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 January 24, 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 January 24, 2003
Common Stock	339,333,827

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PART I. FINANCIAL INFORMATION

Item 1. ***Condensed Consolidated Financial Statements***

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS

(In thousands — unaudited)

	January 24, 2003	April 30, 2002
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 230,089	$ 210,756
Short-term investments	308,493	243,371
Accounts receivable, net of allowances of $5,673 at January 24, 2003 and $8,416 at April 30, 2002	169,152	146,511
Inventories	37,421	23,849
Prepaid expenses and other	27,117	22,112
Deferred income taxes	25,615	32,529
Total current assets	797,887	679,128
Property and Equipment, net	358,046	345,195
Goodwill	49,422	49,422
Intangible Assets, net	4,318	8,828
Other Assets	51,544	26,233
	$1,261,217	$1,108,806
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 38,115	$ 40,243
Income taxes payable	44,142	17,073
Accrued compensation and related benefits	30,984	39,434
Other accrued liabilities	48,625	42,671
Deferred revenue	109,169	76,139
Total current liabilities	271,035	215,560
Long-Term Deferred Revenue	47,219	31,036
Long-Term Obligations	3,254	3,734
Total liabilities	321,508	250,330
Stockholders' Equity:		
Common stock	339	335
Additional paid-in capital	682,094	656,619
Deferred stock compensation	(1,813)	(3,777)
Retained earnings	259,314	207,665
Cumulative other comprehensive loss	(225)	(2,366)
Total stockholders' equity	939,709	858,476
	$1,261,217	$1,108,806

See accompanying notes to condensed consolidated financial statements.

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NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share amounts — unaudited)

	Three Months Ended		Nine Months Ended	
	January 24, 2003	January 25, 2002	January 24, 2003	January 25, 2002
Revenues				
Product revenue	$205,046	$180,631	$585,143	$544,653
Service revenue	23,418	17,718	65,320	48,837
Total revenues	228,464	198,349	650,463	593,490
Cost of Revenues				
Cost of product revenue	71,501	59,572	199,784	203,132
Cost of service revenue	16,911	15,440	47,172	40,941
Total cost of revenues	88,412	75,012	246,956	244,073
Gross margin	140,052	123,337	403,507	349,417
Operating Expenses:				
Sales and marketing	76,969	66,726	225,078	209,290
Research and development	28,289	28,451	84,530	85,888
General and administrative	9,833	10,587	26,403	31,401
Amortization of goodwill and intangible assets	1,364	5,226	4,114	15,678
Stock compensation(1)	1,238	1,133	3,106	5,755
Restructuring charges	1,257	—	1,257	7,980
Total operating expenses	118,950	112,123	344,488	355,992
Income (Loss) from Operations	21,102	11,214	59,019	(6,575)
Other Income (Expense), net:				
Interest income	3,068	4,023	9,099	14,668
Other income (expense), net	270	(449)	(919)	(865)
Impairment loss on investment	—	—	(726)	(13,008)
Gain on sale of intangible asset	—	—	604	—
Total other income, net	3,338	3,574	8,058	795
Income (Loss) Before Income Taxes	24,440	14,788	67,077	(5,780)
Provision (Benefit) for Income Taxes	4,769	7,804	15,428	(1,040)
Net Income (Loss)	$ 19,671	$ 6,984	$ 51,649	$ (4,740)
Net Income (Loss) per Share:				
Basic	$ 0.06	$ 0.02	$ 0.15	$ (0.01)
Diluted	$ 0.06	$ 0.02	$ 0.15	$ (0.01)
Shares Used in per Share Calculations:				
Basic	338,345	332,403	336,911	330,726
Diluted	351,114	352,868	349,449	330,726

(1) Stock compensation includes:				
Sales and marketing	$ 361	$ 263	$ 1,228	$ 806
Research and development	796	736	1,638	4,542
General and administrative	81	134	240	407
	$ 1,238	$ 1,133	$ 3,106	$ 5,755

See accompanying notes to condensed consolidated financial statements.

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands — unaudited)

	Nine Months Ended	
	January 24, 2003	January 25, 2002
Cash Flows from Operating Activities:		
Net income (loss)	$ 51,649	$ (4,740)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	38,924	33,519
Amortization of goodwill	—	11,383
Amortization of intangible assets	4,114	4,295
Stock compensation	3,106	5,755
Impairment loss on investments	726	13,008
Gain on sale of intangible asset	(604)	—
Provision for doubtful accounts (reversal)	(1,636)	6,015
Deferred income taxes	(16,231)	(26)
Deferred rent	(62)	(63)
Changes in assets and liabilities:		
Accounts receivable	(20,898)	41,853
Inventories	(19,619)	(9,178)
Prepaid expenses and other assets	(7,783)	(460)
Accounts payable	(2,128)	(29,854)
Income taxes payable	27,069	(4,164)
Accrued compensation and related benefits	(8,450)	(15,887)
Other accrued liabilities	5,537	17,809
Deferred revenue	49,213	18,932
Net cash provided by operating activities	102,927	88,197
Cash Flows from Investing Activities:		
Purchases of short-term investments	(261,636)	(273,464)
Redemptions of short-term investments	200,260	178,203
Purchases of property and equipment	(45,905)	(22,485)
Purchase of equity securities	(650)	(875)
Net cash used in investing activities	(107,931)	(118,621)
Cash Flows from Financing Activities:		
Proceeds from sale of common stock, net	24,337	31,262
Increase in restricted cash	—	(57,284)
Net cash provided by (used in) financing activities	24,337	(26,022)
Net Change in Cash and Cash Equivalents	19,333	(56,446)
Cash and Cash Equivalents:		
Beginning of period	210,756	271,931
End of period	$ 230,089	$ 215,485
Noncash Investing and Financing Activities:		
Deferred stock compensation, net of reversals	$ (361)	$ 47
Conversion of evaluation inventory to fixed assets	6,530	3,951
Milestone shares issued	920	2,439
Supplemental cash flow information:		
Income taxes paid	5,565	279

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 open network storage solutions for the data-intensive enterprise. NetApp® network storage solutions and service offerings provide data-intensive enterprises with consolidated storage, improved data center operations, economical business continuance, and efficient remote data access across the distributed enterprise. Network Appliance's success to date has been in delivering highly cost-effective network storage solutions that reduce the complexity associated with conventional storage solutions. 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.

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/ A for the year ended April 30, 2002. The results of operations for the three and nine-month periods ended January 24, 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 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 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.

