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UNITED STATES 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 30, 2004

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 ☐

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

Number of shares outstanding of the registrant's common stock, $0.001 par value, as of the latest practicable date.

Class	Outstanding at July 30, 2004
Common Stock	357,676,696

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PART II — OTHER INFORMATION

PART I. FINANCIAL INFORMATION

Item 1. ***Condensed Consolidated Financial Statements (Unaudited)***

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands — unaudited)

	July 30, 2004	April 30, 2004
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 228,045	$ 241,149
Short-term investments	598,596	566,816
Accounts receivable, net of allowances of $4,917 at July 30, 2004 and $5,071 at April 30, 2004	199,746	193,942
Inventories	34,710	34,109
Prepaid expenses and other	39,290	29,057
Deferred income taxes	24,719	24,163
Total current assets	1,125,106	1,089,236
Property and Equipment, net	392,588	370,717
Goodwill	291,816	291,816
Intangible Assets, net	28,935	31,718
Other Assets	82,642	93,779
	$1,921,087	$1,877,266
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 51,691	$ 52,719
Income taxes payable	15,172	16,033
Accrued compensation and related benefits	50,866	65,186
Other accrued liabilities	46,775	43,683
Deferred revenue	182,801	166,602
Total current liabilities	347,305	344,223
Long-Term Deferred Revenue	126,355	112,337
Long-Term Obligations	4,787	4,858
Total liabilities	478,447	461,418
Stockholders' Equity:		
Common stock	367	364
Additional paid-in capital	1,166,580	1,138,158
Deferred stock compensation	(20,775)	(23,348)
Treasury stock	(183,914)	(136,172)
Retained earnings	483,086	436,224
Accumulated other comprehensive loss	(2,704)	622
Total stockholders' equity	1,442,640	1,415,848
	$1,921,087	$1,877,266

See accompanying notes to unaudited condensed consolidated financial statements.

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NETWORK APPLIANCE, INC.

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

	Three Months Ended	
	July 30, 2004	August 1, 2003
Revenues:		
Product revenue	$ 324,627	$ 235,786
Service revenue	33,794	24,723
Total revenues	358,421	260,509
Cost of Revenues:		
Cost of product revenue	114,215	85,039
Cost of service revenue	29,248	19,347
Total cost of revenues	143,463	104,386
Gross margin	214,958	156,123
Operating Expenses:		
Sales and marketing	103,311	79,356
Research and development	38,703	31,541
General and administrative	16,882	12,265
Stock compensation(1)	2,104	654
Total operating expenses	161,000	123,816
Income from Operations	53,958	32,307
Other Income (Expense), net:		
Interest income	4,082	3,045
Other expenses, net	(912)	(47)
Net gain on investments	—	145
Total other income, net	3,170	3,143
Income before Income Taxes	57,128	35,450
Provision for Income Taxes	10,266	8,377
Net Income	$ 46,862	$ 27,073
Net Income per Share:		
Basic	$ 0.13	$ 0.08
Diluted	$ 0.13	$ 0.08
Shares Used in per Share Calculations:		
Basic	356,743	341,687
Diluted	372,974	358,497

(1) Stock compensation includes:

Sales and marketing	$ 510	$358
Research and development	1,384	192
General and administrative	210	104
	$2,104	$654

See accompanying notes to unaudited condensed consolidated financial statements.

NETWORK APPLIANCE, INC.

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

	Three Months Ended	
	July 30, 2004	**August 1, 2003**
Cash Flows from Operating Activities:		
Net income	$ 46,862	$ 27,073
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	13,239	13,426
Amortization of patents	450	150
Amortization of intangible assets	2,333	1,364
Stock compensation	2,104	654
Net gain on investments	(29)	(145)
Allowance for doubtful accounts	(154)	(290)
Deferred rent	90	271
Changes in assets and liabilities:		
Accounts receivable	(5,650)	9,638
Inventories	(3,330)	(5,796)
Prepaid expenses and other assets	(1,261)	(2,306)
Accounts payable	(1,028)	2,202
Income taxes payable	4,831	2,602
Accrued compensation and related benefits	(14,320)	(5,271)
Other accrued liabilities	3,669	(1,708)
Deferred revenue	30,217	14,912
Net cash provided by operating activities	78,023	56,776
Cash Flows from Investing Activities:		
Purchases of short and long-term investments	(69,245)	(89,136)
Redemptions of short and long-term investments	35,645	92,581
Purchases of property and equipment	(33,285)	(12,318)
Proceeds from disposal of property and equipment	—	105
Proceeds from sales of investments	298	419
Purchase of patents	—	(9,015)
Purchases of equity securities	—	(325)
Net cash used in investing activities	(66,587)	(17,689)
Cash Flows from Financing Activities:		
Proceeds from sale of common stock related to employee stock transactions	23,202	24,256
Repurchases of common stock	(47,742)	(26,825)
Net cash used in financing activities	(24,540)	(2,569)
Net Increase (Decrease) in Cash and Cash Equivalents	(13,104)	36,518
Cash and Cash Equivalents:		
Beginning of period	241,149	284,161
End of period	$ 228,045	$ 320,679
Noncash Investing and Financing Activities:		
Deferred stock compensation, net of reversals	$ (546)	$ 1,668
Conversion of evaluation inventory to fixed assets	$ 2,729	$ 661
Income tax benefit from employee stock transactions	$ 5,692	$ 9,874
Supplemental cash flow information:		
Income taxes paid	$ 6,826	$ 1,456

See accompanying notes to unaudited condensed consolidated financial statements.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED 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 offers unified storage solutions for the data-intensive enterprise. NetApp® network storage solutions and service offerings provide data-intensive enterprises with consolidated storage, improved data center operations, economical business continuance, and efficient remote data access across the distributed enterprise.

2. Condensed Consolidated Financial Statements

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

We operate on a 52-week or 53-week year ending on the last Friday in April. For presentation purposes we have indicated in the accompanying interim unaudited condensed consolidated financial statements that our fiscal year end is April 30. The first quarters of fiscal 2005 and 2004 were 13-week and 14-week fiscal periods, respectively.

These financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in our Annual Report on Form 10-K for the year ended April 30, 2004. The results of operations for the three-month period ended July 30, 2004 are not necessarily indicative of the operating results to be expected for the full fiscal year or future operating periods. In the following notes to our interim condensed consolidated financial statements, Network Appliance Inc. is also referred to as "we", "our" and "us".

3. Use of Estimates

The preparation of the condensed consolidated 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 condensed consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Such estimates include, but are not limited to, revenue recognition and allowances; valuation of goodwill and intangibles; accounting for income taxes; inventory write-down; restructuring accruals; impairment losses on investments; accounting for stock-based compensation; and loss contingencies. Actual results could differ from those estimates.

4. Derivative Instruments

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

As a result of our significant international operations, we are subject to risks associated with fluctuating exchange rates. We use derivative financial instruments, principally currency forward contracts and currency options, to attempt to minimize the impact of exchange rate movements on our balance sheet relating to certain foreign currency assets and liabilities and operating results. We have established transaction and balance sheet risk management programs to protect against reductions in fair value and volatility of future cash flows caused by changes in exchange rates. Factors that could have an impact on the effectiveness of our hedging program include the accuracy of forecasts and the volatility of foreign currency markets. These programs reduce, but do not always entirely eliminate, the impact of currency exchange movements. The maturities of these instruments are generally less than one year.

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

Balance Sheet. We utilize currency forward contracts and currency options to hedge currency exchange rate fluctuations related to certain foreign currency assets and liabilities. Gains and losses on these derivatives offset gains and losses on the assets and liabilities being hedged and the net amount is included in earnings. For the three-month periods ended July 30, 2004 and August 1, 2003, net gains generated by hedged assets and liabilities totaled $1,288 and $2,447, respectively, and were offset by losses on the related derivative instruments of $2,216 and $2,618, respectively.

The premiums paid on the foreign currency option contracts are recognized as a reduction to other income when the contract is entered into. Other than the risk associated with the financial condition of the counterparties, our maximum exposure related to foreign currency options is limited to the premiums paid.

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

If the underlying forecasted transactions do not occur, or it becomes probable that they will not occur, the gain or loss on the related cash flow hedge is recognized immediately in earnings. For the three-month periods ended July 30, 2004 and August 1, 2003, we did not record any gains or losses related to forecasted transactions that did not occur or became improbable.

We measure the effectiveness of hedges of forecasted transactions on at least a quarterly basis by comparing the fair values of the designated currency forward contracts with the fair values of the forecasted transactions. No ineffectiveness was recognized in earnings during the three-month periods ended July 30, 2004 and August 1, 2003.

We do not believe that these derivatives present significant credit risks, because the counterparties to the derivatives consist of major financial institutions, and we manage the notional amount of contracts entered into with any one counterparty. We do not enter into derivative financial instruments for speculative or trading purposes.

5. Balance Sheet Components

Inventories

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

	July 30, 2004	April 30, 2004
Purchased components	$13,156	$13,296
Work in process	1,111	624
Finished goods	20,443	20,189
	$34,710	$34,109

Property and Equipment

	July 30, 2004	April 30, 2004
Land	$ 163,110	$ 158,316
Buildings and building improvements	119,729	119,262
Leasehold improvements	17,886	16,788
Computers, related equipment and purchased software	219,502	211,956
Furniture	21,212	20,781
Construction-in-progress	37,535	16,750
	578,974	543,853
Accumulated depreciation and amortization	(186,386)	(173,136)
	$ 392,588	$ 370,717

During the first quarter of fiscal 2005, as part of our expansion efforts, we purchased three buildings in Research Triangle Park ("RTP"), North Carolina, for $24,095 and was included in Land and Construction-in-progress at July 30, 2004.

6. Goodwill and Intangible Assets

Goodwill is reviewed annually for impairment (or more frequently if indicators of impairment arise). We completed our annual impairment assessment on February 27, 2004 and concluded that goodwill was not impaired. From the period subsequent to February 27, 2004 through July 30, 2004, there was no impairment of goodwill and intangible assets.

Goodwill and identified intangible assets relate to our acquisitions of Spinnaker Networks, Inc. ("Spinnaker") in February 2004, WebManage Technologies, Inc. ("WebManage") in November 2000, and

Orca Systems, Inc. (“Orca”) in June 2000. Balances as of July 30, 2004 and April 30, 2004 are summarized as follows:

	July 30, 2004			
	Amortization Period (Years)	Gross Assets	Accumulated Amortization	Net Assets
			(In thousands)	
Intangible assets:				
Patents	5	$ 9,145	$ (2,084)	$ 7,061
Existing technology	5	33,525	(17,938)	15,587
Trademarks/ Tradenames	3	280	(42)	238
Customer Contracts/ Relationships	1.5	1,100	(336)	764
Covenants Not to Compete	1.5	7,610	(2,325)	5,285
Total Intangible assets, net		$51,660	$ (22,725)	$28,935

	April 30, 2004			
	Amortization Period (Years)	Gross Assets	Accumulated Amortization	Net Assets
			(In thousands)	
Intangible assets:				
Patents	5	$ 9,145	$ (1,633)	$ 7,512
Existing technology	5	33,525	(17,080)	16,445
Trademarks/ Tradenames	3	280	(19)	261
Customer Contracts/ Relationships	1.5	1,100	(153)	947
Covenants Not to Compete	1.5	7,610	(1,057)	6,553
Total Intangible assets, net		$51,660	$ (19,942)	$31,718

Amortization expense for identified intangibles is summarized below:

	Three Months Ended	
	July 30, 2004	August 1, 2003
Patents	$ 450	$ 150
Existing technology	858	1,364
Other identified intangibles	1,475	—
	$ 2,783	$ 1,514

Capitalized patents are amortized over an estimated useful life of five years as research and development expenses. Existing technology is amortized as cost of product revenue. Existing technology from the WebManage acquisition is fully amortized at April 30, 2004. Trademarks and tradenames as well as customer contracts and relationships are amortized as sales and marketing expenses. Covenants not to compete are amortized as general and administrative expenses.

Based on the identified intangible assets (including patents) recorded at July 30, 2004, the future amortization expense of identified intangibles for the next five fiscal years is as follows:

Year ending April,	Amount
2005	$ 8,351
2006	7,022
2007	5,309
2008	5,235
2009	3,018
Thereafter	—
Total	$28,935

7. Stock Compensation

We account for stock-based compensation in accordance with the provisions of Accounting Principle Board Opinion ("APB") No. 25, *"Accounting for Stock Issued to Employees,"* and comply with the disclosure provisions of SFAS No. 123 as amended by SFAS No. 148, *"Accounting for Stock-Based Compensation — Transition and Disclosures."* Deferred compensation recognized under APB No. 25 is amortized ratably to expense over the vesting periods. We account for stock options issued to non-employees in accordance with the provisions of SFAS No. 123 and Emerging Issues Task Force ("EITF") No. 96-18 *"Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services"* under the fair value based method.

Had compensation expense been determined based on the fair value at the grant date for awards, consistent with the provisions of SFAS No. 123, our pro forma net income (loss) and pro forma net income (loss) per share would be as follows (in thousands, except per share data):

	Three Months Ended	
	July 30, 2004	August 1, 2003
Net income as reported	$ 46,862	$ 27,073
Add: stock based employee compensation expense included in reported net income under APB No. 25, net of related tax effects	1,216	311
Deduct: total stock based compensation determined under fair value based method for all awards, net of related tax effects	18,551	32,147
Pro forma net income (loss)	$ 29,527	$ (4,763)
Basic net income per share, as reported	$ 0.13	$ 0.08
Diluted net income per share, as reported	$ 0.13	$ 0.08
Basic net income (loss) per share, pro forma	$ 0.08	$ (0.01)
Diluted net income (loss) per share, pro forma	$ 0.08	$ (0.01)

We amortize deferred stock-based compensation ratably over the vesting periods of the applicable stock purchase rights, restricted stocks and stock options, generally four years. Deferred stock compensation under APB No. 25 and pro forma net income (loss) under the provisions of SFAS No. 123 are adjusted to reflect cancellations and forfeitures due to employee terminations as they occur.

We recorded $2,027 and $519 of compensation expense for the three-month periods ended July 30, 2004 and August 1, 2003, respectively, primarily related to the amortization of deferred stock compensation from unvested options assumed in the WebManage and Spinnaker acquisitions, the retention escrow shares relative to Spinnaker, the grant of stock options to certain highly compensated employees below fair value at the date of grant and the award of restricted stock to certain employees. We reversed $687 and $60 of deferred compensation to deferred stock compensation and common stock in the three-month periods ended July 30, 2004 and August 1, 2003, all due to employee terminations.

Estimated future deferred stock compensation amortization for fiscal 2005, 2006, 2007 and 2008 are expected to be $5,483, $6,578, $5,032 and $3,682, respectively, and none thereafter.

We recorded $77 and $135 in compensation expense in the three-month periods ending July 30, 2004 and August 1, 2003, respectively, for the fair value of options granted to a member of the Board of Directors in recognition for services performed outside of the normal capacity of a board member.

8. Earnings Per Share

Basic net income per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for that period. Diluted net income per share is computed giving effect to all dilutive potential shares that were outstanding during the period. Dilutive potential common shares consist of incremental common shares subject to repurchase, common shares issuable upon exercise of stock options and restricted stock awards.

During all periods presented, we had certain 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. These certain options were antidilutive in the three-month periods ended July 30, 2004 and August 1, 2003 as these options’ exercise prices were above the average market prices in such periods. For the three-month periods ended July 30, 2004 and August 1, 2003, 27,992 and 30,278 shares of common stock options with a weighted average exercise price of $38.88 and $38.21, respectively, were excluded from the diluted net income per share computation.

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

	Three Months Ended	
	July 30, 2004	**August 1, 2003**
Net Income (Numerator):		
Net income, basic and diluted	$ 46,862	$ 27,073
Shares (Denominator):		
Weighted average common shares outstanding	357,290	341,732
Weighted average common shares outstanding subject to repurchase	(547)	(45)
Shares used in basic computation	356,743	341,687
Weighted average common shares outstanding subject to repurchase	547	45
Common shares issuable upon exercise of stock options	15,684	16,765
Shares used in diluted computation	372,974	358,497
Net Income Per Share:		
Basic	$ 0.13	$ 0.08
Diluted	$ 0.13	$ 0.08

9. Comprehensive Income

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

	Three Months Ended	
	July 30, 2004	August 1, 2003
Net income	$ 46,862	$ 27,073
Currency translation adjustment	(1,363)	1,402
Unrealized loss on derivatives	(1,307)	(286)
Unrealized gain (loss) on investments	(656)	(1,070)
Comprehensive income	$ 43,536	$ 27,119

The components of accumulated other comprehensive income (loss) net of related tax effects were as follows:

	July 30, 2004	April 30, 2004
Accumulated translation adjustments, net	$ (161)	$ 1,202
Accumulated realized loss on derivatives	(344)	$ 312
Accumulated unrealized gain on available-for-sale investments, net	(2,199)	(892)
Total accumulated other comprehensive loss	$(2,704)	$ 622

10. Restructuring Charges

Fiscal 2002 Second Quarter Restructuring Plan

In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in workforce and consolidations of facilities. As a result of the restructuring in August 2001, we recorded a charge of $7,980. The restructuring charge included $4,796 of severance-related amounts, $2,656 of committed excess facilities and facility closure expenses, and $528 in fixed assets write-offs. The reserve balance related to this restructuring charge was $854 at July 30, 2004 was included in other accrued liabilities.

