

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 JULY 27, 2001

OR

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

FOR THE TRANSITION PERIOD FROM _____ TO _____ .

COMMISSION FILE NUMBER 0-27130

NETWORK APPLIANCE, INC.
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

CALIFORNIA
(STATE OR OTHER JURISDICTION OF
INCORPORATION OR ORGANIZATION)

77-0307520
(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

Number of shares outstanding of the registrant's class of common stock,
as of the latest practicable date.

CLASS	OUTSTANDING AT JULY 27, 2001
Common Stock.....	330,203,694

PART I -- FINANCIAL INFORMATION

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ITEM 1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(IN THOUSANDS)

	JULY 27, 2001	APRIL 30, 2001
	----- (UNAUDITED)	----- **
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	\$ 239,287	\$ 271,931
Short-term investments	129,378	92,094
Accounts receivable, net	155,166	186,956
Inventories	23,764	22,504
Prepaid expenses and other assets	28,096	25,745
Deferred income taxes	35,737	36,287
	-----	-----
Total current assets	611,428	635,517
RESTRICTED CASH	199,983	193,747
PROPERTY AND EQUIPMENT, NET	100,789	103,238
INTANGIBLE ASSETS, NET	74,284	79,510
OTHER ASSETS	23,675	24,240
	-----	-----
	\$ 1,010,159	\$ 1,036,252
	=====	=====
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable	\$ 48,208	\$ 64,892
Income taxes payable	16,050	21,844
Accrued compensation and related benefits	26,217	50,523
Other accrued liabilities	29,682	23,198
Deferred revenue	54,284	58,316
	-----	-----
Total current liabilities	174,441	218,773
LONG-TERM DEFERRED REVENUE	16,772	12,882
LONG-TERM OBLIGATIONS	137	149
	-----	-----
Total liabilities	191,350	231,804
	-----	-----
SHAREHOLDERS' EQUITY:		
Common stock	631,171	616,595
Deferred stock compensation	(10,767)	(12,044)
Retained earnings	204,119	204,632
Cumulative other comprehensive loss	(5,714)	(4,735)
	-----	-----
Total shareholders' equity	818,809	804,448
	-----	-----
	\$ 1,010,159	\$ 1,036,252
	=====	=====

** Derived from audited consolidated financial statements.

See accompanying notes to condensed consolidated financial statements.

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)
(UNAUDITED)

	THREE MONTHS ENDED	
	JULY 27, 2001	JULY 28, 2000
NET SALES	\$ 200,426	\$231,159
COST OF SALES	88,077	89,457
Gross Margin	112,349	141,702
OPERATING EXPENSES:		
Sales and marketing	71,642	63,818
Research and development	29,083	23,623
General and administrative	10,262	8,879
Amortization of intangible assets	5,226	666
In-process research and development	--	26,688
Stock compensation (1)	2,699	429
Total operating expenses	118,912	124,103
INCOME (LOSS) FROM OPERATIONS	(6,563)	17,599
OTHER INCOME:		
Interest income	5,482	4,264
Other income (expense), net	12	116
Total other income, net	5,494	4,380
INCOME (LOSS) BEFORE INCOME TAXES	(1,069)	21,979
PROVISION (BENEFIT) FOR INCOME TAXES	(556)	17,003
NET INCOME (LOSS)	\$ (513)	\$ 4,976
NET INCOME (LOSS) PER SHARE:		
Basic	\$ (0.00)	\$ 0.02
Diluted	\$ (0.00)	\$ 0.01
SHARES USED IN PER SHARE CALCULATIONS:		
Basic	329,336	313,559
Diluted	329,336	359,778
(1) Stock compensation		
Sales and marketing	\$ 313	\$ 241
Research and development	2,243	82
General and administrative	143	106
	\$ 2,699	\$ 429

See accompanying notes to condensed consolidated financial statements.

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(IN THOUSANDS)
(UNAUDITED)

	THREE MONTHS ENDED	
	JULY 27, 2001	JULY 28, 2000
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income (loss)	\$ (513)	\$ 4,976
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	10,614	5,892
In-process research and development	--	26,688
Amortization of intangible assets	5,226	666
Stock compensation	2,699	429
Provision for doubtful accounts	1,639	172
Deferred income taxes	3,927	(2,114)
Deferred rent	(12)	--
Changes in assets and liabilities net of effects of businesses acquired:		
Accounts receivable	30,117	(29,412)
Inventories	(2,810)	(4,988)
Prepaid expenses and other assets	(4,567)	9,141
Accounts payable	(16,684)	15,875
Income taxes payable	(5,794)	22,491
Accrued compensation and related benefits	(24,306)	(1,446)
Other accrued liabilities	6,484	7,137
Deferred revenue	(142)	8,308
	-----	-----
Net cash provided by operating activities	5,878	63,815
	-----	-----
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchases of short-term investments	(76,486)	(51,699)
Redemptions of short-term investments	38,018	45,109
Purchases of property and equipment	(6,822)	(21,034)
Purchase of equity securities	(150)	(1,000)
Purchase of businesses, net of cash acquired	--	(2,161)
	-----	-----
Net cash used in investing activities	(45,440)	(30,785)
	-----	-----
CASH FLOWS FROM FINANCING ACTIVITIES:		
Proceeds from sale of common stock, net	13,154	19,705
Increase in restricted cash	(6,236)	--
	-----	-----
Net cash provided by financing activities	6,918	19,705
	-----	-----
NET CHANGE IN CASH AND CASH EQUIVALENTS	(32,644)	52,735
CASH AND CASH EQUIVALENTS:		
Beginning of period	271,931	279,014
	-----	-----
End of period	\$ 239,287	\$ 331,749
	=====	=====
NONCASH INVESTING AND FINANCING ACTIVITIES:		
Income tax benefit from employee stock transactions	\$ --	\$ 18,000
Conversion of evaluation inventory to fixed assets	1,321	2,728
Common stock issued and options assumed for acquired businesses	--	47,579
Milestone shares issued (Note 5)	1,434	--
SUPPLEMENTAL CASH FLOW INFORMATION:		
Income taxes paid	62	54

See accompanying notes to condensed consolidated financial statements.

