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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

Form 10-Q

(Mark One)

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

For the quarterly period ended January 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, $.001 par value, as of the latest practicable date.

Class	Outstanding at January 30, 2004
Common Stock	347,516,353

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PART I. FINANCIAL INFORMATION

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

NETWORK APPLIANCE, INC.

CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands — unaudited)

	January 30, 2004	April 30, 2003
ASSETS		
Current Assets:		
Cash and cash equivalents	$ 263,644	$ 284,161
Short-term investments	514,460	334,677
Accounts receivable, net of allowances of $5,010 at January 30, 2004 and $5,355 at April 30, 2003	194,274	151,637
Inventories	38,704	31,559
Prepaid expenses and other	26,036	24,014
Deferred income taxes	44,390	27,444
Total current assets	1,081,508	853,492
Property and Equipment, net	366,749	362,862
Goodwill	48,212	48,212
Intangible Assets, net	7,963	2,954
Other Assets	62,883	51,653
	$1,567,315	$1,319,173
LIABILITIES AND STOCKHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$ 43,000	$ 39,600
Income taxes payable	5,809	30,256
Accrued compensation and related benefits	55,287	40,647
Other accrued liabilities	43,942	43,841
Deferred revenue	142,260	110,672
Total current liabilities	290,298	265,016
Long-Term Deferred Revenue	94,534	63,698
Long-Term Obligations	4,453	3,102
Total liabilities	389,285	331,816
Stockholders' Equity:		
Common stock	348	341
Additional paid-in capital	825,506	704,338
Deferred stock compensation	(2,277)	(1,363)
Treasury stock	(44,862)	—
Retained earnings	399,775	284,137
Accumulated other comprehensive loss	(460)	(96)
Total stockholders' equity	1,178,030	987,357
	$1,567,315	$1,319,173

See accompanying notes to unaudited condensed consolidated financial statements.

NETWORK APPLIANCE, INC.

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

	Three Months Ended		Nine Months Ended	
	January 30, 2004	January 24, 2003	January 30, 2004	January 24, 2003
Revenues:				
Product revenue	$268,955	$205,046	$754,273	$585,143
Service revenue	28,332	23,418	79,073	65,320
Total revenues	297,287	228,464	833,346	650,463
Cost of Revenues:				
Cost of product revenue	93,442	72,865	266,571	203,898
Cost of service revenue	23,722	16,911	65,466	47,172
Total cost of revenues	117,164	89,776	332,037	251,070
Gross margin	180,123	138,688	501,309	399,393
Operating Expenses:				
Sales and marketing	85,975	76,969	247,516	225,078
Research and development	32,948	28,289	96,002	84,530
General and administrative	13,744	9,833	38,737	26,403
Stock compensation(1)	465	1,238	2,012	3,106
Restructuring charges	—	1,257	1,110	1,257
Total operating expenses	133,132	117,586	385,377	340,374
Income from Operations	46,991	21,102	115,932	59,019
Other Income (Expense), net:				
Interest income	3,862	3,068	9,737	9,099
Other income (expense), net	(833)	270	(2,089)	(919)
Net gain (loss) on investments	217	—	362	(726)
Gain on sale of intangible asset	—	—	—	604
Total other income, net	3,246	3,338	8,010	8,058
Income before Income Taxes	50,237	24,440	123,942	67,077
Provision for Income Taxes	10,085	4,769	8,304	15,428
Net Income	$ 40,152	$ 19,671	$115,638	$ 51,649
Net Income per Share:				
Basic	$ 0.12	$ 0.06	$ 0.34	$ 0.15
Diluted	$ 0.11	$ 0.06	$ 0.32	$ 0.15
Shares Used in per Share Calculations:				
Basic	346,305	338,345	343,906	336,911
Diluted	366,429	351,114	363,214	349,449

(1) Stock compensation includes:				
Sales and marketing	$ 194	$ 361	$ 1,153	$ 1,228
Research and development	173	796	553	1,638
General and administrative	98	81	306	240
	$ 465	$ 1,238	$ 2,012	$ 3,106

See accompanying notes to unaudited condensed consolidated financial statements.

NETWORK APPLIANCE, INC.

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

	Nine Months Ended	
	January 30, 2004	January 24, 2003
Cash Flows from Operating Activities:		
Net income	$ 115,638	$ 51,649
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	40,021	38,924
Amortization of patents	1,052	—
Amortization of intangible assets	2,954	4,114
Stock compensation	2,012	3,106
Net (gain) loss on investments	(362)	726
Gain on sale of intangible asset	—	(604)
Allowance for doubtful accounts (reversal)	(221)	(1,636)
Deferred income taxes	(16,184)	(16,231)
Deferred rent	142	(62)
Changes in assets and liabilities:		
Accounts receivable	(42,416)	(20,898)
Inventories	(13,170)	(19,619)
Prepaid expenses and other assets	(14,610)	(7,783)
Accounts payable	3,400	(2,128)
Income taxes payable	22,589	27,069
Accrued compensation and related benefits	14,640	(8,450)
Other accrued liabilities	(192)	5,537
Deferred revenue	62,424	49,213
Net cash provided by operating activities	177,717	102,927
Cash Flows from Investing Activities:		
Purchases of short-term investments	(438,058)	(261,636)
Redemptions of short-term investments	257,681	200,260
Purchases of property and equipment	(35,609)	(45,905)
Proceeds from disposal of fixed assets	105	—
Proceeds from sales of investments	636	—
Purchases of patents	(9,015)	—
Purchase of equity securities	(325)	(650)
Net cash used in investing activities	(224,585)	(107,931)
Cash Flows from Financing Activities:		
Proceeds from sale of common stock related to employee stock transactions	71,213	24,337
Repurchases of common stock	(44,862)	—
Net cash provided by financing activities	26,351	24,337
Net Change in Cash and Cash Equivalents	(20,517)	19,333
Cash and Cash Equivalents:		
Beginning of period	284,161	210,756
End of period	$ 263,644	$ 230,089
Noncash Investing and Financing Activities:		
Deferred stock compensation, net of reversals	$ 2,387	$ (361)
Conversion of evaluation inventory to fixed assets	$ 6,025	$ 6,530
Income tax benefit from employee stock transactions	$ 48,003	$ —
Supplemental cash flow information:		
Income taxes paid	$ 9,280	$ 5,565
Income taxes refund	$ 10,361	$ 72

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

2. Condensed Consolidated Financial Statements

The accompanying interim unaudited condensed consolidated financial statements have been prepared by Network Appliance, Inc. without audit and reflect all adjustments, (consisting only of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of our financial position, results of operations and cash flows for the interim periods presented. The statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("generally accepted accounting principles") for interim financial information and in accordance with the instructions to Form 10-Q and 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 nine months of fiscal 2004 and 2003 were 40-week and 39-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, 2003. The results of operations for the three and nine-month periods ended January 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".

Certain prior-period amounts have been reclassified to conform to the current period presentation. These reclassifications did not change previously reported total assets, liabilities and stockholders' equity or net income.

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; inventory write-down; restructuring accruals; loss contingencies; impairment losses on investments; accounting for income taxes; accounting for stock-based compensation; and derivative instruments. Actual results could differ from those estimates.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS — (Continued)

4. Summary of Significant Accounting Policies

Revenue Recognition and Allowances

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

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

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

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

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

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

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

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

	Three Months Ended		Nine Months Ended	
	January 30, 2004	January 24, 2003	January 30, 2004	January 24, 2003
Product revenue:				
Products	80.7%	80.9%	80.9%	82.0%
Software subscriptions	9.8	8.8	9.6	8.0
	90.5	89.7	90.5	90.0
Service revenue	9.5	10.3	9.5	10.0
Total revenues	100.0%	100.0%	100.0%	100.0%

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS — (Continued)

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

Allowance for Doubtful Accounts

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

Inventory Write-down

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

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

Restructuring Accruals

In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in Information Technology (“IT”) spending rates, we implemented two restructuring plans, which included reductions in our workforce and a consolidation of our facilities. These restructuring accruals were accounted for in accordance with Emerging Issues Task Force (“EITF”) Issue No. 94-3, *“Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring),”* and included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. These estimates are reviewed and revised periodically and may result in a substantial change to restructuring expense should different conditions prevail than were anticipated in original management estimates. Future restructuring will be accounted for under Statement of Financial Accounting Standards (“SFAS”) 146 *“Accounting for Costs associated with Exit or Disposal Activities”* which superceded EITF 94-3. See footnote 10 — Restructuring Charges for further discussion.