In the event that the foreign facilities are not subleased, we will be obligated for additional total lease payments of approximately $366 as of July 30, 2004 to be payable through January 2006.

As of July 30, 2004, we have $722 outstanding in our accrued and unpaid severance-related restructuring costs due to changes in estimated costs of certain severance-related matters. We expect to pay or adjust the remaining severance-related restructuring costs pending the outcome of the ultimate resolution of these matters in the next twelve months.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following analysis sets forth the significant components of the second quarter fiscal 2002 restructuring at July 30, 2004:

	Severance-related amounts	Fixed Assets write-off	Facility	Total
Restructuring charge	$ 4,796	$ 528	$ 2,656	$ 7,980
Cash payments and others	(4,508)	—	(803)	(5,311)
Non-cash portion	—	(528)	(37)	(565)
Adjustments	(95)	—	(1,509)	(1,604)
Reserve balance at April 30, 2002	193	—	307	500
Cash payments and others	64	—	(82)	(18)
Non-cash portion	—	—	(9)	(9)
Adjustments	410	—	(76)	334
Reserve balance at April 30, 2003	667	—	140	807
Cash payments and others	50	—	(9)	41
Reserve balance at April 30, 2004	717	—	131	848
Cash payments and others	5	—	1	6
Reserve balance at July 30, 2004	$ 722	$ —	$ 132	$ 854

Fiscal 2002 Fourth Quarter Restructuring Plan

In April 2002, we completed a restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters. As a result of this restructuring, we incurred a charge of $5,850. The restructuring charge included $813 of severance-related amounts, $4,564 of committed excess facilities and facility closure expenses, and $473 in fixed assets write-offs. Of the reserve balance at July 30, 2004, $653 was included in other accrued liabilities and the remaining $4,375 was classified as long-term obligations.

In fiscal 2003 and 2004, we updated our assumptions and estimates based on certain triggering events, which resulted in additional net charges of $923 and $1,327 respectively, primarily relating to sublease assumptions for our engineering facility lease. Our restructuring estimates are reviewed and revised periodically and may result in a substantial charge to restructuring expense should different conditions prevail than were anticipated in previous management estimates. Such estimates included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. In the event that the engineering facility is not subleased as anticipated, we will be obligated for additional total lease payments of $1,761 as of July 30, 2004 to be payable through November 2010.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS — (Continued)

The following analysis sets forth the significant components of the restructuring reserve at July 30, 2004:

	Severance-related amounts	Fixed Assets write-off	Facility	Total
Restructuring charge	$ 813	$ 473	$4,564	$ 5,850
Cash payments and others	(629)	—	(32)	(661)
Non-cash portion	—	(473)	—	(473)
Reserve balance at April 30, 2002	184	—	4,532	4,716
Cash payments and others	(77)	—	(991)	(1,068)
Adjustments	(107)	—	1,030	923
Reserve balance at April 30, 2003	—	—	4,571	4,571
Cash payments and others	—	—	(690)	(690)
Adjustments	—	—	1,327	1,327
Reserve balance at April 30, 2004	—	—	5,208	5,208
Cash payments and others	—	—	(180)	(180)
Reserve balance at July 30, 2004	$ —	$ —	$5,028	$ 5,028

11. Short-Term Investments

All our investments are classified as available for sale at July 30, 2004 and April 30, 2004. Available-for-sale investments with original maturities of greater than three months are classified as short-term investments, as these investments generally consist of highly marketable securities that are intended to be available to meet current cash requirements. Investment securities classified as available-for-sale are reported at fair market value, and net unrealized gains or losses are recorded in accumulated other comprehensive loss, a separate component of stockholders' equity, net of taxes. Any gains or losses on sales of investments are computed based upon specific identification. For all periods presented, realized gains and losses on available-for-sale investments were not material. Management evaluates investments on a regular basis to determine if an other-than-temporary impairment has occurred. Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value and such a decline is not considered temporary. We adopted the provisions of EITF No. 03-01 on other-than-temporary impairments on debt and equity investments, the adoption did not have a significant impact on our carrying value of our investment at July 30, 2004.

12. New Accounting Pronouncements

The Financial Accounting Standards Board ("FASB") issued Interpretation No. 46 ("FIN 46"), *"Consolidation of Variable Interest Entities,"* in January 2003, and a revised interpretation of FIN No. 46 ("FIN 46-R") in December 2003. FIN No. 46 requires certain variable interest entities ("VIEs") to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The provisions of FIN No. 46 are effective immediately for all arrangements entered into after January 31, 2003. Since January 31, 2003, the Company has not invested in any entities it believes are variable interest entities for which the Company is the primary beneficiary. For all arrangements entered into after January 31, 2003, the Company is required to continue to apply FIN No. 46 through April 30, 2004. The Company is required to adopt the provisions of FIN No. 46-R for those arrangements on May 1, 2004. For arrangements entered into prior to February 1, 2003, the Company is required to adopt the provisions of FIN No. 46-R on May 1, 2004.

The Company does not expect the adoption of FIN No. 46-R to have an impact on the financial position, results of operations or cash flows of the Company.

In November 2003, the EITF reached an interim consensus on EITF No. 03-01, *"The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments,"* to require additional disclosure requirements for securities classified as available-for-sale or held-to-maturity for fiscal years ending after December 15, 2003. In March 2004, the EITF reached a final consensus on this Issue, to provide additional guidance which companies must follow in determining whether investment securities have an impairment which should be considered other-than-temporary. The guidance is applicable for reporting periods after June 15, 2004. Adoption of the consensus did not have a significant impact on the carrying value of its investments at July 30, 2004. The Company will continue to monitor the carrying value of its investments under this new guidance in fiscal 2005.

13. Commitments and Contingencies

The following summarizes our commitments and contingencies at July 30, 2004, and the effect such obligations may have on our future periods, (in thousands):

	Payments Due by Period						
	2005	2006	2007	2008	2009	Thereafter	Total
Commitments & Contingencies:							
Rent operating lease payments(1)	$ 9,404	$11,176	$ 7,494	$6,667	$6,584	$ 9,533	$50,858
Equipment operating lease payments	1,970	2,465	1,505	203	73	—	6,216
Venture capital funding commitments(2)	423	564	564	552	539	1,077	3,719
Purchase commitments and other(3)	10,186	720	600	—	—	—	11,506
Communications & Maintenance(4)	4,352	3,735	170	29	12	—	8,298
Estimated contingent lease payments(5)	78	125	374	385	427	738	2,127
Total Commitments & Contingencies:	$26,413	$18,785	$10,707	$7,836	$7,635	$ 11,348	$82,724

	Amount of Commitment Expiration Per Period						
	2005	2006	2007	2008	2009	Thereafter	Total
Other Commercial Commitments:							
Letters of Credit(6)	$1,423	$ —	$ —	$ —	$ —	$ 337	$1,760
Restricted Cash(7)	875	675	508	439	277	99	2,873
Total Commercial Commitments	$2,298	$675	$508	$439	$277	$ 436	$4,633

(1) We lease sales offices and research and development facilities throughout the U.S. and internationally. These sales offices are also leased under operating leases which expire through fiscal 2019. We are responsible for certain maintenance costs, taxes, and insurance under these leases. Substantially all lease agreements have fixed payment terms based on the passage of time. Some lease agreements provide us with the option to renew the lease. Our future operating lease obligations would change if we were to exercise these renewal options and if we were to enter into additional operating lease agreements. Certain real estate operating sub-lease income of $271 has been included as a reduction of the payment amounts shown in the table. Rent operating lease payments in the table exclude the leases impacted by the restructurings and include only rent lease commitments that are over one year.

(2) Venture capital funding commitments includes a quarterly committed management fee based on a percentage of our committed funding to be payable through June 2011.

(3) Purchase commitments represent agreements to purchase component inventory from our suppliers and contract manufacturers that are enforceable and legally binding against us. Other commitments include facilities-related and utilities usage minimum commitment. Purchase commitments and other excludes purchases of good and services we expect to consume in the ordinary course of business in the next twelve months. It also excludes costs that are not reasonably estimable at this time.

(4) Under certain communications contracts with major telephone companies as well as maintenance contracts with multiple vendors, we are required to pay based on a minimum volume. Such obligations expire in January 2009.

(5) As a result of headcount reductions and a restructuring in fiscal 2002, we are not currently utilizing certain existing space at our California headquarters site. Additionally, we have also exited office space under non-cancellable leases in certain locations both in the U.S. and Europe. If we are unable to successfully sublease our vacated and unoccupied office space under operating leases, we would be obligated to pay $2,127 million in excess of the liability recorded in our restructuring reserves. See “Note 10 — Restructuring Charges.”

(6) The amounts outstanding under these letters of credit relate to workers’ compensation, customs guarantee and a foreign lease.

(7) Restricted cash arrangements relate to facility lease requirements, service performance guarantees, customs and duties guarantees, and VAT requirements and are included under Prepaid Expenses and Other and Other Assets on our Consolidated Balance Sheets.

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

From time to time, we have committed to purchase various key components used in the manufacture of our products. 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. While the outcome of these legal matters is currently not determinable, we do not believe that any current litigation or claims will have a material adverse effect on our business, cash flow, operating results, or financial condition.

14. Guarantees

As of July 30, 2004, our financial guarantees consisted of standby letters of credit outstanding, bank guarantee, and restricted cash, which were related to facility lease requirements, service performance guarantees, customs and duties guarantees, VAT requirements, and workers' compensation plans. The maximum amount of potential future payments under these arrangements was $4,633 and $4,338 as of July 30, 2004 and April 30, 2004, respectively. Of this maximum exposure, $2,873 and $2,736 of restricted cash was classified under Prepaid Expense and Other Assets on our balance sheet at July 30, 2004 and April 30, 2004, respectively. We have not recorded any liability at July 30, 2004 and April 30, 2004, respectively, related to these guarantees.

As of July 30, 2004, our notional fair values of foreign exchange forward and foreign currency option contracts totaled $145,985. We do not believe that these derivatives present significant credit risks, because the counterparties to the derivatives consist of major financial institutions, and we manage the notional amount of contracts entered into with any one counterparty. We do not enter into derivative financial instruments for speculative or trading purposes. Other than the risk associated with the financial condition of the counterparties, our maximum exposure related to foreign currency forward and option contracts is limited to the premiums paid.

We offer both recourse and non-recourse lease financing arrangements to our customers. Under the terms of recourse leases, which are generally three years or less, we remain liable for the aggregate unpaid remaining lease payments to the third-party leasing company in the event that any customers were to default. We defer 100% of the recourse lease obligation and recognize revenue over the term of the lease as the lease payments become due. As of July 30, 2004 and April 30, 2004, the maximum recourse exposure under such leases totaled approximately $6,711 and $6,755, respectively. Under the terms of the non-recourse leases we do not have any continuing obligations or liabilities. To date, we have not experienced significant losses under this lease financing program.

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

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

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), and are subject to the safe harbor provisions set forth in the Exchange Act. Forward-looking statements usually contain the words "estimate," "intend," "plan," "predict," "seek," "may," "will," "should," "would," "anticipate," "expect," "believe," or similar expressions and variations or negatives of these words. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. All forward-looking statements, including, but not limited to, (1) our plans to continue to leverage our product capabilities to enhance our storage grid architectures; (2) the possibility that we may engage in future acquisitions; (3) our expectation that we will increasingly rely on our indirect sales channel for a significant portion of our revenue; (4) our expectation that the ultimate costs to resolve any outstanding legal claims or proceedings will not be material to our business; (5) our expectation that we will see strong demand for storage in many areas; (6) our belief that our unified storage architecture provides for a complete and flexible solution across all tiers of storage; (7) our intent to regularly introduce new products and product enhancements and our intent to support current and new products and product enhancements; (8) our expectation that our expenditures on expanding our current product offerings and introducing new products in order to capitalize on growth opportunities will increase in absolute dollars; (9) the possibility that we may need to increase our materials purchases, contract manufacturing capacity and internal test and quality functions to meet anticipated demand; (10) our belief that our products currently compete favorably with our competitors; (11) our intention to continue to establish and maintain business relationships with technology companies; (12) our belief that our existing facilities and those currently being developed, will be sufficient for our needs for at least the next two years; (13) our expectation that we will continue to add sales capacity; (14) our expectation that we will increase sales and marketing expenses commensurate with future revenue growth; (15) our belief that our general and administrative expenses will increase in absolute terms in fiscal 2005; (16) our belief that our existing liquidity and capital resources are sufficient to fund our operations for at least the next twelve months; (17) our expectation that interest income will increase in fiscal 2005; (18) our expectation that the value of our investments will not decline significantly because of changes in market interest rates; (19) the expected impact of recent accounting pronouncements on our financial condition and results of operations; (20) our belief that our forward currency contracts will not subject us to undue risk; (21) our expectation regarding estimated future deferred stock compensation amortization expenses; (22) the possibility that we may be obligated for additional lease payments to be payable through November 2010 in the event that our vacated facilities are not subleased; (23) our expectation that there will be a further decline in the price per petabyte; (24) our estimates of future intangibles and stock compensation amortization expense relating to the Spinnaker acquisition; (25) our expectation that service margins will improve; (26) our estimates regarding future capitalized patents amortization expenses; (27) our expectation that we will continuously support current and future product development and enhancement efforts and incur corresponding charges; (28) our intention to continuously broaden our existing product offerings and introduce new products; (29) our belief that our research and development expenses will increase in absolute dollars for fiscal 2005; (30) our expectation that capital expenditures will increase consistent with our business growth; and (31) our expectations regarding our contractual cash obligations and other commercial commitments at July 30, 2004 for fiscal years 2005 through 2009 and thereafter, which we anticipate will equal no more than $91.1 million in the aggregate; (32) our belief that our strategic investments are targeted at some of the strongest growth areas of the storage market are inherently uncertain as they are based on management's current expectations and assumptions concerning future events, and they are subject to numerous known and unknown risks and uncertainties. Therefore, our actual results may differ materially from the forward-looking statements contained herein. Factors that could cause actual results to differ materially from those described herein include, but are not limited to: (1) the amount of orders received in future periods; (2) our ability to ship our products in a timely manner; (3) our ability to achieve anticipated pricing, cost and gross margin levels; (4) our ability to successfully introduce new products; (5) our ability to achieve and capitalize on changes in market demand; (6) acceptance of, and demand for, our products; (7) our ability to identify and respond to significant market trends and emerging standards; (8) our ability to realize our financial objectives through increased investment in people, process and systems; (9) acceptance of, and demand for, our products; (10) our ability to maintain our supplier and contract manufacturer relationships; (11) the ability of our competitors to introduce new products that compete successfully with our products; (12) the general economic environment and the continued growth of the storage and content delivery markets; (13) our ability to sustain and/or improve our cash and overall financial position; (14) our ability to generate future income to utilize our deferred tax assets; and (15) those factors discussed under “Risk Factors” elsewhere in this Quarterly Report on Form 10-Q. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof and are based upon information available to us at this time. These statements are not guarantees of future performance. We disclaim any obligation to update information in any forward-looking statement.

Overview

Based in Sunnyvale, California, Network Appliance was incorporated in California in April 1992, and reincorporated in Delaware in November 2001. Network Appliance offers unified storage solutions for the data-intensive enterprise. Network Appliance™ network storage solutions and service offerings provide data-intensive enterprises with consolidated storage, improved data center operations, economical business continuance, and efficient remote data access across the distributed enterprise. Network Appliance solutions are the data management and storage foundation for enterprises, government agencies, and universities worldwide.

First Quarter Fiscal 2005 Highlights

Throughout the first quarter of fiscal year 2005, we deployed our tier-one storage solutions for the most demanding customers, expanded partnerships, and enhanced our storage grid architecture. Enterprise customers have chosen to deploy Network Appliance solutions to reduce complexity, achieve a low total cost of ownership (TCO), and utilize our advanced storage and software management capabilities.. We expect to continue to see strong demand for storage in many areas, including mission-critical tier-one environments, distributed enterprise, disk-to-disk backup, compliance, disaster recovery, and unified SAN and NAS solutions.

Customers across all geographies deploy our solutions for a variety of database, collaborative, and other data center and mission-critical applications. Customers are increasingly moving towards storage solutions that support multiple applications. Our customers are adopting our technology to build storage infrastructures that support all tiers of data — creating a multi-purpose storage utility, similar in concept to their network utility which is independent of the applications it supports, and therefore much more flexible. For example, in our SAN business, customers are using both IP SAN and fibre channel SAN together in the systems they purchase. Many of our systems are purchased along with multiple protocols and interfaces to support a variety of access types and data structures. We believe it is our unified architecture, based on one operating system with interoperability across all of our product lines, that provides for a complete and flexible solution for our customers across all of their tiers of storage.

