELEN BRADLEY joined the Company as Vice President, Engineering in September 1995. Prior to that, Ms. Bradley owned a management consulting business from January 1995 to September 1995. She also served as Senior Vice President, Technology Development at Openvision, a client-server applications company, from May 1994 to January 1995. From August 1990 to April 1994, Ms. Bradley was the Vice President, Systems Software at Sun Microsystems. Ms. Bradley holds a B.S. degree in mathematics from the Massachusetts Institute of Technology and an M.S. degree in computer science from the Georgia Institute of Technology.

JEFFRY R. ALLEN joined the Company in December 1996 as Vice President, Finance and Operations, Chief Financial Officer and Secretary. From October 1994 to December 1996, Mr. Allen served in various capacities, including Senior Vice President of Operations and Vice President and Controller of Bay Networks, Inc., a networking company. From December 1990 to October 1994, Mr. Allen held various positions at SynOptics, the latest of which was Vice President and Controller. Before joining SynOptics, he held various positions, from December 1973 to November 1990, at Hewlett-Packard Company, the latest of which was Controller of the Information Networks Group. Mr. Allen holds a B.S. degree from San Diego State University.

THOMAS F. MENDOZA joined the Company in May 1994 as Vice President, North American Sales. From November 1993 to April 1994, Mr. Mendoza served in various capacities including Vice President, Sales at Work Group Technology, a product data management company. Prior to that, Mr. Mendoza served in various capacities including Vice President of North American Sales at Auspex, a UNIX-based network file server company, from November 1990 to October 1993. Mr. Mendoza was previously Vice President of Western Operations at Stratus Computer, a vendor of fault tolerant computers, from May 1982 to October 1990. Mr. Mendoza holds a B.A. degree from the University of Notre Dame.

CHARLES E. SIMMONS joined the Company in May 1996 as Vice President, Marketing. Prior to that, Mr. Simmons was a senior partner at Rohner & Associates, a consulting firm, from January 1995 to May 1996. From February 1994 to October 1994, Mr. Simmons served as Vice President of Marketing at Voyant Corporation, a developer of videoconferencing equipment. Prior to that, Mr. Simmons was with Sun Microsystems Computer Company, a subsidiary of Sun Microsystems, Inc., from November 1984 to February 1994, most recently as Director of Business Strategy and Technology Marketing. Mr. Simmons received a B.S. degree in electrical engineering from Washington University, an M.S. degree in electrical engineering from the Massachusetts Institute of Technology and an MBA from Santa Clara University.

PART II

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED SHAREHOLDER MATTERS

The Company's common stock commenced trading on the Nasdaq National Market on November 21, 1995 and is traded under the symbol "NTAP." As of May 31, 1997 there were approximately 380 holders of record of the common stock. The following table sets forth for the periods indicated the high and low closing sale prices for the common stock as reported on the Nasdaq National Market.

	FISCAL 1997		FISCAL 1996	
	HIGH	LOW	HIGH	LOW
First Quarter.....	\$38.75	\$24.25	\$ --	\$ --
Second Quarter.....	\$35.19	\$21.75	\$ --	\$ --
Third Quarter.....	\$56.00	\$31.50	\$41.12	\$13.50
Fourth Quarter.....	\$55.00	\$26.25	\$38.75	\$27.00

The Company has never paid cash dividends on its capital stock. The Company currently anticipates that it will retain all available funds for use in its business and does not anticipate paying any cash dividends.

ITEM 6. SELECTED CONSOLIDATED FINANCIAL DATA

FIVE FISCAL YEARS ENDED APRIL 30, 1997  
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	1997	1996	1995	1994	1993
Net Sales.....	\$93,333	\$46,632	\$14,796	\$ 2,244	\$ --
Income (Loss) from Operations(1).....	\$ 3,083	\$ 6,000	\$ (4,913)	\$ (1,955)	\$ (825)
Net Income (Loss) (2).....	\$ 250	\$ 6,600	\$ (4,764)	\$ (1,874)	\$ (836)
Net Income (Loss) per Share(2).....	\$ .01	\$ .42	\$ (.38)	\$ --	\$ --
Total Assets.....	\$68,941	\$45,449	\$10,628	\$ 4,055	\$ 612
Long-Term Obligations.....	\$ 232	\$ 318	\$11,607	\$ 4,855	\$ --
Total Shareholders' Equity (Deficit).....	\$54,029	\$39,029	\$ (5,923)	\$ (1,324)	\$ 545

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- (1) Fiscal 1997 includes the purchased in-process technology and compensation charge related to the IMC acquisition of \$10,519 and the Whipsaw litigation of \$4,300. See Notes 6 and 11 of Notes to Consolidated Financial Statements.
- (2) Fiscal 1997 includes the purchased in-process technology and compensation charge related to the IMC acquisition of \$9,215 (net of taxes) and the Whipsaw litigation of \$2,795 (net of taxes).

ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

OVERVIEW

Network Appliance, Inc. was incorporated in April 1992 to design, manufacture, market and support network data storage appliances ("filers"). The Company's filer products combine specialized proprietary software and state-of-the-art industry standard hardware to provide a unique solution for the NFS, CIFS and HTTP server markets.

In September 1995, the Company introduced the NetApp F330, a rack-mounted, Pentium and PCI bus-based filer. In January 1996, the Company introduced the NetApp F220, a rack-mounted, Pentium and PCI bus-based filer designed for workgroup and LAN environments. In May 1996, the Company introduced the NetApp F540, an enterprise-class file server appliance. In October 1996, the Company first shipped systems and software with multiprotocol capabilities.

In March 1997, the Company acquired IMC, a developer of Internet/intranet proxy-caching software. The acquisition was accounted for as a purchase and, accordingly, the results of operations of IMC from the date of acquisition forward have been included in the Company's consolidated financial statements. A substantial portion of the purchase price was charged to expense as purchased in-process technology. IMC net sales and expenses subsequent to the acquisition were not significant. The Company intends to continue product development and to incorporate IMC software into the Company's future product line. See Note 6 of Notes to Consolidated Financial Statements.

In May 1997, the Company announced a new product expansion. Included within the new products is the NetApp F630, a high-capacity enterprise class server, and the NetApp F210, an entry-level filer for small workgroups.

#### RESULTS OF OPERATIONS

The following table sets forth certain consolidated statement of operations data as a percentage of net sales for the periods indicated:

	YEARS ENDED APRIL 30,		
	1997	1996	1995
Net Sales.....	100.0%	100.0%	100.0%
Cost of Sales.....	40.8	44.1	53.8
Gross margin.....	59.2	55.9	46.2
Operating Expenses:			
Sales and marketing.....	26.0	27.3	42.5
Research and development.....	9.6	10.2	17.6
General and administrative.....	4.4	5.5	19.3
Purchased in-process technology and related compensation charge.....	11.3	--	--
Litigation settlement.....	4.6	--	--
Total operating expenses.....	55.9	43.0	79.4
Income (Loss) from Operations.....	3.3	12.9	(33.2)
Other Income, net.....	1.0	1.3	1.0
Income (Loss) Before Income Taxes.....	4.3	14.2	(32.2)
Provision for Income Taxes.....	4.0	--	--
Net Income (Loss).....	0.3%	14.2%	(32.2)%

#### FISCAL 1997 COMPARED TO FISCAL 1996

Net Sales -- Net sales increased by 100% from \$46.6 million in fiscal 1996 to \$93.3 million in fiscal 1997. This increase was attributable to an increased shipping volume of filers and related peripheral devices and

higher average selling prices of filers. The increase in filer shipments resulted primarily from the Company's expansion of its domestic and international direct sales force, growth of the Company's domestic and international indirect sales channel, increased market acceptance of the Company's products and the introduction of the NetApp F540. The higher average selling prices resulted primarily from the introduction of the enterprise-class NetApp F540 and the shipment of a greater number of units directly to end users, who generally purchase more highly configured systems at higher average selling prices than resellers. Net sales also increased as a result of the introduction of multiprotocol systems and the licensing of multiprotocol software to pre-existing customers. See revenue recognition policy within Note 2 of Notes to Consolidated Financial Statements.

There can be no assurance that the Company's net sales will continue to increase in absolute dollars or at the rate at which they have grown in recent fiscal years.

Gross Margin -- Gross margin increased from 55.9% in fiscal 1996 to 59.2% in fiscal 1997. This increase in gross margin was primarily attributable to the increase in product volume in fiscal 1997, lower costs of key components and increased manufacturing efficiencies. Gross margin also increased over the prior fiscal year as a result of licensing multiprotocol software and increases in software subscription revenue due to a larger installed base. These factors offset the effect of increased sales of highly configured systems during fiscal

1997, which generally generate lower gross margins per system due to higher disk drive content.

The Company's gross margin has been and will continue to be affected by a variety of factors, including competition, product configuration, direct versus indirect sales, the mix and average selling prices of products, new product introductions and enhancements, and the cost of components and manufacturing labor. In particular, the Company's gross margin varies based upon the configuration of systems that are sold and whether they are sold directly or through indirect channels. Highly configured systems typically generate lower overall gross margin percentages due to greater disk drive and memory content.

Sales and Marketing -- Sales and marketing expenses consist primarily of salaries, commissions, advertising and promotional expenses and customer service and support costs. Sales and marketing expenses increased 90.6% from \$12.7 million in fiscal 1996 to \$24.3 million in fiscal 1997. These expenses were 26.0% and 27.3% of net sales in fiscal 1997 and 1996, respectively. The increase in absolute dollars was primarily related to the expansion of the Company's sales and marketing organization, particularly the increase in the direct sales force, and increased commission expenses related to higher sales volumes. The Company expects to continue to increase its sales and marketing expenses in an effort to expand domestic and international markets. The Company believes that its continued growth and profitability is dependent in part on the successful expansion of its international operations, and therefore, has committed significant resources to international sales.

Research and Development -- Research and development expenses consist primarily of salaries and benefits, prototype expenses, and fees paid to outside consultants. Research and development expenses increased 88.3% from \$4.8 million in fiscal 1996 to \$9.0 million in fiscal 1997. These expenses represented 9.6% and 10.2% of net sales in fiscal 1997 and 1996, respectively, and increased in absolute dollars primarily as a result of increased headcount, prototyping expenses associated with the development of new products and the support of the current and future product development and enhancement efforts. Software development costs capitalized in fiscal 1997 were not significant. In fiscal 1996, no software development costs were capitalized as amounts that qualified for capitalization were immaterial. The Company believes that significant investments in research and development will be required to remain competitive and expects that such expenditures will continue to increase in absolute dollars.

General and Administrative -- General and administrative expenses were \$4.1 million in fiscal 1997, compared to \$2.6 million in fiscal 1996, an increase of 60.4%. These expenses represented 4.4% and 5.5%, respectively, of net sales for such periods. In fiscal 1997, the Company continued its investments in additional staffing, facilities expansion and related occupancy costs necessary to manage and support the Company's growth. Professional fees also increased from fiscal 1996 to fiscal 1997. The growth in professional fees was primarily related to increases in general legal fees, investor relation activities and accounting related services.

17

18

The Company believes that its general and administrative expenses will increase in absolute dollars as the Company continues to build its infrastructure to support future growth.

The level of the Company's operating expenses are partially based on its expectations of future revenue. Since expense levels are usually committed in advance of revenues and because only a small portion of expenses vary with revenue, the Company's operating results may be materially adversely affected if revenue does not materialize in a period as expected.

Purchased In-Process Technology and Related Compensation Charge -- On March 17, 1997, the Company acquired all outstanding shares and options to purchase shares of IMC common stock by issuing 187,023 shares of the Company's common stock and options to purchase shares of the Company's common stock. In connection with the acquisition, intangible assets of \$8.4 million were acquired, of which \$7.4 million was reflected as a one-time charge to operations for the write-off of in-process research and development that had not reached technological feasibility and, in management's opinion, had no probable alternative future use. The remaining intangible assets of \$1.0 million, consisting of existing technology and goodwill, are included in other assets in

the accompanying consolidated balance sheets and are being amortized over their estimated useful lives of five years.

Certain key employees of IMC who continued as employees of the Company were also granted vested options to purchase shares of the Company's common stock at a discount to the market price of the Company's common stock immediately preceding the acquisition. In connection with the granting of these options, the Company recorded a compensation charge of \$3.2 million in the fourth quarter of fiscal 1997.

The acquisition was accounted for as a purchase and, accordingly, the results of operations of IMC from the date of acquisition forward have been included in the Company's consolidated financial statements. IMC results of operations included in the Company's consolidated financial statements for fiscal 1997 were not significant. See Note 6 of Notes to Consolidated Financial Statements for pro forma financial information.

Litigation Settlement -- In July 1994, the Company and certain of its former employees were named as defendants in a lawsuit which alleged that one of the Company's founders, who left the Company in March 1995, misappropriated confidential information prior to the Company's founding in April 1992. In August 1996, the Company entered into a settlement with the plaintiff which resulted in a charge to earnings of \$4.3 million in the first quarter of fiscal 1997, which included a \$3.5 million payment to the plaintiffs and \$0.8 million of legal fees. As the payment released the Company from all liabilities associated with the case, the Company has no future obligations to the plaintiffs. The Company denies any wrongdoing on its part or on the part of the founder.

Other Income, net -- Other income, net, was \$1.0 million and \$0.6 million in fiscal 1997 and 1996, respectively. In both of these periods, other income, net, represented less than 2% of net sales. Other income, net, increased in fiscal 1997 due primarily to interest income earned over four quarters of fiscal 1997 on the net proceeds of \$25.7 million from the Company's November 1995 initial public offering ("IPO") compared to interest earnings on IPO proceeds over two quarters for fiscal 1996.

Provision for Income Taxes -- The fiscal 1997 income tax provision was \$3.8 million (effective rate of 93.8%). The fiscal 1997 tax rate was primarily affected by the one-time charge to operations of \$7.4 million for the write-off of purchased in-process research and development related to the IMC acquisition which is not deductible for income tax purposes. Excluding the net effect of the IMC acquisition, the effective tax rate would have been 35%. As of April 30, 1997, a valuation allowance was deemed unnecessary as Company management determined that it is more likely than not that the net deferred tax asset is realizable.

In fiscal 1996, the Company's federal and state income tax liabilities were offset by the realization of a portion of its net deferred tax assets. The Company recognized a benefit for its net deferred tax assets to the extent that they were recoverable through tax refunds in the event of future net operating losses. The Company recorded a valuation allowance for the balance of its net deferred tax assets as a result of uncertainty regarding realization of the assets, including the limited operating history of the Company.

18

19

The Company expects that its effective tax rate will be slightly higher in fiscal 1998 than the 35% rate in fiscal 1997, excluding the net effect of the IMC acquisition, as fiscal 1997 included a benefit for the reversal of a valuation allowance previously provided against deferred tax assets which will not occur in fiscal 1998.

#### FISCAL 1996 COMPARED TO FISCAL 1995

Net Sales -- Net sales increased by 215% from \$14.8 million in fiscal 1995 to \$46.6 million in fiscal 1996. In fiscal 1995, the Company sold its products primarily through indirect channels. The increase in net sales in fiscal 1996 resulted primarily from the Company's expansion of its domestic direct sales force, increased market acceptance of the Company's products, and the introduction of two new system products, the NetApp F330 and F220. The Company also shipped a greater number of units directly to end users in fiscal 1996, which generally purchase more highly configured systems at higher average

selling prices than resellers.

Gross Margin -- Gross margin increased from 46.2% in fiscal 1995 to 55.9% in fiscal 1996. This increase in gross margin was primarily attributable to more efficient absorption of manufacturing overhead, lower costs of key components and manufacturing efficiencies achieved during fiscal 1996, all of which were related to the significant increase in production volume. These factors offset the effect of increased sales of highly configured systems during fiscal 1996 which generally generate lower gross margins per system.

Sales and Marketing -- Sales and marketing expenses increased 102.3% from \$6.3 million in fiscal 1995 to \$12.7 million in fiscal 1996. These expenses were 27.3% and 42.5% of net sales in fiscal 1996 and 1995, respectively. The increase in absolute dollars was primarily related to the expansion of the Company's sales and marketing organization, particularly the increase in the direct sales force, and increased commission expenses related to higher sales volumes.

Research and Development -- Research and development expenses increased 82.6% from \$2.6 million in fiscal 1995 to \$4.8 million in fiscal 1996. These expenses represented 10.2% and 17.6% of net sales in fiscal 1996 and 1995, respectively. These expenses increased in absolute dollars primarily as a result of increased headcount, prototyping expenses associated with the development of new products and the support of the current and future product development and enhancement efforts.