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

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

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

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

A typical arrangement includes product, software subscription, and maintenance. Some arrangements include training and consulting. Software subscriptions include unspecified 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		Nine Months Ended	
	January 24, 2003	January 25, 2002	January 24, 2003	January 25, 2002
Revenues:				
Products	80.9%	84.1%	82.0%	85.4%
Software subscriptions	8.8%	7.0%	8.0%	6.4%
System products and software subscriptions	89.7%	91.1%	90.0%	91.8%
Services	10.3%	8.9%	10.0%	8.2%
Total revenues	100.0%	100.0%	100.0%	100.0%

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 workforce and a consolidation of facilities. These restructuring accruals were accounted for in accordance with Emerging Issues Task Force (“EITF”) Issue No. 94-3, Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring), and included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. These estimates are reviewed and revised periodically and may result in a substantial change to restructuring expense should different conditions prevail than were anticipated in original management estimates. See footnote 11 — Restructuring Charges for further discussion.

Loss Contingencies

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

Impairment Losses on Investments

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, other-than-temporary write down of $726 related to an impairment of our investment in a publicly traded company. In the second quarter of fiscal 2002, we recorded a non cash, other-than-temporary write down of $13,008 related to impairments of our investments in publicly traded and private companies.

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.

5. Inventories

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

	January 24, 2003	April 30, 2002
Purchased components	$ 17,660	$11,870
Work in process	1,544	1,431
Finished goods	18,217	10,548
	$ 37,421	$23,849

6. Intangible Assets

Balances are summarized as follows:

	January 24, 2003			April 30, 2002		
	Gross Assets	Accumulated Amortization	Net Assets	Gross Assets	Accumulated Amortization	Net Assets
Intangible assets:						
Existing technology	$ 16,365	$ (12,047)	$4,318	$ 17,179	$ (8,351)	$8,828

Existing technology is amortized over three years and total amortization expense for existing technology was $1,364 and $1,432 for the three months ended January 24, 2003, and January 25, 2002, respectively. Total amortization expense for existing technology was $4,114 and $4,295 for the nine-months ended January 24, 2003, and January 25, 2002, respectively. Estimated future amortization expense is $1,364 for the remaining three months of fiscal 2003. For fiscal 2004, estimated future amortization expense is $2,954 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 Statement of Financial Accounting Standards ("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.

Under terms of the acquisition agreement with Orca Systems, Inc. ("Orca"), we released shares of common stock to former Orca shareholders upon meeting certain performance criteria. The fair market values of the shares were measured on the date the performance criteria were met and were recognized as stock compensation. During the first quarter of fiscal 2003, no stock compensation was recorded relating to Orca achieving their performance milestones. During the second and third quarters of fiscal 2003, we released an additional 33 and 66 shares of common stock, respectively, valued at $267 and $653, respectively. During the first and second quarters of fiscal 2002, we released an additional 66 and 66 shares of common stock, respectively, valued at $1,434 and $1,006, respectively. In the third quarter of fiscal 2002, no stock compensation was recorded relating to Orca achieving their performance milestones. There are no additional performance milestones remaining.

We recorded $139 and $582 in compensation expense in the three and nine-month periods ended January 24, 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. Derivative Instruments

As a result of our significant international operations, we are subject to risks associated with fluctuating exchange rates. We use foreign 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. 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. For the three and nine-month periods ended January 24, 2003, net gains generated by hedged assets and liabilities totaled $5,756 and $9,585, respectively, and were offset by losses on the related derivative instruments of $5,433 and $10,260, respectively. For the three and nine-month periods ended January 25, 2002, net losses generated by hedged assets and liabilities totaled $1,437 and $543, respectively, which were offset by gains (losses) on the related derivative instruments of $935 and $(384), respectively. 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 forecasted transactions, firm commitments or equity investments.

9. Earnings Per Share

Basic net income (loss) per share is computed by dividing income (loss) available to common stockholders by the weighted average number of common shares outstanding for that period. Diluted net income (loss) per share is computed giving effect to all dilutive potential shares that were outstanding during the period. Dilutive potential common shares consist of incremental common shares subject to repurchase 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. Options were antidilutive in the nine-month period ended January 25, 2002 due to the net loss reported in that period. Options were antidilutive in the three-month periods ended January 24, 2003 and January 25, 2002 and the nine-month period ended January 24, 2003 as the options' exercise prices were above the average market prices in such periods. For the three-months ended January 24, 2003 and January 25, 2002, 46,269 and 24,673 shares of common stock options with a weighted average exercise price of $30.64 and $45.89, respectively, were excluded from the diluted net income per share computation. For the nine months ended January 24, 2003 and January 25, 2002, 51,482 and 72,042 shares of common stock options with a weighted average exercise price of $29.14 and $21.10, respectively, were excluded from the diluted net income (loss) per share computation.

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

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

	Three Months Ended		Nine Months Ended	
	January 24, 2003	January 25, 2002	January 24, 2003	January 25, 2002
Net Income (Loss) (Numerator):				
Net income (loss), basic and diluted	$ 19,671	$ 6,984	$ 51,649	$ (4,740)
Shares (Denominator):				
Weighted average common shares outstanding	338,370	332,537	336,994	330,888
Weighted average common shares outstanding subject to repurchase	(25)	(134)	(83)	(162)
Shares used in basic computation	338,345	332,403	336,911	330,726
Weighted average common shares outstanding subject to repurchase	25	134	83	—
Common shares issuable upon exercise of stock options	12,744	20,331	12,455	—
Shares used in diluted computation	351,114	352,868	349,449	330,726
Net Income (Loss) Per Share:				
Basic	$ 0.06	$ 0.02	$ 0.15	$ (0.01)
Diluted	$ 0.06	$ 0.02	$ 0.15	$ (0.01)

10. Comprehensive Income (loss)

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

	Three Months Ended		Nine Months Ended	
	January 24, 2003	January 25, 2002	January 24, 2003	January 25, 2002
Net income (loss)	$ 19,671	$ 6,984	$ 51,649	$ (4,740)
Foreign currency translation adjustment	342	(218)	589	(397)
Net gain (loss) on investments	736	(98)	1,552	1,471
Comprehensive income (loss)	$ 20,749	$ 6,668	$ 53,790	$ (3,666)

The components of accumulated other comprehensive income (loss) were as follows:

	January 24, 2003	April 30 2002
Cumulative translation adjustments	$ (1,613)	$(2,202)
Unrealized gain (loss) on investments	1,388	(164)
Total accumulated other comprehensive loss	$ (225)	$(2,366)

11. Restructuring Charges

In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in workforce and a consolidation of facilities. As a result of the restructuring in August 2001, we incurred a charge of $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 $804 at January 24, 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 the third quarter of fiscal 2003, we recorded a net restructuring adjustment of $334 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 $916 to be payable through January 2006.

