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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended August 1, 2003

or

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

For the transition period from to

Commission file number 0-27130

Network Appliance, Inc.

(Exact name of registrant as specified in its charter)

Delaware *(State or other jurisdiction of incorporation or organization)*	**77-0307520** *(IRS Employer Identification No.)*

495 East Java Drive,
Sunnyvale, California 94089
(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code:

(408) 822-6000

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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). Yes ☑ No ☐

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

Class	Outstanding at August 1, 2003
Common Stock	341,884,890

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PART I. FINANCIAL INFORMATION

Item 1. *Condensed Consolidated Financial Statements*

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands — unaudited)

	August 1, 2003	April 30, 2003
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 320,679	$ 284,161
Short-term investments	329,426	334,677
Accounts receivable, net of allowances of $4,996 at August 1, 2003 and $5,355 at April 30, 2003	142,290	151,637
Inventories	36,694	31,559
Prepaid expenses and other	24,225	24,014
Deferred income taxes	27,906	27,444
Total current assets	881,220	853,492
Property and Equipment, net	363,677	362,862
Goodwill	48,212	48,212
Intangible Assets, net	10,455	2,954
Other Assets	53,787	51,653
	$1,357,351	$1,319,173
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 41,802	$ 39,600
Income taxes payable	22,984	30,256
Accrued compensation and related benefits	35,376	40,647
Other accrued liabilities	50,220	43,841
Deferred revenue	110,247	110,672
Total current liabilities	260,629	265,016
Long-Term Deferred Revenue	79,035	63,698
Long-Term Obligations	3,254	3,102
Total liabilities	342,918	331,816
Stockholders' Equity:		
Common stock	342	341
Additional paid-in capital	740,271	704,338
Deferred stock compensation	(2,512)	(1,363)
Treasury stock	(34,828)	—
Retained earnings	311,210	284,137
Accumulated other comprehensive loss	(50)	(96)
Total stockholders' equity	1,014,433	987,357
	$1,357,351	$1,319,173

See accompanying notes to condensed consolidated financial statements.

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NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share amounts — unaudited)

	Three Months Ended	
	August 1, 2003	July 26, 2002
Revenues:		
Product revenue	$235,786	$186,740
Service revenue	24,723	20,088
Total revenues	260,509	206,828
Cost of Revenues:		
Cost of product revenue	85,039	63,655
Cost of service revenue	19,347	15,458
Total cost of revenues	104,386	79,113
Gross margin	156,123	127,715
Operating Expenses:		
Sales and marketing	79,356	71,902
Research and development	31,541	27,868
General and administrative	12,265	7,438
Stock compensation (1)	654	983
Total operating expenses	123,816	108,191
Income from Operations	32,307	19,524
Other Income (Expense), net:		
Interest income	3,045	3,151
Other expense, net	(47)	(1,000)
Net gain/(loss) on investments	145	(726)
Gain on sale of intangible asset	—	604
Total other income, net	3,143	2,029
Income before Income Taxes	35,450	21,553
Provision for Income Taxes	8,377	5,388
Net Income	$ 27,073	$ 16,165
Net Income per Share:		
Basic	$ 0.08	$ 0.05
Diluted	$ 0.08	$ 0.05
Shares Used in per Share Calculations:		
Basic	341,687	335,783
Diluted	358,497	350,122
(1) Stock compensation includes:		
Sales and marketing	$ 358	$ 572
Research and development	192	324
General and administrative	104	87
	$ 654	$ 983

See accompanying notes to condensed consolidated financial statements.

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NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands — unaudited)

	Three Months Ended	
	August 1, 2003	July 26, 2002
Cash Flows from Operating Activities:		
Net income	$ 27,073	$ 16,165
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	13,426	11,599
Amortization of patents	150	—
Amortization of intangible assets	1,364	1,386
Stock compensation	654	983
Net (gain) loss on investments	(145)	726
Gain on sale of intangible asset	—	(604)
Provision for doubtful accounts	(290)	(1,455)
Deferred income taxes	—	(565)
Deferred rent	271	(1)
Changes in assets and liabilities:		
Accounts receivable	9,638	7,637
Inventories	(5,796)	(6,412)
Prepaid expenses and other assets	(2,306)	(4,733)
Accounts payable	2,202	541
Income taxes payable	2,602	4,767
Accrued compensation and related benefits	(5,271)	(11,635)
Other accrued liabilities	(1,708)	303
Deferred revenue	14,912	8,189
Net cash provided by operating activities	56,776	26,891
Cash Flows from Investing Activities:		
Purchases of short-term investments	(89,136)	(70,214)
Redemptions of short-term investments	92,581	88,744
Purchases of property and equipment	(12,318)	(14,425)
Proceeds from disposal of fixed assets	105	—
Proceeds from sales of investments	419	—
Purchases of patents	(9,015)	—
Purchase of equity securities	(325)	(325)
Net cash provided by (used in) investing activities	(17,689)	3,780
Cash Flows from Financing Activities:		
Proceeds from sale of common stock related to employee stock transactions	24,256	10,310
Repurchases of common stock	(26,825)	—
Net cash provided by (used in) financing activities	(2,569)	10,310
Net Change in Cash and Cash Equivalents	36,518	40,981
Cash and Cash Equivalents:		
Beginning of period	284,161	210,756
End of period	$ 320,679	$ 251,737
Noncash Investing and Financing Activities:		
Deferred stock compensation, net of reversals	$ 1,668	$ (124)
Conversion of evaluation inventory to fixed assets	661	2,268
Income tax benefit from employee stock transactions	9,874	—
Supplemental cash flow information:		
Income taxes paid	1,456	1,697

See accompanying notes to condensed consolidated financial statements.

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(Dollar and share amounts in thousands, except per-share data — unaudited)

1. The Company

Based in Sunnyvale, California, Network Appliance was incorporated in California in April 1992, and reincorporated in Delaware in November 2001. Network Appliance is a world leader in unified storage solutions for the data-intensive enterprise. NetApp® network storage solutions and service offerings provide data-intensive enterprises with consolidated storage, improved data center operations, economical business continuance, and efficient remote data access across the distributed enterprise. Network Appliance's success to date has been in delivering highly cost-effective network storage solutions that reduce the complexity associated with conventional storage solutions. Network Appliance™ solutions are the data management and storage foundation for leading enterprises, government agencies, and universities worldwide. Since its inception in 1992, Network Appliance has pioneered technology, product, and partner firsts that continue to drive the evolution of storage.

2. Condensed Consolidated Financial Statements

The accompanying interim unaudited condensed consolidated financial statements have been prepared by Network Appliance, Inc. without audit and reflect all adjustments, (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of our financial position, results of operations and cash flows for the interim periods presented. The statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("generally accepted accounting principles") for interim financial information and in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Accordingly, they do not include all information and footnotes required by generally accepted accounting principles for annual consolidated financial statements.

We operate on a 52-week or 53-week year ending on the last Friday in April. For presentation purposes we have indicated in the accompanying interim unaudited condensed consolidated financial statements that our fiscal year end is April 30. The first quarters of fiscal 2004 and 2003 were 14-week and 13-week fiscal quarters, respectively.

These financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended April 30, 2003. The results of operations for the three-month period ended August 1, 2003 are not necessarily indicative of the operating results to be expected for the full fiscal year or future operating periods. In the following notes to our interim condensed consolidated financial statements, Network Appliance Inc. is also referred to as "we", "our" and "us".

Certain prior-period amounts have been reclassified to conform to the current period presentation.

3. Use of Estimates

The preparation of the condensed consolidated 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 condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

4. Summary of Significant Accounting Policies

Revenue Recognition and Allowances

We apply the provisions of Statement of Position ("SOP") 97-2, *"Software Revenue Recognition"*, and related interpretations to all revenue transactions. We recognize revenue when:

- *Persuasive Evidence of an Arrangement Exists.* It is our customary practice to have a purchase order prior to recognizing revenue on an arrangement from our end user customers, value added resellers, or distributors.

- *Delivery has Occurred.* Our product is physically delivered to our customers, generally with standard transfer terms as FOB shipping point. We typically do not allow for re-stocking rights with any of our value added resellers or distributors. Products shipped with acceptance criteria or return rights are not recognized as revenue until all criteria are achieved. If undelivered products or services exist that are essential to the functionality of the delivered product in an arrangement, delivery is not considered to have occurred.

- *The Fee is Fixed or Determinable.* Arrangements with payment terms extending beyond our standard terms and condition practices are not considered to be fixed or determinable. Revenue from such arrangements is recognized as the fees become due and payable. We typically do not allow for price-protection rights with any of our value added resellers or distributors.

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

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

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

The following table presents the components of revenues, stated as a percentage of total revenues:

	Three Months Ended	
	August 1, 2003	July 26, 2002
Product revenue:		
Products	81.3%	83.1%
Software subscriptions	9.2%	7.2%
	90.5%	90.3%
Service revenue	9.5%	9.7%
Total revenues	100.0%	100.0%

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

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

Allowance for Doubtful Accounts

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

Inventory Write-down

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

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

Restructuring Accruals

In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in Information Technology ("IT") spending rates, we implemented two restructuring plans, which included reductions in our workforce and a consolidation of our facilities. These restructuring accruals were accounted for in accordance with Emerging Issues Task Force ("EITF") Issue No. 94-3, *"Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring),"* and included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. These estimates are reviewed and revised periodically and may result in a substantial change to restructuring expense should different conditions prevail than were anticipated in original management estimates. See footnote 10 — Restructuring Charges for further discussion.

Loss Contingencies

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

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Impairment Losses on Investments

We perform periodic reviews of our investments for impairment. Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value, and such a decline is not considered temporary. Our investments in privately held companies are considered impaired when a review of the investees' operations and other indicators of impairment indicate that the carrying value of the investment is not likely to be recoverable. Such indicators include, but are not limited to, limited capital resources, limited prospects of receiving additional financing, and limited prospects for liquidity of the related securities. In the first quarter of fiscal 2003, we recorded a non-cash write down of $726 related to an impairment of our investment in a publicly traded company as its reduction in value was judged to be other than temporary. In the first quarter of fiscal 2004, we recorded a gain of $145 related to sales of previously impaired investments.

Accounting for Income Taxes

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

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

Derivative Instruments

We adopted Statement of Financial Accounting Standards ("SFAS") 133, *"Accounting for Derivative Instruments and Hedging Activities"* as amended by SFAS No. 149, *"Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities."* Derivatives that are not designated as hedges are adjusted to fair value through earnings. If the derivative is designated as a hedge, depending on the nature of the exposure being hedged, changes in fair value will either be offset against the change in fair value of the hedged asset or liability through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of the hedge is recognized in earnings immediately.

As a result of our significant international operations, we are subject to risks associated with fluctuating exchange rates. We use derivative financial instruments, principally currency forward contracts, to attempt to minimize the impact of exchange rate movements on our balance sheet relating to certain foreign currency assets and liabilities and operating results. The forward foreign exchange contracts require us to exchange foreign currencies for U.S. dollars or vice versa and generally mature in less than one year. Other than foreign exchange contracts, we have not entered into any other material financial derivative instruments.

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

We do not enter into derivative financial instruments for speculative or trading purposes. Currently, we do not enter into any foreign exchange forward contracts to hedge exposures related to firm commitments or equity investments. Our major foreign currency exchange exposures and related hedging programs are described below:

Balance Sheet. We utilize currency forward contracts to hedge currency exchange rate fluctuations related to certain foreign currency assets and liabilities. Gains and losses on these undesignated derivatives offset gains and losses on the assets and liabilities being hedged and the net amount is included in earnings. In the first quarter of fiscal 2004, net gains generated by hedged assets and liabilities totaled $2,447, which were offset by losses on the related derivative instruments of $2,618. In the first quarter of fiscal 2003, net gains generated by hedged assets and liabilities totaled $3,988, which were offset by losses on the related derivative instruments of $4,928.

Forecasted Transactions. We use currency forward contracts to hedge exposures related to forecasted sales and operating expenses denominated in Euros and British Pounds. These contracts are designated as cash flow hedges when the transactions are forecasted and in general closely match the underlying forecasted transactions in duration. The contracts are carried on the balance sheet at fair value and the effective portion of the contracts' gains and losses is recorded as other comprehensive income until the forecasted transaction occurs.

If the underlying forecasted transactions do not occur, or it becomes probable that they will not occur, the gain or loss on the related cash flow hedge is recognized immediately in other income. During the first quarter of fiscal 2004, we did not record any gains or losses related to forecasted transactions that did not occur or became improbable.

We measure the effectiveness of hedges of forecasted transactions on at least a quarterly basis by comparing the fair values of the designated currency forward contracts with the fair values of the forecasted transactions. No ineffectiveness was recognized in earnings during the first quarter of fiscal 2004.

Stock-Based Compensation

We account for stock-based compensation in accordance with the provisions of Accounting Principle Board Opinion No. 25 ("APB No. 25") *"Accounting for Stock Issued to Employees,"* and comply with the disclosure provisions of SFAS No. 123 as amended by SFAS 148, *"Accounting for Stock-Based Compensation — Transition and Disclosures."* Deferred compensation recognized under APB No. 25 is amortized to expense using the graded vesting method. We account for stock options issued to non-employees in accordance with the provisions of SFAS No. 123 and EITF No. 96-18 under the fair value based method.

We adopted the disclosure-only provisions of SFAS 123, and accordingly, no expense has been recognized for options granted to employees under the various stock plans. We amortize deferred stock-based compensation on the graded vesting method over the vesting periods of the applicable stock purchase rights and stock options, generally four years. The graded vesting method provides for vesting of portions of the overall awards at interim dates and results in greater vesting in earlier years than the straight-line method.

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

Had compensation expense been determined based on the fair value at the grant date for awards, consistent with the provisions of SFAS 123, the Company's pro forma net loss and net loss per share would be as follows (in thousands, except per share data):

	Three Months Ended	
	August 1, 2003	July 26, 2002
Net income as reported	$27,073	$ 16,165
Add: stock based employee compensation expense included in reported net income under APB 25, net of related tax effects	311	382
Deduct: total stock based compensation determined under fair value based method for all awards, net of related tax effects	32,147	49,504
Pro forma net loss	$ (4,763)	$(32,957)
Basic net income per share, as reported	$ 0.08	$ 0.05
Diluted net income per share, as reported	$ 0.08	$ 0.05
Basic and diluted net loss per share, pro forma	$ (0.01)	$ (0.10)

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, and is not subject to revaluation as a result of subsequent stock price fluctuations. The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option pricing models require the input of highly subjective assumptions, including the expected stock price volatility. We use projected volatility rates, which are based upon historical volatility rates since our initial public offering, trended into future years. Because our employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of our options.