General and Administrative -- General and administrative expenses were \$2.6 million in fiscal 1996, compared to \$2.9 million in fiscal 1995. These expenses represented 5.5% and 19.3%, respectively, of net sales for such periods. The higher level of general and administrative expenses during fiscal 1995 related primarily to certain litigation expenses, severance costs and increases in the provision for bad debts. In fiscal 1996, the Company continued its investments in additional staffing, facilities expansion and related occupancy costs and information system investments necessary to manage and support the Company's growth.

Other Income, net -- Other income, net, was \$0.6 million and \$0.1 million in fiscal 1996 and 1995, respectively. In both of these periods, other income, net, represented less than 2% of net sales. Other income, net, increased in fiscal 1996 due primarily to interest income earned on the net proceeds of \$25.7 million from the Company's initial public offering that was completed in November 1995.

Provision for Income Taxes -- The Company did not incur state or federal income taxes in fiscal 1995 due to operating losses incurred during those periods. In fiscal 1996, the Company's federal and state income tax liabilities were offset by the realization of a portion of its net deferred tax assets. The Company recognized a benefit for its net deferred tax assets to the extent that they are recoverable through tax refunds in the event of future net operating losses. The Company recorded a valuation allowance for the balance of its net deferred tax assets as a result of significant uncertainties regarding the realization of the assets, including the limited operating history of the Company, a recent history of losses and the variability of operating results.

#### LIQUIDITY AND CAPITAL RESOURCES

As of April 25, 1997, the Company's liquidity primarily consisted of cash and cash equivalents of \$21.5 million and short-term investments of \$6.9 million. The Company generated cash from operating activities totaling \$6.3 million and \$3.5 million in fiscal 1997 and fiscal 1996, respectively. Net cash provided by operating activities in fiscal 1997 principally related to purchased in-process technology and related

compensation expense (a non-cash expense of \$10.5 million), and to increases in accounts payable, accrued compensation and related benefits and income taxes payable, offset by increases in accounts receivable and inventories.

The Company used \$7.1 million and \$4.3 million of cash during fiscal 1997 and 1996, respectively, to purchase property and equipment. The increase in purchases of property and equipment over the prior year was primarily due to computer and equipment purchases to support increased headcount and to the Company's move to a new leased facility which required furniture purchases and

leasehold improvements. In addition, the Company used \$3.9 million and \$3.0 million in fiscal 1997 and 1996, respectively, for net short-term investment purchases. Financing activities provided \$1.7 million and \$26.6 million during fiscal 1997 and 1996, respectively, due primarily to the exercise of stock options in fiscal 1997 and 1996 and to proceeds from the Company's IPO in fiscal 1996.

The Company currently has no significant capital commitments other than commitments under operating and capital leases. The Company believes that its existing liquidity and capital resources are sufficient to fund its operations for at least the next twelve months.

#### RECENTLY ISSUED ACCOUNTING STANDARD

In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, "Earnings per Share" ("SFAS 128"). The Company is required to adopt SFAS 128 in the third quarter of fiscal 1998 and will restate at that time earnings per share ("EPS") data for prior periods to conform with SFAS 128. Earlier application is not permitted.

SFAS 128 replaces current EPS reporting requirements and requires a dual presentation of basic and diluted EPS. Basic EPS excludes dilution and is computed by dividing net income by the weighted average of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. If SFAS 128 had been in effect for fiscal 1997, basic and diluted EPS would not have been significantly different than EPS currently reported in fiscal 1997.

20

21

#### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

##### INDEPENDENT AUDITORS' REPORT

To the Shareholders of  
Network Appliance, Inc.:

We have audited the accompanying consolidated balance sheets of Network Appliance, Inc. and its subsidiaries as of April 30, 1997 and 1996, and the related consolidated statements of operations, shareholders' equity (deficit) and cash flows for each of the three years in the period ended April 30, 1997. Our audit also included the consolidated financial statement schedule listed in Item 14(a)(2). These financial statements and financial statement schedule are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Network Appliance, Inc. and its subsidiaries as of April 30, 1997 and 1996, and the results of their operations and their cash flows for each of the three years in the period ended April 30, 1997 in conformity with generally accepted accounting principles. Also, in our opinion, such consolidated financial statement schedule, when considered in relation to the basic financial statements taken as a whole, presents fairly in all material respects the information set forth therein.

/s/ DELOITTE & TOUCHE LLP

San Jose, California  
May 5, 1997

21

NETWORK APPLIANCE, INC.  
 CONSOLIDATED BALANCE SHEETS  
 (IN THOUSANDS, EXCEPT SHARE AMOUNTS)

	APRIL 30,	
	1997	1996
<b>ASSETS</b>		
Current Assets:		
Cash and cash equivalents.....	\$21,520	\$24,637
Short-term investments.....	6,916	2,982
Accounts receivable, net of allowances of \$330 in 1997 and 1996.....	13,911	5,330
Inventories.....	9,920	4,825
Prepaid expenses and other.....	1,253	528
Deferred taxes.....	3,100	2,100
	-----	-----
Total current assets.....	56,620	40,402
	-----	-----
Property and Equipment, net.....	9,238	4,849
Other Assets.....	3,083	198
	-----	-----
	\$68,941	\$45,449
	=====	=====
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Current Liabilities:		
Current portion of long-term obligations.....	\$ 21	\$ 19
Accounts payable.....	4,394	2,099
Income taxes payable.....	1,023	500
Accrued compensation and related benefits.....	4,666	2,015
Other accrued liabilities.....	2,280	1,110
Deferred revenue.....	2,317	378
	-----	-----
Total current liabilities.....	14,701	6,121
	-----	-----
Long-Term Obligations, net of current portion.....	12	31
Deferred Rent.....	199	268
Commitments and Contingencies (Notes 5 and 11)		
Shareholders' Equity:		
Preferred stock, no par value; 5,000,000 shares authorized; shares outstanding: none in 1997 and 1996.....	--	--
Common stock, no par value; 55,000,000 shares authorized; shares outstanding: 16,415,835 in 1997 and 16,140,083 in 1996.....	54,707	40,286
Deferred stock compensation.....	(54)	(383)
Accumulated deficit.....	(624)	(874)
	-----	-----
Total shareholders' equity.....	54,029	39,029
	-----	-----
	\$68,941	\$45,449
	=====	=====

See notes to consolidated financial statements.

NETWORK APPLIANCE, INC.  
 CONSOLIDATED STATEMENTS OF OPERATIONS  
 (IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

	YEARS ENDED APRIL 30,		
	1997	1996	1995
NET SALES.....	\$93,333	\$46,632	\$14,796

COST OF SALES.....	38,061	20,557	7,957
	-----	-----	-----
Gross margin.....	55,272	26,075	6,839
	-----	-----	-----
OPERATING EXPENSES			
Sales and marketing.....	24,268	12,735	6,284
Research and development.....	8,968	4,762	2,608
General and administrative.....	4,134	2,578	2,860
Purchased in-process technology and related compensation charge.....	10,519	--	--
Litigation settlement.....	4,300	--	--
	-----	-----	-----
Total operating expenses.....	52,189	20,075	11,752
	-----	-----	-----
INCOME (LOSS) FROM OPERATIONS.....	3,083	6,000	(4,913)
	-----	-----	-----
OTHER INCOME (EXPENSE)			
Interest income.....	1,048	668	157
Interest and other expense.....	(88)	(68)	(8)
	-----	-----	-----
Total other income.....	960	600	149
	-----	-----	-----
Income (Loss) Before Income Taxes.....	4,043	6,600	(4,764)
Provision for Income Taxes.....	3,793	--	--
	-----	-----	-----
NET INCOME (LOSS).....	\$ 250	\$ 6,600	\$ (4,764)
	=====	=====	=====
NET INCOME (LOSS) PER SHARE.....	\$ .01	\$ .42	\$ (.38)
	=====	=====	=====
WEIGHTED AVERAGE COMMON AND COMMON EQUIVALENT SHARES.....	17,392	15,820	12,590
	=====	=====	=====

See notes to consolidated financial statements.

23

24

NETWORK APPLIANCE, INC.

CONSOLIDATED STATEMENTS OF SHAREHOLDERS' EQUITY (DEFICIT)  
(IN THOUSANDS, EXCEPT SHARE AMOUNTS)

	SERIES A CONVERTIBLE PREFERRED STOCK		SHARES	AMOUNT	DEFERRED STOCK COMPENSATION	ACCUMULATED DEFICIT	TOTAL
	SHARES	AMOUNT					
BALANCES, APRIL 30, 1994.....	1,186,922	\$ 1,340	4,089,500	\$ 46	\$ --	\$ (2,710)	\$ (1,324)
Sale of common stock.....	--	--	375,635	59	--	--	59
Exercise of stock options.....	--	--	843,589	108	--	--	108
Repurchase of common stock....	--	--	(242,578)	(2)	--	--	(2)
Net loss.....	--	--	--	--	--	(4,764)	(4,764)
	-----	-----	-----	-----	-----	-----	-----
BALANCES, APRIL 30, 1995.....	1,186,922	1,340	5,066,146	211	--	(7,474)	(5,923)
Exercise of stock options.....	--	--	1,437,328	274	--	--	274
Exercise of warrants.....	--	--	359,690	708	--	--	708
Issuance of common stock in connection with the Company's initial public offering.....	--	--	2,155,000	25,714	--	--	25,714
Repurchase of common stock....	--	--	(214,464)	(68)	--	--	(68)
Conversion of Series A preferred stock into common stock.....	(1,186,922)	(1,340)	1,186,922	1,340	--	--	--
Conversion of Series B and C preferred stock into common stock.....	--	--	6,149,461	11,354	--	--	11,354
Deferred stock compensation...	--	--	--	515	(515)	--	--
Amortization of deferred stock compensation.....	--	--	--	--	132	--	132
Income tax benefit from employee stock transactions.....	--	--	--	238	--	--	238
Net income.....	--	--	--	--	--	6,600	6,600
	-----	-----	-----	-----	-----	-----	-----
BALANCES, APRIL 30, 1996.....	--	--	16,140,083	40,286	(383)	(874)	39,029
Issuance of common stock.....	--	--	291,349	1,730	--	--	1,730
Repurchase of common stock....	--	--	(187,969)	(52)	--	--	(52)
Amortization of deferred stock compensation.....	--	--	--	--	85	--	85
Reversal of deferred stock compensation due to employee termination.....	--	--	--	(244)	244	--	--

Income tax benefit from employee stock transactions.....	--	--	--	2,487	--	--	2,487
Common stock issued for IMC acquisition.....	--	--	172,372	7,350	--	--	7,350
Compensation charge for IMC acquisition.....	--	--	--	3,150	--	--	3,150
Net income.....	--	--	--	--	--	250	250
BALANCES, APRIL 30, 1997.....	--	\$ --	16,415,835	\$54,707	\$ (54)	\$ (624)	\$54,029

See notes to consolidated financial statements.

NETWORK APPLIANCE, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(IN THOUSANDS)

	YEARS ENDED APRIL 30,		
	1997	1996	1995
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income (loss).....	\$ 250	\$ 6,600	\$ (4,764)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation and amortization.....	2,781	1,254	389
Amortization of deferred stock compensation.....	85	132	--
Purchased in-process technology and related compensation charge.....	10,519	--	--
Provision for doubtful accounts.....	--	110	210
Deferred income taxes.....	(2,794)	(2,100)	--
Deferred rent.....	(69)	87	125
Changes in assets and liabilities:			
Accounts receivable.....	(8,573)	(2,270)	(2,860)
Inventories.....	(5,095)	(1,181)	(3,214)
Prepaid expenses and other.....	(1,031)	(525)	(154)
Accounts payable.....	2,295	(1,415)	3,119
Accrued compensation and related benefits.....	2,636	1,065	869
Income taxes payable.....	3,010	500	--
Other accrued liabilities.....	338	876	424
Deferred revenue.....	1,917	370	8
Net cash provided by (used in) operating activities.....	6,269	3,503	(5,848)
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Purchases of property and equipment.....	(7,124)	(4,281)	(1,504)
Redemptions of short-term investments.....	13,836	--	--
Purchases of short-term investments.....	(17,770)	(2,982)	--
Cash acquired from IMC purchase.....	11	--	--
Net cash used in investing activities.....	(11,047)	(7,263)	(1,504)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Proceeds from issuance of long-term debt.....	--	1,250	--
Repayments of long-term obligations.....	(17)	(1,272)	(3)
Payments for repurchase of common stock.....	(52)	(68)	(2)
Proceeds from sale of common stock, net.....	1,730	26,696	167
Proceeds from sale of preferred stock, net.....	--	--	6,555
Net cash provided by financing activities.....	1,661	26,606	6,717
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS.....	(3,117)	22,846	(635)
<b>CASH AND CASH EQUIVALENTS</b>			
Beginning of period.....	24,637	1,791	2,426
End of period.....	\$21,520	\$24,637	\$ 1,791

See notes to consolidated financial statements.

## NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(DOLLAR VALUES IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

## 1. THE COMPANY

Network Appliance, Inc., incorporated in the state of California in April 1992, and its subsidiaries (the "Company") operates in a single industry segment and is involved in the design, manufacturing, marketing and support of network data storage appliances.

## 2. SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation -- The consolidated financial statements include the Company and its wholly-owned subsidiaries. Intercompany accounts and transactions are eliminated in consolidation. Beginning in fiscal 1996, the Company's fiscal year ended on the Friday nearest to April 30. For fiscal 1997 and for fiscal 1996, the Company's fiscal years ended on April 25 and April 26, respectively. For presentation purposes, the Company reflects April 30 as the fiscal year end for all periods presented in the accompanying consolidated financial statements.

Cash and Cash Equivalents -- The Company considers all highly liquid debt investments with original maturities of three months or less to be cash equivalents.

Short-term Investments -- The Company's short-term investments consist of securities with original maturities ranging between three and six months. All of the Company's investments are classified as available-for-sale, and are stated at amortized cost, which approximates fair market value. Short-term investments consisted of \$6,916 of municipal securities at April 30, 1997, and \$1,982 of corporate debt securities and \$1,000 of certificates of deposit at April 30, 1996. No short-term investments were sold during fiscal 1997.

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

Property and Equipment -- Property and equipment is stated at cost and is depreciated on a straight-line basis over estimated useful lives which range from three to five years. Equipment under capital lease is stated at the present value of the minimum lease payments at the inception of the lease. Such equipment and leasehold improvements are amortized over their estimated useful lives or the life of the lease, whichever is shorter.

Revenue Recognition -- The Company recognizes revenue and records estimated product return and warranty reserves upon shipment if no material obligations remain outstanding and the collectibility of receivables is deemed to be probable. Service revenues are recognized over the term of the related contractual period. Software subscription revenues are recognized over the term of the related contractual period. Combined service and software subscription revenues were less than 10% of net sales for all of the periods presented.

Software Development Costs -- The Company capitalizes eligible computer software development costs, which include software enhancement costs, upon the establishment of technological feasibility, which occurs upon the completion of a working model. For fiscal 1997 software development costs capitalized were not significant. In fiscal 1996 and 1995, costs which were eligible for capitalization were insignificant, and thus, the Company charged all software development costs to research and development expense in the accompanying consolidated statements of operations.

Foreign Currency Translation -- The functional currency of the Company's foreign subsidiaries is the U.S. dollar. Accordingly, all monetary assets and liabilities are translated at the current exchange rate at the end of the year, nonmonetary assets and liabilities are translated at historical rates and net sales and expenses are translated at average exchange rates in effect during the period. Transaction gains and losses, which are included in other income (expense) in the accompanying consolidated statements of operations, have not been significant.

## NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
(DOLLAR VALUES IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

Certain Significant Risks and Uncertainties -- The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Such management estimates include the allowance for doubtful accounts receivable, inventory reserves, various accruals, valuation allowances for deferred tax assets and warranty reserves. Actual results could differ from those estimates.

Financial instruments which potentially subject the Company to concentrations of credit risk consist primarily of cash equivalents, short-term investments and accounts receivable. Cash equivalents and short-term investments consist primarily of money market funds that are held with two financial institutions and municipal securities. The Company sells its products primarily to large organizations in different industries and geographies. Credit risk is further mitigated by the Company's credit evaluation process and limited payment terms. The Company does not require collateral or other security to support accounts receivable. While the Company maintains an allowance for potential credit losses, such losses have not been significant.