Loss Contingencies

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

Impairment Losses on Investments

We perform periodic reviews of our investments for impairment. Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value, and such a decline is not considered temporary. Our investments in privately held companies are considered impaired when a review of the investees' operations and other indicators of impairment indicate that the carrying value of the investment is not likely to be recoverable. Such indicators include, but are not limited to, limited capital resources, limited prospects of receiving additional financing, and limited prospects for liquidity of the related securities. In the nine-month period ended January 24, 2003, we recorded a non-cash write down of $726 related to an impairment of our investment in a publicly traded company as its reduction in value was judged to be other than temporary. In the three and nine-month periods ended January 30, 2004, we recorded a gain of $217 and $362, respectively, related to sales of previously impaired investments.

Accounting for Income Taxes

The determination of our tax provision is subject to judgments and estimates due to operations in several tax jurisdictions outside the United States. Earnings derived from our international business are generally taxed at rates that are lower than U.S. rates, resulting in a reduction of our effective tax rate. The ability to maintain our current effective tax rate is contingent upon existing tax laws in both the United States and in the respective countries in which our international subsidiaries are located. Future changes in domestic or international tax laws could affect the continued realization of the tax benefits we are currently receiving and expect to receive from international business. In addition, a decrease in the percentage of our total earnings from our international business or in the mix of international business among particular tax jurisdictions could increase our overall effective tax rate. Also, our current effective tax rate assumes that U.S. income taxes are not provided for undistributed earnings of certain non-U.S. subsidiaries. These earnings could become subject to incremental foreign withholding or federal and state income taxes should they be either deemed or actually remitted to the U.S. For the three and nine-month periods ended January 30, 2004, we recorded a non-recurring income tax benefit of $16,831 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 future tax rate benefits. During the third quarter of fiscal 2004, we received a substantial tax refund that relates to prior years' tax payments.

The carrying value of our net deferred tax assets, which consists primarily of the reversal of net deductible temporary differences including credits, and net operating loss carryforwards, assumes that we will be able to generate sufficient future taxable income to fully utilize these tax attributes. If we do not generate sufficient future income, the realization of these deferred tax assets may be impaired resulting in additional income tax expense. We have provided a valuation allowance on the deferred tax attributes associated with the exercise of employee stock options (primarily credits and net operating loss carryforwards) because of uncertainty regarding their realizability due to the expectation of future employee stock option exercises. If these attributes are realized, the associated tax benefit will be credited to stockholders' equity, rather than as a reduction in the income tax provision.

Derivative Instruments

We adopted 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. All foreign currency derivatives are authorized and executed pursuant to our policies. 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 undesignated derivatives offset gains and losses on the assets and liabilities being hedged and the net amount is included in earnings. For the three and nine-month periods ended January 30, 2004, net gains generated by hedged assets and liabilities totaled $4,608 and $9,353, respectively, and were offset by losses on the related derivative instruments of $5,385 and $11,462, respectively. For the three and nine-month periods ended January 24, 2003, net gains generated by hedged assets and liabilities totaled $5,756 and $9,585, respectively, and were offset by losses on the related derivative instruments of $5,433 and $10,260, respectively.

The premiums paid on the foreign currency option contracts are recognized in 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 other income. For the three and nine-month periods ended January 30, 2004, we did not record any gains or losses related to forecasted transactions that did not occur or became improbable.

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

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.

Stock-Based Compensation

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

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

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 net income (loss) per share would be as follows (in thousands, except per share data):

	Three Months Ended		Nine Months Ended	
	January 30, 2004	January 24, 2003	January 30, 2004	January 24, 2003
Net income as reported	$ 40,152	$ 19,671	$115,638	$ 51,649
Add: stock based employee compensation expense included in reported net income under APB No. 25, net of related tax effects	272	268	884	962
Deduct: total stock based compensation determined under fair value based method for all awards, net of related tax effects	24,860	41,405	81,193	134,093
Pro forma net income (loss)	$ 15,564	$ (21,466)	$ 35,329	$ (81,482)
Basic net income per share, as reported	$ 0.12	$ 0.06	$ 0.34	$ 0.15
Diluted net income per share, as reported	$ 0.11	$ 0.06	$ 0.32	$ 0.15
Basic net income (loss) per share, pro forma	$ 0.04	$ (0.06)	$ 0.10	$ (0.24)
Diluted net income (loss) per share, pro forma	$ 0.04	$ (0.06)	$ 0.10	$ (0.24)

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS — (Continued)

5. Inventories

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

	January 30, 2004	April 30, 2003
Purchased components	$ 18,441	$16,277
Work in process	717	537
Finished goods	19,546	14,745
	$ 38,704	$31,559

6. Intangible Assets

Balances are summarized as follows:

	January 30, 2004			April 30, 2003		
	Gross Assets	Accumulated Amortization	Net Assets	Gross Assets	Accumulated Amortization	Net Assets
Intangible assets:						
Patents	$ 9,145	$ (1,182)	$7,963	$ 130	$ (130)	$ —
Existing technology	$16,365	$ (16,365)	$ —	$16,365	$ (13,411)	$2,954

During the first quarter of fiscal 2004, we acquired additional patents that will enhance our technology base to build next-generation network-attached storage ("NAS",) storage area network ("SAN",) and fabric-attached storage ("FAS") systems for the benefit of our enterprise customers. The costs of such acquired intangibles for use in research and development activities that have alternative future uses have been capitalized and amortized as intangible assets in accordance with APB Opinion No. 17 *"Intangible Assets."* Capitalized patents are amortized over five years as research and development expenses and total amortization for capitalized patents was $451 and $1,052 for the three and nine-month periods ending January 30, 2004, respectively as compared to none for the same periods in the prior year. Estimated future patents amortization expenses are $451 for fiscal 2004, $1,803 for each of the fiscal years 2005, 2006, 2007 and 2008, and $300 thereafter.

Existing technology is amortized over three years as cost of product revenue and total amortization expense for existing technology was $227 and $2,954 for the three and nine-month periods ending January 30, 2004, respectively, as compared to $1,364 and $4,114 for the three and nine-month periods ending January 24, 2003, respectively. Other than the amortization of existing technology that may arise from the Spinnaker acquisition, estimated future amortization is none for the remainder of fiscal 2004 and thereafter.

7. Stock Compensation

We record stock compensation in accordance with provisions of APB No. 25, for employee awards and SFAS No. 123, for non-employee awards. Accordingly, we recognize the intrinsic value for employees and the fair value for non-employees as stock compensation expense over the vesting terms of the awards.

We recorded $452 and $1,473 of compensation expense for the three and nine-month periods ended January 30, 2004, respectively and $446 and $1,603 for the three and nine-month periods ended January 24, 2003, respectively, primarily related to the recognition of stock compensation of unvested options assumed in the WebManage acquisition in fiscal 2001, the grant of stock options to certain highly compensated employees and the award of restricted stocks to certain employees. We reversed $6 and $122 of deferred compensation in the three and nine-month periods ended January 30, 2004, respectively and $0 and $1,517 in the three and nine-month periods ended January 24, 2003, respectively, all due to employee terminations.

We recorded $13 and $539 in compensation expense in the three and nine-month periods ending January 30, 2004, respectively, and $139 and $582 in the three and nine-month periods ending January 24, 2003, for the fair value of options granted to a member of the Board of Directors in recognition for services performed outside of the normal capacity of a board member. The 100,000 common shares under the 1999 Plan were granted at an exercise price of $15.72 per share, the fair market value per share on the grant date. The option has a term of 10 years measured from the grant date, subject to earlier termination following his cessation of board service, and will vest in a series of 48 successive equal monthly installments upon his completion of each month of board service over the 48 month period measured from the grant date.

For the three and nine-month periods ended January 24, 2003, under terms of the acquisition agreement with Orca Systems Inc. (“Orca”), we released 66 and 99 shares of common stock, respectively, to former Orca shareholders upon meeting certain performance criteria. The fair market value of the shares of $653 and $920, respectively, for those periods was measured on the date the performance criteria were met and was recognized as stock compensation. In fiscal 2004, there are no more restricted milestones shares remaining under the Orca acquisition agreement.

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 and common shares issuable using the treasury stock method upon exercise of stock options.