Our year-over-year quarterly revenue growth was driven by strong demand for our new products across all major product lines, as well as increased sales of our software and services products, however, we cannot assure you that revenue will continue to grow at previous rates. In addition, we also broadened our channel strategy with the addition of distributors such as, Arrow and Avnet to expand our storage businesses and gain greater market penetration opportunities. This revenue growth has occurred while the market for our storage products and solutions has grown more competitive with downward pricing pressures that could negatively impact our revenue growth rate. At the same time, we anticipate and continue to experience further price decline per petabyte for our products which may have an adverse impact on our gross margin if not offset by favorable software mix and higher average selling prices associated with new products. We continue to expect our gross margin to be impacted by factors such as new product introductions and enhancements, add-on software and product mix, discount level, competition and global service investment. Revenue growth in fiscal 2005 is dependent on the introduction of our new products, including but not limited to the incorporation of new advanced distributed storage technologies from our Spinnaker acquisition into our existing products. As with any product introduction, we face risks in the design, testing, qualification and market acceptance of our new products. If we fail to timely introduce new products, or if there is no or reduced demand for these or our current products, we may experience a decline in revenue. We believe that our strategic investments are targeted at some of the strongest growth areas of the storage market. However, if any storage market trends and emerging standards on which we are basing our assumptions do not materialize as anticipated, our business could be materially adversely affected. Additionally, we plan to invest in the people, processes, and systems necessary to best optimize these growth opportunities. However, we cannot assure you that such investments will achieve our financial objectives. See “Risk Factors” under Item 2.

First Quarter Fiscal 2005 Financial Performance

- Our revenues for the first quarter of fiscal 2005 were $358.4 million, a 37.6% increase over the same period a year ago. While all product areas contributed to revenue growth, NearStore, FAS 980 and the FAS 270 were significant contributors.

- Our overall gross margins improved to 60.0% in the first quarter of fiscal 2005 from 59.9% in the same period in fiscal 2004. The slight improvement in our gross margin was attributable to a favorable change in product and add-on software mix, partially offset by the continued investment in our service infrastructure.

- Net income for the first quarter increased 73.1% to $46.9 million compared to net income of $27.1 million for the same period a year ago.

- Our balance sheet as of July 31, 2004 remains debt-free, with cash, cash equivalents and investments of $826.6 million (net of $47.7 million of cash repurchases of our common stock in the first quarter of fiscal 2005), due primarily to our net income and the related cash generated from operations. Days Sales Outstanding decreased to 51 days as of July 30, 2004 from 54 days as of August 1, 2003, reflecting more linear quarterly sales and solid credit management. Inventory turns were 16.4 times, improved 54.4% from a year ago. Deferred revenue increased 63.3% to $309.2 million from $189.3 million reported a year ago. Capital purchases of plant, property and equipment were $33.3 million, which included the $24.1 million site purchase in Research Triangle Park, North Carolina.

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 30, 2004	**August 1, 2003**
Revenues:	100.0%	100.0%
Product revenue	90.6	90.5
Service revenue	9.4	9.5
Cost of Revenues:		
Cost of product revenue	31.8	32.6
Cost of service revenue	8.2	7.5
Gross margin	60.0	59.9
Operating Expenses:		
Sales and marketing	28.8	30.4
Research and development	10.8	12.1
General and administrative	4.7	4.7
Stock compensation	0.6	0.3
Total operating expenses	44.9	47.5

	Three Months Ended	
	July 30, 2004	August 1, 2003
Income from Operations	15.1	12.4
Other Income (Expense), net:		
Interest income	1.1	1.2
Other expenses, net	(0.2)	(0.1)
Net gain on investments	—	0.1
Total other income, net	0.9	1.2
Income before Income Taxes	16.0	13.6
Provision for Income Taxes	2.9	3.2
Net Income	13.1%	10.4%

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

	Three Months Ended	
	July 30, 2004	August 1, 2003
Product revenue:		
Products	80.4%	81.3%
Software subscriptions	10.2%	9.2%
	90.6%	90.5%
Service revenue	9.4%	9.5%
Total revenues	100.0%	100.0%

Discussion of Results of Operations

Product Revenues — Product revenues increased by 37.7% to $324.6 million for the first quarter of fiscal 2005, from $235.8 million for the first quarter of fiscal 2004. Product revenues growth was across all geographies. This increase in product revenues was specifically attributable to increased software licenses and software subscriptions and an increase in units shipped, as compared to the same period in the prior year.

Product revenues were favorably impacted by the following factors:

• increased revenues from our current product portfolio, such as: FAS980, FAS270, and FAS250 filer products; NearStore® R200 nearline storage systems; and NetCache® C2100 and C6200 appliances;

• increased revenues from our solutions portfolio, which consists of multiple access types and multiple applications under one common architecture;

• increased sales of software subscription upgrades representing 10.2% of total revenues for the first quarter of fiscal 2005 compared to 9.2% of total revenue for the same period in fiscal 2004;

• increased demand for NetApp’s mission-critical tier-one storage environments, distributed enterprise, disk-to-disk backup, compliance, disaster recovery, and unified SAN and NAS solutions;

• increased sales through indirect channels in absolute dollars, including sales through our resellers, distributors and OEM partners, representing 45.9% and 51.7% of total revenues for the first quarters of fiscal 2005 and fiscal 2004, respectively.

Product revenues were negatively impacted by the following factors:

• lower-cost-per-megabyte disks;

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

• incremental revenue due to an extra week of business in the first quarter of fiscal 2004 compared to the same quarter in fiscal 2005.

The Spinnaker acquisition did not have a significant impact on our first quarter fiscal 2005 revenue. We cannot assure you that we will be able to maintain or increase market demand for our products.

Service Revenues — Service revenues, which include hardware support, professional services, and educational services, increased by 36.7% to $33.8 million in the first quarter of fiscal 2005, from $24.7 million in the first quarter of fiscal 2004. Service revenues are generally deferred and, in most cases, recognized ratably over the service obligation periods, which are typically one to three years. Service revenues represented 9.4% and 9.5% of total revenues for the first quarters of fiscal 2005 and fiscal 2004, respectively. The increase in absolute dollars was due to an increasing number of enterprise customers, which typically purchase more complete and generally longer-term service packages than our non-enterprise customers. Higher service revenues were also related to a growing installed base resulting in new customer support contracts in addition to support contract renewals by existing customers. While it is an element of our strategy to expand and offer a more comprehensive, global enterprise support and service solution, we cannot assure you that service revenue will grow at the current rate in the remainder of fiscal 2005.

International total revenues — International total revenues (including United States exports) increased by 37.6% for the first quarter of fiscal 2005 as compared to the same period of fiscal 2004. International total revenues were $149.3 million, or 41.6% of total revenues and $108.5 million, or 41.6% of total revenues for the first quarters of fiscal 2005 and fiscal 2004, respectively. The increase in international sales was primarily a result of European and Asia Pacific net revenues growth, driven by larger storage implementations, increased demand for our current product portfolio and higher storage spending in certain geographic regions, as compared to the same period in the prior fiscal year. We cannot assure you that we will be able to maintain or increase international revenues in the remainder of fiscal 2005.

Product Gross Margin — Product gross margin increased to 64.8% for the first quarter of fiscal 2005, from 63.9% for the first quarter of fiscal 2004. Amortization of existing technology included in cost of product revenues was $0.9 million and $1.4 million for the first quarters of fiscal 2005 and 2004, respectively. Estimated future amortization of existing technology to cost of product revenues relating to the Spinnaker acquisition will be $2.6 million for 2005 and $3.4 million for each of fiscal years 2006, 2007, 2008; $2.8 million for fiscal year 2009; and none thereafter.

Product gross margin was favorably impacted by:

• favorable product and add-on software mix;

• competitive pricing solutions with our bundled software and solutions set;

• higher average selling prices for our newer products;

• growth in software subscription upgrades and software licenses due primarily to a larger installed base and an increasing number of new enterprise customers;

• lower cost of components; and

• transitional expenses incurred in the first quarter of fiscal 2004 associated with the initial implementation of a new Enterprise Resource Planning (“ERP”) system, which we did not incur in the first quarter of fiscal 2005.

Product gross margin was negatively impacted by:

• increased sales through certain indirect channels, which carry a lower gross margin than our direct sales;

• higher disk content with an expanded storage capacity for the higher-end filers and Nearstore systems, as resale of disk drives generates lower gross margin;

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

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

Service Gross Margin — Service gross margin decreased to 13.5% in the first quarter of fiscal 2005 as compared to 21.7% in the first quarter of fiscal 2004. Investments in customer service increased by 51.2% to $29.2 million in the first quarter of fiscal 2005, from $19.3 million in the first quarter of fiscal 2004. The decrease in service gross margin was primarily due to the continued investment in our service infrastructure to support our increasing enterprise customer base partially offset by improved headcount utilization. These investments included additional professional support engineers, increased support center activities and global service partnership programs. Service gross margin will typically experience some variability over time due to the timing of technical support service initiations and renewals and additional investments in our customer support infrastructure. We expect service margin to improve as we begin to see service revenue growth and improved headcount utilization, partially offset by major investments in headcount and logistics as we continue to build out our service capability and capacity.

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 30.2% to $103.3 million for the first quarter of fiscal 2005, from $79.4 million for the first quarter of fiscal 2004. These expenses were 28.8% and 30.4% of total revenues for the first quarters of fiscal 2005 and fiscal 2004, respectively. The increase in absolute dollars was attributed to increased sales kick off expenses, increased commission expenses resulting from increased revenues, higher performance-based payroll expenses due to higher profitability, and the continued worldwide investment in our sales and global service organizations associated with selling complete enterprise solutions and scaling our sales infrastructure, offset by a 14-week quarter in the first quarter of fiscal 2004 as compared to a 13-week quarter in the same period in fiscal 2005. Amortization of Spinnaker trademarks/tradenames and customer contracts/relationships included in sales and marketing expenses was $0.2 million for the first quarter of fiscal 2005 and none in the first quarter of fiscal 2004, respectively. Estimated future amortization of trademarks, tradenames, customer contracts and relationships relating to the Spinnaker acquisition will be $0.6 million for the remainder of fiscal year 2005 and $0.4 million for fiscal 2006, respectively, and none thereafter.

Sales and marketing headcount increased to 1,515 at July 30, 2004 from 1,188 at August 1, 2003. We expect to continue to selectively add sales capacity in an effort to expand domestic and international markets, introduce new products, establish and expand new distribution channels, and increase product and company awareness. We expect to increase our sales and marketing expenses commensurate with future revenue growth.

Research and Development — Research and development expenses consist primarily of salaries and benefits, prototype expenses, non-recurring engineering charges, fees paid to outside consultants and amortization of capitalized patents. Included in research and development expenses is capitalized patents amortization of $0.5 million for the three-month period ending July 30, 2004, as compared to $0.2 million for the same period in the prior year. Estimated future capitalized patents amortization expenses for fiscal 2005 will be $1.4 million, $1.8 million for each of the fiscal years 2006, 2007 and 2008 and $0.3 million thereafter.

Research and development expenses increased 22.7% to $38.7 million for the first quarter of fiscal 2005 from $31.5 million for the first quarter of fiscal 2004. These expenses represented 10.8% and 12.1% of total revenues for the first quarters of fiscal 2005 and 2004, respectively. The increase in research and development expenses was primarily a result of increased headcount, increased ongoing impact of the Spinnaker acquisition, ongoing support of current and future product development and enhancement efforts, higher performance-based payroll expenses due to higher profitability, offset by an extra week of expenses in the first quarter of fiscal 2004 compared to the same period in fiscal 2005, cost control and reduction in discretionary spending efforts. Research and development headcount increased to 687 as of July 30, 2004 compared to 540 as of August 1, 2003. For both the first quarters of fiscal 2005 and 2004, no software development costs were capitalized.

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

We believe that our research and development expenses will increase in absolute dollars for the remainder of fiscal 2005, primarily due to ongoing costs associated with the development of new products and technologies, projected headcount growth and the operating impact of the Spinnaker acquisition as compared to the comparable period in the prior year.

General and Administrative — General and administrative expenses increased 37.6% to $16.9 million for the first quarter of fiscal 2005, from $12.3 million for the first quarter of fiscal 2004. These expenses represented 4.7% and 4.7% of total revenues for the first quarters of fiscal 2005 and 2004, respectively. This increase in absolute dollars was primarily due to expenses associated with expanded regulatory requirements, higher legal expenses and professional fees for general corporate matters, higher performance-based payroll expenses due to higher profitability, partially offset by reduced expenses as a result of one less week of expenses in the first quarter of fiscal 2005 compared to the same period in fiscal 2004 and higher expenses associated with investments in our enterprise-wide ERP system and back-office infrastructure in the first quarter of fiscal 2004.

General and administrative headcount increased to 348 at July 30, 2004 from 282 at August 1, 2003. We believe that our general and administrative expenses will increase in absolute dollars for the remainder of fiscal 2005 due to additional expenses related to expanded regulatory requirements as compared to the same period in the prior year. Amortization of Spinnaker covenants not to compete included in general and administrative expenses was $1.3 million for the first quarter of fiscal 2005 and none in the first quarter of fiscal 2004. Estimated future amortization of covenants not to compete relating to the Spinnaker acquisition will be $3.8 million in the remainder of fiscal 2005 and $1.5 million for fiscal year 2006, respectively, and none thereafter.

Stock Compensation — Stock compensation expenses were $2.1 million and $0.7 million for the first quarters of fiscal 2005 and 2004, respectively. This net increase in stock compensation expenses reflected primarily higher stock compensation relating to the Spinnaker acquisition and restricted stock awards offset by forfeitures of unvested options assumed in the Spinnaker and WebManage acquisitions. Estimated future deferred stock compensation amortization expenses are $5.5 million in the remainder of fiscal 2005, $6.6 million in fiscal 2006, $5.0 million in fiscal 2007 and $3.7 million in fiscal 2008 and none thereafter.

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

Fiscal 2002 Second Quarter Restructuring Plan

In August 2001, we implemented the first restructuring plan, which included a reduction in workforce by approximately 200 employees and a consolidation of facilities. The action was required to properly align and manage the business commensurate with our revenue at that time. All functional areas of the Company were affected by the reduction. We completed our actions during the second quarter of fiscal 2002. As a result of this restructuring, we recorded a charge of $8.0 million. The restructuring charge included $4.8 million of severance-related amounts, $2.7 million of committed excess facilities and facility closure expenses, including certain facilities in foreign countries, and $0.5 million in fixed assets write-offs. The reserve balance related to this restructuring charge was $0.9 million at July 30, 2004 was included in other accrued liabilities.

In the event that the foreign facilities that we vacated are not subleased, we will be obligated for additional total lease payments of approximately $0.4 million as of July 30, 2004 to be payable through January 2006.

As of July 30, 2004, we have $0.7 million outstanding in our accrued and unpaid severance-related restructuring costs due to changes in estimated costs of certain severance-related matters. We expect to pay or adjust the remaining severance-related restructuring costs pending the outcome of the ultimate resolution of these matters in the next twelve months.

The following analysis sets forth the significant components of the second quarter fiscal 2002 restructuring at July 30, 2004 (in thousands):

	Severance-related amounts	Fixed Assets write-off	Facility	Total
Restructuring charge	$ 4,796	$ 528	$ 2,656	$ 7,980
Cash payments and others	(4,508)	—	(803)	(5,311)
Non-cash portion	—	(528)	(37)	(565)
Adjustments	(95)	—	(1,509)	(1,604)
Reserve balance at April 30, 2002	193	—	307	500
Cash payments and others	64	—	(82)	(18)
Non-cash portion	—	—	(9)	(9)
Adjustments	410	—	(76)	334
Reserve balance at April 30, 2003	667	—	140	807
Cash payments and others	50	—	(9)	41
Reserve balance at April 30, 2004	717	—	131	848
Cash payments and others	5	—	1	6
Reserve balance at July 30, 2004	$ 722	$ —	$ 132	$ 854

Fiscal 2002 Fourth Quarter Restructuring Plan

In April 2002, we completed a restructuring related to the closure of an engineering facility and consolidation of resources to the Sunnyvale headquarters. As a result of this restructuring, we recorded a charge of $5.9 million. The restructuring charge included $0.8 million of severance-related amounts, $4.6 million of committed excess facilities and facility closure expenses, and $0.5 million in fixed assets write- offs. Of the reserve balance at July 30, 2004, $0.7 million was included in other accrued liabilities and the remaining $4.3 million was classified as long-term obligations.

In fiscal 2003 and 2004, we updated our assumptions and estimates based on certain triggering events, which resulted in additional net charges of $0.9 million and $1.3 million, respectively, primarily relating to sublease assumptions for our engineering facility. Our estimates are reviewed and revised periodically and may result in a substantial charge to restructuring expense should different conditions prevail than were anticipated in previous management estimates. Such estimates included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. In the event that the engineering facility is not subleased as anticipated, we will be obligated for an additional total lease payments of $1.8 million as of July 30, 2004 to be payable through November 2010.