The Company is subject to certain risks, including without limitation risks relating to history of operating losses, fluctuating operating results, customer and market acceptance of new products, dependence on new products, rapid technological change, litigation, dependence on growth in the network file server market, expansion of international operations, product concentration, changing product mix, competition, recent management additions, management of expanding operations, dependence on high-quality components, dependence on proprietary technology, intellectual property rights, dependence on key personnel, volatility of stock price, shares eligible for future sale, effect of certain anti-takeover provisions and dilution.

Net Income (Loss) Per Share -- Net income (loss) per share is computed using the weighted average number of common and common equivalent shares outstanding during the period. Common equivalent shares include preferred stock (using the "if converted" method) and stock options and warrants (using the treasury stock method). Common equivalent shares are excluded from the computation if their effect is anti-dilutive except that, pursuant to the Securities and Exchange Commission's Staff Accounting Bulletins and staff policy, such computations include all common and common equivalent shares issued within the 12 months preceding the initial filing date of the Company's Form S-1 Registration Statement (October 6, 1995) as if they were outstanding for all periods presented. In addition, all outstanding preferred stock that converted in connection with the initial public offering is included in the computation as common equivalent shares even when the effect is anti-dilutive.

## NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
(DOLLAR VALUES IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

Statements of Cash Flows -- Supplemental cash flow and noncash investing and financing activities are as follows:

YEARS ENDED APRIL 30,		
1997	1996	1995
-----	-----	---

SUPPLEMENTAL CASH FLOW INFORMATION

Interest paid.....	\$ --	\$ 60	\$ 8
Income taxes paid.....	\$3,809	\$ 1,362	\$--
NONCASH INVESTING AND FINANCING ACTIVITIES			
Deferred stock compensation.....	\$ (244)	\$ 515	\$--
Conversion of preferred stock into common stock.....	\$ --	\$12,694	\$--
Income tax benefit from employee stock transactions.....	\$2,487	\$ 238	\$--
Equipment acquired under capital lease.....	\$ --	\$ --	\$75
Common stock issued for IMC acquisition.....	\$7,350	\$ --	\$--
Compensation charge for IMC acquisition.....	\$3,150	\$ --	\$--

Reclassification -- Certain amounts in prior years have been reclassified to conform with the fiscal 1997 presentation. These reclassifications did not change previously reported total assets, liabilities, shareholders' equity or net income (loss).

Stock-Based Compensation -- The Company accounts for stock-based awards to employees using the intrinsic value method in accordance with APB No. 25, "Accounting for Stock Issued to Employees."

Accounting for Long-Lived Assets -- Effective May 1, 1996, the Company adopted Financial Accounting Standards Board Statement No. 121 ("SFAS 121"), "Accounting for the Impairment of Long-Lived Assets and for Long-Lived Assets to be Disposed of," which requires the Company to review the impairment of long-lived assets, certain identifiable intangibles and goodwill related to those assets whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. The adoption of SFAS 121 had no impact on the Company's financial condition or results of operations.

Recently Issued Accounting Standard -- In February 1997, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards No. 128, "Earnings per Share" ("SFAS 128"). The Company is required to adopt SFAS 128 in the third quarter of fiscal 1998 and will restate at that time earnings per share ("EPS") data for prior periods to conform with SFAS 128. Earlier application is not permitted. SFAS 128 replaces current EPS reporting requirements and requires a dual presentation of basic and diluted EPS. Basic EPS excludes dilution and is computed by dividing net income by the weighted average of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock. If SFAS 128 had been in effect for fiscal 1997, basic and diluted EPS would not have been significantly different than EPS currently reported in fiscal 1997.

NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
(DOLLAR VALUES IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

3. INVENTORIES

Inventories consist of the following:

	APRIL 30,	
	1997	1996
	-----	-----
Purchased components.....	\$6,775	\$2,161
Work in process.....	1,524	970
Finished goods.....	1,621	1,694
	-----	-----
	\$9,920	\$4,825
	=====	=====

4. PROPERTY AND EQUIPMENT

Property and equipment consists of the following:

	APRIL 30,	
	1997	1996
Computers, related equipment and purchased software.....	\$11,011	\$ 5,691
Furniture and fixtures.....	1,221	397
Leasehold improvements.....	1,520	494
	-----	-----
	13,752	6,582
Accumulated depreciation and amortization.....	(4,514)	(1,733)
	-----	-----
	\$ 9,238	\$ 4,849
	=====	=====

#### 5. COMMITMENTS AND CAPITAL LEASE OBLIGATIONS

Certain equipment is leased under capital lease agreements. As of April 30, 1997 the net book value of equipment under capital lease was \$23 (net of accumulated amortization of \$37).

The Company leases its main facility and various sales offices under operating leases that expire through fiscal 2001. The Company is responsible for certain maintenance costs, taxes and insurance under the leases. Future minimum annual lease payments as of April 30, 1997 are as follows:

YEARS ENDING APRIL 30,	LEASES	
	OPERATING	CAPITAL
-----	-----	-----
1998.....	\$ 2,742	\$ 22
1999.....	2,282	13
2000.....	2,142	--
2001.....	183	--
	-----	-----
Total lease payments.....	\$ 7,349	35
	=====	
Amounts representing interest.....		(2)
		-----
		33
Current portion.....		(21)
		-----
Long-term portion.....		\$ 12
		=====

Rent expense was approximately \$1,195, \$755, and \$566 for the years ended April 30, 1997, 1996 and 1995, respectively. Rent expense under a Company facility lease is recognized on a straight-line basis over the term of the lease. The difference between the amounts paid and the amounts expensed is classified as deferred rent in the accompanying consolidated balance sheets.

#### NETWORK APPLIANCE, INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED) (DOLLAR VALUES IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

The total of minimum rental payments to be received through 1999 under non-cancelable subleases is \$2,016 as of April 30, 1997.

#### 6. ACQUISITION

On March 17, 1997, the Company acquired all outstanding shares and options to purchase shares of IMC common stock by issuing 187,023 shares of the Company's common stock and options to purchase shares of the Company's common stock. The purchase price related to the common stock and options to purchase shares of the Company's common stock was \$7,350. IMC was founded in 1996 to develop and commercialize Internet/intranet proxy caching software.

Certain key employees of IMC who continued as employees of the Company were also granted vested options to purchase shares of the Company's common stock at a discount to the market price of the Company's common stock immediately preceding the acquisition. In connection with the granting of discounted options to purchase shares of the Company's common stock, the Company recorded a compensation expense of approximately \$3,150 in the fourth quarter of fiscal 1997. The Company also recorded a deferred income tax benefit of \$1,304, primarily related to the compensation charge.

The acquisition was accounted for as a purchase and, accordingly, the results of operations of IMC from the date of acquisition forward have been included in the Company's consolidated financial statements. In connection with the acquisition, intangible assets of \$8,362 were acquired, of which \$7,369 was reflected as a one-time charge to operations for the write-off of purchased in-process research and development that had not reached technological feasibility and, in management's opinion, had no probable alternative future use. The \$10,519 combined one-time charge for purchased in-process technology and compensation expense has been reflected in the Company's fiscal 1997 consolidated statement of operations within operating expenses. The remaining intangible assets of \$993, consisting of existing technology and goodwill, are included in other assets in the accompanying consolidated balance sheets and are being amortized over their estimated useful lives of five years.

In connection with the acquisition, net assets acquired are as follows:

Current assets.....	\$	21
Property and equipment, net.....		46
Intangible assets, including purchased in-process technology.....		8,362
Current liabilities assumed.....		(1,079)
		-----
Net assets acquired.....	\$	7,350
		=====

The following unaudited pro forma information shows the results of operations for the two fiscal years ended April 30, 1997 as if the IMC acquisition had occurred at the beginning of each period presented and at the purchase price established in March 1997. The results are not necessarily indicative of what would have occurred had the acquisition actually been made at the beginning of each of the respective periods presented or of future operations of the combined companies. The pro forma results for fiscal 1997 combine the Company's results of operations for the fiscal year ended April 30, 1997 with the results of IMC for the period from inception (May 6, 1996) through the date of acquisition and include the \$10,519 charge for purchased in-process technology and the related compensation charge, as well as the related tax benefits, and the straight-line amortization of intangible assets over a period of five years. The pro forma results for fiscal 1996

NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
(DOLLAR VALUES IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

reflect the Company's actual results of operations for that year less the amortization of intangible assets related to the acquisition:

	1997	1996
Net Sales.....	\$93,552	\$46,632
Net Income (Loss).....	\$ (390)	\$ 6,401
Net Income (Loss) per Share.....	\$ (.02)	\$ .40
Weighted Average Common and Common Equivalent Shares (in thousands).....	16,337	16,075

## 7. COMMON STOCK AND STOCK OPTION PLANS

Initial Public Offering -- In November 1995, the Company completed its initial public offering of 2,155,000 shares of its common stock. Net proceeds from the offering were approximately \$25,714. In conjunction with the offering, all outstanding shares of preferred stock automatically converted into common stock. In addition, the Company issued 181,119 shares of common stock upon the exercise of Series A preferred warrants, and 178,571 shares of common stock upon the exercise of Series C preferred warrants. The Company received total proceeds of approximately \$708 from the exercise of these warrants.

Stock Option Plans -- The Company adopted the 1993 Stock Option/Stock Issuance Plan (the "1993 Plan") in April 1993. In September 1995, the Company adopted the 1995 Stock Incentive Plan (the "1995 Plan"). The 1995 Plan replaced the 1993 Plan, and provides for the grant of options and the issuance of common stock under terms substantially the same as those provided under the 1993 Plan, except that the 1995 Plan does not allow for the exercise of options prior to vesting. Accordingly, all options and shares issued under the 1993 Plan were incorporated into the 1995 Plan upon the effectiveness of the Company's initial public offering.

## NETWORK APPLIANCE, INC.

### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED) (DOLLAR VALUES IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

Under the 1995 Plan, the Board of Directors may grant to employees, directors and consultants options to purchase shares of the Company's common stock. The exercise price for an incentive stock option and a nonqualified stock option cannot be less than 100% and 85%, respectively, of the fair market value of the Company's common stock as determined by the Board of Directors on the date of grant. Options granted under the 1995 Plan generally vest at a rate of 25% on the first anniversary of the vesting commencement date and then ratably over the following 36 months. Options expire as determined by the Board of Directors, but not more than ten years after the date of grant. A summary of the combined activity under the Company's stock option plans and agreements is as follows:

	SHARES AVAILABLE FOR GRANT	OUTSTANDING OPTIONS	
		NUMBER OF SHARES	WEIGHTED AVERAGE
Balances, April 30, 1994.....	451,000	549,000	\$ 0.12
Shares reserved for plan.....	1,400,000	--	--
Options granted.....	(1,832,500)	1,832,500	\$ 0.14
Options exercised.....	--	(843,589)	\$ 0.13
Options canceled.....	149,428	(149,428)	\$ 0.13
Balances, April 30, 1995.....	167,928	1,388,483	\$ 0.14
Shares reserved for plan.....	3,250,000	--	--
Options granted (weighted average fair value of \$3.20).....	(1,793,190)	1,793,190	\$ 8.46
Options exercised.....	--	(1,437,328)	\$ 0.21
Options canceled.....	147,721	(147,721)	\$ 2.01
Balances, April 30, 1996.....	1,772,459	1,596,624	\$ 9.25

Shares reserved for IMC acquisition....	129,148	--	--
Options granted (weighted average fair value of \$13.19).....	(1,668,908)	1,668,908	\$29.67
Options exercised.....	--	(208,977)	\$ 3.29
Options canceled.....	236,977	(236,977)	\$10.69
	-----	-----	
Balances, April 30, 1997.....	469,676	2,819,578	\$21.66
	=====	=====	

Options for the purchase of approximately 497,709 shares of common stock were vested as of April 30, 1997. Unvested common shares issued under the 1993 Plan of approximately 577,013 as of April 30, 1997 are subject to repurchase by the Company.

Additional information regarding options outstanding as of April 30, 1997 is as follows:

RANGE OF EXERCISE PRICES	OPTIONS OUTSTANDING			OPTIONS EXERCISABLE	
	NUMBER OUTSTANDING AT APRIL 30, 1997	WEIGHTED AVERAGE REMAINING CONTRACTUAL LIFE (IN YEARS)	WEIGHTED AVERAGE EXERCISE PRICE	NUMBER EXERCISABLE	WEIGHTED AVERAGE EXERCISE PRICE
\$0.10 - \$0.20	145,304	7.27	\$ 0.15	145,304	\$ 0.15
\$0.28 - \$0.28	54,917	8.08	\$ 0.28	54,917	\$ 0.28
\$2.00 - \$4.50	163,812	8.22	\$ 3.01	149,165	\$ 3.02
\$6.00 - \$11.79	676,945	8.71	\$ 8.84	562,444	\$ 8.24
\$21.75 - \$48.25	1,778,600	9.53	\$30.67	86,682	\$27.28
	-----			-----	
	2,819,578			998,512	
	=====			=====	

32

33

NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
(DOLLAR VALUES IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

Employee Stock Purchase Plan -- Under the Employee Stock Purchase Plan, employees are entitled to purchase shares of the Company's common stock at 85% of the fair market value at certain specified dates. Of the 350,000 shares authorized to be issued under this plan, 267,628 shares were available for issuance at April 30, 1997 and 82,372 shares were issued in fiscal 1997 at a weighted average price of \$12.65.

Pro Forma Information -- As discussed in Note 2, the Company continues to account for its stock-based awards using the intrinsic value method in accordance with Accounting Principles Board No. 25, "Accounting for Stock Issued to Employees" and its related interpretations. Accordingly, no compensation expense has been recognized in the financial statements for employee stock arrangements with the exception of \$85 and \$132 in fiscal 1997 and 1996, respectively, which relates to amortization of deferred stock compensation initially recorded in May 1995.

Statement of Financial Accounting Standards No. 123, "Accounting for Stock-Based Compensation," ("SFAS 123") requires the disclosure of pro forma net income and earnings per share had the Company adopted the fair value method as of the beginning of fiscal 1996. Under SFAS 123, the fair value of stock-awards to employees is calculated through the use of option pricing models, even though such models were developed to estimate the fair value of freely tradeable, fully transferable options without vesting restrictions, which significantly differ from the Company's stock option awards. These models also require subjective assumptions, including future stock price volatility and expected time to exercise, which greatly affect the calculated values. The Company's calculations were made using the Black-Scholes option pricing model with the following weighted average assumptions:

	YEARS ENDED APRIL 30,	
	1997	1996
Expected life (in years).....	2.90	3.01
Risk-free interest rate.....	6.06%	5.89%
Volatility.....	50%	50%
Expected dividend.....	\$ --	\$ --

The Company's calculations are based on a multiple option valuation approach and forfeitures are recognized as they occur. If the computed fair values of the fiscal 1997 and 1996 awards had been amortized to expense over the vesting period of the awards, pro forma net income (loss) would have been \$(4,661) or \$(.29) per share in fiscal 1997 and \$5,824 or \$.37 per share in fiscal 1996. However, the impact of outstanding non-vested stock options granted prior to fiscal 1996 has been excluded from the pro forma calculations; accordingly, the fiscal 1997 and 1996 pro forma adjustments are not indicative of future period pro forma adjustments, when the calculation will apply to all applicable stock options.

Deferred Stock Compensation -- In May 1995, the Company issued stock options for the purchase of 531,500 shares of common stock at \$.28 per share. The Company recognized \$515 of deferred compensation in May 1995 equal to the difference between the option price as determined by the Board of Directors and \$1.25 (the deemed fair value for financial reporting purposes) for each option. The Company is amortizing the deferred compensation expense ratably over the four-year period in which the options vest.

#### 8. EMPLOYEE BENEFIT PLAN

The Company has established a 401(k) tax-deferred savings plan. Employees meeting the eligibility requirements, as defined, may contribute specified percentages of their salaries. For the fiscal year ended April 30, 1997, the Company contributed \$119 (none in fiscal 1996 and 1995).

### NETWORK APPLIANCE, INC.

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED) (DOLLAR VALUES IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

#### 9. INCOME TAXES

The Company incurred losses for financial reporting and tax purposes in fiscal 1995, and accordingly did not record a provision for income taxes. In fiscal 1997 and 1996, the provision for income taxes consists of the following:

	YEARS ENDED APRIL 30,	
	1997	1996
CURRENT		
Federal.....	\$5,062	\$ 1,880
State.....	1,525	220
Total current.....	6,587	2,100
DEFERRED		
Federal.....	(2,394)	(1,880)
State.....	(400)	(220)
Total deferred.....	(2,794)	(2,100)
Provision for income taxes.....	\$3,793	\$ --

Deferred income taxes result from differences in the timing of certain expense items for tax and financial reporting purposes.