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 and nine-month periods ended January 30, 2004 and January 24, 2003 as these options’ exercise prices were above the average market prices in such periods. For the three-month periods ended January 30, 2004 and January 24, 2003, 18,038 and 46,269 shares of common stock options with a weighted average exercise price of $50.14 and $30.64, respectively, were excluded from the diluted net income per share computation. For the nine-month periods ended January 30, 2004 and January 24, 2003, 24,559 and 51,482 shares of common stock options with a weighted average exercise price of $42.50 and $29.14, respectively, were excluded from the diluted net income per share computation.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS — (Continued)

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		Nine Months Ended	
	January 30, 2004	January 24, 2003	January 30, 2004	January 24, 2003
Net Income (Numerator):				
Net income, basic and diluted	$ 40,152	$ 19,671	$115,638	$ 51,649
Shares (Denominator):				
Weighted average common shares outstanding	346,415	338,370	343,985	336,994
Weighted average common shares outstanding subject to repurchase	(110)	(25)	(79)	(83)
Shares used in basic computation	346,305	338,345	343,906	336,911
Weighted average common shares outstanding subject to repurchase	110	25	79	83
Common shares issuable upon exercise of stock options	20,014	12,744	19,229	12,455
Shares used in diluted computation	366,429	351,114	363,214	349,449
Net Income Per Share:				
Basic	$ 0.12	$ 0.06	$ 0.34	$ 0.15
Diluted	$ 0.11	$ 0.06	$ 0.32	$ 0.15

9. Comprehensive Income

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

	Three Months Ended		Nine Months Ended	
	January 30, 2004	January 24, 2003	January 30, 2004	January 24, 2003
Net income	$ 40,152	$ 19,671	$115,638	$ 51,649
Currency translation adjustment	(1,039)	342	875	589
Unrealized loss on derivatives	(711)	—	(1,093)	—
Unrealized gain (loss) on investments	842	736	(146)	1,552
Comprehensive income	$ 39,244	$ 20,749	$115,274	$ 53,790

The components of accumulated other comprehensive loss were as follows:

	January 30, 2004	April 30, 2003
Accumulated translation adjustments, net	$ (363)	$(1,238)
Accumulated realized loss on derivatives	(1,122)	(29)
Accumulated unrealized gain on available-for-sale investments, net	1,025	1,171
Total accumulated other comprehensive loss	$ (460)	$ (96)

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS — (Continued)

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 of $888 at January 30, 2004 was included in other accrued liabilities.

During fiscal 2002, we purchased our Sunnyvale headquarters site and terminated the operating leases. As a result, an adjustment was made to reduce the previously recorded estimated facilities lease losses by $1,509. During fiscal 2002 and 2003, we recorded a net restructuring adjustment increase of $95 and a decrease of $334, respectively, due to changes in the estimated costs of certain actions and final resolution of certain restructuring activities. In the event that the foreign facilities are not subleased, we will be obligated for additional total lease payments of approximately $524 to be payable through January 2006.

As of January 30, 2004, we have $746 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 January 30, 2004:

	Severance-related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge	$ 4,796	$ 528	$ 2,656	$ 7,980
Cash payments and others	(4,444)	—	(885)	(5,329)
Non-cash portion	—	(528)	(46)	(574)
Adjustments	315	—	(1,585)	(1,270)
Reserve balance at April 30, 2003	667	—	140	807
Cash payments and others	11	—	(9)	2
Non-cash portion	—	—	(1)	(1)
Reserve balance at August 1, 2003	678	—	130	808
Cash payments and others	19	—	3	22
Non-cash portion	—	—	(1)	(1)
Reserve balance at October 31, 2003	697	—	132	829
Cash payments and others	49	—	10	59
Reserve balance at January 30, 2004	$ 746	$ —	$ 142	$ 888

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

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January 30, 2004, $816 was included in other accrued liabilities and the remaining $4,295 was classified as long-term obligations.

In January 2003 and October 2003, we updated our assumptions and estimates based on certain triggering events, which resulted in additional net charges of $923 and $1,110 respectively, primarily relating to our engineering facility lease. Our estimates are reviewed and revised periodically and may result in a substantial charge to restructuring expense should different conditions prevail than were anticipated in original management estimates. Such estimates included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. In the event that the engineering facility is not subleased, we will be obligated for additional total lease payments of $2,261 to be payable through November 2010.

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

	Severance-related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge	$ 813	$ 473	$ 4,564	$ 5,850
Net cash payments	(706)	—	(1,023)	(1,729)
Non-cash portion	—	(473)	—	(473)
Adjustments	(107)	—	1,030	923
Reserve balance at April 30, 2003	—	—	4,571	4,571
Net cash payments	—	—	(205)	(205)
Reserve balance at August 1, 2003	—	—	4,366	4,366
Net cash payments	—	—	(203)	(203)
Adjustments	—	—	1,110	1,110
Reserve balance at October 31, 2003	—	—	5,273	5,273
Cash payments and others	—	—	(162)	(162)
Reserve balance at January 30, 2004	$ —	$ —	$ 5,111	$ 5,111

11. Short-Term Investments

All our investments are classified as available for sale at January 30, 2004 and April 30, 2003. Available-for-sale investments with original maturities of greater than three months are classified as short-term investments, as these investments generally consist of highly marketable securities that are intended to be available to meet current cash requirements. Investment securities classified as available-for-sale are reported at fair market value, and net unrealized gains or losses are recorded in accumulated other comprehensive loss, a separate component of stockholders' equity, net of taxes. Any gains or losses on sales of investments are computed based upon specific identification. For all periods presented, realized gains and losses on available-for-sale investments were not material. Management evaluates investments on a regular basis to determine if an other-than-temporary impairment has occurred.

Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value, and such a decline is not considered temporary. In the nine-month period ended January 24, 2003, we recorded a non-cash write down of $726 related to the impairment of our investment in a publicly traded company as its reduction in value was judged to be other than temporary. In three and nine-month periods ended January 30, 2004, we recorded a gain of $217 and $362, respectively, related to sales of previously impaired investments.

12. New Accounting Pronouncements

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

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

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, which requires that certain financial instruments be presented as liabilities that were previously presented as equity or as temporary equity. Such instruments include mandatory redeemable preferred and common stock, and certain options and warrants. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and was effective at the beginning of the first interim period beginning after June 15, 2003. In November 2003, the FASB issued FASB Staff Position ("FSP") No. 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under SFAS No. 150*, which defers the effective date for various provisions of SFAS No. 150. As of January 30, 2004, we had no financial instruments within the scope of this pronouncement.

NETWORK APPLIANCE, INC.

NOTES TO UNAUDITED CONDENSED CONSOLIDATED

FINANCIAL STATEMENTS — (Continued)

13. Commitments and Contingencies

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

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

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

14. Guarantees

As of January 30, 2004, our financial guarantees consisted of standby letters of credit outstanding, bank guarantee and restricted cash, which were related to facility lease requirements, product performance guarantees, customs and duties guarantees, VAT requirements, workers' compensation plans. The maximum amount of potential future payments under all of the foregoing arrangements was $2,674. Of this maximum exposure, $1,030 of restricted cash was classified under Other Assets and Prepaid Expenses and Other on our balance sheet at January 30, 2004. We have not recorded any liability at January 30, 2004 related to these guarantees.

As of January 30, 2004, our fair values of foreign exchange forward and option contracts totaled $163,792. 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 forwards and options is limited to the premiums paid.

We provide both recourse and non-recourse lease financing options to our customers. Under the terms of recourse leases, which are generally 3 years or less, we remain liable for the aggregate unpaid remaining lease payments. We defer 100% of the recourse lease obligation and recognize revenue over the term of the lease as the lease payments become due. As of January 30, 2004 the maximum recourse exposure under such leases totaled approximately $3,718. Under the terms of the non-recourse leases we do not have any continuing obligations or liabilities. To date, we have not experienced significant losses under this lease financing program.

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

We defend and indemnify certain subcontractors and customers 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. However, there can be no assurances that we will not have any future financial exposure under these indemnification obligations.

15. Subsequent Events

On February 18, 2004, Network Appliance announced that it completed the acquisition of Spinnaker Networks, Inc., (“Spinnaker”) a privately held company based in Pittsburgh, Pennsylvania. Under the terms of the definitive agreement announced November 4, 2003, Network Appliance acquired Spinnaker for approximately $300,000 in an all-stock transaction and will operate Spinnaker as part of its engineering organization. The number of common shares to be issued will be determined using our average stock price based on a period immediately preceding the close date on February 18, 2004.