5. Inventories

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

	August 1, 2003	April 30, 2003
Purchased components	$18,573	$16,277
Work in process	69	537
Finished goods	18,052	14,745
	$36,694	$31,559

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

6. Intangible Assets

Balances are summarized as follows:

	August 1, 2003			April 30, 2003		
	Gross Assets	Accumulated Amortization	Net Assets	Gross Assets	Accumulated Amortization	Net Assets
			(In thousands)			
Intangible assets:						
Patents	$ 9,145	$ (280)	$8,865	$ 130	$ (130)	$ —
Existing technology	$ 16,365	$ (14,775)	$1,590	$ 16,365	$ (13,411)	$2,954

During the first quarter of fiscal 2004, we acquired additional patents that will enhance our technology base to build next-generation network-attached storage (“NAS”,) storage area network (“SAN”,) and fabric-attached storage (“FAS”) systems for the benefit of our enterprise customers. The costs of such acquired intangibles for use in research and development activities that have alternative future uses have been capitalized and amortized as intangible assets in accordance with APB Opinion No. 17. Capitalized patents are amortized over five years as research and development expenses and total amortization for capitalized patents was $150 and none for the first quarters of fiscal 2004 and 2003, respectively. Estimated future patents amortization expenses are $1,352 for fiscal 2004, $1,803 for each of the fiscal years 2005, 2006, 2007 and 2008, and $300 thereafter.

Existing technology is amortized over three years as cost of product revenue and total amortization expense for existing technology was $1,364 and $1,386 for the first quarters of fiscal 2004 and 2003, respectively. Estimated future amortization expense is $1,590 for fiscal 2004 and none thereafter.

7. Stock Compensation

We record stock compensation in accordance with provisions of Accounting Principle Board Opinion No. 25, *“Accounting for Stock Issued to Employees,”* for employee awards and SFAS No. 123, *“Accounting for Stock-Based Compensation,”* for non-employee awards. Accordingly, we recognize the intrinsic value for employees and the fair value for non-employees as stock compensation expense over the vesting terms of the awards.

We recorded $519 and $637 of deferred compensation in the first quarters of fiscal 2004 and 2003, respectively, primarily related to the recognition of stock compensation of unvested options assumed in the WebManage acquisition in fiscal 2001, the grant of stock options to certain highly compensated employees and the award of restricted stocks to certain employees. We reversed $60 and $124 of deferred compensation in the first quarters of fiscal 2004 and 2003, respectively due to employee terminations.

We recorded $135 and $346 in compensation expense in the first quarters of fiscal 2004 and 2003, respectively, for the fair value of options granted to a member of the Board of Directors in recognition for services performed outside of the normal capacity of a board member. The 100,000 common shares under the 1999 Plan were granted at an exercise price of $15.72 per share, the fair market value per share on the grant date. The option has a term of 10 years measured from the grant date, subject to earlier termination following his cessation of board service, and will vest in a series of 48 successive equal monthly installments upon his completion of each month of board service over the 48 month period measured from the grant date.

8. Earnings Per Share

Basic net income per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for that period. Diluted net income per share is computed giving effect to all dilutive potential shares that were outstanding during the period. Dilutive

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

potential common shares consist of incremental common shares subject to repurchase and common shares issuable upon exercise of stock options.

During all periods presented, we had options outstanding, which could potentially dilute basic earnings per share in the future, but were excluded in the computation of diluted earnings per share in such periods, as their effect would have been antidilutive. For the three-months ended August 1, 2003 and July 26, 2002, 30,278 and 44,237 shares of common stock options with a weighted average exercise price of $38.21 and $32.55, respectively, were excluded from the diluted net income per share computation.

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

	Three Months Ended	
	August 1, 2003	July 26, 2002
Net Income (Numerator):		
Net income, basic and diluted	$ 27,073	$ 16,165
Shares (Denominator):		
Weighted average common shares outstanding	341,732	335,911
Weighted average common shares outstanding subject to repurchase	(45)	(128)
Shares used in basic computation	341,687	335,783
Weighted average common shares outstanding subject to repurchase	45	128
Common shares issuable upon exercise of stock options	16,765	14,211
Shares used in diluted computation	358,497	350,122
Net Income Per Share:		
Basic	$ 0.08	$ 0.05
Diluted	$ 0.08	$ 0.05

9. Comprehensive Income

The components of comprehensive income, net of tax, were as follows:

	Three Months Ended	
	August 1, 2003	July 26, 2002
Net income	$27,073	$16,165
Currency translation adjustment	1,402	344
Unrealized loss on derivatives	(286)	—
Unrealized gain (loss) on investments	(1,070)	959
Comprehensive income	$27,119	$17,468

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The components of accumulated other comprehensive loss were as follows:

	Three Months Ended	
	August 1, 2003	April 30 2003
Accumulated translation adjustments, net	$ 164	$(1,238)
Accumulated realized loss on derivatives	$ (315)	$ (29)
Accumulated unrealized gain on available-for-sale investments, net	101	1,171
Total accumulated other comprehensive loss	$ (50)	$ (96)

10. Restructuring Charges

Fiscal 2002 Second Quarter Restructuring Plan

In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in workforce and a consolidation of facilities. As a result of the restructuring in August 2001, we recorded a charge of $7,980. The restructuring charge included $4,796 of severance-related amounts, $2,656 of committed excess facilities and facility closure expenses, and $528 in fixed assets write-offs. The reserve balance of $808 at August 1, 2003 was included in other accrued liabilities.

During fiscal 2002, we purchased our Sunnyvale headquarters site and terminated the operating leases. As a result, an adjustment was made to reduce the previously recorded estimated facilities lease losses by $1,509. During fiscal 2002 and 2003, we recorded a net restructuring adjustment of $95 and $334, respectively, due to changes in the estimated costs of certain actions and final resolution of certain restructuring activities. In the event that the foreign facilities are not subleased, we will be obligated for additional total lease payments of approximately $605 to be payable through January 2006.

The following analysis sets forth the significant components of the second quarter fiscal 2002 restructuring at August 1, 2003:

	Severance-Related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge	$ 4,796	$ 528	$ 2,656	$ 7,980
Cash payments	(4,444)	—	(885)	(5,329)
Non-cash portion	—	(528)	(46)	(574)
Adjustments	315	—	(1,585)	(1,270)
Reserve balance at April 30, 2003	667	—	140	807
Cash payments	11	—	(9)	2
Non-cash portion	—	—	(1)	(1)
Reserve balance at August 1, 2003	$ 678	$ —	$ 130	$ 808

Fiscal 2002 Fourth Quarter Restructuring Plan

In April 2002, we completed a restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters. As a result of this restructuring, we incurred a charge of $5,850. The restructuring charge included $813 of severance-related amounts, $4,564 of committed excess facilities and facility closure expenses, and $473 in fixed assets write-offs. Of the reserve balance at August 1, 2003, $1,399 was included in other accrued liabilities and the remaining $2,967 was classified as long-term obligations.

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In January 2003, we updated our assumptions and estimates based on certain triggering events, which resulted in an additional net charge of $923, primarily relating to our engineering facility lease. Our estimates are reviewed and revised periodically and may result in a substantial charge to restructuring expense should different conditions prevail than were anticipated in original management estimates. Such estimates included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. In the event that the engineering facility is not subleased, we will be obligated for additional total lease payments of $3,242 to be payable through November 2010.

The following analysis sets forth the significant components of the fourth quarter fiscal 2002 restructuring at August 1, 2003:

	Severance-related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge	$ 813	$ 473	$ 4,564	$ 5,850
Cash payments	(706)	—	(1,023)	(1,729)
Non-cash portion	—	(473)	—	(473)
Adjustments	(107)	—	1,030	923
Reserve balance at April 30, 2003	—	—	4,571	4,571
Cash payments	—	—	(205)	(205)
Reserve balance at August 1, 2003	$ —	$ —	$ 4,366	$ 4,366

11. Short-Term Investments

All our investments are classified as available for sale at August 1, 2003 and April 30, 2003. Available-for-sale investments with original maturities of greater than three months are classified as short-term investments, as these investments generally consist of highly marketable securities that are intended to be available to meet current cash requirements. Investment securities classified as available-for-sale are reported at fair market value, and net unrealized gains or losses are recorded in accumulated other comprehensive loss, a separate component of stockholders' equity, net of taxes. Any gains or losses on sales of investments are computed based upon specific identification. For all periods presented, realized gains and losses on available-for-sale investments were not material. Management evaluates investments on a regular basis to determine if an other-than-temporary impairment has occurred.

Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value, and such a decline is not considered temporary. In the first quarter of fiscal 2003, we recorded a non-cash write down of $726 related to the impairment of our investment in a publicly traded company as its reduction in value was judged to be other than temporary. In the first quarter of fiscal 2004, we recorded a gain of $145 related to sales of previously impaired investments.

12. New Accounting Pronouncements

In December 2002, the EITF reached a consensus on EITF 00-21, *"Revenue Arrangements with Multiple Deliverables."* This issue addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. In some arrangements, the different revenue-generating activities (deliverables) are sufficiently separable and there exists sufficient evidence of their fair values to separately account for some or all of the deliverables (that is, there are separate units of accounting). In other arrangements, some or all of the deliverables are not independently functional, or there is not sufficient evidence of their fair values to account for them separately. This issue addresses when and, if so, how an arrangement involving multiple deliverables should be divided into separate units of accounting.

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

This issue does not change otherwise applicable revenue recognition criteria. The guidance in this issue is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The Company does not expect that the adoption of EITF 00-21 will have a material effect on its consolidated financial statements.

In January 2003, the Financial Accounting Standards Board ("FASB") issued Interpretation No. 46 ("FIN 46"), *"Consolidation of Variable Interest Entities."* FIN 46 requires an investor with a majority of the variable interests in a variable interest entity to consolidate the entity and also requires majority and significant variable interest investors to provide certain disclosures. A variable interest entity is an entity in which the equity investors do not have a controlling interest or the equity investment at risk is insufficient to finance the entity's activities without receiving additional subordinated financial support from the other parties. As of August 1, 2003, the Company had no investments which would require consolidation under FIN 46.

In April 2003, the FASB issued SFAS No. 149, *"Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities."* SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. In particular, this Statement clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative. It also clarifies when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 is generally effective for contracts entered into or modified after June 30, 2003. The adoption of this accounting standard did not have a significant impact on our financial position, results of operations and cash flow.

In May 2003, the FASB has issued SFAS No. 150, *"Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity."* The Statement improves the accounting for certain financial instruments that, under previous guidance, issuers could account for as equity. The new Statement requires that those instruments be classified as liabilities in statements of financial position. This statement is effective for interim periods beginning after June 15, 2003. As of August 1, 2003, the Company had no financial instruments within the scope of this pronouncement.

13. Commitments and Contingencies

In May 2000, we entered into a split dollar insurance arrangement with Daniel J. Warmenhoven. Under the arrangement, we will pay the annual premiums on several insurance policies on the life of the survivor of Mr. Warmenhoven and his wife Charmaine Warmenhoven, and Mr. Warmenhoven will pay us each year for a portion of those premiums equal to the economic value of the term insurance coverage provided him under the policies. For each of the 2001, 2002, 2003 and 2004 fiscal years, we paid an aggregate net annual premium on these split dollar polices in the amount of approximately $2,050. Under the arrangement, we will be reimbursed for all premium payments made on those policies, and it is intended that we will be reimbursed not later than May 2005. The policies are owned by a family trust established by Mr. Warmenhoven, and upon the death of the survivor of Mr. Warmenhoven and his wife or any earlier cash-out of the policies, we will be entitled to a portion of the insurance proceeds or cash surrender value of the policies equal to the net amount of cumulative premiums paid on those policies by us, and the balance will be paid to the trust. We have obtained a collateral assignment of the policies as a security interest for our portion of the proceeds or cash surrender value payable to us under the policies, and neither Mr. Warmenhoven nor the trust may borrow against the policies while that security interest remains in effect. The arrangement is terminable by us upon thirty (30)-days prior notice, and such termination will trigger a refund of the net cumulative premiums paid by us on the policies.

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

We are subject to various legal proceedings and claims which may arise in the normal course of business. We do not believe that any current litigation or claims will have a material adverse effect on our business, operating results, or financial condition.

14. Guarantees

As of August 1, 2003, our financial guarantees consisted of standby letters of credit outstanding, bank guarantee and restricted cash, which were related to facility lease requirements, product performance guarantees, customs and duties guarantees, VAT requirements and workers' compensation plans. The maximum amount of potential future payments under all of the foregoing arrangements was $2,408. Of this maximum exposure, $896 of restricted cash was classified under Other Assets on our balance sheet at August 1, 2003. We have not recorded any liability at August 1, 2003 related to these guarantees.

We provide both recourse and non-recourse lease financing options to our customers. Under the terms of recourse leases, which are generally 3 years or less, we remain liable for the aggregate unpaid remaining lease payments. We defer 100% of the recourse lease obligation and recognize revenue over the term of the lease as the lease payments become due. As of August 1, 2003 the maximum recourse exposure totaled approximately $4,365. Under the terms of the non-recourse leases we do not have any continuing obligations or liabilities. To date, we have not experienced significant losses under this lease financing program.

We do not maintain a general warranty reserve for estimated costs of product warranties at the time revenue is recognized due to our extensive product quality program and processes and because our customer service inventories utilized to correct product failures are carried at zero cost.

We defend and indemnify our customers for damages and reasonable costs incurred in any suit or claim brought against them alleging that our products sold to our customers infringe any U.S. patent, copyright, trade secret or similar right. If a product becomes the subject of an infringement claim, we may, at our option: (i) replace the product with another non-infringing product that provides substantially similar performance; (ii) modify the infringing product so that it no longer infringes but remains functionally equivalent; (iii) obtain the right for the customer to continue using the product at our expense and for the reseller to continue selling the product; (iv) take back the infringing product and refund to customer the purchase price paid less depreciation amortized on a straight line basis. We have not been required to make material payments pursuant to these provisions historically. We have not identified any losses that are probable under these provisions and, accordingly, we have not recorded a liability related to these indemnification provisions.