The provision for income taxes differs from the amount computed by applying the statutory federal income tax rate as follows:

	YEARS ENDED APRIL 30,	
	1997	1996
Tax computed at federal statutory rate.....	\$1,415	\$ 2,310
State income taxes, net of federal benefit.....	764	405
Non-deductible acquisition charges related to the IMC acquisition.....	2,904	--
Research and experimentation credit.....	(410)	(50)
Investment tax credit.....	--	(150)
Benefit of foreign sales corporation.....	(105)	--
Tax exempt interest.....	(184)	--
Change in valuation allowance.....	(673)	(2,510)
Other.....	82	(5)
	-----	-----
Provision for income taxes.....	\$3,793	\$ --
	=====	=====

The income tax benefits associated with dispositions from employee stock transactions reduced taxes currently payable for fiscal 1997 by \$2,487 (\$238 and \$0 for fiscal 1996 and 1995, respectively).

Income before income taxes is as follows:

	YEARS ENDED APRIL 30,	
	1997	1996
Domestic.....	\$3,983	\$6,580
Foreign.....	60	20
	-----	-----
Total.....	\$4,043	\$6,600
	=====	=====

NETWORK APPLIANCE, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)  
(DOLLAR VALUES IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)

Current net deferred tax assets at April 30, 1997 and 1996 were \$3,100 and \$2,100, respectively. Non-current net deferred tax assets at April 30, 1997 and 1996 of \$1,794 and \$0, respectively, are included in other assets within the accompanying consolidated balance sheets. The components of the Company's net deferred tax assets are as follows:

	APRIL 30,	
	1997	1996
Deferred tax assets:		
Capitalized research and development costs.....	\$ 142	\$ 696
Reserves and accruals not currently deductible for tax purposes.....	2,662	1,828
Net operating loss carryforwards.....	116	141

Depreciation.....	369	--
Deferred rent.....	80	108
Tax benefit of options issued in IMC acquisition.....	1,304	--
Other.....	221	--
	-----	-----
	4,894	2,773
Valuation allowance.....	--	(673)
	-----	-----
Net deferred tax asset.....	\$4,894	\$2,100
	=====	=====

As of April 30, 1997, the Company had federal net operating loss carryforwards of approximately \$332 available to offset future taxable income. These carryforwards expire in 2010.

#### 10. OPERATIONS BY GEOGRAPHIC AREA AND SIGNIFICANT CUSTOMERS

The Company operates primarily in one industry segment: the design, manufacturing and marketing of high-performance network data storage devices.

The Company's foreign operations consist of sales by its subsidiaries in the United Kingdom, France, Germany and Italy to either unaffiliated European customers or to independent distributors. The following table summarizes the Company's fiscal 1997 operations by geographic area:

	UNITED STATES -----	EUROPE -----	TOTAL -----
Net sales.....	\$83,342	\$9,991	\$93,333
Income (loss) from operations.....	\$ 3,023	\$ 60	\$ 3,083
Identifiable assets.....	\$66,019	\$2,922	\$68,941

Sales by the Company's foreign subsidiaries for fiscal 1996 and fiscal 1995 were less than 10% of net sales. No customer accounted for 10% or more of net sales in either fiscal 1997 or in fiscal 1996. In fiscal 1995, two customers each accounted for 10% of net sales.

#### 11. LITIGATION

The computer industry is characterized by frequent litigation regarding intellectual property rights. During fiscal 1995 a lawsuit of this nature was filed against the Company and two of its shareholders (the "Whipsaw Litigation"). During the first quarter of fiscal 1997, the Company settled the Whipsaw litigation and recorded a pre-tax expense of \$4,300 (\$3,500 in payments to the plaintiffs and \$800 in legal fees). In connection with the settlement, the Whipsaw group released the Company from all liabilities.

35

36

#### ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

#### PART III

#### ITEM 10. DIRECTORS AND OFFICERS OF THE REGISTRANT

The information required by this Item with respect to the Company's executive officers is incorporated herein by reference from the information under Item 4 of Part I of this Report under the section entitled "Executive Officers". The information required by this Item with respect to the Company's directors is incorporated herein by reference from the information provided under the heading "Election of Directors" of the Proxy Statement which will be filed with the Commission. The information required by Item 405 of Regulation S-K is incorporated herein by reference from the information provided under the heading "Section 16(a) Beneficial Ownership Reporting Compliance" of the Proxy

Statement.

ITEM 11. EXECUTIVE COMPENSATION

Information regarding the compensation of executive officers and directors of the Company is incorporated by reference from the information under the heading "Executive Compensation and Related Information" in the Company's Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

Information regarding security ownership of certain beneficial owners and management is incorporated by reference from the information under the heading "Security Ownership of Certain Beneficial Owners and Management" in the Company's Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

Information regarding certain relationships and related transactions is incorporated by reference from the information under the caption "Employment Contracts, Termination of Employment and Change-In-Control Agreements" in the Company's Proxy Statement.

PART IV

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K

(a) List of Documents filed as part of this Annual Report on Form 10-K.

1. The following consolidated financial statements of Network Appliance, Inc. are filed as part of this Form 10-K:

Independent Auditors' Report  
Consolidated Balance Sheets -- April 30, 1997 and 1996  
Consolidated Statements of Operations for the years ended April 30, 1997, 1996 and 1995  
Consolidated Statements of Shareholders' Equity (Deficit) for the years ended April 30, 1997, 1996 and 1995  
Consolidated Statements of Cash Flows for the years ended April 30, 1997, 1996 and 1995  
Notes to Consolidated Financial Statements

2. Financial Statement Schedule.

The following financial statement schedule of the Company is filed as part of this Annual Report on Form 10-K:

Schedule II -- Valuation and Qualifying Accounts

All other schedules have been omitted since the required information is not present in amounts sufficient to require submission of the schedule or because the information required is included in the consolidated financial statements or notes thereto.

36

37

3. Exhibits.

EXHIBIT NO.	DESCRIPTION
2.1(1)	Agreement and Plan of Reorganization, dated as of March 17, 1997, between the Registrant and IMC, a California corporation
2.2(1)	Agreement of Merger between the Registrant and IMC as filed with the California Secretary of State on March 17, 1997
3.1(2)	Restated Articles of Incorporation of the Company
3.2(3)	Bylaws of the Company
4.1(3)	Reference is made to Exhibits 3.1 and 3.2
4.2(3)	Specimen Common Stock certificate
4.3(3)	Amended and Restated Investors' Rights Agreement, dated September 23,

	1994, among the Company and the investors and the founders named therein, as amended
4.4(3)	Amended and Restated Shareholders Agreement, dated September 23, 1994, among the Company and the employee holders and the Preferred Stock investors named therein
4.5(3)	Forms of Warrants to Purchase Shares of Series A and Series C Preferred Stock
10.1(3), (4)	Distributor Agreement, dated June 1, 1993, by and among the Company, ITOCHU Corporation and CTC Supply Sales
10.2(3)	Forms of Indemnification Agreements entered into between the Company and its directors and officers
10.3(3)	The Company's 1993 Stock Option/Stock Issuance Plan
10.4(3)	The Company's 1993 Stock Incentive Plan
10.5(3)	The Company's Employee Stock Purchase Plan
10.6(3)	Series C Preferred Stock and Common Stock and Warrant to Purchase Series C Preferred Stock Purchase Agreement, dated September 23, 1994, among the Company and the purchasers named therein
10.7(3)	Office lease dated October 21, 1993, between the Company and Vanni Business Park General Partnership ("Vanni") and Office Lease Agreement, dated October 20, 1994, between the Company and Vanni
10.8(3)	Agreement dated June 19, 1995, between the Company and Imperial Bank, as amended, Promissory Note issued thereunder and ancillary documents
10.9(3)	Settlement Agreement and General Release, dated June 28, 1995, between the Company and Michael Malcolm
10.10(3)	Security and Loan Agreement, Credit Terms and Conditions and General Security Agreement between the Company and Imperial Bank, dated August 31, 1994, as amended
10.11(5)	Facility sublease, dated August 9, 1996, by and between S3, Inc. and the Registrant
10.12	The Company's Amended 1995 Stock Incentive Plan
10.13	The Company's Special Non-Officer Stock Option Plan
16.1(3)	Letter Regarding Change in Independent Auditors
21.1	Subsidiaries of the Company
23.1	Independent Auditors' Consent
24.1	Power of Attorney (see signature page)
27.1	Financial Data Schedule

- 
- (1) Previously filed as an exhibit with the Company's Form 8-K dated March 17, 1997.
  - (2) Previously filed as an exhibit with the Company's Annual Report on Form 10-K dated July 25, 1996.
  - (3) Previously filed as an exhibit to the Company' Registration Statement on Form S-1 (No. 33-97864).
  - (4) Confidential treatment requested as to certain portions of these exhibits.
  - (5) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated March 7, 1997.

37

38

- (b) Reports on Form 8-K.

On March 28, 1997, the Company filed a current report on Form 8-K, announcing the execution of an Agreement and Plan of Reorganization with Internet Middleware Corporation on March 17, 1997.

#### SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Company has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on July 22, 1997.

NETWORK APPLIANCE, INC.

By: /s/ DANIEL J. WARMENHOVEN

-----  
Daniel J. Warmenhoven  
President and Chief Executive  
Officer

## POWER OF ATTORNEY

KNOW ALL MEN BY THESE PRESENTS, that each person whose signature appears below constitutes and appoints Daniel J. Warmenhoven and Jeffrey R. Allen, and each of them, as his true and lawful attorneys-in-fact and agents, with full power of substitution and resubstitution, for him and in his name, place and stead, in any and all capacities, to sign any and all amendments (including post-effective amendments) to this Report on Form 10-K, and to file the same, with all exhibits thereto, and other documents in connection therewith, with the Securities and Exchange Commission, granting unto said attorneys-in-fact and agents, and each of them, full power and authority to do and perform each and every act and thing requisite and necessary to be done in connection therewith, as fully to all intents and purposes as he might or could do in person, hereby ratifying and confirming all that said attorneys-in-fact and agents, or any of them, or their or his substitutes, may lawfully do or cause to be done by virtue thereof.

Pursuant to the requirements of the Securities Exchange Act of 1934, as amended, this report has been signed below by the following persons on behalf of the Company and in the capacities and on the dates indicated:

SIGNATURES	TITLE	DATE
/s/ DANIEL J. WARMENHOVEN ----- (Daniel J. Warmenhoven)	President and Chief Executive Officer, Director (Principal Executive Officer)	July 22, 1997
/s/ DONALD T. VALENTINE ----- (Donald T. Valentine)	Chairman of the Board, Director	July 22, 1997
/s/ JEFFRY R. ALLEN ----- (Jeffry R. Allen)	Vice President Finance and Operations, Chief Financial Officer and Secretary (Principal Financial and Accounting Officer)	July 22, 1997
/s/ CAROL A. BARTZ ----- (Carol A. Bartz)	Director	July 22, 1997
/s/ LARRY R. CARTER ----- (Larry R. Carter)	Director	July 22, 1997
/s/ MICHAEL R. HALLMAN ----- (Michael R. Hallman)	Director	July 22, 1997
/s/ KURT R. JAGGERS ----- (Kurt R. Jagggers)	Director	July 22, 1997
/s/ ROBERT T. WALL ----- (Robert T. Wall)	Director	July 22, 1997

## SCHEDULE II

## NETWORK APPLIANCE, INC.

VALUATION AND QUALIFYING ACCOUNTS  
YEARS ENDED APRIL 30, 1997, 1996 AND 1995  
(IN THOUSANDS)

DESCRIPTION	BALANCE AT BEGINNING OF PERIOD	CHARGED TO COSTS AND EXPENSES	DEDUCTIONS	BALANCE AT END OF PERIOD
Allowance for doubtful account:				
1997.....	\$ 330	\$ --	\$ --	\$ 330
1996.....	220	110	--	330
1995.....	10	210	--	220
Excess and obsolescence inventory reserve:				
1997.....	\$1,043	\$2,551	\$578	\$3,016
1996.....	345	698	--	1,043
1995.....	45	300	--	345

41

INDEX TO EXHIBITS

EXHIBIT NO.	DESCRIPTION
10.12	The Company's Amended 1995 Stock Incentive Plan
10.13	The Company's Special Non-Officer Stock Option Plan
21.1	Subsidiaries of the Company
23.1	Independent Auditors' Consent
24.1	Power of Attorney (see signature page)
27.1	Financial Data Schedule

NETWORK APPLIANCE, INC.  
1995 STOCK INCENTIVE PLAN

(AMENDED AND RESTATED AS OF JULY 17, 1997)

ARTICLE ONE

GENERAL PROVISIONS

I. PURPOSE OF THE PLAN

This 1995 Stock Incentive Plan is intended to promote the interests of Network Appliance, Inc., a California corporation, by providing eligible persons with the opportunity to acquire a proprietary interest, or otherwise increase their proprietary interest, in the Corporation as an incentive for them to remain in the service of the Corporation.

Capitalized terms shall have the meanings assigned to such terms in the attached Appendix.

II. STRUCTURE OF THE PLAN

A. The Plan shall be divided into four separate equity programs:

(i) the Discretionary Option Grant Program under which eligible persons may, at the discretion of the Plan Administrator, be granted options to purchase shares of Common Stock,

(ii) the Salary Investment Option Grant Program under which the Corporation's officers and other highly-compensated employees may elect to have a portion of their base salary reduced each year in return for options to purchase shares of Common Stock,

(iii) the Stock Issuance Program under which eligible persons may, at the discretion of the Plan Administrator, be issued shares of Common Stock directly, either through the immediate purchase of such shares or as a bonus for services rendered the Corporation (or any Parent or Subsidiary), and

(iv) the Automatic Option Grant Program under which Eligible Directors shall automatically receive option grants at periodic intervals to purchase shares of Common Stock.

B. The provisions of Articles One and Six shall apply to all equity programs under the Plan and shall accordingly govern the interests of all persons under the Plan.

III. ADMINISTRATION OF THE PLAN

A. The Primary Committee shall have sole and exclusive authority to administer the Discretionary Option Grant and Stock Issuance Programs with respect to Section 16 Insiders. Administration of the Discretionary Option Grant and Stock Issuance Programs with respect to all other persons eligible to participate in those programs may, at the Board's discretion, be vested in the Primary Committee or a Secondary Committee, or the Board may retain the power to administer those programs with respect to all such persons. The Primary Committee shall also have the sole and exclusive authority to administer the Salary Investment Option Grant Program and to select the eligible individuals who are to participate in that program for one or more calendar years.

B. Members of the Primary Committee or any Secondary Committee shall serve for such period of time as the Board may determine and may be removed by the Board at any time. The Board may also at any time terminate the functions of any Secondary Committee and reassume all powers and authority previously delegated to such committee.

C. Each Plan Administrator shall, within the scope of its

administrative functions under the Plan, have full power and authority to establish such rules and regulations as it may deem appropriate for proper administration of the Discretionary Option Grant and Stock Issuance Programs and to make such determinations under, and issue such interpretations of, the provisions of such programs and any outstanding options or stock issuances thereunder as it may deem necessary or advisable. Decisions of the Plan Administrator within the scope of its administrative functions under the Plan shall be final and binding on all parties who have an interest in the Discretionary Option Grant or Stock Issuance Program under its jurisdiction or any stock option or stock issuance thereunder.

D. Service on the Primary Committee or the Secondary Committee shall constitute service as a Board member, and members of each such committee shall accordingly be entitled to full indemnification and reimbursement as Board members for their service on such committee. No member of the Primary Committee or the Secondary Committee shall be liable for any act or omission made in good faith with respect to the Plan or any option grants or stock issuances under the Plan.

E. Administration of the Automatic Option Grant Program shall be self-executing in accordance with the terms of that program, and no Plan Administrator shall exercise any discretionary functions with respect to option grants made thereunder.

2

3

#### IV. ELIGIBILITY

A. The persons eligible to participate in the Discretionary Option Grant and Stock Issuance Programs are as follows:

- (i) Employees,
- (ii) non-employee members of the Board or the board of directors of any Parent or Subsidiary, and
- (iii) consultants and other independent advisors who provide services to the Corporation (or any Parent or Subsidiary).