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements usually contain the words "estimate," "intend," "plan," "predict," "seek," "may," "will," "should," "would," "anticipate," "expect," "believe," or similar expressions and variations or negatives of these words. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances, including any underlying assumptions, are forward-looking statements. All forward-looking statements, including, but not limited to, (1) our intent to regularly introduce new products and product enhancements and our intent to support current and new products and product enhancements and incur prototype expenses and non-recurring engineering charges associated with the development of new products and technologies; (2) our expectation that our expenditures on expanding our current product offerings and introducing new products will increase in absolute dollars; (3) our intention to continue to establish and maintain business relationships with technology companies; (4) our expectation that we will increase sales and marketing expenses and add additional sales capacity commensurate with future revenue growth; (5) our belief that our general and administrative expenses will increase in absolute terms in the remainder of fiscal 2004; (6) our belief that our existing liquidity and capital resources are sufficient to fund our operations for at least the next twelve months; (7) our belief that our forward and option currency contracts will not subject us to undue risk; (8) our intention to continuously broaden our existing product offerings and introduce new products that expand our solutions portfolio; (9) our belief that our research and development expenses will increase in absolute dollars for the remainder of fiscal 2004 as compared to the comparable period in the prior year; (10) our belief that our products currently compete favorably with our competitors; (11) the possibility that we may engage in future acquisitions; (12) our expectation that the value of our investments will not decline significantly because of changes in market interest rates; (13) our expectation that other than the amortization of existing technology that may arise from the Spinnaker acquisition, estimated future amortization is none for the remainder of fiscal 2004 and thereafter; (14) our expectation that amortization expense for capitalized patents for fiscal 2004 will be $0.4 million, and $1.8 million for each of the fiscal years 2005, 2006, 2007 and 2008 and $0.3 million thereafter; (15) our expectation that other than the deferred stock compensation that may arise from the Spinnaker acquisition, estimated future amortization will be $0.5 million in fiscal 2004, $1.2 million in fiscal 2005 and $0.6 million in fiscal 2006 and none thereafter, respectively; (16) our belief that if we are not able to sublease our currently vacated facilities, our aggregate liability for these additional lease payments will be approximately $2.8 million; (17) our belief that our future contractual cash obligations as of January 30, 2004 will be no more than $5.3 million in fiscal 2004, $19.1 million in fiscal 2005, $14.1 million in fiscal 2006, $7.1 million in fiscal 2007, $5.6 million in fiscal 2008 and $15.2 million thereafter, and our belief that our commercial commitments as of January 30, 2004 will be no more than $1.3 million in fiscal 2004, $0.3 million in fiscal 2005, $0.3 million in fiscal 2006, $0.1 million in fiscal 2007, and $0.7 million thereafter; (18) our expectation that interest income will increase for the remainder of fiscal 2004; (19) our belief that our acquisition of Spinnaker Networks, Inc. will further accelerate our Storage Grid strategy and will allow us to target markets with customers who use large-scale Linux® farms; (20) our expectation that Microsoft's support of iSCSI for the SQL Server and Exchange environment will help encourage iSCSI adoption within the enterprise and that our Windows® business will be a strong driver of growth in block storage solutions; (21) our expectation that the service margin will improve as recent headcount and logistical investments begin to deliver revenue growth; (22) our intention to resell Content Reporter™ through a licensing arrangement; (23) our belief that our competitive advantage is a result of lower total costs of ownership for our products; and (24) our intent to provide storage solutions that meet the growing demands of grid computing, are inherently uncertain as they are based on management's current expectations and assumptions concerning future events, and they are subject to numerous known and unknown risks and uncertainties. Therefore, our actual results may differ materially from the forward-looking statements contained herein. Factors that could cause actual results to differ materially from those described herein include, but are not limited to: (1) the amount of orders received in future periods; (2) our ability to ship our products in a timely manner; (3) our ability to achieve anticipated pricing, cost and gross margin levels; (4) our ability to successfully introduce new products; (5) our ability to achieve and capitalize on changes in market demand; (6) acceptance of, and demand for, our products; (7) our ability to maintain our supplier and contract manufacturer relationships; (8) our ability to expand our storage business through our indirect channel; (9) the ability of our competitors to introduce new products that compete successfully with our products; (10) the general economic environment and the continued growth of the storage and content delivery markets; (11) our ability to sustain and/or improve our cash and overall financial position; (12) our ability to generate future income to utilize our deferred tax assets; and (13) those factors discussed under “Risk Factors” elsewhere in this Quarterly Report on Form 10-Q. Readers are cautioned not to place undue reliance on these forward-looking statements, which speak only as of the date hereof and are based upon information available to us at this time. These statements are not guarantees of future performance. We disclaim any obligation to update information in any forward-looking statement.

Overview

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

Code of Business Conduct and Ethics

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

Critical Accounting Estimates

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

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

• revenue recognition and allowances;

• inventory write-down;

• restructuring accruals;

• loss contingencies;

• impairment losses on investments;

• accounting for income taxes; and

• accounting for stock-based compensation.

Revenue Recognition and Allowances

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

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

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

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

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

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

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

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

Allowance for Doubtful Accounts

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

Inventory Write-down

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

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

Restructuring Accruals

In fiscal 2002, as a result of continuing unfavorable economic conditions and a reduction in IT spending rates, we implemented two restructuring plans, which included reductions in our workforce and a consolidation of our facilities. These restructuring accruals were accounted for in accordance with EITF Issue No. 94-3, *"Liability Recognition for Certain Employee Termination Benefits and Other Costs to Exit an Activity (including Certain Costs Incurred in a Restructuring)"*, and included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. These estimates are reviewed and revised periodically and may result in a substantial change to restructuring expense should different conditions prevail than were anticipated in original management estimates. Future restructuring will be accounted for under SFAS 146 *"Accounting for Costs associated with Exit or Disposal Activities"* which superceded EITF 94-3. See Note 10 to the Condensed Consolidated Financial Statements for further discussion.

Loss Contingencies

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

Impairment Losses on Investments

We perform periodic reviews of our investments for impairment. Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value, and such a decline is not considered temporary. Our investments in privately held companies are considered impaired when a review of the investees' operations and other indicators of impairment indicate that the carrying value of the investment is not likely to be recoverable. Such indicators include, but are not limited to, limited capital resources, limited prospects of receiving additional financing, and limited prospects for liquidity of the related securities. In the nine-month period ended January 24, 2003, we recorded a non-cash write-down of $0.7 million related to impairments of our investment in a publicly traded company as its reduction in value was judged to be other than temporary. In the three and nine-month periods ended January 30, 2004, we recorded a gain of $0.2 and $0.4 million, respectively, related to sales of previously impaired investments.

Accounting for Income Taxes

The determination of our tax provision is subject to judgments and estimates due to operations in several tax jurisdictions outside the U.S. Earnings derived from our international business are generally taxed at rates that are lower than U.S. rates, resulting in a reduction of our effective tax rate. The ability to maintain our current effective tax rate is contingent upon existing tax laws in both the U.S. and in the respective countries in which our international subsidiaries are located. Future changes in domestic or international tax laws could affect the continued realization of the tax benefits we are currently receiving and expect to receive from international business. In addition, a decrease in the percentage of our total earnings from our international business or in the mix of international business among particular tax jurisdictions could increase our overall effective tax rate. Also, our current effective tax rate assumes that U.S. income taxes are not provided for undistributed earnings of certain non-U.S. subsidiaries. These earnings could become subject to incremental foreign withholding or federal and state income taxes should they be either deemed or actually remitted to the U.S. For the three and nine-month periods ended January 30, 2004, we recorded a non-recurring income tax benefit of $16.8 million 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 future tax rate benefits. During the third quarter of fiscal 2004, we received a substantial tax refund that relates to prior years' tax payments.

The carrying value of our net deferred tax assets, which consists primarily of the reversal of net deductible temporary differences including credits, and net operating loss carryforwards, assumes that we will be able to generate sufficient future taxable income to fully utilize these tax attributes. If we do not generate sufficient future income, the realization of these deferred tax assets may be impaired resulting in additional income tax expense. We have provided a valuation allowance on the deferred tax attributes associated with the exercise of employee stock options (primarily credits and net operating loss carryforwards) because of uncertainty regarding their realizability due to the expectation of future employee stock option exercises. If these attributes are realized, the associated tax benefit will be credited to stockholders' equity, rather than as a reduction in the income tax provision.