NETWORK APPLIANCE, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(IN THOUSANDS)
(UNAUDITED)

1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The accompanying condensed consolidated financial statements have been prepared by Network Appliance, Inc. without audit and reflect all 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 the regulations of the Securities and Exchange Commission (SEC) for interim financial statements. Accordingly, they do not include all information and footnotes required by accounting principles generally accepted in the United States of America for annual financial statements.

These financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended April 27, 2001. The results of operations for the three-month period ended July 27, 2001 are not necessarily indicative of the operating results to be expected for the full fiscal year or future operating periods.

2. RECLASSIFICATIONS

Certain reclassifications have been made to prior-period balances, none of which affected our financial position, results of operations and cash flows, to present the consolidated financial statements on a consistent basis.

3. SIGNIFICANT ACCOUNTING POLICIES

Fiscal Periods - We operate on a 52-week or 53-week year ending on the last Friday in April. Fiscal 2002 is a 52-week year. Fiscal 2001 was a 52-week year. The quarter ended July 27, 2001 includes 13 weeks of operating activity, compared to 13 weeks of activity for the corresponding period of the prior fiscal year.

Foreign Currency Translation -- In the first quarter of fiscal 2002, we determined that the functional currency of one of our subsidiaries had changed from the Euro to the US Dollar. Accordingly, all monetary assets and liabilities were translated at the current exchange rate in effect as of the balance sheet date, nonmonetary assets and liabilities were translated at historical rates and net sales and expenses were translated at average exchange rates in effect during the period. Transaction gains and losses, which are included in other income (expense) in the accompanying consolidated statements of operations, have not been significant.

NETWORK APPLIANCE, INC.
 NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
 (IN THOUSANDS)
 (UNAUDITED)

4. INVENTORIES

Inventories consist of the following:

	JULY 27, 2001	APRIL 30, 2001
	-----	-----
	(IN THOUSANDS)	
Purchased components	\$ 11,554	\$ 11,106
Work in process	505	560
Finished goods	11,705	10,838
	-----	-----
	\$ 23,764	\$ 22,504
	=====	=====

5. STOCK COMPENSATION

We record stock compensation in accordance with provisions of Accounting

Principle Board No. 25, "Accounting for Stock Issued to Employees," for employee awards and in accordance with the disclosure provisions of 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. During the first quarter of fiscal 2002, under terms of the acquisition agreement with Orca Systems, Inc. ("Orca"), we issued an additional 66 shares of common stock to former Orca shareholders upon meeting certain performance criteria. The fair market value of the shares of \$1,434 was measured on the date the performance criteria were met and was recognized as stock compensation.

6. DERIVATIVE INSTRUMENTS

Effective May 1, 2001, we adopted SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities," as amended, which establishes accounting and reporting standards for derivative instruments, including certain derivative instruments embedded in other contracts, and for hedging activities. Under SFAS No. 133, certain contracts that were not formerly considered derivatives may now meet the definition of a derivative. SFAS No. 133 requires that all derivatives be recognized as either assets or liabilities at fair value. Derivatives that are not designated as hedges are adjusted to fair value through earnings. If the derivative is designated as a hedge, depending on the nature of the exposure being hedged, changes in fair value will either be offset against the change in fair value of the hedged asset, liability, or firm commitment through earnings, or recognized in other comprehensive income until the hedged item is recognized in earnings. The ineffective portion of the hedge is recognized in earnings immediately.

As a result of our significant international operations, we are subject to risks associated with fluctuating exchange rates. We use 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 first three months of fiscal 2002, net losses generated by hedged assets and liabilities totaled \$246, which were offset by gains on the related derivative instruments of \$265. We do not enter into derivative financial instruments for speculative or trading purposes.

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NETWORK APPLIANCE, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(IN THOUSANDS)
(UNAUDITED)

Currently, we do not enter into any foreign exchange forward contracts to hedge exposures related to forecasted transactions, firm commitments or equity investments. The adoption of SFAS No. 133 did not have a significant impact on our financial position, results of operations or cash flow.

7. EARNINGS PER SHARE

Basic and diluted net income (loss) per share are computed using weighted-average common shares outstanding in accordance with SFAS No. 128, "Earnings Per Share." Diluted net income per share also includes the effect of stock options.

At July 27, 2001 and July 28, 2000, 73,945 and 983 shares of common stock options with a weighted average exercise price of \$21.48 and \$81.39, respectively, were excluded from the diluted net income (loss) per share computation as their effect would be antidilutive due to the net loss for the three-month period ended July 27, 2001 and due to the fact that the exercise prices were greater than the average market price of the common shares for the three-month period ended July 28, 2000.