The following analysis sets forth the significant components of the fourth quarter fiscal 2002 restructuring at July 30, 2004 (in thousands):

	Severance-related amounts	Fixed Assets write-off	Facility	Total
Restructuring charge	$ 813	$ 473	$4,564	$ 5,850
Cash payments and others	(629)	—	(32)	(661)
Non-cash portion	—	(473)	—	(473)
Reserve balance at April 30, 2002	184	—	4,532	4,716
Cash payments and others	(77)	—	(991)	(1,068)
Adjustments	(107)	—	1,030	923
Reserve balance at April 30, 2003	—	—	4,571	4,571
Cash payments and others	—	—	(690)	(690)
Adjustments	—	—	1,327	1,327
Reserve balance at April 30, 2004	—	—	5,208	5,208
Cash payments and others	—	—	(180)	(180)
Reserve balance at July 30, 2004	$ —	$ —	$5,028	$ 5,028

Interest Income — Interest income was $4.1 million and $3.0 million for the first quarters of fiscal 2005 and 2004, respectively. The increase in interest income was primarily driven by higher cash and investment balances provided by operating activities and higher average interest rates on our investment portfolio. We expect interest income to increase for fiscal 2005 as a result of higher cash and invested balances in a higher interest-rate portfolio environment as we reinvest our securities in longer-term investments and rising average interest rates.

Other Expenses, Net — The first quarters of fiscal 2005 and 2004 included net exchange losses from foreign currency transactions of $0.9 million and $0.2 million, respectively. The increase in net exchange loss in the first quarter of fiscal 2005 was a result of volatility of the currency exchange market and increased hedging costs associated with our forward and option activities compared to the same period a year ago.

Net Gain 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 2004, we realized a net gain of $0.1 million on the sale of previously impaired investments.

Provision for Income Taxes — For the first quarter of fiscal 2005, we applied an annual tax rate of 18.0% 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.

Provision for income taxes for fiscal 2004 included a nonrecurring income tax benefit of $16.8 million or approximately $0.05 per share associated with a favorable foreign tax ruling, which occurred during the second quarter of fiscal 2004. This favorable ruling from the Netherlands provides for retroactive benefits dating back to fiscal year 2001 as well as current and future tax rate benefits. This Dutch tax ruling, however, will expire at the end of calendar 2005. There are uncertainties associated with securing a new Dutch tax ruling. As such, we cannot assure you that we will be able to extend this ruling or secure any new favorable rulings, the absence of which may have an adverse impact on the results of our international operations.

Liquidity and Capital Resources

As of July 30, 2004, as compared to April 30, 2004, our cash, cash equivalents, and short-term investments increased by $18.7 million to $826.6 million. We derive our liquidity and capital resources primarily from our cash flow from operations and from working capital. Working capital increased by $32.8 million to $777.8 million as of July 30, 2004, compared to $745.0 million as of April 30, 2004.

In addition to higher net income in the first quarter of fiscal 2005, the primary factors that impacted the period-to-period change in cash flows relating to operating activities included the following:

- Increase in deferred revenues from higher software subscription and service billings attributable to our continuing shift toward larger enterprise customers;

- Increased income taxes payable, primarily reflecting higher profitability in the first quarter of fiscal 2005 as compared to the same period in fiscal 2004; partially offset by higher worldwide tax payments.

The above factors were partially offset by the effects of:

- Increased accounts receivable balances due to higher revenues offset by more linear quarterly sales resulting in more collections in the first quarter of fiscal 2005 compared to the same period in the prior year;

- Decreased accrued compensation and related benefits due to the payout of higher commission and other profit dependent payroll-related expenses accrued in fiscal 2004 and paid in the first quarter of fiscal 2005 as compared to the same period a year ago.

Capital expenditures for the first quarter of fiscal 2005 were $33.3 million, which included the $24.1 million site purchase in Research Triangle Park (RTP), North Carolina, as compared to $12.3 million in the same period a year ago. We used net proceeds of $33.6 million in the first quarter of fiscal 2005 and received net proceeds of $3.4 million in first quarter of fiscal 2004 respectively, for net purchases/redemptions of short-term investments. In the first quarter of fiscal 2004, we acquired additional patents for a purchase price of approximately $9.0 million. Investing activities in the first quarter of fiscal 2004 also included new investments in privately held companies of $0.3 million. We received $0.3 million and $0.4 million in sales proceeds from sales of short and long-term investments in the first quarters of fiscal 2005 and fiscal 2004, respectively.

We used $24.5 million and $2.6 million in the first quarters of fiscal 2005 and fiscal 2004 from net financing activities, which included sales of common stock related to employee stock transactions net of common stock repurchases. We repurchased 2.5 million shares of common stock at a total of $47.7 million during the first quarter of fiscal 2005. During the first quarter of fiscal 2004, we repurchased 2.2 million shares at a total of $34.8 million, of which we paid cash of $26.8 million and the remaining $8.0 million was included in other accrued liabilities. Other financing activities provided $23.2 million and $24.3 million in the first quarters of fiscal 2005 and fiscal 2004, respectively, which related to sales of common stock related to employee stock transactions. The change in cash flow from financing was primarily due to the effects of higher common stock repurchases partially offset by proceeds from issuance of common stock under employee programs compared to the same period in the prior year. Net proceeds from the issuance of common stock related to employee participation in employee stock programs have historically been a significant component of our liquidity. The extent to which our employees participate in these programs generally increases or decreases based upon changes in the market price of our common stock. As a result, our cash flow resulting from the issuance of common stock related to employee participation in employee stock programs will vary.

On May 18, 2004, we announced that the Board authorized an expansion of our stock repurchase program to purchase up to $200.0 million of outstanding common stock in the open market. Any repurchases under our stock repurchase program may be made from time to time in the open market subject to market conditions. The stock repurchase program may be suspended or discontinued at any time. The stock repurchases will be funded from available working capital. The shares repurchased have been taken in as treasury shares and will be held as treasury shares until our Board of Directors designates that these shares be retired or used for some other purpose.

For the first quarters of fiscal 2005 and 2004, we recorded tax benefits, in the form of reduced payments, of $5.7 million and $9.9 million, respectively, associated with disqualifying dispositions of employee stock options. If stock option exercise patterns change, we may receive less cash from stock option exercises and may not receive the same level of tax benefits in the future, which could cause our cash payments for income taxes to increase.

In August 2004, we received a tax refund of $9.0 million and $1.3 million of interest income, in connection with a carryback of net operating losses generated in fiscal 2000. These losses are being carried back into tax years fiscal 1996, 1997, 1998, and 1999.

We expect capital expenditures to increase in the future consistent with the growth in our business, as we continue to invest in people, land, buildings, capital equipment and enhancements to our infrastructure. We expect that our existing facilities and those being developed in Sunnyvale, California and RTP, North Carolina are adequate for our requirements over at least the next two years and that additional space will be available as needed. During the first quarter of fiscal 2005, we purchased three buildings in RTP, North Carolina, for $24.1 million. We expect to finance these construction projects through cash from operations and existing cash and investments. In July 2004, we announced that we are the recipient of an award under the new state Job Development Investment Grant (JDIG) program from the state of North Carolina to assist in our expansion of newly acquired offices in RTP, North Carolina.

Under the split dollar insurance arrangement with Daniel J. Warmenhoven (see Note 13) , we will be reimbursed for all premium payments made on these policies. We expect to be reimbursed $10.2 million no later than May 2005.

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

Contractual Cash Obligations and Other Commercial Commitments

The following summarizes our contractual cash obligations and commercial commitments at July 30, 2004, and the effect such obligations are expected to have on our liquidity and cash flow in future periods, (in thousands):

	Payments Due by Period						
	2005	**2006**	**2007**	**2008**	**2009**	**Thereafter**	**Total**
Contractual Obligations:							
Facilities operating lease payments(1)	$ 9,404	$11,176	$ 7,494	$6,667	$6,584	$ 9,533	$50,858
Equipment operating lease payments	1,970	2,465	1,505	203	73	—	6,216
Venture capital funding commitments(2)	423	564	564	552	539	1,077	3,719
Purchase commitments and other(3)	10,186	720	600	—	—	—	11,506
Communications & Maintenance(4)	4,352	3,735	170	29	12	—	8,298
Restructuring Charges(5)	1,342	794	832	836	818	1,260	5,882
Total Contractual Cash Obligations	$27,677	$19,454	$11,165	$8,287	$8,026	$ 11,870	$86,479

For purposes of the above table, contractual obligations for the purchase of goods and services are defined as agreements that are enforceable, legally binding on us, and subject us to penalties if we cancel the agreement.

	Amount of Commitment Expiration Per Period						
	2005	**2006**	**2007**	**2008**	**2009**	**Thereafter**	**Total**
Other Commercial Commitments:							
Letters of Credit(6)	$1,423	$ —	$ —	$ —	$ —	$ 337	$1,760
Restricted Cash(7)	875	675	508	439	277	99	2,873
Total Commercial Commitments	$2,298	$675	$508	$439	$277	$ 436	$4,633

(1) We enter into facilities operating leases in the normal course of business. Substantially all lease agreements have fixed payment terms based on the passage of time. Some lease agreements provide us with the option to renew the lease. Our future operating lease obligations would change if we were to exercise these renewal options and if we were to enter into additional operating lease agreements. Certain facilities operating sublease income of $271 has been included as a reduction of the payment amounts shown in the table. Facilities operating lease payments exclude the leases impacted by the restructurings. The amounts for the leases impacted by the restructurings are included in sub-paragraph (5) below.

(2) Venture capital funding commitments includes a quarterly committed management fee based on a percentage of our committed funding to be payable through June 2011.

(3) Purchase commitments represent agreements to purchase component inventory from our suppliers and contract manufacturers that are enforceable and legally binding against us. Other commitments include facilities-related and utilities usage minimum commitment. Purchase commitments and other excludes purchases of good and services we expect to consume in the ordinary course of business in the next twelve months. It also excludes costs that are not reasonably estimable at this time.

(4) Under certain communication contracts with major telco companies as well as maintenance contracts with multiple vendors, we are required to pay based on a minimum volume. Such obligations expire through January 2009.

(5) These amounts are included on our Consolidated Balance Sheets under Long-term Obligations and Other Accrued Liabilities which is comprised of committed lease payments, operating expenses net of committed and estimated sublease income. The restructuring estimated sublease income included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. The actual amount paid, if the facility is not subleased, would be increased by $2,127 to be payable through November 2010.

(6) The amounts outstanding under these letters of credit relate to workers' compensation, customs guarantee and a foreign lease.

(7) Restricted cash arrangements relate to facility lease requirements, service performance guarantees, customs and duties guarantees, and VAT requirements and are included under Prepaid Expenses and Other and Other Assets on our Consolidated Balance Sheets.

Guarantees

As of July 30, 2004, our notional fair values of foreign exchange forward and foreign currency option contracts totaled $145,985. We do not believe that these derivatives present significant credit risks, because the counterparties to the derivatives consist of major financial institutions, and we manage the notional amount of contracts entered into with any one counterparty. We do not enter into derivative financial instruments for speculative or trading purposes. Other than the risk associated with the financial condition of the counterparties, our maximum exposure related to foreign currency forward and option contracts is limited to the premiums paid.

We offer both recourse and non-recourse lease financing arrangements to our customers. Under the terms of recourse leases, which are generally three years or less, we remain liable for the aggregate unpaid remaining lease payments to the third-party leasing company in the event that any customers were to default. We defer 100% of the recourse lease obligation and recognize revenue over the term of the lease as the lease payments become due. As of July 30, 2004 and April 30, 2004, the maximum recourse exposure under such leases totaled approximately $6,711 and $6,755, respectively. Under the terms of the non-recourse leases we do not have any continuing obligations or liabilities. To date, we have not experienced significant losses under this lease financing program.

Critical Accounting Estimates and Policies

Our consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of such statements requires us to make estimates and assumptions that affect the reported amounts of revenues and expenses during the reporting period and the reported amounts of assets and liabilities as of the date of the financial statements. Our estimates are based on historical experience and other assumptions that we consider to be appropriate in the circumstances. However, actual future results may vary from our estimates.

We believe that the following accounting policies are "critical" as defined by the Securities and Exchange Commission, in that they are both highly important to the portrayal of our financial condition and results, and require difficult management judgments and assumptions about matters that are inherently uncertain. We also have other important policies, including those related to derivative instruments and concentration of credit risk. However, these policies do not meet the definition of critical accounting policies because they do not generally require us to make estimates or judgments that are difficult or subjective. These policies are discussed in the Notes to the Consolidated Financial Statements, which are included in our Annual Report on Form 10-K for the fiscal year ended June 30, 2004.

We believe the accounting policies described below 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;
- valuation of goodwill and intangibles;
- accounting for income taxes;
- inventory write-down;
- restructuring accruals;
- impairment losses on investments;
- accounting for stock-based compensation; and
- loss contingencies.

These accounting estimates and policies 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, 2004.

New Accounting Standards

The FASB issued FIN No. 46, *"Consolidation of Variable Interest Entities,"* in January 2003, and a revised interpretation of FIN 46 ("FIN 46-R") in December 2003. FIN 46 requires certain variable interest entities ("VIEs") to be consolidated by the primary beneficiary of the entity if the equity investors in the entity do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support from other parties. The provisions of FIN 46 are effective immediately for all arrangements entered into after January 31, 2003. Since January 31, 2003, the Company has not invested in any entities it believes are variable interest entities for which the Company is the primary beneficiary. For all arrangements entered into after January 31, 2003, the Company is required to continue to apply FIN 46 through April 30, 2004. The Company is required to adopt the provisions of FIN 46-R for those arrangements on May 1, 2004. For arrangements entered into prior to February 1, 2003, the Company is required to adopt the provisions of FIN 46-R on May 1, 2004. The Company does not expect the adoption of FIN 46-R to have an impact on the financial position, results of operations or cash flows of the Company.

In November 2003, the EITF reached an interim consensus on EITF No. 03-01, *"The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments,"* to require additional disclosure requirements for securities classified as available-for-sale or held-to-maturity for fiscal years ending after December 15, 2003. In March 2004, the EITF reached a final consensus on this Issue, to provide additional guidance which companies must follow in determining whether investment securities have an impairment which should be considered other-than-temporary. The guidance is applicable for reporting periods after June 15, 2004. Adoption of the consensus did not have a significant impact on the carrying value of its investments at July 30, 2004. The Company will continue to monitor the carrying value of its investments under this new guidance in fiscal 2005.

Risk Factors

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

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

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

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

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

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

• the level of competition in our target product markets;

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

• product configuration and mix;

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

• market acceptance of new products and product enhancements;

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

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

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

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

• supply constraints;

• technological changes in our target product markets;

- the levels of expenditure on research and development and sales and marketing programs;
- our ability to achieve targeted cost reductions;
- excess facilities;
- future accounting pronouncements and changes in accounting policies; and
- seasonality.

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

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

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

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

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

- demand for storage and content delivery products;
- discount levels and price competition;
- direct versus indirect sales;
- product and add-on software mix;
- the mix of services as a percentage of revenue;
- the mix and average selling prices of products;
- the mix of disk content;
- new product introductions and enhancements;
- excess inventory purchase commitments as a result of changes in demand forecasts and possible product and software defects as we transition our products; and
- the cost of components, manufacturing labor, and quality.

Changes in service gross margin may result from various factors such as continued investments in our customer support infrastructure, changes in the mix between technical support services and professional services, as well as the timing of technical support service contract initiations and renewals.

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

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

If we fail to manage our expanding business effectively our operating results could be materially adversely affected.

We have experienced growth in fiscal 2004 and the first quarter of fiscal 2005. Our future operating results depend to a large extent on management's ability to successfully manage expansion and growth, including but not limited to expanding international operations, forecasting revenues, addressing new markets, controlling expenses, implementing infrastructure and systems and managing our assets. In addition, an unexpected decline in the growth rate of revenues without a corresponding and timely reduction in expense growth or a failure to manage other aspects of growth could materially adversely affect our operating results.

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

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

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

In addition, our business also depends on general economic and business conditions. A reduction in demand for network storage and content delivery caused by weakening economic conditions and decreases in corporate spending have resulted in decreased revenues and lower revenue growth rates. In prior years, the network storage and content delivery market growth declined significantly 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, channel and strategic partners; and
- general market conditions.

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

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

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

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

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

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

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

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

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

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

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

We conduct business internationally. For first quarter of fiscal year 2005, approximately 41.6% of our total revenues was from international customers (including U.S. exports). Accordingly, our future operating results could be materially adversely affected by a variety of factors, some of which are beyond our control, including regulatory, political, or economic conditions in a specific country or region, trade protection measures and other regulatory requirements, government spending patterns, and acts of terrorism and international conflicts.

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

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

Potentially adverse tax consequences could also negatively impact the operating and financial results from international operations. International operations currently benefit from a tax ruling concluded in the Netherlands. The Dutch tax ruling, however, will expire at the end of calendar 2005. There are uncertainties associated with securing a new Dutch tax ruling.

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

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

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

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

In the storage market, our FAS appliances and associated storage software portfolio compete primarily with storage system products and data management software from EMC Corporation, Hitachi Data Systems, Hewlett-Packard Company (including the integrated Compaq Computer Corporation), IBM Corporation, and Sun Microsystems, Inc. We have also historically encountered less-frequent competition from companies including Dell, Engenio Information Technologies, Inc. (formerly the Storage Systems Group of LSI Logic Corp.), StorageTek Technology Corporation, Silicon Graphics, Inc., and Xiotech Corporation. In the nearline storage market, which includes the disk-to-disk backup and regulated data storage segments, our NearStore appliances compete primarily against products from EMC and StorageTek. Our NearStore appliances also compete indirectly with traditional tape backup solutions in the broader data backup/recovery space.

