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 26, 2002

or

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

For the transition period from to

Commission File Number 0-27130

Network Appliance, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**77-0307520**
(State or other jurisdiction of incorporation or organization)	*(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 common stock, $.001 par value, as of the latest practicable date.

Class	Outstanding at July 26, 2002
Common Stock	336,507,299

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PART I. FINANCIAL INFORMATION

Item 1. *Condensed Consolidated Financial Statements*

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands — unaudited)

	July 26, 2002	April 30, 2002
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 251,737	$ 210,756
Short-term investments	227,104	243,371
Accounts receivable, net of allowances of $6,596 at July 26, 2002 and $8,416 at April 30, 2002	140,386	146,511
Inventories	28,280	23,849
Prepaid expenses and other	24,977	22,112
Deferred income taxes	32,122	32,529
Total current assets	704,606	679,128
Property and Equipment, net	349,205	345,195
Goodwill	49,422	49,422
Intangible Assets, net	7,046	8,828
Other Assets	29,450	26,233
	$1,139,729	$1,108,806
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 40,784	$ 40,243
Income taxes payable	21,840	17,073
Accrued compensation and related benefits	25,277	36,912
Other accrued liabilities	45,611	45,193
Deferred revenue	80,485	76,139
Total current liabilities	213,997	215,560
Long-Term Deferred Revenue	34,879	31,036
Long-Term Obligations	3,617	3,734
Total liabilities	252,493	250,330
Stockholders' Equity:		
Common stock	337	335
Additional paid-in capital	667,149	656,619
Deferred stock compensation	(3,017)	(3,777)
Retained earnings	223,830	207,665
Cumulative other comprehensive loss	(1,063)	(2,366)
Total stockholders' equity	887,236	858,476
	$1,139,729	$1,108,806

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 26, 2002	July 27, 2001
Revenues		
Product revenue	$186,740	$185,460
Service revenue	20,088	14,966
Total revenues	206,828	200,426
Cost of Revenues		
Cost of product revenue	62,269	75,383
Cost of service revenue	15,458	12,694
Total cost of revenues	77,727	88,077
Gross margin	129,101	112,349
Operating Expenses:		
Sales and marketing	71,902	71,642
Research and development	27,868	29,083
General and administrative	7,438	10,262
Amortization of goodwill and intangible assets	1,386	5,226
Stock compensation(1)	983	2,699
Total operating expenses	109,577	118,912
Income (Loss) from Operations	19,524	(6,563)
Other Income (Expense), net:		
Interest income	3,151	5,482
Other income (expense), net	(1,000)	12
Impairment loss on investment	(726)	—
Gain on sale of intangible asset	604	—
Total other income, net	2,029	5,494
Income (Loss) Before Income Taxes	21,553	(1,069)
Provision (Benefit) for Income Taxes	5,388	(556)
Net Income (Loss)	$ 16,165	$ (513)
Net Income per Share:		
Basic	$ 0.05	$ (0.00)
Diluted	$ 0.05	$ (0.00)
Shares Used in per Share Calculations:		
Basic	335,783	329,336
Diluted	350,122	329,336

(1) Stock compensation includes:

Sales and marketing	$572	$ 313
Research and development	324	2,243
General and administrative	87	143
	$983	$2,699

See accompanying notes to condensed consolidated financial statements.

NETWORK APPLIANCE, INC.