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

	THREE MONTHS ENDED	
	JULY 27, 2001	JULY 28, 2000
	-----	-----
(IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)		
NET INCOME (LOSS) (NUMERATOR):		
Net income (loss), basic and diluted	\$ (513)	\$ 4,976
	=====	=====
SHARES (DENOMINATOR):		
Weighted average common shares outstanding	329,550	313,750
Weighted average common shares outstanding subject to repurchase	(214)	(191)
	-----	-----
Shares used in basic computation	329,336	313,559
Weighted average common shares outstanding subject to repurchase	--	191
Common shares issuable upon exercise of stock options	--	46,028
	-----	-----
Shares used in diluted computation	329,336	359,778
	=====	=====
NET INCOME (LOSS) PER SHARE:		
Basic	\$ (0.00)	\$ 0.02
	=====	=====
Diluted	\$ (0.00)	\$ 0.01
	=====	=====

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NETWORK APPLIANCE, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(IN THOUSANDS)
(UNAUDITED)

8. COMPREHENSIVE INCOME (LOSS)

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

	THREE MONTHS ENDED	
	JULY 27, 2001	JULY 28, 2000
	-----	-----
(IN THOUSANDS)		
Net income (loss)	\$ (513)	\$ 4,976
Foreign currency translation adjustment	(263)	157
Unrealized gain (loss) on investments	(716)	11,474
	-----	-----
Comprehensive income (loss)	\$ (1,492)	\$ 16,607
	=====	=====

9. COMMITMENTS

We have commitments related to operating lease arrangements for our headquarter site in Sunnyvale, California, under which we have options to purchase various properties at the expiration or termination of the leases for \$309,000, or arrange for the sale of the property to third parties for at least \$309,000 with a contingent liability for any deficiency. If the property is not purchased or sold as described above, we will be obligated for additional lease payments of approximately \$276,566.

Restricted cash, classified as non-current assets collateralizing these leases, was \$195,258 at July 27, 2001. The lease payments under operating leases collateralized by restricted cash, will vary based on London Interbank Offered Rate (LIBOR) plus a spread (4.1% at July 27, 2001). The remaining non-collateralized operating lease requires monthly payments, which vary, based on LIBOR plus a spread (5.3% at July 27, 2001). The operating leases mentioned above require us to maintain specified financial covenants with which we were in compliance as of July 27, 2001.

We also entered into agreements and established Network Appliance accounts with Goldman, Sachs and Co. and Deutsche Banc Alex. Brown whereby we guarantee any defaults by our President, Mr. Thomas F. Mendoza, of certain margin loans made to him by these financial institutions on his Network Appliance stock. The amount of the guarantee is limited to the difference between the amount of such loans and fair market value of the Network Appliance stock securing the loans. As of July 27, 2001, the ending balance in these accounts was approximately \$4,725 in order to collateralize the margin requirement and as of that date the amount Network Appliance would owe, that was not covered by the value of the stock, was \$0. The balance under these accounts mentioned above was classified as restricted cash.

10. NEW ACCOUNTING PRONOUNCEMENTS

In June 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets". Under SFAS No. 141, all business combinations initiated after June 30, 2001 must be accounted for using the purchase method. Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually for impairment (or more frequently if indicators of impairment arise). Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives (but with no maximum life). The amortization provisions of SFAS No. 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, we are required to adopt SFAS No. 142 effective April 27, 2002. Upon adoption of SFAS

NETWORK APPLIANCE, INC.
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
(IN THOUSANDS)
(UNAUDITED)

No. 142, we will stop the amortization of goodwill with a net carrying value of approximately \$48,912 at April 26, 2002 and the annual amortization of \$14,575 that resulted from business combinations initiated prior to the adoption. We will evaluate goodwill under the SFAS No. 142 transitional impairment test. Any transitional impairment loss will be recognized as a change in accounting principle on the date of adoption. If any impairment of goodwill is recognized prior to the date of adoption, the loss will be charged to operating expenses.

11. SUBSEQUENT EVENTS

In August 2001, we announced a restructuring and our intention to reduce our workforce by approximately 8 percent, or approximately 200 employees. The action is required to properly align and manage the business commensurate with our current revenue levels. As a result of this planned workforce reduction, we expect to incur a one-time charge of approximately \$6,000 to \$8,000 for severance and other related costs in the quarter ending October 26, 2001.

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

In addition to historical information, this Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These statements may contain words such as "expects," "anticipates," "intends," "plans," "believes," "estimates," or other words indicating future results. These forward-looking statements are subject to certain risks and uncertainties that could cause actual results to differ materially from those reflected in the forward-looking statement. Factors that could cause or contribute to such differences include, but are not limited to, those discussed in the following 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 for the year ended April 27, 2001. We undertake no obligation to revise or publicly release the results of any revision to these forward-looking statements. Given these risks and uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements.

OVERVIEW

We pioneered the concept of the "network appliance" for storage, an extension of the industry trend toward dedicated, specialized products that perform a single function. Our storage and content delivery platforms (filers and NetCache(R) appliances) are coupled with content distribution and reporting software. This Center-to-Edge(TM) solution offers seamless data management from the back-end data center to the edge of the network quickly, simply, and reliably. The Network Appliance product portfolio utilizes our innovative data access software, known as the Data ONTAP(TM) operating system, as well as standards-compliant hardware. It also offers multiprotocol support and integration for UNIX(R) and Windows(R) environments.