B. Only the Corporation's officers and other highly-compensated Employees shall be eligible to participate in the Salary Investment Option Grant Program.

C. Each Plan Administrator shall, within the scope of its administrative jurisdiction under the Plan, have full authority (subject to the provisions of the Plan) to determine, (i) with respect to the option grants under the Discretionary Option Grant Program, which eligible persons are to receive option grants, the time or times when such option grants are to be made, the number of shares to be covered by each such grant, the status of the granted option as either an Incentive Option or a Non-Statutory Option, the time or times when each option is to become exercisable, the vesting schedule (if any) applicable to the option shares and the maximum term for which the option is to remain outstanding and (ii) with respect to stock issuances under the Stock Issuance Program, which eligible persons are to receive stock issuances, the time or times when such issuances are to be made, the number of shares to be issued to each Participant, the vesting schedule (if any) applicable to the issued shares and the consideration to be paid for such shares. The Primary Committee shall have sole and exclusive authority to select the individuals eligible to participate in the Salary Investment Option Grant Program, but all options granted under such program shall be made solely in accordance with the express terms and conditions of Article Three of the Plan.

D. The Plan Administrator shall have the absolute discretion either to grant options in accordance with the Discretionary Option Grant Program or to effect stock issuances in accordance with the Stock Issuance Program.

E. The individuals eligible to participate in the Automatic Option Grant Program shall be limited to (i) those individuals who first become non-employee Board members on or after the Plan Effective Date, whether through appointment by the Board or election by the Corporation's stockholders, and (ii) those individuals who are re-elected as non-employee Board members at one or more Annual Stockholders Meetings held after the Plan Effective Date, including those individuals serving as non-employee Board members on the Plan Effective

Date. A non-employee Board member who has previously

3

4

been in the employ of the Corporation (or any Parent or Subsidiary) shall not be eligible to receive an initial option grant under the Automatic Option Grant Program on the Plan Effective Date or (if later) at the time he or she first becomes a non-employee Board member, but such individual shall be eligible to receive periodic option grants under the Automatic Option Grant Program upon his or her re-election as a non-employee Board member at one or more Annual Stockholders Meetings.

V. STOCK SUBJECT TO THE PLAN

A. The stock issuable under the Plan shall be shares of authorized but unissued or reacquired Common Stock, including shares repurchased by the Corporation on the open market. The maximum number of shares of Common Stock which may be issued over the term of the Plan shall not exceed 5,006,262 shares. Such authorized share reserve includes the additional increase of 1,600,000 shares authorized by the Board on July 17, 1997, subject to stockholder approval at the 1997 Annual Meeting.

B. No one person participating in the Plan may receive options and direct stock issuances for more than 500,000 shares of Common Stock in the aggregate per calendar year, beginning with the 1995 calendar year.

C. Shares of Common Stock subject to outstanding options shall be available for subsequent issuance under the Plan to the extent (i) the options (including any options incorporated from the Predecessor Plan) expire or terminate for any reason prior to exercise in full or (ii) the options are cancelled in accordance with the cancellation-regrant provisions of Article Two. In addition, any unvested shares issued under the Plan and subsequently repurchased by the Corporation, at the option exercise or direct issue price paid per share, pursuant to the Corporation's repurchase rights under the Plan shall be added back to the number of shares of Common Stock reserved for issuance under the Plan and shall accordingly be available for reissuance through one or more subsequent option grants or direct stock issuances under the Plan. Should the exercise price of an option under the Plan (including any option incorporated from the Predecessor Plan) be paid with shares of Common Stock or should shares of Common Stock otherwise issuable under the Plan be withheld by the Corporation in satisfaction of the withholding taxes incurred in connection with the exercise of an option or the vesting of a stock issuance under the Plan, then the number of shares of Common Stock available for issuance under the Plan shall be reduced by the gross number of shares for which the option is exercised or which vest under the stock issuance, and not by the net number of shares of Common Stock issued to the holder of such option or stock issuance.

D. Should any change be made to the Common Stock by reason of any stock split, stock dividend, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding Common Stock as a class without the Corporation's receipt of consideration, appropriate adjustments shall be made to (i) the maximum number and/or class of securities issuable under the Plan, (ii) the maximum number and/or class

4

5

of securities for which any one person may be granted options and direct stock issuances per calendar year, (iii) the number and/or class of securities for which automatic option grants are to be made subsequently per Eligible Director under the Automatic Option Grant Program and (iv) the number and/or class of securities and the exercise price per share in effect under each outstanding option (including any option incorporated from the Predecessor Plan) in order to prevent the dilution or enlargement of benefits thereunder. The adjustments determined by the Plan Administrator shall be final, binding and conclusive.

5

6

DISCRETIONARY OPTION GRANT PROGRAM

I. OPTION TERMS

Each option shall be evidenced by one or more documents in the form approved by the Plan Administrator; provided, however, that each such document shall comply with the terms specified below. Each document evidencing an Incentive Option shall, in addition, be subject to the provisions of the Plan applicable to such options.

A. Exercise Price.

1. The exercise price per share shall be fixed by the Plan Administrator but shall not be less than one hundred percent (100%) of the Fair Market Value per share of Common Stock on the option grant date.

2. The exercise price shall become immediately due upon exercise of the option and shall be payable in one or more of the forms specified below:

(i) cash or check made payable to the Corporation,

(ii) shares of Common Stock held for the requisite period necessary to avoid a charge to the Corporation's earnings for financial reporting purposes and valued at Fair Market Value on the Exercise Date, or

(iii) to the extent the option is exercised for vested shares, through a special sale and remittance procedure pursuant to which the Optionee shall concurrently provide irrevocable instructions to (a) a Corporation-designated brokerage firm to effect the immediate sale of the purchased shares and remit to the Corporation, out of the sale proceeds available on the settlement date, sufficient funds to cover the aggregate exercise price payable for the purchased shares plus all applicable Federal, state and local income and employment taxes required to be withheld by the Corporation by reason of such exercise and (b) the Corporation to deliver the certificates for the purchased shares directly to such brokerage firm in order to complete the sale transaction.

Except to the extent such sale and remittance procedure is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

6

7

B. Exercise and Term of Options. Each option shall be exercisable at such time or times, during such period and for such number of shares as shall be determined by the Plan Administrator and set forth in the documents evidencing the option. However, no option shall have a term in excess of ten (10) years measured from the option grant date.

C. Effect of Termination of Service.

1. The following provisions shall govern the exercise of any options held by the Optionee at the time of cessation of Service or death:

(i) Any option outstanding at the time of the Optionee's cessation of Service for any reason shall remain exercisable for such period of time thereafter as shall be determined by the Plan Administrator and set forth in the documents evidencing the option, but no such option shall be exercisable after the expiration of the option term.

(ii) Any option exercisable in whole or in part by the Optionee at the time of death may be exercised subsequently by the personal representative of the Optionee's estate or by the person or persons to whom the option is transferred pursuant to the Optionee's will or in accordance with the laws of descent and distribution.

(iii) During the applicable post-Service exercise period, the option may not be exercised in the aggregate for more than the number of vested shares for which the option is exercisable on the date of the

Optionee's cessation of Service. Upon the expiration of the applicable exercise period or (if earlier) upon the expiration of the option term, the option shall terminate and cease to be outstanding for any vested shares for which the option has not been exercised. However, the option shall, immediately upon the Optionee's cessation of Service, terminate and cease to be outstanding to the extent the option is not otherwise at that time exercisable for vested shares.

(iv) Should the Optionee's Service be terminated for Misconduct, then all outstanding options held by the Optionee shall terminate immediately and cease to be outstanding.

2. The Plan Administrator shall have the discretion, exercisable either at the time an option is granted or at any time while the option remains outstanding, to:

(i) extend the period of time for which the option is to remain exercisable following the Optionee's cessation of Service from the period otherwise in effect for that option to such greater period of time as the

7

8

Plan Administrator shall deem appropriate, but in no event beyond the expiration of the option term, and/or

(ii) permit the option to be exercised, during the applicable post-Service exercise period, not only with respect to the number of vested shares of Common Stock for which such option is exercisable at the time of the Optionee's cessation of Service but also with respect to one or more additional installments in which the Optionee would have vested under the option had the Optionee continued in Service.

D. Stockholder Rights. The holder of an option shall have no stockholder rights with respect to the shares subject to the option until such person shall have exercised the option, paid the exercise price and become a holder of record of the purchased shares.

E. Repurchase Rights. The Plan Administrator shall have the discretion to grant options which are exercisable for unvested shares of Common Stock. Should the Optionee cease Service while holding such unvested shares, the Corporation shall have the right to repurchase, at the exercise price paid per share, any or all of those unvested shares. The terms upon which such repurchase right shall be exercisable (including the period and procedure for exercise and the appropriate vesting schedule for the purchased shares) shall be established by the Plan Administrator and set forth in the document evidencing such repurchase right.

F. Limited Transferability of Options. During the lifetime of the Optionee, Incentive Options shall be exercisable only by the Optionee and shall not be assignable or transferable other than by will or by the laws of descent and distribution following the Optionee's death. However, Non-Statutory Options may, in connection with the Optionee's estate plan, be assigned in whole or in part during the Optionee's lifetime to one or more members of the Optionee's immediate family or to a trust established exclusively for one or more such family members. The assigned portion may only be exercised by the person or persons who acquire a proprietary interest in the option pursuant to the assignment. The terms applicable to the assigned portion shall be the same as those in effect for the option immediately prior to such assignment and shall be set forth in such documents issued to the assignee as the Plan Administrator may deem appropriate.

## II. INCENTIVE OPTIONS

The terms specified below shall be applicable to all Incentive Options. Except as modified by the provisions of this Section II, all the provisions of Articles One, Two and Six shall be applicable to Incentive Options. Options which are specifically designated as Non-Statutory Options when issued under the Plan shall not be subject to the terms of this Section II.

8

A. Eligibility. Incentive Options may only be granted to Employees.

B. Exercise Price. The exercise price per share shall not be less than one hundred percent (100%) of the Fair Market Value per share of Common Stock on the option grant date.

C. Dollar Limitation. The aggregate Fair Market Value of the shares of Common Stock (determined as of the respective date or dates of grant) for which one or more options granted to any Employee under the Plan (or any other option plan of the Corporation or any Parent or Subsidiary) may for the first time become exercisable as Incentive Options during any one (1) calendar year shall not exceed the sum of One Hundred Thousand Dollars (\$100,000). To the extent the Employee holds two (2) or more such options which become exercisable for the first time in the same calendar year, the foregoing limitation on the exercisability of such options as Incentive Options shall be applied on the basis of the order in which such options are granted.

D. 10% Stockholder. If any Employee to whom an Incentive Option is granted is a 10% Stockholder, then the exercise price per share shall not be less than one hundred ten percent (110%) of the Fair Market Value per share of Common Stock on the option grant date, and the option term shall not exceed five (5) years measured from the option grant date.

### III. CORPORATE TRANSACTION/CHANGE IN CONTROL

A. In the event of any Corporate Transaction, each outstanding option shall automatically accelerate so that each such option shall, immediately prior to the effective date of the Corporate Transaction, become fully exercisable with respect to the total number of shares of Common Stock at the time subject to such option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. However, an outstanding option shall not so accelerate if and to the extent: (i) such option is, in connection with the Corporate Transaction, either to be assumed by the successor corporation (or parent thereof) or to be replaced with a comparable option to purchase shares of the capital stock of the successor corporation (or parent thereof), (ii) such option is to be replaced with a cash incentive program of the successor corporation which preserves the spread existing on the unvested option shares at the time of the Corporate Transaction and provides for subsequent payout in accordance with the same vesting schedule applicable to such option or (iii) the acceleration of such option is subject to other limitations imposed by the Plan Administrator at the time of the option grant. The determination of option comparability under clause (i) above shall be made by the Plan Administrator, and its determination shall be final, binding and conclusive.

B. All outstanding repurchase rights shall also terminate automatically, and the shares of Common Stock subject to those terminated rights shall immediately vest in full, in the event of any Corporate Transaction, except to the extent: (i) those repurchase rights are to be assigned to the successor corporation (or parent thereof) in connection with such Corporate Transaction or (ii) such accelerated vesting is precluded by other limitations imposed by the Plan Administrator at the time the repurchase right is issued.

C. Immediately following the consummation of the Corporate Transaction, all outstanding options shall terminate and cease to be outstanding, except to the extent assumed by the successor corporation (or parent thereof).

D. Each option which is assumed in connection with a Corporate Transaction shall be appropriately adjusted, immediately after such Corporate Transaction, to apply to the number and class of securities which would have been issuable to the Optionee in consummation of such Corporate Transaction had the option been exercised immediately prior to such Corporate Transaction. Appropriate adjustments to reflect such Corporate Transaction shall also be made to (i) the exercise price payable per share under each outstanding option, provided the aggregate exercise price payable for such securities shall remain the same, (ii) the maximum number and/or class of securities available for issuance over the remaining term of the Plan and (iii) the maximum number and/or class of securities for which any one person may be granted stock options and direct stock issuances under the Plan per calendar year.

E. The Plan Administrator shall have full power and authority to grant options under the Discretionary Option Grant Program which will automatically accelerate in whole or in part in the event the Optionee's Service subsequently terminates by reason of an Involuntary Termination within a designated period (not to exceed twelve (12) months) following the effective date of any Corporate Transaction in which those options are assumed or replaced and do not otherwise accelerate. Any options so accelerated shall remain exercisable for fully-vested shares until the earlier of (i) the expiration of the option term or (ii) the expiration of the one (1)-year period measured from the effective date of the Involuntary Termination. In addition, the Plan Administrator may provide that one or more of the Corporation's outstanding repurchase rights with respect to shares held by the Optionee at the time of such Involuntary Termination shall immediately terminate in whole or in part, and the shares subject to those terminated rights shall accordingly vest.

F. The Plan Administrator shall have full power and authority to grant options under the Discretionary Option Grant Program which will automatically accelerate in whole or in part in the event the Optionee's Service subsequently terminates by reason of an Involuntary Termination within a designated period (not to exceed twelve (12) months) following the effective date of any Change in Control. Each option so accelerated shall remain exercisable for fully-vested shares until the earlier of (i) the expiration of the option term or (ii) the expiration of the one (1)-year period measured from the effective date of the Involuntary Termination. In addition, the Plan Administrator may provide that

10

11  
one or more of the Corporation's outstanding repurchase rights with respect to shares held by the Optionee at the time of such Involuntary Termination shall immediately terminate in whole or in part, and the shares subject to those terminated rights shall accordingly vest.

G. The portion of any Incentive Option accelerated in connection with a Corporate Transaction or Change in Control shall remain exercisable as an Incentive Option only to the extent the applicable One Hundred Thousand Dollar limitation is not exceeded. To the extent such dollar limitation is exceeded, the accelerated portion of such option shall be exercisable as a Non-Qualified Option under the Federal tax laws.

H. The outstanding options shall in no way affect the right of the Corporation to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

#### IV. CANCELLATION AND REGRANT OF OPTIONS

The Plan Administrator shall have the authority to effect, at any time and from time to time, with the consent of the affected option holders, the cancellation of any or all outstanding options under the Discretionary Option Grant Program (including outstanding options incorporated from the Predecessor Plan) and to grant in substitution new options covering the same or different number of shares of Common Stock but with an exercise price per share based on the Fair Market Value per share of Common Stock on the new grant date.

11

12

### ARTICLE THREE

#### SALARY INVESTMENT OPTION GRANT PROGRAM

##### I. OPTION GRANTS

The Primary Committee shall have the sole and exclusive authority to determine the calendar year or years (if any) for which the Salary Investment Option Grant Program is to be in effect and to select the Corporation's officers and other highly compensated Employees who are to participate in the Salary Investment Option Grant Program for those calendar year or years. Each selected individual who elects to participate in the Salary Investment Option Grant Program must, prior to the start of each calendar year of participation, file

with the Primary Committee (or its designate) an irrevocable authorization directing the Corporation to reduce his or her salary for that calendar year. The minimum amount of authorized salary reduction shall not be less than Fifteen Thousand Dollars (\$15,000), and the maximum salary reduction amount authorized by any individual shall not exceed Seventy Five Thousand Dollars (\$75,000). Each selected individual who files a proper salary reduction authorization shall automatically be granted an option under this Salary Investment Option Grant Program on the first trading day in January of the calendar year for which that salary reduction is to be in effect.

## II. OPTION TERMS

Each option shall be a Non-Statutory Option evidenced by one or more documents in the form approved by the Primary Committee; provided, however, that each such document shall comply with the terms specified below.