In the content delivery market, our NetCache appliances and content delivery software compete against caching appliance and content delivery software vendors including BlueCoat Systems (formerly CacheFlow, Inc.), and Cisco Systems, Inc. Our NetCache business is also subject to indirect competition from content delivery service products such as those offered by Akamai Technologies.

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

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

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

We rely on a limited number of suppliers, and any disruption or termination of these supply arrangements could delay shipment of our products and could materially and 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 products to our customers in a timely manner.

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

We currently rely on several contract manufacturers to manufacture most of our products. Our reliance on our third-party contract manufacturers reduces our control over the manufacturing process, exposing us to risks, including reduced control over quality assurance, production costs, and product supply. If we should fail to effectively manage our relationships with our contract manufacturers, or if our contract manufacturers experience delays, disruptions, capacity constraints, or quality control problems in their manufacturing operations, our ability to ship products to our customers could be impaired and our competitive position and reputation could be harmed. Qualifying a new contract manufacturer and commencing volume production are expensive and time-consuming. If we are required to change contract manufacturers or assume internal manufacturing operations, we may lose revenue and damage our customer relationships. If we inaccurately forecast demand for our products, we may have excess or inadequate inventory, or incur cancellation charges or penalties, which could adversely impact our operating results. As of July 30, 2004, we have no such purchase commitment.

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

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

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

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

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

From time to time, we make equity investments for the promotion of business and strategic objectives. We have already made strategic investments in a number of network storage-related technology companies. Equity investments may result in the loss of investment capital. The market price and valuation of our equity investments in these companies may fluctuate due to market conditions and other circumstances over which we have little or no control. 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.

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 three companies since the beginning of fiscal 2001, including the acquisition of Spinnaker Networks, Inc., for approximately $306.0 million. We completed the Spinnaker acquisition during the fourth quarter of fiscal 2004 and have completed integrating the acquired operations and products from this acquisition into our operations. 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 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 operations.

In addition, we adopted SFAS No. 142 *"Goodwill and Other Intangible Assets,"* which changes the accounting for goodwill from an amortization method to an impairment-only approach. As of July 30, 2004, the fair value for each of our reporting units exceeded the reporting unit's carrying amount and no impairment was recognized. On an ongoing basis, goodwill is reviewed annually for impairment (or more frequently if indicators of impairment arise). There had been no impairment of goodwill and intangible assets as of the end of the first quarter of fiscal 2005. There can be no assurance that future impairment tests will not result in a charge to earnings.

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

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

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

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

If actual results or events differ materially from our estimates and assumptions, our reported financial condition and results of operations for future periods could be materially affected.

The preparation of the consolidated financial statements and related disclosure in conformity with accounting principles generally accepted in the United States of America requires management to establish policies that contain estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Note 2 of the Notes to Consolidated Financial Statements of the Annual Report on Form 10-K for the year ended April 30, 2004 describes the significant accounting policies essential to preparing our consolidated financial statements. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosures. We base our estimates on historical experience and assumptions that we believe to be reasonable under the circumstances. Actual future results may differ materially from these estimates. We evaluate, on an ongoing basis, our estimates and assumptions. In addition, see our Critical Accounting Estimates and Policies under Item 7 of the Annual Report on Form 10-K for the year ended April 30, 2004.

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

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

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

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

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

Market Interest and Interest Income Risk

Interest and Investment Income — As of July 30, 2004, we had short-term investments of $598.6 million. Our investment portfolio primarily consists of highly liquid investments with original maturities at the date of purchase of greater than three months, which are classified as available-for-sale, and investment in marketable equity securities in primarily technology companies. These highly liquid investments, consisting primarily of government and corporate debt securities, are subject to interest rate and interest income risk and will decrease in value if market interest rates increase. A hypothetical 10 percent increase in market interest rates from levels at July 30, 2004 would cause the fair value of these short-term investments to decline by approximately $1.3 million. By policy, we limit our exposure to longer term investments, and a substantial majority of our investment portfolio has maturities of less than three years. Because we have the ability to hold these investments until maturity we would not expect any significant decline in value of our investments caused by market interest rate changes. Declines in interest rates over time will, however, reduce our interest income. We do not use derivative financial instruments in our investment portfolio.

Market Price Risk

Equity Securities — We are also exposed to market price risk on our equity securities included in our short-term investments, which are primarily in publicly traded companies in the volatile high-technology industry sector.

We do not attempt to reduce or eliminate our market exposure on these securities and, as a result, the amount of income and cash flow that we ultimately realize from our investment in future periods may vary materially from the current fair value. A 50% adverse change in the equity price would result in an immaterial decrease in the fair value of our equity security as of July 30, 2004.

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 and option contracts to hedge against the short-term impact of foreign currency fluctuations on certain assets and liabilities denominated in foreign currencies. All balance sheet hedges are marked to market through earnings every period. We also use foreign exchange forward contracts to hedge foreign currency forecasted transactions related to certain sales and operating expenses. These derivatives are designated as cash flow hedges under SFAS No. 133. For cash flow hedges, the gains or losses were included in other comprehensive income at July 30, 2004.

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

The following table provides information about our foreign exchange forward and option contracts outstanding on July 30, 2004 (in thousands):

Currency	Buy/Sell	Foreign Currency Amount	Contract Value USD	Fair Value in USD
Forward contracts:				
CAD	Sell	4,829	$ 3,623	$ 3,650
CHF	Sell	2,882	$ 2,246	$ 2,246
EUR	Sell	64,707	$ 77,777	$ 77,838
GBP	Sell	18,830	$ 34,042	$ 34,113
ZAR	Sell	23,304	$ 3,687	$ 3,687
AUD	Buy	1,915	$ 1,332	$ 1,332
DKK	Buy	7,252	$ 1,173	$ 1,173
EUR	Buy	7,534	$ 9,049	$ 9,062
GBP	Buy	1,809	$ 3,265	$ 3,277
SEK	Buy	6,359	$ 827	$ 827
Option contracts:				
EUR	Sell	5,000	$ 6,017	$ 6,085
GBP	Buy	1,500	$ 2,722	$ 2,695

Item 4. *Controls and Procedures*

Disclosure Controls are procedures designed to ensure that information required to be disclosed in our reports filed under the Exchange Act, such as this Quarterly Report, is recorded, processed, summarized and reported within the time periods specified in the U.S. Securities and Exchange Commission’s rules and forms. Disclosure Controls are also designed to ensure that such information is accumulated and communicated to our management, including the CEO and CFO, as appropriate to allow timely decisions regarding required disclosure.

Under the supervision and with the participation of our management, including our principal executive officer and principal financial officer, we conducted an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended, as of the end of the period covered by this report (the “Evaluation Date”). Based on this evaluation, our principal executive officer and principal financial officer concluded as of the Evaluation Date that our disclosure controls and procedures were effective such that the information relating to Network Appliance, including our consolidated subsidiaries, required to be disclosed in our Securities and Exchange Commission (“SEC”) reports (i) is recorded, processed, summarized and reported within the time periods specified in SEC rules and forms, and (ii) is accumulated and communicated to Network Appliance’s management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

There was no change in our internal control over financial reporting that occurred during the period covered by this Quarterly Report that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

PART II. OTHER INFORMATION

Item 1. ***Legal Proceedings***

None

Item 2. ***Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities***

Repurchases of common stock

On May 13, 2003, we announced that the Board of Directors approved a $150.0 million stock repurchase program to purchase shares of our outstanding common stock in the open market. During fiscal 2004, we repurchased 6.9 million shares of our common stock at an aggregate cost of $136.2 million. The repurchases were recorded as treasury stock and resulted in a reduction of stockholders' equity. On May 18, 2004, we announced that the Board authorized an expansion of the program to purchase an additional $200.0 million of outstanding common stock. Total authorized stock purchase spending may be up to $350.0 million. The stock repurchase program may be suspended or discontinued at any time. The duration of the repurchase program is open-ended. Under the program, we may purchase shares of common stock through open market transactions at prices deemed appropriate by management. The timing and amount of repurchase transactions under this program will depend on market conditions and corporate and regulatory considerations. The purchases will be funded from available working capital.

The following table sets forth common stock repurchases by Network Appliance for the periods indicated:

Period	Shares purchased	Average price paid per share	Total number of shares purchased as part of the Repurchase Program	Approximate Dollar Value of Shares that may yet be purchased under the Repurchase Program
May 1, 2004 – May 31, 2004	1,910,000	$ 19.37	1,910,000	$ 176,825,438
June 1, 2004 – June 30, 2004	550,000	$ 19.52	550,000	$ 166,087,623
July 1, 2004 – July 30, 2004	—	$ —	—	$ 166,087,623
Total	2,460,000	$ 19.41	2,460,000	$ 166,087,623

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

None

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

None

Item 5. ***Other Information***

The information required by this item is incorporated by reference from our Proxy Statement for the 2004 Annual Meeting of Stockholders.

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

(a) *Exhibits*

2.1(3)	Agreement and Plan of Merger, dated as of November 3, 2003, by and among Network Appliance, Inc., Nagano Sub, Inc., and Spinnaker Networks, Inc.
2.2(3)	Amendment to Merger Agreement, dated as of February 9, 2004, by and among Network Appliance, Inc., Nagano Sub, Inc., and Spinnaker Networks, Inc.
3.1(1)	Certificate of Incorporation of the Company
3.2(1)	Bylaws of the Company
4.1(1)	Reference is made to Exhibits 3.1 and 3.2
4.2(4)	Spinnaker Networks, Inc. 2000 Stock Plan
10.1(2)	Asset Purchase Agreement dated June 20, 2003, by and between Auspex Systems, Inc. and the Company.
10.2	Purchase and Sale Agreement dated July 27, 2004 by and between Cisco Systems, Inc. and the Company.
21(5)	Subsidiaries of the Company
31.1	Certification of Chief Executive Officer pursuant to Securities Exchange Act Rules 13a-15(e) and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated August 31, 2004.
31.2	Certification of Chief Financial Officer pursuant to Securities Exchange Act Rules 13a-15(e)and 15d-15(e) as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002, dated August 31, 2004.
32.1	Certification of Chief Executive Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated August 31, 2004.
32.2	Certification of Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated August 31, 2004.

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

(2) Previously filed as an exhibit with the Company's Quarterly Report on Form 10-Q dated September 3, 2003.

(3) Previously filed as an exhibit with the Company's Current Report on Form 8-K dated February 27, 2004.

(4) Previously filed as an exhibit with the Company's Form S-8 registration statement dated March 1, 2004.

(5) Previously filed as an exhibit with the Company's Annual Report on Form 10-K dated June 29, 2004.

(b) *Reports on Form 8-K*

On May 18, 2004, we furnished (but did not file) a report on Form 8-K relating to financial information for Network Appliance for the quarter and year ended April 30, 2004 and forward-looking statements relating to fiscal year 2005, as presented in a press release of May 18, 2004.

SIGNATURE

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

NETWORK APPLIANCE INC.
(Registrant)

/s/ STEVEN J. GOMO

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

Date: August 31, 2004

EXHIBIT INDEX

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EXHIBIT 10.2

PURCHASE AND SALE AGREEMENT

Seller: CISCO SYSTEMS, INC.,
A CALIFORNIA CORPORATION

Buyer: NETWORK APPLIANCE, INC.,
A DELAWARE CORPORATION

Dated as of: July_______, 2004

Property: Research Triangle Park Site 12
Buildings 13, 14 and 15
7301-13 Kit Creek Road
7301-14 Kit Creek Road
7301-15 Kit Creek Road
Research Triangle Park, North Carolina 27709

SUBMISSION NOT AN OPTION

THE SUBMISSION OF THIS AGREEMENT FOR EXAMINATION AND NEGOTIATION DOES NOT CONSTITUTE AN OFFER TO SELL, A RESERVATION OF, OR OPTION FOR THE PROPERTY AND SHALL VEST NO RIGHT IN ANY PARTY. BUYER OR ANYONE CLAIMING UNDER OR THROUGH BUYER SHALL HAVE THE RIGHTS TO THE PROPERTY AS SET FORTH HEREIN AND THIS AGREEMENT SHALL BECOME EFFECTIVE AS A AGREEMENT ONLY UPON EXECUTION, ACKNOWLEDGMENT AND DELIVERY THEREOF BY SELLER AND BUYER, REGARDLESS OF ANY WRITTEN OR VERBAL REPRESENTATION OF ANY AGENT, MANAGER OR EMPLOYEE OF SELLER TO THE CONTRARY.

PURCHASE AND SALE AGREEMENT

Buyer and Seller hereby enter into this Purchase and Sale Agreement (this "Agreement"), intending to be legally bound hereby, as of July ____, 2004 (the "Effective Date") (i.e., the date both parties have executed this Agreement).

1. DEFINED TERMS:

a. The terms listed below shall have the following meanings throughout this Agreement:

Buyer: Network Appliance, Inc., a Delaware corporation

Buyer's Address: 495 East Java Drive
Sunnyvale, California 94089
Attn: Vice President, Work Place Resources

Closing Date: The Effective Date, or such later date (but no later than July 30, 2004) as may be agreed to in writing between Buyer and Seller.

Improvements: A four story office building (Building 13), a three story office building (Building 14), and a three story office building (Building 15), all with accessory surface parking areas and other improvements located on or affixed to the Land, including any and all, heating, air conditioning and ventilation lines, utilities and boilers, fixtures, parking areas, and landscaping.

Leases: None.

Land: That certain parcel of land located in Research Triangle Park, Wake County, North Carolina, more particularly described on Exhibit A attached hereto, together with all rights and interests appurtenant thereto.

Operating

Agreements:	(i) all assignable contracts and agreements (collectively, the "Service Contracts") (it being understood that there are no Service Contracts), and (ii) all assignable licenses, permits, plans, drawings, soils reports, engineering reports, warranties, guaranties, and indemnities in favor of the Seller relating to or affecting the ownership, maintenance or use of the Property, together with any and all amendments, modifications or supplements thereto (collectively, the "Intangibles").
Personal Property:	All items of tangible personal property owned by Seller located at or attached and appurtenant to or forming a part of the Property.
Property:	The Real Property, the Personal Property, and the Operating Agreements.

Property Address:	Research Triangle Park Site 12 Buildings 13, 14 and 15 7301-13 Kit Creek Road 7301-14 Kit Creek Road 7301-15 Kit Creek Road Research Triangle Park, North Carolina 27709
Purchase Price:	$23,968,760.00, all cash.
Real Property:	The Land and the Improvements.
Review Period:	The period commencing as of June 30, 2004 (which the parties acknowledge is the commencement date of the Review Period even though such date is before the date this Agreement is fully executed), and ending immediately prior to the Closing.
Seller:	Cisco Systems, Inc., a California corporation
Seller's Address:	170 West Tasman Drive San Jose, California 95134-1706 Attn: Director, Americas Real Estate
Tenants:	None.
Title Company/ Escrow Agent:	Chicago Title Insurance Company 150 Fayetteville Street Mall, Suite 1130 (27601) P.O. Box 1880 Raleigh, North Carolina 27602-1883 Attn: Ms. Dixie R. Ladrie

b. The following terms are defined in the referenced portion of this Agreement:

Defined Term	Defined In
Agreement	Preliminary Statement
Buyer's Agents	Section 4
Closing	Section 7.a
Contingencies	Section 5.a
Deed	Section 2.a
Forced Removal Title Exceptions	Section 6.c
General Instrument	Section 2.b
Hazardous Substances	Section 11.k
Mortgage Exceptions	Section 6.c
Notice	Section 21
Review Materials	Section 4

Seller's Documents	Section 8.a
Specimen Title Policy	Section 6.a
Survey	Section 6.a
Title Commitment	Section 6.a
Title Requirements	Section 6.a

2. PURCHASE OF PROPERTY: PAYMENT OF PURCHASE PRICE.

Seller shall sell the Property to Buyer, and Buyer shall purchase the Property from Seller, subject to all of the terms, covenants and conditions hereinafter set forth in this Agreement.

a. Real Property. Seller shall sell the Real Property to Buyer, and Buyer shall purchase the Real Property from Seller, on all of the mutual terms, covenants and conditions hereinafter set forth in this Agreement. The Real Property shall be conveyed to Buyer by a Special Warranty Deed ("DEED") in the form attached hereto as Exhibit B and incorporated herein by this reference.

b. Other Interests. All other interests of Seller in the Property (including the Personal Property) shall be transferred and assigned by Seller to Buyer pursuant to the General Instrument of Transfer ("GENERAL INSTRUMENT") in the form annexed hereto as Exhibit C and incorporated herein by this reference.