RECENT EVENT

In August 2001, we announced a restructuring and our intention to reduce our workforce by approximately 8 percent, or approximately 200 employees. The action is required to properly align and manage the business commensurate with our current revenue levels. As a result of this planned workforce reduction, we expect to incur a one-time charge of approximately \$6 million to \$8 million for severance and other related costs in the quarter ending October 26, 2001.

RESULTS OF OPERATIONS

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

	THREE MONTHS ENDED	
	JULY 27, 2001	JULY 28, 2000
Net sales	100.0 %	100.0 %
Cost of sales	43.9	38.7
Gross margin	56.1	61.3

Operating expenses:		
Sales and marketing	35.8	27.6
Research and development	14.5	10.2
General and administrative	5.1	3.8
Amortization of intangible assets	2.6	0.3
In-process research and development	--	11.6
Stock compensation	1.4	0.2
	-----	-----
Total operating expenses	59.4	53.7
	-----	-----
Income (loss) from operations	(3.3)	7.6
Total other income, net	2.8	1.9
	-----	-----
Income (loss) before income taxes	(0.5)	9.5
Provision (benefit) for income taxes	(0.2)	7.4
	-----	-----
Net income (loss)	(0.3)%	2.1 %
	=====	=====

Net Sales -- Net sales decreased by 13.3% to \$200.4 million for the three-month period ended July 27, 2001, from \$231.2 million for the three-month period ended July 28, 2000. The decline in net sales was due to a decrease in sales to Internet-based companies and weak capital spending among technology companies, primarily in North America. This decrease in net sales was specifically attributable to a lower volume of units shipped, as compared to the corresponding period of the prior fiscal year.

Factors negatively impacting net sales include:

- reduced demand for our products resulting from deteriorating macro economic conditions;
- smaller orders from enterprise customers as infrastructure deployments are slowly ramping up;
- continued weakness in technology spending from Internet- and technology-related customers;
- slower sales from low-end filer product;
- decreased sales through indirect channels, including sales through our OEM partners, representing 19.0% and 26.6% of total net sales for the first quarter of fiscal 2002 and 2001, respectively;
- reduced revenue from software licenses;
- declining average selling price of the F700 filers and older caching products; and
- declining unit sales of our older products.

Net sales were favorably impacted by the following factors:

- competitive pricing and aggressive discounting;
- a higher average selling price of our new products: higher capacity F840, mid-range F820 and entry-level F85 filer products as well as new NetCache appliances and software features;
- Center-to-Edge data fabric solutions that bundle filers with caching and content delivery software providing for enterprise storage infrastructure;

- increased revenue and units shipped from our new content delivery solutions, including new NetCache platforms C6100, C3100 and C1105 and new NetCache software;

- competitive pricing advantage offered by the Total Cost of Ownership (TCO) proposition in four aspects: lower acquisition cost, reduced administrative overhead, minimized service cost and reduced downtime of critical business applications;
- data management and content delivery software offering a unique set of features to ensure mission-critical availability, while reducing the complexity of enterprise storage management;
- higher software subscription and service revenues to support a growing installed base;
- increased add-on software revenue from Multi-Protocol solutions; and
- expansion of our sales organization to 1,009 as of July 27, 2001 from 704 as of July 28, 2000.

International net sales (including United States exports) grew by 6.9% and 157.3% for the three months ended July 27, 2001 and July 28, 2000, respectively. International net sales were \$78.1 million, or 39.0% of total net sales, and \$73.1 million, or 31.6% of total net sales, for the three-month periods ended July 27, 2001 and July 28, 2000, respectively. The moderate increase in international sales for the three months ended July 27, 2001 was primarily a result of our increased sales and marketing efforts internationally offset by a slower demand in Europe and Asia Pacific markets, as compared to the three months ended July 28, 2000. 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 believe our international net sales will not increase in fiscal 2002 at the rate at which they grew in fiscal 2001.

Gross Margin -- Gross margin decreased to 56.1% for the three-month period ended July 27, 2001 from 61.3% for the three-month period ended July 28, 2000.

Gross margin was negatively impacted by:

- the decrease in product sales volume;
- sales price reductions due to competitive pricing pressure;
- pricing discounts;
- lower of cost or market adjustments to inventory;
- reduced licensing of add-on software options such as Cluster Failover, SnapMirror(TM), SnapRestore(TM) and SnapManager(TM), partially offset by increased licensing of new NetCache software, including ContentReporter(TM) and ContentDirector(TM);
- higher disk content with an expanded storage capacity for the higher-end filers including the F840 filer; and
- increased investments in customer service.

Gross margin was favorably impacted by:

- lower costs of key components;
- higher average selling prices for our new products;
- cost control and reduction efforts, including a one week facility shutdown; and
- growth in software subscriptions due primarily to a larger installed base.

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 12.3% to \$71.6 million for the three-month period ended July 27, 2001 from \$63.8 million for the three-month periods ended July 28, 2000. These expenses were 35.8% and 27.6% of net sales for the three-month periods ended July 27, 2001 and July 28, 2000, respectively. The increase in absolute dollars was primarily related to the continued worldwide investment in our sales and customer service organizations

and continued spending in various marketing and industry initiatives, partially offset by various cost control and reduction measures, lower commission expenses and other profit-dependent payroll related expenses. Sales and marketing headcount increased to 1,316 at July 27, 2001 from 916 at July 28, 2000. We expect to continue to selectively add sales capacity in an effort to expand domestic and

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international markets, introduce new products, establish and expand new distribution channels and increase product and company awareness. We do not expect to increase our sales and marketing expenses materially in fiscal 2002.