### A. Exercise Price.

1. The exercise price per share shall be thirty-three and one-third percent (33-1/3%) of the Fair Market Value per share of Common Stock on the option grant date.

2. The exercise price shall become immediately due upon exercise of the option and shall be payable in one or more of the alternative forms authorized under the Discretionary Option Grant Program. Except to the extent the sale and remittance procedure specified thereunder is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

12

13

B. Number of Option Shares. The number of shares of Common Stock subject to the option shall be determined pursuant to the following formula (rounded down to the nearest whole number):

$$X = A / (B \times 66-2/3\%), \text{ where}$$

X is the number of option shares,

A is the dollar amount by which the Optionee's base salary is to be reduced for the calendar year, and

B is the Fair Market Value per share of Common Stock on the option grant date.

C. Exercise and Term of Options. The option shall become exercisable in a series of twelve (12) successive equal monthly installments upon the Optionee's completion of each calendar month of Service in the calendar year for which the salary reduction is in effect. Each option shall have a maximum term of ten (10) years measured from the option grant date.

D. Effect of Termination of Service. Should the Optionee cease Service for any reason while holding one or more options under this Article Three, then each such option shall remain exercisable, for any or all of the shares for which the option is exercisable at the time of such cessation of Service, until the expiration of the ten (10)-year option term. Should the Optionee die while holding one or more options under this Article Three, then each such option may be exercised, for any or all of the shares for which the option is exercisable at the time of the Optionee's cessation of Service (less any shares subsequently purchased by Optionee prior to death), by the personal representative of the Optionee's estate or by the person or persons to whom the option is transferred pursuant to the Optionee's will or in accordance with the laws of descent and distribution. Such right of exercise shall lapse, and the option shall terminate, upon the expiration of the ten (10)-year option term. However, the option shall, immediately upon the Optionee's cessation of Service for any reason, terminate and cease to remain outstanding with respect to any and all shares of Common Stock for which the option is not otherwise at that time exercisable.

## III. CORPORATE TRANSACTION/CHANGE IN CONTROL

A. Should any Corporate Transaction be effected while the Optionee remains in Service, then each outstanding option held by such Optionee under the

Salary Investment Option Grant Program shall automatically accelerate so that each such option shall, immediately prior to the effective date of the Corporate Transaction, become fully exercisable with respect to the total number of shares of Common Stock at the time subject to such option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. Each such outstanding option shall be assumed by the successor

13

14

corporation (or parent thereof) in the Corporate Transaction and shall remain exercisable for the fully-vested shares until the expiration of the ten (10)-year option term.

B. Should any Change in Control occur while the Optionee remains in Service, then each outstanding option held by such Optionee under the Salary Investment Option Grant Program shall automatically accelerate so that each such option shall, immediately prior to the effective date of the Change in Control, become fully exercisable with respect to the total number of shares of Common Stock at the time subject to such option and may be exercised for any or all of those shares as fully-vested shares of Common Stock. The option shall remain so exercisable until the expiration of the ten (10)-year option term.

C. The grant of options under the Salary Investment Option Grant Program shall in no way affect the right of the Corporation to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

### III. REMAINING TERMS

The remaining terms of each option granted under the Salary Investment Option Grant Program shall be the same as the terms in effect for option grants made under the Discretionary Option Grant Program.

14

15

## ARTICLE FOUR

### STOCK ISSUANCE PROGRAM

#### I. STOCK ISSUANCE TERMS

Shares of Common Stock may be issued under the Stock Issuance Program through direct and immediate issuances without any intervening option grants. Each such stock issuance shall be evidenced by a Stock Issuance Agreement which complies with the terms specified below. Shares of Common Stock may also be issued under the Stock Issuance Program pursuant to share right awards which entitle the recipients to receive those shares upon the attainment of designated performance goals.

##### A. Purchase Price.

1. The purchase price per share of Common Stock subject to direct issuance shall be fixed by the Plan Administrator, but shall not be less than one hundred percent (100%) of the Fair Market Value per share of Common Stock on the issuance date.

2. Shares of Common Stock may be issued under the Stock Issuance Program for any of the following items of consideration which the Plan Administrator may deem appropriate in each individual instance:

- (i) cash or check made payable to the Corporation, or
- (ii) past services rendered to the Corporation (or any Parent or Subsidiary).

##### B. Vesting/Issuance Provisions.

1. The Plan Administrator may issue shares of Common Stock under the Stock Issuance Program which are fully and immediately vested upon

issuance or which are to vest in one or more installments over the Participant's period of Service or upon attainment of specified performance objectives. The elements of the vesting schedule applicable to any unvested shares of Common Stock issued under the Stock Issuance Program, namely:

(i) the Service period to be completed by the Participant or the performance objectives to be attained,

(ii) the number of installments in which the shares are to vest,

15

16

(iii) the interval or intervals (if any) which are to lapse between installments, and

(iv) the effect which death, Permanent Disability or other event designated by the Plan Administrator is to have upon the vesting schedule,

shall be determined by the Plan Administrator and incorporated into the Stock Issuance Agreement. Alternatively, the Plan Administrator may issue share right awards under the Stock Issuance Program which shall entitle the recipient to receive a specified number of shares of Common Stock upon the attainment of one or more performance goals established by the Plan Administrator. Upon the attainment of such performance goals, fully-vested shares of Common Stock shall be issued in satisfaction of those share right awards.

2. Any new, substituted or additional securities or other property (including money paid other than as a regular cash dividend) which the Participant may have the right to receive with respect to his or her unvested shares of Common Stock by reason of any stock dividend, stock split, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding Common Stock as a class without the Corporation's receipt of consideration shall be issued subject to (i) the same vesting requirements applicable to the Participant's unvested shares of Common Stock and (ii) such escrow arrangements as the Plan Administrator shall deem appropriate.

3. The Participant shall have full stockholder rights with respect to any shares of Common Stock issued to the Participant under the Stock Issuance Program, whether or not the Participant's interest in those shares is vested. Accordingly, the Participant shall have the right to vote such shares and to receive any regular cash dividends paid on such shares.

4. Should the Participant cease to remain in Service while holding one or more unvested shares of Common Stock issued under the Stock Issuance Program or should the performance objectives not be attained with respect to one or more such unvested shares of Common Stock, then those shares shall be immediately surrendered to the Corporation for cancellation, and the Participant shall have no further stockholder rights with respect to those shares. To the extent the surrendered shares were previously issued to the Participant for cash consideration, the Corporation shall repay that consideration to the Participant at the time the shares are surrendered.

5. The Plan Administrator may in its discretion waive the surrender and cancellation of one or more unvested shares of Common Stock (or other assets attributable thereto) which would otherwise occur upon the cessation of the Participant's Service or the non-attainment of the performance objectives applicable to those shares. Such waiver shall result in the immediate vesting of the Participant's interest in the shares

16

17

of Common Stock as to which the waiver applies. Such waiver may be effected at any time, whether before or after the Participant's cessation of Service or the attainment or non-attainment of the applicable performance objectives.

6. Outstanding share right awards under the Stock Issuance Program shall automatically terminate, and no shares of Common Stock shall actually be issued in satisfaction of those awards, if the performance goals established for such awards are not attained. The Plan Administrator, however,

shall have the discretionary authority to issue shares of Common Stock in satisfaction of one or more outstanding share right awards as to which the designated performance goals are not attained.

## II. CORPORATE TRANSACTION/CHANGE IN CONTROL

A. All of the Corporation's outstanding repurchase rights under the Stock Issuance Program shall terminate automatically, and all the shares of Common Stock subject to those terminated rights shall immediately vest in full, in the event of any Corporate Transaction, except to the extent (i) those repurchase rights are to be assigned to the successor corporation (or parent thereof) in connection with such Corporate Transaction or (ii) such accelerated vesting is precluded by other limitations imposed in the Stock Issuance Agreement.

B. The Plan Administrator shall have the discretionary authority, exercisable either at the time the unvested shares are issued or any time while the Corporation's repurchase rights remain outstanding under the Stock Issuance Program, to provide that those rights shall automatically terminate in whole or in part, and the shares of Common Stock subject to those terminated rights shall immediately vest, in the event the Participant's Service should subsequently terminate by reason of an Involuntary Termination within twelve (12) months following the effective date of any Corporate Transaction in which those repurchase rights are assigned to the successor corporation (or parent thereof).

C. The Plan Administrator shall have the discretionary authority, exercisable either at the time the unvested shares are issued or any time while the Corporation's repurchase rights remain outstanding under the Stock Issuance Program, to provide that those rights shall automatically terminate in whole or in part, and the shares of Common Stock subject to those terminated rights shall immediately vest, in the event the Participant's Service should subsequently terminate by reason of an Involuntary Termination within twelve (12) months following the effective date of any Change in Control.

## III. SHARE ESCROW/LEGENDS

Unvested shares may, in the Plan Administrator's discretion, be held in escrow by the Corporation until the Participant's interest in such shares vests or may be issued directly to the Participant with restrictive legends on the certificates evidencing those unvested shares.

17

18

## ARTICLE FIVE

### AUTOMATIC OPTION GRANT PROGRAM

#### I. OPTION TERMS

A. GRANT DATES. Option grants shall be made on the dates specified below:

1. Each individual who is first elected or appointed as a non-employee Board member on or after the Plan Effective Date shall automatically be granted, on the date of such initial election or appointment, a Non-Statutory Option to purchase 24,000 shares of Common Stock, provided such individual has not previously been in the employ of the Corporation (or any Parent or Subsidiary).

2. On the date of each Annual Stockholders Meeting held after the Plan Effective Date, each individual who is to continue to serve as an Eligible Director shall automatically be granted a Non-Statutory Option to purchase 6,000 shares of Common Stock, provided such individual has served as a non-employee Board member for at least six (6) months. There shall be no limit on the number of such 6,000-share option grants any one Eligible Director may receive over his or her period of Board service.

#### B. EXERCISE PRICE.

1. The exercise price per share shall be equal to one hundred percent (100%) of the Fair Market Value per share of Common Stock on the option grant date.

2. The exercise price shall be payable in one or more of the alternative forms authorized under the Discretionary Option Grant Program. Except to the extent the sale and remittance procedure specified thereunder is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

C. OPTION TERM. Each option shall have a term of ten (10) years measured from the option grant date.

D. EXERCISE AND VESTING OF OPTIONS. Each option shall be immediately exercisable for any or all of the option shares. However, any shares purchased under the option shall be subject to repurchase by the Corporation, at the exercise price paid per share, upon the Optionee's cessation of Board service prior to vesting in those shares. Each initial 24,000-share grant shall vest, and the Corporation's repurchase right shall lapse, in a series of four (4) successive equal annual installments over the Optionee's period of

18

19  
continued service as a Board member, with the first such installment to vest upon the Optionee's completion of one (1) year of Board service measured from the option grant date. Each annual 6,000-share grant made on or after July 17, 1997 shall vest, and the Corporation's repurchase right shall lapse, upon the Optionee's continuation in Board service through the day immediately preceding the next Annual Stockholders Meeting following the option grant date.

E. EFFECT OF TERMINATION OF BOARD SERVICE. The following provisions shall govern the exercise of any options held by the Optionee at the time the Optionee ceases to serve as a Board member:

(i) The Optionee (or, in the event of Optionee's death, the personal representative of the Optionee's estate or the person or persons to whom the option is transferred pursuant to the Optionee's will or in accordance with the laws of descent and distribution) shall have a twelve (12)-month period following the date of such cessation of Board service in which to exercise each such option.

(ii) During the twelve (12)-month exercise period, the option may not be exercised in the aggregate for more than the number of vested shares of Common Stock for which the option is exercisable at the time of the Optionee's cessation of Board service.

(iii) Should the Optionee cease to serve as a Board member by reason of death or Permanent Disability, then all shares at the time subject to the option shall immediately vest so that such option may, during the twelve (12)-month exercise period following such cessation of Board service, be exercised for all or any portion of those shares as fully-vested shares of Common Stock.

(iv) In no event shall the option remain exercisable after the expiration of the option term. Upon the expiration of the twelve (12)-month exercise period or (if earlier) upon the expiration of the option term, the option shall terminate and cease to be outstanding for any vested shares for which the option has not been exercised. However, the option shall, immediately upon the Optionee's cessation of Board service for any reason other than death or Permanent Disability, terminate and cease to be outstanding to the extent the option is not otherwise at that time exercisable for vested shares.

19

20

## II. CORPORATE TRANSACTION/CHANGE IN CONTROL

A. The shares of Common Stock subject to each outstanding option at the time of a Corporate Transaction but not otherwise vested shall automatically vest in full so that each such option shall, immediately prior to the effective date of that Corporate Transaction, become fully exercisable for all of the shares of Common Stock at the time subject to such option and may be exercised for all or any portion of those shares as fully-vested shares of Common Stock. Immediately following the consummation of the Corporate Transaction, each

automatic option grant shall terminate and cease to be outstanding, except to the extent assumed by the successor corporation (or parent thereof).

B. The shares of Common Stock subject to each outstanding option at the time of a Change in Control but not otherwise vested shall automatically vest in full so that each such option shall, immediately prior to the effective date of that Change in Control, become fully exercisable for all of the shares of Common Stock at the time subject to such option and may be exercised for all or any portion of those shares as fully-vested shares of Common Stock. Each such option shall remain exercisable for such fully-vested option shares until the expiration or sooner termination of the option term.

C. All repurchase rights of the Corporation outstanding under the Automatic Option Grant Program at the time of a Corporate Transaction or Change in Control shall automatically terminate at that time, and the shares of Common Stock subject to those terminated rights shall immediately vest.

D. Each option which is assumed in connection with a Corporate Transaction shall be appropriately adjusted, immediately after such Corporate Transaction, to apply to the number and class of securities which would have been issuable to the Optionee in consummation of such Corporate Transaction had the option been exercised immediately prior to such Corporate Transaction. Appropriate adjustments shall also be made to the exercise price payable per share under each outstanding option, provided the aggregate exercise price payable for such securities shall remain the same.

E. The grant of options under the Automatic Option Grant Program shall in no way affect the right of the Corporation to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

### III. REMAINING TERMS

The remaining terms of each option granted under the Automatic Option Grant Program shall be the same as the terms in effect for option grants made under the Discretionary Option Grant Program.

20

21

## ARTICLE SIX

### MISCELLANEOUS

#### I. TAX WITHHOLDING

A. The Corporation's obligation to deliver shares of Common Stock upon the exercise of stock options or the issuance or vesting of such shares under the Plan shall be subject to the satisfaction of all applicable Federal, state and local income and employment tax withholding requirements.

B. The Plan Administrator may, in its discretion, provide any or all holders of Non-Statutory Options or unvested shares of Common Stock under the Plan (other than the options granted or the shares issued under the Automatic Option Grant Program) with the right to use shares of Common Stock in satisfaction of all or part of the Taxes incurred by such holders in connection with the exercise of their options or the vesting of their shares. Such right may be provided to any such holder in either or both of the following formats:

(i) Stock Withholding: The election to have the Corporation withhold, from the shares of Common Stock otherwise issuable upon the exercise of such Non-Statutory Option or the vesting of such shares, a portion of those shares with an aggregate Fair Market Value equal to the percentage of the Taxes (not to exceed one hundred percent (100%)) designated by the holder.

(ii) Stock Delivery: The election to deliver to the Corporation, at the time the Non-Statutory Option is exercised or the shares vest, one or more shares of Common Stock previously acquired by such holder (other than in connection with the option exercise or share vesting triggering the Taxes) with an aggregate Fair Market Value equal to the percentage of the Taxes (not to exceed one hundred percent (100%))

designated by the holder.

## II. EFFECTIVE DATE AND TERM OF THE PLAN

A. The Plan became effective on the Plan Effective Date and serves as the successor to the Predecessor Plan, and no further option grants or direct stock issuances are to be made under the Predecessor Plan after the Plan Effective Date. All options outstanding under the Predecessor Plan as of such date have been incorporated into the Plan and shall be treated as outstanding options under the Plan. However, each outstanding option so incorporated shall continue to be governed solely by the terms of the documents evidencing such option, and no provision of the Plan shall be deemed to affect or otherwise

21

22

modify the rights or obligations of the holders of such incorporated options with respect to their acquisition of shares of Common Stock.

B. One or more provisions of the Plan, including (without limitation) the option/vesting acceleration provisions of Article Two relating to Corporate Transactions and Changes in Control, may, in the Plan Administrator's discretion, be extended to one or more options incorporated from the Predecessor Plan which do not otherwise contain such provisions.