3. [Intentionally Deleted]

4. DELIVERY OF MATERIALS FOR REVIEW; CONFIDENTIALITY.

In connection with Buyer's acquisition of the Property, Seller has delivered to Buyer or made available to Buyer for its review at the Property, at Seller's Address or at the offices of O'Brien/Atkins Associates, PA, located in Research Triangle Park, North Carolina, any operating files maintained by Seller or its property manager in connection with the leasing, current maintenance and/or management of the Property, including, without limitation, operating agreements, insurance policies, bills, invoices, receipts and other general records relating to the

income and expenses of the Property, correspondence, surveys, plans and specifications, warranties for services and materials provided to the Property, environmental audits and similar materials, but excluding materials not directly related to the leasing, current maintenance and/or management of the Property such as, without limitation, Seller's internal memoranda, financial projections, budgets, appraisals, accounting and tax records and similar proprietary, elective or confidential information ("REVIEW MATERIALS"). In addition to the Review Materials, Seller has made available to Buyer at such place or places at the Property, in the offices of the property manager or elsewhere as the same may be located, copies of all other materials and other information in connection with the leasing, current maintenance and/or management of the Property, to the extent the same were requested by Buyer.

The Review Materials and all materials, books and records made available to or examined by or on behalf of Buyer pursuant to this Agreement shall: (i) be held in strict confidence by Buyer; (ii) not be used for any purpose other than the investigation and evaluation of the Property by Buyer and its lenders, attorneys, engineers, consultants and representatives (collectively, "BUYER'S AGENTS"); and (iii) not be disclosed, divulged or otherwise furnished to any other person or entity except to Buyer's Agents or as required by law. If this Agreement is terminated for any reason whatsoever, Buyer shall return to Seller all of the Review Materials, in the possession of Buyer and Buyer's Agents. The provisions of this Section shall survive the termination of this Agreement.

5. CONTINGENCIES.

a. Contingencies to Purchase. Buyer's obligation to purchase the Property is subject to the satisfaction of the contingencies described below ("CONTINGENCIES TO PURCHASE").

(1) Seller shall have delivered to Escrow Agent or Buyer all of the items required to be delivered to Escrow Agent or

Buyer pursuant to the terms of this Agreement, including but not limited to, those required to be delivered by Seller pursuant to Section 8.

(2) All of the representations and warranties of Seller contained in this Agreement shall be true and correct in all material respects as of the Closing Date (with appropriate modifications permitted under this Agreement or not materially adverse to Buyer).

(3) Seller shall have performed and observed, in all material respects, all covenants and agreements of this Agreement to be performed and observed by Seller as of the Closing Date.

b. Contingencies to Sell. Seller's obligation to sell the Property is subject to the satisfaction of the contingencies described below ("CONTINGENCIES TO SELL").

(1) Seller shall have received the Purchase Price as adjusted pursuant to and payable in the manner provided for in this Agreement.

(2) Buyer shall have delivered to Escrow Agent or Seller all of the items required to be delivered to Escrow Agent or Seller pursuant to the terms of this Agreement, including but not limited to, those provided for in Section 8.

(3) All of the representations and warranties of Buyer contained in this Agreement shall be true and correct in all material respects as of the date of Closing.

(4) Buyer shall have performed and observed, in all material respects, all covenants and agreements of this Agreement to be performed and observed by Buyer as of the date of Closing.

(5) Seller shall have received written approval of this transaction from Research Triangle Foundation of North Carolina.

6. TITLE. At Closing, Seller shall convey and transfer to Buyer such title to the Property as will enable the Title Company to issue to Buyer, at Buyer's expense, an ALTA Owner's Policy of Title Insurance (the "TITLE POLICY") covering the Property, in the full amount of the Purchase Price. Notwithstanding anything contained herein to the contrary, the Property shall be conveyed subject to the following matters, which shall be deemed to be Permitted Exceptions: (i) the lien of all ad valorem real estate taxes and assessments not yet due and payable as of the date of Closing, subject to adjustment as herein provided; (ii) local, state and federal laws, ordinances or governmental regulations, including but not limited to, building and zoning laws, ordinances and regulations, now or hereafter in effect relating to the Property; and (iii) items appearing of record (other than the Forced Removal Title Exceptions (as defined below)) or shown on the Survey.

(a) Title Commitment; Survey. Buyer, at Buyer's expense, shall have the right to cause the issuance of (i) a commitment of the Title Company ("TITLE COMMITMENT") for an owner's title insurance policy in the form of a specimen ALTA Form B (1987) with respect to the Real Property ("SPECIMEN TITLE POLICY"), containing such endorsements, affirmative coverages, deletions of printed exceptions and title exceptions, and reinsurance agreements as Buyer shall approve, and Title Company agrees to issue, and specifying Title Company's requirements relating to the issuance of such Specimen Title Policy ("TITLE REQUIREMENTS") and (ii) an ALTA survey of the Real Property by a duly licensed surveyor showing all physical conditions affecting the Real Property sufficient for the deletion of the survey exception in accordance with the Title Requirements ("SURVEY").

(b) [Intentionally Deleted]

(c) Forced Removal Title Exceptions. Seller hereby agrees that it shall remove (x) a mechanic's or materialman's lien for work performed on the Property at the request of Seller; or (y) a mortgage or related security documents or similar encumbrance given to secure indebtedness for money borrowed by Seller ("MORTGAGE EXCEPTIONS") (all of the foregoing in (x) and (y)) hereinafter collectively referred to as "FORCED REMOVAL TITLE EXCEPTIONS").

7. CLOSING REQUIREMENTS.

a. The Closing. On the Closing Date, all matters to be performed under this Agreement incident to the sale of the Property, and the payment of the Purchase Price (collectively, "CLOSING") shall be performed at the offices of Escrow Agent in Raleigh, North Carolina, or other mutually acceptable location agreed to in writing by Buyer and Seller. The Closing shall commence at 10:00 a.m. Notwithstanding anything in this Section 7.a to the contrary, the parties agree to use commercially reasonable efforts to pre-close the transaction contemplated hereby (i.e., sign documents into escrow) on the business day immediately preceding the then-scheduled date of Closing.

b. Possession and Condition of the Property. Without limiting the generality of the foregoing, at Closing full possession of the Real Property is to be delivered to Buyer, subject to the Permitted Exceptions.

8. CLOSING DELIVERIES.

a. Seller's Deliveries. Seller shall deliver or cause to be delivered the following documents ("SELLER'S DOCUMENTS") at or prior to the Closing:

(1) The duly executed and acknowledged Deed.

(2) A certification duly executed by Seller under penalty of perjury stating that Seller is not a "foreign person" within the meaning of Section 1445 of the Internal Revenue Code of 1986, as amended, in the form annexed hereto as Exhibit E.

(3) Originals (or copies thereof if originals are not available) of all documents and materials in the possession of Seller or Seller's agents assigned pursuant to the General Instrument.

(4) Originals (or copies thereof if originals are not available) of all Review Materials if not already provided, and all other books and records of Seller in the possession or control of Seller pertaining in a material way to the operation and management of the Property (excluding materials not directly related to the maintenance, operation or management of the Property such as, without limitation, Seller's internal memoranda, financial projections, budgets, appraisals, accounting and income tax records and similar proprietary, elective or confidential information).

(5) [Intentionally Deleted]

(6) [Intentionally Deleted]

(7) Such affidavits as the Title Company may reasonably require in order to omit from any title insurance policy issued to Buyer or Buyer's mortgagee except for (i) parties in possession and (ii) mechanic's liens created by or through Seller.

(8) Any corporate, partnership or other authorization documents necessary to record the Deed.

(9) Evidence as the Title Company may reasonably require as to the authority of any individuals or constituent members in Seller to execute any instruments executed and delivered by Seller at Closing.

(10) Any of the following which are requested by Buyer and in the possession of or reasonably available to Seller: any and all keys, and lock and safe combinations.

(11) Additional documents reasonably required by the Title Company to consummate the transaction expressly contemplated

by this Agreement.

b. Mutual Deliveries. Buyer and Seller shall deliver or cause to be delivered the following at or prior to the Closing:

(1) Executed counterparts of the General Instrument; and

(2) A closing statement reflecting the adjustments made at the Closing and described in Section 9 hereof.

c. Buyer's Deliveries. Buyer shall, at or prior to the Closing:

(1) Pay to Seller the full amount of the Purchase Price (plus any additional funds necessary to pay Buyer's share of closing costs and prorations, as hereinafter set forth) by wire transfer of immediately available funds; and

(2) [Intentionally Deleted]

(3) Deliver evidence as the Title Company may reasonably require as to the authority of any individuals or constituent members in Buyer to execute any instruments executed and delivered by Buyer at Closing.

9. CLOSING COSTS AND PRORATIONS. At Closing, closing costs shall be paid and prorations made as follows:

a. Closing Costs. Seller shall pay: (a) the fees of any counsel representing it in connection with this transaction; (b) one-half (1/2) of any escrow fee which may be charged by the Title Company; and (c) all state, county, or local transfer (excise) taxes. Buyer shall pay: (u) the fees of any counsel representing it in connection with this transaction; (v) recording charges and costs; (x) the fee for any title exam and the title insurance premium for the Owner's title insurance policy issued at Closing to Buyer by the Title Company; (y) the costs for the Survey; and (z) one-half (1/2) of any escrow fee charged by the Title Company.

b. Prorations. The Purchase Price shall be subject to the following prorations. All such prorations shall be made so that Buyer has the benefit of rent and bears the burden of expenses as of 12:01 a.m. on the date of Closing.

(1) Taxes. Non-delinquent real property taxes and non-delinquent general and special assessments shall be prorated through the Closing Date on the basis of

the calendar year for such taxes and assessments. Delinquent real property taxes or delinquent general or special assessments shall be paid at Closing, and Seller shall be charged an amount equal to that portion of such taxes or assessments which relates to the period prior to Closing. If the Closing Date shall occur before the real property tax rate for such calendar year is fixed, the apportionment of taxes shall be made on the basis of the taxes assessed for the preceding calendar year. After the real property taxes are finally fixed for the calendar year in which the Closing Date occurs, Seller and Buyer shall make a recalculation of the apportionment of such taxes, and Seller or Buyer, as the case may be, shall make an appropriate payment to the other based on such recalculation. To the extent Seller has undertaken to obtain any real estate tax abatement, the amount of the net proceeds of such tax abatement shall be prorated through the Closing Date, if, as and when such proceeds are paid by the applicable governmental taxing authority.

(2) Utilities. Final readings on all gas, water and electric meters shall be made as of the Closing Date, if possible. If final readings are not possible, gas, water and electricity charges will be prorated based on the most recent period for which costs are available. Any deposits made by Seller with utility companies shall be returned to Seller by such utility companies. Buyer shall be responsible for making all arrangements for the continuation of utility services.

Notwithstanding any of the foregoing provisions: the Personal Property is included in this sale, without further charge, except that Buyer shall pay to Seller the amount of any and all sales or similar taxes payable in connection with the Personal Property, if any, and Buyer shall execute and deliver any tax returns required of it in connection therewith, said obligations of Buyer to survive Closing.

10. DEFAULT.

a. Buyer's Default. If Seller is not in default of Seller's representations, warranties and covenants under this Agreement and is ready, willing and able to convey the Property in accordance with this Agreement, and Buyer fails to consummate this Agreement and take title, then the parties hereto recognize and agree that the damages that Seller will sustain as a result thereof will be substantial, but difficult if not impossible to ascertain and Seller shall, as its sole remedy, be entitled to retain the Deposit as liquidated damages, and not as a penalty and neither party shall have any further rights or obligations with respect to the other under this Agreement, except for the those which are expressly stated to survive termination of this Agreement. Buyer agrees not to interpose any defense or otherwise seek to interfere with Seller's retention and ownership of the Deposit.

b. Seller's Default. In the event that Buyer is not in default of Buyer's representations, warranties and covenants under this Agreement and is ready, willing and able to take title to the Property in accordance with this Agreement, and Seller fails to consummate this Agreement and convey title as set forth herein, Buyer shall have an action for specific performance of Seller's obligations to execute the documents required to convey the Property to Buyer, it being understood that the remedy of specific performance shall not be available to enforce any other obligation of Seller hereunder; alternatively, Buyer may elect to terminate this Agreement and recover the Deposit. In either such case, Buyer shall have no right to an action

for damages against Seller other than for the return of the Deposit. Buyer shall be deemed to have elected to terminate this Agreement and receive back the Deposit if Buyer fails to file suit for specific performance against Seller in a court having jurisdiction in the county and state in which the Property is located, on or before sixty (60) following the date upon which Closing was to have occurred.

11. SELLER'S REPRESENTATIONS AND WARRANTIES. Seller hereby makes the following representations and warranties to Buyer as of the Effective Date:

a. Due Authorization. Seller is duly organized, validly existing, and in good standing under the laws of the State of California, has all necessary power and authority to own and use its properties and to transact the business in which it is engaged, and has full power and authority to enter into this Agreement, to execute and deliver the documents and instruments required of Seller herein, and to perform its obligations hereunder. Seller is duly authorized to execute and deliver, and perform this Agreement and all documents and instruments and transactions contemplated hereby or incidental hereto.

b. Leases. There are no leases or occupancy agreements to which Seller is a party affecting the Property.

c. No Conflict. The execution and delivery of, and consummation of the transactions contemplated by this Agreement is not prohibited by, and will not conflict with, constitute grounds for termination of, or result in the breach of any agreement or instrument to which Seller is now a party or otherwise subject.

d. Notices. To Seller's knowledge, prior to the Effective Date Seller has received no written notice or citation (a "NOTICE") from any federal, state, county or municipal authority or any other party alleging any fire, health, safety, building pollution, environmental, zoning or other violation of any law, regulation, permit, order or directive in respect of the Property or any part thereof which violation remains outstanding.

e. Legal Proceedings. Seller has received no written notice of any actions, suits or proceedings, pending before any court, commission, agency or other administrative authority against, or affecting the Property which, if adversely determined, could individually or in the aggregate have a materially adverse effect on title to the Property or any portion thereof or which could in any material way interfere with the consummation by Seller of the transaction contemplated by this Agreement.

f. [Intentionally Deleted]

g. Eminent Domain. Seller has received no written notice from any governmental authority that any eminent domain proceedings relating to the Property are pending, and to Seller's knowledge no such proceedings are threatened.

h. No Other Contracts. There are no other written agreements affecting the Property by which Purchaser would be bound other than the Operating Agreements, the Permitted Exceptions and this Agreement (and the closing documents executed by Buyer in connection herewith).

i. Updating of Schedules Exhibits Representations and Warranties. Seller shall modify, update and supplement all representations, warranties, exhibits and schedules attached to or delivered in connection with this Agreement through the Closing Date to the extent required to make such representations, warranties, exhibits and schedules true, accurate and complete.

j. As-Is Purchase. As a material inducement to Seller to execute this Agreement, Buyer acknowledges, represents and warrants that, subject to and in reliance on the representations and warranties of Seller set forth in this Section 11, upon the satisfaction or waiver of the Contingencies (i) Buyer will have fully examined and inspected the Property, together with the Review Materials and such other documents and materials with respect to the Property which Buyer deems necessary or appropriate in connection with its investigation and examination of the Property, (ii) Buyer will have accepted the foregoing and the physical condition, value, presence/absence of Hazardous Substances, financing status, use, leasing, operation, tax status, income and expenses of the Property, (iii) except with respect to Seller's representations and warranties as set forth in this Section 11 (subject to the limitations set forth in this Section 11, including, without limitation, in subsections l and m), the Property will be purchased by Buyer "AS IS" and "WHERE IS" and with all faults and, upon Closing, Buyer shall assume responsibility for the physical condition of the Property and (iv) Buyer will have decided to purchase the Property solely on the basis of its own independent investigation. Except as expressly set forth herein or in Seller's Documents, Seller has not made, does not make, and has not authorized anyone else to make any representation as to the present or future physical condition, value, presence/absence of Hazardous Substances, financing status, leasing, operation, use, tax status, income and expenses or any other matter or thing pertaining to the Property, and Buyer acknowledges that no such representation or warranty has been made and that in entering into this Agreement it does not rely on any representation or warranty other than those expressly set forth in this Agreement or in Seller's Documents. EXCEPT AS EXPRESSLY SET FORTH IN THIS AGREEMENT OR IN SELLER'S DOCUMENTS, SELLER MAKES NO WARRANTY OR REPRESENTATION, EXPRESS OR IMPLIED OR ARISING BY OPERATION OF LAW, INCLUDING, WITHOUT LIMITATION, ANY WAY OF CONDITION, HABITABILITY, MERCHANTABILITY, OR FITNESS FOR A PARTICULAR PURPOSE OF THE PROPERTY. Seller shall not be liable for or bound by any verbal or written statements, representations, real estate broker's "setups" or information pertaining to the Property furnished by any real estate broker, agent, employee, servant or any other person unless the same are specifically set forth in this Agreement or in Seller's Documents. The provisions of this Section 11.j. shall survive the Closing. If Buyer shall proceed to Closing with actual knowledge of any matter, or as to any matter set forth in the Review Materials which is in conflict with any of Seller's representations, warranties or indemnities made in this Agreement, Buyer shall be deemed to have waived such Seller's representations, warranties or indemnities to the extent inconsistent with such actual knowledge or the contents of such Review Materials.