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 increased 23.1% to \$29.1 million for the three-month period ended July 27, 2001 from \$23.6 million for the three-month period ended July 28, 2000. These expenses represented 14.5% and 10.2% of net sales for the three-month periods ended July 27, 2001 and July 28, 2000, respectively. Research and development expenses increased in absolute dollars, primarily as a result of increased headcount, the operating impact of the Orca and WebManage acquisitions, ongoing support of current and future product development and enhancement efforts, prototyping expenses and non-recurring engineering charges associated with the development of new products and technologies, partially offset by cost control, reduction in discretionary spending efforts and lower profit-related payroll and related costs. Research and development headcount increased to 567 at July 27, 2001 from 381 at July 28, 2000.

During the first quarter of fiscal 2002, we continued our enterprise focus by introducing new Center-to-Edge solutions for global Information Technology (IT) infrastructures, offering greater data availability and enhanced disaster recovery:

- NetApp(R) DataFabric(TM) Manager, a software package for global enterprise and content delivery network deployments allowing IT staff to monitor and configure multiple storage and content delivery appliances throughout a network;
- new Fibre Channel Fabric Tape Storage Area Network (SAN) Backup solutions, along with leading data protection companies, underscoring our open storage networking approach to data management;
- DiskShelf14, a new 14-slot Fibre Channel disk drive shelf that holds up to one terabyte of data. Customers will benefit from the increased data storage and performance densities, which help to lower their overall cost of storage;
- SnapManager 1.1 for Microsoft(R) Exchange 5.5 environments, a new version of the industry-leading online backup and rapid data recovery solution. SnapManager 1.1 simplifies data management by providing near instantaneous on-line backup and recovery, faster response times, and enhanced Windows(R) 2000 support;
- SecureShare(R) Quota Manager 2.0, a graphical user interface tool to centrally manage and control hard and soft quotas on thousands of Microsoft Windows NT(R)/2000 versions working with many NetApp filers. The solution is based on the Microsoft Management Console standard interface, and allows for a single point of control across multiple filers.

We believe that our future performance will depend in large part on our ability to maintain and enhance our current product line, develop new products that achieve market acceptance, maintain technological competitiveness and meet an expanding range of customer requirements. We intend to continuously expand our existing product offerings and introduce new products and expect that such expenditures will continue to increase moderately in absolute dollars. For the three-month periods ended July 27, 2001 and July 28, 2000, no software development costs were capitalized.

General and Administrative -- General and administrative expenses

increased 15.6% to \$10.3 million for the three-month period ended July 27, 2001, from \$8.9 million for the three-month period ended July 28, 2000. These expenses represented 5.1% and 3.8% of net sales for the three-month periods ended July 27, 2001 and July 28, 2000, respectively. Increases in absolute dollars were primarily due to increased headcount, expenses associated with initiatives to enhance enterprise-wide management information systems and an increase in the allowance for bad debts, partially offset by cost control, reduction in discretionary spending efforts and lower profit-dependent personnel and other expenses. General and administrative headcount increased to 261 at July 27, 2001 from 181 at July 28, 2000. We believe that our general and administrative expenses will not increase significantly in absolute dollars in fiscal 2002.

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Amortization of Intangible Assets -- Amortization of intangible assets represents the amortization on acquired intangible assets and the excess of the aggregate purchase price over the fair value of the tangible and identifiable intangible assets acquired by us. Intangible assets as of July 27, 2001, including goodwill, existing workforce and technology, are being amortized over estimated useful lives of three to five years. We assess the recoverability of intangible assets by determining whether the amortized asset over its useful life may be recovered through estimated useful cash flows. Amortization of intangible assets charged to operations increased due to a full quarter impact of the acquisitions occurring in fiscal 2002 and was \$5.2 million and \$0.7 million in the first quarter of fiscal 2002 and 2001, respectively.

In-process Research and Development -- We incurred in-process research and development charges of approximately \$26.7 million in the first quarter of fiscal 2001 related to the acquisition of Orca. The purchase price of the transaction was allocated to the acquired assets and liabilities based on their estimated fair values as of the date of the acquisition. Approximately \$26.7 million was allocated to in-process research and development and charged to operations, because the acquired technology had not reached technological feasibility and had no alternative uses. The value was determined by estimating the costs to develop the acquired in-process technology into commercially viable products, estimating the resulting net cash flows from such projects, and discounting the net cash flows back to their present value. The discount rate included a factor that took into account the uncertainty surrounding the successful development of the acquired in-process technology. These estimates are subject to change, given the uncertainties of the development process, and no assurance can be given that deviations from these estimates will not occur. Excluding the charge that may result from the remaining 198,373 contingently issuable common shares, research and development costs to bring the products from Orca to technological feasibility are not expected to have a material impact on our future results of operations or financial condition. Costs incurred prior to establishment of technological feasibility are charged to research and development expense and have not been material through July 27, 2001.