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements usually contain the words "estimate," "intend," "plan," "predict," "seek," "may," "will," "should," "would," "anticipate," "expect," "believe," or similar expressions and variations or negatives of these words. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. All forward-looking statements, including, but not limited to, (1) our intent to regularly introduce new products and product enhancements and our intent to support current and new products and product enhancements and incur prototype expenses and non-recurring engineering charges associated with the development of new products and technologies; (2) our expectation that our expenditures on expanding our current product offerings and introducing new products will increase in absolute dollars; (3) our intention to continue to establish and maintain business relationships with technology companies; (4) our expectation that we will increase sales and marketing expenses and add additional sales capacity commensurate with future revenue growth; (5) our belief that our general and administrative expenses will increase in absolute terms in the remainder of fiscal 2004; (6) our belief that our existing liquidity and capital resources are sufficient to fund our operations for at least the next twelve months; (7) our belief that our forward currency contracts will not subject us to undue risk; (8) our intention to continuously broaden our existing product offerings and introduce new products that expand our solutions portfolio; (9) our belief that our research and development expenses will increase in absolute dollars for the remainder of fiscal 2004 as compared to the comparable period in the prior year; (10) our belief that our products currently compete favorably with our competitors; (11) the possibility that we may engage in future acquisitions and (12) our expectation that the value of our investments will not decline significantly because of changes in market interest rates; (13) our expectation that amortization expense for existing technology will be $1.6 million in the remainder of fiscal 2004; (14) our expectation that deferred stock compensation amortization for fiscal 2004, 2005 and 2006 will be $1.2 million, $0.7 million and $0.6 million, respectively; (15) our expectation that amortization expense for capitalized patents for fiscal 2004 will be $1.4 million, and $1.8 million for each of the fiscal years 2005, 2006, 2007 and 2008 and $0.3 million thereafter; and (16) our belief that if we are not able to sublease our currently vacated facilities, our aggregate liability for these additional lease payments will be approximately $3.8 million; (17) our belief that our future contractual obligations as of August 1, 2003 will be no more than $27.1 million in fiscal 2004, $25.0 million in fiscal 2005, $21.4 million in fiscal 2006, $14.7 million in fiscal 2007, $3.8 million in fiscal 2008 and $10.5 million thereafter, are inherently uncertain as they are based on management's current expectations and assumptions concerning future events, and they are subject to numerous known and unknown risks and uncertainties. Therefore, our actual results may differ materially from the forward-looking statements contained herein. Factors that could cause actual results to differ materially from those described herein include, but are not limited to: (1) the amount of orders received in future periods; (2) our ability to ship our products in a timely manner; (3) our ability to achieve anticipated pricing, cost and gross margin levels; (4) our ability to successfully introduce new products; (5) our ability to achieve and capitalize on changes in market demand; (6) acceptance of, and demand for, our products; (7) our ability to maintain our supplier and contract manufacturer relationships; (8) our ability to expand our storage business through our indirect channel; (9) the ability of our competitors to introduce new products that compete successfully with our products; (10) the general economic environment and the continued growth of the storage and content delivery markets; (11) our ability to sustain and/or improve our cash and overall financial position; (12) our ability to generate future income to utilize our deferred tax assets; and (13) those factors discussed under "Risk Factors" elsewhere in this Quarterly Report on Form 10-Q. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof and are based upon information available to us at this time. These statements are not guarantees of future performance. We disclaim any obligation to update information in any forward-looking statement.

Overview

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

Code of Business Conduct and Ethics

We maintain a code of business conduct and ethics for directors, officers and employees, and will promptly disclose any waivers of the code for directors or executive officers. Our code of business practices addresses all major aspects of employee behavior including, conflicts of interest; confidentiality; compliance with laws, rules and regulations (including insider trading laws); and related matters. We require as part of our regular process that all employees sign a statement that they have all read and understood the code of business conduct and ethics.

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Note 2 to the Consolidated Financial Statements in the Annual Report on Form 10-K for the fiscal year ended April 30, 2003 describes the significant accounting policies and methods used in the preparation of the Consolidated Financial Statements. The preparation of these Consolidated Financial Statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses, and related disclosure of contingent assets and liabilities. We evaluate, on an ongoing basis, our estimates and judgments, including those related to sales returns, bad debts, excess inventory and purchase commitments, investments, intangible assets, lease losses and restructuring accruals, income taxes, and loss contingencies. We base our estimates on historical experience and assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates.

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

- revenue recognition and allowances;
- inventory write-down;
- restructuring accruals;
- loss contingencies;
- impairment losses on investments;
- accounting for income taxes;
- accounting for stock-based compensation; and
- derivative instruments.

Revenue Recognition and Allowances

We apply the provisions of SOP 97-2, *"Software Revenue Recognition"* and related interpretations, to all transactions that generate revenue. We recognize revenue when:

- *Persuasive Evidence of an Arrangement Exists.* It is our customary practice to have a purchase order prior to recognizing revenue on an arrangement from our end user customers, value added resellers, or distributors.

- *Delivery has Occurred.* Our product is physically delivered to our customers, generally with standard transfer terms as FOB shipping point. We typically do not allow for re-stocking rights with any of our value added resellers or distributors. Products shipped with acceptance criteria or return rights are not recognized as revenue until all criteria are achieved. If undelivered products or services exist that are essential to the functionality of the delivered product in an arrangement, delivery is not considered to have occurred.

- *The Fee is Fixed or Determinable.* Arrangements with payment terms extending beyond our standard terms and condition practices are not considered to be fixed or determinable. Revenue from such arrangements is recognized as the fees become due and payable. We typically do not allow for price-protection rights with any of our value added resellers or distributors.

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

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

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

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

Allowance for Doubtful Accounts

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

Inventory Write-down

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

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

Restructuring Accruals

In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in our workforce and a consolidation of our facilities. These restructuring accruals were accounted for in accordance with EITF Issue No. 94-3, *"Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)"*, and included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. These estimates are reviewed and revised periodically and may result in a substantial change to restructuring expense should different conditions prevail than were anticipated in original management estimates. See Note 10 to the Condensed Consolidated Financial Statements for further discussion.

Loss Contingencies

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

Impairment Losses on Investments

We perform periodic reviews of our investments for impairment. Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value, and such a decline is not considered temporary. Our investments in privately held companies are considered impaired when a review of the investees' operations and other indicators of impairment indicate that the carrying value of the investment is not likely to be recoverable. Such indicators include, but are not limited to, limited capital resources, limited prospects of receiving additional financing, and limited prospects for liquidity of the related securities. In the first quarter of fiscal 2003, we recorded a non-cash write-down of $0.7 million related to impairments of our investment in a publicly traded company as its reduction in value was judged to be other than temporary. In the first quarter of fiscal 2004, we recorded a gain of $0.1 million related to sales of previously impaired investments.

Accounting for Income Taxes

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

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

Accounting for Stock-based Compensation

We account for stock-based compensation in accordance with the provisions of APB No. 25, *"Accounting for Stock Issued to Employees,"* and comply with the disclosure provisions of SFAS No. 123 *"Accounting for Stock-Based Compensation,"* as amended by SFAS No. 148, *"Accounting for Stock-Based Compensation — Transition and Disclosures."* Deferred compensation recognized under APB No. 25 is amortized to expense using the graded vesting method. We account for stock options issued to non-employees in accordance with the provisions of SFAS No. 123 and EITF No. 96-18 under the fair value based method.

Derivative Instruments

We adopted SFAS 133, *"Accounting for Derivative Instruments and Hedging Activities"* as amended by SFAS No. 149, *"Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities."* Derivatives that are not designated as hedges are adjusted to fair value through earnings. If the derivative is designated as a hedge, depending on the nature of the exposure being hedged, changes in fair value will either be offset against the change in fair value of the hedged asset or liability through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of the hedge is recognized in earnings immediately.

New Accounting Standards

In December 2002, the EITF reached a consensus on EITF 00-21, *"Revenue Arrangements with Multiple Deliverables."* This issue addresses certain aspects of the accounting by a vendor for arrangements under which it will perform multiple revenue-generating activities. In some arrangements, the different revenue-generating activities (deliverables) are sufficiently separable and there exists sufficient evidence of their fair values to separately account for some or all of the deliverables (that is, there are separate units of accounting). In other arrangements, some or all of the deliverables are not independently functional, or there is not sufficient evidence of their fair values to account for them separately. This issue addresses when and, if so, how an arrangement involving multiple deliverables should be divided into separate units of accounting. This issue does not change otherwise applicable revenue recognition criteria. The guidance in this issue is effective for revenue arrangements entered into in fiscal periods beginning after June 15, 2003. The Company does not expect that the adoption of EITF 00-21 will have a material effect on its consolidated financial statements.

In January 2003, the FASB issued FIN 46, *"Consolidation of Variable Interest Entities."* FIN 46 requires an investor with a majority of the variable interests in a variable interest entity to consolidate the entity and also requires majority and significant variable interest investors to provide certain disclosures. A variable interest entity is an entity in which the equity investors do not have a controlling interest or the equity investment at risk is insufficient to finance the entity's activities without receiving additional subordinated financial support from the other parties. As of August 1, 2003, the Company had no investments which would require consolidation under FIN 46.

In April 2003, the FASB issued SFAS No. 149, *"Amendment of SFAS No. 133 on Derivative Instruments and Hedging Activities."* SFAS No. 149 amends and clarifies accounting for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities under SFAS No. 133. In particular, this Statement clarifies under what circumstances a contract with an initial net investment meets the characteristic of a derivative. It also clarifies when a derivative contains a financing component that warrants special reporting in the statement of cash flows. SFAS No. 149 is generally effective for contracts entered into or modified after June 30, 2003. The adoption of this accounting standard did not have a significant impact on our financial position, results of operations and cash flow.

In May 2003, the FASB has issued SFAS No. 150, *"Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity."* The Statement improves the accounting for certain financial instruments that, under previous guidance, issuers could account for as equity. The new Statement requires that those instruments be classified as liabilities in statements of financial position. This statement is effective for interim periods beginning after June 15, 2003. As of August 1, 2003, the Company had no financial instruments within the scope of this pronouncement.

Results of Operations

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

	Three Months Ended	
	August 1, 2003	**July 26, 2002**
Revenues:	100.0%	100.0%
Product revenue	90.5	90.3
Service revenue	9.5	9.7
Cost of Revenues:		
Cost of product revenue	32.6	30.8
Cost of service revenue	7.5	7.5
Gross margin	59.9	61.7
Operating Expenses:		
Sales and marketing	30.4	34.7
Research and development	12.1	13.5
General and administrative	4.7	3.6
Stock compensation	0.3	0.5
Total operating expenses	47.5	52.3
Income from Operations	12.4	9.4
Other Income (Expense), net:		
Interest income	1.2	1.6
Other expense, net	(0.1)	(0.5)
Net gain/(loss) on investments	0.1	(0.4)
Gain on sale of intangible asset	—	0.3
Total other income, net	1.2	1.0
Income before Income Taxes	13.6	10.4
Provision for Income Taxes	3.2	2.6
Net Income	10.4%	7.8%

In the first quarter of fiscal year 2004, we continued to enhance our enterprise solutions, broaden our customer portfolio, expand our partnerships with other industry leaders, and gain market acceptance for our unified storage, iSCSI, NearStore™, NetCache® and gateway filers (gFiler™) solutions. We extended our strategic partnerships to develop and deliver enterprise storage solutions on Linux technology. Our revenue growth was primarily driven by new product innovation as we continued to penetrate into a variety of industries worldwide to help customers store, manage and consolidate their business- and mission-critical data. We believe our competitive advantage is a result of lower total cost of ownership from a combination of four factors: lower acquisition cost, reduced administrative overhead, minimized service cost, and reduced downtime of critical business applications.

We further demonstrated our commitment to interoperable management solutions by releasing the Manage ONTAP™ API Suite and Software Developers' Kit, which provides developers open access to Network Appliance™ application programming interfaces, enabling partners to more tightly integrate and synergize their management applications for optimal performance in NetApp environments.

We also expanded our channel strategy by signing distribution agreements with the North American Computer Products group of Arrow Electronics and Avnet Hall-Mark. The agreements enable new Network Appliance distributors to provide value-added resellers the tools, training, marketing, sales, and technical services to build and expand their storage businesses and open up greater market penetration opportunities for Network Appliance.

Product Revenues — Product revenues increased by 26.3% to $235.8 million for the first quarter of fiscal 2004, from $186.7 million for the first quarter of fiscal 2003. Product revenues growth was across all geographies. This increase in product revenues was specifically attributable to increased software licenses and software subscriptions and an increase in units shipped, as compared to the same period in the prior year.

Product revenues were favorably impacted by the following factors:

• increased revenues from our new product introductions such as: FAS960, FAS940, and FAS250 filer products; NearStore R150 nearline storage systems; NetCache C2100 and C1200 appliances, as well as our gateway filers (gFiler,) GF960, GF940 and GF825;

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

• higher sales of software subscription upgrades representing 9.2% and 7.2% of total revenues for the first quarters of fiscal 2004 and 2003, respectively.

• a higher average selling price for our newer products: FAS960, FAS940 and FAS250 filers, C1200 NetCache products, NearStore R100, R150 nearline storage systems and software features, as well as our gateway filers (gFiler,) GF960, GF940 and GF825;

• increased sales through indirect channels, including sales through our OEM partners, representing 51.7% and 42.1% of total revenues for the first quarters of fiscal 2004 and 2003, respectively, and

• incremental revenue due to an extra week of business in the first quarter of fiscal 2004 (a 14-week first quarter in fiscal 2004 versus a 13-week first quarter in fiscal 2003.)

Product revenues were negatively impacted by the following factors:

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

• larger, lower cost per megabyte disks as a result of larger disk capacity; and

• declining average selling price and unit sales of our older filer and caching products.