k. Environmental Status. Except as disclosed in Exhibit F and the additional reports and/or governmental files referred to therein, to Seller's knowledge, Seller has received no written notification that any governmental or quasi-governmental authority has determined that there are any violations of any environmental statutes, ordinances or regulations affecting the Property. As used herein, the term "HAZARDOUS SUBSTANCES" shall include, asbestos-containing materials, polychlorinated biphenyls, flammable materials, explosives, radioactive materials, petroleum products and those materials or substances now or heretofore defined as "hazardous substances," "hazardous materials," "hazardous waste," "toxic substances," or other similar designations under the Comprehensive Environmental Response, Compensation and Liability Act of 1980, as amended, 42 U.S.C. Section 9601 et seq., the Resource Conservation and Recovery Act, 42 U.S.C. Section 6901 et seq., the Hazardous Materials Transportation Act, 49 U.S.C. Section 1801 et seq., the Federal Water Pollution Control Act, 33 U.S.C. Section 1251 et seq., the Clean Air Act, 42 U.S.C. Section 7401 et seq., the Toxic Substances Control Act, 15 U.S.C. Section 2601 et seq., the Refuse Act, 33 U.S.C. Section 407 et seq., together with all implementing regulations or any other applicable similar state federal, county, regional, municipal or local law, statute, ordinance, rule or regulation governing the control of substances dangerous to public health or safety as same may be amended from time to time.

l. Limitation of Seller's Representations. All representations and warranties made by Seller in this Agreement, unless expressly provided otherwise, shall not survive the Closing. Where representations and warranties are made in this Agreement to "Seller's knowledge," such phrase shall mean and be limited to the actual knowledge of Suzanne Cooper, Chris Kite and Thomas Colwell (the "DESIGNATED EMPLOYEES") and shall not be construed, by imputation or otherwise, to refer to the knowledge of Seller or any affiliate of Seller, to any property manager or to any officer, agent, manager, representative or employee of Seller or any affiliate of Seller, or to impose upon such Designated Employees any duty to investigate the matter to which such actual knowledge, or the absence thereof, pertains.

m. Survival of Seller's Representations and Warranties. The representations and warranties of Seller set forth in this Section 11, as updated by the certificate of Seller to be delivered to Buyer at Closing in accordance with Section 8.a(6) hereof, shall survive Closing for a period of twelve (12) months. No claim for a breach of any representation or warranty of Seller shall be actionable or payable (a) if the breach in question results from or is based on a condition, state of facts or other matter which was actually known to Buyer or disclosed in writing to Buyer prior to Closing, (b) unless the valid claims for all such breaches collectively aggregate more than Fifty-Thousand Dollars ($50,000.00), in which event the full amount of such claims shall be actionable, and (c) unless written notice containing a description of the specific nature of such breach shall have been given by Buyer to Seller prior to the expiration of said twelve (12) month period and an action shall have been commenced by Buyer against Seller within ninety (90) days after the termination of the survival period provided for above in this Section. Buyer agrees to first seek recovery under any insurance policies and service contracts prior to seeking recovery from Seller, and Seller shall not be liable to Buyer if Buyer's claim is satisfied from such insurance policies and service contracts. As used herein, the term "Cap" shall mean the total aggregate amount of One Million Dollars ($1,000,000.00). In no event shall Seller's aggregate liability to Buyer under this Agreement, for breach of any representation or warranty of Seller in this Agreement or the certificate to be delivered by Seller at Closing pursuant to Section 8.a(6) hereof or otherwise for any other breach by Seller under this Agreement, exceed the amount of the Cap.

12. BUYER'S REPRESENTATIONS AND WARRANTIES. Buyer hereby makes the following representations and warranties to Seller as of the Effective Date:

a. Due Authorization. Buyer is duly organized, validly existing, and in good standing under the laws of the State of Delaware, is duly qualified and in good standing under the laws of the State of North Carolina, has full power to execute, deliver and carry out the terms and provisions of this Agreement and has taken all necessary action to authorize the execution, delivery and performance of this Agreement, and the individual(s) executing this Agreement on behalf of Buyer has the authority to bind Buyer to the terms and conditions of this Agreement.

b. Enforceability. This Agreement and all documents required hereby to be executed by Buyer, when so executed, shall be legal, valid, and binding obligations of Buyer, enforceable against Buyer in accordance with their respective terms, subject to applicable bankruptcy, insolvency, reorganization, moratorium, and other similar laws affecting the rights of creditors generally and, as to enforceability, to general principles of equity (regardless of whether enforcement is sought in a proceeding in equity or at law).

13. GENERAL COVENANTS. The parties covenant to do the following.

a. [Intentionally Deleted]

b. Entry; Buyer's Inspection; Termination. During the Review Period, Buyer and Buyer's Agents may enter the Property from time to time (and without unreasonably interfering with the operation of the Property) for purposes of (i) performing non-invasive physical tests (except that Buyer may perform minor testing to determine the presence of asbestos-containing materials, termites and other wood destroying insects, provided that all damage resulting therefrom is promptly repaired by Buyer at its sole expense and to Seller's reasonable satisfaction) and (ii) conduct any and all engineering, environmental and other inspections at the Property and examine and evaluate relevant agreements and documents within the possession of Seller or subject to its control as Buyer may reasonably request. No soil and/or ground water sampling shall be performed unless and until the location, scope and methodology of such sampling and the environmental consultant selected by Buyer to perform such sampling have all been approved by Seller. Prior to conducting any such sampling, Buyer shall have a utility mark-out performed for the Property. Copies of all environmental and engineering reports prepared by or on behalf of Buyer with respect to the Property shall be provided promptly to Seller. With respect to Buyer's right to inspect the Property, Buyer agrees that each inspection shall be performed during normal business hours or at such other times as Seller and Buyer shall mutually agree. Seller shall have the right, at its option, to cause Seller's representative to be present at all inspections, reviews and examinations conducted on the Property by Buyer. All communications in connection with this Agreement and/or access to the Property shall be through Suzanne Cooper and no one else. Such inspections, assessments and tests shall not damage the Property in any respect, shall not be invasive in any respect (unless Buyer obtains Seller's prior written consent), and shall be conducted in accordance with standards customarily employed in the industry and in compliance with all governmental laws, rules and regulations. Following each entry by Buyer with respect to inspections and/or tests on the Property, Buyer shall restore the Property to a condition which is as near to its original condition as existed prior to any such inspections and/or tests. Buyer shall not contact any third parties in connection with the Property without obtaining Seller's prior consent and shall not disrupt Seller's activities on the Property. Buyer shall obtain, pay for, and maintain at all times during the term of this Agreement, insurance policies and minimum limits of coverage as designated below, and any

other insurance required by law, regulation or order, with insurance companies licensed to do business in the state in which Buyer's activities hereunder are to be performed, with an A.M. Best's Insurance Rating of A:VIII or better. In no way do these minimum requirements limit the liability assumed elsewhere in this Agreement, including but not limited to Buyer's defense and indemnity obligations.

(i) Workers' Compensation insurance as required by any applicable law or regulation, and Employer's Liability insurance in amounts not less than $1,000,000;

(ii) Commercial General Liability insurance on an occurrence, not claims-made, basis, including coverage for bodily injury, property damage, personal and advertising injury, products/completed operations, contractual liability and cross liability, covering all operations by or on behalf of Buyer arising out of or connected with this Agreement, with the minimum limits of $1,000,000.00 per occurrence and $2,000,000.00 in the annual aggregate, and including Seller as an additional insured, but only to the extent of Buyer's indemnity obligations pursuant to this Agreement;

(iii) Automobile Liability insurance covering all Buyer's owned, hired and non-owned vehicles used in connection with this Agreement, providing coverage of $1,000,000.00 combined single limit; and

(iv) Umbrella and/or Excess Liability insurance on an occurrence, not claims-made, basis, with minimum limits of $5,000,000.00 per occurrence excess of Buyer's Employer's Liability, Commercial General Liability and Automobile Liability policies, and with coverage terms at least as broad as the underlying insurance

Buyer's insurance shall be primary to and noncontributory with any and all other insurance maintained by or otherwise afforded to Seller. Except where prohibited by law, Buyer's insurers shall waive all rights of recovery or subrogation against Seller, but only to the extent of liabilities falling within Buyer's indemnity obligations under this Agreement. Buyer shall deliver to Seller certificates of insurance evidencing the coverages outlined above at the time this Agreement is executed or within a reasonable time thereafter and within a reasonable time after such coverage is renewed or replaced. All such certificates shall provide that the insurer will endeavor to provide Seller with 30 days prior written notice in the event of cancellation or non-renewal of coverage. The provisions of this Section 13.b shall survive the Closing or the earlier termination of this Agreement.

c. [Intentionally Deleted]

d. Tenant Estoppels. No estoppels are required to be obtained or delivered by Seller in connection with the transaction contemplated by this Agreement.

14. USE OF PROCEEDS TO CLEAR TITLE. Any unpaid taxes, assessments, water charges and sewer rents, together with the interest and penalties thereon, which are due and payable on or before the Closing Date, and any other liens and encumbrances which Seller is obligated to pay and discharge, together with the cost of recording and filing any instruments necessary to discharge such liens and encumbrances of record, may be paid out of the proceeds of the monies

payable on the Closing Date provided satisfactory arrangements are made with the Title Company to ensure obtaining and recording of discharges with respect to the same.

15. SURVIVAL. The terms, covenants and indemnities contained in this Agreement required to be operative after delivery of the Deed shall survive delivery of the Deed without limitation as to time, unless a time limitation is expressly provided, and shall not be deemed to have been merged in the Deed.

16. DAMAGE TO PROPERTY. If the Property or any part thereof (i) is damaged by casualty or (ii) is taken by exercise of the power of eminent domain prior to the Closing Date, and in the case of either such casualty or taking the damage to the Property exceeds One Million Dollars ($1,000,000), as reasonably determined by Seller, Buyer may terminate this Agreement by notice given to Seller within ten (10) business days of the date Seller gives notice to Buyer of such casualty or taking. If Buyer does so terminate this Agreement, Seller shall promptly return the Deposit to Buyer. If Buyer does not so terminate this Agreement or such damage does not exceed One Million Dollars ($1,000,000) the parties shall proceed to Closing without any reduction in the Purchase Price except as specifically provided below. At the Closing, Seller shall assign to Buyer all insurance proceeds arising from the casualty, together with a credit against the Purchase Price equal to the deductible amount under the applicable insurance policy, or pay over or assign to Buyer all awards recovered or recoverable on account of such taking. As an inducement to Buyer to agree to the provisions of this Section 16, Seller represents to Buyer that Seller maintains property insurance for the Property through a program of self insurance in an amount equal to the full replacement cost of the Improvements, and Seller agrees to continue coverage in such amount in effect through the Closing Date.

17. BROKERAGE COMMISSION. Seller and Buyer each warrant to the other party that its sole contact with the other party or the Property regarding this transaction has been directly with the other party. Nevertheless, Seller has communicated with The Staubach Company ("STAUBACH") and Buyer has communicated with Tri Properties ("TP") and Commercial Carolina Corporation ("CCC") in connection with the transaction contemplated by this Agreement. Seller has agreed to pay a commission to Staubach in connection with the transaction contemplated by this Agreement in the amount of one hundred thousand dollars ($100,000.00). As an accommodation, Seller has agreed to pay a commission directly to each of TP and CCC in connection with the transaction contemplated by this Agreement in the amount of one quarter of one percent (.25%) of the Purchase Price (collectively, the "Cisco Share"). Neither Staubach, CCC nor TP shall be entitled to any other commission, brokerage fee,

or other compensation from Seller in connection with this transaction. Any additional compensation which may be due to TP and CCC shall be payable from Buyer only. The foregoing commissions shall be earned, due and payable only upon consummation of Closing (including recordation of the Deed and receipt of Seller's funds) and not otherwise. In the event Closing (including recordation of the Deed and receipt of Seller's funds) does not occur, for whatever reason, whether by default of Buyer or Seller, or otherwise, Staubach, TP and CCC hereby waive any right to any fee or commission and any claim or right of claim to any fee or commission, including, without limitation, a claim of frustration of commission. Seller and Buyer further warrant to each other that no other broker or finder can properly claim a right to a commission or finder's fee based upon contacts between the claimant and the warranting party with respect to the other party or the Property. Seller and Buyer shall indemnify, defend, protect and hold the

other party harmless from and against any loss, cost or expense, including, but not limited to, reasonable attorneys' fees and court costs, resulting from any claim for a fee or commission by any broker or finder in connection with the Property and this Agreement resulting from the indemnifying party's actions or a breach of any of the foregoing provisions. Without limiting the foregoing, Buyer specifically agrees to indemnify Cisco for any amounts that may be payable to TP or CCC over and above the Cisco Share and for any loss, cost or expense, including, but not limited to, reasonable attorneys' fees and court costs, resulting from CCC's or TP's failure to sign the signature block of this Agreement. The foregoing indemnities shall survive the Closing.

18. SUCCESSORS AND ASSIGNS. The terms, covenants and conditions herein contained shall be binding upon and inure to the benefit of the successors and assigns of the parties hereto. Buyer may not assign its rights under this Agreement without first obtaining Seller's written approval, which approval may be given or withheld in Seller's sole and absolute discretion. No assignment shall release or otherwise relieve Buyer from any obligations hereunder.

19. ENTIRE AGREEMENT. This Agreement contains all of the covenants, conditions and agreements between the parties and shall supersede all prior correspondence, agreements and understandings, both verbal and written. The parties intend that this Agreement constitute the complete and exclusive statement of its terms and that no extrinsic evidence may be introduced in any proceeding involving this Agreement.

20. ATTORNEYS' FEES. In the event of any litigation regarding the rights and obligations under this Agreement or in the Escrow Agreement, the prevailing party shall be entitled to reasonable attorneys' fees and court costs. Each party shall bear its own attorneys' fees in connection with the preparation of this Agreement and the consummation of the transactions contemplated hereunder.

21. NOTICES. Any notice, demand, request, consent, approval, disapproval or certificate ("NOTICE") required or desired to be given under this Agreement shall be in writing and given by certified mail, return receipt requested, by personal delivery or by Federal Express or a similar nationwide over-night delivery service providing a receipt for delivery. Notices may not be given by facsimile. The date of giving any Notice shall be deemed to be the date upon which delivery is actually made by one of the methods described in this Section 12.7 (or attempted if said delivery is refused or rejected). If a Notice is received on a Saturday, Sunday or legal holiday, it shall be deemed received on the next business day. All notices, demands, requests, consents, approvals, disapprovals, or certificates shall be addressed as follows:

If to Buyer:	Network Appliance, Inc. 495 East Java Drive Sunnyvale, California 94089 Attn: Mr. Thomas Bryant
with a copy to:	Cox, Castle & Nicholson LLP 555 Montgomery Street Suite 1500 San Francisco, California 94111 Attn: Doug Van Gessel, Esq.

If to Seller: Cisco Systems, Inc.
170 West Tasman Drive
San Jose, California 95134-1706
Attn: Director of Americas Real Estate

with a copy to: Piper Rudnick LLP
1200 Nineteenth Street, N.W.
Washington, D.C. 20036
Attn: Jeffrey R. Keitelman, Esq.

Either party may change its address by giving reasonable advance written Notice of its new address in accordance with the methods described in this Section 21.

22. EXHIBITS AND DEFINED TERMS. All exhibits attached hereto are incorporated herein by reference thereto. All of the terms and definitions set forth in the Defined Terms section are incorporated in this Agreement by reference thereto.

23. TIME. Time is of the essence of every provision herein contained. When the last day for the performance of any act permitted or required hereunder falls on any day which is not a business day in the City of Raleigh, North Carolina, such act may be performed on the next business day in said city. When an act must be performed or a notice given by the end of a specified day, such act must be performed or such notice given by 5:00 p.m. in the City of Raleigh, North Carolina.

24. CONFIDENTIALITY. Buyer and its representatives shall hold in strictest confidence all data and information obtained with respect to Seller or its business, whether obtained before or after the execution and delivery of this Agreement, and shall not disclose the same to others; provided, however, that it is understood and agreed that Buyer may disclose such data and information to the employees, consultants, accountants and attorneys of Buyer provided that such persons agree in writing to treat such data and information confidentially. In the event this Agreement is terminated or Buyer fails to perform hereunder, Buyer shall promptly return to Seller any statements, documents, schedules, exhibits or other written information obtained from Seller in connection with this Agreement or the transaction contemplated herein. It is understood and agreed that, with respect to any provision of this Agreement which refers to the termination of this Agreement and the return of the Deposit to Buyer, such Deposit shall not be returned to Buyer unless and until Buyer has fulfilled its obligation to return to Seller the materials described in the preceding sentence. In the event of a breach or threatened breach by Buyer or its agents or representatives of this Section 24, Seller shall be entitled to an injunction restraining Buyer or its agents or representatives from disclosing, in whole or in part, such confidential information. Nothing herein shall be construed as prohibiting Seller from pursuing any other available remedy at law or in equity for such breach or threatened breach. The provisions of this Section 24 shall survive Closing or any early termination of this Agreement.

25. APPLICABLE LAW. This Agreement shall be governed by the laws of the State of North Carolina.

26. NO ORAL MODIFICATION OR WAIVER. This Agreement may not be changed or amended orally, but only by an agreement in writing. No waiver shall be effective hereunder unless given in writing, and waiver shall not be inferred from any conduct of either party.