The following analysis sets forth the significant components of the second quarter fiscal 2002 restructuring at January 24, 2003:

	Severance-Related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge	$ 4,796	$ 528	$ 2,656	$ 7,980
Cash payments	(4,508)	—	(803)	(5,311)
Non-cash portion	—	(528)	(37)	(565)
Adjustments	(95)	—	(1,509)	(1,604)
Reserve balance at April 26, 2002	193	—	307	500
Cash payments	11	—	—	11
Non-cash portion	—	—	(3)	(3)
Reserve balance at July 26, 2002	204	—	304	508
Cash payments	(3)	—	(76)	(79)
Reserve balance at October 25, 2002	201	—	228	429
Cash payments	44	—	2	46
Non-cash portion	—	—	(5)	(5)
Adjustments	410	—	(76)	334
Reserve balance at January 24, 2003	$ 655	$ —	$ 149	$ 804

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 January 24, 2003, $1,519 was included in other accrued liabilities and the remaining $3,239 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 $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 $3,385 to be payable through November 2010.

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following analysis sets forth the significant components of the fourth quarter fiscal 2002 restructuring at January 24, 2003:

	Severance-Related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge	$ 813	$ 473	$4,564	$5,850
Cash payments	(629)	—	(32)	(661)
Non-cash portion	—	(473)	—	(473)
Reserve balance at April 26, 2002	184	—	4,532	4,716
Cash payments	(77)	—	(285)	(362)
Reserve balance at July 26, 2002	107	—	4,247	4,354
Cash payments	—	—	(263)	(263)
Reserve balance at October 25, 2002	107	—	3,984	4,091
Cash payments	—	—	(256)	(256)
Adjustments	(107)	—	1,030	923
Reserve balance at January 24, 2003	$ —	$ —	$4,758	$4,758

12. Short-Term Investments

All our investments are classified as available for sale at January 24, 2003 and April 30, 2002. 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 market value, and net unrealized gains or losses are recorded in cumulative other comprehensive loss, a separate component of stockholders' equity, until realized. Realized gains and losses on non-equity investments are computed based upon specific identification and are included in interest income and other, net. 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, other-than-temporary write down of $726 related to the impairment of our investment in a publicly traded company. In the second quarter of fiscal 2002, we recorded a non cash, other-than-temporary write down of $13,008 related to impairments of our investments in publicly traded and private companies.

13. New Accounting Pronouncements

In June 2001, the Financial Accounting Standards Board ("FASB") issued SFAS No. 142, *Goodwill and Other Intangible Assets*. SFAS No. 142 addresses the initial recognition and measurement of intangible assets acquired outside of a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. SFAS No. 142 provides that intangible assets with finite useful lives will be amortized and that goodwill and intangible assets with indefinite lives will not be amortized, but rather will be tested at least annually for impairment. We adopted SFAS No. 142 effective May 1, 2002. Upon adoption of SFAS No. 142, we discontinued the amortization of our recorded goodwill of $49,422 as of that date, identified our reporting units based on our current segment reporting structure and allocated all recorded

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

goodwill, as well as other assets and liabilities, to the reporting units. We concluded that our reporting units are the same as our operating segments. Under SFAS No. 142, goodwill attributable to each of our reporting units is required to be tested for impairment by comparing the fair value of each reporting unit with its carrying value. As of May 1, 2002, this evaluation indicated that the fair value for each of our reporting units exceeded the reporting unit's carrying amount and no impairment was recognized. On an ongoing basis, we will perform our impairment tests annually (or more frequently if indicators of impairment arise). There can be no assurance that future impairment tests will not result in a charge to earnings.

In connection with the adoption of SFAS No. 142, we also reassessed the useful lives and the classification of our purchased intangible assets and determined that they continued to be appropriate except for acquired workforce net of deferred tax liabilities of $502, which was reclassified into goodwill.

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

	Three Months Ended		Nine Months Ended	
	January 24, 2003	January 25, 2002	January 24, 2003	January 25, 2002
	(In thousands)			
Net income (loss), as reported	$ 19,671	$ 6,984	$ 51,649	$ (4,740)
Add: Goodwill amortization, including acquired workforce	—	3,794	—	11,383
Adjusted net income	$ 19,671	$ 10,778	$ 51,649	$ 6,643
Basic net income (loss) per share, as reported	$ 0.06	$ 0.02	$ 0.15	$ (0.01)
Goodwill amortization, including acquired workforce	—	0.01	—	0.03
Adjusted basic net income per share	$ 0.06	$ 0.03	$ 0.15	$ 0.02
Diluted net income (loss) per share, as reported	$ 0.06	$ 0.02	$ 0.15	$ (0.01)
Goodwill amortization, including acquired workforce	—	0.01	—	0.03
Adjusted diluted net income per share	$ 0.06	$ 0.03	$ 0.15	$ 0.02

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

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

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others" ("FIN 45"). FIN 45 requires that upon issuance of a guarantee, a guarantor must recognize a liability for the fair value of an obligation assumed under a guarantee. FIN 45 also requires additional disclosures by a guarantor in its interim and annual financial statements about the obligations associated with guarantees issued. The liability recognition provisions of FIN 45 are effective for any guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002. We have provided disclosures for the nine months ended January 24, 2003 as required by FIN 45 in Note 15. We do not expect adoption of the liability recognition provisions to have a material impact on our financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, “Accounting for Stock-Based Compensation-Transition and Disclosure.” SFAS No. 148 amends SFAS No. 123, “Accounting for Stock-Based Compensation,” and provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123 to require more prominent and frequent disclosures in financial statements about the effects of stock-based compensation. We will adopt the disclosure provisions of SFAS No. 148 beginning in our annual financial statements for fiscal 2003.

14. Commitments and Contingencies

In the past, we entered into agreements and established Network Appliance accounts with Deutsche Banc Alex. Brown whereby we had the option to guarantee any defaults of certain margin loans made to two corporate officers by the financial institution on their Network Appliance stock. In the past, we also entered into an agreement and established a Network Appliance account with Goldman, Sachs and Co. whereby we had the option to guarantee any default of a certain margin loan made to a third corporate officer by the financial institution on his Network Appliance stock. The amount of the guarantee was limited to the excess, if any, of the amount of such loans over the fair market value of the Network Appliance stock securing the loans. As of August 26, 2002, these accounts with Deutsche Banc Alex. Brown and Goldman, Sachs and Co. were closed.