We believe we can utilize the Orca acquisition to develop the first virtual interface-based (VI) next generation of network storage systems. We are leveraging VI architecture to develop the Direct Access File System (DAFS) protocol. DAFS, as a file access protocol, reduces application server workloads by eliminating the need for meta-data transfers and bypassing the overhead found in traditional network protocol stacks. More importantly it leverages next generation network capabilities such as remote direct memory access (RDMA) that are found in VI and InfiniBand. We expect to continue the development of products using this protocol and believe that there is a reasonable chance of successfully delivering initial products in early calendar year 2002. However, there is risk associated with the completion of the in-process project and there can be no assurance that such project will meet with either technological or commercial success. Failure to successfully develop and commercialize this in-process project would result in the loss of the expected economic return inherent in the fair value allocation. Additionally, the value of other intangible assets acquired may become impaired. The risks associated with the research and development are still considered high and no assurance can be made that upcoming products will meet market expectations or gain market acceptance.

Stock Compensation -- We account for stock-based employee compensation arrangements in accordance with provisions of APB No. 25, "Accounting for Stock Issued to Employees," and comply with the provisions of SFAS No. 123,

"Accounting for Stock-Based Compensation," for non-employee compensation awards. Accordingly, we recognize the intrinsic value for employees and the fair value for non-employees as stock compensation expense over the vesting terms of the awards. Stock compensation expenses were \$2.7 million and \$0.4 million in the first quarter of fiscal 2002 and 2001, respectively. This increase was primarily attributable to the recognition of stock compensation on options assumed in the WebManage acquisition, the issuance of 66,124 contingently issuable milestones shares relating to Orca valued at \$1.4 million, increased participation in the salaried stock option grant program by certain highly compensated employees and non-employee stock options awards.

Total Other Income, net -- Total other income, net, was \$5.5 million and \$4.4 million for the three-month periods ended July 27, 2001 and July 28, 2000, respectively. The increase is attributable to increased interest income primarily due to higher average investment balances from cash, short-term investments and restricted cash generated from operations and net proceeds from stock option exercises,

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partially offset by lower average interest rates. We expect interest income to moderately decline in future quarters in fiscal 2002, as existing investments mature and proceeds are reinvested in a lower interest-rate environment.

Provision (Benefit) for Income Taxes -- For the three-month period ended July 27, 2001, we applied an annual rate of 52% to pretax income. Our estimate is based on existing tax laws and our current projections of income and distributions of income among different entities and tax jurisdictions, and is subject to change, based primarily on varying levels of profitability.

LIQUIDITY AND CAPITAL RESOURCES

As of July 27, 2001, as compared to the April 30, 2001 balances, our cash, cash equivalents and short-term investments increased by \$4.6 million to \$368.7 million. Working capital increased by \$20.2 million to \$437.0 million. We generated cash from operating activities totaling \$5.9 million and \$63.8 million for the three-month periods ended July 27, 2001 and July 28, 2000, respectively. Net cash provided by operating activities for the three-month period ended July 27, 2001 was principally related to decreases in accounts receivable and deferred income taxes and increases in other accrued liabilities, coupled with depreciation, amortization of intangibles and stock compensation, partially offset by net loss of \$0.5 million, decreases in accounts payable, income taxes payable, accrued compensation and related benefits, deferred revenue and increases in inventories and prepaid expenses and other assets.

The primary factors that impacted the period-to-period change in cash flows relating to operating activities included the following:

- lower accounts receivable balances due to lower sales and more collections in the first quarter of fiscal 2002;
- non-cash acquisition-related charges, stock compensation and depreciation included in net income (loss).

The above factors were partially offset by the effects of:

- decreased balances for accounts payable and deferred revenue due to lower levels of business activity in the first quarter of fiscal 2002;
- decreased accrued compensation and related benefits due to payouts of profit dependent personnel expenses accrued in fiscal 2001 and paid in fiscal 2002, vacation taken during a July 2001 facility shutdown and lower commission accrual as a result of lower levels of sales;
- decreased income taxes payable, primarily reflecting lower profitability in fiscal 2002;
- lower net income in the first quarter of fiscal 2002.

Since we have curtailed capital expenditures, purchases of property and equipment were only \$6.8 million in the first quarter of fiscal 2002, compared to \$21.0 million the same period a year ago. The decrease was primarily attributed to the slowdown in hiring and various cost control and cutting measures. We have used \$38.5 million and \$6.6 million during the three-month periods ended July 27, 2001 and July 28, 2000, respectively, for net purchases of short-term investments. In the first quarter of fiscal 2001, we acquired Orca for a purchase price of approximately \$50.0 million, including common stock, contingently issuable common stock, assumed options, cash payments of \$2.0 million and related transaction costs. Investing activities in the three-month period ended July 27, 2001 also included new equity investments of \$0.2 million.

We have received \$6.9 million and \$19.7 million during the three-month periods ended July 27, 2001 and July 28, 2000, respectively, from financing activities, primarily from the sale of common stock. The decrease in cash provided by sales of common stock for the three-month period ended July 27, 2001, compared to the corresponding period of the prior fiscal year, was primarily due to lower stock option exercise proceeds as a result of the recent decline in our stock price. This decrease was partially offset by a

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greater number of employees participating in the employee stock purchase plan and an increase in restricted cash. See "Commitments, Note 9 to the Notes to the Condensed Consolidated Financial Statements."

Excluding the commitments related to operating lease arrangements for various properties in our Sunnyvale headquarters, which aggregate \$309.0 million, we currently have no significant commitments other than commitments under operating leases. We believe that our existing liquidity and capital resources, including the available amounts under our \$5.0 million line of credit, are sufficient to fund our operations for at least the next twelve months. We may also investigate other financing alternatives; however, we cannot be certain that additional financing will be available on satisfactory terms.