Accounting for Stock-based Compensation

We adopted the disclosure-only provisions of SFAS 123 as amended by SFAS 148 and provided pro forma disclosure using the Black-Scholes option pricing model to value our employee stock options. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, and is not subject to revaluation as a result of subsequent stock price fluctuations. The Black-Scholes option pricing model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option pricing models require the input of highly subjective assumptions, including the expected stock price volatility. We use projected volatility rates, which are based upon historical volatility rates since our initial public offering, trended into future years. Because our employee stock options have characteristics significantly different from those of traded options and because changes in the subjective input assumptions can materially affect the fair value estimate, in management's opinion, the existing models do not necessarily provide a reliable single measure of the fair value of our options.

New Accounting Standards

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

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

In May 2003, the FASB issued SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, which requires that certain financial instruments be presented as liabilities that were previously presented as equity or as temporary equity. Such instruments include mandatory redeemable preferred and common stock, and certain options and warrants. SFAS No. 150 is effective for financial instruments entered into or modified after May 31, 2003 and was effective at the beginning of the first interim period beginning after June 15, 2003. In November 2003, the FASB issued FASB Staff Position ("FSP") No. 150-3, *Effective Date, Disclosures, and Transition for Mandatorily Redeemable Financial Instruments of Certain Nonpublic Entities and Certain Mandatorily Redeemable Noncontrolling Interests under SFAS No. 150*, which defers the effective date for various provisions of SFAS No. 150. As of January 30, 2004, we had no financial instruments within the scope of this pronouncement.

Results of Operations

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

	Three Months Ended		Nine Months Ended	
	January 30, 2004	January 24, 2003	January 30, 2004	January 24, 2003
Revenues:	100.0%	100.0%	100.0%	100.0%
Product revenue	90.5	89.7	90.5	90.0
Service revenue	9.5	10.3	9.5	10.0

	Three Months Ended		Nine Months Ended	
	January 30, 2004	January 24, 2003	January 30, 2004	January 24, 2003
Cost of Revenues:				
Cost of product revenue	31.4	31.9	32.0	31.3
Cost of service revenue	8.0	7.4	7.9	7.3
Gross margin	60.6	60.7	60.1	61.4
Operating Expenses:				
Sales and marketing	28.9	33.7	29.7	34.6
Research and development	11.1	12.4	11.5	13.0
General and administrative	4.6	4.3	4.6	4.1
Stock compensation	0.2	0.5	0.2	0.5
Restructuring charges	—	0.6	0.1	0.2
Total operating expenses	44.8	51.5	46.1	52.4
Income from Operations	15.8	9.2	14.0	9.0
Other Income (Expense), net:				
Interest income	1.3	1.3	1.2	1.4
Other income (expense), net	(0.3)	0.2	(0.3)	(0.1)
Net gain (loss) on investments	0.1	—	—	(0.1)
Gain on sale of intangible asset	—	—	—	0.1
Total other income, net	1.1	1.5	0.9	1.3
Income before Income Taxes	16.9	10.7	14.9	10.3
Provision for Income Taxes	3.4	2.1	1.0	2.4
Net Income	13.5%	8.6%	13.9%	7.9%

Third Quarter Fiscal 2004 Highlights

In the third quarter of fiscal year 2004, we continued to enhance our enterprise solutions, broaden our customer portfolio, extend our channel/partner opportunities, and gain market share for our iSCSI, unified storage, and NearStore® solutions. We also continued to win enterprise customers across all target industries with our storage and data management solutions.

We announced our Storage Grid strategy which enables customers to realize more value from their storage and data infrastructures. As part of this strategy, we introduced the FAS980 and FAS980c, the newest members of our NetApp FAS900 platform, that will help us extend the NetApp unified storage systems into the high-end of the enterprise storage market. Also during the quarter, we introduced and shipped the NetApp NearStore R200 storage system and SnapVault™ software solution for backup, compliance, reference, archive and secondary data needs. We also announced the integration of RAID-DP (double-disk parity) into our full line of enterprise storage systems which increases the level of data protection in the event of multiple storage-related disk failure. In addition, we announced that our NetApp gFiler™ supports unified NAS and SAN consolidation for IBM storage system platforms.

We reaffirmed our commitment to iSCSI technology by completing Microsoft's Design for Windows Logo testing for the NetApp FAS960, FAS960c, FAS940c, F825, F825c, FAS250 and NearStore R150 to ensure that they meet Microsoft standards for iSCSI compatibility and interoperability with the Windows platform. In addition, we extended support for IBM Lotus applications by announcing iSCSI support for NetApp SnapManager® for Lotus Domino. We believe that Microsoft's support of iSCSI for the SQL server and Exchange environment will help encourage further iSCSI adoption within the enterprise. We expect our Windows business to be a strong driver of the growth of our block storage solutions.

During the third quarter of fiscal year 2004, we also announced several strategic partnerships with other major technology companies to address a variety of data management, information life cycle management (ILM), backup and recovery, and compliance/retention issues that are important to our enterprise customers.

Discussion of Results of Operations

Overall, our revenue growth was primarily driven by a combination of new product innovation, additional channel/partner opportunities, and improving IT ("Information Technology") spending. We believe our competitive advantage is a result of lower total cost of ownership from a combination of four factors: lower acquisition cost, reduced administrative overhead, minimized service cost, and reduced downtime of critical business applications.

While the quantity of online data continues to grow, the price of storage continues to decline. With speeds and capacity continuing to increase, it becomes easier and cheaper for companies to justify the implementation of better systems and applications with higher performance characteristics and greater storage capacity requirements. We deliver a full-line of enterprise storage and data management solutions to help our customers store, manage, protect and consolidate their business- and mission-critical data while meeting their demands for solutions that help them consolidate their data infrastructure.

As the trend toward larger storage capacity and faster processing power continues, we will continue to provide storage solutions that meet the growing demands of grid computing and help customers, develop, deploy, and manage enterprise grid computing architectures. The combination of NetApp unified storage and software solutions with advanced distributed systems architectures acquired from Spinnaker will further our strategy to deliver new Storage Grid as the foundation for data infrastructures of the future. Additionally, the Spinnaker acquisition will allow us to target markets with customers who use large-scale Linux farms for performance-sensitive applications in verticals like Energy, High-tech, Entertainment and Federal. We have supported Linux clients for many years, and many of our customers use Linux servers in conjunction with our storage solutions. Additionally, we continue to support efforts to improve the interoperability of Linux with our systems, and have relationships with the leading suppliers of commercial Linux software, RedHat Corp. and SUSE (recently acquired by Novell). We also furthered our Linux Strategy by joining the Open Source Development Labs, a global consortium dedicated to accelerating the adoption of Linux.

Current generation backups for data integrity are moving to cheap disk for storage and immediate recovery. We introduced the industry's first Advanced Technology Attachment ATA-based mass storage system intended for enterprise environments in December 2001, and during the third quarter of fiscal 2004, we introduced and shipped our third generation of NearStore products in this area. Our multi-terabytes ATA disk-based storage provides economical secondary storage that helps customers protect their most valuable data, while at the same time improving uptime, significantly reducing time-to-recovery, and reducing management costs.

Regulatory compliance also continues to be a strong driver of our business. Customers are looking for simple, easy-to-deploy and cost-effective solutions to their compliance driven business initiatives. Our new SnapLock™ software enables customers to meet the data permanence requirements of regulations like Rule 17(a)(4) of the Securities and Exchange Act of 1934, as amended, which relates to preservation of certain records by certain exchange members as well as brokers and dealers, as well as Health Insurance Portability and Accountability Act ("HIPPA") and several government defense requirements.

While we believe that the above-mentioned factors favorably impacted our business, we cannot assure you that revenue from our storage and data management solutions will continue to grow at previous rates. See "— Risk Factors — Factors beyond our control could cause our quarterly results to fluctuate."

Product Revenues — Product revenues increased by 31.2% to $269.0 million for the third quarter of fiscal 2004, from $205.0 million for the third quarter of fiscal 2003. Product revenues increased by 28.9% to $754.3 million for the nine-month period ended January 30, 2004, from $585.1 million for the nine-month period ended January 24, 2003. Product revenues growth was across all geographies. This increase in product revenues was specifically attributable to increased software licenses and software subscriptions and an increase in units shipped, as compared to the same periods in the prior year.