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

Service Revenues — Service revenues, which include hardware support, professional services, and educational services, increased by 23.1% to $24.7 million in the first quarter of fiscal 2004, from $20.1 million in the first quarter of fiscal 2003. Service revenues are generally deferred and, in most cases, recognized ratably over the service period obligations, which are typically one to three years. Service revenues represented 9.5% and 9.7% of total revenues for the first quarters of fiscal 2004 and 2003, respectively. The increase was due to an increasing number of enterprise customers, who typically purchase more complete service packages. Higher service revenues was also related to a growing installed base resulting in new customer support contracts in addition to support contract renewals by existing customers. While it is an element of our strategy to expand

and offer a more comprehensive, global enterprise support and service solution, we cannot assure you that service revenue will grow at the current rate in the remainder of fiscal 2004.

International total revenues (including United States exports) increased by 39.9% for the first quarter of fiscal 2004 as compared to the same period in fiscal 2003. International total revenues were $108.5 million, or 41.6% of total revenues, and $77.5 million, or 37.5% of total revenues for the first quarters of fiscal 2004 and 2003, respectively. The increase in international sales was primarily a result of European and Asia Pacific net revenues growth, driven by larger storage implementations, new products, higher storage spending in certain geographic regions, and positive foreign exchange effects from a weaker U.S. dollar, as compared to the same period in the prior year. We cannot assure you that we will be able to maintain or increase international revenues in the remainder of fiscal 2004.

Product Gross Margin — Product gross margin decreased to 63.9% for the first quarter of fiscal 2004, from 65.9% for the first quarter of fiscal 2003. Amortization of existing technology included in cost of product revenues was $1.4 million for both first quarters of fiscal 2004 and 2003. Estimated future amortization for fiscal 2004 will be $1.6 million and none thereafter.

Product gross margin was negatively impacted by:

- increased sales through indirect channels, which have a lower gross margin than our direct sales;
- transitional costs associated with the implementation of a new Enterprise Resource Planning (“ERP”) system;
- higher disk content with an expanded storage capacity for the higher-end filers and Nearstore systems;
- sales price reductions due to competitive pricing pressure and selective pricing discounts;
- lower average selling price of certain add-on software options.

Product gross margin was favorably impacted by:

- favorable product and add-on software mix;
- competitive pricing solutions with our core filer products bundled with software features;
- higher average selling prices for our new products; and
- growth in software subscription upgrades and software licenses due primarily to a larger installed base and an increasing number of new enterprise customers.

Service Gross Margin — Service gross margin decreased to 21.7% in the first quarter of fiscal 2004 as compared to 23.0% in the first quarter of fiscal 2003. Investments in customer service increased by 25.2% to $19.3 million in the first quarter of fiscal 2004, from $15.5 million in the first quarter of fiscal 2003. The decrease in service gross margin was primarily due to the continued investment in our service infrastructure to support our increasing enterprise customer base, including investment in the Bangalore Technology Center in India.

Sales and Marketing — Sales and marketing expenses consist primarily of salaries, commissions, advertising and promotional expenses, and certain customer service and support costs. Sales and marketing expenses increased 10.4% to $79.4 million for the first quarter of fiscal 2004, from $71.9 million for the first quarter of fiscal 2003. These expenses were 30.4% and 34.7% of total revenues for the first quarters of fiscal 2004 and fiscal 2003, respectively. The increase in absolute dollars was attributed to a 14-week first quarter in fiscal 2004 versus a 13-week first quarter in fiscal 2003; sales kick off/club meetings, increased commission expenses and the continued worldwide investment in our sales and customer service organizations associated with selling complete solutions at the enterprise level, offset by cost control and reduction in discretionary spending efforts. Sales and marketing headcount decreased to 1,188 at August 1, 2003 from 1,265 at July 26, 2002.

We expect to continue to selectively add sales capacity in an effort to expand domestic and international markets, introduce new products, establish and expand new distribution channels, and increase product and company awareness. We expect to increase our sales and marketing expenses commensurate with future revenue growth.

Research and Development — Research and development expenses consist primarily of salaries and benefits, prototype expenses, non-recurring engineering charges, fees paid to outside consultants and amortization of capitalized patents. Estimated future capitalized patents amortization expenses for fiscal 2004 will be $1.4 million, $1.8 million for each of the fiscal years 2005, 2006, 2007 and 2008 and $0.3 million thereafter.

Research and development expenses increased 13.2% to $31.5 million for the first quarter of fiscal 2004 from $27.9 million for the first quarter of fiscal 2003. These expenses represented 12.1% and 13.5% of total revenues for the first quarters of fiscal 2004 and 2003, respectively. The increase in research and development expenses was primarily a result of a 14-week first quarter in fiscal 2004 versus a 13-week first quarter in fiscal 2003, increased headcount, offset by a partial holiday shutdown, cost control and reduction in discretionary spending efforts. Research and development headcount increased to 540 as of August 1, 2003 compared to 522 as of July 26, 2002. For both the first quarters of fiscal 2004 and 2003, no software development costs were capitalized.

We believe that our future performance will depend in large part on our ability to maintain and enhance our current product line, develop new products that achieve market acceptance, maintain technological competitiveness, and meet an expanding range of customer requirements. We expect to continuously support current and future product development and enhancement efforts, and incur prototyping expenses and non-recurring engineering charges associated with the development of new products and technologies. We intend to continuously broaden our existing product offerings and introduce new products that expand our solutions portfolio.

We believe that our research and development expenses will increase in absolute dollars for the remainder of fiscal 2004 as compared to the comparable period in the prior year.

General and Administrative — General and administrative expenses increased 64.9% to $12.3 million for first quarter of fiscal 2004, from $7.4 million for the first quarter of fiscal 2003. These expenses represented 4.7% and 3.6% of total revenues for the first quarters of fiscal 2004 and 2003, respectively. This increase in absolute dollars was primarily due to the investment in our enterprise-wide ERP system, expenses associated with expanded regulatory requirements, a 14-week first quarter in fiscal 2004 versus a 13-week first quarter in fiscal 2003, a $1.5 million benefit from the collection of previously accrued customer-specific bad debt allowance in the same quarter prior year, offset by cost control, reduction in discretionary spending efforts and a partial holiday shutdown. General and administrative headcount increased to 282 at August 1, 2003 from 256 at July 26, 2002. We believe that our general and administrative expenses will increase in absolute dollars for the remainder of fiscal 2004 due to the investment in our enterprise-wide ERP system and expanded regulatory requirements as compared to the comparable period in the prior year.

Stock Compensation — We account for stock-based compensation in accordance with the provisions of APB No. 25 and comply with the disclosure provisions of SFAS No. 123, as amended by SFAS No. 148. Deferred compensation recognized under APB No. 25 is amortized to expense using the graded vesting method. We account for stock options issued to non-employees in accordance with the provisions of SFAS No. 123 and EITF No. 96-18 under the fair value based method.

Stock compensation expenses were $0.7 million and $1.0 million in the first quarters of fiscal 2004 and 2003, respectively. This decrease was primarily due to lower stock compensation in first quarter of fiscal 2004 as compared to same period in fiscal 2003 attributed to forfeitures of unvested options assumed in the WebManage Technologies, Inc. acquisition in fiscal 2001; offset by an increase in stock compensation expenses relating to restricted stock awards. Estimated future deferred stock compensation amortization expenses are $1.2 million in fiscal 2004, $0.7 million in fiscal 2005 and $0.6 million in fiscal 2006 and none thereafter.

Restructuring Charges — In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in our workforce and a consolidation of our facilities.

Fiscal 2002 Second Quarter Restructuring Plan

As a result of the restructuring in August 2001, we recorded a charge of $8.0 million. The restructuring charge included $4.8 million of severance-related amounts, $2.7 million of committed excess facilities and facility closure expenses, and $0.5 million in fixed assets write-offs. The reserve balance of $0.8 million at August 1, 2003 was included in other accrued liabilities.

During fiscal 2002, we purchased our Sunnyvale headquarters site and terminated the operating leases. As a result, an adjustment was made to reduce the previously recorded estimated facilities lease losses by $1.5 million. During fiscal 2002 and 2003, we recorded a net restructuring adjustment of $0.1 million, $0.3 million, respectively, due to changes in the estimated costs of certain actions and final resolution of certain restructuring activities. In the event that the foreign facilities are not subleased, we will be obligated for additional total lease payments of approximately $0.6 million to be payable through January 2006.

The following analysis sets forth the significant components of the second quarter fiscal 2002 restructuring at August 1, 2003 (in thousands):

	Severance-related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge	$ 4,796	$ 528	$ 2,656	$ 7,980
Cash payments	(4,444)	—	(885)	(5,329)
Non-cash portion	—	(528)	(46)	(574)
Adjustments	315	—	(1,585)	(1,270)
Reserve balance at April 30, 2003	667	—	140	807
Cash payments	11	—	(9)	2
Non-cash portion	—	—	(1)	(1)
Reserve balance at August 1, 2003	$ 678	$ —	$ 130	$ 808

Fiscal 2002 Fourth Quarter Restructuring Plan

In April 2002, we completed a restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters. As a result of this restructuring, we recorded a charge of $5.9 million. The restructuring charge included $0.8 million of severance-related amounts, $4.6 million of committed excess facilities and facility closure expenses, and $0.5 million in fixed assets write-offs. Of the reserve balance at August 1, 2003, $1.4 million was included in other accrued liabilities and the remaining $3.0 million was classified as long-term obligations.

In January 2003, we updated our assumptions and estimates based on certain triggering events, which resulted in an additional net charge of $0.9 million, primarily relating to our engineering facility lease. Our estimates are reviewed and revised periodically and may result in a substantial charge to restructuring expense should different conditions prevail than were anticipated in original management estimates. Such estimates included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. In the event that the engineering facility is not subleased, we will be obligated for an additional total lease payments of $3.2 million to be payable through November 2010.

The following analysis sets forth the significant components of the fourth quarter fiscal 2002 restructuring at August 1, 2003 (in thousands):

	Severance-related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge	$ 813	$ 473	$ 4,564	$ 5,850
Cash payments	(706)	—	(1,023)	(1,729)
Non-cash portion	—	(473)	—	(473)
Adjustments	(107)	—	1,030	923
Reserve balance at April 30, 2003	—	—	4,571	4,571
Cash payments	—	—	(205)	(205)
Reserve balance at August 1, 2003	$ —	$ —	$ 4,366	$ 4,366

Interest Income — Interest income was $3.0 million and $3.2 million for the first quarters of fiscal 2004 and 2003, respectively. The moderate decrease in interest income was primarily due to lower average interest rates, and lower investment balances as we utilized $26.8 million to repurchase our common stock in the first quarter of fiscal 2004.

Other Income (Expense), Net — The first quarters of fiscal 2004 and 2003 included a net exchange loss from foreign currency transactions of $0.2 million and $1.0 million, respectively.

Net Gain/(Loss) on Investments — Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value, and such a decline is not considered temporary. In the first quarter of fiscal 2003, we recorded a noncash write down of $0.7 million related to the impairment of our investment in a publicly traded company as its reduction in value was judged to be other than temporary. In the first quarter of fiscal 2004, we sold certain previously impaired investments and realized a net gain of $0.1 million.

Gain on Sale of Intangible Assets — We recorded a gain on sale of intangible assets of $0.6 million in the first quarter of fiscal 2003 related to the sale of our ContentReporter™ software. We intend to resell this software through a licensing arrangement.

Provision for Income Taxes — For first quarter of fiscal 2004, we applied an annual tax rate of 23.6% to pretax income. Our estimate is based on existing tax laws and our current projections of income (loss) and distributions of income (loss) among different entities and tax jurisdictions, and is subject to change, based primarily on varying levels of profitability.

Liquidity and Capital Resources

As of August 1, 2003, as compared to the April 30, 2003 balances, our cash, cash equivalents, and short-term investments increased by $31.3 million to $650.1 million. We derive our liquidity and capital resources primarily from our cash flow from operations and from working capital. Working capital increased by $32.1 million to $620.6 million as of August 1, 2003, compared to $588.5 million as of April 30, 2003.

We generated cash from operating activities totaling $56.8 million and $26.9 million for the first quarters of fiscal 2004 and 2003, respectively. Net cash provided by operating activities in the first quarter of fiscal 2004 was principally related to net income of $27.1 million, decreases in accounts receivable, increases in accounts payable, income taxes payable, deferred revenue, coupled with depreciation, net gain or loss on investments, amortization of intangibles and stock compensation, partially offset by decreased accrued liabilities, accrued compensation and related benefits and increases in inventories, deferred income taxes and prepaid expenses and other assets.

We used $12.3 million and $14.4 million of cash in the first quarters of fiscal 2004 and 2003, respectively, for capital expenditures. We received net proceeds of $3.4 million and $18.5 million in the first quarters of fiscal 2004 and 2003, respectively, for net purchases/ redemptions of short-term investments. In June 2003, we acquired additional patents for a purchase price of approximately $9.0 million. Investing activities in the first quarters of fiscal 2004 and 2003 also included new investments in privately-held companies of $0.3 million for both periods.

Financing activities used $2.6 million in the first quarter of fiscal 2004, which included both common stock repurchases and sales of common stock. We repurchased 2.2 million shares of common stock at a total of $34.8 million, of which we paid cash of $26.8 million and the remaining $8.0 million was included in other accrued liabilities. Financing activities provided $10.3 million in the first quarter of fiscal 2003, which related to sales of common stock related to employee stock transactions. The change in cash flow from financing was primarily due to the effects of the common stock repurchases partially offset by higher proceeds from issuance of common stock under employee programs compared to the same period in the prior year.

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

Contractual Obligations

The following summarizes our contractual obligations at August 1, 2003, and the effect such obligations are expected to have on our liquidity and cash flow in future periods, (in thousands):

	2004	2005	2006	2007	2008	Thereafter	Total
Operating lease payments	$ 8,131	$10,163	$ 7,628	$ 4,668	$3,793	$10,512	$ 44,895
Venture capital funding commitments	982	1,309	1,309	—	—	—	3,600
Purchase commitments	14,526	8,400	10,000	10,000	—	—	42,926
Maintenance services and other	3,425	5,094	2,493	—	—	—	11,012
	$27,064	$24,966	$21,430	$14,668	$3,793	$10,512	$102,433

Risk Factors

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

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

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

- changes in general economic conditions and specific economic conditions in the computer, storage, and networking industries;

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

• the effects of terrorist activity and international conflicts, which could lead to business interruptions and difficulty in forecasting;

• the level of competition in our target product markets;

• the size, timing, and cancellation of significant orders;

• product configuration and mix;

• the extent to which our customers renew their service and maintenance contracts with us;

• market acceptance of new products and product enhancements;

• announcements, introductions, and transitions of new products by us or our competitors;

• deferrals of customer orders in anticipation of new products or product enhancements introduced by us or our competitors;

• changes in pricing by us in response to competitive pricing actions;

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

• supply constraints;

• technological changes in our target product markets;

• the levels of expenditure on research and development and sales and marketing programs;

• our ability to achieve targeted cost reductions;

• excess facilities;

• future accounting pronouncements and changes in accounting policies; and

• seasonality.