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

	Three Months Ended	
	July 26, 2002	July 27, 2001
Cash Flows from Operating Activities:		
Net income (loss)	$ 16,165	$ (513)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation and amortization	11,599	10,614
Amortization of goodwill	—	3,794
Amortization of intangible assets	1,386	1,432
Stock compensation	983	2,699
Impairment loss on investments	726	—
Gain on sale of intangible asset	(604)	—
Provision for doubtful accounts	(1,455)	1,639
Deferred income taxes	(565)	3,927
Deferred rent	(1)	(12)
Changes in assets and liabilities:		
Accounts receivable	7,637	30,117
Inventories	(6,412)	(2,810)
Prepaid expenses and other assets	(4,733)	(4,567)
Accounts payable	541	(16,684)
Income taxes payable	4,767	(5,794)
Accrued compensation and related benefits	(11,635)	(24,306)
Other accrued liabilities	303	6,484
Deferred revenue	8,189	(142)
Net cash provided by operating activities	26,891	5,878
Cash Flows from Investing Activities:		
Purchases of short-term investments	(70,214)	(76,486)
Redemptions of short-term investments	88,744	38,018
Purchases of property and equipment	(14,425)	(6,822)
Purchase of equity securities	(325)	(150)
Net cash provided by (used in) investing activities	3,780	(45,440)
Cash Flows from Financing Activities:		
Proceeds from sale of common stock, net	10,310	13,154
Increase in restricted cash	—	(6,236)
Net cash provided by financing activities	10,310	6,918
Net Change in Cash and Cash Equivalents	40,981	(32,644)
Cash and Cash Equivalents:		
Beginning of period	210,756	271,931
End of period	$251,737	$239,287
Noncash Investing and Financing Activities:		
Deferred stock compensation, net of reversals	$ (124)	$ (11)
Conversion of evaluation inventory to fixed assets	2,268	1,321
Milestone shares issued	—	1,434
Supplemental cash flow information:		
Income taxes paid	1,697	62

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 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 instructions to Form 10-Q and Article 10 of Regulation S-X. 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 30, 2002. The results of operations for the three-months ended July 26, 2002 are not necessarily indicative of the operating results to be expected for the full fiscal year or future operating periods.

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

3. Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. 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 (as amended by SOP 98-4 and SOP 98-9), and related interpretations to all revenue transactions. We recognize revenue when:

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

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

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in thousands, except per-share data — unaudited)

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

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

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

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

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

	Three Months Ended	
	July 26, 2002	July 27, 2001
Revenues:		
Products	83.1%	86.7%
Software subscriptions	7.2%	5.8%
System products and software subscriptions	90.3%	92.5%
Services	9.7%	7.5%
Total revenues	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 12 — Restructuring Charges for further discussion.

Loss Contingencies

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

Impairment Losses on Investments

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

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

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in thousands, except per-share data — unaudited)

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:

	July 26, 2002	April 30, 2002
Purchased components	$16,732	$11,870
Work in process	220	1,431
Finished goods	11,328	10,548
	$28,280	$23,849

6. Balance Sheet Components

Property and Equipment

	July 26, 2002	April 30, 2002
Land	$158,636	$158,636
Buildings and building improvements	84,822	84,621
Leasehold improvements	12,768	12,304
Computers, related equipment and purchased software	131,384	123,164
Furnitures	18,598	18,327
Construction in progress	31,052	24,597
	437,260	421,649
Accumulated depreciation and amortization	(88,055)	(76,454)
	$349,205	$345,195

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in thousands, except per-share data — unaudited)

7. Intangible Assets

Balances are summarized as follows:

	July 26, 2002			April 30, 2002		
	Gross Assets	Accumulated Amortization	Net Assets	Gross Assets	Accumulated Amortization	Net Assets
Intangible assets:						
Existing technology	$ 16,365	$ (9,319)	$7,046	$ 17,179	$ (8,351)	$8,828

Existing technology is amortized over three years and total amortization expense for existing technology was $1,386 and $1,432 for the three months ended July 26, 2002, and July 27, 2002, respectively.

8. 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. During the first quarter of fiscal 2002, under terms of the acquisition agreement with Orca Systems, Inc. (“Orca”), we released 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. In the first quarter of fiscal 2003, no stock compensation was recorded relating to Orca achieving their performance milestones.

During the first quarter of fiscal 2003, we recorded $346 in compensation expense 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.

9. 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 first quarter of fiscal 2003, net gains generated by hedged assets and liabilities totaled $3,988, which were offset by losses on the related derivative instruments of $4,928. For the first quarter 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.

Currently, we do not enter into any foreign exchange forward contracts to hedge exposures related to forecasted transactions, firm commitments or equity investments.