In May 2000, we entered into a split dollar insurance arrangement with our CEO. Under the arrangement, we will pay the annual premiums on several insurance policies on the life of the survivor of our CEO and his wife, and our CEO will reimburse 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 and 2002 fiscal years, we paid an aggregate net annual premium on these split dollar polices in the amount of $2,050. During the first quarter of fiscal 2003, we paid the aggregate net annual premium on these split dollar policies in the amount of $2,050 for fiscal 2003. 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. Upon the death of both our CEO and his wife or any earlier cash-out of the policies, we will be entitled to a refund of all cumulative premiums paid on these policies by us, and the balance will be paid to our CEO or his designated beneficiaries. 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.

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

15. Guarantees

As of January 24, 2003, our financial guarantees consisted of standby letters of credit outstanding, bank guarantee and restricted cash, which were related to facility leases requirement, customs and duties guarantees, and workers' compensation plans. We also maintained a restricted cash requirement collateralizing our product performance in a certain foreign country. The maximum amount of potential future payments under these arrangements was $3.1 million. We have not recorded any liability at January 24, 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 January 24, 2003 the maximum recourse exposure totaled approximately $4.9 million. 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.

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

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

Overview

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

On October 1, 2002, Network Appliance announced new products that significantly expand our solutions portfolio, including the FAS900 series, our new flagship storage platform and a key element in the NetApp® unified storage portfolio. With software updates from Data ONTAP™, the FAS900 series is also our first storage appliance to support Fibre Channel Storage Area Network ("SAN") environments, enabling Network Appliance to deliver the industry's first unified storage engine capable of handling networked storage in SAN and/or Network Attached Storage ("NAS") mode. This product announcement event repositions Network Appliance as a full-line enterprise storage solutions provider and illustrates how Network Appliance is tailoring solutions that meet its customers' needs for storage consolidation, data center operations, business continuance, and distributed enterprise applications.

Code of Business Conduct and Ethics

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

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Note 2 to the Consolidated Financial Statements in the Annual Report on Form 10-K/ A for the fiscal year ended April 26, 2002 describes the significant accounting policies and methods used in the preparation of the Consolidated Financial Statements. The preparation of these Consolidated Financial Statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues, and expenses, and related disclosure of contingent assets and liabilities. We evaluate, on an ongoing basis, our estimates and judgments, including those related to sales returns, bad debts, excess inventory and purchase commitments, investments, long-lived assets, restructuring accruals, income taxes, and loss contingencies. We base our estimates on historical experience and assumptions that we believe to be reasonable under the circumstances. Actual results may differ from these estimates.

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

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

Revenue Recognition and Allowances

We apply the provisions of 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.

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

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

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

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

A typical arrangement includes product, software subscription, and maintenance. Some arrangements include training and consulting. Software subscriptions include unspecified 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 workforce and a consolidation of 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 11 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, other-than-temporary write down of $0.7 million related to impairments of our investments in a publicly traded company. In the second quarter of fiscal 2002, we recorded a non cash, other-than-temporary write down of $13.0 million related to impairments of our investments in publicly traded and private companies.

Accounting for Income Taxes

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

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

New Accounting Standards

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

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

The amounts allocated to existing technology are being amortized over an estimated useful life of three years. Estimated future amortization expense is $1.4 million for the remaining three months of fiscal 2003. For fiscal 2004, estimated future amortization expense is $3.0 million.

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

	Three Months Ended		Nine Months Ended	
	January 24, 2003	January 25, 2002	January 24, 2003	January 25, 2002
	(In thousands)			
Net income (loss), as reported	$ 19,671	$ 6,984	$ 51,649	$ (4,740)
Add: Goodwill amortization, including acquired workforce	—	3,794	—	11,383
Adjusted net income	$ 19,671	$ 10,778	$ 51,649	$ 6,643
Basic net income (loss) per share, as reported	$ 0.06	$ 0.02	$ 0.15	$ (0.01)
Goodwill amortization, including acquired workforce	—	0.01	—	0.03
Adjusted basic net income per share	$ 0.06	$ 0.03	$ 0.15	$ 0.02
Diluted net income (loss) per share, as reported	$ 0.06	$ 0.02	$ 0.15	$ (0.01)
Goodwill amortization, including acquired workforce	—	0.01	—	0.03
Adjusted diluted net income per share	$ 0.06	$ 0.03	$ 0.15	$ 0.02

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

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

In November 2002, the FASB issued FASB Interpretation No. 45, "Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others". FIN 45 requires that upon issuance of a guarantee, a guarantor must recognize a liability for the fair value of an obligation assumed under a guarantee. FIN 45 also requires additional disclosures by a guarantor in its interim and annual financial statements about the obligations associated with guarantees issued. The liability recognition provisions of FIN 45 are effective for any guarantees issued or modified after December 31, 2002. The disclosure requirements are effective for financial statements of interim or annual periods ending after

December 15, 2002. We have provided disclosures for the nine months ended January 24, 2003 as required by FIN 45 in Note 15. We do not expect adoption of the liability recognition provisions to have a material impact on our financial position or results of operations.

In December 2002, the FASB issued SFAS No. 148, "Accounting for Stock-Based Compensation-Transition and Disclosure." SFAS No. 148 amends SFAS No. 123, "Accounting for Stock-Based Compensation," and provides alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based compensation. SFAS No. 148 also amends the disclosure requirements of SFAS No. 123 to require more prominent and frequent disclosures in financial statements about the effects of stock-based compensation. We will adopt the disclosure provisions of SFAS No. 148 beginning in our annual financial statements for fiscal 2003.