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

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

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

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

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

• demand for storage and content delivery products;

• discount levels and price competition;

• direct versus indirect sales;

• product and add-on software mix;

- the mix of services as a percentage of revenue;

- the mix and average selling prices of products;

- the mix of disk content;

- new product introductions and enhancements;

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

- the cost of components, manufacturing labor, and quality.

A significant percentage of our expenses are fixed, which could materially and adversely affect our net income.

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

Because cost and expense control is critical to maintaining our positive cash flow from operations and profitability, if we are unable to control costs and expenses relative to our revenue, our cash flow and net income will be adversely affected.

In fiscal 2002, we reduced fixed costs through workforce reductions and a consolidation of our facilities. We believe strict cost containment is essential to maintaining positive cash flow from operations and remaining profitable in future quarters, especially since the outlook for future quarters is uncertain. Additional measures to reduce expenses may be undertaken if revenues and market conditions do not improve. A number of factors could preclude us from successfully bringing costs and expenses in line with our revenues, such as our inability to accurately forecast business activities and deterioration of our revenues. If we are not able to effectively control our costs and achieve an expense structure commensurate with our business activities and revenues, our cash flow and net income will be adversely affected.

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

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

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

In addition, our business also depends on general economic and business conditions. A reduction in demand for network storage and content delivery caused by weakening economic conditions and decreases in corporate spending have resulted in decreased revenues and lower revenue growth rates. The network storage and content delivery market growth declined significantly beginning in the third quarter of fiscal 2001, causing both our revenues and operating results to decline. If the network storage and content delivery markets grow more slowly than anticipated or if emerging standards other than those adopted by us become increasingly accepted by these markets, our operating results could be materially adversely affected.

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

The market price for our common stock has experienced substantial volatility in the past, and several factors could cause the price to fluctuate substantially in the future. These factors include:

- fluctuations in our operating results;
- fluctuations in the valuation of companies perceived by investors to be comparable to us;
- economic developments in the network storage market as a whole;
- international conflicts and acts of terrorism;
- a shortfall in revenues or earnings compared to securities analysts' expectations;
- changes in analysts' recommendations or projections;
- announcements of new products, applications or product enhancements by us or our competitors;
- changes in our relationships with our suppliers, customers and strategic partners; and
- general market conditions.

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

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

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

In particular, in conjunction with the introduction of our product offerings in the fabric-attached storage market, we introduced products with new features and functionality that address the storage area network market. During fiscal 2003, we introduced iSCSI-enabled unified storage solutions. We also introduced Direct Access File System (DAFS) protocol-capable products and NearStore backup and recovery products during fiscal 2002. We face risks relating to these product introductions, including risks relating to forecasting of demand for such products, as well as possible product and software defects and a potentially different sales and support environment associated with selling these new systems. If any of the foregoing occur, our operating results could be adversely affected.

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

Our business could be materially adversely affected as a result of a natural disaster, terrorist acts, or other catastrophic events.

Our operations, including our suppliers' and contract manufacturers' operations, are susceptible to outages due to fire, floods, power loss, power shortages, telecommunications failures, break-ins, and similar events. In addition, our headquarters are located in Northern California, an area susceptible to earthquakes. If any significant disaster were to occur, our ability to operate our business could be impaired.

Weak economic conditions or terrorist actions could lead to significant business interruptions. If such disruptions result in cancellations of customer orders, a general decrease in corporate spending on information technology, or direct impacts on our marketing, manufacturing, financial functions, or our suppliers' logistics function, our results of operations and financial condition could be adversely affected.

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

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

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

We conduct business internationally. For the first quarter of fiscal 2004, approximately 41.6% of our total revenues was from international customers (including U.S. exports). Accordingly, our future operating results could be materially adversely affected by a variety of factors, some of which are beyond our control, including regulatory, political, or economic conditions in a specific country or region, trade protection measures and other regulatory requirements, government spending patterns, and acts of terrorism and international conflicts.

Our international sales are denominated in U.S. dollars and in foreign currencies. An increase in the value of the U.S. dollar relative to foreign currencies could make our products more expensive and, therefore, potentially less competitive in foreign markets. For international sales and expenditures denominated in foreign currencies, we are subject to risks associated with currency fluctuations. We hedge risks associated with foreign currency transactions in order to minimize the impact of changes in foreign currency exchange rates on earnings. We utilize forward contracts to hedge our currency exposure associated with certain assets and liabilities as well as anticipated foreign currency cash flow. All balance sheet hedges are marked to market through earnings every period, while gains and losses on cash flow hedges are recorded in other comprehensive income. There can be no assurance that such hedging strategies will be successful and that currency exchange rate fluctuations will not have a material adverse effect on our operating results.

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

Although operating results have not been materially adversely affected by seasonality in the past, because of the significant seasonal effects experienced within the industry, particularly in Europe, our future operating results could be materially adversely affected by seasonality.

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

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

The storage and content delivery markets are intensely competitive and are characterized by rapidly changing technology.

In the storage market, our FAS appliances and data management software compete primarily against storage products and data management software from EMC Corporation, Hitachi Data Systems, Hewlett-Packard Company (including the integrated Compaq Computer Corporation), IBM Corporation, and Sun Microsystems, Inc. We have also historically encountered less-frequent competition from companies including Dell, LSI Logic Corp., MTI Corp., Procom Technology and Silicon Graphics, Inc.

In the content delivery market, our NetCache appliances and content delivery software compete against caching appliance and content delivery software vendors including Akamai Technologies, Inc., BlueCoat Systems (formerly Cacheflow, Inc.) and Cisco Systems, Inc.

Additionally a number of new, privately held companies are currently attempting to enter the storage and content delivery markets, some of which may become significant competitors in the future.

We believe that the principal competitive factors affecting the storage and content delivery markets include product benefits such as response time, reliability, data availability, scalability, ease of use, price, multiprotocol capabilities, and customer service and support. To date, we have been able to compete successfully with our principal competitors in large part based on the product benefits that we believe result from the superior technology of our products. We must continue to maintain and enhance this technological advantage over our competitors. Otherwise, if those competitors with greater financial, marketing, service, support, technical and other resources were able to offer products that matched or surpassed the technological capabilities of our products, these competitors would, by virtue of these greater resources, gain a competitive advantage over us that would lead to greater sales for these competitors at the expense of our own market share, which would have a material adverse affect on our business, financial condition and results of operations.

Increased competition could also result in price reductions, reduced gross margins, and loss of market share, any of which could materially adversely affect our operating results. Our competitors may be able to respond more quickly than we can to new or emerging technologies and changes in customer requirements, or devote greater resources to the development, promotion, sale, and support of their products. In addition, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties. Accordingly, it is possible that new competitors or alliances among competitors may emerge and rapidly acquire significant market share. We cannot assure you that we will be able to compete successfully against current or future competitors. Competitive pressures we face could materially adversely affect our operating results.

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

We rely on a limited number of suppliers of several key components utilized in the assembly of our products. We purchase most of our disk drives through a single supplier. We purchase computer boards and microprocessors from a limited number of suppliers. Our reliance on a limited number of suppliers involves several risks, including:

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

• supplier capacity constraints;

• price increases;

- timely delivery; and

- component quality.

Component quality is particularly significant with respect to our suppliers of disk drives. In order to meet product performance requirements, we must obtain disk drives of extremely high quality and capacity. In addition, there are periodic supply-and-demand issues for disk drives, microprocessors, and for semiconductor memory components, which could result in component shortages, selective supply allocations, and increased prices of such components. We cannot assure you that we will be able to obtain our full requirements of such components in the future or that prices of such components will not increase. In addition, problems with respect to yield and quality of such components and timeliness of deliveries could occur. Disruption or termination of the supply of these components could delay shipments of our products and could materially adversely affect our operating results. Such delays could also damage relationships with current and prospective customers.

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

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

We currently rely on several contract manufacturers to manufacture most of our products. Our reliance on our third-party contract manufacturers reduces our control over the manufacturing process, exposing us to risks including reduced control over quality assurance, production costs, and product supply. If we should fail to effectively manage our relationship with our contract manufacturers, or if our contract manufacturers experience delays, disruptions, capacity constraints, or quality control problems in their manufacturing operations, our ability to ship products to our customers could be impaired and our competitive position and reputation could be harmed. Qualifying a new contract manufacturer and commencing volume production are expensive and time-consuming. If we are required to change contract manufacturers or assume internal manufacturing operations, we may lose revenue and damage our customer relationships. If we inaccurately forecast demand for our products, we may have excess or inadequate inventory, or incur cancellation charges or penalties, which could adversely impact our operating results.

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

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

An element of our strategy to enhance revenue is to strategically partner with major third-party software and hardware vendors who integrate our products into their products and also comarket our products. A number of these strategic partners are industry leaders that offer us expanded access to segments of the storage market. There is intense competition for attractive strategic partners, and even if we can establish strategic relationships with these partners, we cannot assure you that these partnerships will generate significant revenue or that the partnerships will continue to be in effect for any specific period of time.

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

We may incur problems with current or future equity investments and acquisitions, and these investments may not achieve our objectives.

From time to time, we make equity investments for the promotion of business and strategic objectives. We have already made strategic investments in a number of network storage-related technology companies. Equity investments may result in the loss of investment capital. The market price and valuation of our equity investments in these companies may fluctuate due to market conditions and other circumstances over which we have little or no control, and recent events have adversely affected the public equity market. To the extent that the fair value of these securities is less than our cost over an extended period of time, our results of operations and financial position could be negatively impacted. In the first quarter of fiscal 2003, we recorded a non-cash write-down of $0.7 million related to the impairment of our investment in a publicly traded company as its reduction in value was judged to be other than temporary. In the first quarter of fiscal 2004, we recorded a gain of $0.1 million related to sales of previously impaired investments.

As part of our strategy, we are continuously evaluating opportunities to buy other businesses or technologies that would complement our current products, expand the breadth of our markets, or enhance our technical capabilities. We have acquired two companies since the beginning of fiscal 2001. We may engage in future acquisitions that dilute our stockholders' investments and cause us to use cash, to incur debt, or to assume contingent liabilities.

Acquisitions of companies entail numerous risks, and we may not be able to successfully integrate acquired operations and products or to realize anticipated synergies, economies of scale, or other value. In addition, we may experience a diversion of management's attention, the loss of key employees of acquired operations, or the inability to recover strategic investments in development stage entities. Any such problems could have a material adverse effect on our business, financial condition, and results of operation.

In addition, we adopted SFAS 142 *"Goodwill and Other Intangible Assets,"* which changes the accounting for goodwill from an amortization method to an impairment-only approach. As of August 1, 2003, the fair value for each of our reporting units exceeded the reporting unit's carrying amount and no impairment was recognized. On an ongoing basis, goodwill is reviewed annually for impairment (or more frequently if indicators of impairment arise). There had been no impairment of goodwill and intangible assets as of the end of the first quarter of fiscal 2004. There can be no assurance that future impairment tests will not result in a charge to earnings.

We rely and will increasing rely on our indirect sales channel for a significant portion of our revenue. If we are unable to manage effectively this sales channel, we will not be able to maintain or increase our revenue as we have forecasted, which would have a materially adverse impact on our business, financial condition and results of operations.

We market and sell our storage solutions directly through our worldwide sales force and indirectly through channels such as value-added resellers ("VARs"), systems integrators, distributors and strategic business partners and derive a significant portion of our revenue from these indirect channel partners. However, in order for us to maintain our current revenue sources and grow our revenue as we have forecasted, we must effectively manage our relationships with these indirect channel partners. To do so, we must attract and retain a sufficient number of qualified channel partners to successfully market our products. However, because we also sell our products directly to customers through our sales force, we on occasion compete with our indirect channels for sales of our products to our end customers, competition that could result in conflicts with these indirect channel partners and make it harder for us to attract and retain these indirect channel partners. At the same time, our indirect channel partners may develop and offer products of their own that are competitive to ours. Or, because our reseller partners generally offer products from several different companies, including products of our competitors, these resellers may give higher priority to the marketing, sale and support of our competitors' products than ours. If we fail to manage effectively our relationships with these indirect channel partners to minimize channel conflict and continue to evaluate and meet our indirect sales partners' needs with respect to our products, we will not be able to maintain or increase our revenue as we have forecasted, which would have a materially adverse affect on our business, financial condition and results of operations.

Undetected software, hardware errors, or failures found in new products may result in loss of or delay in market acceptance of our products, which could increase our costs and reduce our revenues.

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

If actual results or events differ materially from those contemplated by us in making estimates and assumptions, our reported financial condition and results of operation for future periods could be materially affected.

The preparation of the consolidated financial statements and related disclosure in conformity with accounting principles generally accepted in the United States of America requires management to establish policies that contain estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Note 4 of the Notes to Condensed Consolidated Financial Statements describes the significant accounting policies essential to preparing our consolidated financial statements. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures. We base our estimates on historical experience and assumptions that we believe to be reasonable under the circumstances. Actual future results may differ materially from these estimates. We evaluate, on an ongoing basis, our estimates and assumptions. In addition, see our Critical Accounting Policies under Item 7.

If we are unable to protect our intellectual property, we may be subject to increased competition that could materially adversely affect our operating results.

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

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

We are subject to intellectual property infringement claims. We may, from time to time, receive claims that we are infringing third parties' intellectual property rights. Third parties may in the future claim infringement by us with respect to current or future products, patents, trademarks, or other proprietary rights. We expect that companies in the appliance market will increasingly be subject to infringement claims as the number of products and competitors in our industry segment grows and the functionality of products in different industry segments overlaps. Any such claims could be time-consuming, result in costly litigation, cause product shipment delays, require us to redesign our products or require us to enter into royalty or licensing agreements, any of which could materially adversely affect our operating results. Such royalty or licensing agreements, if required, may not be available on terms acceptable to us or at all.