Product revenues were favorably impacted by the following factors:

- increased revenues from our new product introductions in the three and nine-month periods ended January 30, 2004 such as: FAS960, FAS940, FAS270, and FAS250 filer products; NearStore R200 and R150 nearline storage systems; NetCache® C2100 and C6200 appliances, as well as our gateway filers (gFiler,) GF960, GF940 and GF825;

- increased revenues from data management software products that are focused on solving enterprise customer storage challenges including regulatory and compliance data needs, storage consolidation, Internet access and security, technical applications, and data protection;

- higher sales of software subscription upgrades representing 9.8% and 9.6% of total revenues for the three and nine-month periods ended January 30, 2004, respectively and 8.8% and 8.0% of total revenues for the three and nine-month periods ended January 24, 2003, respectively.

- a higher average selling price for our newer products: FAS270 and FAS250 filers, C6200 NetCache products, NearStore R200 and R150 nearline storage systems and software features, as well as our gateway filers (gFiler,) GF960, GF940 and GF825;

- increased demand for regulatory compliance WORM (write-once, read many) solutions and back-up to disk solutions;

- increased sales through indirect channels, including sales through our resellers, distributors and OEM partners, representing 50.4% and 49.7% of total revenues for the three and nine-month periods ended January 30, 2004, respectively, and 50.7% and 46.0% for the three and nine-month periods ended January 24, 2003, respectively, and

- incremental revenue due to an extra week of business in the nine-month period ended January 30, 2004 compared to the same period in the prior year.

Product revenues were negatively impacted by the following factors:

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

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

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

Service Revenues — Service revenues, which include hardware support, professional services, and educational services, increased by 21.0% to $28.3 million in the third quarter of fiscal 2004, from $23.4 million in the third quarter of fiscal 2003. Service revenues increased by 21.1% to $79.1 million for the nine-month period ended January 30, 2004 from $65.3 for the nine-month period ended January 24, 2003. 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 9.5% of total revenues for both the three and nine-month periods ended January 30, 2004 and 10.3% and 10.0% of total revenues for the three and nine-month periods ended January 24, 2003, respectively. The increase in absolute dollars was due to an increasing number of enterprise customers, which typically purchase more complete service packages. 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 2004.

International total revenues (including United States exports) increased by 28.5% and 35.9% for the three and nine-month periods ended January 30, 2004 as compared to the same periods of fiscal 2003, respectively. International total revenues were $132.6 million, or 44.6% of total revenues, and $354.0 million, or 42.5% of total revenues, for the three and nine-month periods ended January 30, 2004, respectively. The increase in international sales for the three and nine-month periods ended January 30, 2004 was primarily a result of European and Asia Pacific net revenues growth, driven by larger storage implementations, new products and higher storage spending in certain geographic regions, as compared to the same periods 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 2004.

Product Gross Margin — Product gross margin increased to 65.3% for the third quarter of fiscal 2004, from 64.5% for the third quarter of fiscal 2003. Product gross margin decreased to 64.7% for the nine-month period ended January 30, 2004, from 65.2% for the nine-month period ended January 24, 2003. Amortization of existing technology included in cost of product revenues was $0.2 million and $3.0 million for the three and nine-month periods ended January 30, 2004, respectively, and $1.4 million and $4.1 million for the three and nine-month periods ended January 24, 2003, respectively. Other than the amortization of existing technology that may arise from the Spinnaker acquisition, there will be no future amortization of existing technology remaining for fiscal 2004 and 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 new products;
- growth in software subscription upgrades and software licenses due primarily to a larger installed base and an increasing number of new enterprise customers; and
- lower cost of components.

Product gross margin was negatively impacted by:

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

The overall decrease in product gross margin for the nine-month period ended January 30, 2004 as compared to the same period ended January 24, 2003 was generally attributed to the same offsetting factors as cited above for the third quarters of fiscal 2004 and 2003.

Service Gross Margin — Service gross margin decreased to 16.3% in the third quarter of fiscal 2004 as compared to 27.8% in the third quarter of fiscal 2003. Service gross margin decreased to 17.2% in the nine-month period ended January 30, 2004 as compared to 27.8% in the nine-month period ended January 24, 2003. Investments in customer service increased by 40.3% to $23.7 million in the third quarter of fiscal 2004, from $16.9 million in the third quarter of fiscal 2003. Investments in customer service increased by 38.8% to $65.5 million in the nine-month period ended January 30, 2004, from $47.2 million in the nine-month period ended January 24, 2003. The decrease in service gross margin was primarily due to the continued investment in our service infrastructure to support our increasing enterprise customer base 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 recent headcount and logistical investments begin to deliver revenue growth.

Sales and Marketing — Sales and marketing expenses consist primarily of salaries, commissions, advertising and promotional expenses, and certain customer service and support costs. Sales and marketing expenses increased 11.7% to $86.0 million for the third quarter of fiscal 2004, from $77.0 million for the third quarter of fiscal 2003. These expenses were 28.9% and 33.7% of total revenues for the third quarters of fiscal 2004 and fiscal 2003, respectively. Sales and marketing expenses increased 10.0% to $247.5 million for the nine-month period ended January 30, 2004, from $225.1 million for the nine-month period ended January 24, 2003. These expenses were 29.7% and 34.6% of total revenues for the nine-month periods ended January 30, 2004, and January 24, 2003, respectively. The increase in absolute dollars was attributed to an extra week of expenses in the nine-month period ended January 30, 2004 compared to the same period in the prior year, sales kick off and club meetings, increased commission expenses resulting from increased revenues, the continued worldwide investment in our sales and customer service organizations associated with selling complete solutions at the enterprise level, offset by cost control, and reduction in discretionary spending efforts.

Sales and marketing headcount increased to 1,266 at January 30, 2004 from 1,247 at January 24, 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 and $1.1 million for the three and nine-month periods ending January 30, 2004, respectively as compared to none for the same periods in the prior year. Estimated future capitalized patents amortization expenses for fiscal 2004 will be $0.4 million, $1.8 million for each of the fiscal years 2005, 2006, 2007 and 2008 and $0.3 million thereafter.

Research and development expenses increased 16.5% to $32.9 million for the third quarter of fiscal 2004 from $28.3 million for the third quarter of fiscal 2003. These expenses represented 11.1% and 12.4% of total revenues for the third quarters of fiscal 2004 and 2003, respectively. Research and development expenses increased 13.6% to $96.0 million for the nine-month period ended January 30, 2004 from $84.5 million for the nine-month period ended January 24, 2003. These expenses represented 11.5% and 13.0% of total revenues for the nine-month periods ended January 30, 2004 and January 24, 2003, respectively. The increase in research and development expenses was primarily a result of an extra week of expenses in the nine-month period ended January 30, 2004 compared to the same period in the prior year, increased headcount, ongoing support of current and future product development and enhancement efforts, prototyping expenses and non-recurring engineering charges offset by a partial holiday shutdown in July 2003, cost control, and reduction in discretionary spending efforts. Research and development headcount increased to 578 as of January 30, 2004 compared to 531 as of January 24, 2003. For both the three and nine-month periods ended January 30, 2004 and January 24, 2003, no software development costs were capitalized.

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

We believe that our research and development expenses will increase in absolute dollars for the remainder of fiscal 2004, primarily due to ongoing costs associated with the development of new products and technologies 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 39.8% to $13.7 million for the third quarter of fiscal 2004, from $9.8 million for the third quarter of fiscal 2003. These expenses represented 4.6% and 4.3% of total revenues for the third quarters of fiscal 2004 and 2003, respectively. General and administrative expenses increased 46.7% to $38.7 million for the nine-month period ended

January 30, 2004, from $26.4 million for the nine-month period ended January 24, 2003. These expenses represented 4.6% and 4.1% of total revenues for the nine-month periods ended January 30, 2004 and January 24, 2003, respectively. This increase in absolute dollars was primarily due to the investment in our enterprise-wide ERP system, expenses associated with expanded regulatory requirements, general legal expenses, an extra week of expenses in the nine-month period ended January 30, 2004 compared to the same period in the prior year, a $1.5 million benefit from the collection of previously accrued customer-specific bad debt allowance in the nine-month period ended in the prior year, offset by a partial holiday shutdown in July 2003. General and administrative headcount increased to 312 at January 30, 2004 from 270 at January 24, 2003. We believe that our general and administrative expenses will increase in absolute dollars for the remainder of fiscal 2004 due to the investment in our enterprise-wide ERP system and additional expenses related to expanded regulatory requirements as compared to the comparable period in the prior year.