C. The Plan shall terminate upon the earliest of (i) August 31, 2005, (ii) the date on which all shares available for issuance under the Plan shall have been issued as fully-vested shares pursuant to option exercises or direct stock issuances under the Plan or (iii) the termination of all outstanding options in connection with a Corporate Transaction. Upon such Plan termination, all outstanding stock options and unvested stock issuances shall continue to have force and effect in accordance with the provisions of the documents evidencing such options or issuances.

## III. AMENDMENT OF THE PLAN

A. The Board shall have complete and exclusive power and authority to amend or modify the Plan in any or all respects. However, no such amendment or modification shall adversely affect any rights and obligations with respect to options or unvested stock issuances at the time outstanding under the Plan unless the Optionee or the Participant consents to such amendment or modification. In addition, certain amendments may require stockholder approval pursuant to applicable laws or regulations.

B. The Plan was amended and restated by the Board on July 17, 1997 (the "1997 Restatement") to effect the following changes: (i) increase the maximum number of shares of Common Stock authorized for issuance over the term of the Plan from 3,406,262 shares to 5,006,262 shares, (ii) modify the vesting provisions to be in effect for future option grants made to non-employee Board members under the Automatic Option Grant Program, (iii) render the non-employee Board members who are serving as Plan Administrator eligible to receive option grants and direct stock issuances under the Discretionary Option Grant and Stock Issuance Programs, (iv) allow unvested shares issued under the Plan and subsequently repurchased by the Corporation at the option exercise price or direct issue price paid per share to be reissued under the Plan, (v) remove certain restrictions on the eligibility of non-employee Board members to serve as Plan Administrator, (vi) eliminate the stock appreciation right provisions and loan features of the Plan and (vii) effect a series of additional changes to the provisions of the Plan (including the stockholder approval requirements and the transferability of Non-Statutory Options) in order to take advantage of the recent amendments to Rule 16b-3 of the Securities and Exchange Commission which exempts certain officer and director transactions under the Plan from the short-swing liability provisions of the federal securities laws. The 1997 Restatement is subject to stockholder approval at the 1997 Annual Meeting, and no option grants made on the basis

22

23

of the 1,600,000-share increase shall become exercisable in whole or in part unless and until the 1997 Restatement is approved by the stockholders. Should such stockholder approval not be obtained, then any options granted on the basis of the 1,600,000-share increase shall terminate without ever becoming

exercisable for those shares, and no further option grants or direct stock issuances shall be made on the basis of such share increase. In addition, none of the other changes effected by 1997 Restatement shall be implemented, except to the extent the Plan Administrator otherwise deems it advisable to do so. However, in the absence of such stockholder approval, option grants and direct stock issuances may continue to be made pursuant to the provisions of the Plan as in effect immediately prior to the 1997 Restatement. All option grants and direct stock issuances made prior to the 1997 Restatement shall remain outstanding in accordance with the terms and conditions of the respective instruments evidencing those options or issuances, and nothing in the 1997 Restatement shall be deemed to modify or in any way affect those outstanding options or issuances. Subject to the foregoing limitations, the Plan Administrator may make option grants and direct stock issuances under the Plan at any time before the date fixed herein for the termination of the Plan.

C. Options to purchase shares of Common Stock may be granted under the Discretionary Option Grant and Salary Investment Option Grant Programs and shares of Common Stock may be issued under the Stock Issuance Program that are in each instance in excess of the number of shares then available for issuance under the Plan, provided any excess shares actually issued under those programs are held in escrow until there is obtained stockholder approval of an amendment sufficiently increasing the number of shares of Common Stock available for issuance under the Plan. If such stockholder approval is not obtained within twelve (12) months after the date the first such excess grants or issuances are made, then (i) any unexercised options granted on the basis of such excess shares shall terminate and cease to be outstanding and (ii) the Corporation shall promptly refund to the Optionees and the Participants the exercise or purchase price paid for any excess shares issued under the Plan and held in escrow, together with interest (at the applicable Short Term Federal Rate) for the period the shares were held in escrow, and such shares shall thereupon be automatically cancelled and cease to be outstanding.

#### IV. REGULATORY APPROVALS

A. The implementation of the Plan, the granting of any option under the Plan and the issuance of any shares of Common Stock either upon the exercise of any option or under the Stock Issuance Program shall be subject to the Corporation's procurement of all approvals and permits required by regulatory authorities having jurisdiction over the Plan, the options granted under it and the shares of Common Stock issued pursuant to it.

B. No shares of Common Stock or other assets shall be issued or delivered under the Plan unless and until there shall have been compliance with all applicable requirements of Federal and state securities laws, including the filing and effectiveness of

23

24  
the Form S-8 registration statement for the shares of Common Stock issuable under the Plan, and all applicable listing requirements of any stock exchange (or the Nasdaq National Market, if applicable) on which Common Stock is then listed for trading.

#### V. USE OF PROCEEDS

Any cash proceeds received by the Corporation from the sale of shares of Common Stock under the Plan shall be used for general corporate purposes.

#### VI. NO EMPLOYMENT/SERVICE RIGHTS

Nothing in the Plan shall confer upon the Optionee or the Participant any right to continue in Service for any period of specific duration or interfere with or otherwise restrict in any way the rights of the Corporation (or any Parent or Subsidiary employing or retaining such person) or of the Optionee or the Participant, which rights are hereby expressly reserved by each, to terminate such person's Service at any time for any reason, with or without cause.

24

25

APPENDIX

The following definitions shall be in effect under the Plan:

A. AUTOMATIC OPTION GRANT PROGRAM shall mean the automatic option grant program in effect under the Plan.

B. BOARD shall mean the Corporation's Board of Directors.

C. CHANGE IN CONTROL shall mean a change in ownership or control of the Corporation effected through either of the following transactions:

(i) the acquisition, directly or indirectly, by any person or related group of persons (other than the Corporation or a person that directly or indirectly controls, is controlled by, or is under common control with, the Corporation), of beneficial ownership (within the meaning of Rule 13d-3 of the 1934 Act) of securities possessing more than fifty percent (50%) of the total combined voting power of the Corporation's outstanding securities pursuant to a tender or exchange offer made directly to the Corporation's stockholders, or

(ii) a change in the composition of the Board over a period of thirty-six (36) consecutive months or less such that a majority of the Board members ceases, by reason of one or more contested elections for Board membership, to be comprised of individuals who either (A) have been Board members continuously since the beginning of such period or (B) have been elected or nominated for election as Board members during such period by at least a majority of the Board members described in clause (A) who were still in office at the time the Board approved such election or nomination.

D. CODE shall mean the Internal Revenue Code of 1986, as amended.

E. COMMON STOCK shall mean the Corporation's common stock.

F. CORPORATE TRANSACTION shall mean either of the following stockholder-approved transactions to which the Corporation is a party:

(i) a merger or consolidation in which securities possessing more than fifty percent (50%) of the total combined voting power of the Corporation's outstanding securities are transferred to a person or persons different from the persons holding those securities immediately prior to such transaction; or

A-1.

26

(ii) the sale, transfer or other disposition of all or substantially all of the Corporation's assets in complete liquidation or dissolution of the Corporation.

G. CORPORATION shall mean Network Appliance, Inc., a California corporation, and any corporate successor to all or substantially all of the assets or voting stock of Network Appliance, Inc. which shall by appropriate action adopt the Plan.

H. DISCRETIONARY OPTION GRANT PROGRAM shall mean the discretionary option grant program in effect under the Plan.

I. ELIGIBLE DIRECTOR shall mean a non-employee Board member eligible to participate in the Automatic Option Grant Program in accordance with the eligibility provisions of Article One.

J. EMPLOYEE shall mean an individual who is in the employ of the Corporation (or any Parent or Subsidiary), subject to the control and direction of the employer entity as to both the work to be performed and the manner and method of performance.

K. EXERCISE DATE shall mean the date on which the Corporation shall have received written notice of the option exercise.

L. FAIR MARKET VALUE per share of Common Stock on any relevant date shall be determined in accordance with the following provisions:

(i) If the Common Stock is at the time traded on the Nasdaq National Market, then the Fair Market Value shall be the closing selling price per share of Common Stock on the date in question, as such price is reported by the National Association of Securities Dealers on the Nasdaq National Market or any successor system. If there is no closing selling price for the Common Stock on the date in question, then the Fair Market Value shall be the closing selling price on the last preceding date for which such quotation exists.

(ii) If the Common Stock is at the time listed on any Stock Exchange, then the Fair Market Value shall be the closing selling price per share of Common Stock on the date in question on the Stock Exchange determined by the Plan Administrator to be the primary market for the Common Stock, as such price is officially quoted in the composite tape of transactions on such exchange. If there is no closing selling price for the Common Stock on the date in question, then the Fair Market Value shall be the closing selling price on the last preceding date for which such quotation exists.

A-2.

27

M. INCENTIVE OPTION shall mean an option which satisfies the requirements of Code Section 422.

N. INVOLUNTARY TERMINATION shall mean the termination of the Service of any individual which occurs by reason of:

(i) such individual's involuntary dismissal or discharge by the Corporation for reasons other than Misconduct, or

(ii) such individual's voluntary resignation following (A) a change in his or her position with the Corporation which materially reduces his or her level of responsibility, (B) a reduction in his or her level of compensation (including base salary, fringe benefits and participation in corporate-performance based bonus or incentive programs) by more than fifteen percent (15%) or (C) a relocation of such individual's place of employment by more than fifty (50) miles, provided and only if such change, reduction or relocation is effected by the Corporation without the individual's consent.

O. MISCONDUCT shall mean the commission of any act of fraud, embezzlement or dishonesty by the Optionee or Participant, any unauthorized use or disclosure by such person of confidential information or trade secrets of the Corporation (or any Parent or Subsidiary), or any other intentional misconduct by such person adversely affecting the business or affairs of the Corporation (or any Parent or Subsidiary) in a material manner. The foregoing definition shall not be deemed to be inclusive of all the acts or omissions which the Corporation (or any Parent or Subsidiary) may consider as grounds for the dismissal or discharge of any Optionee, Participant or other person in the Service of the Corporation (or any Parent or Subsidiary).

P. 1934 ACT shall mean the Securities Exchange Act of 1934, as amended.

Q. NON-STATUTORY OPTION shall mean an option not intended to satisfy the requirements of Code Section 422.

R. OPTIONEE shall mean any person to whom an option is granted under the Discretionary Option Grant, Salary Investment Option Grant or Automatic Option Grant Programs.

S. PARENT shall mean any corporation (other than the Corporation) in an unbroken chain of corporations ending with the Corporation, provided each corporation in the unbroken chain (other than the Corporation) owns, at the time of the determination, stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

A-3.

28

T. PARTICIPANT shall mean any person who is issued shares of Common Stock

under the Stock Issuance Program.

U. PERMANENT DISABILITY OR PERMANENTLY DISABLED shall mean the inability of the Optionee or the Participant to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment expected to result in death or to be of continuous duration of twelve (12) months or more. However, solely for the purposes of the Automatic Option Grant Program, Permanent Disability or Permanently Disabled shall mean the inability of the non-employee Board member to perform his or her usual duties as a Board member by reason of any medically determinable physical or mental impairment expected to result in death or to be of continuous duration of twelve (12) months or more.

V. PLAN shall mean the Corporation's 1995 Stock Incentive Plan, as set forth in this document.

W. PLAN ADMINISTRATOR shall mean the particular entity, whether the Primary Committee, the Board or the Secondary Committee, which is authorized to administer the Discretionary Option Grant and Stock Issuance Programs with respect to one or more classes of eligible persons, to the extent such entity is carrying out its administrative functions under those programs with respect to the persons under its jurisdiction.

X. PLAN EFFECTIVE DATE shall mean November 20, 1995, the date on which the Underwriting Agreement was executed and the initial public offering price of the Common Stock was established.

Y. PREDECESSOR PLAN shall mean the Corporation's 1993 Stock Option/Stock Issuance Plan.

Z. PRIMARY COMMITTEE shall mean the committee of two (2) or more non-employee Board members appointed by the Board to administer the Discretionary Option Grant and Stock Issuance Programs with respect to Section 16 Insiders.

AA. SALARY INVESTMENT OPTION GRANT PROGRAM shall mean the special equity incentive program in effect under the Plan pursuant to which selected individuals may apply a portion of their base salary to the acquisition of below-market option grants.

AB. SECONDARY COMMITTEE shall mean a committee of two (2) or more Board members appointed by the Board to administer the Discretionary Option Grant and Stock Issuance Programs with respect to eligible persons other than Section 16 Insiders.

AC. SECTION 16 INSIDER shall mean an officer or director of the Corporation subject to the short-swing profit liabilities of Section 16 of the 1934 Act.

A-4.

29

AD. SERVICE shall mean the provision of services to the Corporation (or any Parent or Subsidiary) by a person in the capacity of an Employee, a non-employee member of the board of directors or a consultant or independent advisor, except to the extent otherwise specifically provided in the documents evidencing the option grant or stock issuance.

AE. STOCK EXCHANGE shall mean either the American Stock Exchange or the New York Stock Exchange.

AF. STOCK ISSUANCE AGREEMENT shall mean the agreement entered into by the Corporation and the Participant at the time of issuance of shares of Common Stock under the Stock Issuance Program.

AG. STOCK ISSUANCE PROGRAM shall mean the stock issuance program in effect under the Plan.

AH. SUBSIDIARY shall mean any corporation (other than the Corporation) in an unbroken chain of corporations beginning with the Corporation, provided each corporation (other than the last corporation) in the unbroken chain owns, at the time of the determination, stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

AI. TAXES shall mean the Federal, state and local income and employment tax liabilities incurred by the holder of Non-Statutory Options or unvested shares of Common Stock in connection with the exercise of those options or the vesting of those shares.

AJ. 10% STOCKHOLDER shall mean the owner of stock (as determined under Code Section 424(d)) possessing more than ten percent (10%) of the total combined voting power of all classes of stock of the Corporation (or any Parent or Subsidiary).

AK. UNDERWRITING AGREEMENT shall mean the agreement between the Corporation and the underwriter or underwriters who managed the initial public offering of the Common Stock.

NETWORK APPLIANCE, INC.  
SPECIAL NON-OFFICER STOCK OPTION PLAN

ARTICLE ONE

GENERAL

A. This Special Non-Officer Stock Option Plan is intended to promote the interests of Network Appliance, Inc., a California corporation, by authorizing an additional reserve of shares of the Corporation's common stock for issuance through long-term option grants to individuals in the employ of the Corporation (or any Parent or Subsidiary) who are neither officers of the Corporation nor members of the Board and who are not otherwise Section 16 Insiders.

B. The Plan shall become effective immediately upon adoption by the Board on April 30, 1997.

C. This Plan shall supplement the authorized share reserve under the Corporation's 1995 Stock Incentive Plan, and share issuances under this Plan shall not reduce or otherwise affect the number of shares of the Corporation's common stock available for issuance under the 1995 Stock Incentive Plan. In addition, share issuances under the 1995 Stock Incentive Plan shall not reduce or otherwise affect the number of shares of the Corporation's common stock available for issuance under this Plan.

Capitalized terms shall have the meanings assigned to such terms in the attached Appendix.

I. ADMINISTRATION OF THE PLAN

A. The Plan Administrator shall have full power and discretion (subject to the express provisions of the Plan) to establish such rules and regulations as it may deem appropriate for the proper administration of the Plan and to make such determinations under, and issue such interpretations of, the provisions of the Plan and any outstanding option grants thereunder as it may deem necessary or advisable. Decisions of the Plan Administrator shall be final and binding on all parties who have an interest in the Plan or any outstanding option thereunder.

B. The individuals serving as Plan Administrator shall serve for such period as the Board may determine and shall be subject to removal by the Board at any time.

2

C. Service as Plan Administrator shall constitute service as a Board member, and each Board member serving as Plan Administrator shall accordingly be entitled to full indemnification and reimbursement as a Board member for such service. No individual serving as Plan Administrator shall be liable for any act or omission made in good faith with respect to the Plan or any option granted under the Plan.

II. ELIGIBILITY

A. The persons eligible to participate in the Plan shall be limited to those Employees who are neither officers of the Corporation nor members of the Board and who are not otherwise Section 16 Insiders.