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

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

Market Interest and Interest Income Risk

Interest and Investment Income — As of August 1, 2003, we had short-term investments of $329.4 million. Our investment portfolio primarily consists of highly liquid investments with original maturities at the date of purchase of greater than three months, which are classified as available-for-sale, and investment in marketable equity securities in primarily technology companies. These highly liquid investments, consisting primarily of government and corporate debt securities, are subject to interest rate and interest income risk and will decrease in value if market interest rates increase. A hypothetical 10 percent increase in market interest rates from levels at August 1, 2003 would cause the fair value of these short-term investments to decline by approximately $0.7 million. Because we have the ability to hold these investments until maturity we would not expect any significant decline in value of our investments caused by market interest rate changes. Declines in interest rates over time will, however, reduce our interest income. We do not use derivative financial instruments in our investment portfolio.

Market Price Risk

Equity Securities — We are also exposed to market price risk on our equity securities included in our short-term investments, which are primarily in publicly traded companies in the volatile high-technology industry sector. In the first quarter of fiscal 2003, we recorded a non-cash write down of $0.7 million related to the impairment of our investment in a publicly traded company as its reduction in value was judged to be other than temporary.

We do not attempt to reduce or eliminate our market exposure on these securities and, as a result, the amount of income and cash flow that we ultimately realize from our investment in future periods may vary materially from the current fair value. A 50% adverse change in the equity price would result in an immaterial decrease in the fair value of our equity security as of August 1, 2003.

The hypothetical changes and assumptions discussed above will be different from what actually occurs in the future. Furthermore, such computations do not anticipate actions that may be taken by management, should the hypothetical market changes actually occur over time. As a result, the effect on actual earnings in the future will differ from those described above.

Foreign Currency Exchange Rate Risk

We hedge risks associated with foreign currency transactions in order to minimize the impact of changes in foreign currency exchange rates on earnings. We utilize forward contracts to hedge against the short-term impact of foreign currency fluctuations on certain assets and liabilities denominated in foreign currencies. All balance sheet hedges are marked to market through earnings every period. We also use foreign exchange forward contracts to hedge foreign currency forecasted transactions related to certain sales and operating expenses. These derivatives are designated as cash flow hedges under SFAS 133. For cash flow hedges, the gains or losses were included in other comprehensive income and were not material at August 1, 2003.

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

The following table provides information about our foreign exchange forward contracts outstanding on August 1, 2003, (in thousands):

Currency	Buy/Sell	Foreign Currency Amount	Contract Value USD	Fair Value in USD
AUD	Sell	10,300	$ 6,677	$ 6,677
CHF	Sell	3,500	$ 2,554	$ 2,554
GBP	Sell	14,095	$ 22,618	$22,621
EUR	Sell	42,041	$ 47,232	$47,257
CAD	Sell	10,100	$ 7,187	$ 7,186
ZAR	Sell	19,500	$ 2,580	$ 2,580

Item 4. ***Controls and Procedures***

Evaluation of Disclosure Controls and Procedures. Our management evaluated, with the participation of our Chief Executive Officer and our Chief Financial Officer, the effectiveness of our disclosure controls and procedures as of the end of the period covered by this Quarterly Report on Form 10-Q. Based on this evaluation, our Chief Executive Officer and our Chief Financial Officer have concluded that our disclosure controls and procedures are effective to ensure that information we are required to disclose in reports that we file or submit under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in Securities and Exchange Commission rules and forms.

Changes in Internal Control over Financial Reporting. There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report on Form 10-Q that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting. In May 2003, we implemented new enterprise-wide software, as well as new business processes and procedures to support the software. These changes are the result of our normal business process to evaluate and upgrade or replace our systems software and related business processes to support our evolving operational needs. The new software and processes have been used to record and report our fiscal 2004 financial results.

Item 5. ***Other Information***

In accordance with Section 10A(i)(2) of the Securities Exchange Act of 1934, as added by Section 202 of the Sarbanes-Oxley Act of 2002 (the “Act”), we are required to disclose the non-audit services approved by our Audit Committee to be performed by Deloitte & Touche LLP, our external auditor. Non-audit services are defined in the Act as services other than those provided in connection with an audit or a review of the financial statements of a company. The Audit Committee has approved the engagement of Deloitte & Touche LLP for services related to local statutory audits and certain taxation matters.

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PART II. OTHER INFORMATION

Item 1. ***Legal Proceedings***

None

Item 2. ***Changes in Securities***

None

Item 3. ***Defaults Upon Senior Securities***

None

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

None

Item 5. ***Other Information***

None

Item 6. ***Exhibits and Reports on Form 8-K***

(a) *Exhibits*

3.1(1)	Certificate of Incorporation of the Company
3.2(1)	Bylaws of the Company
4.1(1)	Reference is made to Exhibits 3.1 and 3.2
10.1	Asset Purchase Agreement dated June 20, 2003, by and between Auspex System, Inc. and the Company.
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 dated September 3, 2003.
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e)and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 dated September 3, 2003.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 dated September 3, 2003.

(1) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated December 4, 2001.

(b) *Reports on Form 8-K*

On May 13, 2003, we furnished (but did not file) a report on Form 8-K relating to financial information for Network Appliance for the year ended April 30, 2003 and forward-looking statements relating to fiscal 2004, as presented in a press release of May 13, 2003.

SIGNATURE

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

NETWORK APPLIANCE INC.
(Registrant)

/s/ STEVEN J. GOMO

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

Date: September 3, 2003

EXHIBIT INDEX

Exhibit No.	Description
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Exhibit 10.1

ASSET PURCHASE AGREEMENT

This Asset Purchase Agreement (hereinafter "Agreement"), is entered into as of June 20, 2003 (the "Effective Date"), by and between Auspex Systems, Inc., a Chapter 11 debtor in possession, United States Bankruptcy Court for the Northern District of California (the "Bankruptcy Court"), Case No. 03-52596-mml 1 (hereinafter "Seller"), and Network Appliance, Inc., a Delaware corporation (hereinafter "Purchaser").

Whereas Seller is the owner of full right and title (both legal and equitable) to certain inventions, patents, and applications, defined herein as "Seller Patents"; and

Whereas Purchaser is desirous of acquiring the entire domestic and foreign right title and interest in and to such Seller Patents.

Now, therefore, Seller and Purchaser hereby covenant and agree as follows:

1. DEFINITIONS

1.1. "Seller Patents" shall mean those patents and applications identified as such in Exhibit A and (i) all U.S. and foreign patents and patent applications that claim priority to such identified patents and applications and all U.S. and foreign patents and applications to which such identified patents and applications relate or claim priority, (ii) any continuations, continuations-in-part, divisions, reissue applications, extensions, Patent Cooperation Treaty applications, or derivatives of any of the foregoing, both foreign and domestic, and (iii) all patentable inventions, in the U.S. and every foreign country, described or embodied in any of the foregoing.

1.2. "Prosecution History Files" shall mean all files, documents and tangible things, as those terms have been interpreted pursuant to Federal Rule of Civil Procedure 34, constituting, comprising or relating to investigation, evaluation, prosecution, filing and registration of the Seller Patents, and specifically includes e-mail messages and other electronic or computer stored or generated data.

2. TRANSFER OF RIGHTS

2.1. For good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Seller hereby agrees to assign and transfer to Purchaser and its representatives, successors and assigns its full and exclusive right, title and interest in and to all Seller Patents. Seller also hereby agrees to assign and transfer to Purchaser and its representatives, successors and assigns their full and exclusive right, title and interest in and to all protectable (e.g., as by patenting) inventions, in the U.S. and every foreign country, described or embodied in the Seller Patents.

2.2. Seller hereby agrees to assign and transfer to Purchaser and its representatives, successors and assigns the full and exclusive right to sue upon and otherwise enforce the Seller Patents and to recover all past damages and other potential relief arising from infringement of the Seller Patents assigned by this Agreement.

2.3. The closing (the "Closing") of the assignment and transfer of the Seller Patents and other rights and assets described in Section 2.1 and 2.2 (the "Purchased Assets") shall take

place on the second business day following the satisfaction of the conditions set forth in Sections 2.4 through 2.7 and Section 5.19 of this Agreement or at such other place and time as Seller and Purchaser may mutually agree.

2.4. For the purpose of recordation and in accordance with the transfers herein, at the Closing, Seller shall execute the assignment document attached as Exhibit B listing the Seller Patents. Upon the written request of the Buyer and without additional charge or at the Buyer's expense, the Seller shall execute and deliver to the Buyer all such additional instruments of transfer, conveyance, endorsement and assignment (in a form satisfactory to the Buyer) as shall be necessary to transfer (or perfect or record the transfer of) the Seller Patents to Buyer including separate assignments for each Seller Patent.

2.5. Effective upon the Closing, Seller authorizes and requests the Commissioner of Patents to issue U.S. patents to Purchaser, its representatives, successors and assigns relating to the inventions and applications conveyed by this Agreement.

2.6. Effective upon the Closing, Seller conveys to Purchaser, its representatives, successors and assigns, the right to make applications on their own behalf for protection of the inventions conveyed herein in the U.S. and foreign countries and to claim, under United States law, the Patent Cooperation Treaty, the International Convention and/or other international arrangements for any such application, priority to any earlier application or patent.

2.7. Within 30 days of the Closing, Seller shall i) provide a complete and accurate docket identifying the relevant dates when any action or response is due within the next six (6) months in any US and foreign patent offices with respect to the Seller Patents, and ii) transfer, at Purchaser's expense, all Prosecution History Files and related files maintained by Seller outside counsel and in-house counsel for the Seller Patents to Purchaser.

3. NO IMPLIED OR EXPRESS LICENSES

3.1. Except for the Limited Use License (as defined below) set forth as Exhibit C hereto, Purchaser does not grant to Seller or any other entity any implied or express licenses or rights whatsoever under this Agreement. Purchaser does not grant to Seller or any other entity any implied or express licenses or rights with respect to any patents other than the Seller Patents. No licenses or rights are granted to Seller or any other entity regarding subject matter not invented by employees, contractors or other agents of Seller.

4. PAYMENT

4.1. As consideration for the assignment of the Seller Patents and other rights granted by Seller herein, Purchaser shall pay to Seller on or prior to the Closing, the total sum of eight million nine hundred seventy-five thousand U.S. Dollars ($8,975,000) (hereinafter referred to as the "Purchase Price"). The assignment and license provisions set forth herein are contingent upon the payment of the Purchase Price to Seller on or prior to Closing.

4.2. Payment under Paragraph 4.1 shall be made by electronic funds transfer. Such payment shall be deemed to be made on the date credited to the following account:

Pay to:	City National Bank 150 California Street San Francisco, CA 94111
Routing & Transit #:	1220-1606-6
For Credit Of:	Cooley Godward LLP FBO Auspex Systems, Inc.
Credit Account #:	432-654869

(Clearly indicate the originator (Purchaser's Name) and the beneficiary (Auspex Systems, Inc.)

5. COVENANTS AND OTHER PROVISIONS

5.1. Seller represents and warrants that (a) it has the right to assign the Purchased Assets, and (b) it is conveying through this Agreement its undivided right, title and interest in and to the Purchased Assets and that, to its knowledge, no other party has any claim of ownership to the Purchased Assets, except as explicitly provided for herein.

5.2. Seller represents and warrants that no agreements with third parties under any of the Seller Patents prevent Seller from entering into this Agreement. Seller further represents and warrants that no entities have licenses or rights under 11 U.S.C. Section 365(n) with respect to the Seller Patents.

5.3. Seller represents and warrants that, to its knowledge it has not taken, and will not take, any action materially adversely affecting the validity, enforceability, or issuance of the Seller Patents.

5.4. Seller represents and warrants that, to its knowledge, all of the domestic patent applications listed in Exhibit A are pending in the United States Patent and Trademark Office and that none of such applications have been abandoned.

5.5. Seller represents and warrants that except as set forth on Schedule 5.5, no procedures are necessary and no payment of filing, examination or maintenance fees are required to be paid on or prior to July 30, 2003 with respect to any issued patents or pending patent applications included in the Seller Patents to maintain their compliance with formal legal requirements for filing, issuance and maintenance.

5.6. Seller represents and warrants that none of the Seller Patents set forth on Exhibit A is involved in any interference or opposition proceeding, and to Seller's, knowledge, no such proceeding is being threatened with respect to any such Seller Patents.

5.7. Seller represents and warrants that subject to appropriate order of the Bankruptcy Court, it is able to convey the Seller Patents free and clear of any liens, encumbrances, security interests, or other claims to the fullest extent of the Bankruptcy Court's authority to so order, except for the Limited Use License noted in this Agreement.

5.8. Seller shall pay all transfer taxes imposed on the sale of the Purchased Assets, including all sales, gross receipts, excise and gross income taxes.

5.9. Subject to the authority and jurisdiction of the Bankruptcy Court and except as is consistent with the applicable orders of the Bankruptcy Court with respect to the procedures relating to the sale of its assets, Seller covenants and agrees that it shall not execute any writing or do any act whatsoever conflicting with the terms of this Agreement, and that, following the Closing, Seller will at any time upon request, without further or additional consideration, but at the expense of Purchaser, execute such additional assignments or other writings and perform such additional acts as Purchaser may deem reasonably necessary to perfect Purchaser's ownership of the Purchased Assets. Seller further covenants and agrees, at Purchaser's expense, to render all reasonably necessary assistance following the Closing in making application for, prosecuting in any patent office internationally, and obtaining original, continuation, continuation-in-part, divisional, reissued, reexamined, and National phase patents of the U.S. or of any and all foreign countries on the inventions assigned herein, and in enforcing any rights or choses in action accruing as a result of the rights assigned herein, and by executing statements and other affidavits, it being understood that the foregoing covenant and agreement shall bind, and inure to the benefit of, the assigns and representatives of all parties hereto.

5.10. At the Closing, Purchaser agrees to execute and deliver to such party as may be designated by Seller, a limited use license in the form set forth as Exhibit C (the "Limited Use License").

5.11. This Agreement and all matters relating to this Agreement shall be construed and controlled by the laws of the State of California. If any legal proceeding or other legal action relating to this Agreement is brought or otherwise initiated by the parties to this

Agreement, the venue therefore will be the Bankruptcy court. Purchaser and Seller hereby expressly and irrevocably consent and submit to the jurisdiction of the Bankruptcy Court.