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		Nine Months Ended	
	January 24, 2003	January 25, 2002	January 24, 2003	January 25, 2002
Revenues:	100.0%	100.0%	100.0%	100.0%
Product Revenue	89.7	91.1	90.0	91.8
Service Revenue	10.3	8.9	10.0	8.2
Cost of Revenues:				
Cost of Product Revenue	31.3	30.0	30.7	34.2
Cost of Service Revenue	7.4	7.8	7.3	6.9
Gross Profit	61.3	62.2	62.0	58.9
Operating Expenses:				
Sales and Marketing	33.7	33.6	34.6	35.3
Research and Development	12.4	14.3	13.0	14.5
General and Administrative	4.3	5.4	4.1	5.3
Amortization of goodwill and intangible assets	0.6	2.6	0.6	2.6
Stock compensation	0.5	0.6	0.5	1.0
Restructuring charges	0.6	—	0.2	1.3
Total Operating Expenses	52.1	56.5	53.0	60.0
Income (Loss) From Operations	9.2	5.7	9.0	(1.1)
Other Income (Expense), net:				
Interest income	1.3	2.0	1.4	2.5
Other income (expense), net	0.2	(0.2)	(0.1)	(0.2)
Impairment loss on investment	—	—	(0.1)	(2.2)
Gain on sale of intangible asset	—	—	0.1	—
Total other income, net	1.5	1.8	1.3	0.1
Income (Loss) Before Income Taxes	10.7	7.5	10.3	(1.0)
Provision (Benefit) for Income Taxes	2.1	4.0	2.4	(0.2)
Net Income (Loss)	8.6%	3.5%	7.9%	(0.8)%

Product Revenues — Product revenues increased by 13.5% to $205.0 million for the third quarter of fiscal 2003, from $180.6 million for the third quarter of fiscal 2002. Product revenues increased by 7.4% to

$585.1 million for the nine-month period ended January 24, 2003, from $544.7 for the nine-month period ended January 25, 2002. Product revenues growth was across all geographies for both the three and nine-month periods ended January 24, 2003. This increase in product revenues for the three and nine-month periods ended January 24, 2003 was specifically attributable to increased software licenses and software subscriptions and an increase in units shipped, as compared to the same periods in fiscal 2002.

Our revenue growth was primarily driven by new product innovation as we continue to enhance and extend our full-line enterprise portfolio, providing customers with a lower overall cost of ownership. 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.

Product revenues were favorably impacted by the following factors:

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

• a higher average selling price for our newer products: FAS960, FAS940, F825 filer, F87 filer, C2100 and C1200 NetCache® products, as well as NearStore™ R100 nearline storage appliances and software features;

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

• increased sales of software subscription upgrades to 8.8% and 8.0% of total revenues for the three and nine-month periods ended January 24, 2003, respectively, from 7.0% and 6.4% of total revenues for the three and nine-month periods ended January 25, 2002, respectively;

• increased revenues from our new product introductions such as: FAS960, FAS940, F825, F810 and F87 filer products; NearStore R100 appliance; and NetCache C2100 and C1200 appliances; and

• increased sales through indirect channels, including sales through our OEM partners, representing 50.7% and 39.3% of total revenues for the third quarters of fiscal of 2003 and 2002, respectively and 46.0% and 38.9% of total revenues for the first nine-month periods ended January 24, 2003 and January 25, 2002.

Product revenues were negatively impacted by the following factors:

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

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

• decreased cost per megabyte as a result of larger disk capacity; and

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

Service Revenues — Service revenues, which include hardware support, professional services, and educational services, increased by 32.2% to $23.4 million in the third quarter of fiscal 2003, from $17.7 million in the third quarter of fiscal 2002. Service revenues increased by 33.8% to $65.3 million in the nine-month period ended January 24, 2003 from $48.8 million in the nine-month period ended January 25, 2002, respectively. Service revenues are generally deferred and, in most cases, recognized ratably over the service period obligations, which are typically one to three years. The increase in service revenues as a percentage of revenues (representing 10.3% and 8.9% of total revenues for the third quarter of fiscal 2003 and 2002, respectively, and 10.0% and 8.2% of total revenues for the nine-month periods ended January 24, 2003 and January 25, 2002, respectively) was due to an increasing number of enterprise customers, who typically purchase more complete service packages. In addition, higher service revenues for both the three and nine-month periods ended January 24, 2003 was also related to a growing installed base resulting in new customer support contracts in addition to support contract renewals by existing customers.

International total revenues (including United States exports) increased by 24.4% and 10.0% for the three and nine-month periods ended January 24, 2003 as compared to the same periods of fiscal 2002, respectively. International total revenues were $103.2 million, or 45.2% of total revenues, and $260.5 million, or 40.0% of total revenues for the three and nine-month periods ended January 24, 2003 respectively. For the three and nine-month periods ended January 24, 2003 the increase in international sales was primarily a result of European and Asia Pacific net revenues growth, driven by larger storage implementations and new products, and positive foreign exchange effects from a weak U.S. dollar, as compared to the same periods in the prior year.

Product Gross Margin — Product gross margin decreased to 61.3% for the third quarter of fiscal 2003, from 62.2% for the third quarter of fiscal 2002. Product gross margin increased to 62.0% for the nine-month period ended January 24, 2003, from 58.9% for the nine-month period ended January 25, 2002.

Product gross margin was negatively impacted by:

• increased sales through indirect channels;

• higher disk content with an expanded storage capacity for the higher-end filers;

• 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.

The overall gross margin increase during the nine-month period ended January 24, 2003 compared to January 25, 2002 was generally attributed to the same favorable factors partially offset by unfavorable factors cited above for the third quarters of fiscal 2003 and 2002. In addition, gross margin was also positively impacted by a favorable adjustment of approximately $1.2 million as a result of a supplier contract renegotiation in the first nine-months period of fiscal 2003 as well as an increase in product sales volume as compared to the same period in fiscal 2002.

Service Gross Margin — Service gross margin increased to 27.8% in the third quarter of fiscal 2003 as compared to 12.9% in the third quarter of fiscal 2002. Service gross margin increased to 27.8% in the nine-month period ended January 24, 2003 as compared to 16.2% in the nine-month period ended January 25, 2002. Investments in customer service increased by 9.5% to $16.9 million in the third quarter of fiscal 2003, from $15.4 million in the third quarter of fiscal 2002. Investments in customer service increased by 15.2% to $47.2 million in the nine-month period ended January 24, 2003, from $40.9 million in the nine-month period ended January 25, 2002. The improvement in service gross margin in the three and nine-month periods ended January 24, 2003 was primarily due to operational and cost efficiencies in the global customer service organizations, combined with the ramping up of our service infrastructure in fiscal 2002 in anticipation of service revenue growth.