27. NO RECORDING. Buyer agrees that it shall not record or file this Agreement or any summary of the provisions thereof. Any such recording or filing shall automatically render this Agreement null and void.

28. COUNTERPARTS; ELECTRONIC COPY. This Agreement may be executed in any number of counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument. This Agreement is legally effective, valid, and enforceable despite the fact that it or signatures on it may be in electronic form or that it may have been created, transmitted, stored, or otherwise handled or formed, in whole or in part, by electronic means.

29. CAPTIONS. The captions of this Agreement are for convenience and reference only and in no way define, describe, extend or limit the scope,

meaning or intent of this Agreement.

30. SEVERABILITY. The invalidation or unenforceability in any particular circumstance of any of the provisions of this Agreement shall in no way affect any of the other provisions hereof which shall remain in full force and effect.

31. NO JOINT VENTURE. This Agreement shall not be construed as in any way establishing a partnership, joint venture, express or implied agency, or employer-employee relationship between Buyer and Seller.

32. NO THIRD PARTY BENEFICIARIES. This Agreement is for the sole benefit of the parties hereto, their respective successors and permitted assigns, and no other person or entity shall be entitled to rely upon or receive any benefit from this Agreement or any term hereof.

33. NO PERSONAL LIABILITY. No general or limited partner of Seller, no officer, director, or stockholder or member of any corporation or limited liability company which is a partner at any tier in Seller, no disclosed or undisclosed principal of Seller, and no person or entity in any way affiliated with Seller shall have any personal liability with respect to this Agreement, any instrument delivered by Seller at Closing, or the transaction contemplated hereby, nor shall the property of any such person or entity be subject to attachment, levy, execution or other judicial process. No general or limited partner of Buyer, no officer, director, or stockholder or member of any corporation or limited liability company which is a partner at any tier in Buyer, no disclosed or undisclosed principal of Buyer, and no person or entity in any way affiliated with Buyer shall have any personal liability with respect to this Agreement, any instrument delivered by Buyer at Closing, or the transaction contemplated hereby, nor shall the property of any such person or entity be subject to attachment, levy, execution or other judicial process.

34. EXECUTION. The submission of this Agreement for examination does not constitute an offer by or to either party. This Agreement shall be effective and binding only after

due execution and delivery by the parties hereto; provided, however, that this Agreement shall not be binding in any way upon Seller unless and until:

(a) Seller shall execute and deliver the same to Buyer; and

(b) Research Triangle Foundation of North Carolina has given its written approval thereof.

If Seller notifies Buyer in writing at or prior to Closing that this Agreement has not been approved by Research Triangle Foundation, then this Agreement shall be deemed terminated.

[SIGNATURES ON FOLLOWING PAGE]

IN WITNESS WHEREOF, the parties have executed this Agreement as of the date first above written.

BUYER	SELLER
NETWORK APPLIANCE, INC., A DELAWARE CORPORATION	CISCO SYSTEMS, INC., A CALIFORNIA CORPORATION
By: /s/ STEVEN J. GOMO	By:________________________________
Its: Senior Vice President of Finance and Chief Financial Officer	Its:________________________________
Date: July 27, 2004	Date:________________________________
	ESCROW AGENT
	CHICAGO TITLE INSURANCE COMPANY

By:_________________________________

Its:________________________________

Date:_______________________________

Staubach, CCC and TP join herein to agree to the provisions of Section 17 above.

THE STAUBACH COMPANY

By:_________________________________

Its:________________________________

Date:_______________________________

COMMERCIAL CAROLINA CORPORATION

By:_________________________________

Its:________________________________

Date:_______________________________

TRI PROPERTIES

By:_________________________________

Its:________________________________

Date:_______________________________

EXHIBIT A

LAND DESCRIPTION

That certain parcel of land situate in Research Triangle Park, Cedar Fork Township, Wake County, North Carolina, described more particularly as follows:

BEING all of Site 12 containing 37.8259 acres (including Surface Cover Maintenance Easement containing 0.7774 acres) as shown on that map entitled 'Exempt Subdivision Map of Site 12' prepared by Barbara H. Mulkey Engineering, Inc., on May 30, 2000 as recorded in Book of Maps 2000, Page 1300, Wake County, North Carolina Registry.

TOGETHER WITH a permanent, non-exclusive open space easement over all of that property identified as 'Natural Area Preserve' containing 26.0741 acres as shown on the aforesaid map, said easement being more particularly described in instrument recorded in Book 8706, Page 1763, aforesaid records.

EXHIBIT B

FORM OF DEED

Excise Tax - $47,938.00   Recording Time, Book and Page

Tax Lot No._________________________   Parcel Identifier No.______________
Verified by_________________________ County on _____________________, 20________
by____

Mail after recording to: Edward P. Tewkesbury

1604 Battleground Ave., Suite B, Greensboro, NC 27408

This instrument was prepared by: Edward P. Tewkesbury

Brief description for the index:____

NORTH CAROLINA SPECIAL WARRANTY DEED

THIS DEED is made on________________, 2004, by and between

GRANTOR	GRANTEE
Cisco Systems, Inc. 170 West Tasman Drive San Jose, California 95134-1706	Network Appliance, Inc. 495 East Java Drive Sunnyvale, California 94089

The designations Grantor and Grantee include the parties, their heirs, successors, and assigns, and include the singular, plural, masculine, feminine or neuter as required by context.

WITNESSETH, that Grantor, for valuable consideration paid by Grantee, the receipt of which is hereby acknowledged, has and by these presents does grant, bargain, sell and convey to Grantee in fee simple, the parcel of land situated in Cedar Fork Township, Wake County, North Carolina, and more particularly described on Exhibit A attached and incorporated into this Deed (the "Property").

TO HAVE AND TO HOLD the Property, and all privileges and appurtenances thereto belonging, to Grantee in fee simple.

And Grantor covenants with Grantee that Grantor has done nothing to impair such title as Grantor received and that Grantor will warrant and defend the title against the lawful claims of all persons claiming by, under or through Grantor, except for matters of record, to which title to the Property is subject.

IN WITNESS WHEREOF, Grantor has caused this instrument to be signed in its corporate name by its duly authorized officer by authority of its board of directors, the date first written above.

CISCO SYSTEMS, INC., a California corporation

By:_________________________________
Name:_______________________________
Title:______________________________

County of _________________
State of _________________

I, a Notary Public of ______________ County, _______________, certify that _____________________ personally came before me this day and acknowledged that (s)he is the ____________________ of Cisco Systems, Inc., a California corporation, and that (s)he, as _________, being authorized to do so, executed the foregoing on behalf of the corporation. Witness my hand and official seal or stamp on_________________, 2004.

My Commission Expires:_______________ ____________________________Notary Public

[Official seal or stamp]

EXHIBIT C

FORM OF GENERAL INSTRUMENT

GENERAL INSTRUMENT OF TRANSFER
7301-13, 7301-14 and 7301-15 Kit Creek Road
Research Triangle Park, North Carolina 27709

This General Instrument of Transfer ("INSTRUMENT") is made as of the ____ day of __________, 2004, by and between CISCO SYSTEMS, INC., a California corporation with a principal place of business at 170 West Tasman Drive, San Jose, California 95134-1706 ("Assignor"), and NETWORK APPLIANCE, INC., a Delaware corporation having a place of business at 495 East Java Drive, Sunnyvale, California 94089 ("Assignee").

In connection with the conveyance of certain property owned by Assignor known and numbered as Research Triangle Park Site 12 (Buildings 13, 14 and 15), 7301-13,7301-14, and 7301-15 Kit Creek Road, Research Triangle Park, North Carolina 27709, more particularly described on Schedule I attached hereto and made a part hereof (the "Premises"), and in consideration of Ten Dollars ($10.00) and other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, Assignor hereby sells, assigns, transfers, grants and conveys unto Assignee, all of Assignor's right, title and interest in and to the following to the extent the same apply to the Premises and are transferable or assignable (collectively, the "Interests"):

1. All appurtenances and privileges belonging to the Premises and the rights, benefits and privileges of owning and operating the same;

2. All rights, entitlements and/or approvals to develop the Premises which have been or may hereafter be granted by governmental bodies having jurisdiction or authority over the Premises, and any certificates evidencing compliance therewith;

3. All variances, conditional use permits, special permits, exceptions, rezonings, general plan amendments, parcel maps, development agreements, permits, Licenses, applications, any other governmental approvals and consents (if any) relating to the Premises;

4. All guarantees, warranties, and indemnities giving rise to any rights or benefits of Assignor in respect of the Premises and all claims and/or causes of action against contractors with respect to the Premises or any part thereof or any buildings, structures or improvements thereon, provided, however, that Assignor reserves, in common with Assignee, such rights in respect of the matters assigned in this paragraph 4 as may be necessary or convenient for Assignor's discharge of liabilities, or defense of claims, relating to the Premises which are not assigned to or assumed by Buyer in connection with the acquisition of the Premises;

5. All bonds, construction contracts, architect's contracts, licenses, applications, permits, plans, drawings, specifications, "as-built" plans and/or surveys, site plans, maps, and any other plans relating to the construction of the improvements on the Premises;

6. All engineering, soils, ground water and environmental reports and other technical descriptions and environmental reports concerning the Premises; and

7. All tangible personal property owned by Assignor and located on or attached and appurtenant to, or forming part of the Premises ("PERSONAL PROPERTY").

Assignee hereby accepts the foregoing transfer from Assignor of the above-assigned Interests.

This Instrument shall be binding upon and inure to the benefit of the parties hereto and their respective heirs, successors and assigns and shall be governed by the laws of the State of North Carolina.

This Instrument may be executed in multiple counterparts, each of which shall be deemed an original, but all of which together shall constitute one and the same instrument.

IN WITNESS WHEREOF, the parties have executed this Assignment under seal as of the date first written above.

ASSIGNEE	ASSIGNOR
NETWORK APPLIANCE, INC., A DELAWARE CORPORATION	CISCO SYSTEMS, INC., A CALIFORNIA CORPORATION
By:_________________________________	By:_________________________________
Its:________________________________	Its:________________________________
Date:______________________	Date:______________________

Schedule I

The Premises

That certain parcel of land situate in Research Triangle Park, Cedar Fork Township, Wake County, North Carolina, described more particularly as follows:

BEING all of Site 12 containing 37.8259 acres (including Surface Cover Maintenance Easement containing 0.7774 acres) as shown on that map entitled 'Exempt Subdivision Map of Site 12' prepared by Barbara H. Mulkey Engineering, Inc., on May 30, 2000 as recorded in Book of Maps 2000, Page 1300, Wake County, North Carolina Registry.

TOGETHER WITH a permanent, non-exclusive open space easement over all of that property identified as 'Natural Area Preserve' containing 26.0741 acres as shown on the aforesaid map, said easement being more particularly described in instrument recorded in Book 8706, Page 1763, aforesaid records.

EXHIBIT D

[RESERVED]

EXHIBIT E

FORM OF NON-FOREIGN CERTIFICATE

NON-FOREIGN CERTIFICATE

7301-13, 7301-14 and 7301-15 Kit Creek Road
Research Triangle Park, North Carolina 27709

Section 1445 of the Internal Revenue Code provides that a purchaser of a United States Property interest must withhold tax if the seller is a foreign person. To inform Network Appliance, Inc., a Delaware corporation ("Buyer") that withholding of tax is not required upon the disposition of a United States Property interest by Cisco Systems, Inc. ("Seller"), the undersigned hereby certifies the following on behalf of Seller:

1. Seller is not a foreign person (as that term is defined in the Internal Revenue Code and Income Tax Regulations);

2. Seller's United States employer identification number is 77-0059951; and

3. Seller's office address is 170 West Tasman Drive
San Jose, California 95134-1706

Seller understands that this certification may be disclosed to the Internal Revenue Service by Buyer and that any false statement contained herein could be punished by fine, imprisonment, or both.

Under penalties of perjury I declare that I have examined this certification and to the best of my knowledge and belief it is true, correct, and complete, and I further declare that I have authority to sign this document on behalf of Seller.

CISCO SYSTEMS, INC., A CALIFORNIA CORPORATION

By:_________________________________

Its:________________________________

Date:______________________

EXHIBIT F

ENVIRONMENTAL REPORTS SCHEDULE

TITLE	AUTHOR	DATE
Phase 1 Environmental Site Assessment	Engineering Consulting Services, LTD.	March 24, 2000
Abandonded Underground Natural Gas Pipeline Investigation, Research Triangle Park, North Carolina	Arcadis Geraghty & Miller of North Carolina, Inc.	July 12, 2000
Phase 1 Environmental Site Assessment	Engineering Consulting Services, LTD.	July 20, 2000
Report of Subsurface Exploration and Geotechnical Engineering Analysis	Engineering Consulting Services, LTD.	July 25, 2000
RTP Site 12 Site Plan Approval Letter	Elizabeth H. Rooks-Research Triangle Foundation of North Carolina	August 17, 2000
Architectural Elevation Approval for Buildings 13-15	Elizabeth H. Rooks-Research Triangle Foundation of North Carolina	September 27, 2000
Report of Additional Subsurface Explorations for the Parking Lots on Cisco Systems Site 12 Located in Research Triangle Park, North Carolina ECS, Ltd. Project Number 8590	Engineering Consulting Services, LTD.	October 4, 2000
Right of Way Encroachment Agreement Primary and Secondary Highways	State of North Carolina Wake County	November 1, 2000
Three Party Right of Way Encroachment Agreement on Primary and Seconday System	State of North Carolina Wake County	November 1, 2000

TITLE	AUTHOR	DATE
Application for Driveway Entrance onto Louis Stevens Road Permit Number D51-40-00-259	Brandon H. Jones-State of North Carolina Department of Transportation	December 8, 2000
Application for Driveway Entrance onto SR 1639 Permit Number D51-40-00-252	Brandon H. Jones-State of North Carolina Department of Transportation	December 8, 2000
Encroachment Contract 12" x 8" tapping	State of North Carolina	December 29, 2000

sleeve, 8" gate valve and 20" steel carrier pipe Louis Stevens Drive E51-40-00-0886	Department of Transportation	
Encroachment Contract 12" x 8" tapping sleeve and 8" gate SR 1639 E51-40-00-0887	State of North Carolina Department of Transportation	December 29, 2000
Certificate of Substantial Completion Site 12	O'Brien/Atkins Associates	February 21, 2001
Encroachment Contract Tree Clearing and Grading SR 1639 E51-4--01-0739	State of North Carolina Department of Transportation	August 6, 2001
Cisco Systems, Inc. Building 13 Warranties, General Information, Operations & Maintenance Manuals, Test Reports	Bovis Lend Lease, Inc.	November 6, 2001
Certificate of Substantial Completion Building 14	O'Brien/Atkins Associates	November 16, 2001
Cisco Systems, Inc. Building 14 Warranties, General Information, Operations & Maintenance Manuals, Test Reports	Bovis Lend Lease, Inc.	December 14, 2001
Cisco Systems, Inc. Building 15 Warranties, General Information, Operations & Maintenance Manuals, Test Reports	Bovis Lend Lease, Inc.	February 13, 2002
Cisco Systems, Inc. Site 12 Operations & Maintenance Manuals, General Information & Warranties	Bovis Lend Lease, Inc.	February 15, 2002

TITLE	AUTHOR	DATE
Total Acceptance of Maintenance-Public Water and Sanitary Sewer lines	Jimmy Little-Development Inspector, Town of Cary	May 9, 2002
Air Permit No. 9439M00	Laura S. Butler-North Carolina Department of Environmental and Natural Resources Division of Air Quality	June, 04 2004

Exhibit 31.1

CERTIFICATION PURSUANT TO SECTION 302(a)
OF THE SARBANES-OXLEY ACT OF 2002

I, Daniel J. Warmenhoven, certify that:

1) I have reviewed this quarterly report on Form 10-Q of Network Appliance, Inc.;

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

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

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

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

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

   c) disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;

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

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

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

/s/ DANIEL J. WARMENHOVEN

Daniel J. Warmenhoven
Chief Executive Officer

Date: August 31, 2004

EXHIBIT 31.2

CERTIFICATION PURSUANT TO SECTION 302(a)
OF THE SARBANES-OXLEY ACT OF 2002

I, Steven J. Gomo, certify that:

1) I have reviewed this quarterly report on Form 10-Q of Network Appliance, Inc.;

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

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

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

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

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

   c) disclosed in this quarterly report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;

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

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

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

/s/ STEVEN J. GOMO

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

Date: August 31, 2004

EXHIBIT 32.1

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

I, Daniel J. Warmenhoven, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Network Appliance, Inc., on Form 10-Q for the quarterly period ended July 30, 2004 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and that information contained in such Quarterly Report on Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Network Appliance, Inc.

/s/ DANIEL J. WARMENHOVEN

Daniel J. Warmenhoven
Chief Executive Officer

Date: August 31, 2004

EXHIBIT 32.2

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

I, Steven J. Gomo, certify, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, that the Quarterly Report of Network Appliance, Inc., on Form 10-Q for the quarterly period ended July 30, 2004 fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, and that information contained in such Quarterly Report on Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of Network Appliance, Inc.

/s/ STEVEN J. GOMO

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

Date: August 31, 2004