NEW ACCOUNTING STANDARDS

In June 2001, the Financial Accounting Standards Board issued SFAS No. 141, "Business Combinations," and SFAS No. 142, "Goodwill and Other Intangible Assets". Under SFAS No. 141, all business combinations initiated after June 30, 2001 must be accounted for using the purchase method. Under SFAS No. 142, goodwill and intangible assets with indefinite lives are no longer amortized but are reviewed annually for impairment (or more frequently if indicators of impairment arise). Separable intangible assets that are not deemed to have indefinite lives will continue to be amortized over their useful lives (but with no maximum life). The amortization provisions of SFAS No. 142 apply to goodwill and intangible assets acquired after June 30, 2001. With respect to goodwill and intangible assets acquired prior to July 1, 2001, we are required to adopt SFAS No. 142 effective April 27, 2002. Upon adoption of SFAS No. 142, we will stop the amortization of goodwill with a net carrying value of approximately \$48,912 at April 26, 2002 and the annual amortization of \$14,575 that resulted from business combinations initiated prior to the adoption. We will evaluate goodwill under the SFAS No. 142 transitional impairment test. Any transitional impairment loss will be recognized as a change in accounting principle on the date of adoption. If any impairment of goodwill is recognized prior to the date of adoption, the loss will be charged to operating expenses.

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.

Although we have experienced significant revenue growth in recent

periods prior to the third quarter of fiscal 2001, this growth may not be indicative of our future operating results. As a result, 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:

- general economic trends;
- global trends related to Information Technology spending;
- demand for storage and content delivery products;
- the level of competition in our target product markets;
- the size, timing, and cancellation of significant orders;
- product configuration and mix;
- market acceptance of new products and product enhancements;
- new product announcements or introductions by us or our competitors;
- deferrals of customer orders in anticipation of new products or product enhancements;
- changes in pricing by us or our competitors;
- our ability to develop, introduce, and market new products and enhancements in a timely manner;

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- supply constraints;
- technological changes in our target product markets;
- the levels of expenditure on research and development and expansion of our sales and marketing programs; and
- seasonality.

In addition, sales for any future quarter may vary and accordingly be inconsistent with our plans. We generally operate with limited order backlog because our products are typically shipped shortly after orders are received. As a result, product sales in any quarter are generally dependent on orders booked and shipped in that quarter. Product sales are also difficult to forecast because the network 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, as has been the case through the last two quarters of fiscal 2001 and first quarter of fiscal 2002. In such event, the trading price of our common stock would likely decrease.

OUR GROSS MARGINS MAY VARY BASED ON THE CONFIGURATION OF OUR PRODUCTS.

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

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

- demand for storage and content delivery products;
- discount levels and price competition;
- direct versus indirect sales;
- the mix of software as a percentage of revenue;
- the mix and average selling prices of products;
- new product introductions and enhancements; 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, as has been the case through the second half of fiscal 2001 and the first quarter of fiscal 2002, net income will be disproportionately affected.

OUR FUTURE FINANCIAL PERFORMANCE DEPENDS ON GROWTH IN THE NETWORK STORAGE AND CONTENT DELIVERY MARKET 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 market. Accordingly, our future financial performance will depend in large part on continued growth in the storage and content delivery market and on emerging standards in these markets. We cannot assure you that the market 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 NT and the World Wide Web server markets. 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 has resulted in decreased revenues or 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 network storage and content delivery based on emerging standards other than those adopted by us become increasingly accepted by the market, 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 been volatile 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;
- 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; and

- changes in our relationships with our suppliers, customers and strategic partners.

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 macro economic factors such as changes in interest rates as well as market climate for the high technology sector 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.

THE SUCCESS OF OUR NETCACHE APPLIANCE PRODUCTS DEPENDS UPON MARKET ACCEPTANCE OF CACHING TECHNOLOGY AND CONTINUED GROWTH IN THE CONTENT DELIVERY MARKET.

In late 1997, we released our NetCache appliance products, a new category of hardware-based Internet caching appliances designed to speed and manage the delivery of information stored on the Web. However, hardware-based caching technology is still developing.

Our future financial performance will depend in part on the acceptance of caching technology and the acceptance of our NetCache appliance products. We cannot assure you that the caching appliance market will continue to grow at previous rates or at all.

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, 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 sub-systems 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.

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 three-month periods ended July 27, 2001 and July 28, 2000, approximately 39.0% and 31.6% of our net sales, respectively, were to 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 and government spending patterns.

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. We believe our net sales will not increase in fiscal 2002 at the rate at which they grew in fiscal 2001.

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, Compaq Computer Corporation, Sun Microsystems, Inc., Hewlett-Packard Company, and IBM Corporation. We also encounter less frequent competition from companies including MTI Corp., Procom Technology, LSI Logic Corp., and Auspex Systems, Inc.

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., CacheFlow, Inc., Inktomi Corp., Akamai Technologies, Inc., and Volera.

This past year has seen an increasing number of new, privately held companies 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 but are not limited to:

- Response time and performance
- Scalability
- Data availability
- Multiprotocol data sharing

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- Acquisition price and low overall total cost of ownership
- Ease-of-use and deployment
- Customer service and support

Although we believe that our products currently compete favorably with

respect to these factors, we can not 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.

In the future, we intend to increasingly rely on contract manufacturers to assemble our products. If our contract manufacturers' operations were interrupted for any reason, our ability to meet scheduled product deliveries to customers would be materially adversely affected.