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 15.4% to $77.0 million for the third quarter of fiscal 2003, from $66.7 million for the third quarter of fiscal 2002. These expenses were 33.7% and 33.6% of total revenues for the third quarter of fiscal 2003 and fiscal 2002, respectively. Sales and marketing expenses increased 7.5% to $225.1 million for the nine-month period ended January 24, 2003, from $209.3 million for the nine-month period ended January 25, 2002. These expenses were 34.6% and 35.3% of total revenues for the nine-month periods ended January 24, 2003 and January 25, 2002, respectively. The increase was attributed to the continued worldwide investment in our sales and customer service organizations associated with selling complete solutions at the enterprise level, marketing and various advertising programs, and expenses associated with our growing mix of enterprise customers and associated global account programs. Sales and marketing headcount increased to 1,247 at January 24, 2003 from 1,197 at January 25, 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, and fees paid to outside consultants. Research and development expenses decreased 0.6% to $28.3 million for the third quarter of fiscal 2003 from $28.5 million for the third quarter of fiscal 2002. These expenses represented 12.4% and 14.3% of total revenues for the third quarters of fiscal 2003 and 2002, respectively. Research and development expenses remained relatively flat, primarily as a result of cost control, reduction in discretionary spending efforts, and the impact of fiscal 2002 restructuring activities. Research and development headcount remained relatively flat at 531 as of January 24, 2003 compared to 533 as of January 25, 2002.

Research and development expenses decreased 1.6% to $84.5 million for the nine-month period ended January 24, 2003 from $85.9 million for the nine-month period ended January 25, 2002. These expenses represented 13.0% and 14.5% of total revenues for the nine-month periods ended January 24, 2003 and January 25, 2002, respectively. Research and development expenses decreased in absolute dollars, primarily as a result of cost control, reduction in discretionary spending efforts, and the impact of fiscal 2002 restructuring activities. For both the three and nine-month periods of fiscal 2003 and 2002, no software development costs were capitalized.

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

During the second quarter of fiscal 2003, we introduced and shipped new products that expand our solutions offering, including the FAS900 series, our new flagship storage platform and a key element in the NetApp® unified storage portfolio. We also entered into new and expanded corporate partnerships with Brocade, Oracle, and VERITAS Software. These partnerships allow us to offer customers enhanced service, support, sales, and technology in the Fibre Channel SAN market. Finally, we introduced enhanced or new open management products: DataFabric™ Manager 2.1, SnapDrive™ 2.0, and VFM™ (Virtual File Manager); the DataFabric Management Services program; and Manage ONTAP™ solutions; and expanded relationships with open management partners including BMC Software and Computer Associates.

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 not increase significantly in absolute dollars for the remainder of fiscal 2003 as compared to the comparable period in the prior year.

General and Administrative — General and administrative expenses decreased 7.1% to $9.8 million for third quarter of fiscal 2003, from $10.6 million for the third quarter of fiscal 2002. These expenses represented 4.3% and 5.4% of total revenues for the third quarters of fiscal 2003 and 2002, respectively. General and administrative expenses decreased 15.9% to $26.4 million for the nine-month period ended January 24, 2003, from $31.4 million for the nine-month period ended January 25, 2002. These expenses represented 4.1% and

5.3% of total revenues for the nine-month periods ended January 24, 2003 and January 25, 2002, respectively. Decreases in absolute dollars were primarily due to cost control, reduction in discretionary spending efforts, benefit from the successful collection of previously accrued customer-specific bad debt allowance, partially offset by expenses associated with initiatives to enhance and implement an enterprise-wide ERP system. General and administrative headcount increased to 270 at January 24, 2003 from 241 at January 25, 2002. We believe that our general and administrative expenses will not increase significantly in absolute dollars for the remainder of fiscal 2003 as compared to the comparable period in the prior year.

Amortization of Goodwill — Due to the adoption of SFAS No. 142, goodwill is no longer amortized in fiscal 2003 as compared to amortization expense of $3.8 million in the third quarter of fiscal 2002 and $11.4 million in the nine-month period ended January 25, 2002.

Amortization of Purchased Intangible Assets — Intangible assets as of January 24, 2003, including existing technology, are amortized over estimated useful lives of three years. Amortization of existing technology included in operating expenses was $1.4 million for both the third quarters of fiscal 2003 and 2002. Amortization of existing technology was $4.1 million for the nine-month period ended January 24, 2003 as compared to $4.3 million of the nine-month period ended January 25, 2002, respectively. Estimated future amortization expense is $1.4 million for the remaining three months of fiscal 2003. For fiscal 2004, estimated future amortization expense is $3.0 million and none thereafter.

Stock Compensation — We account for stock-based employee compensation arrangements in accordance with the provisions of Accounting Principles Board No. 25, *"Accounting for Stock Issued to Employees,"* and comply with the provisions of SFAS No. 123, *"Accounting for Stock-Based Compensation,"* for non-employee compensation awards. Accordingly, we recognize the intrinsic value for employees and the fair value for non-employees as stock compensation expense over the vesting terms of the awards.

Stock compensation expenses were $1.2 million and $1.1 million in the third quarter of fiscal 2003 and 2002, respectively. For the nine-month periods, stock compensation expenses decreased to $3.1 million in fiscal 2003 from $5.8 million in fiscal 2002, respectively, for those periods. This decrease was primarily due to $1.7 million of lower stock compensation in first nine-month period of fiscal 2003 as compared to same period in fiscal 2002 attributed to forfeitures of unvested options assumed in the WebManage Technologies, Inc. acquisition; a decrease of $1.5 million of stock compensation as 132,248 contingently issuable milestone shares relating to Orca valued at $2.4 million were released in the first nine-month period of fiscal 2002 as compared to the release of 99,186 shares valued at $0.9 million in the same period of fiscal 2003; offset by an increase of $0.6 million relating to the fair value of options granted to a member of the Board of Directors.

Restructuring charges — In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in workforce and a consolidation of facilities. As a result of the restructuring in August 2001, we incurred a charge of $8.0 million. The restructuring charge included $4.8 million of severance-related amounts, $2.7 million of committed excess facilities and facility closure expenses, and $0.5 million in fixed assets write-offs. The reserve balance of $0.8 million at January 24, 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 the third quarter of fiscal 2003, we recorded a net restructuring adjustment of $0.3 million 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 $0.9 million to be payable through January 2006.