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

Stock compensation expenses were $0.5 million and $1.2 million for the third quarters of fiscal 2004 and 2003, respectively. Stock compensation expenses were $2.0 million and $3.1 million in the nine-month periods ended January 30, 2004 and January 24, 2003, respectively. This net decrease in the nine-month periods in stock compensation expenses reflected primarily lower stock compensation attributed to forfeitures of unvested options assumed in the WebManage Technologies, Inc. acquisition in fiscal 2001; offset by an increase in stock compensation expenses relating to restricted stock awards. Other than the amortization of deferred stock compensation that may arise from the Spinnaker acquisition, estimated future deferred stock compensation amortization expenses are $0.5 million in the remainder of fiscal 2004, $1.2 million in fiscal 2005 and $0.6 million in fiscal 2006 and none thereafter.

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

Fiscal 2002 Second Quarter Restructuring Plan

As a result of the restructuring in August 2001, we recorded a charge of $8.0 million. The restructuring charge included $4.8 million of severance-related amounts, $2.7 million of committed excess facilities and facility closure expenses, including certain facilities in foreign countries, and $0.5 million in fixed assets write-offs. The reserve balance of $0.9 million at January 30, 2004 was included in other accrued liabilities.

During fiscal 2002, we purchased our Sunnyvale headquarters site and terminated the operating leases. As a result, an adjustment was made to reduce the previously recorded estimated facilities lease losses by $1.5 million. During fiscal 2002 and 2003, we recorded net restructuring adjustments of $0.1 million and $0.3 million, respectively, due to changes in the estimated costs of certain actions and final resolution of certain restructuring activities. In the event that the foreign facilities that we vacated are not subleased, we will be obligated for additional total lease payments of approximately $0.5 million to be payable through January 2006.

As of January 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 January 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	(4,444)	—	(885)	(5,329)
Non-cash portion	—	(528)	(46)	(574)
Adjustments	315	—	(1,585)	(1,270)
Reserve balance at April 30, 2003	667	—	140	807
Cash payments and others	11	—	(9)	2
Non-cash portion	—	—	(1)	(1)
Reserve balance at August 1, 2003	678	—	130	808
Cash payments and others	19	—	3	22
Non-cash portion	—	—	(1)	(1)
Reserve balance at October 31, 2003	697	—	132	829
Cash payments and others	49	—	10	59
Reserve balance at January 30, 2004	$ 746	$ —	$ 142	$ 888

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 January 30, 2004, $0.8 million was included in other accrued liabilities and the remaining $4.3 million was classified as long-term obligations.

In January 2003 and October 2003, we updated our assumptions and estimates based on certain triggering events, which resulted in additional net charges of $0.9 million and $1.1 million, respectively, primarily relating to our engineering facility lease. Our estimates are reviewed and revised periodically and may result in a substantial charge to restructuring expense should different conditions prevail than were anticipated in original management estimates. Such estimates included various assumptions such as the time period over which the facilities will be vacant, expected sublease terms, and expected sublease rates. In the event that the engineering facility is not subleased, we will be obligated for an additional total lease payments of $2.3 million to be payable through November 2010.

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

	Severance-related Amounts	Fixed Assets Write-off	Facility	Total
Restructuring charge	$ 813	$ 473	$ 4,564	$ 5,850
Net cash payments	(706)	—	(1,023)	(1,729)
Non-cash portion	—	(473)	—	(473)
Adjustments	(107)	—	1,030	923
Reserve balance at April 30, 2003	—	—	4,571	4,571
Net cash payments	—	—	(205)	(205)
Reserve balance at August 1, 2003	—	—	4,366	4,366
Net cash payments	—	—	(203)	(203)
Adjustments	—	—	1,110	1,110
Reserve balance at October 31, 2003	—	—	5,273	5,273
Cash payments and others	—	—	(162)	(162)
Reserve balance at January 30, 2004	$ —	$ —	$ 5,111	$ 5,111

Interest Income — Interest income was $3.9 million and $3.1 million for the third quarters of fiscal 2004 and 2003, respectively. For the nine-month periods ended January 30, 2004 and January 24, 2003, interest income was $9.7 million and $9.1 million, respectively. The increase in interest income was primarily driven by higher cash and investment balances provided by operating activities partially offset by lower average interest rates on our investment portfolio. We expect interest income to increase for the remainder of fiscal 2004 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.

Other Income (Expense), Net — The three and nine-month periods ended January 30, 2004 included a net exchange loss from foreign currency transactions of $0.8 million and $2.1 million, respectively and for the three and nine-month periods ended January 24, 2003, a gain of $0.3 million and a net loss of $0.7 million, respectively. The increase in net exchange loss was attributed to the impact of currency balance sheet hedging activities resulting from forecast variances.

Net Gain (Loss) on Investments — Our investments in publicly held companies are generally considered impaired when a decline in the fair value of an investment as measured by quoted market prices is less than its carrying value, and such a decline is not considered temporary. In the nine-month ended January 24, 2003, we recorded a noncash write down of $0.7 million related to the impairment of our investment in a publicly traded company as its reduction in value was judged to be other than temporary. In the three and nine-month ended January 30, 2004, we sold certain previously impaired investments and realized a net gain of $0.2 million and $0.4 million, respectively.

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

Provision for Income Taxes — Provision for income taxes for the nine-month period ended January 30, 2004 included a non-recurring 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 future tax rate benefits. For the nine-month period ended January 30, 2004, we applied an annual tax rate of 20.3% to pretax income, which excluded the $16.8 million non-recurring benefit from the foreign tax ruling. Our estimate is based on existing tax laws and our current projections of income (loss) and distributions of income (loss) among different entities and tax jurisdictions, and is subject to change, based primarily on varying levels of profitability.

Liquidity and Capital Resources

As of January 30, 2004, as compared to the April 30, 2003 balances, our cash, cash equivalents, and short-term investments increased by $159.3 million to $778.1 million. We derive our liquidity and capital resources primarily from our cash flow from operations and from working capital. Working capital increased by $202.7 million to $791.2 million as of January 30, 2004, compared to $588.5 million as of April 30, 2003.

In addition to higher net income in the nine-month period ended January 30, 2004, the primary factors that impacted the period-to-period change in cash flows relating to operating activities included the following:

- Increased accounts receivable balances due to higher revenues;

- Increased prepaid expenses and decreased other accrued liabilities primarily due to payment of a license fee of $13.0 million;

- Increased prepaid expenses and other assets also a result of a $5.0 million bridge loan payment in connection with the Spinnaker acquisition;

The above factors were partially offset by the effects of:

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

- Increased accrued compensation and related benefits due to higher commission and other profit dependent payroll-related accruals resulting from higher revenue and profitability;

- Increased income taxes payable, primarily reflecting higher profitability in the nine-month period ended January 30, 2004 as compared to the same period in the prior year; tax refunds associated with the favorable foreign tax ruling, partially offset by a favorable foreign tax ruling of $16.8 million from the Netherlands and worldwide tax payments.

We used $35.6 million and $45.9 million of cash in the nine-month periods ended January 30, 2004 and January 24, 2003, respectively, for capital expenditures. We used net proceeds of $180.4 million and $61.4 million in the nine-month periods ended January 30, 2004 and January 24, 2003, respectively, for net purchases/ redemptions of short-term investments. In June 2003, we acquired additional patents for a purchase price of approximately $9.0 million. Investing activities in the nine-month periods January 30, 2004 and January 24, 2003 also included new investments in privately-held companies of $0.3 million and $0.7 million, respectively. In the nine-month period ended January 30, 2004, we received $0.6 million sales proceeds from sales of previously impairment investments.

We received $26.4 million and $24.3 million in the nine-month periods ended January 30, 2004 and January 24, 2003 from financing activities, which included sales of common stock net of common stock repurchases. We repurchased 2.7 million shares of common stock at a total of $44.9 million during the nine-month period ended January 30, 2004. Other financing activities provided $71.2 million and $24.3 million in the nine-month periods ended January 30, 2004, and January 24, 2003, 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 the common stock repurchases partially offset by higher proceeds from issuance of common stock under employee programs compared to the same period in the prior year.