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in thousands, except per-share data — unaudited)

10. Earnings Per Share

Basic net income per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for that period. Diluted net income per share is computed giving effect to all dilutive potential shares that were outstanding during the period. Dilutive 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 three months ended July 27, 2001 due to the net loss reported in that period and in the three months ended July 26, 2002 as the options' exercise prices were above the average market prices in that period. For the three months ended July 26, 2002 and July 27, 2001, 44,237 and 73,945 shares of common stock options with a weighted average exercise price of $32.55 and $21.48, respectively, were excluded from the diluted net income per share computation.

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

	Three Months Ended	
	July 26, 2002	July 27, 2001
Net Income (Loss) (Numerator):		
Net income (loss), basic and diluted	$ 16,165	$ (513)
Shares (Denominator):		
Weighted average common shares outstanding	335,911	329,550
Weighted average common shares outstanding subject to repurchase	(128)	(214)
Shares used in basic computation	335,783	329,336
Weighted average common shares outstanding subject to repurchase	128	—
Common shares issuable upon exercise of stock options	14,211	—
Shares used in diluted computation	350,122	329,336
Net Income (Loss) Per Share:		
Basic	$ 0.05	$ (0.00)
Diluted	$ 0.05	$ (0.00)

11. Comprehensive Income (Loss)

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

	Three Months Ended	
	July 26, 2002	July 27, 2001
Net income (loss)	$16,165	$ (513)
Foreign currency translation adjustment	344	(263)
Net gain (loss) on investments	959	(716)
Comprehensive income (loss)	$17,468	$(1,492)

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in thousands, except per-share data — unaudited)

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

	Three Months Ended	
	July 26, 2002	April 30, 2002
Cumulative translation adjustments	$(1,858)	$(2,202)
Unrealized gain (loss) on investments	795	(164)
Total accumulated other comprehensive loss	$(1,063)	$(2,366)

12. 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 $508 at July 26, 2002 was included in other accrued liabilities.

During fiscal 2002, we purchased our Sunnyvale headquarters site and terminated the operating leases. As a result, an adjustment was made to reduce the previously recorded estimated facilities lease losses by $1,509.

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

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

In April 2002, we completed a restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters. As a result of this restructuring, we incurred a charge of $5,850. 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 July 26, 2002, $814 was included in other accrued liabilities and the remaining $3,540 was classified as long-term obligations.

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in thousands, except per-share data — unaudited)

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

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

13. Short-Term Investments

All our investments are classified as available for sale at July 26, 2002 and April 30, 2002. Available-for-sale investments 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.

14. 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 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.

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in thousands, except per-share data — unaudited)

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

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

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 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.

15. 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 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 July 26, 2002, there was no such amount. 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

NETWORK APPLIANCE, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Dollar and share amounts in thousands, except per-share data — unaudited)

$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 are 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.

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 for the year ended April 30, 2002. We undertake no obligation to revise or update publicly any forward-looking statements for any reason.

Overview

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

Code of Business Conduct and Ethics

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

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States of America requires management to make judgments, assumptions and estimates that affect the amounts reported in the Consolidated Financial Statements and accompanying notes. Note 2 to the Consolidated Financial Statements in the Annual Report on Form 10-K 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 Statement of Position ("SOP") 97-2, "Software Revenue Recognition" (as amended by SOP 98-4 and SOP 98-9), and related interpretations to all revenue transactions. We recognize revenue when:

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

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

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

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

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

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

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

Allowance for Doubtful Accounts

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

Inventory Write-down

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

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

Restructuring Accruals

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

Loss Contingencies

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

Impairment Losses on Investments

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

Accounting for Income Taxes

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

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

New Accounting Standards

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

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

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

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

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

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

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

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

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

Product revenues were favorably impacted by the following factors:

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

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

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

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

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

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

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

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

Product revenues were negatively impacted by the following factors:

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

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

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

• declining unit sales of our older products.