The following analysis sets forth the significant components of the second quarter fiscal 2002 restructuring at January 24, 2003 (in thousands):

	Severance-Related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge	$ 4,796	$ 528	$ 2,656	$ 7,980
Cash payments	(4,508)	—	(803)	(5,311)
Non-cash portion	—	(528)	(37)	(565)
Adjustments	(95)	—	(1,509)	(1,604)
Reserve balance at April 26, 2002	193	—	307	500
Cash payments	11	—	—	11
Non-cash portion	—	—	(3)	(3)
Reserve balance at July 26, 2002	204	—	304	508
Cash payments	(3)	—	(76)	(79)
Reserve balance at October 25, 2002	201	—	228	429
Cash payments	44	—	2	46
Non-cash portion	—	—	(5)	(5)
Adjustments	410	—	(76)	334
Reserve balance at January 24, 2003	$ 655	$ —	$ 149	$ 804

In April 2002, we completed a restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters. As a result of this restructuring, we incurred a charge of $5.9 million. The restructuring charge included $0.8 million of severance-related amounts, $4.6 million of committed excess facilities and facility closure expenses, and $0.5 million in fixed assets write-offs. Of the reserve balance at January 24, 2003, $1.5 million was included in other accrued liabilities and the remaining $3.3 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 $3.4 million to be payable through November 2010.

The following analysis sets forth the significant components of the fourth quarter fiscal 2002 restructuring at January 24, 2003 (in thousands):

	Severance-Related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge	$ 813	$ 473	$4,564	$5,850
Cash payments	(629)	—	(32)	(661)
Non-cash portion	—	(473)	—	(473)
Reserve balance at April 26, 2002	184	—	4,532	4,716
Cash payments	(77)	—	(285)	(362)
Reserve balance at July 26, 2002	107	—	4,247	4,354
Cash payments	—	—	(263)	(263)
Reserve balance at October 25, 2002	107	—	3,984	4,091
Cash payments	—	—	(256)	(256)
Adjustments	(107)	—	1,030	923
Reserve balance at January 24, 2003	$ —	$ —	$4,758	$4,758

Interest income — Interest income was $3.1 million and $4.0 million for the third quarter of fiscal 2003 and 2002, respectively. Interest income was $9.1 million and $14.7 million for the nine-month periods ended January 24, 2003 and January 25, 2002, respectively. The decrease in interest income was primarily due to lower average interest rates, and lower investment balances as we utilized $249.8 million to purchase the land and buildings at our Sunnyvale facility in April 2002.

Other income (expense), net — The third quarters of fiscal 2003 and 2002 included a net exchange gain (loss) from foreign currency transactions of $0.3 million and $(0.5) million, respectively. The nine-month period ended January 24, 2003 included primarily a net loss of $0.7 million from foreign currency transactions as compared to a net loss of $0.9 million in the nine-month period ended January 25, 2002.

Impairment loss on investments — Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value, and such a decline is not considered temporary. In the first quarter of fiscal 2003, we recorded a noncash, other-than-temporary write down of $0.7 million related to the impairment of our investment in a publicly traded company. In the second quarter of fiscal 2002, we recorded a noncash, other-than-temporary write down of $13.0 million related to impairments of our investments in publicly traded and private companies.

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 (Benefit), for Income Taxes — For the nine-month period ended January 24, 2003, we applied an annual tax rate of 23% to pretax income. The decrease from 25% for the six-month period ended October 25, 2002 was due primarily to the expected increase in profits from Europe and other geographies that are subject to a lower tax rate. Our estimate is based on existing tax laws and our current projections of income (loss) and distributions of income (loss) among different entities and tax jurisdictions, and is subject to change, based primarily on varying levels of profitability.

Liquidity and Capital Resources

We derive our liquidity and capital resources primarily from our cash flow from operations and from working capital, which increased by $63.3 million to $526.9 million as of January 24, 2003, compared to $463.6 million as of April 30, 2002. As of January 24, 2003, as compared to the April 30, 2002 balances, our cash, cash equivalents, and short-term investments increased by $84.5 million to $538.6 million. We generated cash from operating activities totaling $102.9 million and $88.2 million for the nine-month periods ended January 24, 2003 and January 25, 2002, respectively. Net cash provided by operating activities in the nine-month period ended January 24, 2003 was principally related to net income of $51.6 million, increases in other accrued liabilities, income taxes payable, deferred revenue, coupled with depreciation, impairment loss on investments, amortization of intangibles and stock compensation, partially offset by decreased accounts payable, decreased accrued compensation and related benefits and increases in accounts receivable, inventories, deferred income taxes and prepaid expenses and other assets.

We used $45.9 million and $22.5 million of cash in the nine-month periods ended January 24, 2003 and January 25, 2002, respectively, for capital expenditures. The increase was primarily attributed to upgrades of our ERP infrastructure, computer-related purchases, and building improvements. We used net proceeds of $61.4 million and $95.3 million in the nine-month periods ended January 24, 2003 and January 25, 2002, respectively, for net purchases of short-term investments. Investing activities in the nine-month periods of fiscal 2003 and 2002 also included new investments in privately-held companies of $0.7 million and $0.9 million, respectively.

We received $24.3 million in the nine-month period ended January 24, 2003 from financing activities. We used $26.0 million in the nine-month period ended January 25, 2002 for financing activities. The change in cash flow from financing was primarily due to the effects of the change in restricted cash requirements in the nine-month period ended January 25, 2002 of $57.3 million. This requirement was eliminated in April 2002 in conjunction with the purchase of our Sunnyvale headquarters and termination of our operating leases, and thus had no effect on cash flows from financing activities in the current fiscal periods. The change in cash flow from financing activities was partially offset by lower proceeds from stock option exercises as a result of the decline in our stock price.

Our capital and liquidity requirements depend on numerous factors, including risks relating to fluctuating operating results, continued growth in the network storage and content delivery markets, customer and market acceptance of our products, dependence on new products, rapid technological change, dependence on qualified technical and sales personnel, risk inherent in our international operations, competition, reliance on a limited number of suppliers and contract manufacturers, relationships with strategic partners, 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 January 24, 2003, and the effect such obligations are expected to have on our liquidity and cash flow in future periods, (in thousands):

	2003	2004	2005	2006	2007	Thereafter	Total
Operating lease payments	$ 2,780	$ 9,781	$8,369	$5,897	$3,534	$12,616	$42,977
Venture capital funding commitments	302	1,208	1,208	1,207	—	—	3,925
Purchase commitments	8,383	20,634	—	—	—	—	29,017
	$11,465	$31,623	$9,577	$7,104	$3,534	$12,616	$75,919

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 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; 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.

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 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.

Cost and expense control may be critical to maintaining positive cash flow from operations and profitability.

In fiscal 2002, we reduced fixed costs through workforce reductions and a consolidation of 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, and any lack of growth will have a material adverse effect on our operating results.