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

Contractual Cash Obligations and Other Commercial Commitments

The following summarizes our contractual cash obligations and commercial commitments at January 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						
Contractual Cash Obligations:	**2004**	**2005**	**2006**	**2007**	**2008**	**Thereafter**	**Total**
Operating lease payments(1)	$2,959	$11,213	$ 8,714	$5,201	$4,199	$11,385	$43,671
Venture capital funding commitments(2)	154	616	616	616	603	1,776	4,381
Purchase commitments(3)	835	—	—	—	—	—	835
Communications & Maintenance(4)	1,211	5,767	4,040	477	16	12	11,523
Restructuring Charges(5)	165	1,507	727	802	807	1,991	5,999
Total Contractual Cash Obligations	$5,324	$19,103	$14,097	$7,096	$5,625	$15,164	$66,409

(1) We enter into real estate 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 exercised these renewal options and if we entered into additional operating lease agreements. Certain real estate operating sub-lease income of $346 has been included in the table.

(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 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 GAAP 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 $2,785 to be payable through November 2010.

	Amount of Commitment Expiration Per Period						
Other Commercial Commitments:	**2004**	**2005**	**2006**	**2007**	**2008**	**Thereafter**	**Total**
Lines of Credit(1)	$1,307	$ —	$ —	$ —	$ —	$ 337	$1,644
Restricted Cash(2)	10	315	321	66	—	318	1,030
Total Commercial Commitments	$1,317	$315	$321	$ 66	$ —	$ 655	$2,674

(1) The amounts outstanding under this line of credit relate to workers' compensation, customs guarantee and a foreign lease.

(2) Restricted cash arrangements relate to facility lease requirements, product performance guarantees, customs and duties guarantees, and VAT requirements.

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 the first nine months of fiscal 2004. 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 and Exchange Act of 1934, as amended) in the United States and in the other countries in which we operate. If our products do not meet, and continue to comply with, these evolving governmental regulations in this regard, customers in these market and geographical segments will not purchase our products and, therefore, we will not be able to expand our product offerings in these market and geographical segments at the rates for which we have forecast.

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

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

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

- fluctuations in our operating results;
- fluctuations in the valuation of companies perceived by investors to be comparable to us;
- economic developments in the network storage market as a whole;
- international conflicts and acts of terrorism;
- a shortfall in revenues or earnings compared to securities analysts’ expectations;
- changes in analysts’ recommendations or projections;
- announcements of new products, applications or product enhancements by us or our competitors;
- changes in our relationships with our suppliers, customers, 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. In spite of the economic downturn, competition for qualified engineers, particularly in Silicon Valley, can be intense. The loss of the services of a significant number of our engineers or sales people could be disruptive to our development efforts or business relationships and could materially adversely affect our operating results.

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

We conduct business internationally. For the three and nine-month ended January 30, 2004, approximately 44.6% and 42.5%, respectively, 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, difficulties in managing international operations, and potentially adverse tax consequences. Such factors could materially adversely affect our future international sales and, consequently, our operating results.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

An element of our strategy to grow revenue is to strategically partner with major third-party software and hardware vendors who integrate our products into their products and also comarket our products 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. In fiscal 2003, we recorded a non-cash write-down of $0.7 million related to the impairment of our investment in a publicly traded company as its reduction in value was judged to be other than temporary. In the nine-month ended January 30, 2004, we recorded a gain of $0.4 million related to sales of previously impaired investments.

As part of our strategy, we are continuously evaluating opportunities to buy other businesses or technologies that would complement our current products, expand the breadth of our markets, or enhance our technical capabilities. We have acquired three companies since the beginning of fiscal 2001. We completed the acquisition of one of these companies after the third quarter of fiscal 2004 and will integrate acquired operations and products from this acquisition into our operations during our fourth quarter of fiscal 2004. See Note 15 Subsequent Events. 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 operation.

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 January 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 third quarter of fiscal 2004. There can be no assurance that future impairment tests will not result in a charge to earnings.

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

We market and sell our storage solutions directly through our worldwide sales force and indirectly through channels such as value-added resellers ("VARs"), systems integrators, distributors and strategic business partners and derive a significant portion of our revenue from these indirect channel partners. However, in order for us to maintain our current revenue sources and grow our revenue as we have forecasted, we must effectively manage our relationships with these indirect channel partners. To do so, we must attract and retain a sufficient number of qualified channel partners to successfully market our products. However, because we also sell our products directly to customers through our sales force, 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, sale and support of our competitors' products than ours. If we fail to manage effectively our relationships with these indirect channel partners to minimize channel conflict and continue to evaluate and meet our indirect sales partners' needs with respect to our products, we will not be able to maintain or increase our revenue as we have forecasted, which would have a materially adverse affect on our business, financial condition and results of operations.

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

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

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

The preparation of the consolidated financial statements and related disclosure in conformity with accounting principles generally accepted in the United States of America requires management to establish policies that contain estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Note 2 to the Consolidated Financial Statements in the Annual Report on Form 10-K for the fiscal year ended April 30, 2003 describes the significant accounting policies 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 under Item 2.

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 January 30, 2004, we had short-term investments of $514.5 million. Our investment portfolio primarily consists of highly liquid investments with original maturities at the date of purchase of greater than three months, which are classified as available-for-sale, and investment in marketable equity securities in primarily technology companies. These highly liquid investments, consisting primarily of government and corporate debt securities, are subject to interest rate and interest income risk and will decrease in value if market interest rates increase. A hypothetical 10 percent increase in market interest rates from levels at January 30, 2004 would cause the fair value of these short-term investments to decline by approximately $1.0 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. In fiscal 2003, we recorded a non-cash write down of $0.7 million related to the impairment of our investment in a publicly traded company as its reduction in value was judged to be other than temporary.

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

Currency	Buy/Sell	Foreign Currency Amount	Contract Value USD	Fair Value in USD
Forward contracts:				
AUD	Sell	785	$ 595	$ 595
CAD	Sell	5,704	$ 4,280	$ 4,279
CHF	Sell	2,736	$ 2,173	$ 2,173
GBP	Sell	16,272	$ 29,428	$ 29,582
EUR	Sell	83,288	$ 103,344	$103,577
ZAR	Sell	13,992	$ 1,957	$ 1,957
EUR	Buy	5,653	$ 6,989	$ 7,029
GBP	Buy	1,659	$ 2,994	$ 3,017
Option contracts:				
EUR	Sell	7,000	$ 8,708	$ 8,822
GBP	Sell	1,500	$ 2,729	$ 2,761

Item 4. *Controls and Procedures*

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

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

PART II. OTHER INFORMATION

Item 1. *Legal Proceedings*

None

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

None

Item 3. *Defaults Upon Senior Securities*

None

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

None

Item 5. *Other Information*

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

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.
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 March 2, 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 March 2, 2004.
32.1	Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, dated March 2, 2004.

(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 Quarterly Report on Form 10-Q dated December 4, 2003.

(b) *Reports on Form 8-K*

On November 18, 2003, we furnished (but did not file) a report on Form 8-K relating to financial information for Network Appliance for the three and six-month ended October 31, 2003 and forward-looking statements relating to fiscal year 2004, as presented in a press release of November 18, 2003.

On November 4, 2003, we furnished (but did not file) a report on Form 8-K relating to the signing of a definitive agreement to acquire Spinnaker Networks, Inc., as presented in a press release of November 4, 2003.

SIGNATURE

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

NETWORK APPLIANCE INC.
(Registrant)

/s/ STEVEN J. GOMO

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

Date: March 2, 2004

EXHIBIT INDEX

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Exhibit 31.1

CERTIFICATION

I, Daniel J. Warmenhoven, certify that:

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

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

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

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

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

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

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

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

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

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

/s/ DANIEL J. WARMENHOVEN

Daniel J. Warmenhoven
Chief Executive Officer

Date: March 2, 2004

Exhibit 31.2

CERTIFICATION

I, Steven J. Gomo, certify that:

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

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

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

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

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

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

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

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

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

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

/s/ STEVEN J. GOMO

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

Date: March 2, 2004

Exhibit 32.1

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

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

(i) the Quarterly Report on Form 10-Q of the Company for the quarterly period ended January 30, 2004, as filed with the Securities and Exchange Commission (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended; and

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

Date: March 2, 2004

/s/ Daniel J. Warmenhoven

Daniel J. Warmenhoven
Chief Executive Officer

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

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

(i) the Quarterly Report on Form 10-Q of the Company for the quarterly period ended January 30, 2004, as filed with the Securities and Exchange Commission (the "Report") fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended; and

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

Date: March 2, 2004

/s/ Steven J. Gomo

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