5.12. Except as otherwise provided in the Agreement, the parties shall pay their respective expenses incurred in connection with the preparation, execution, and delivery of this Agreement and the consummation of the transactions contemplated hereby.

5.13. All notices, requests, demands, and other communications hereunder shall be deemed to have been duly given on the day they are (i) deposited in the U.S. mail, postage prepaid, certified or registered, return receipt requested; or (ii) sent by air express courier, charges prepaid, and addressed as follows:

5.13.1. If to Purchaser: Network Appliance, Inc., 495 East Java Drive, Sunnyvale, CA 94089 Attention: Gary Ross, Esq.

5.13.2. If to Seller: Auspex Systems, Inc., c/o J. Michael Kelly, Cooley Godward LLP One Maritime Plaza, 20th Floor, San Francisco, CA 94111.

5.13.3. A copy to Daren Brinkman, Esq., 4333 Park Terrace St., Suite 205, Westlake Village, CA 91361.

5.13.4. Such addresses may be changed, from time to time, by means of a written notice delivered by the party seeking to change such address in the manner provided for in this paragraph.

5.14. This Agreement shall be binding upon and inure to the benefit of the parties and their respective successors and assigns.

5.15. This Agreement may be terminated only by mutual consent of the parties or by either party prior to the Closing upon approval by the Bankruptcy Court of a transaction or series of transactions involving a sale, transfer or assignment of all or substantially all the Purchased Assets to a party other than Purchaser. In the event that this Agreement shall be terminated pursuant to this Section 5.15, all further obligations of the parties under this Agreement shall terminate without further liability or obligation of any party hereunder; provided, that the parties will remain bound by the provisions of that certain confidentiality agreement dated May 8, 2003 by and between the parties.

5.16. The invalidity or unenforceability of any term or provision of this Agreement or the application of such term or provision to any person or circumstance shall not impair or affect the remainder of this Agreement or its application to other persons and circumstances, and the remaining terms and provisions shall remain in full force and effect.

5.17. This Agreement constitutes the entire agreement between the parties and supersedes all prior agreements and understandings, oral and written, among the undersigned with respect to the subject matter hereof.

5.18. None of Seller's representations, warranties and pre-closing covenants contained in this Agreement or in any other agreement, document or certificate delivered pursuant to this Agreement shall survive the Closing. Notwithstanding any provision hereof to the contrary, Seller's undertakings set forth in the second sentence of Section 2.4, Section 2.7 (ii), Section 5.8 and Section 5.9 shall continue in full force and effect following the Closing. Neither Seller nor any of its officers, directors, representatives, employees, advisors or agents shall have any liability to Purchaser or any other party after the Closing for any breach thereof.

5.19. The Closing and the transactions contemplated herein are and shall be contingent upon (i) the issuance by the Bankruptcy Court of an order, in a form reasonably satisfactory to Purchaser, approving the transactions provided for herein free and clear of liens and encumbrances to the fullest extent of the Bankruptcy Court's authority to so order (the "Sale Order"); (ii) execution and delivery of the documents and other instruments required to be delivered by Purchaser and Seller on or prior to Closing pursuant to this Agreement; and (iii) receipt by Seller of the Purchase Price. The Sale Order shall contain, among other things, a finding that the sale of the Purchased Assets to Purchaser is in good faith within the meaning of Bankruptcy Code Section 363(m).

In witness whereof, the parties hereto have caused this agreement to be Trade and executed by duly authorized officers as of the dates indicated below.

Agreed to: AUSPEX SYSTEMS, INC.	Agreed to: NETWORK APPLIANCE, INC.
By: /s/ Peter R. Simpson	By:
Name: Peter R. Simpson	Name:
Title: CFO	Title:
Date: 6/19/2003	Date:

In witness whereof, the parties hereto have caused this agreement to be made and executed by duly authorized officers as of the dates indicated below.

Agreed to: AUSPEX SYSTEMS, INC.	Agreed to: NETWORK APPLIANCE, INC.
By:	By: /s/ Steven Gomo
Name:	Name: Steven Gomo
Title:	Title: Sr. VP and CFO
Date:	Date: 6/19/2003

EXHIBIT A TO ASSET PURCHASE AGREEMENT

All U.S. and foreign patents and patent applications currently assigned to Seller, under an obligation to assign to Seller, or in which Seller has an ownership interest, including specifically the following identified patents and patent applications:

SELECT SELLER U.S. AND FOREIGN PATENTS:

TITLE	PATENT NUMBER	STATUS	COUNTRY/REGION
Bridge for Direct Data Storage Device Access	5,941,969	Issued	US
Bridge for Direct Data Storage Device Access	6,253,271	Issued	US
Processing System with Dynamically Allocatable Buffer Memory	6,081,883	Issued	US
Characterization of Data Access Using File System	6,442,682	Issued	US
Intelligent Virtual Volume Access	6,389,432	Issued	US

Method an Apparatus for Using Intercepted Operator Messages to Control Robotics	5,465,329	Issued	US
System and Method for Reading and Writing Disks Formatted for an Operating System Foreign to Host Computer	5,537,592	Issued	US
Parallel I/O Network File Server Architecture	5,163,131	Issued	US
Parallel I/O Network File Server Architecture	647414	Issued	Australia
Parallel I/O Network File Server Architecture	670376	Issued	Australia
Parallel I/O Network File Server Architecture	0490973	Issued	European
Parallel I/O Network File Server Architecture	0490973	Issued	UK
Parallel I/O Network File Server Architecture	1011772	Issued	Hong Kong

Parallel I/O Network File Server Architecture	201574	Issued	South Korea
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Parallel I/O Network File Server Architecture	116288	Issued	Israel
Parallel I/O Network File Server Architecture	107646	Issued	Israel
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Parallel I/O Network File Server Architecture	5,802,366	Issued	US
Parallel I/O Network File Server Architecture	5,931,918	Issued	US
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Multiple Facility Operating System Architecture	6,065,037	Issued	US
Multiple Facility Operating System Architecture	201772	Issued	South Korea
Multiple Facility Operating System Architecture	2945757	Issued	Japan
Multiple Facility Operating System Architecture	95449	Issued	Israel
Multiple Facility Operating System Architecture	1014064	Issued	Hong Kong
Multiple Facility Operating System Architecture	0490980	Issued	European
Multiple Facility Operating			

System Architecture	2,066,566	Issued	Canada
Multiple Facility Operating System Architecture	651321	Issued	Australia
Multiple Facility Operating System Architecture	0490980	Issued	UK

Fault Tolerant NFS Server System and Mirroring Protocol	5,513,314	Issued	US
High Performance Non-Volatile RAM Protected Write Cache Accelerator System Employing DMA and Data Transferring Scheme (as amended)	5,701,516	Issued	US
High-Speed, Flexible Source/Destination Data Burst Direct Memory Access Controller	5,175,825	Issued	US
High-Speed, Flexible Source/Destination Data Burst Direct Memory Access Controller	95445	Issued	Israel
Bus Locking FIFIO Multi-Processing Communication System	95448	Issued	Israel
Image File Storage and Retrieval System	5,761,655	Issued	US
Enhanced VMEbus protocol utilizing pseudosynchronous handshaking and block mode data transfer	5,388,231	Issued	US
Method for transmitting commands excluded from a predefined command set	5,379,389	Issued and Lapsed/Abandoned	US
System and method for performing a multi-file transfer operation	5,053,945	Issued and Lapsed/Abandoned	US

SELECT SELLER U.S. AND FOREIGN APPLICATIONS:

Loosely Coupled-Multi Processor Server	87120169	Pending	Taiwan
Coherent Device to Device Data Replication	09/375,819	Pending	US
Intelligent Virtual Machines	10/068,352	Pending	US
Microkernel for Real Time Applications	09/408,149	Pending	US

Parallel I/O Network File Server Architecture	2066443	Allowed	Canada
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Fault Tolerant NFS Server System and Mirroring Protocol	2,211,654	Pending	Canada
High Availability Cluster Virtual Server System	09/911,902	Published	US
High Availability Cluster Virtual Server System	WO US02/23417	Published	WIPO
Active File Change Notification	WO US03/00704	Pending	WIPO
Active File Change Notification	10/341,811	Pending	US
Internet Cache	09/324,801	Pending	US

EXHIBIT B TO ASSET PURCHASE AGREEMENT

ASSIGNMENT

WHEREAS, AUSPEX SYSTEMS, INC., a Delaware corporation, (hereinafter referred to as "Assignor") owns all right, title and interest in and to certain patents and patent applications identified in Exhibit A attached hereto; and

WHEREAS, NETWORK APPLIANCE, INC., a Delaware corporation, (hereinafter referred to as "Assignee"), is desirous of acquiring the entire domestic and foreign right, title, and interest in and under the Intellectual Property (as defined below).

NOW, THEREFORE, for good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Assignor assigns and transfers to the Assignee and the Assignee's legal representatives, successors and assigns, pursuant to the terms of a concurrently executed Asset Purchase Agreement, its full and exclusive right, title and interest to those patents and applications identified as such in Exhibit A hereto, and (i) all U.S. and foreign patents and patent applications that claim priority to such identified patents and applications and all U.S. and foreign patents and applications to which such identified patents and applications relate or claim priority, (ii) any provisionals, continuations, continuations-in-part, divisions, reissue applications, extensions, Patent Cooperation Treaty applications, or derivatives of any of the foregoing, both foreign and domestic, and (iii) all patentable inventions, in the U.S. and every foreign country, described or embodied in any of the foregoing, (the "Intellectual Property") and does hereby authorize and request the Commissioner of Patents to issue U.S. patents to the above-mentioned Assignee in accordance with the terms of this assignment document. Such full and exclusive rights shall include, without limitation, the right to sue upon and otherwise enforce the Intellectual Property and to recover all past damages and other potential relief arising from infringement of the Intellectual Property assigned by this Agreement.

ASSIGNOR HEREBY AUTHORIZES the Assignee to insert in Exhibit A to this assignment document the filing date and application number of any application if the date and number are unavailable at the time this document is executed.

UPON SAID CONSIDERATION, Assignor conveys to the Assignee the right to make application in its own behalf for protection of the Intellectual Property in the U.S. and countries foreign to the U.S. and to claim under the Patent Cooperation Treaty, the International Convention and/or other international arrangement for any such application the date of any earlier U.S. application (or any other application on the invention) to gain priority with respect to other applications.

IN WITNESS WHEREOF, Assignor has caused one of its officers to hereunder set his hand on the date shown below and Assignee has caused one of its officers to hereunder set his hand on the date shown below to signify its acceptance of this Assignment.

AUSPEX SYSTEMS, INC.

By: ______________________

Name: ______________________

Title: ______________________

Date: ______________________, 2003

STATE OF ______________________)
)SS:
COUNTY OF ______________________)

On this ________ day of _____________, _________, before me, a Notary Public in and for said county, appeared , who is personally known to me to be the same person whose name is subscribed to the foregoing assignment document, and acknowledged that he/she signed and delivered the document as his/her free and voluntary act for the uses and purposes therein set forth.

____
Notary Public

{SEAL}
My Commission Expires: ______________________

ACCEPTANCE BY ASSIGNEE:

NETWORK APPLIANCE, INC.

By: ______________________

Name: ______________________

Title: ______________________

Date: ______________________

STATE OF ______________________)
)SS:
COUNTY OF ______________________)

On this ________ day of _____________, _________, before me, a Notary Public in and for said county, appeared , who is personally known to me to be the same person whose name is subscribed to the foregoing assignment document, and acknowledged that he/she signed and delivered the document as his/her free and voluntary act for the uses and purposes therein set forth.

Notary Public

{SEAL}

My Commission Expires: -------------------------

EXHIBIT C

LIMITED USE LICENSE

FORM OF PATENT LICENSE AGREEMENT

THIS PATENT LICENSE AGREEMENT ("Agreement") is entered into, subject to Bankruptcy Court approval, as of June , 2003 ("Effective Date") between the licensor named below ("Licensor") and the licensee named below ("Licensee"). Licensor and Licensee may be referred to herein individually as a "party" and collectively as the "parties."

RECITALS

A. Auspex Systems, Inc. ("Auspex") is debtor in possession in a chapter 11 bankruptcy case pending in the Bankruptcy Court for the Northern District of California administered under Case No. 03-52596-MM11.

B. Auspex has, prior the Effective Date, been a provider of network storage products. Its products include hardware devices that operate in conjunction with software provided by Auspex or its licensors. Auspex has, prior to the Effective Date, provided a maintenance and repair service to users of its products (as defined below, the "Maintenance Service").

C. Auspex has sold to Licensor certain of Auspex's patents (as defined below, "Licensed Patents").

D. Auspex has sold to Licensee certain other assets relating to its Maintenance Service. The provision of such Maintenance Service by Licensee may, in some cases, infringe one or more of the Licensed Patents.

E. Licensee desires to receive, and Licensor desires to grant, a perpetual, royalty-free license under the Licensed Patents to permit Licensee to provide Maintenance Services.

AGREEMENT

Now, therefore, in consideration of the mutual covenants and agreements contained herein and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties to this Agreement, intending to be legally bound, hereby agree as follows:

1. DEFINITIONS.

Capitalized terms used in this Agreement are defined in this Section 1 or in the Section where they are first used.

1.1 "MAINTENANCE SERVICE" means the service of repairing, maintaining or refurbishing Existing Installed Products, including the provision of spare parts for same and the correction of Errors in the software that accompanies or is embedded in Existing Installed Products.

1.2 "ERRORS" means an error or other nonconformity in software that causes the software, or the hardware product which the software operates, to malfunction or otherwise

deviate from its published performance specifications or to be incompatible with the network, operating system or other environment in which it is deployed.

1.3 "EXISTING INSTALLED PRODUCTS" means network storage products, including accompanying or embedded software, manufactured or distributed by Auspex before the Effective Date.

1.4 "LICENSED PATENTS" means those patents and applications identified as such in Schedule 1 hereto, including (i) all U.S. and foreign patents and patent applications that claim priority to such identified patents and applications and all U.S. and foreign patents and applications to which such identified patents and applications relate or claim priority, and (ii) any provisionals, continuations, continuations-in-part, divisions, reissue applications, extensions, Patent Cooperation Treaty applications, or derivatives of any of the foregoing, both foreign and domestic.