Component quality is particularly significant with respect to our supplier 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.

WE CANNOT ASSURE YOU THAT WE WILL NOT INCUR PROBLEMS WITH CURRENT OR FUTURE EQUITY INVESTMENTS AND ACQUISITIONS OR THAT WE WILL REALIZE VALUE FROM SUCH STRATEGIC RELATIONSHIPS.

We are continuously evaluating alliances and external investment in technologies related to our business. We have already made relatively small strategic investments in a number of network storage related technology companies and acquired two companies since the beginning of fiscal 2001. Equity investments may result in the loss of investment capital. Acquisitions of companies or products and alliances and strategic investments entail numerous risks, and we cannot assure you that we will 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 DISTRIBUTORS AND ACCORDINGLY THERE IS A RISK THAT THOSE DISTRIBUTORS MAY GIVE HIGHER PRIORITY TO PRODUCTS OF OTHER SUPPLIERS, WHICH COULD MATERIALLY ADVERSELY AFFECT OUR OPERATING RESULTS.

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

UNDETECTED SOFTWARE ERRORS OR FAILURES FOUND IN NEW PRODUCTS MAY RESULT IN LOSS OF OR DELAY IN MARKET ACCEPTANCE OF OUR PRODUCTS WHICH COULD MATERIALLY ADVERSELY AFFECT OUR OPERATING RESULTS.

Our products may contain undetected software 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. Other United States trademarks and some of the other 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 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.

PROTECTIVE ANTI-TAKEOVER PROVISIONS IN OUR CHARTER AND BYLAWS COULD MATERIALLY ADVERSELY AFFECT STOCKHOLDERS.

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Our Board of Directors has the authority to issue up to 5,000,000 shares of preferred stock and to determine the price, rights, preferences, privileges and restrictions, including voting rights, of those shares without any further vote or action by the shareholders. The rights of the holders of common stock will be subject to, and may be materially adversely affected by, the rights of the holders of any preferred stock that may be issued in the future. The issuance of preferred stock could have the effect of making it more difficult for a third party to acquire a majority of our outstanding voting stock. Further, certain provisions of our bylaws pertaining to the future elimination of cumulative voting and shareholder action by written consent could delay or make more difficult a proxy contest involving us, which could materially adversely affect the market price of our common stock.

WE RELY ON A CONTINUOUS POWER SUPPLY AND ANY POWER SHORTAGE COULD INTERRUPT OUR MANUFACTURING OPERATIONS AND COULD MATERIALLY ADVERSELY AFFECT OUR OPERATING RESULTS.

California is in the midst of an energy crisis that could disrupt our operations and increase our expenses. In the event of an acute power shortage, that is, when power reserves for the State of California fall below certain critical levels, California has on some occasions implemented, and may in the future continue to implement, rolling blackouts. We currently have limited backup generators or alternate sources of power in the event of a blackout, and our current insurance does not provide coverage for any damages we or our customers/suppliers may suffer as a result of any interruption in our power supply. If blackouts interrupt our power supply or our suppliers' power supply, we could be temporarily unable to continue operations at our California facilities. Any such interruption in our ability to continue operations at our facilities or our suppliers' facilities to manufacture products could damage our reputation, harm our ability to retain existing customers and to obtain new customers, and could result in lost revenue, any of which could materially adversely affect our operating results.

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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 July 27, 2001, we had short-term investments of \$129.4 million. Our investment portfolio consists of highly liquid investments with original maturities at the date of purchase between three and twelve months and investment in marketable equity securities in certain 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 July 27, 2001, would cause the fair value of these short-term investments to decline by an immaterial amount. 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.

Operating Lease Commitments -- As of July 27, 2001, we have outstanding lease commitments to a third-party entity under operating lease agreements, which vary based on a monthly LIBOR rate plus a spread. A hypothetical 10 percent increase in interest rates would increase our annual rent expense under operating lease commitments by approximately \$1.3 million. Increases in interest rates could, however, increase our rent expenses associated with future lease payments. We do not currently hedge against interest rate increases. Our investment portfolio offers a natural hedge against interest rate risk from our operating lease commitments in the event of a significant increase in the market interest rate. Moreover, a total of \$195.3 million in operating leases are collateralized with investments that have similar, and thus offsetting, interest rate characteristics.

Market Price Risk

Equity Securities -- We are also exposed to market price risk on our equity securities included in our short-term investments. These investments are in publicly traded companies in the volatile high-technology industry sector. 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 these investments in future periods may vary materially from the current unrealized amount. A 50% adverse change in the equity price would result in an approximate \$4.2 million decrease in the fair value of our equity securities as of July 27, 2001.

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.

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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.

The following table provides information about our foreign exchange forward contracts outstanding on July 27, 2001, (in thousands):

CURRENCY	BUY/ SELL	FOREIGN CURRENCY AMOUNT	CONTRACT VALUE USD	FAIR VALUE IN USD
AUD	Sell	5,911	\$ 2,978	\$ 2,983
CHF	Sell	1,539	\$ 895	\$ 895
GBP	Sell	13,235	\$18,817	\$18,840
EUR	Sell	47,465	\$41,409	\$41,437

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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

None

(b) REPORTS ON FORM 8-K

None

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SIGNATURE

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

NETWORK APPLIANCE INC.
(Registrant)

/s/ JEFFRY R. ALLEN

Jeffry R. Allen
Executive Vice President Finance and
Operations, and Chief Financial Officer

Date: September 10, 2001

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