B. The Plan Administrator shall have full authority to determine which eligible Employees are to receive option grants under the Plan, the number of shares to be covered by each such grant, the time or times at which each granted option is to become exercisable and the maximum term for which the option may remain outstanding. All options granted under the Plan shall be Non-Statutory Options.

III. STOCK SUBJECT TO THE PLAN

A. Shares of Common Stock shall be available for issuance under

the Plan and shall be drawn from either the Corporation's authorized but unissued shares of Common Stock or from reacquired shares of Common Stock, including shares repurchased by the Corporation on the open market. The maximum number of shares of Common Stock reserved for issuance over the term of the Plan shall be limited to 400,000 shares, subject to adjustment from time to time in accordance with the provisions of this Section III.

B. Should one or more outstanding options under this Plan expire or terminate for any reason prior to exercise in full (including any option cancelled in accordance with the cancellation-regrant provisions of Section III of Article Two), then the shares subject to the portion of each option not so exercised shall be available for subsequent issuance under the Plan. Should the exercise price of an outstanding option under the Plan be paid with shares of Common Stock, then the number of shares of Common Stock available for issuance under the Plan shall be reduced by the gross number of shares for which the option is exercised, and not by the net number of shares of Common Stock actually issued to the holder of such option.

C. Should any change be made to the Common Stock issuable under the Plan by reason of any stock split, stock dividend, recapitalization, combination of shares, exchange of shares or other change affecting the outstanding Common Stock as a class without the Corporation's receipt of consideration, then appropriate adjustments shall be made to (i) the maximum number and/or class of securities issuable under the Plan, and (ii) the number and/or class of securities and price per share in effect under each option outstanding under the Plan. Such adjustments to the outstanding options are to be effected

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in a manner which shall preclude the enlargement or dilution of rights and benefits under such options. The adjustments determined by the Plan Administrator shall be final, binding and conclusive.

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## ARTICLE TWO

### OPTION GRANT PROGRAM

#### I. OPTION TERMS

Options granted under the Plan shall be authorized by action of the Plan Administrator and shall be evidenced by one or more instruments in the form approved by the Plan Administrator; provided, however, that each such instrument shall comply with the terms and conditions specified below. All such granted options shall be Non-Statutory Options.

##### A. Exercise Price.

1. The exercise price per share shall be fixed by the Plan Administrator but shall not be less than one hundred percent (100%) of the Fair Market Value per share of Common Stock on the grant date.

2. Full payment of the exercise price shall become immediately due upon exercise of the option and shall be payable in one or more of the forms specified below:

(i) cash or check made payable to the Corporation's order,

(ii) shares of Common Stock held for the requisite period necessary to avoid a charge to the Corporation's earnings for financial reporting purposes and valued at Fair Market Value on the Exercise Date, or

(iii) through a special sale and remittance procedure

pursuant to which the Optionee shall concurrently provide irrevocable instructions to (a) a Corporation-designated brokerage firm to effect the immediate sale of the purchased shares and remit to the Corporation, out of the sale proceeds available on the settlement date, sufficient funds to cover the aggregate exercise price payable for the purchased shares plus all applicable Federal, state and local income and employment taxes required to be withheld by the Corporation in connection with such purchase and to (b) the Corporation to deliver the certificates for the purchased shares directly to such brokerage firm in order to complete the sale transaction.

Except to the extent such sale and remittance procedure is utilized, payment of the exercise price for the purchased shares must be made on the Exercise Date.

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5

B. Term and Exercise of Options. Each option shall be exercisable at such time or times, during such period and for such number of shares as shall be determined by the Plan Administrator and set forth in the documents evidencing such option. No option shall have a maximum term in excess of ten (10) years. During the lifetime of the Optionee, the option shall be exercisable only by the Optionee and shall not be assignable or transferable except for a transfer of the option effected by will or by the laws of inheritance following the Optionee's death.

C. Effect of Termination of Service.

1. The following provisions shall govern the exercise of any options held by the Optionee at the time of cessation of Service or death:

(i) Should Optionee cease to remain in Service for any reason (other than death, Permanent Disability or Misconduct) while this option is outstanding, then Optionee shall retain the right to exercise this option until the expiration of the earlier of (A) the three (3)-month period commencing with the date of such cessation of Service or (B) the ten (10)-year option term.

(ii) If the Optionee dies while holding an outstanding option, then the personal representative of Optionee's estate or the person or persons to whom the option is transferred pursuant to Optionee's will or in accordance with the laws of inheritance shall have the right to exercise this option. Such right shall lapse, and this option shall cease to be outstanding, upon the expiration of the earlier of (A) the twelve (12)-month period measured from the date of Optionee's death or (B) the ten (10)-year option term.

(iii) Should Optionee cease Service by reason of Permanent Disability while this option is outstanding, then Optionee shall retain the right to exercise this option until the expiration of the earlier of (A) the twelve (12)-month period commencing with the date of such cessation of Service or (B) the ten (10)-year option term.

(iv) Should Optionee's Service be terminated for Misconduct, then this option shall terminate immediately and cease to remain outstanding.

(v) During the applicable post-Service exercise period, the option may not be exercised in the aggregate for more than the number of shares for which the option is exercisable on the date of Optionee's cessation of Service. Upon the expiration of the applicable exercise period or (if earlier) upon the expiration of the option term, the option shall

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6

terminate and cease to be outstanding for any otherwise exercisable shares for which the option has not been exercised. However, the option shall, immediately upon Optionee's cessation of Service for any reason, terminate and cease to be outstanding with respect to any and all option

shares for which the option is not otherwise at the time exercisable.

2. The Plan Administrator shall have the discretion, exercisable either at the time an option is granted or at any time while the option remains outstanding, to:

(i) extend the period of time for which the option is to remain exercisable following Optionee's cessation of Service or death from the limited period otherwise in effect for that option to such greater period of time as the Plan Administrator shall deem appropriate, but in no event beyond the expiration of the option term, and/or

(ii) permit the option to be exercised, during the applicable post-Service exercise period, not only with respect to the number of shares of Common Stock for which such option is exercisable at the time of the Optionee's cessation of Service but also with respect to one or more additional installments for which the option would have become exercisable had the Optionee continued in Service.

D. Shareholder Rights. A Optionee shall have none of the rights of a shareholder with respect to any option shares until such person shall have exercised the option and paid the exercise price for the purchased shares.

## II. CORPORATE TRANSACTION

A. In the event of any Corporate Transaction, each option which is at the time outstanding under the Plan shall automatically accelerate so that each such option shall, immediately prior to the specified effective date for such Corporate Transaction, become fully exercisable with respect to the total number of shares of Common Stock at the time subject to that option and may be exercised for all or any portion of those shares as fully-vested shares. However, an outstanding option under the Plan shall NOT so accelerate if and to the extent: (i) such option is, in connection with the Corporate Transaction, to be assumed by the successor corporation or parent thereof, (ii) such option is to be replaced with a cash incentive program of the successor corporation which preserves the option spread existing at the time of the Corporate Transaction and provides for subsequent payout in accordance with the same exercise schedule applicable to such option or (iii) the acceleration of such option is subject to other limitations imposed by the Plan Administrator at the time of the option grant.

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7

B. The Plan Administrator shall have the discretionary authority to structure one or more options under the Plan so that those options shall immediately accelerate upon an Involuntary Termination of the Optionee's Service within a designated period (not to exceed twelve (12) months) following the effective date of a Corporate Transaction in which those options are assumed by the successor corporation and accordingly do not accelerate at the time of such Corporate Transaction.

C. Immediately following the consummation of the Corporate Transaction, all outstanding options under the Plan shall terminate and cease to remain outstanding, except to the extent assumed by the successor corporation or its parent company.

D. Each outstanding option which is assumed in connection with the Corporate Transaction shall be appropriately adjusted, immediately after such Corporate Transaction, to apply and pertain to the number and class of securities which would have been issued to the Optionee, in consummation of the Corporate Transaction, had such person exercised the option immediately prior to such Corporate Transaction. Appropriate adjustments shall also be made to the exercise price payable per share, provided the aggregate exercise price payable for such securities shall remain the same. In addition, the class and number of securities available for issuance under the Plan following the consummation of the Corporate Transaction shall be appropriately adjusted.

E. The grant of options under the Plan shall in no way affect the right of the Corporation to adjust, reclassify, reorganize or otherwise change its capital or business structure or to merge, consolidate, dissolve, liquidate or sell or transfer all or any part of its business or assets.

## III. CANCELLATION AND REGRANT OF OPTIONS

The Plan Administrator shall have the sole and exclusive authority to effect, at any time and from time to time, with the consent of the affected Optionees, the cancellation of any or all outstanding options under the Plan and to grant in substitution new options under the Plan covering the same or different numbers of shares of Common Stock but with an exercise price per share not less than the Fair Market Value of the Common Stock on the new grant date.

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8

### ARTICLE THREE

#### MISCELLANEOUS

##### I. AMENDMENT OF THE PLAN

The Board has complete and exclusive power and authority to amend or modify the Plan in any or all respects whatsoever. However, no such amendment or modification shall adversely affect rights and obligations with respect to stock options at the time outstanding under the Plan, unless the affected Optionees consent to such amendment.

##### II. TAX WITHHOLDING

The Corporation's obligation to deliver shares of Common Stock upon the exercise of stock options under the Plan shall be subject to the satisfaction of all applicable Federal, state and local income tax and employment tax withholding requirements.

##### III. EFFECTIVE DATE AND TERM OF PLAN

A. This Plan became effective upon approval by the Board at the April 30, 1997 Board meeting and shall not be subject to shareholder approval.

B. The Plan shall terminate upon the earlier of (i) December 31, 2007 or (ii) the date on which all shares available for issuance under the Plan shall have been issued pursuant to the exercise of options under the Plan. If the date of termination is determined under clause (i) above, then all option grants outstanding on such date shall thereafter continue to have force and effect in accordance with the provisions of the instruments evidencing those grants.

##### IV. USE OF PROCEEDS

Any cash proceeds received by the Corporation from the sale of shares pursuant to option grants under the Plan shall be used for general corporate purposes.

##### V. REGULATORY APPROVALS

A. The implementation of the Plan, the granting of any option under the Plan, and the issuance of Common Stock upon the exercise of the stock options granted hereunder shall be subject to the Corporation's procurement of all approvals and permits required by regulatory authorities having jurisdiction over the Plan, the stock options granted under it and the Common Stock issued pursuant to it.

8.

9

B. No shares of Common Stock or other assets shall be issued or delivered under this Plan unless and until there shall have been compliance with all applicable requirements of Federal and state securities laws, including the filing and effectiveness of the Form S-8 registration statement for the shares of Common Stock issuable under the Plan, and all applicable listing requirements of any securities exchange on which the Common Stock is then listed for trading.

##### VI. NO EMPLOYMENT/SERVICE RIGHTS

Neither the action of the Corporation in establishing the Plan, nor any action taken by the Plan Administrator hereunder, nor any provision of the Plan shall be construed so as to grant any individual the right to remain in Service for any period of specific duration, and the Corporation (or any Parent or Subsidiary employing such individual) may terminate such individual's Service at any time and for any reason, with or without cause.

9.

10

APPENDIX

The following definitions shall be in effect under the Plan:

- A. BOARD shall mean the Corporation's Board of Directors.
- B. CODE shall mean the Internal Revenue Code of 1986, as amended.
- C. COMMON STOCK shall mean the Corporation's common stock.
- D. CORPORATE TRANSACTION shall mean either of the following shareholder-approved transactions to which the Corporation is a party:
  - a merger or consolidation in which securities possessing more than fifty percent (50%) of the total combined voting power of the Corporation's outstanding securities are transferred to a person or persons different from the persons holding those securities immediately prior to such transaction; or
  - the sale, transfer or other disposition of all or substantially all of the Corporation's assets in complete liquidation or dissolution of the Corporation.
- E. CORPORATION shall mean Network Appliance, Inc., a California corporation, and any corporate successor to all or substantially all of the assets or voting stock of Network Appliance, Inc. which shall by appropriate action adopt the Plan.
- F. EMPLOYEE shall mean an individual who is in the employ of the Corporation (or any Parent or Subsidiary), subject to the control and direction of the employer entity as to both the work to be performed and the manner and method of performance.
- G. EXERCISE DATE shall mean the date on which the Corporation shall have received written notice of the option exercise.
- H. FAIR MARKET VALUE per share of Common Stock on any relevant date shall be determined in accordance with the following provisions:
  - If the Common Stock is at the time traded on the Nasdaq National Market, then the Fair Market Value shall be the closing selling price per share of Common Stock on the date in question, as such price is reported by the National Association of Securities Dealers on the Nasdaq National Market or any successor system. If there is no closing selling price for the Common Stock on the date in question, then the Fair Market Value shall be

A-1.

11

the closing selling price on the last preceding date for which such quotation exists.

- If the Common Stock is at the time listed on any national securities exchange, then the Fair Market Value shall be the closing selling price per share of Common Stock on the date in question on that exchange, as such price is officially quoted in the composite tape of transactions on such exchange. If there is no closing selling price for the Common Stock on the date in question, then the Fair Market Value shall be the closing selling price on the last preceding date for which

such quotation exists.

I. INVOLUNTARY TERMINATION shall mean the termination of the Service of any individual which occurs by reason of:

- such individual's involuntary dismissal or discharge by the Corporation for reasons other than Misconduct, or

- such individual's voluntary resignation following (A) a change in his or her position with the Corporation which materially reduces his or her level of responsibility, (B) a reduction in his or her level of compensation (including base salary, fringe benefits and target bonuses under corporate-performance based bonus or incentive programs) by more than fifteen percent (15%) or (C) a relocation of such individual's place of employment by more than fifty (50) miles, provided and only if such change, reduction or relocation is effected by the Corporation without the individual's consent.

J. MISCONDUCT shall mean the commission of any act of fraud, embezzlement or dishonesty by the Optionee, any unauthorized use or disclosure by the Optionee of confidential information or trade secrets of the Corporation (or any Parent or Subsidiary), or any other intentional misconduct by the Optionee adversely affecting the business or affairs of the Corporation (or any Parent or Subsidiary) in a material manner. The foregoing definition shall not be deemed to be inclusive of all the acts or omissions which the Corporation (or any Parent or Subsidiary) may consider as grounds for the dismissal or discharge of any Optionee or other person in the Service of the Corporation (or any Parent or Subsidiary).

K. NON-STATUTORY OPTION shall mean an option not intended to satisfy the requirements of Code Section 422.

L. OPTIONEE shall mean any person to whom an option is granted under the Plan.

A-2.

12

M. PARENT shall mean any corporation (other than the Corporation) in an unbroken chain of corporations ending with the Corporation, provided each corporation in the unbroken chain (other than the Corporation) owns, at the time of the determination, stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.

N. PERMANENT DISABILITY OR PERMANENTLY DISABLED shall mean the inability of the Optionee to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment expected to result in death or to be of continuous duration of twelve (12) months or more.

O. PLAN shall mean the Corporation's Special Non-Officer Stock Option Plan, as set forth in this document.

P. PLAN ADMINISTRATOR shall mean the committee comprised of one or more Board members appointed by the Board to administer the Plan.

Q. SECTION 16 INSIDER shall mean an officer or director of the Corporation subject to the short-swing profit restrictions of Section 16 of the 1934 Act.

R. SERVICE shall mean the provision of services on a periodic basis to the Corporation (or any Parent or Subsidiary) in the capacity of an Employee or an independent consultant or advisor, except to the extent otherwise specifically provided in the applicable stock option agreement.

S. SUBSIDIARY shall mean any corporation (other than the Corporation) in an unbroken chain of corporations beginning with the Corporation, provided each corporation (other than the last corporation) in the unbroken chain owns, at the time of the determination, stock possessing fifty percent (50%) or more of the total combined voting power of all classes of stock in one of the other corporations in such chain.



SUBSIDIARIES OF THE COMPANY

SUBSIDIARIES

Network Appliance Ltd. (U.K.)  
Network Appliance Corporation France  
Network Appliance Srl. (Italy)  
Network Appliance GmbH (Germany)  
Network Appliance FSC Incorporated

INDEPENDENT AUDITORS' CONSENT

To the Board of Directors and Shareholders of Network Appliance, Inc.

We consent to the incorporation by reference in Registration Statement Nos. 33-99638 and 333-25277 on Form S-8 and Registration No. 333-26163 on Form S-3 of our report dated May 5, 1997, appearing in this Annual Report on Form 10-K of Network Appliance, Inc. for the year ended April 30, 1997.

/s/ DELOITTE & TOUCHE LLP

San Jose, California  
July 21, 1997

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