2. RIGHTS GRANTED.

2.1 GRANT. Subject to the terms and conditions of this Agreement, Licensor hereby grants to Licensee a non-exclusive, royalty-free, limited license under the Licensed Patents to: (a) make, have made, use, sell, offer for sale, import, compile, modify, reproduce and distribute software accompanying or embedded in Existing Installed Products for the sole purpose of correcting Errors in such software, and (b) otherwise provide Maintenance Services with respect to Existing Installed Products.

2.2 RESTRICTIONS. The license granted hereunder is made only to the extent of Licensor's rights in the Licensed Patents. To the extent that any Licensed Patents are subject to rights of third parties, Licensee must separately procure a license from such third parties.

2.3 LICENSOR'S RIGHTS. Licensee acknowledges that, subject to the license grant in Section 2.1, Licensor retains all right, title and interest in and to the Licensed Patents. There are no implied licenses under this Agreement, and any rights not expressly granted to Licensee hereunder are reserved by Licensor, including the right to grant third parties non exclusive licenses under the Licensed Patents.

2.4 SUBLICENSING. Licensee may sublicense the rights granted to it under this Section 2, subject to the teens and conditions of this Agreement.

3. OTHER MATTERS.

3.1 DISCLOSURE. Licensor has no obligation hereunder to make any disclosures to Licensee of technical information.

3.2 Services. Licensor has no obligation hereunder to provide technical support, maintenance, training or any other services of any kind to Licensee.

3.3 IMPROVEMENTS. As between the parties, Licensee will own any derivative works or improvements that it makes in respect to the subject matter of the Licensed Patents ("Improvements") but such Improvements will remain subject at all times to the Licensed Patents so that, apart from the rights granted under Section 2.1, Licensee will have no right to make, use, sell or import Improvements that embody underlying subject matter protected

by the Licensed Patents. Licensee will not be required to disclose Improvements to Licensor.

4. CONFIDENTIALITY OF AGREEMENT.

This Agreement will be confidential. Neither party shall disclose any terms of this Agreement to anyone other than its attorneys, accountants, and other professional advisors under a duty of confidentiality except: (a) to the minimum extent required by law or regulation including any filing required under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, or the regulations promulgated thereunder or under the rules of any selfregulatory body to which such party is subject; (b) pursuant to a mutually agreeable press release; or (c) to prospective investors, lenders or purchasers in connection with a proposed merger, financing, or sale of such party's business; provided that any third party to whom the terms of this Agreement are to be disclosed agrees in writing to keep such terms confidential.

5. WARRANTY DISCLAIMER.

THE LICENSED PATENTS ARE PROVIDED "AS IS" WITHOUT WARRANTY OF ANY KIND, EITHER EXPRESS OR IMPLIED. LICENSOR EXPRESSLY DISCLAIMS ANY AND ALL WARRANTIES, EITHER EXPRESS OR IMPLIED, INCLUDING WITHOUT LIMITATION THE IMPLIED WARRANTIES OF MERCHANTABILITY, FITNESS FOR A PARTICULAR PURPOSE, TITLE, NON-INFRINGEMENT OR QUIET ENJOYMENT.

6. LIMITATION OF LIABILITY.

TO THE EXTENT PERMITTED BY APPLICABLE LAW, IN NO EVENT SHALL LICENSOR BE LIABLE FOR ANY CONSEQUENTIAL, INCIDENTAL, SPECIAL OR INDIRECT DAMAGES OF ANY KIND, INCLUDING, BUT NOT LIMITED TO, THIRD PARTY INFRINGEMENT CLAIMS OR LOST PROFITS, ARISING FROM OR RELATING TO THE LICENSED PATENTS, OR OTHERWISE RELATING TO THIS AGREEMENT, EVEN IF LICENSOR HAS BEEN ADVISED OF THE POSSIBILITY OF SUCH DAMAGES. LICENSEE USES LICENSED PATENTS ENTIRELY AT LICENSEE'S OWN RISK.

7. TERM AND TERMINATION.

7.1 TERM. The term of this Agreement shall begin as of the Effective Date and shall remain in effect until the expiration of the last-to-expire of the Licensed Patents.

7.2 TERMINATION FOR CONVENIENCE. Licensee may terminate this Agreement for any reason or no reason by giving the Licensor thirty (30) days prior written notice.

7.3 TERMINATION FOR DEFAULT. If either party materially breaches its obligations hereunder, the non-breaching party may terminate this Agreement in accordance with the following procedure. The non-breaching party must provide the breaching party with a notice of default ("Notice of Default"), specifying in reasonable detail the nature of the alleged material breach. The breaching party shall have a thirty (30) day grace period after its receipt of the Notice of Default ("Grace Period") to correct or cure any material breach specified therein. If the breach identified in the Notice of Default is corrected within the Grace Period, then this Agreement shall remain in effect; otherwise, this Agreement shall terminate upon the conclusion of the Grace Period.

7.4 EFFECTS OF TERMINATION. Upon the termination or expiration of this Agreement the following terms shall apply:

(a) all licenses granted under this Agreement shall immediately terminate; and

(b) Sections 1 (Definitions), 2.2 (Restrictions), 2.3 (Licensor's Rights), 3.3 (Improvements), 4 (Confidentiality), 5 (Warranty Disclaimer), 6 (Limitations of Liability), 7.4 (Effects of Termination), 8 (Dispute Management) and 9 (General) survive the expiration or termination of this Agreement for any reason.

8. DISPUTE MANAGEMENT.

8.1 APPLICABLE LAW; JURISDICTION. THIS AGREEMENT SHALL BE GOVERNED BY AND CONSTRUED AND ENFORCED IN ACCORDANCE WITH THE LAWS OF THE STATE OF CALIFORNIA, EXCLUDING CONFLICT OF LAW RULES AND PRINCIPLES. THE PARTIES AGREE THAT THE BANKRUPTCY COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA SHALL HAVE EXCLUSIVE JURISDICTION TO DETERMINE ALL MATTERS RELATING TO THIS AGREEMENT AND THAT VENUE IS PROPER IN SUCH COURT. ALL PARTIES WAIVE ANY OBJECTIONS TO THE JURISDICTION (IN REM, PERSONAL OR SUBJECT MATTER) OF OR LAYING OF VENUE IN SUCH COURTS. ALL PARTIES HEREBY WAIVE PERSONAL SERVICE OF THE SUMMONS, COMPLAINT AND OTHER PROCESS ISSUED IN ANY SUCH ACTION OR SUIT AND AGREE THAT SERVICE OF SUCH SUMMONS, COMPLAINT AND OTHER PROCESS MAY BE MADE BY

REGISTERED OR CERTIFIED MAIL ADDRESSED TO SUCH PARTY AT ITS ADDRESS SET FORTH IN THE PREAMBLE TO THIS AGREEMENT OR TO SUCH OTHER ADDRESS AS DESIGNATED IN ACCORDANCE WITH THIS AGREEMENT.

8.2 WAIVER OF JURY TRIAL. EACH PARTY TO THIS AGREEMENT WAIVES THE RIGHT TO TRIAL BY JURY IN ANY ACTION, SUIT, PROCEEDING, OR COUNTERCLAIM OF ANY KIND ARISING OUT OF OR RELATED TO THIS AGREEMENT OR THE TRANSACTIONS CONTEMPLATED BY THIS AGREEMENT. EACH SUCH PARTY WARRANTS AND REPRESENTS THAT IT HAS REVIEWED THE FOREGOING WAIVERS WITH ITS LEGAL COUNSEL AND HAS KNOWINGLY AND VOLUNTARILY WAIVED ITS JURY TRIAL RIGHTS FOLLOWING CONSULTATION WITH LEGAL COUNSEL. IN THE EVENT OF LITIGATION, THIS AGREEMENT MAY BE FILED AS A WRITTEN CONSENT TO A TRIAL BY THE COURT.

9. GENERAL.

9.1 NOTICES. All notices under this Agreement must be delivered in writing by courier, electronic facsimile, electronic mail, or by certified or registered mail (postage prepaid and return receipt requested) to the other party at its address set forth on the signature page below or as amended by notice pursuant to this Section 9.1. If not received sooner, notice by mail shall be deemed received five (5) days after deposit in the U.S. mails.

9.2 RELATIONSHIP OF PARTIES. The parties hereto are independent contractors. Nothing in this Agreement shall be deemed to create an agency, employment, partnership, fiduciary or joint venture relationship between the parties. Neither party (nor any agent or employee of that party) is the representative of the other party for any purpose and neither party has the power or authority as agent, employee or in any other capacity to represent, act for, bind or otherwise create or assume any obligation on behalf of the other party for any purpose whatsoever.

9.3 NO THIRD PARTY BENEFICIARIES. No party shall be deemed a third-party beneficiary to this Agreement.

9.4 NO ADMISSION. Nothing in this Agreement shall constitute an admission by either party with respect to the validity, scope or infringement of any United States or foreign patent or other proprietary right except as otherwise provided in the Agreement.

9.5 COSTS AND EXPENSES. Except as expressly provided for elsewhere in this Agreement, each party shall be responsible for all costs and expenses incurred by such party in performing its obligations or exercising its rights under this Agreement.

9.6 CONSTRUCTION. In constructing the terms of this Agreement, no presumption shall operate in favor of or against any party as a result of its counsel's role in drafting the terms and provisions hereof.

9.7 Assignment. This Agreement, and all rights and obligations hereunder, are assignable by Licensor. Licensee may not assign this Agreement, nor assign any rights or delegate any obligations under this Agreement, without the prior written consent of Licensor (which consent shall not be unreasonably withheld or delayed) except that Licensee may assign this Agreement, with prior written notice but without Licensor's written consent, to an entity with whom the Licensee merges or consolidates or to whom the Licensee sells substantially all of its assets relating to the Maintenance Service, but only if such assignee agrees to be bound by all provisions of this Agreement applicable to Licensee. Any attempted or purported assignment or delegation by Licensee in violation of this Section 9.7 shall be null and void. This Agreement shall be binding on, and inure to the benefit of, the parties hereto, and the respective successors and assigns of each of them.

9.8 WAIVER AND MODIFICATIONS. All waivers must be in writing. Any waiver by Licensor of a provision of this Agreement on one occasion shall not be deemed a waiver of any other provision or such provision on any other occasion. This Agreement may only be amended by a written document signed by both parties.

[THIS SPACE INTENTIONALLY BLANK]

9.9 ENTIRE AGREEMENT. This Agreement, including the Schedules hereto, constitutes the entire and final agreement between the parties regarding the Licensed Patents and supersedes all prior or contemporaneous, agreements, understandings and communications, whether, written and oral, relating to the Licensed Patents.

9.10 COUNTERPARTS. This Agreement may be signed in several counterparts, each of which shall constitute an original.

IN WITNESS WHEREOF, the undersigned have caused this Agreement to be executed and delivered as of the Effective Date first set forth above by their respective authorized representatives.

NETWORK APPLIANCE, INC.	GLASSHOUSE TECHNOLOGIES, INC.
By: ________________________	By: ________________________
Name: ________________________	Name: ________________________
Title: ________________________	Title: ________________________
Address for Notice:	Address for Notice:
________________________	________________________
________________________	________________________
Attn: ________________________	Attn: ________________________
Fax: ________________________	Fax: ________________________

[SIGNATURE PAGE TO PATENT LICENSE AGREEMENT]

SCHEDULE 1

LICENSED PATENTS

TITLE	PATENT NUMBER	STATUS	COUNTRY/REGION
Bridge for Direct Data Storage Device Access	5,941,969	Issued	US
Bridge for Direct Data Storage Device Access	6,253,271	Issued	US
Processing System with Dynamically Allocatable Buffer Memory	6,081,883	Issued	US
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Architecture	0490980	Issued	UK
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High-Speed, Flexible Source/Destination Data Burst Direct Memory Access Controller	5,175,825	Issued	US
High-Speed, Flexible Source/Destination Data Burst Direct Memory Access Controller	95445	Issued	Israel
Bus Locking FIFIO Multi-Processing Communication System	95448	Issued	Israel
Image File Storage and Retrieval System	5,761,655	Issued	US
Enhanced VMEbus protocol utilizing pseudosynchronous handshaking and block mode data transfer	5,388,231	Issued	US
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System and method for performing a multi-file transfer operation	5,053,945	Issued	US

U.S. AND FOREIGN APPLICATIONS:

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Fault Tolerant NFS Server System and Mirroring Protocol	2,211,654	Pending	Canada
High Availability Cluster Virtual			

Server System	09/911,902	Published	US
High Availability Cluster Virtual Server System	WO US02/23417	Published	WIPO
Active File Change Notification	WO US03/00704	Pending	WIPO
Active File Change Notification	10/341,811	Pending	US
Internet Cache	09/324,801	Pending	US

Exhibit 31.1

CERTIFICATION

I, Daniel J. Warmenhoven, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Network Appliance Inc. (the "registrant");

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ DANIEL J. WARMENHOVEN

Daniel J. Warmenhoven
Chief Executive Officer

Date: September 3, 2003

Exhibit 31.2

CERTIFICATION

I, Steven J. Gomo, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Network Appliance Inc. (the "registrant");

2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;

3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;

4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) for the registrant and have:

(a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;

(b) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and

(c) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and

5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

(a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and

(b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

/s/ STEVEN J. GOMO

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

Date: September 3, 2003

Exhibit 32.1

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Daniel J. Warmenhoven, Chief Executive Officer of Network Appliance, Inc. (the "Company"), pursuant to 18 U.S.C.Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002, hereby certify to my knowledge that:

(i) the Quarterly Report on Form 10-Q of the Company for the quarterly period ended August 1, 2003, as filed with the Securities and Exchange Commission (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended; and

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

Date: September 3, 2003

/s/ Daniel J. Warmenhoven

Daniel J. Warmenhoven
Chief Executive Officer

CERTIFICATION PURSUANT TO
18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

I, Steven J. Gomo, Senior Vice President of Finance and Chief Financial Officer of Network Appliance, Inc. (the "Company"), pursuant to 18 U.S.C.Section 1350, as created by Section 906 of the Sarbanes-Oxley Act of 2002, hereby certify to my knowledge that:

(i) the Quarterly Report on Form 10-Q of the Company for the quarterly period ended August 1, 2003, as filed with the Securities and Exchange Commission (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended; and

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

Date: September 3, 2003

/s/ Steven J. Gomo

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