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

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

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

Product gross margin was favorably impacted by:

• lower costs of key components and subsystems;

• favorable product and software mix;

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

• higher average selling prices for our new products; and

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

Product gross margin was negatively impacted by:

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

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

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

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

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

Sales and Marketing — Sales and marketing expenses consist primarily of salaries, commissions, advertising and promotional expenses, and certain customer service and support costs. Sales and marketing expenses increased 0.4% to $71.9 million for the first quarter of fiscal 2003, from $71.6 million for the first quarter of fiscal 2002. These expenses were 34.7% and 35.8% of total revenues for the first quarter of fiscal 2003 and fiscal 2002, respectively. The slight increase in absolute dollars was attributed to the continued worldwide investment in our sales and customer service organizations, offset by the various cost control and reduction measures, restructuring impact, and a favorable impact from a change in health insurance estimates. Sales and marketing headcount decreased to 1,265 at July 26, 2002 from 1,316 at July 27, 2001 primarily due to the restructuring impact. We expect to continue to selectively add sales capacity in an effort to expand domestic and international markets, introduce new products, establish and expand new distribution channels, and increase product and company awareness. We expect to increase our sales and marketing expenses commensurate with future revenue growth.

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

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

We believe that our future performance will depend in large part on our ability to maintain and enhance our current product line, develop new products that achieve market acceptance, maintain technological competitiveness, and meet an expanding range of customer requirements. We intend to continuously expand our existing product offerings and introduce new products, and expect that expenditures for these purposes will increase in absolute dollars. For both the first quarter of fiscal 2003 and 2002, no software development costs were capitalized.

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

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

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

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

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

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

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

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

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

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

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

We expect annual cost savings of approximately $29.8 million as a result of the restructuring and reduction in force actions taken in the second and fourth quarters of fiscal 2002. Our estimates are reviewed and revised periodically and may change should different conditions prevail than were anticipated in original management estimates.

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

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

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

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

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

Liquidity and Capital Resources

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

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

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

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

Contractual Obligations

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

	2003	2004	2005	2006	2007	Thereafter	Total
Operating lease payments	$ 7,567	$8,137	$7,911	$4,722	$2,913	$122,546	$153,796
Venture capital funding commitments	850	1,133	1,133	1,134	—	—	4,250
Purchase commitments	3,365	—	—	—	—	—	3,365
	$11,782	$9,270	$9,044	$5,856	$2,913	$122,546	$161,411

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 or our competitors;
- our ability to develop, introduce, and market new products and enhancements in a timely manner;
- supply constraints;
- technological changes in our target product markets;
- the levels of expenditure on research and development and sales and marketing programs;
- our ability to achieve targeted cost reductions;
- excess facilities; and
- seasonality.

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

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

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

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

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

- demand for storage and content delivery products;
- discount levels and price competition;
- direct versus indirect sales;
- the mix of software as a percentage of revenue;
- the mix of services as a percentage of revenue;
- the mix and average selling prices of products;
- new product introductions and enhancements;
- 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 (SAN) 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 first quarter of fiscal 2003, approximately 37.5% 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., CacheFlow, 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.

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.

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 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. 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 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 July 26, 2002, we had short-term investments of $227.1 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 a technology company. 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 26, 2002, would cause the fair value of these short-term investments to decline by approximately $0.6 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 security included in our short-term investments. Such investment is in a publicly traded company 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.

We do not attempt to reduce or eliminate our market exposure on this security and, as a result, the amount of income and cash flow that we ultimately realize from this 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 July 26, 2002.

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 July 26, 2002, (in thousands):

Currency	Buy/Sell	Foreign Currency Amount	Contract Value USD	Fair Value in USD
AUD	Sell	5,219	$ 2,780	$ 2,788
CHF	Sell	3,603	$ 2,453	$ 2,451
EUR	Sell	37,000	$ 36,375	$36,427
GBP	Sell	10,720	$ 16,738	$16,766

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 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/ STEVEN J. GOMO

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

Date: August 29, 2002

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

CERTIFICATION OF CHIEF EXECUTIVE OFFICER

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 July 26, 2002 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, 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.

Dated: August 29, 2002

/s/ Daniel J. Warmenhoven

Daniel J. Warmenhoven
Chief Executive Officer

CERTIFICATION OF SENIOR VICE PRESIDENT OF FINANCE AND CHIEF FINANCIAL OFFICER

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 July 26, 2002 (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d), as applicable, 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.

Dated: August 29, 2002

/s/ Steven J. Gomo

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