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. 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 high-technology companies. Additionally, certain macroeconomic factors such as changes in interest rates, the market climate for the high-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, or 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 the 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 block-data storage market, we have begun introducing products with new features and functionality that address the storage area network market. 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 war or acts of terrorism.

Current global economic and political factors, including terrorism, could harm our business. Weak economic conditions, terrorist actions, and the effects of ongoing military actions against terrorists 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.

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. Competition for qualified engineers, particularly in Silicon Valley, is 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 nine-month period ended January 24, 2003, approximately 40.0% of our total revenues were from international customers (including United States 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 trade and intercompany receivables and payables. All hedge contracts are marked to market through earnings every period. There can be no assurance that such hedging strategy 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 filer 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 Auspex Systems, Inc., Dell, LSI Logic Corp., MTI Corp., and Procom Technology.

In the content delivery market, our NetCache appliances and content delivery software compete against caching appliance and content delivery software vendors including Cisco Systems, Inc., Inktomi Corp., and Akamai Technologies, Inc.

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

We believe that the principal competitive factors affecting our market include product benefits such as response time, reliability, data availability, scalability, ease of use, price, multiprotocol capabilities, and customer service and support. Although we believe that our products currently compete favorably with respect to these factors, we cannot assure you that we can maintain our competitive position against current and potential competitors, especially those with significantly greater financial, marketing, service, support, technical, and other resources.

Increased competition could 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 our sole contract manufacturer or the failure to accurately forecast demand for our products or successfully manage our relationship with our contract manufacturer could negatively impact our ability to manufacture and sell our products.

We currently rely on a contract manufacturer to manufacture most of our products. Our reliance on a third-party contract manufacturer 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 manufacturer, or if our contract manufacturer experiences delays, disruptions, capacity constraints, or quality control problems in its manufacturing operations, our ability to ship products to our customers could be delayed 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 manufacturer 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 manufacturer to provide us with adequate supplies of high-quality products, or the ability 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 co-market 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 that we are unsuccessful in developing new relationships and maintaining our existing relationships, our future revenue and operating results could be impacted negatively. In addition, the loss of a strategic partner could have a material adverse effect on 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, other-than-temporary write down of $0.7 million related to the impairment of our investment in a publicly traded company. In the second quarter of fiscal 2002, we recorded a noncash, other-than-temporary write down of $13.0 million related to impairments in publicly traded and private companies.

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.

We do not have exclusive relationships with our resellers and accordingly there is a risk that those resellers may give higher priority to products of other suppliers, which could materially adversely affect our operating results.

Our reseller partners generally offer products from several different companies, including products of our competitors. Accordingly, there is risk that these resellers may give higher priority to products of other suppliers, which could materially adversely affect our operating results.

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 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 United States trademarks and some United States-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 United States and international patent applications pending and multiple United States 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 United States. We cannot assure you that our means of protecting our proprietary rights will be adequate or that our competitors will not independently develop similar technology, duplicate our products, or design around patents issued to us or other intellectual property rights of ours.

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

Market Interest and Interest Income Risk

Interest and Investment Income — As of January 24, 2003, we had short-term investments of $308.5 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 January 24, 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, other-than-temporary write down of $0.7 million related to the impairment of our investment in a publicly traded company. In the second quarter of fiscal 2002, we recorded a noncash, other-than-temporary write down of $13.0 million related to impairments in publicly traded and private companies.

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 approximate $0.1 million decrease in the fair value of our equity security as of January 24, 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 hedge instruments are marked to market through earnings every period. We believe that these forward contracts do not subject us to undue risk due to foreign exchange movements because gains and losses on these contracts are offset by losses and gains on the underlying assets and liabilities.

All contracts have a maturity of less than one year and we do not defer any gains and losses, as they are all accounted for through earnings every period.

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 Board-approved policies.

The following table provides information about our foreign exchange forward contracts outstanding on January 24, 2003, (in thousands):

Currency	Buy/ Sell	Foreign Currency Amount	Contract Value USD	Fair Value in USD
AUD	Sell	7,390	$ 4,329	$ 4,342
CHF	Sell	3,027	$ 2,242	$ 2,241
EUR	Sell	39,648	$ 43,006	$43,069
GBP	Sell	16,900	$ 27,541	$27,597
CAD	Sell	6,622	$ 4,340	$ 4,345

Item 4. *Controls and Procedures*

Based on their evaluation, as of a date within 90 days of the filing of this Form 10-Q, the Company's Chief Executive Officer and Chief Financial Officer have concluded the Company's disclosure controls and procedures (as defined in Rules 13a-14 and 15d-14 under the Securities Exchange Act of 1934) are effective. There have been no significant changes in internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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*

99.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

(b) *Reports on Form 8-K*

None

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: February 26, 2003

CERTIFICATIONS PURSUANT TO RULE 13a-14 UNDER

THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED

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 quarterly 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 quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly 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-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures 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 quarterly report is being prepared;

b) evaluated the effectiveness of the registrant’s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the “Evaluation Date”); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant’s other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant’s auditors and the audit committee of registrant’s board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant’s ability to record, process, summarize and report financial data and have identified for the registrant’s auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal controls; and

6. The registrant’s other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ DANIEL J. WARMENHOVEN

Daniel J. Warmenhoven
Chief Executive Officer

Date: February 26, 2003

CERTIFICATIONS PURSUANT TO RULE 13a-14 UNDER

THE SECURITIES EXCHANGE ACT OF 1934, AS AMENDED

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 quarterly 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 quarterly report;

3. Based on my knowledge, the financial statements, and other financial information included in this quarterly 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 quarterly 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-14 and 15d-14) for the registrant and we have:

a) designed such disclosure controls and procedures 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 quarterly report is being prepared;

b) evaluated the effectiveness of the registrant’s disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the “Evaluation Date”); and

c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;

5. The registrant’s other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant’s auditors and the audit committee of registrant’s board of directors (or persons performing the equivalent function):

a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant’s ability to record, process, summarize and report financial data and have identified for the registrant’s auditors any material weaknesses in internal controls; and

b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant’s internal controls; and

6. The registrant’s other certifying officer and I have indicated in this quarterly report whether or not there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

/s/ STEVEN J. GOMO

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

Date: February 26, 2003

EXHIBIT INDEX

Exhibit Number	Description
99.1	Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

EXHIBIT 99.1

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 January 24, 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: February 26, 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 January 24, 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: February 26, 2003

/s/ Steven J. Gomo

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